BANK FOR
INTERNATIONAL SETTLEMENTS

FIFTY-FOURTH ANNUAL REPORT

1st APRIL 1983 – 31st MARCH 1984

BASLE

18th June 1984

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FIFTY-FOURTH ANNUAL REPORT

submitted to the

ANNUAL GENERAL MEETING

of the

BANK FOR INTERNATIONAL SETTLEMENTS

held in

Basle on 18th June 1984

Ladies and Gentlemen,

I have the honour to submit herewith the fifty-fourth Annual Report of the Bank for International Settlements for the financial year which began on 1st April 1983 and ended on 31st March 1984.

The net profit for the year amounted to 67,492,877 gold francs, after transfer of 441,391 gold francs to the Provision for Exceptional Costs of Administration. This compares with a net profit for the preceding year of 65,826,173 gold francs.

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 16,492,877 gold francs in payment of a dividend of 145 Swiss francs per share.

The Board further recommends that 20,400,000 gold francs be transferred to the General Reserve Fund and the remainder of 30,600,000 gold francs to the Free Reserve Fund.

If these proposals are approved, the Bank's dividend for the financial year 1983–84 will be payable to shareholders on 1st July 1984.

I. TOWARDS SUSTAINABLE GROWTH?

Recovery in the industrial countries has been the dominant feature of world economic developments over the last eighteen months. A leading part was played by the buoyant upswing in domestic expenditure in the United States, but the process was also supported by an autonomous strengthening of demand in other major countries, particularly Germany and the United Kingdom. The domestic and international implications of this recovery, together with the hopes it raises and the new problems it creates, constitute the thread that links the individual chapters of this Report.

The importance of the recovery can scarcely be over-emphasised. The process of disinflation upon which the major industrial countries embarked in 1980 had been preceded by two oil shocks, long years of inflationary mismanagement, a seven-year period of marked slowdown in the growth trend of the industrial economies, growing unemployment and, under the joint influence of all these developments, imbalances in the accumulation of domestic as well as international debt. Small wonder that disinflation went hand in hand with a severe recession, even faster rising unemployment and manifestations of both domestic and international financial fragility, exposing the world to the dangers of a full-blown financial crisis. However, as a result of successful international co-operation and careful domestic policy management, the crisis was averted. Concurrently, the process of disinflation began to show positive results, not only in a sharp deceleration of inflation rates but also in a gradual strengthening of corporate financial structures within the industrial world. It nevertheless became evident during the winter of 1982–83 that, without an early and significant economic recovery in the industrial countries, it would become more and more difficult to contain the international debt crisis through further financial holding operations, let alone to find any lasting solution. It was then, at the very end of 1982, that the US economy began to pick up — at just about the eleventh hour.

The positive effects of the US recovery have become clearly visible. From the trough of the recession in the fourth quarter of 1982 to the first quarter of 1984 real aggregate domestic demand increased by about 10 per cent. and employment expanded by more than 5 million persons. As a result, the rate of unemployment has fallen from a peak of 10.7 to 7.8 per cent. At the same time, the twelve-month rate of consumer price inflation, which had declined during the recession from almost 15 per cent. in March 1980 to less than 4 per cent. by the end of 1982, was still at the relatively low level of 4.5 per cent. in April 1984. It must be added, of course, that this very favourable price performance owes much to the sharp rise in the trade-weighted value of the dollar since 1980. Finally, corporate profits and related financial ratios have improved substantially and fixed capital investment has picked up — in some areas quite sharply.

The US upswing has been transmitted to the rest of the world mainly through the vigorous growth of US imports (over 30 per cent. between the fourth quarter of 1982 and the first quarter of 1984), which has played a material rôle in taking world trade from recession to recovery and has provided a helpful external stimulus to the autonomous domestic revival in some of the other major industrial countries, notably Germany, the United Kingdom and Japan. Indeed, a significant and encouraging feature was the fact that those countries which have been most successful in fighting inflation have also been best placed to generate a recovery of their own and — at a later stage — to benefit from the upturn in the United States.

At the same time, the US recovery has also made a decisive contribution to the *success of the adjustment efforts* undertaken by a number of deficit countries. The bilateral trade balance between the United States and the non-OPEC LDCs as a group moved from a small surplus of $0.3 billion in 1981 to a large deficit of $13.2 billion in 1983, though a significant part of this change reflected autonomous cutbacks in LDC imports. Even so, it is inconceivable that without the support coming from the United States the combined trade deficit of the non-OPEC LDCs could have fallen during the same period, as it did, from $65 billion to $26 billion. Nor would it have been possible, without the help of the US-led recovery, for a number of deficit countries in western Europe substantially to improve their external accounts. In short, the turn-round in the US economy has brought invaluable relief to the world economy by stimulating world trade, helping the external adjustment process in the deficit countries, reinforcing the pick-up in the United Kingdom, Germany and Japan and contributing to the resumption of growth in the rest of the industrial world.

It is against the background of this highly positive assessment that we have to set the preoccupations expressed in various chapters of this Report and in the policy recommendations of the Conclusion. These concern the nature of the current recovery in the United States, its international implications and its resilience and sustainability.

One of these preoccupations is best understood when — with hindsight — we attempt an analysis of the origin of, and the current driving forces behind, the US recovery. Has it come about as a result of a "normal" cyclical upswing? Had the process of disinflation gone far enough to ensure that as the recovery progresses the rate of inflation will not accelerate beyond what is more or less unavoidable? Has the recovery been artificially stimulated through policy influences? The answer must be a mixed one.

One element of the recovery can no doubt be attributed to those forces that traditionally contribute to a revival in business activity: an end to inventory disinvestment; the life cycle of automobiles and household durables; the resumption of house-building, partly under the impact of lower interest rates, partly as a result of demographic developments. Another element — the increase in real incomes and the decline in households' saving ratios — may well have come about under the combined influence of sharply lower current inflation rates, a probable decline in expectations of future inflation and therefore greater consumer confidence. In this process monetary policy made a decisive contribution.

So far so good. But it is impossible to ignore the highly plausible assumption that fiscal policy has also exerted a strongly stimulatory influence on business activity: not just that part of the budget deficit which resulted from deepening recession and automatic stabiliser effects, though earlier extensions of entitlement programmes under the social insurance system strengthened these effects and also increased the trend growth of public expenditure; rather, and mainly, the additional deficit resulting from new discretionary policy decisions, namely the tax cuts and increased defence spending. The concerns of financial-market participants about the financing of the rising structural element of the US budget deficit surfaced at a very early stage and accordingly were a major factor tending to keep long-term interest rates at an unusually high level in the midst of recession. This may have delayed the recovery somewhat; but in the end the sheer income and expenditure-creating effects of the deficit prevailed and have contributed powerfully both to the take-off and to the continued vigour of the business upswing. Whatever the Administration's medium or long-term supply-side objectives may have been, and however successful so far in deploying new investment incentives, its policy has in the meantime helped along a very conventional demand-propelled recovery.

From the point of view of the US economy itself two alternative dangers are inherent in this sort of recovery. One is that by pushing up interest rates to levels even higher than they are today, it might create a situation in which the income and expenditure effects of the budget deficit would be more than offset by the slowdown in private spending. Because of financial "crowding-out", in other words, the recovery could grind to an early halt. The other is that, on the contrary, a revival of inflationary expectations, fuelled by the persistently large budget deficits, might sustain the momentum of the recovery for quite a long time, but lead at a later stage to a sudden and prolonged depression. Neither outcome can be regarded as attractive.

The international concerns are equally weighty.

First and foremost, there is cause for concern about what will in the event happen within the US economy itself. A slowdown of the US recovery is desirable and, as is argued in the Conclusion, it is incumbent on the rest of the industrial world to pursue policies that would allow a satisfactory momentum of recovery to continue independently of developments in the United States. This implies principally further emphasis on structural policies designed to foster labour-market flexibility and dynamic domestic investment, though by their nature these policies can be expected to work only slowly over time.

Nonetheless, a favourable start has already been made, as testified by the fact that the recovery in the United Kingdom and in Germany, for example, began independently of that in the United States. But given the size of the US economy, neither Japan nor western Europe could hope to isolate themselves fully from the effects of an early exhaustion of the US recovery, and even less from a deep US depression accompanied by financial turbulence. What the US recovery is doing for the rest of the world, a US recession could undo just as quickly.

Another matter for concern, more immediate than the first one, is the influence of the current US policy mix, via interest rates, on exchange rate developments. There are many reasons for the current high level of the dollar in relation to the European currencies and the Japanese yen. Some of these have to do with the vigour of the US recovery and the accompanying high yields on investment; others relate to "safe-haven" considerations. On the other hand, one would normally expect that a large and expanding structural budget deficit, accompanied by a growing current-account deficit of massive proportions, would have an adverse impact on a country's exchange rate. As time has gone on, market participants' views of the substance or importance of these factors have probably become more mixed and volatile. It is not surprising, therefore, that *changes* in nominal or real interest rate differentials have not had consistently unambiguous effects on exchange rate developments in recent years. It nevertheless seems reasonable to assume, at least, that the dollar/Deutsche Mark and dollar/yen exchange rates would not be what they are today were it not for the persistence of very large interest rate differentials in favour of the dollar.

Current real exchange rate levels, because of their impact on the competitiveness of the US tradeable goods sector, carry the obvious danger of exacerbating protectionist pressures within the United States. At the same time, while giving a boost to competitiveness elsewhere, they have limited to some extent the anti-inflationary benefits which the rest of the industrial world might have derived from the recessionary decline in the dollar prices of oil and commodities. And, with commodity prices again moving upwards, the persistence of a high dollar exchange rate could well push some of the industrial countries into anti-inflationary policies that would not otherwise be warranted or necessary. But, most important, the present configuration of exchange rates is clearly not compatible with a sustainable long-run pattern of current accounts (or, looking at it from the opposite angle, of capital flows). The unprecedented rate of deterioration of the net creditor position of the United States has significantly raised the likelihood of future financial dislocations emanating from the exchange markets. Indeed, the growing uncertainties surrounding the dollar have already led to large short-term exchange rate volatility and might lead as time goes on to even stronger turbulences. In short, while there is no denying that the US current-account deficit has had beneficial effects on the world economy, even good things may become harmful in excess. An unbalanced recovery in the United States inevitably entails an unbalanced recovery abroad.

Last but not least, the high level of dollar interest rates has kept up, and more recently has tended to aggravate, the interest burden on countries' external debt. About two-thirds of the non-OPEC LDCs' total external debt (which stood at the equivalent of $560 billion at the end of 1983) is denominated in dollars; and more than half of this bears floating interest rates. There is a real danger, especially for those countries whose external debt is a multiple of their yearly export earnings, that the benefit derived from higher exports or from import restrictions may be offset by the additional interest burden. Given the present size of international financial markets and the dollar's status as the predominant international financial currency, the international impact of US interest rates is much greater than the relative size of the US economy alone would suggest.

Two years ago this Report expressed concern about the narrow path of policy facing policy-makers in a world engaged in a process of disinflation: the pursuit of anti-inflationary policies was necessary, but there was a clear danger of cumulative recession. Last year it voiced the hope that with the successes achieved in fighting inflation and the beginning of recovery, some of the pain of disinflation would be alleviated. This time, there is no doubt that the recovery is very much under way and has already had beneficial effects; we can now afford to shift our attention towards assuring that it is a balanced and sustainable recovery.

II. RECOVERY: ORIGINS, BALANCE AND SUSTAINABILITY.

Highlights.

Economic recovery took hold strongly in North America early last year. By the end of the year it had spread in varying degrees to much of the rest of the industrial world. The lead was taken by the United States, where output rose by more than 6 per cent. over the year to the fourth quarter. At the other extreme, a few countries were constrained to continue their adjustment efforts and recorded little or no growth before the end of the year. Even so, for the Group of Ten countries in total, output growth probably averaged 4 per cent. or more between the fourth quarters of 1982 and 1983.*

This development marked a clear end to the prolonged period of recession which had followed the second oil price rise. It brought with it the promise — and in some cases the fact — of some relief from record levels of unemployment. And it also provided one of the most important preconditions for the alleviation of the international debt crisis.

The origins of the recovery appear to have been twofold and of a somewhat contrasting nature. On the one hand, US fiscal policy — which had been reoriented towards more medium-term supply-side goals — provided in the meantime a strong boost to demand. For the rest of the world, this demand stimulus was reinforced by the competitiveness effects of the sharp rise in the dollar since 1980.

On the other hand, the long-awaited benefits of the process of disinflation made themselves felt more clearly last year. The average rate of consumer price inflation fell at mid-year to a temporary low of 4 per cent. as the effects of the fall in oil prices began to work through. With nominal money growth being well maintained, real expenditure started to increase within, as well as outside, the United States. Consumer spending provided an important part of the overall acceleration in demand growth. This upswing was accentuated in varying degrees by a decline in personal saving ratios, either because the need to offset the inflationary erosion of savings had diminished or because of the wealth and expenditure effects of declines in interest rates.

Outside the United States, fiscal retrenchment continued in many countries as a matter of medium-term structural policy calculated to reduce, or limit, the size of the public sector and, with it, the magnitude of existing deficits. If anything, the growing structural budget deficit in the United States, through its influence on interest rates, may have reinforced the efforts of European countries to press ahead with fiscal retrenchment, while allowing some of the automatic recovery mechanisms inherent in disinflation to provide an acceleration in output growth.

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* Following its decision to participate fully in the IMF's General Arrangements to Borrow, Switzerland became a full member of the Group of Ten in April 1984.

What is more, a moderation of wage pressures, together with the short-term productivity effects of accelerating output growth, helped from the unit costs side to reinforce the overall slowdown in inflation.

While this unusual combination of circumstances brought welcome short-term results last year, it also raised two important, interlinked, questions for the future. Firstly, how could the momentum of disinflation be conserved in the face of renewed demand growth? And secondly, did the contrasting medium-term prospects in the United States and the rest of the world also threaten such serious imbalances as to make the recovery unsustainable?

On the first of these questions the most important single consideration would seem to be the behaviour of wages. Whether the process of disinflation has brought permanent changes here is difficult to judge from the raw statistics alone, although a few countries, such as Japan and Germany, have now demonstrated considerable wage moderation over an appreciable period. Nevertheless, with productivity growth apparently not unusually strong for this stage of the cycle, continuing efforts to moderate nominal wage gains will have to be the most important means of controlling unit costs.

The other threat to the world recovery comes from the fiscal policy stance of the United States, which has become clearly inappropriate in the current situation. For the United States itself, the need for an early and substantial reduction of the Government's structural budget deficit has been brought forward by the unexpected pace of the United States' advance towards full employment. Unless this situation is corrected, a continuing conflict between private and public-sector credit demands, together with accompanying upward pressures on interest rates, seems more or less unavoidable. An additional threat to balanced expansion may lie in a further widening of the US current-account deficit leading to even greater exchange rate instability.

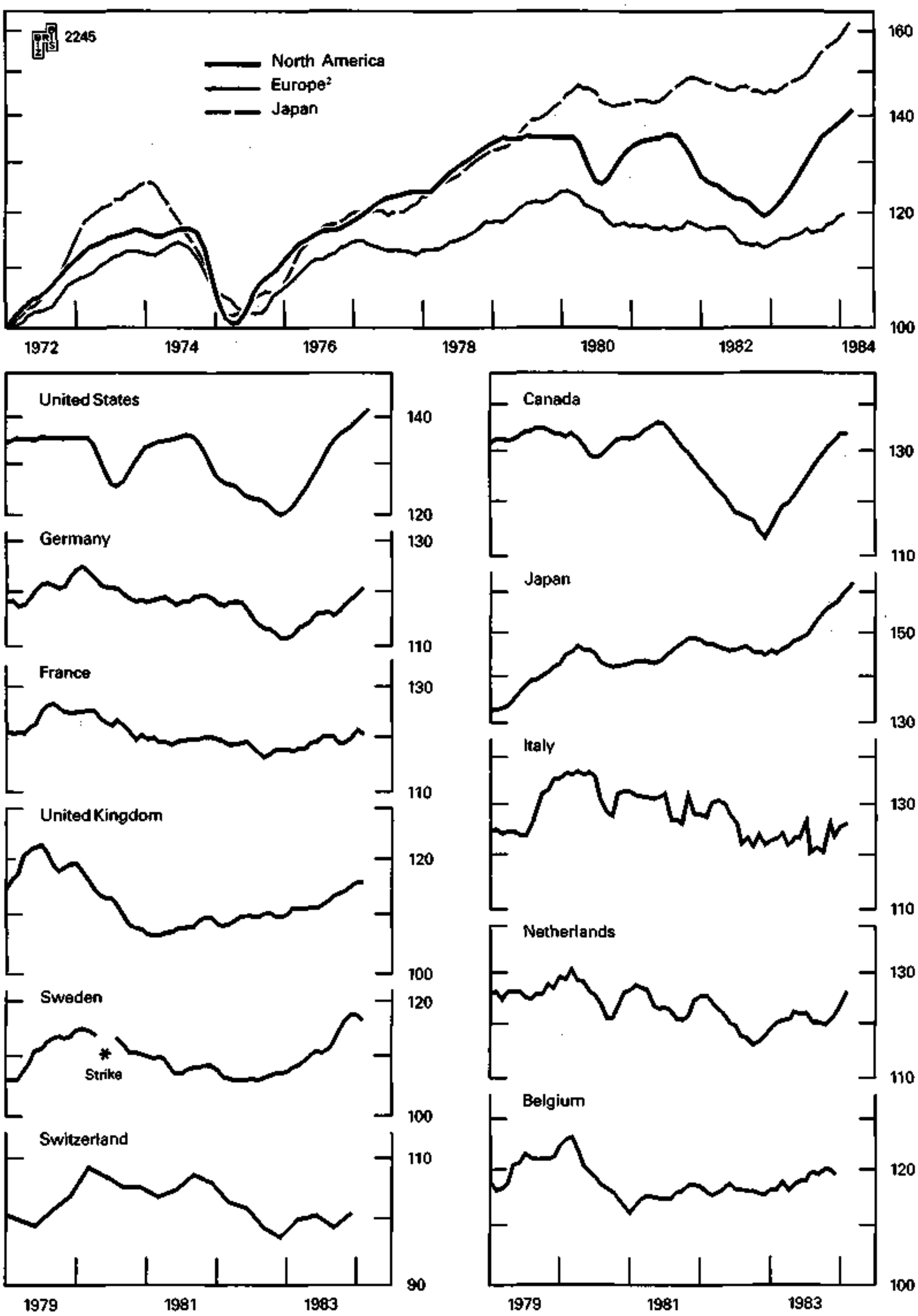
The recovery: demand and output.

Real GNP in the Group of Ten countries rose by about 2½ per cent. last year. However, a more accurate measure of the scale of the upturn is probably given by the rise in output over the year to the fourth quarter of 1983, for which a figure of over 4 per cent. was probably recorded on average.

This average performance represents the fastest overall rate of growth since the recovery from the first oil shock recession in 1975–76. On that occasion, when European recovery was more synchronised with that elsewhere, the growth of output was somewhat more rapid during the first year of the upturn — some 5½ per cent. over the year to the second quarter of 1976. More significantly, the whole process from recession to recovery has been much longer drawn out on this occasion than it was nine years ago. In terms of industrial production (see the graph overleaf), although the move into recession after 1979 was not on average so abrupt, it was nevertheless not until the end of last year that industrial output in the Group of Ten countries regained the level already seen nearly four years earlier.

Industrial production.[1]

December 1971 = 100.



[1] Three-month moving averages; the indices for North America and Europe were calculated using 1982 GNP weights.
[2] Comprises Belgium, France, Germany, Italy, the Netherlands, Sweden, Switzerland and the United Kingdom.

The lead of the United States. The United States has clearly led the process of world recovery. At 6¾ per cent. per annum over the first fifteen months since the trough, output growth has been only slightly less than that normally recorded at a similar stage of earlier cycles. On the other hand, the effect of the US upturn on the rest of the world has been greater than usual, largely because of the loss of US competitiveness as a result of the dollar's appreciation since 1980.

At first sight, it might seem that the stimulus implied by the rising Federal budget deficit should be cited as the most important factor behind the economy's recovery. Closer analysis suggests, however, that — while important, and possibly predominant — it was probably not the only factor at work. In any case, as was analysed more fully in last year's Annual Report, the fiscal stance was also significant in a different sense. That is, the expectation was that exceptional deficits would persist long beyond even the usual period of counter-cyclical stimulus. In turn, against the background of monetary policy aiming at gradual disinflation, this appeared to have brought forward a period of very high interest rates. With the full extent of the proposed tax cuts being phased in gradually over the years 1981–83, the early effect of this policy mix may well have been to accentuate the recession.

By the summer of 1982, with the inflation rate falling quickly, the Federal Reserve authorities began to ease interest rates — a process that continued well into 1983. However, when the recovery finally began late in 1982, interest rates were still comparatively high, particularly in real terms, but proved to be no great hindrance to a renewed upswing. Indeed, real business investment spending rose almost 13 per cent. over the following four quarters — appreciably faster than in previous cycles. No doubt the improved tax treatment of fixed investment played an important rôle here. In addition, however, high interest rates were not, until more recently, an obvious restraining factor on residential investment, which rose by nearly 40 per cent. both between fourth quarters and in 1983 as a whole.

At the same time, high real interest rates were an important factor, though not the only one, in the rise of the dollar. And the resulting loss of competitiveness was almost certainly an important cause of the unprecedented deterioration in the net external trade position. Especially during the second half of last year, US imports surged ahead, so that by the fourth quarter they stood, in volume terms, 21½ per cent. above their level twelve months previously. This rise was something like twice that normally recorded at this stage of the cycle. And, while exports were beginning to recover somewhat at the end of the year (as the worst of the import adjustment among the indebted LDCs came to an end), for the year as a whole they again fell sharply.

Despite the fact that so much demand leaked away through the foreign balance in this way, the strength of overall demand was such as to give a substantial net boost to output. For example, between fourth quarters the turn-round in stock formation amounted to as much as 2 per cent. of GNP. However, both for the year as a whole and between fourth quarters, it was consumer spending which provided the greater part of the acceleration in domestic demand.

Here the influence of the growing budget deficit — and in particular of the cut in taxes — can be seen more clearly. Even in this case, however, as the table on page

Major industrial countries:
Changes in real gross national product and its components.[1]

Countries	Years	Real GNP	Consumption: private	Consumption: public	Gross fixed investment: private: non-residential	Gross fixed investment: private: residential	Gross fixed investment: public	Exports	Imports	Change in stock-building[2]
		annual volume changes, in percentages								
United States	1980	– 0.3	0.5	2.2[3]	– 2.4	–20.3		8.8	– 0.2	– 0.8
	1981	2.6	2.7	0.8[3]	5.2	– 5.2		0.4	7.3	0.9
	1982	– 1.9	1.4	1.8[3]	– 4.7	–15.3		– 7.8	1.4	– 1.2
	1983	3.3	4.2	0.5[3]	1.4	39.4		– 5.8	7.2	0.5
	1983 IV	6.2	5.4	– 2.4[3]	12.6	37.4		3.0	21.4	2.1
Japan	1980	4.8	1.3	2.9	8.1	– 9.2	– 3.6	18.8	– 4.0	– 0.1
	1981	4.1	0.7	5.2	5.6	– 2.5	4.3	15.9	5.5	– 0.1
	1982	3.3	4.2	2.3	3.6	– 0.8	– 0.8	3.5	2.6	– 0.1
	1983	3.0	3.3	2.4	2.0	– 4.7	– 0.6	4.8	– 4.7	– 0.6
	1983 IV	3.6	2.3	2.8	4.0	– 8.0	– 2.9	12.2	3.7	0.0
Germany	1980	1.9	1.4	2.6	3.5	3.3	1.8	5.6	3.9	– 0.6
	1981	– 0.3	– 1.2	1.5	– 2.8	– 4.5	– 8.7	8.7	1.3	– 1.2
	1982	– 1.1	– 2.2	– 1.0	– 4.4	– 4.2	– 9.3	3.7	0.8	0.3
	1983	1.3	1.0	– 0.2	4.8	4.7	– 8.3	– 0.9	0.8	0.7
	1983 IV	2.9	1.5	1.3		5.1[4]		2.7	7.3	1.9
France	1980	1.1	1.5	1.8	5.3	– 4.1	0.9	2.4	7.2	0.4
	1981	0.2	2.0	2.2	– 0.7	– 0.9	– 1.7	5.3	1.6	– 2.0
	1982	2.0	3.5	2.5	0.6	– 7.4	5.5	– 2.2	6.3	1.6
	1983	1.0	1.0	1.8	– 1.8	– 2.4	2.1	3.6	– 0.9	– 0.9
	1983 IV	0.7	0.7	1.3	1.3	– 3.2	– 3.8	4.2	0.8	– 0.7
United Kingdom[5] .	1980	– 2.6	– 0.5	1.5	– 3.0	–10.3	– 7.6	– 0.1	– 4.1	– 2.5
	1981	– 1.4	0.2	– 0.3	– 4.7	–17.4	–15.0	– 2.0	– 3.4	0.3
	1982	1.9	1.3	1.4	9.2	6.1	0.1	1.2	3.8	0.7
	1983	3.0	3.9	3.2	– 1.3	21.9	13.2	0.8	5.0	0.7
	1983 IV	3.2	3.1	2.9	– 0.7	20.1	12.1	3.9	10.8	1.7
Italy	1980	3.9	4.3	2.1		9.4[4]		– 4.3	8.3	2.1
	1981	0.2	0.5	3.3		0.6[4]		5.2	– 5.3	– 3.1
	1982	– 0.4	0.5	2.4		– 5.3[4]		0.8	2.1	0.0
	1983	– 1.2	– 0.5	2.8		– 5.3[4]		3.8	0.8	– 1.2
	1983 IV	1.2	0.4	0.4		– 2.1[4]		11.1	7.1	0.0
Canada	1980	1.0	1.0	0.8	7.4	– 5.7	0.9	1.9	– 2.0	– 1.9
	1981	3.4	1.9	0.5	7.6	5.1	2.3	2.8	3.8	1.0
	1982	– 4.4	– 2.1	0.5	–11.2	–23.1	3.3	– 1.6	–11.3	– 2.8
	1983	3.0	3.0	0.3	–12.2	27.5	2.9	6.5	8.7	2.4
	1983 IV	7.5	4.5	1.8	– 8.3	15.9	3.6	21.8	21.4	4.4
Group of Ten countries[6] ..	1980	1.1	1.0	2.2		– 1.3[4]		5.6	1.3	– 0.5
	1981	1.8	1.4	1.4		0.8[4]		4.8	1.6	– 0.1
	1982	– 0.4	1.3	1.4		– 3.4[4]		– 0.3	1.5	– 0.4
	1983	2.5	2.9	1.1		3.1[4]		1.0	2.2	0.2
	1983 IV[7]	4.5	3.7	– 0.4		7.7[4]		6.7	11.2	1.5

[1] Figures for 1983 and 1983 IV are still preliminary. [2] As a percentage of the previous year's GNP. [3] Including public investment. [4] Total fixed investment. [5] GNP figures show changes in the average estimate. [6] 1982 weights and exchange rates. [7] Seven largest countries only.

14 suggests, other factors seem to have been at work. With personal tax payments rising much more slowly than total personal income in both 1982 and — more especially — 1983, *disposable* personal income rose faster than real income before tax. In addition, however, the saving ratio fell sharply in 1982, possibly in response to the sharp decline in inflation. This gave an early boost to consumer spending over

and above that apparently resulting from the new tax programme. It should be noted, too, that the "split" of consumers' incomes between price and volume changes will have benefited from the price effects of the rising exchange rate of the dollar and of the fall in oil prices last year. One estimate suggests that the dollar's rise may have reduced the rate of consumer price inflation by about 1½ per cent. in each of the years 1981–83. The rather faster rise in productivity last year will also have helped to hold down price increases and thus raise consumers' real incomes.

In short, the direct effects of the budget only partly explain the US upturn in 1983. This conclusion seems to be reinforced by the fact that — as the table on page 12 shows — direct public expenditure on goods and services has as yet been very restrained, notwithstanding the planned defence build-up. For the time being, however, the latter may be reflected to some extent in the build-up of stocks. In addition, the recorded figures for public consumption spending reflect exceptional payments made for agricultural support during the winter of 1982–83.

Nevertheless, so far as the rest of the world is concerned, the short-term direct demand effects of the US recovery have been greater than in previous such episodes. Indirect effects — notably those of high interest rates and the related need for a cautious monetary policy stance in the face of exchange rate weakness — have, on the other hand, worked in the opposite direction. Moreover, with US interest rates beginning to move up again early this year, the adverse side-effects of US policy are rapidly becoming predominant.

Indications of recovery in Europe and Japan. Even so, the broad generalisation stands that last year the rest of the world received a positive net demand effect through the foreign balance, while the United States experienced the reverse. The contrast may be carried further. For whereas in the United States budgetary control has become a growing concern, the rest of the world has, by and large, continued to wrestle both with public-sector deficits and with the tendency for the size of the public sector to grow inexorably.

What is more, the fact that recovery began to emerge in many other countries does not appear to have been due simply to the fact that the net external stimulus from the United States was greater than any conventional short-term demand effects of further domestic fiscal retrenchment. Rather, the need to deal with structural budget problems and persevere with disinflation has to be seen as a vital precondition for a sound upswing. And, indeed, there were indications last year of spontaneous forces of recovery coming to the aid of the upturn. In the United Kingdom these forces were dominant and clearly preceded the US upswing.

One aspect of this can be seen in the greater proportion of nominal demand changes accounted for by volume increases. Another can be seen in the development of personal savings. In Canada and the United Kingdom the declines in saving propensities have been particularly large, and in the British case were already coming through in 1981 and 1982. The British saving ratio has been falling sharply for three years from a peak of 14½ per cent. in 1980 to about 8½ per cent. last year.

There would seem to be little doubt that at least part of the decline in saving ratios has been the result of the decline in inflation itself. The mechanism was probably at least twofold. Firstly, declining inflation implies a slowing-down in the rate at which certain financial assets lose their real value. Secondly, the accompanying declines in nominal interest rates will have brought capital gains to bondholders. Moreover, stock markets tended to be relatively buoyant last year, adding to the total of capital gains experienced by holders of financial wealth. The latter gains were probably related, at least in part, to bond-market developments themselves and possibly also to a more general revival of confidence as inflation continued to come down. Consumers' confidence may also have been bolstered by rather better employment prospects — at least in some countries.

Changes in consumers' income, spending and saving in selected countries.

Countries	Years	Change in nominal gross income	Change in nominal disposable income	Change in consumers' expenditure deflator	Change in consumers' real disposable income	Change in saving ratio[1]	Change in real consumer spending
		fourth quarter to fourth quarter changes, in percentages					
United States	1981	11.1	11.1	7.5	3.4	1.5	1.7
	1982	4.6	5.1	4.9	0.2	−2.1	2.5
	1983	7.7	8.8	3.4	5.2	0.0	5.4
Japan[2]	1981	7.3	6.0	4.8	1.1	0.5	0.7
	1982	5.2	4.6	2.8	1.8	− 2.0	4.2
	1983	5.7	4.6	1.5	3.1	− 0.5	3.3
Germany	1981	5.1[3]	6.3	6.6	− 0.3	0.9	− 1.4
	1982	3.3[3]	1.0	4.8	− 3.6	− 1.1	− 2.5
	1983	5.3[3]	3.5	2.5	1.0	− 0.5	1.5
France.............	1981	17.7	17.4	13.1	3.6	1.0	2.5
	1982	11.5	10.8	8.7	1.9	− 0.8	3.3
	1983	9.2	9.8	9.6	0.2	− 0.2	0.7
United Kingdom	1981	8.2	7.3	11.2	− 3.5	− 3.7	0.7
	1982	7.7	7.2	6.8	0.4	− 2.6	3.4
	1983	7.8	8.1	4.9	3.1	− 0.1	3.1
Canada	1981	17.4	16.5[4]	11.1	4.9	3.3	0.1
	1982	6.4	7.2[4]	10.2	− 2.7	− 0.5	− 1.3
	1983	6.6	5.6[4]	4.6	1.0	− 2.0	4.5

[1] In percentage points. [2] Annual averages. [3] Net factor income. [4] Including net interest payments.

The broad characterisation given so far of the recovery outside the United States as being due to a combination of an external stimulus and automatic domestic forces (stemming partly from disinflation) is of course only a generalised picture. Considerable differences were to be observed between individual country experiences.

For example, the net external balance played a varying quantitative rôle depending both on the shares of exports going to the United States and to competing markets and on particular exchange rate and competitive experiences. Thus, the growth of total Japanese exports, for which the United States is an important market, accelerated markedly in the second half of last year, so that in the final quarter their volume was more than 12 per cent. higher than it had been a year earlier. For the same reason, Canadian exports also rose — in this case even more sharply, by nearly 22 per cent. However, with domestic demand, especially stockbuilding, rebounding very strongly, imports grew just as fast. Similarly, countries such as France, Sweden, Spain and Belgium, whose exchange rates have declined more than the average in the recent past, saw a combination of export growth and import restraint which added noticeably to GNP growth. For example, the volume of Swedish exports rose by as much as 11½ per cent. last year and imports by only 1½ per cent., while in Belgium the change in the real foreign balance amounted to almost 3 per cent. of GNP, mostly as a result of declining imports. In the Netherlands the competitiveness effects of moderate wage behaviour helped to bring about a qualitatively similar result. In contrast, Germany, Switzerland and Austria received a negative net stimulus from this source, at least taking the year as a whole. It is true that export growth in these countries did accelerate noticeably during the year, but in Germany a minor boom in stockbuilding appears also to have sucked in imports at a quickening pace through the year.

The strength of automatic domestic forces acting through consumers' spending propensities has also varied considerably between countries. The exceptional case of the United Kingdom has already been noted. However, how much of the fall in the saving ratio has been due to a further decline in inflation and how much to the abolition of all consumer credit controls in 1982 is not clear. At all events, consumer spending dominated demand developments last year. In Germany, too, the unblocking of certain frozen savings accounts last year probably exerted an independent effect on the saving ratio.

At the other extreme, in several other countries in Europe where inflation remained relatively high — for example, Italy, Sweden, Belgium and Spain — little or no demand support was forthcoming from consumer spending.

The short-term adaptations in fiscal stance also varied between countries outside the United States last year, though in a longer-run perspective the general trend remains very much towards budgetary retrenchment. Indeed, several countries for which such a policy was the most desirable made the clearest moves so far in the direction of greater fiscal discipline last year. However, for a few of the larger countries, 1983 saw some temporary slackening of the pace of progress towards healthier public finances. The depth of the recession appears to have been the main motivation for tempering fiscal retrenchment. This can be seen fairly clearly in the case of Canada, which had suffered a particularly severe contraction. In Japan, too, some small tax reliefs and expenditure measures were implemented, though still against a background of some overall decline in the general-government budget deficit as a percentage of GNP. A similar development occurred in Germany, where the device of an explicitly temporary increase in investment tax incentives was used once again. As the table on page 12 shows, this may have helped, together with more general efforts to improve profitability, to encourage business capital spending, which rebounded quite sharply last year.

In the United Kingdom public-sector borrowing overshot earlier plans for a time in late 1982 and early 1983. For 1983 as a whole, public direct consumption spending rose by 3¼ per cent., and public-sector investment by as much as 13 per cent. Limited attempts to support demand — though often against unpropitious backgrounds — were made in Sweden, Austria, Greece and Norway. (More recently, in the Austrian case, some return to fiscal retrenchment has been felt to be necessary.)

In Italy and France, on the other hand, some degree of retrenchment remained necessary, even in the face of further rises in unemployment. And among the smaller countries notable changes of course in this direction have been seen over the past year or two in Belgium, Ireland, Denmark and Spain.

Finally, for the industrial countries as a whole, import demand movements in the developing world were again a somewhat negative influence on demand. For the second year running, the volume of merchandise imports into these countries fell by 2½–3 per cent. In 1983 the main cause was a cutback on the part of OPEC countries following the fall in oil prices in March. In 1982 the main reason had been the adjustment forced on the non-OPEC developing countries as a result of the debt crisis. However, despite some recovery in non-oil commodity prices last year the size of the fall in oil prices (see pages 19 and 20) was such as to give the industrial countries a rather greater improvement in their terms of trade than they had experienced in 1982. Consequently, the slowdown in overall import price increases no doubt helped to boost consumers' real incomes to some degree. And by helping to reduce the general rate of inflation, it also added to the scope for real growth within the financial limits set by the various domestic policy stances adopted in the industrial world.

The net result of all these influences is probably best seen in the graph of industrial production on page 10. From this it is clear that, although recovery has been led by North America, there were other countries, such as Germany, Sweden and Switzerland, where it began almost simultaneously. What is more, its more moderate pace in some countries could be a pointer to its longer-term sustainability. Japan found recovery setting in in the second half of the year, at the same time as the United Kingdom also experienced some modest acceleration in its cautious climb out of deep recession. More recently, the recovery seems to have spread to Belgium and the Netherlands, and also to Norway. In terms of leading indicators, there is also evidence that some degree of upturn may now be beginning in several other smaller European economies, and perhaps in Italy.

Unemployment.

The contrast between economic developments in the United States and those in the rest of the world last year is even sharper when labour markets are considered. For not only is the United States the only country to have recorded a sharp recovery in the strong sense of a large fall in unemployment, but the fall itself is large even in the context of the United States' own previous experience. Between December 1982 and December 1983 recorded unemployment in the United States fell from 10.7 per cent. to 8.2 per cent., equivalent to nearly 2¾ million individuals. By March of this year the figure was down further to 7.8 per cent. of the labour force. This represents by far the fastest cyclical decline in unemployment since the upturn following the 1949 recession. It is true that part of this decline can apparently be accounted for by demographic factors affecting the growth of the labour force. But the overwhelming influence was a 4 per cent. increase in civilian employment during the course of the year. With the rise in total output over this period being slightly less than normal for the first year of the cycle, the implication is that productivity growth in the economy as a whole was relatively slow.

Unemployment.

Countries	1974	1976	1979	1981	1982	1983	1984 March
	annual average, as a percentage of the labour force						
United States	5.6	7.7	5.9	7.6	9.7	9.6	7.8
Canada	5.3	7.1	7.4	7.5	11.1	11.9	11.4
Japan	1.4	2.0	2.1	2.2	2.4	2.7	2.7
Germany	2.7	4.6	3.8	5.6	7.7	9.2	9.0
France	2.3	4.3	6.0	7.8	8.8	9.0	9.9
United Kingdom[1]	2.4	4.9	5.4	10.0	11.7	12.4	12.6
Italy	5.4	6.7	7.7	8.5	9.1	9.9	9.9[2]
Netherlands[3]	3.3	5.5	5.1	9.0	12.6	17.1	18.0
Sweden	2.0	1.6	2.1	2.5	3.1	3.5	3.2
Belgium	2.6	5.7	7.1	9.4	10.9	12.2	12.3
Switzerland	0.0	0.7	0.3	0.2	0.4	0.9	1.1
Group of Ten countries	3.8	5.5	5.0	6.6	8.1	8.5	7.9

[1] New series from October 1979. [2] First week in January 1984. [3] New series from January 1983.

That part of the unemployment decline which is the arithmetic counterpart of slow productivity growth is often ascribed to a greater degree of real wage flexibility in the United States compared with elsewhere, especially Europe. However, whether real wage flexibility has actually increased over recent years in the United States is not quite so clear. At all events, the overall decline in US unemployment last year was clearly due to the strength of the recovery as well.

Despite the contrast between the United States and the rest of the world, there was in 1983 also a change in unemployment trends elsewhere, particularly in Europe. There, it seems that, on average, unemployment at least stopped rising in the second quarter and has been more or less stable since, albeit at a very high level of around 10½ per cent. In Germany a fairly slow, but definite, downward trend appeared from about mid-year onwards, and some downward movement became apparent in Belgium rather later. In the United Kingdom, however, a welcome halt to the rise in unemployment early in the year failed to turn into any noticeable decline. In France unemployment continued to edge upwards very slowly, while in the Netherlands, although the steepness of the upward trend was curtailed, unemployment continued to rise well beyond previous post-war peaks.

In many European countries the unemployment problem is exacerbated by demographic factors tending to enlarge the labour force. Participation rates are also still rising on average in Europe. When to these factors are added those of slower and delayed recovery and higher long-run trends in productivity growth (perhaps due in part to excessive levels of real wages) it is not surprising that the European unemployment problem stands in marked contrast to that in the United States.

Price and wage developments in 1983.

During the first half of 1983 various favourable factors combined to cause the downward course of inflation in the Group of Ten countries to continue. From about 5½ per cent. at the end of 1982 the average twelve-month rate of consumer price inflation had fallen to around 4 per cent. in mid-1983. Even by the end of the year the average inflation rate was still somewhat lower than it had been a year earlier, despite the onset of the recovery.

Changes in consumer prices.

Countries	Changes over twelve months ending							
	1976 Dec.	1979 Dec.	1980 Dec.	1981 Dec.	1982 Dec.	1983 June	1983 Dec.	1984 March
	in percentages							
United States	4.8	13.3	12.4	8.9	3.9	2.6	3.8	4.7
Japan	10.4	5.7	7.5	4.3	1.8	2.0	1.8	2.5
Germany	3.7	5.4	5.5	6.3	4.6	2.4	2.6	3.2
Netherlands	8.5	4.8	6.7	7.2	4.3	2.5	3.0	3.9
Belgium	7.6	5.1	7.6	8.1	8.1	7.3	7.2	7.1
Switzerland	1.3	5.2	4.4	6.6	5.5	2.8	2.1	3.4
United Kingdom	15.1	17.2	15.1	12.0	5.4	3.7	5.3	5.2
Italy	21.8	19.9	21.1	17.9	16.3	16.0	12.8	12.0
Sweden	9.5	9.8	14.1	9.2	9.6	8.8	9.2	9.0
France	9.9	11.8	13.7	13.9	9.7	8.8	9.3	8.6
Canada	5.9	9.8	11.2	12.1	9.3	5.6	4.5	4.7
Weighted average of Group of Ten countries*	7.7	11.3	11.4	9.1	5.2	4.0	4.5	5.0

* With weights proportional to GNP for the year 1982.

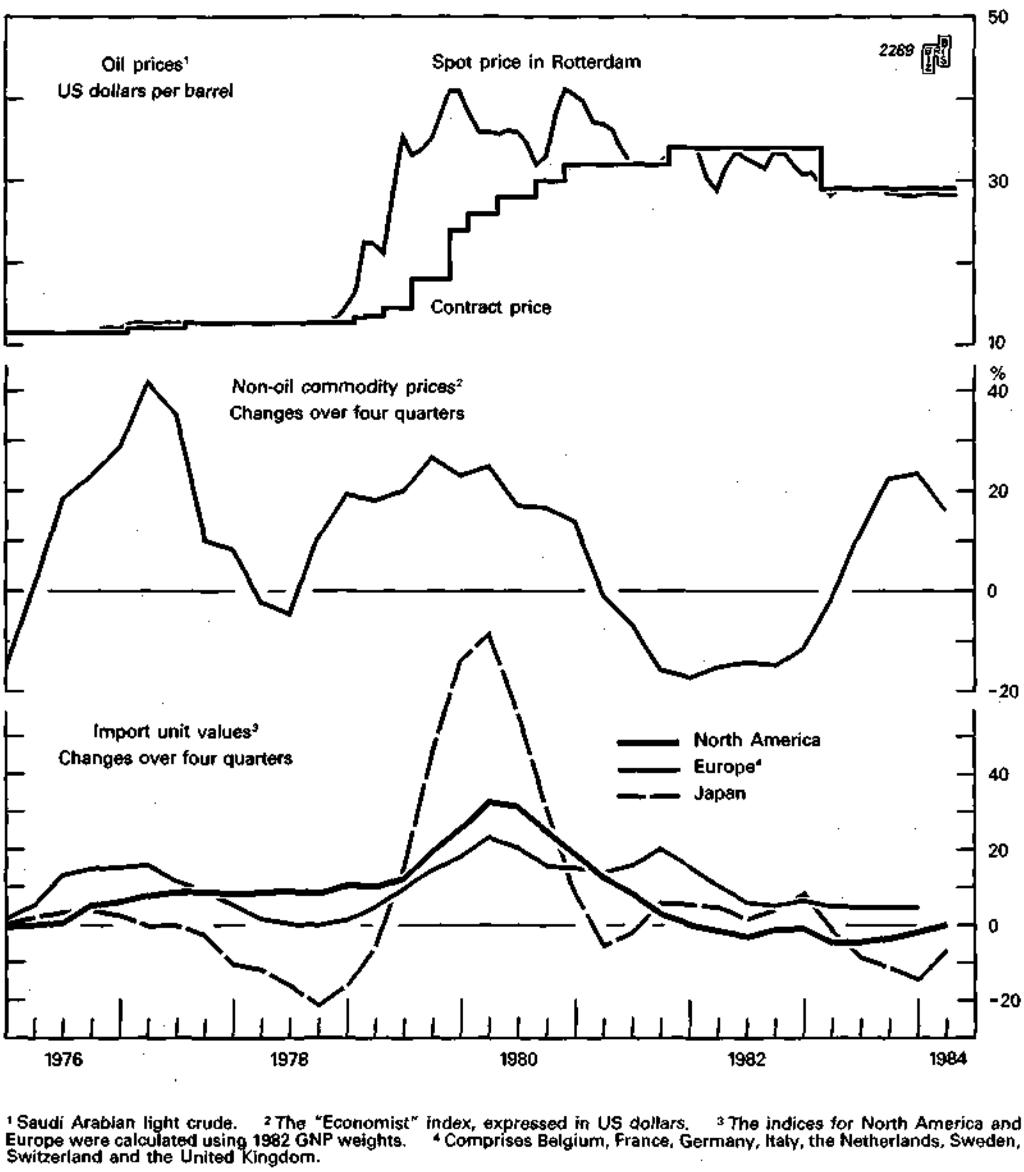
First among the factors responsible for this performance was no doubt the widespread and resolute pursuit of disinflationary policies over the previous three years. The most important manifestation of this was to be found in the further moderation in the inflation of nominal wages. Thus, in the United States nominal wage gains were the lowest seen since the mid-1960s. Similarly, in countries such as Japan, Germany, the Netherlands and Belgium, recent nominal wage increases have been lower than at any time over the past fifteen to twenty years.

Changes in nominal wages.

Countries	Annual averages 1965–72	December to December				
		1979	1980	1981	1982	1983
	in percentages					
United States	6.0	8.0	8.8	7.3	5.0	4.3
Japan	13.3	5.6	5.3	5.5	4.9	3.6
Germany	8.3	4.8	7.5	5.1	3.9	3.1
France	9.6	13.8	15.4	16.4	12.6	9.8
United Kingdom	8.6	19.6	19.2	10.2	7.9	8.0
Italy	8.7	21.3	21.1	21.2	15.2	13.1
Canada	7.6	9.3	11.7	12.7	9.1	4.9
Belgium	9.7	8.4	10.2	10.3	4.5	4.0
Netherlands	9.7	4.3	4.1	4.4	6.6	0.9
Sweden	9.6	8.4	11.9	6.8	6.9	7.8
Switzerland	6.3	3.1	6.4	6.1	5.7	3.1

When combined with some upturn in productivity which is normal early in the recovery phase of the cycle, this favourable nominal wage development implied a particularly advantageous performance in terms of unit labour costs. Indeed, in some countries unit labour costs in manufacturing industry actually registered a decline either on an annual average basis or at least at some point during the year. Among such countries were the United States, Japan, Germany, Belgium, the Netherlands, Sweden and Austria. In Canada unit labour costs virtually stopped rising and in the United Kingdom, although nominal earnings increases did not decelerate further, the healthy rise in productivity continued even against the background of relatively slow recovery.

Commodity prices and import unit values.



[1] Saudi Arabian light crude. [2] The "Economist" index, expressed in US dollars. [3] The indices for North America and Europe were calculated using 1982 GNP weights. [4] Comprises Belgium, France, Germany, Italy, the Netherlands, Sweden, Switzerland and the United Kingdom.

No doubt this moderation in wage cost increases permitted firms in many countries to make much needed upward adjustments to their margins. Even so, at least in the early part of the year, favourable food price developments and the fall in oil prices could be added to the list of factors helping to bring inflation down further. As the graph on page 19 shows, although non-oil commodity prices did begin to pick up quite sharply for a time last year, overall import cost increases facing the industrial countries were for the most part modest. Indeed, largely as a result of the strong dollar, North American import prices fell last year, as they also did in Japan and, to a lesser extent, in Germany, Austria and Switzerland. At the other end of the spectrum, countries with greater-than-average currency depreciation vis-à-vis the dollar, for example France, Belgium, Spain and, especially, Greece and Sweden, experienced further external cost pressures despite the fall in the oil price.

An important question, clearly, is to what extent the generally favourable short-term price and cost developments just described indicate significant longer-term progress in the fight against inflation. Did the events of last year simply reflect a fortuitous combination which is unlikely to persist over a longer period? Or are some or all of the individual factors themselves — for example, the further reduction in nominal wage increases last year — likely to prove transient?

The sustainability of the recovery: wages and productivity.

There can be little doubt that, of all the possible problems which might arise, a failure to consolidate the gains so far made against inflation would pose the most fundamental threat to the continuation and broadening of the recovery. It is true, of course, that the inflation problem could conceivably return as a result of policy mistakes. Macro-economic policy will, however, be considered separately below. For the time being, it will be most convenient to remain within the framework of the disinflation process which began over three years ago. The fundamental aim of that process — which turned out to be very painful in the short run — was to bring about a lasting reduction in inflationary behaviour. In turn, it was hoped that such a development would be accompanied by faster productivity growth, better real wage performance and a corresponding improvement in profitability. This with a view to both stimulating and then sustaining more permanent and healthier economic growth. In what follows, nominal wage behaviour, productivity performance and real wage behaviour will be considered in turn.

Nominal wages. It is in the labour market that one might first look for signs of longer-lasting behavioural change, whether of a voluntary nature or involving the acceptance of some kind of government-imposed guidelines. However brought about, it might be reasonable to assume that the longer the period over which more moderate wage increases have been recorded, the more secure might that behaviour be for the future. In this sense, one group of countries stands out fairly clearly from the table on page 18: Japan, Germany, the Netherlands and Switzerland. In Japan wage inflation was quite quickly reduced soon after the highly inflationary experience of the first oil shock and showed no temporary, renewed acceleration at all in the face of the second. The German experience is equally striking. For, although there was apparently some small re-acceleration of wage increases during the second oil shock, the trend of nominal wage inflation can now be seen to have been clearly downwards on average since the wage explosion of 1969 — and this in the face of two major external shocks.

Bringing in Switzerland, it may be said, too, that in none of these first three cases has unemployment been particularly high. Indeed, in Japan and Switzerland moderate wage increases have been achieved in the context of low rates of unemployment. And even in Germany unemployment, while serious, has not been noticeably above the average. The same cannot, however, be said of the Netherlands, where unemployment is the highest in the Group of Ten countries. Also, in some contrast with the other three, the Netherlands has seen more direct government interference in the price/wage formulation process. Price controls have been in force and strong downward pressure has been placed on public-sector wages. However, with the conclusion of an agreement between the trade union federation and industrial employers in November 1982, the Government was able last year to reduce its own direct rôle in limiting private-sector wage rises.

Turning to the United States, which seems to be in a class rather of its own, the table suggests at first sight no very unusual developments. Year-to-year nominal wage increases have been much less volatile than elsewhere, being on a gradually rising trend from the mid-1960s to the late 1970s, and after reaching a peak in 1980 they declined steadily to under 5 per cent. last year. This relative stability is a reflection of the US practice of multi-year wage contracts and, as a consequence, an unusual degree of flexibility in real wages in the face of external and other price shocks.

The decline in US wage inflation has also occurred in the context of both deep recession and consumer price developments which were favourably — if temporarily — affected by the rising dollar after 1980. On the other hand, it is also a decline from what was previously a relatively stable upward trend over a long period of accelerating inflation. On this comparison the US achievement looks quite impressive — especially as, in addition, the absolute level of wage increase last year had become very low. Last year's further decline was also achieved in the face of a strong recovery in activity and without any governmental interference in the wage bargaining process. Finally, anecdotal evidence, at least for a time, suggested unusually moderate wage behaviour, with reports of outright cuts and of the rescinding of already agreed rises.

In short, the United States may be considered — on the balance of this evidence, which of course excludes the prospective stance of policy — as a late entrant to the group of countries with low wage inflation discussed above. This would seem to make it even more vital that policy should do nothing which might put this anti-inflationary progress at risk.

In the case of some of the other larger countries, the evidence is more mixed. The good Canadian performance last year came only after very deep recession in

1982 and considerable downward pressure on public-sector wages. The case of the United Kingdom is more difficult to characterise. The policy stance has been resolutely anti-inflationary, and that without the aid of any incomes policy measures at all. At the same time, wage rises have fallen to levels not seen since just after the incomes policy episode of 1966–67, and productivity growth has been remarkably high given the pace of output growth. Against this, however, no further progress was apparently made last year in terms of earnings, which was perhaps especially disappointing in that unemployment failed to begin a sustained downward trend.

The experiences of France and Italy are partly explained by their coming to disinflation rather later than most other large countries. Although much reduced by last year, wage inflation clearly remained too high to be compatible with an acceptable rate of price inflation. In Italy, however, a fairly determined attempt is being made by the Government to secure further modifications to the "scala mobile" system of wage indexation. In France policy has included price controls, abolition of wage indexation and limitations or guidelines for both public and private-sector wage increases. In both countries, however, developments have to be seen in the context of continued recession.

In Belgium severe general economic difficulties have accompanied a degree of success for the Government's various attempts to implement prices and incomes measures either voluntarily or, as a last resort, by statute. Similarly, in Denmark the imposition of a temporary wage and profit margin freeze early last year successfully brought down wage increases to below anything seen since before 1965. Again, however, this was only achieved in the context of crisis and further increases in unemployment. Sweden also faced a difficult situation in its attempt to restrain wages in the face of continuing price inflation and an unusually sharp rise in profits stemming partly from the devaluation of the krona. And in April of this year the Government decided to introduce a price freeze as a background to a renewed attempt to reduce wage cost increases.

Productivity growth. The problem of wage costs is, in theory at least, not only one of nominal wages. For any given rate of nominal wage increase, the change in labour costs will clearly be the smaller, the greater the increase in output per person employed. It is true that the scope for holding down unit cost increases from this side must be fairly limited. Nevertheless, with policy-makers in many countries increasingly looking for means to stimulate the supply side of their economies, some examination of recent productivity performance is of interest.

As the following table shows, over the period since the first oil shock the general trend of productivity growth has been universally lower than it was earlier. In Europe, on average, the trend rate of growth of productivity in the whole economy fell from nearly 4½ per cent. per annum between 1960 and 1973 to under 2 per cent. per annum over the years 1974–82. In North America over the same period overall productivity growth came to a virtual halt, while in Japan the earlier rate was reduced by nearly two-thirds.

This inauspicious background had, of course, been an important stimulus to the revival of concern about the supply side of the economy. In turn, the arrival of recovery last year brought for several countries the first opportunity since 1976 to

Trends in labour productivity.

Countries	1960–73	1974–82	1978	1979	1980	1981	1982	1983[1]	*Memorandum items:* *1976*	*Previous two recoveries*[2]
	average annual changes in real gross domestic product per person employed, in percentages									*Average*
United States	2.1	0.0	0.4	−0.4	−0.7	1.5	−1.0	2.0	*1.6*	*2.3*
Canada	2.7	0.2	0.6	−0.8	−1.7	0.8	−1.2	2.3	*3.6*	*4.1*
Japan	8.4	3.0	3.8	3.8	3.8	3.2	2.1	1.3	*4.4*	*10.0*
Germany	4.3	2.2	2.8	2.6	0.9	0.5	0.7	3.0	*6.3*	*5.2*
France	4.9	2.3	3.5	3.4	1.0	1.1	2.0	1.6	*4.5*	*5.3*
United Kingdom[3] .	2.6	1.1	2.5	1.7	−2.5	1.5	3.1	3.3	*2.6*	*4.2*
Italy	5.7	1.3	1.6	3.8	3.1	−0.2	0.0	−1.3	*5.1*	*6.0*
Belgium	4.2	2.2	3.0	0.8	2.7	1.0	2.0	1.5	*6.5*	*5.2*
Netherlands[4]	4.1	1.3	1.5	0.7	−1.4	0.5	0.9	2.8	*5.1*	*5.6*
Sweden	3.5	0.4	0.9	2.7	0.7	−0.4	0.6	2.3	*2.7*[5]	*4.0*
Switzerland	3.1	0.9	−0.2	1.7	2.7	0.2	−0.6	1.0	*1.9*	*3.8*
Denmark	3.1	1.7	1.2	−0.8	−0.3	2.8	2.9	1.8	*4.0*	*5.3*

[1] Preliminary estimates. [2] Based on annual data, using the following years as periods of recovery: 1968 and 1971 for the United States and Canada; 1969 and 1972 for Japan, Germany, France, Italy, Belgium and Denmark; 1968 and 1973 for the United Kingdom and the Netherlands; 1970 and 1973 for Sweden and Switzerland. [3] Based on output data. [4] Based on estimates of the number of persons employed. [5] 1979.

Sources: OECD Historical Statistics and national data for total output and employment.

observe productivity behaviour in the upward phase of the cycle, a phase which has usually been accompanied by larger-than-average productivity gains as more intensive use is made of the existing employed labour force.

In the event, however, productivity performance last year seems to have been unspectacular. In the United States — where the phenomenon was already noted in the unemployment discussion above — economy-wide productivity rose by 2 per cent. for the year as a whole and by a little over 2½ per cent. during the year to the fourth quarter. The latter figure is, perhaps, the more significant in that the speed of the upturn — something over 6 per cent. in terms of GNP — became more visible over that period. Thus, productivity growth last year was well below that recorded for the first year of recovery following the first oil shock (4 per cent.), and only marginally above the average for the period 1960–73. For Canada the historical comparisons are, if anything, somewhat more unfavourable.

For other countries such straightforward comparisons of short-term productivity performance have less clear implications, given that the recovery elsewhere has been either slower, later in starting, or even, in a few cases, not yet existent. Even so, for Germany and Japan, where some noticeable degree of output recovery has emerged, productivity growth — at 3 per cent. and 1¼ per cent. respectively in 1983 — was short of previous norms, particularly in Japan.

Only in the United Kingdom does there appear to be a clear improvement in productivity performance — dating back now two to three years. Despite a relatively modest rate of output growth, economy-wide productivity has risen by more than 3 per cent. per annum since 1981. Even after allowing for the output and productivity "bonus" of continuing increases in North Sea oil production, this probably implies a return to the kind of performance seen in the pre-oil-shocks period, if not a better one. For no other industrial country can such a statement be made. It seems that the severity of the earlier financial squeeze on the company sector induced an unusual degree of efficiency-promoting measures — presumably in the form of changed working practices as well as through the replacement of plant.

Elsewhere, however, productivity performance was generally poor last year. Some pick-up occurred in the Netherlands, but it was fairly modest. In Italy and France continuing recession naturally influenced the figures. Even so, after stagnation in 1981 and 1982, Italian productivity fell last year, making 1983 the worst year (barring 1975) since at least the mid-1960s.

In sum, this review of recent productivity developments suggests that continued control of inflation during the upturn is going to require very moderate nominal wage behaviour. It is true that several countries have yet to experience appreciable output acceleration and may thus have some productivity "bonus" to reap. But the evidence from countries where the recovery is already strong is not encouraging to this argument. In any case the severity of the financial pressures on the company sector in recent years will hardly have been conducive to labour hoarding during the recession.

Real wages. The preceding discussions of prices, nominal wages and productivity can, of course, be combined to bring out developments in terms of real wages and — tentatively — the movement of profit shares. The latter is clearly of additional, independent, importance for the sustainability of recovery. The accompanying graph shows changes in an index of real wages (represented by wages in manufacturing industry, deflated by consumer prices) averaged over three-year periods since 1968–70, with the final point representing the single year 1983. Changes in productivity in the whole economy are plotted in a similar way, and both are set against the rate of unemployment.

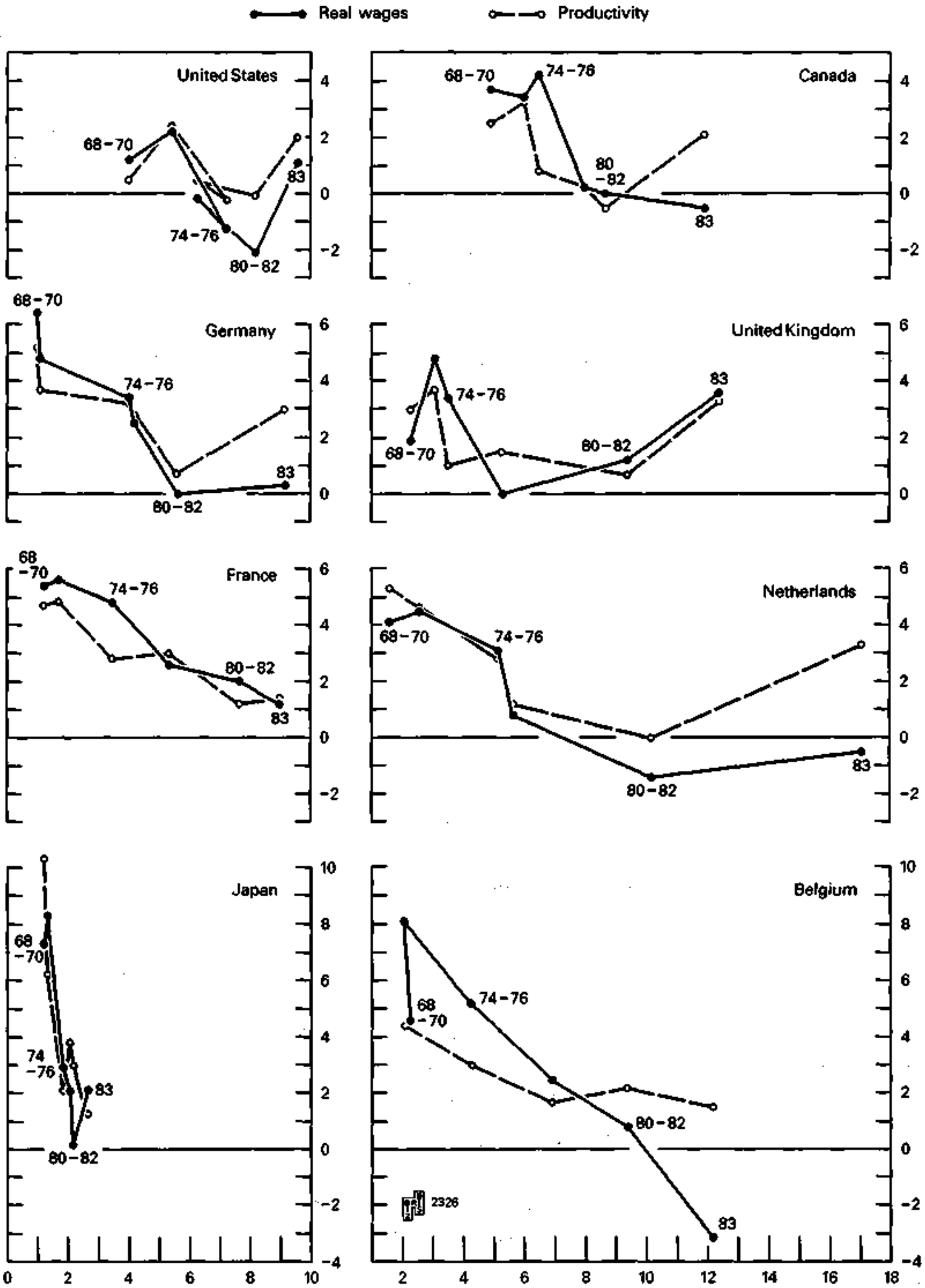
The graph shows, firstly, that the decline in nominal wage inflation already noted has — to varying degrees — been accompanied by a decline in real wage gains. Indeed, in several countries outright declines in real wages have been recorded in recent years. Viewed in this light, the moderation in wage behaviour should perhaps be considered to be rather more significant, even though it has been accompanied by high and rising unemployment.

One of the extreme cases is again Japan, where real wage gains, which had earlier been as much as 10 per cent. per annum, were reduced to nearly zero in the period 1980–82; and that with only a minor rise in recorded unemployment. Such a degree of real wage flexibility was, of course, highly necessary at a time when productivity growth also declined sharply.

The US figures demonstrate that the well-known flexibility of real wages in that country — referred to on page 21 above — is not only a reflection of the slow adjustment of wages to changes in prices. Thus, the real wage line again mirrors productivity movements fairly closely, and the more recent evidence suggests that room has been provided for higher profitability.

Elsewhere, there have been long periods in the past during which real wage growth was out of line with that of productivity, and consequently there was a

Real wages, productivity and unemployment.*



* The graph shows percentage changes in real wages (i.e. earnings or wage rates in manufacturing industry, deflated by consumer prices) and output per employed person for the economy as a whole. These changes are calculated as averages for three-year periods (starting with 1968–70 and ending with 1980–82) and shown against corresponding averages for the rate of unemployment; 1983 figures are shown separately.

growing need for adjustment. The more recent data, however, suggest that some correction of this situation is under way. For some countries, such as Canada, the productivity and real wage lines appear to have crossed fairly recently. For others, however, real wage growth has now been below that of productivity for some time. One example here would be that of Germany. Others, where the need for adjustment was perhaps greater, would be the United Kingdom, Belgium and the Netherlands. Especially in these cases, however, the accompanying very high levels of unemployment make it difficult to be sure yet whether a more fundamental adjustment has taken place — one that would prove durable in the face of continuing and stronger recovery.

Thus, with the secular trend of productivity growth unlikely to accelerate markedly, real — as well as nominal — wage considerations both argue strongly in favour of the need for continuing moderate wage behaviour. At least in an accounting sense, nominal wages make up the greater part of overall costs and prices. If the fundamental prerequisite of sustained recovery — control of inflation — is to be obtained, nominal wage increases will therefore have to be kept to a modest level by one means or another. Similarly, with the need for higher investment to support recovery also being important from the supply side, real wage behaviour will need to be such as to provide the requisite degree of profitability.

The sustainability of the recovery: policy contrasts.

International differences in fiscal policy. A second broad threat to the sustainability of the present recovery lies in the prospect of a continuing lack of balance. A highly unbalanced policy situation in the United States itself of course adds to the inflation risk there. But, in addition, the contrasting movements in policy stance — especially fiscal stance — as between the United States and the rest of the industrial world threaten an unsustainable balance-of-payments configuration. They also distract attention from the fairly general aim of public-sector retrenchment — a policy aim whose full results can only be expected to appear gradually over the medium term, but whose contribution to the longer-run sustainability of recovery is seen as vital. It is important to bear this fact in mind when analysing short-term changes in fiscal stance. That is, it is very likely in the circumstances that traditional fiscal policy analysis will not pick up all the effects of policy — even those on short-term demand developments.

As the following table shows, it is difficult, if not impossible, to discern a clear difference in fiscal stances merely from an examination of the raw budget data for the recent past. Although in the United States the general-government sector has moved into relatively large deficit during the last two years, its position does not look at all striking beside that of the rest of the industrial world. Indeed, several of the smaller countries appear to be in manifestly greater difficulties. In addition, only a minor further deterioration occurred last year, a further increase in the Federal deficit being largely offset by a rise in the surplus of the state and local-government sector.

General-government expenditure and budget balances.[1]

Countries	General-government expenditure					Budget balance				
	1978–79	1980	1981	1982	1983[2]	1978–79	1980	1981	1982	1983[2]
	as a percentage of GNP									
United States	31.3	33.1	33.5	35.4	35.4	0.3	−1.3	−1.0	−3.8	−4.0
Japan[3]	30.0	31.6	32.7	33.2	32.0	−8.5	−6.8	−7.4	−7.0	−6.9
Germany	49.2	50.2	51.6	51.8	50.9	−3.2	−3.8	−4.8	−4.1	−3.3
France	42.8	43.8	46.5	47.6	47.8	−1.2	0.3	−1.9	−2.6	−3.3
United Kingdom	42.1	44.2	45.3	45.6	45.8	−3.7	−3.5	−2.8	−2.0	−3.2
Italy	45.6	46.3	51.7	55.2	57.6	−9.6	−8.0	−11.9	−12.7	−11.8
Canada	39.4	40.4	41.1	45.6	45.9	−2.4	−2.5	−1.1	−5.3	−5.8
Belgium	54.3	57.7	62.8	63.9	63.2	−8.6	−11.7	−16.2	−15.5	−15.3
Netherlands	56.0	59.2	60.6	62.4	64.0	−4.1	−6.4	−7.2	−7.9	−8.9
Sweden	60.6	62.3	65.5	67.8	68.1	−1.8	−3.7	−4.9	−6.4	−5.1
Switzerland	27.0	26.6	25.7	26.5	26.8	−0.5	−0.4	−0.2	−0.7	−1.3

[1] Based on national sources and definitions. [2] Preliminary. [3] Budget balance figures include public corporations.

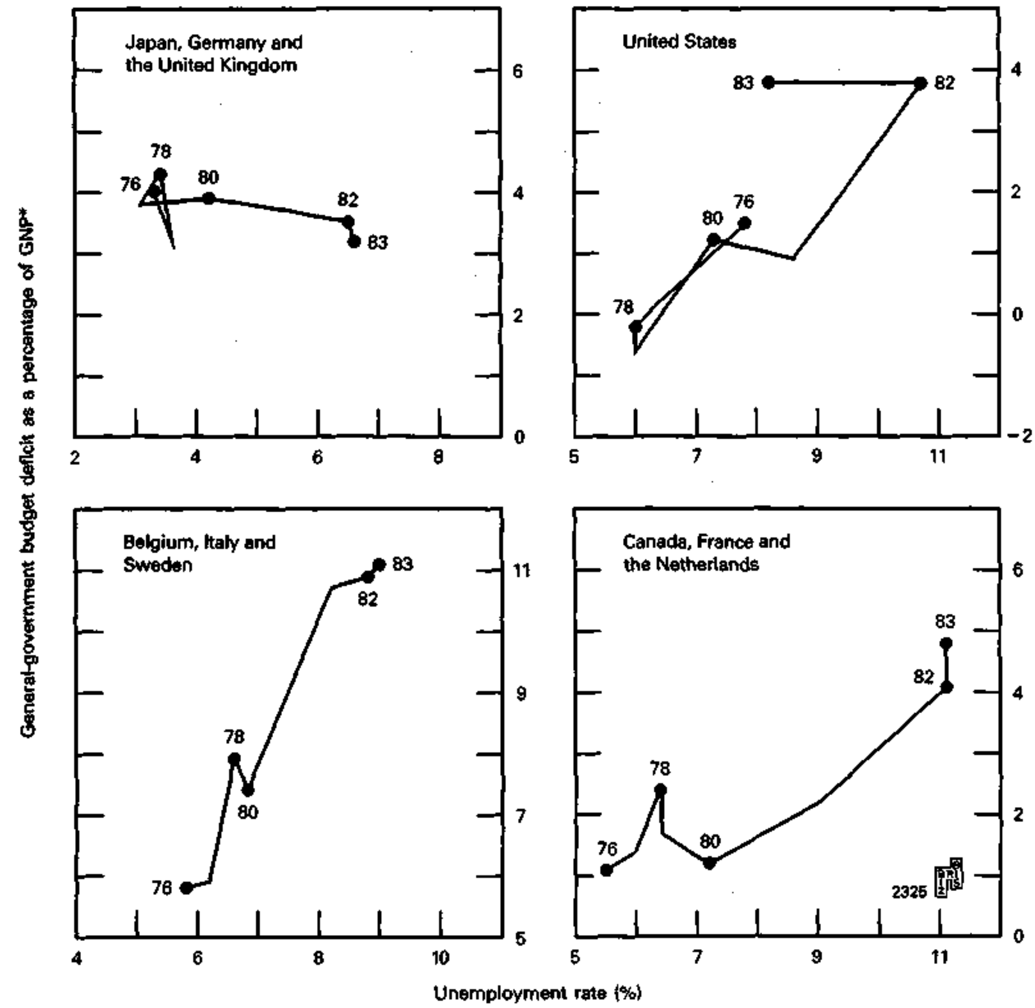
Such a first-glance analysis of the figures omits three crucial factors, however. Firstly, it fails to allow for the movement of the economy itself. Secondly, it cannot allow for what is planned or intended by governments for policy in future years. And finally, it fails to take account of the important problem of the excessive size of the public sector in many countries.

The precise calculation of cyclically adjusted, or structural, budget deficits is fraught with well-known difficulties. It is possible, however, by very simple means to get some impression at least of the relative *direction* of underlying fiscal change. The graph on page 28 plots year-by-year combinations of the general-government budget deficit and the end-year unemployment rate for the United States and three groups of countries. (End-year figures were used in order to make some allowance for the well-known lag between demand changes and their reflection in the labour market.) The points have then been joined up in chronological order.

Interpretation of the graph is qualitatively fairly simple. Movements to the south and/or east, that is downwards and to the right, would unambiguously suggest a restrictive movement of fiscal stance. The budget deficit is being reduced or held steady even in the face of rising unemployment. The automatic effects of the latter in increasing the deficit are implicitly being more than offset by discretionary action in the opposite direction to contain or reduce it. Similarly, a movement towards the north-west suggests a pro-cyclical policy stance in the expansionary direction — the budget deficit being further increased despite a falling rate of unemployment.

Analysed along these lines, the stance of fiscal policy looks very different from the impression gained from the raw budget data alone. As the top right-hand panel of the graph shows, the US public sector moved strongly in the expansionary direction last year as unemployment fell sharply but the automatic effects of this on the budget were overridden. Interestingly, it was not until last year that US policy apparently became strongly expansionary as indicated by this analysis. In 1981, despite the first instalment of supply-side tax cuts, the deficit actually fell slightly, though unemployment rose. In 1982, however, with both the deficit and unemployment rising together, it is not possible to say — without more detailed

Budget deficits and unemployment.



* With weights for country groupings proportional to gross national products for the year 1982.

calculation — whether the rise in the fiscal deficit was more than neutral. In fact, it seems likely that it was, and that policy has been expansionary over the past two years together.

In sharp contrast, the movement in the rest of the industrial world has on average been in almost exactly the opposite direction. In three of the larger countries, Japan, Germany and the United Kingdom (which account for about 60 per cent. of the output of the Group of Ten countries other than the United States), budgetary retrenchment has been pursued for several years even in the face of rising unemployment. It is true, as already noted in the discussion of demand influences above, that the United Kingdom's progress in this direction was temporarily interrupted to some small extent last year. At the same time, however, several other countries, such as Italy, Belgium and Sweden, have seen moves in the more restrictive direction over the past two years.

For the average of countries other than the United States — and after allowing for such counter-examples as Canada — fiscal stance has thus been moving towards more underlying tightness in the conventional sense.

That said, however, an important caveat should be entered. Attempts at budgetary retrenchment have, of course, been an important component of the overall process of disinflation undertaken by the industrial world after the second oil shock. And, as already noted, a successful reduction in inflation appears, even in the relatively short run, to bring in its train rising consumer spending as the consequence of an increase in real disposable income and, in some cases, a fall in personal saving propensities. As it also implies lower interest rates and perhaps greater external competitiveness, demand support may come from the side of investment and exports as well. Such spending reactions will tend to offset any short-term contractionary effects of fiscal tightening and thus help to bridge the gap between the implementation of long-run structural changes in policy and their beneficial effects. On the other hand, in terms of the diagram shown here, the unemployment indicator used reflects, though to an exaggerated degree, the net effect of all demand (and other) influences. Thus, the fact that the line for Japan, Germany and the United Kingdom moves strongly eastwards suggests that the average movement towards fiscal tightening in these countries has so far not been fully compensated, in overall demand terms, by the positive spending effects of disinflation. It is important, however, to see the adjustment as a medium-term process involving a re-allocation of resources to more efficient uses under conditions of greater price stability.

The automatic spending effects of successful disinflation are not normally accounted for in conventional calculations of cyclically adjusted budget positions. This is also true, as alluded to above, of the movement of exchange rates, which has assumed considerable importance recently. How much of the dollar's sharp rise over the past three years has been due purely to differences in the monetary/fiscal policy approaches of the United States and the rest of the world is probably impossible to quantify precisely. Nevertheless, the dollar's rise has — so far — probably also served to mitigate the full potential demand effects of the international differentiation of policy stances. The United States' loss of price competitiveness has been the rest of the world's "gain", without which fiscal retrenchment in other countries might have been accompanied by even higher unemployment in the short run.

Here, however, the distinction already made between the short and longer-term effects of policy differentiation becomes relevant. For while, in the event, differentiated policies in some respects had relatively benign consequences, at least for a time, it seems that over a more extended period the effects could well be the reverse.

Thus, in direction the expansionary US stance can be seen to have been not wholly inappropriate in the very early stages of the cyclical upturn. Both directly and via the rise in the dollar it helped to fill a gap in world demand which has permitted other countries to persist with their desired fiscal and balance-of-payments corrections and begin to reap some of the price and demand rewards of disinflation.

The supply-side orientation of the tax programme of 1981 and 1982 has also clearly begun to bear fruit in terms of business investment. The combined effect of corporate income tax rate reductions and, much more importantly, of the accelerated depreciation provisions is estimated to reduce the corporate tax burden by some $25 billion by next year from what it might otherwise have been. In this way, tax changes have served to raise sharply the net return on business investment.

But the size of the US deficit and, more importantly, the expectation that its structural component will increase further have already brought adverse effects in terms of interest rates. And the danger is that further rises are to come if the budgetary situation goes uncorrected.

The implications of projected US budget deficits. The accompanying table shows the US Administration's fiscal plans and background assumptions as published in the main budget documents early this year. Even at that time, most outside observers felt that such an unprecedented medium-term run of budget deficits would be incompatible with sustained growth. Many also felt that the situation could turn out to be worse than officially expected in that, for example, interest rates might, under the evolving circumstances, rise rather than fall, as projected, and thus add to the deficit problem.

Since then, two things appear to have happened. Firstly, the Administration has itself accepted the need for some modifications to its earlier plans, though it has yet to reach agreement with Congress. At the same time, however, the need for action seems to have become more urgent as a result of an unprecedentedly fast decline in unemployment and as GNP growth rose again to an annual rate of nearly 9 per cent. in the first quarter of this year.

The dangers in this situation are obvious and interlinked. The risk is that interest rates will again move upwards, followed at some point by domestic overheating. Both these developments could be exacerbated by an over-adjustment

The 1985 US Federal Budget: Official forecasts and assumptions.

	1983	1984	1985	1986	1987	1988	1989
Fourth quarter to fourth quarter percentage changes in:							
real GNP	6.1	4.5	4.0	4.0	4.0	4.0	3.8
consumer prices	2.9	4.5	4.7	4.4	4.1	3.8	3.5
Unemployment rate, fourth quarter	8.4	7.7	7.5	7.2	6.5	5.8	5.7
Short-term interest rate[1]	8.6	8.5	7.7	7.1	6.2	5.5	5.0
Federal budget deficit[2]							
in billions of US dollars	−195.4	−183.7	−180.4	−177.1	−180.5	−152.0	−123.4
as a percentage of GNP	6.0	5.2	4.6	4.2	3.9	3.1	2.3

average deficit over 4-year periods as a percentage of GNP

1959–62	1970–73	1975–78	1983–86 (proposed)	Average 1960–73
1.1	1.4	2.9	5.0	1.0

[1] 91-day Treasury bills. [2] On a unified, fiscal year basis, excluding off-budget items.

of the dollar downwards. The latter might appear at first sight to be at odds with recent experience in which the dollar rose simultaneously with a firming of interest rates and a growing external current-account deficit. But whereas exchange markets might well shrug off a large current-account deficit during a temporary period of desynchronised cyclical upturn, the prospect of chronic external deficits of the present size, or even bigger, might at some point come to seem an entirely different matter.

Such a scenario, particularly if accompanied by a precipitate fall of the dollar, would clearly not be in the interests of the United States itself. Inflationary pressures could only be exacerbated both by the direct price effects of an excessively sharp exchange rate adjustment and by its effect on aggregate demand. And since under the US legislative process large fiscal actions have often been difficult to introduce quickly, the monetary authorities would be left with little choice but to allow interest rates to move higher still.

The short-term effect of this kind of development on the rest of the industrial world is difficult to judge. What is clear, though, is that recovery in Europe and Japan has got under way as the positive effects of disinflation and of a medium-term commitment to reduced budget deficits and a smaller share of public spending in GNP have begun to make themselves felt. This is both encouraging in itself and also raises hopes that other, more fundamental factors will come into play to sustain and strengthen the recovery from now on, particularly as monetary policies seem generally calculated to maintain the growth of nominal demand. In particular — as set out in the following chapter — with profitability improving already, private business investment might well take up more of the lead both as a supplement to short-term aggregate demand and as a boost to longer-term supply potential.

The extent to which such an outcome requires further immediate steps along the road of medium-term fiscal retrenchment may, of course, vary between countries. Judgement on this question will depend on the degree to which inflation is already under control, on the amount of slack in the economy and on the size of private-sector savings. It will also depend on the state of the external accounts and the extent to which public-sector growth has already been held in check. In most European countries, however, structural problems in the public sector are acute and are widely held to require redress as part of an overall programme to strengthen and sustain the recovery. In this sense, the focus of fiscal policy has shifted sharply in recent years to concern with the overriding medium-term problem of supply, as opposed to short-term influences on demand.

For example, more rapid progress in curbing public-sector current spending might be expected both to make more room for private-sector recovery and to strengthen other incentives on the supply side of the economy. It would also facilitate some correction of the growing imbalance between current and capital spending within the overall total of public expenditure. In addition, it might be expected that more effective control of the public sector would contribute to better price/cost relationships, especially over the medium term. In this way, business investment might be better supported for longer than has often been the case in earlier recovery phases.

To the extent that the public's perception of a firm medium-term commitment to a non-accommodative policy stance can be heightened, inflation should also be kept under much more secure control than it was in the 1970s. In this way, too, the medium-term orientation of macro-economic policy should bring a growing degree of support to the recovery. Specifically, it should help to ensure that the leeway provided by policy for moderate nominal income growth should be taken up increasingly by real growth, rather than by further price increases.

Even on these optimistic assumptions, however, the industrial countries must face the fact that the large, and still growing, US current-account imbalance is itself not sustainable in the long run. A deficit of this size, though it may afford short-term competitive advantages for other countries, is bound to create investment uncertainties for their export industries and to imply subsequent trade adjustments of considerable size.

In the short run, the prospect of higher interest rates and renewed overheating in the United States is of greater concern, of course, from the standpoint of the heavily indebted less developed countries. The impact of interest rate increases on debt-servicing requirements would stand to erode much of the gain that these countries may have counted on in terms of rising export earnings.

Finally, looking beyond these more immediate hurdles, a looming danger is that overheating in the United States might, by coming increasingly into conflict with a monetary aggregates policy designed to contain inflation, lead to a premature downturn of the economy. Should this occur in combination with a still huge current-account deficit, further protectionist forces could be unleashed, both in the United States and elsewhere.

While this litany of concerns may seem unduly pessimistic, it underlines the importance of timely policy action designed to preserve the stability gains won at such heavy cost over recent years of disinflation.

III. SECTORAL FLOWS AND FINANCIAL MARKETS.

Highlights.

Recent developments in financial markets have been influenced by both cyclical and secular forces. In the first place, short-term adjustments in the real economy (see Chapter II) involved major changes in sectoral financial balances and net borrowing needs. In most countries the reduction in household saving, together with some recovery in residential investment, led to a smaller financial savings surplus, following several years of a strong, recessionary build-up of household liquid assets. Moreover, cyclical recovery combined with continued wage moderation and cost-reducing measures produced a substantial rise in company profits. With fixed investment lagging behind the increase in other demand components, the business sector's financial balance showed a marked improvement. Finally, in many countries the public sector's borrowing requirements, heavy in comparison with earlier cycles, led to a continued build-up of stocks of government debt held domestically and abroad. Despite these broad similarities, patterns of sectoral finance differed significantly from country to country and particularly between European countries and the United States.

Secondly, the extent to which changes in sectoral financial balances were accompanied by changes in portfolio behaviour was greatly influenced by the strength of economic recovery and by expectations with respect to monetary policy. In countries leading the upturn, total borrowing tended to rise relative to gross national product, as increased private demand for credit was superimposed on continuing high public-sector financing requirements, while, at the same time, economic agents attempted to maintain or further strengthen their liquid asset holdings. By contrast, in countries where real economic activity remained relatively subdued throughout most of last year, the process of restructuring financial balances involved a further decline in total borrowing relative to gross national product, mainly as a result of low or even falling private-sector credit demand.

Thirdly, last year witnessed a number of shifts in the composition of financial instruments used and in the rôle of various credit markets and financial institutions. To some extent these developments were related to the cyclical recovery and to the changing pattern of sectoral financial requirements. One major development last year, for example, was the revival in equity markets, which helped companies in many countries to restructure their balance sheets without recourse to debt instruments while strengthening their solvency position as well. With monetary conditions having eased, there was also some tendency towards borrowing at longer maturities, though less so than in earlier cycles. Moreover, there are indications that economic agents are continuing to try to counteract uncertainties with respect to future interest rate developments. In both domestic and international financial markets, last year saw a further rise in the use of debt instruments bearing variable interest rates, with both users and suppliers of funds preferring to avoid longer-term fixed rate commitments. Other developments involved further innovations in public debt management and in techniques to manage interest rate risks, including financial futures trading.

While the process of deregulation and financial innovation can be seen as a response to high inflation and interest rates as well as to legislative and institutional changes, it in turn has had implications for the analysis of financial-market developments and for monetary policy. Firstly, earlier institutional frontiers have been breaking down as market forces have gained strength and the availability of new instruments has affected private-sector portfolio preferences. More particularly, for its "cutting edge", monetary policy in a number of countries has increasingly relied on interest rates rather than on credit-rationing techniques. Secondly, in several countries financial innovations have had a major influence on credit and monetary aggregates, thus complicating the implementation and assessment of monetary policy. This chapter looks primarily at certain developments relating to the first aspect of this process, leaving policy implications and the more specific impact of policies to be discussed in Chapter IV.

Changes in sectoral financial balances.

The incipient cyclical recovery, following a period of severe disinflation and recession, was clearly reflected in the pattern of changes in sectoral financial balances. It was generally marked by a decline in household saving combined with some recovery in residential construction, as well as by higher corporate profits and a certain pick-up in business fixed investment (analysed in the preceding chapter). In most countries households' net saving surplus declined, while the business sector strengthened its net financial position. These changes, in turn, influenced sectoral credit demands and financial-market developments, as reflected in the total amount of funds raised, the credit instruments used and the channels of borrowing and lending.

Turning first to the household sector, the accompanying table shows a fairly uniform picture of strengthening financial surpluses up to 1981–82. After the second oil price shock households responded to accelerating inflation and rising unemployment by cutting back on current consumption and residential investment. In some countries attempts to maintain the real value of wealth appear to have been a main determinant, while in others the fear of higher unemployment and generally weakening consumer confidence may have been dominant. The reactions were similar to those after the first oil price shock, but with the difference that the more recent increase in saving coincided with a slower growth — and in some countries a fall — in real wage earnings.

Last year, however, this trend was reversed in most countries. Lower inflation rates, falling interest rate levels and improved consumer confidence led to more buoyant consumption and in some cases a sharp upturn in residential construction. As a result, households' net financial surpluses generally declined. In the United Kingdom, where the rise in consumption and residential building had begun relatively early, net financial saving fell to only 2 per cent. of gross national product,

Sectoral financial balances.[1]

Countries	Years	Private sector: Households	Private sector: Non-financial business	Private sector: Financial business	Private sector: Total	Public sector[2]	Rest of the world
		as a percentage of GNP					
United States	1975–76	4.5	– 0.3	0.1	4.4	– 4.1	– 0.3
	1980	3.5	– 1.3	0.2	2.4	– 2.5	0.3
	1981	4.4	– 1.8	– 0.1	2.5	– 2.3	0.2
	1982	4.8	0.1	– 0.1	4.8	– 5.3	0.5
	1983	3.6	0.7	0.1	4.3	– 5.6	1.3
Canada	1975–76	4.9	– 5.1	0.4	0.2	– 2.5	2.4
	1980	7.8	– 5.0	0.0	2.8	– 2.4	0.4
	1981	8.5	– 8.2	– 0.2	0.1	– 1.1	1.7
	1982	10.7	– 3.9	– 0.5	6.3	– 5.4	– 0.8
	1983	9.0	– 2.3	– 0.1	6.6	– 5.9	– 0.4
Japan	1975–76	11.0	– 4.1	0.7	7.6	– 7.4	– 0.3
	1980	8.3	– 3.5	0.9	5.7	– 6.8	1.1
	1981	11.2	– 3.1	– 0.2	7.9	– 7.4	– 0.5
	1982	11.0	– 3.9	0.6	7.7	– 7.0	– 0.7
	1983	10.6	– 3.8	1.9	8.7	– 6.9	– 1.8
United Kingdom	1975–76	4.9	– 0.3	0.0	4.6	– 6.9	1.1
	1980	7.1	0.3	– 0.2	7.2	– 4.7	– 1.6
	1981	5.3	1.3	– 0.3	6.3	– 3.4	– 2.9
	1982	3.6	1.3	0.1	5.0	– 2.6	– 2.0
	1983	2.1	2.2	0.0	4.3	– 3.5	– 0.7
France	1975–76	4.7	– 4.3	0.0	0.4	– 1.3	0.9
	1980	3.2	– 5.4	0.5	– 1.7	0.3	1.4
	1981	4.5	– 4.4	0.2	0.3	– 1.8	1.5
	1982	4.8	– 5.3	0.1	– 0.4	– 2.6	3.0
	1983	4.6	– 3.5	0.6	1.7	– 3.3	1.6
Germany	1975–76	6.2	– 1.4	0.6	5.4	– 4.5	– 0.8
	1980	3.4	– 3.5	1.2	1.1	– 3.1	2.1
	1981	4.4	– 3.0	1.3	2.7	– 3.9	1.1
	1982	4.7	– 2.2	1.3	3.8	– 3.4	– 0.4
	1983	2.8	– 1.3	1.8	3.3	– 2.7	– 0.6
Italy	1975–76	15.7	– 7.2	1.6	10.1	–10.8	0.9
	1980	12.2	– 8.7	2.0	5.5	– 9.6	2.5
	1981	14.0	– 6.6	2.2	9.6	–13.4	2.3
	1982	15.1	– 4.0	1.8	12.9	–13.9	1.6
	1983	18.1	– 3.9	2.0	16.2	–15.8	– 0.2
Sweden	1975–76	– 0.9	– 6.4	2.3	– 5.0	3.7	1.3
	1980	0.7	– 4.5	3.9	0.1	– 3.7	3.6
	1981	1.1	– 3.2	4.6	2.5	– 4.9	2.4
	1982	– 0.3	– 1.0	4.1	2.8	– 6.4	3.6
	1983	– 0.1	4.0		3.9	– 5.1	1.2
Belgium	1975–76	7.7	– 1.0		6.7	– 6.9	0.2
	1980	6.2	0.8		7.0	–11.7	4.7
	1981	10.1	1.6		11.7	–16.2	4.5
	1982	9.2	2.3		11.5	–15.5	4.0
	1983	10.2	3.5		13.7	–15.3	1.6
Netherlands	1975–76	8.5	– 1.9		6.6	– 4.0	– 2.6
	1980	4.5	– 0.4		4.1	– 5.9	1.8
	1981	6.9	2.4		9.3	– 7.4	– 1.9
	1982	8.8	2.6		11.4	– 9.1	– 2.3
	1983	7.8	2.8		10.6	– 8.1	– 2.5

[1] Based on flow-of-funds or financial statistics for the United States, Canada, the United Kingdom, France, Germany, Japan and Italy and on national accounts data in the case of Sweden, Belgium and the Netherlands. Because of roundings and residual items not shown in the table, the sectoral balances may not add to zero. Data for 1983 are preliminary. [2] Because of differences in the sectoral definitions used in flow-of-funds and national accounts statistics, the public-sector financial balances may differ from those shown in other tables of this Report.

and in Germany household net saving declined to its lowest level for more than ten years. Last year also witnessed a marked fall in households' net surplus in the United States and an even larger one in Canada, where since the late 1970s household saving had shown a strong positive trend. By contrast, in countries which have in recent years taken steps to curb real wage growth (Italy, Belgium, Sweden and the Netherlands), consumers responded by cutting back spending and strengthening their financial positions.

In the company sector, higher surpluses or reduced deficits were recorded in virtually all countries. This trend had already started two or three years earlier, but it then mainly reflected lower fixed investment and inventory liquidation. In 1983, on the other hand, the improvements were the result of higher profits and cash flows (i.e. gross trading profits after tax and net interest payments). Indeed, though not unusual in the early stages of a cyclical upswing, net company financial saving has remained high even in those countries experiencing some recovery in business fixed investment.

Since in a cyclical context changes in household and company-sector financial balances tend to move inversely and to be partly offsetting, the savings surplus for the private sector as a whole changed relatively little in most countries between 1982 and 1983. However, when seen in a longer-term perspective and compared with corresponding developments in current external accounts and public-sector deficits, the movements in the private-sector net balance in some cases indicate the underlying adjustment patterns and the policies pursued. For instance, in the United Kingdom, the public-sector deficit was sharply reduced between 1975–76 and 1982–83. With the private-sector net balance remaining broadly constant over the same period, it would appear that the public sector's structural budget position considerably strengthened and with it the position vis-à-vis the rest of the world. In the United States private-sector net saving was also substantially unchanged over this period, so that the rise in the public-sector deficit appears to be largely of a structural nature. In Japan and Germany a major structural change since 1980 has been the improvement in the current external account. This mainly reflected a stronger private-sector financial balance and a smaller public-sector structural deficit, while the opposite development seems to have occurred in France.

In the three smaller European countries (Belgium, the Netherlands and Sweden) a striking feature over the years has been the considerable deterioration in the public sector's net financial position, which in the case of Belgium and Sweden was equivalent to almost 10 per cent. of gross national product. Since in all three countries the private-sector savings balance increased by about the same amount, it is difficult to identify structural and cyclical components, but the rising deficits have brought with them significant problems of liquidity control. In Canada and Italy, too, the trend rise in total private-sector saving was very large, but in Canada the "counterparts" were more evenly distributed between a larger public-sector deficit and an improved external account.

Corporate profitability and investment.

Given the widespread policy aim of high investment and sustainable real growth, the longer-term deterioration in company profits and profitability has been a matter of great concern. Starting with the acceleration of nominal and real wage growth in the late 1960s, profit shares have suffered a continuous decline, particularly in Europe and Japan. In Europe these developments have been accentuated by real wage rigidities, unfavourable cyclical developments and high interest rates following the two oil price shocks. In some countries profitability has also been weakened by lower productivity growth, while in others a shift towards rationalisation investment and a consequent decline in the share of net investment and in the growth of the capital stock has been seen as an obstacle to higher output growth.

Over the last two years, however, company-sector positions have shown a marked and welcome improvement. As already noted, the corporate sector's financial balance has strengthened in virtually all countries. This was particularly the case last year, when both profits and cash flows showed very high rates of increase while at the same time profit margins were widening appreciably.

Although an improvement in profits is quite normal in the early phase of a cyclical recovery, the recent upturn has been characterised by certain unusually favourable features. In the first place, the upturn in profits has occurred at a time when the rate of inflation was still falling or had stabilised at a relatively low level. Hence the profit rise was more "genuine" than in earlier cycles when inflationary gains on inventories and the under-depreciation of fixed assets had played a large rôle. Moreover, the increase in profits per unit of output has in several countries considerably exceeded the rise in prices, as more favourable unit cost developments allowed a sizable restoration of profit margins. Available data suggest that in some countries (including the United States) unit costs actually fell last year, reflecting the joint effect of higher labour productivity, moderation in nominal wage increases and a decline in financial costs. In other countries, where the productivity improvement and moderation in wage costs were less pronounced, the deceleration in the growth of other input costs was sufficiently large to allow some, albeit small, rise in profit margins.

Secondly, the improving profit situation was accompanied by unusually strong activity in equity markets. This permitted some increase in equity ratios (i.e. the equity base as a percentage of total company assets), which in many countries had fallen to historically low levels during the preceding recession. In some instances the revival of equity markets was influenced by special tax measures, but preliminary indicators also point to higher "q-ratios" (i.e. the market value of equity plus net debt relative to the replacement value of fixed assets), suggesting an upward revision in stock-market participants' evaluation of firms' future profitability. The rise in equity issues together with sharply higher cash flows also provided scope for restructuring financial balances without recourse to long-term bond markets, thus mitigating the effects of continued high interest rates and in some cases allowing a reduction in firms' financial costs.

When viewed in long-term perspective, however, the profit situation looks less favourable. In several countries profit shares are still below pre-recession levels, which, in turn, were much lower than those of the 1960s and early 1970s. Moreover, because of the continued high level of real and nominal interest rates and the deterioration in traditional financial indicators during the latest recession, firms' profitability and balance-sheet positions may need further improvement before the conditions for a sustainably higher rate of investment can be said to have been restored. In the following sections these problems are first analysed on the basis of profit shares and rates of return as well as of movements in equity ratios and other financial indicators. This is then followed by a brief review of specific problems and concerns in a selected group of countries.

Profit shares and rates of return. As can be seen from the graphs on pages 40–41, the trend decline in the share of profits has been accompanied by a fall in (i) the rate of return on fixed investment (defined as net trading profits before interest and tax payments expressed as a percentage of the stock of fixed assets) and (ii) the return on equity (defined as net income accruing to stockholders after tax and interest payments expressed as a percentage of the equity base). This negative trend is most evident in the case of the United States, Germany and the United Kingdom, but would probably also be observed in many other countries if depreciation allowances and the capital stock were adjusted for past price increases and nominal gains on inventories were excluded. On the other hand, certain exceptional factors may in present conditions have biased profitability indicators, though the net effect will have varied from country to country. These include provisioning for doubtful debts, additions to contingency reserves, redundancy payments and accelerated obsolescence.

At the same time, the graphs also show a trend increase in nominal interest rates, both in absolute terms and relative to the indicators of rates of return. Of course, fixed investment is known to be governed more by the expected development of output than by the past rate of return on capital. However, it is also generally recognised that real investment is likely to be postponed when the expected return — allowing for risk premia and uncertainties — falls below rates on borrowing and the alternative return on financial assets. Indeed, in several countries where there has been a particularly strong incentive to place available resources in high-yielding government securities, firms' holdings of financial assets have increased markedly in recent years. Although nominal interest rates tend to exaggerate the opportunity cost of fixed investment in countries where rates of return are based on current replacement costs of the capital stock (the United States and the United Kingdom), the margin between rates of return and borrowing costs has generally narrowed. Given the simultaneous rise in risks and uncertainties, the volume of potential projects satisfying minimum investment requirements is therefore likely to have been reduced. This may not be reflected in investment trends in the immediate future but could, if there are further increases in nominal, and especially real, interest rates, adversely influence the prospects of achieving a sustainable upturn in investment.

Declining equity ratios. Another general development in the company sector has been the fall in equity ratios. During the 1960s and early 1970s, when real interest rates were low or negative, companies in most countries had an incentive to finance new investment by increasing their debt. Net-of-tax rates on borrowing were well below the return on fixed capital assets, providing a positive "leverage effect" to the after-tax return on equity. However, following the two oil price shocks this "leverage effect" declined sharply, and in several countries it has turned negative during the most recent period of high nominal and real interest rates.

As may be seen in the graphs, equity ratios differ considerably from country to country in terms of both levels and movements. For historical and institutional reasons the equity ratio has been very low in Japan, while a negative trend is most evident in the case of Germany and France. In the United States there has also been widespread concern about the declining equity ratio in manufacturing, but after allowing for the rise in the replacement costs of fixed assets the equity ratio for the corporate sector as a whole has actually shown a slight increase. In the case of the United Kingdom, on the other hand, movements in the equity ratio seem mainly to reflect changes in the share of financial assets, so that *net* debt as a proportion of fixed assets now stands at a fifteen-year low.

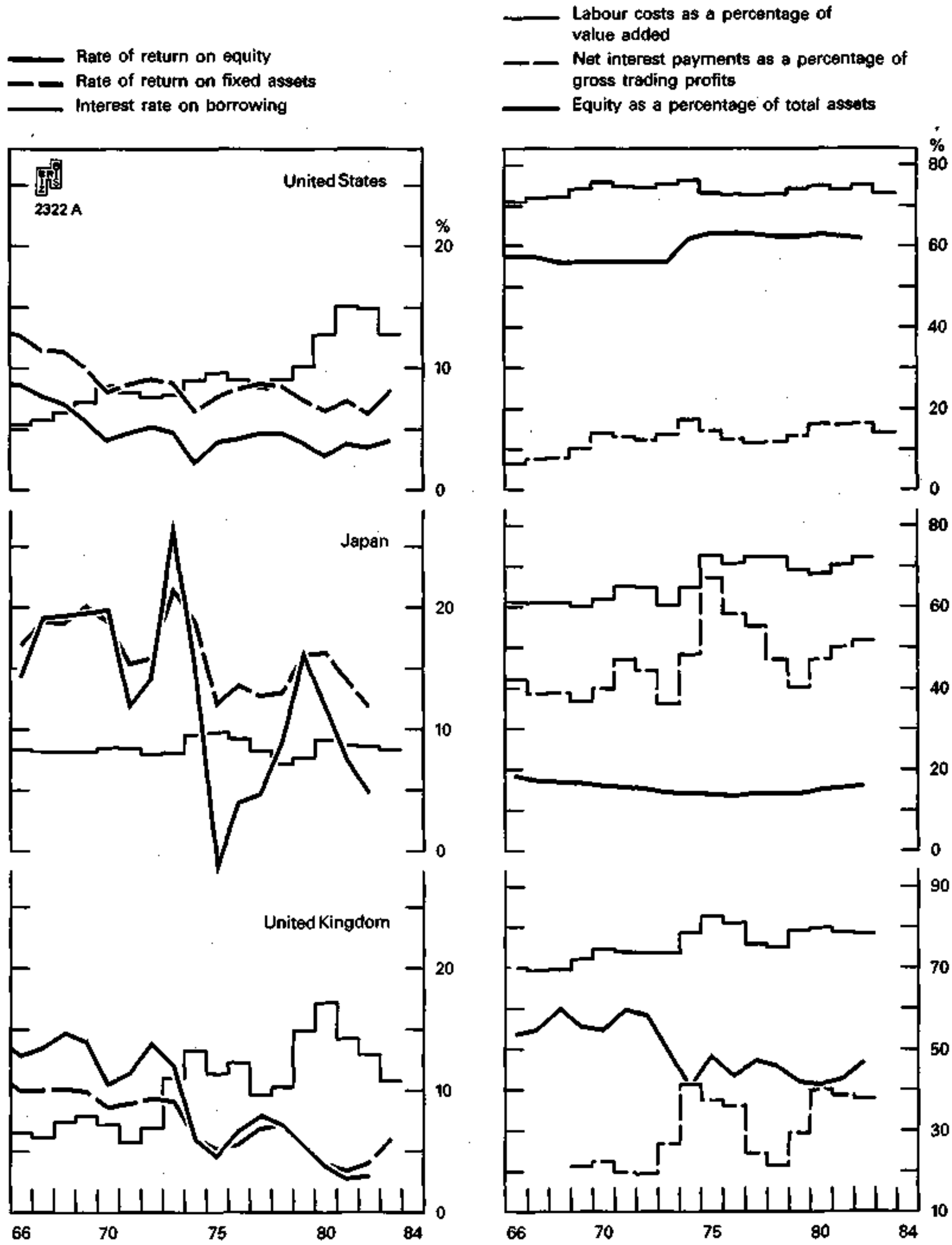
Because of these differences among countries and in the indicators traditionally used, general and firm conclusions regarding the appropriateness of existing equity ratios are difficult to draw. Nonetheless, it is evident that the share of gross trading profits absorbed by interest payments has risen sharply and has remained fairly high even after nominal interest rates had declined. This development underlines companies' heavy debt and interest rate exposure and the desirability of strengthening their equity base. Moreover, a comparison across the countries shown in the graphs suggests that the return on equity is far more volatile in countries with low equity ratios, entailing greater uncertainty and risk for highly geared companies.

Other financial indicators. Among the other aspects of firms' balance sheets, one area of particular concern has been the continued high level of short-term debt relative to total debt. Since in a number of countries public-sector placements account for 90 per cent. or more of total new capital issues, financial "crowding-out" may have prevented a desirable restructuring of firms' debt positions. On the other hand, because of financial innovations — including more frequent use of medium-term bank loans with variable interest rates — the significance of the distinction between short and long-term debts has changed. Moreover, faced with continuing uncertainty about long-term interest rates, companies have in most countries shown little tendency to increase recourse to the bond market, preferring instead to rely on short and medium-term credits. In addition, as noted earlier, many firms have strengthened their financial asset positions, thereby raising the ratio of current assets to short-term liabilities, while leaving the latter very high relative to total liabilities.

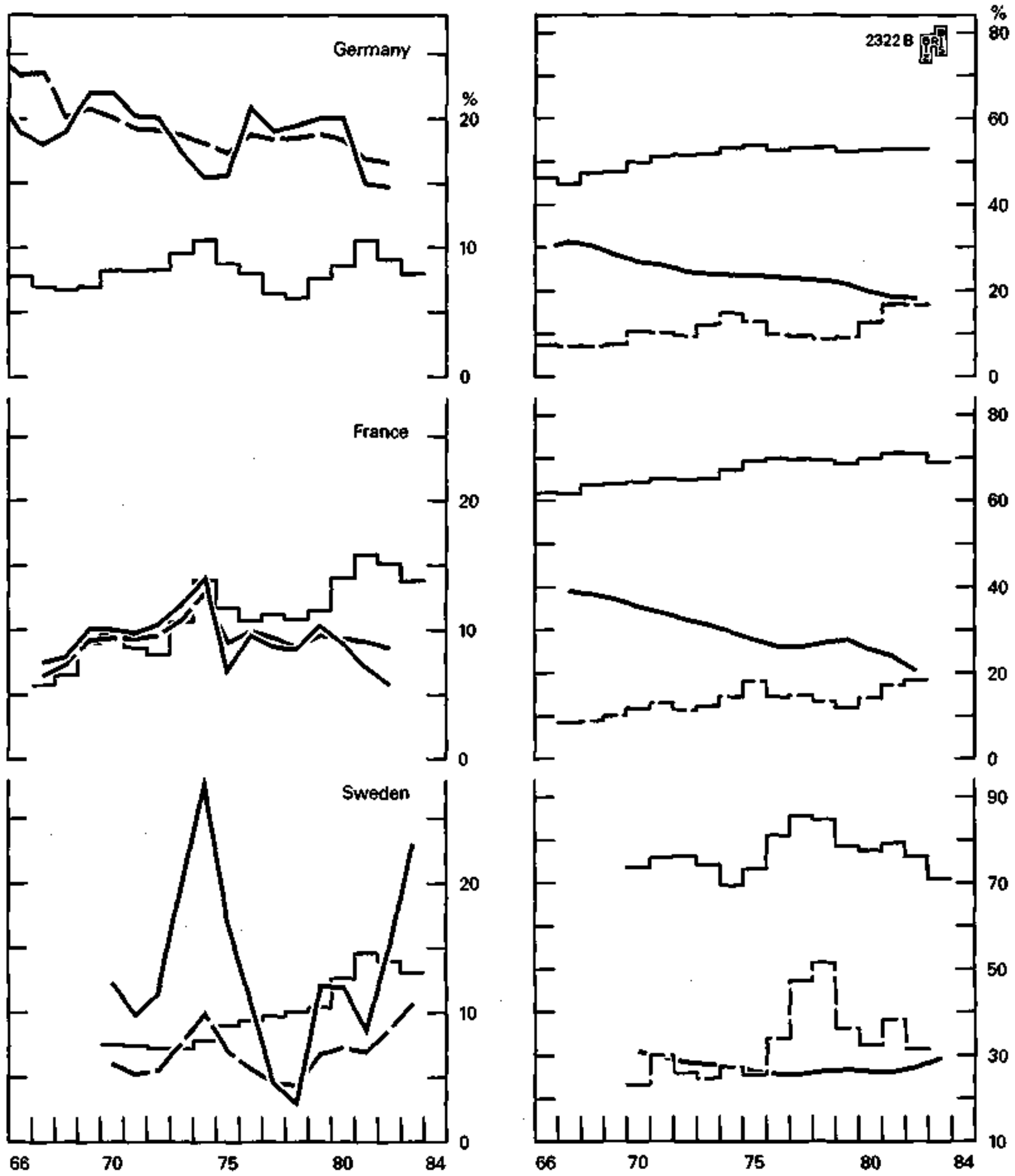
Because of these varied trends it is difficult to say whether the restructuring of balance sheets has gone far enough to foster a sustained higher rate of fixed investment growth. However, two tentative conclusions may be drawn: a broader assessment, including the examination of both sides of firms' balance sheets as well as the composition of assets and liabilities, would seem to be called for; and, secondly, given the higher degree of debt exposure and the greater pervasiveness of market-determined interest rates, corporate decisions may now be more sensitive to fluctuations in interest rates than they used to be.

Country developments. A main feature in the *United States* last year was the impressive rise in profits in a context of generally falling inflation rates. This was

Rates of return and other financial indicators.



Rates of return and other financial indicators
(continued).



Note: Based on national accounts and surveys of company balance sheets. The rate of return on fixed assets is defined as net trading profits as a percentage of fixed assets. In Sweden profits include interest receipts and are measured as a percentage of total assets. Except in the United States and the United Kingdom, depreciation and the value of fixed assets are calculated on the basis of historical costs. The return on equity is defined as net after-tax profits as a percentage of the equity base. In the United Kingdom and Sweden profits are before tax and in the United Kingdom valuation gains on net debts are also included. For the United States the equity base is measured as a residual, including valuation gains on fixed assets. For the interest rates on borrowing the following representative rates have been taken: rates on industrial bonds for the United States, Japan and Sweden; rates on domestic bonds for Germany; and short-term bank lending rates for France and the United Kingdom.

ascribable in part to higher output but in part also to lower unit costs, reflecting the slower growth of unit labour costs, lower financial charges and the lagged effects of the more favourable depreciation allowances introduced in 1981. The greatly improved cash-flow position and recourse to large equity offerings reduced the need for external credits. However, towards the end of last year, with the stock market less buoyant, firms began to increase their demand for bank credit. Despite the strong recovery, interest and debt-service payments, as a proportion of gross after-tax profits, have remained near historical peaks, and the servicing burden of short-term debt is considerably higher than after the 1974–75 recession. So far, there are few signs of high real interest rates having adversely affected overall business fixed investment, and rates of return may increase further as a result of the lagged effects of the Economic Recovery Act of 1981. Nonetheless, firms have become more exposed to changes in interest rates, and the level of real and nominal interest rates continues to be a potential area of concern.

In *Canada*, where comparable data are available only from 1977 onwards, the recovery of profits was even more spectacular, though starting from a severely depressed base. Virtually all financial indicators fell to historically low levels in 1981–82, while debt-service payments soared, reflecting very exposed balance-sheet positions. Last year saw a strong recovery in rates of return which, in turn, led to an increase in equity issues and to some rise in the equity ratio. However, considering the earlier declines, the prevalence of structural difficulties and the continued weakness of business fixed investment, the process of consolidation has not gone far.

A main concern in *Germany* is the trend decline in the equity ratio. Rates of return, though low by historical standards, compare favourably with those in other countries as well as with nominal interest rates. Following a long-term decline in the profit share, which persisted in the wake of the second oil price rise, the restoration of profitability became a primary policy aim. Thanks mainly to a moderation of wage increases, profit margins could be raised in 1982 and the self-financing ratio increased markedly, though largely owing to lower fixed investment spending and cutbacks in inventories. In the course of last year, however, company balance sheets strengthened in several respects, even though the rate of growth of profits declined: firstly, the self-financing ratio remained at a high level after fixed investments started to rise; secondly, the share of short-term debts was further reduced; and, thirdly, firms stepped up their purchases of long-term financial assets, suggesting that liquidity positions had largely been restored.

In *France*, where the equity ratio has also suffered a trend decline, several sectors were hit by rapidly rising interest costs and experienced negative "leverage effects". Other areas of concern are an enduring low degree of self-financing, despite — but probably also contributing to — the weakness of real investment, and the unsatisfactory return on equity, which by 1982 had approached a historical low. The financial problems were accentuated by policy constraints on price adjustments, keener international competition, increases in wages and social charges and higher import prices for raw materials. Preliminary figures for 1983 point to some improvement in the profit situation and in self-financing capacity, due mainly to lower financial costs and a slower rise in input prices.

After some twenty years of continuous decline, the rate of return on fixed capital in the *United Kingdom* bottomed out in the course of 1982, and by the third quarter of last year had returned to 7 per cent. Another feature has been the extensive reliance on bank borrowing, though bond financing increased somewhat last year. The equity ratio has remained relatively high and, as mentioned earlier, has been mirrored in a marked decline in the ratio of net debts to fixed assets. A recent development has been a large build-up of unused tax allowances, reflecting the combined effect of very favourable depreciation allowances and low or negative profits. This has made the after-tax rate of return a less useful indicator of profitability but could also, given new measures proposed in the 1984–85 Budget, provide a stimulus to real investment spending.

In *Japan* the equity ratio has traditionally been very low, though some increase occurred in the mid-1970s and again after the second oil shock in response to negative "leverage effects". The slower rate of investment growth has reduced the overall demand for credit, while the proportion of borrowing needs met via the bond market has increased. A marked rise in firms' rate of return on financial assets seems to reflect the availability of a wider range of assets with market-determined interest rates and more active portfolio management. At the same time, this rise in "opportunity costs" has helped to stabilise inventory investment and generally increased firms' sensitivity to changes in interest rates. The high degree of wage flexibility has widened the scope for an improvement in profits. However, the low rate of inflation has to some extent been obtained at the "expense" of declining margins, as profits per unit of output appear to have fallen by some 5 per cent. since 1981. This negative trend may have been reversed in the course of 1983, though the value added share of profits is still below earlier levels.

Data for *Belgium,* which are available only for a five-year period, confirm that the 1982 economic stabilisation measures, including devaluation, succeeded in raising profitability. Judging by the development of aggregate after-tax gross profits (up by almost 25 per cent.), the improvement continued last year. With higher rates of return firms have been able to reduce the share of short-term debt, while improved cash-flow positions combined with legislative measures have reversed a downward trend in the equity ratio. The process of restructuring balance sheets seems to have been completed in many sectors and the overall profit share has returned to the level of 1974. However, very large sectoral differences remain, highlighted by the adverse conditions in the steel sector.

In *Sweden* the development of profit shares and rates of return has also been significantly influenced by exchange rate changes and measures taken to moderate wage increases. An adjustment process began as early as 1977–78, after the return on equity had fallen to only 3 per cent. and the bond rate had started to rise sharply. The introduction of new debt instruments to finance the public-sector deficit has provided firms with a wider choice of financial assets bearing market-related interest rates, and by 1981 interest incomes were actually as high as net trading profits. At the same time, reflecting the combined effect of the 1982 devaluation and continued wage moderation, the pre-tax return on equity in manufacturing last year came close to 25 per cent. Since, however, the return on financial assets has remained high, firms have used most of the increase in profits to finance further purchases of financial assets. Fixed industrial investment fell to only half its 1972 level, while bank borrowing declined. Thus, in certain respects the Swedish situation illustrates the dilemma facing a number of European countries, i.e. that of facilitating a sustainable recovery in fixed investment in the context of a large public-sector deficit combined with high real interest rates and, in some cases, an external deficit.

Developments in financial markets.

These developments in profitability, of course, affected the overall demand for credit, as was broadly reflected in the changes in sectoral financing requirements discussed earlier. However, as far as individual countries are concerned, a decisive factor appears to have been the stage of the cyclical recovery. Recent changes in the scale of total credit flows have differed significantly between countries that are still in a process of financial adjustment with low rates of growth and countries that have been leading the recovery. As can be seen from the accompanying table, the volume of total funds raised tended to decline relative to gross national product in the first group of countries, though least in those where public-sector deficits have remained high or increased further. On the other hand, total credit demand began to rise — or stopped falling — in the second group of countries. In fact the rise may have been somewhat more pronounced than in earlier cyclical upturns, reflecting the need to finance high or growing budget deficits in conjunction with a strengthening of credit and financial asset demand in the private sector.

Within the private sector, households' gross borrowing as a percentage of gross national product rose substantially in the United States, Canada, the United Kingdom (beginning in 1982) and, to a lesser extent, in Germany. Consumers seem to have financed their increased expenditure on both durable goods and housing more by stepping up borrowing than by utilising their stock of liquid assets, and in the corporate sector the sharp reduction in net borrowing needs was accompanied by a tendency to build up financial assets. Debt repayments by companies appear to have been relatively modest except in Canada, Italy, Belgium and Sweden, where real short-term interest rates attained very high levels. Nonetheless, the share of company borrowing in total funds raised generally declined in 1983 and was particularly low in the United Kingdom, Germany and Canada. In the United States, on the other hand, company borrowing increased sharply towards the end of 1983 owing to the rise in demand for bank credits noted above, and preliminary figures point to a further increase early this year.

The share of government borrowing has remained high, ranging from around 30 per cent. in the United Kingdom to 70–75 per cent. in Belgium and Canada. As in earlier years, a large proportion of the public-sector deficits in Belgium and Sweden was financed by borrowing abroad, and in other countries the impact of public-sector transactions may also have been smaller than the overall figures suggest. In the United States, it may be noted, Treasury borrowing fell in the course of the year, despite a rising net deficit, the authorities having taken advantage of relatively low private demand to borrow more early in the year. Similarly, in Germany the authorities responded to an easing of private demand by stepping up their recourse to the bond market during 1983, even though the net borrowing

Funds raised by domestic non-financial sectors.

	1975–76	1980	1981	1982	1983[1]
	as a percentage of GNP				
United States					
Households	4.3	4.4	4.1	2.8	4.9
Companies (including farm sector)	4.0	5.3	5.0	4.0	4.6
General government	5.7	3.8	3.3	6.4	6.7
of which: central government	*4.8*	*3.0*	*3.0*	*5.2*	*5.6*
Total	14.0	13.5	12.4	13.2	16.2
Canada					
Households	6.5	4.0	1.7	0.0	3.1
Companies	4.9	10.1	12.7	3.3	0.4
General government	7.5	7.5	7.7	10.1	10.4
of which: central government	*2.2*	*4.1*	*3.4*	*5.0*	*6.7*
Total	19.0	21.6	22.1	13.4	13.9
Japan					
Households	5.0	4.4	3.9	3.5	3.7
Corporate firms	10.8	7.8	8.3	8.6	8.1
Public sector	10.1	10.8	10.4	8.7	9.6
of which: central government	*5.3*	*7.0*	*6.4*	*5.0*	*6.6*
Total	25.9	23.0	22.6	20.8	21.4
Germany					
Households (including building sector)	3.3	4.9	4.1	3.4	4.2
Companies	5.0	6.0	6.5	4.9	4.6
General government	5.2	3.7	4.9	4.3	3.4
Total	13.6	14.6	15.5	12.6	12.2
France					
Households	5.0	4.4	4.4	4.1	4.1
Companies	7.7	9.2	8.7	7.7	6.7
General government	4.1	1.7	4.0	5.3	3.7
of which: central government	*2.3*	*1.4*	*2.7*	*4.3*	*2.7*
Total	16.8	15.3	17.1	17.1	14.5
United Kingdom					
Households	3.5	4.7	5.6	7.0	6.8
Companies	3.7	4.3	3.9	3.5	2.6
Public sector	8.6	5.3	4.3	2.0	3.9
of which: central government	*4.3*	*2.9*	*3.9*	*1.5*	*3.0*
Total	15.8	14.3	13.8	12.5	13.3
Italy					
Households	0.7	1.4	0.9	0.8	0.9
Companies	12.6	10.6	11.6	8.2	8.2
General government	21.5	19.6	23.0	21.0	.
of which: central government	*12.8*	*13.0*	*18.3*	*15.0*	.
Total	34.9	31.5	35.6	29.9	. .
Belgium					
Households	3.1	2.5	0.9	0.8	0.4
Companies	7.6	5.8	6.6	5.4	6.1
General government	7.0	11.7	16.2	15.5	15.3
of which: central government	*5.8*	*9.9*	*13.7*	*14.5*	*13.8*
Total	17.7	20.0	23.7	21.7	21.9
Netherlands					
Households and companies	8.5	6.8	4.7	4.1	3.1
General government	3.8	4.7	7.1	8.6	9.2
of which: central government	*2.4*	*4.0*	*5.4*	*7.1*	*8.2*
Total	12.3	11.5	11.8	12.7	12.3
Sweden					
Priority housing	4.4[2]	4.2	4.1	3.9	3.4
Other private	10.0[2]	7.9	9.5	8.4	8.6
General government	5.2[2]	10.7	12.0	13.4	11.9
of which: central government	*5.0*[2]	*10.5*	*11.8*	*13.1*	*11.9*
Total	19.6[2]	22.9	25.6	25.7	23.9

[1] Preliminary. [2] 1977.

requirement was falling. And in the United Kingdom the authorities continued to finance the entire public-sector borrowing requirement by debt sales — national savings or gilts — outside the monetary sector.

The pattern and composition of financial flows.

The banking system. Banks naturally play a central rôle in the process of financial intermediation and in the implementation of monetary policy. Since the demand for bank credit is extensively influenced by economic conditions in the private sector and by shifts in the overall pattern of borrowing, its cyclical volatility is relatively high — much higher than that of total credit. However, in recent years three additional elements have played a significant rôle — differing from country to country — and may to some extent have modified the response of the financial system to changes in credit demand. In the first place, the adoption of aggregate targets in some countries has meant that movements in bank credit tend more directly to reflect the policies pursued and the control techniques applied. Secondly, changes in the level and composition of total bank lending have been influenced by the magnitude of public-sector deficits, though in some countries the introduction of new debt instruments aimed at attracting funds from the non-bank private sector has moderated this effect. Thirdly, further initiatives to deregulate financial activity have led to shifts in the boundaries of competition between the banks, other financial institutions and the markets. In some cases this has enabled banks to compete on a more equal footing with new institutions which had arisen to challenge them.

In these circumstances, observed changes in bank credit will, of course, tend to reflect not only demand as well as supply factors but also the influence of institutional changes. This may be observed in the table on page 47, which shows the movements in bank credit over recent years together with the outcome for 1983.

Accordingly, among the four countries which recorded relatively large declines in the contribution of bank credit to the growth of the broad monetary aggregates, the fall in Canada was mainly due to the unfavourable cyclical conditions. In Sweden demand for bank credit also weakened, but primarily because firms used part of the rise in profits to repay debts. In France the decline in the contribution of bank credit was the result of both tighter policies and less favourable cyclical conditions, while in Italy new instruments helped to finance the public-sector deficit outside the banking system and bank lending to the private sector slowed down because of weak demand.

On the other hand, in those countries that saw a rise in the contribution of bank credit, the main determinants appear to have been demand factors. In the United States and Belgium there was an increase in direct and indirect bank financing of the public-sector deficit, and in the Netherlands and Switzerland private demand for bank credit provided a major source of growth. In the remaining countries the contribution of bank lending was largely unchanged from 1982, though in the United Kingdom the share of credit to the public sector rose, while it declined in Germany, reflecting both further budgetary retrenchment and an increase in borrowing outside the banking system.

Changes in bank credit and the broad money stock.[1]

Countries	Years	Contributions to changes in the broad money stock of changes in: credit to private sector[2]	credit to public sector[3]	total domestic bank credit	net foreign assets[4]	other items[5]	Changes in broad money stock[6]
		December to December, in percentage points					in percentages
United States	1980	4.9	0.9	5.8	4.5		10.3
	1981	3.8	0.0	3.8	8.6		12.4
	1982	3.4	0.9	4.3	5.7		10.0
	1983	3.1	2.3	5.4	4.6		10.0
Canada	1980	14.5	− 0.1	14.4	0.0	3.5	17.9
	1981[7]	24.7	2.0	26.7	− 2.6	− 8.3	15.8
	1982	0.3	1.1	1.4	1.5	5.1	8.0
	1983	− 6.3	4.1	− 2.2	0.2	5.5	3.5
Japan	1980	8.0	2.0	10.0	− 1.0	− 1.8	7.2
	1981	9.0	2.9	11.9	− 0.2	− 0.7	11.0
	1982	8.6	1.2	9.8	− 0.6	− 1.3	7.9
	1983	8.4	0.5	8.9	0.5	− 2.1	7.3
United Kingdom	1980	17.9	4.9	22.8	− 0.8	− 2.4	19.6
	1981	17.1	− 0.8	16.3	0.4	− 3.1	13.6
	1982	21.1	− 6.1	15.0	− 2.8	− 1.7	10.5
	1983	14.0	1.0	15.0	− 0.6	− 3.1	11.3
France	1980	11.8	− 0.5	11.3	2.0	− 3.5	9.8
	1981	15.1	2.4	17.5	− 0.5	− 5.6	11.4
	1982	14.3	2.1	16.4	− 3.2	− 1.7	11.5
	1983	9.1	3.3	12.4	0.4	− 1.8	11.0
Germany	1980	14.6	3.5	18.1	− 1.5	−10.4	6.2
	1981	11.2	6.7	17.9	2.1	−15.0	5.0
	1982	8.5	4.9	13.4	0.4	− 6.7	7.1
	1983	11.0	2.5	13.5	0.7	− 8.9	5.3
Italy	1980	7.0	12.5	19.5	− 2.1	− 0.1	17.3
	1981	4.5	12.5	17.0	0.4	− 1.5	15.9
	1982	3.8	15.2	19.0	− 0.6	− 1.2	17.2
	1983	4.5	10.9	15.4	0.8	− 1.6	14.6
Belgium	1980	5.0	8.5	13.5	− 1.2	− 8.8	3.5
	1981	4.4	7.7	12.1	−11.5	6.0	6.6
	1982	1.5	11.6	13.1	− 7.4	1.5	7.1
	1983	2.9	15.8	18.7	− 8.7	− 1.9	8.1
Netherlands	1980	17.8	4.2	22.0	− 3.7	−14.5	3.8
	1981	10.1	3.7	13.9	3.8	−12.4	5.3
	1982	5.3	4.0	9.3	3.9	− 5.6	7.6
	1983	6.9	4.7	11.6	2.3	− 3.5	10.4
Sweden	1980	10.8	14.1	24.9	− 2.6	−10.0	12.3
	1981	9.7	15.2	24.9	− 3.2	− 7.8	13.8
	1982	12.3	8.4	20.7	− 2.7	−10.3	7.8
	1983	9.4	7.4	16.8	− 0.2	− 8.5	8.1
Switzerland	1980	10.0	0.0	10.0	0.5	− 6.2	4.3
	1981	8.4	0.4	8.8	− 0.9	− 3.7	4.2
	1982	3.1	0.0	3.1	2.8	− 0.6	5.3
	1983	5.3	0.1	5.4	0.3	0.6	6.3

[1] Based on unadjusted national data which differ conceptually from country to country. [2] For the United States, Canada and Switzerland, commercial-bank credit only. [3] For the United States, commercial-bank holdings of Treasury securities only; for France, central government only. [4] For the United States, commercial banks only; for Canada, commercial banks' net foreign currency liabilities to residents and non-residents; for France, Bank of France only; for Switzerland, official reserves only. [5] Including non-monetary *bank liabilities*. [6] For Canada, France, Belgium and the Netherlands, M_2; for Japan, M_2 and CDs; for the United States, Germany, Italy, Sweden and Switzerland, M_3; for the United Kingdom, sterling M_3. [7] Twelve months to October.

It is worth adding that in a number of countries where domestic credit expansion showed a slower or unchanged rate of growth (Japan, the United Kingdom, France, Italy and Sweden), the banking system's net foreign assets increased more, or declined less, than in the preceding year. It will also be noted that in some countries (Japan, Germany, France, Italy and Belgium) an acceleration in the growth of the banks' non-monetary liabilities helped to slow down the growth of the broad money stock.

The financial system as a whole. With regard to the composition of total financial flows, one important development last year was the revival in equity markets. As can be seen from the table on page 49, the increase in share issues, which was triggered by a worldwide boom in share prices, was especially marked in the United States and the United Kingdom. However, companies in Canada, Germany, France, Belgium and Sweden, though reducing their total recourse to external financing, have also raised the proportion accounted for by equity issues. While a more favourable outlook for the business sector, combined with efforts to restructure balance sheets, appears to have been the main factor behind this development, specific measures also played a rôle. In Belgium, France and Sweden the acquisition of equities was encouraged by special tax allowances. Institutional changes, such as the creation of mutual funds and parallel markets giving increased access to smaller firms in particular, have been or will be introduced in the Netherlands, France and Italy. In the United Kingdom the opening of unit trust accounts, as well as the strong growth in the unlisted securities market, seem also to have supported the general rise in equity issues.

Institutional changes and financial innovations have also been important in developing new ways of financing budget deficits (as will be discussed further below) and in supporting residential construction. The higher share of mortgage loans in the United States, for example, was influenced by the offering of loans with variable interest rates. In the United Kingdom the share of mortgages has also increased sharply, reflecting not only the upturn in residential construction but growing competition between banks and building societies and also some use of mortgage loans to finance current spending.

Yet another feature which is ascribable to institutional as well as sectoral and cyclical developments is the evolving rôle of credit supplied outside the banking system. Partly for reasons of definition, but also reflecting different institutional structures and market developments, the average shares of non-bank credits tend to vary from country to country. In addition, there have been rather large differences between countries with respect to the most recent changes. As shown in the table on page 50, in the United States the surge in credit demand has mainly been met by banks, and in Germany, too, banks have increased their share of the total supply of credit. In the United Kingdom, where the total supply of credit rose relative to gross national product, the share of bank lending fell slightly, but this seems chiefly to have been due to developments during the first half of 1983, when firms temporarily stepped up their capital-market borrowing and used the proceeds to repay bank loans. Belgium and the Netherlands have recorded the largest increases in the share of bank lending, but in the case of Belgium this does not seem to reflect an underlying rise in credit demand. Instead it may be ascribed to a contraction in non-bank credit and an increase in the share of the budget deficit financed via the domestic banking system.

Funds raised by domestic non-financial sectors, by instrument or source.

	1975–76	1980	1981	1982	1983[1]
	as a percentage of total funds raised				
United States					
Loans and open-market paper	6.4	13.3	26.8	17.1	13.4
Mortgages	31.2	37.9	31.3	20.4	31.3
Bonds and securities	52.0	38.3	35.9	56.7	45.7
Equities	4.5	3.6	– 3.1	2.8	5.3
Other	5.9	7.0	9.1	3.0	4.3
Canada					
Loans and mortgages	49.6	50.7	53.0	– 6.5	4.7
Bonds and short-term securities	26.4	39.0	31.2	76.2	75.2
Equities	2.8	5.9	6.7	8.7	9.2
Other, including borrowing abroad	21.2	4.4	9.1	21.6	10.9
Japan					
Loans	69.7	60.2	61.3	65.9	64.2
Securities	28.0	35.8	37.0	30.3	33.5
Equities	2.6	2.6	3.7	3.7	2.3
Other, including borrowing abroad	– 0.3	1.4	– 2.0	0.0	0.0
Germany					
Loans	65.6	71.9	65.7	57.2	67.5
of which: long-term and mortgages	*59.0*	*48.1*	*47.6*	*43.4*	*55.1*
Securities	10.9	0.8	0.5	18.4	16.1
Equities	2.9	2.4	1.5	2.2	2.9
Other, including borrowing abroad	20.6	24.9	32.4	22.2	13.6
France					
Loans	76.0	75.5	70.0	64.1	62.3
of which: long-term and mortgages	*54.7*	*54.2*	*44.4*	*44.3*	*45.4*
Securities	12.6	9.9	16.0	25.9	26.7
Equities	6.7	11.3	9.7	5.9	8.7
Other, including borrowing abroad	4.7	3.3	4.3	4.1	2.3
United Kingdom					
Loans	41.2	59.8	60.2	70.3	52.6
of which: long-term and mortgages	*23.6*	*22.7*	*29.1*	*43.0*	*38.2*
Securities	35.2	31.2	27.5	18.4	31.2
Equities	4.9	2.8	4.8	2.7	4.3
Other, including borrowing abroad	18.7	6.2	7.5	8.6	11.9
Italy					
Loans	54.9	55.8	47.8	42.0	.
of which: long-term and mortgages	*21.6*	*19.0*	*18.1*	*18.9*	.
Securities	28.9	23.5	29.9	42.9	.
Equities	5.5	6.2	7.9	8.8	.
Other, including borrowing abroad	10.7	14.4	14.4	6.3	.
Belgium					
Loans	40.3	25.8	12.8	6.6	4.5
Bonds	45.6	26.1	15.1	34.7	49.3
Equities	5.3	5.7	5.6	12.1	13.1
Other, including borrowing abroad	8.8	42.5	66.4	46.5	33.1
Netherlands					
Loans	86.0	84.4	78.9	65.7	54.6
Securities	13.3	14.9	20.9	34.2	43.6
Equities	0.6	0.7	0.2	0.1	1.8
Sweden					
Loans	29.7[2]	20.0	9.3	15.5	.
Bonds	28.1[2]	37.8	52.5	43.7	.
Equities	6.4[2]	5.9	5.4	6.9	8.4
Central-government lending	7.8[2]	11.7	8.3	8.2	9.7
Other, including borrowing abroad	28.1[2]	24.5	24.5	25.6	.

[1] Preliminary. [2] 1977.

In the remaining countries shown in the table the share of credit flows outside the banking system rose in 1983, but the reasons for the increase again differed from country to country. In some cases it may be explained by weak demand for the kind of credits normally supplied by banks, whereas in others it reflected attempts to strengthen the rôle of the capital markets. In Canada bank lending actually fell owing to the unfavourable cyclical conditions and firms' repayment of bank loans. In Sweden, too, firms have been repaying domestic bank loans, but an additional factor has been the authorities' attempt to finance a larger part of the budget deficit outside the banking system. The latter factor has also played a major rôle in Japan and Italy, where borrowing outside the banking system increased substantially. Finally, in France the rise in the share of non-bank credits may be ascribed to various measures taken to strengthen the rôle of the capital markets in meeting both private and public-sector borrowing needs.

Domestic bank credit as a share of total credit.[1]

	1975–76	1980	1981	1982	1983[2]
	in percentages				
United States	19.8	29.3	21.0	23.7	24.8
Canada	28.2	20.9	38.2	3.7	− 5.4
Japan	51.5	35.8	43.7	41.4	38.0
Germany	60.8	57.9	55.1	51.8	54.9
France	44.4	34.3	46.7	42.1	38.3
United Kingdom	32.7	39.2	31.8	36.2	34.2
Italy	.	58.0	41.5	54.6	.
Belgium	30.7	29.2	22.0	25.5	36.6
Netherlands	69.4	58.4	35.6	22.5	30.5
Sweden	45.1[3]	58.4	53.8	46.2	38.5

[1] For all countries measured as the domestic bank credit counterpart to the broad money stock (see table on page 47) in percentage of total funds raised by the domestic non-financial sectors. [2] Preliminary figures. [3] 1977.

The distinction between bank and non-bank lending is not, of course, identical with that between money and credit markets, on the one hand, and capital markets on the other. Nor does the breakdown of lending into broad categories of instruments help very much to show the shifts between short and long-term lending. In a general way, however, it does help to confirm that fund-raising in the form of longer-term loans and mortgages, equities and, in particular, securities issued by the public sector appears to have grown in importance last year.

Financial innovations.

Last year's Annual Report pointed out how financial innovations have had a significant impact on the way in which financial institutions fund their activities and, more broadly, on the process of private financial intermediation. The remainder of this chapter aims to extend last year's discussion of financial innovations by providing a long-term perspective of innovations in techniques for placing mounting stocks of government debt and for the management of heightened interest rate risk through the trading of futures contracts.

Government debt.

Sizable fiscal deficits from the mid-1970s onwards have led to dramatic changes — government-induced financial innovations, as it were — in the mix of financial instruments, in institutional boundaries and in the importance of market-determined interest rates. In particular, surges in government debt offerings prompted major financial-sector adjustments in countries — such as Italy, Spain and Sweden — which had relied on administrative control of financial intermediaries' credit portfolios, such as minimum investment ratios and ceilings on lending to the private sector, to distribute government debt. Frequent upward adjustments of compulsory holdings of government and other priority-sector debt were common, as governments sought to hold down their own borrowing costs and those of designated priority sectors.

The additional cost burdens of compulsory investment in government debt, together with attempts by financial intermediaries to shift these costs onto their customers, contributed to the introduction and wider use of less conventional financial alternatives. This diversion of economic agents' financial transactions away from recognised national channels towards "free" alternatives, including the Euro-currency market, represented a major response to the rising implicit costs of using conventional domestic financial markets. For monetary authorities, such adaptations of financial practices (whether they involved new institutions or new instruments) made it more difficult to measure, define and interpret the behaviour of credit and monetary aggregates.

Mounting difficulties in using non-market techniques to place government debt domestically (for example, those which arose between the Government and member banks of underwriting syndicates in Japan) and increasing concern about the current and prospective exchange rate consequences of over-reliance on foreign borrowing prompted revisions of domestic debt management policies. Under these revised policies, public debt managers cede more responsibility to market participants in the pricing and distribution of public debt. In turn, the acceptance of more market-based public debt management techniques has been complemented, in a number of countries, by efforts to rationalise financial-sector regulation through the removal of mandatory investment requirements, interest rate ceilings and restrictions on secondary-market transactions in securities. Three recent examples of such loosening of controls on credit markets are those in Japan, where from June 1984 banks will be able to sell seasoned government bonds to their customers; in Italy, where the practice of setting ceilings on new bank lending has been discontinued since June 1983; and in Sweden, where auctions of government bonds were initiated in early 1984.

Public debt managers have tended to accept the need to accommodate the more uncertain expectations of market participants by making fuller use of the short maturity range for public debt offerings. However, monetary policy considerations weighed against the issuance of short-term public debt in several countries, such as the Netherlands, in which the monetary authorities monitor broad monetary or liquidity aggregates. These restrictions on public debt management reflect the view that the public issuance of short-dated Treasury securities would unnecessarily interfere with the conduct, and possibly complicate the execution, of monetary policy. A second argument advanced by monetary authorities for not issuing Treasury bills has been the need to limit the attractiveness of short-term investment outlets so as to curb the development of their currencies as international investment vehicles. On the other hand, the development of a domestic Treasury bill market has been encouraged by a number of monetary authorities. Sponsorship by these authorities reflected their announced objectives of moving to monetary control systems which rely on the entire spectrum of maturities for the placement of public-sector debt and for a market determination of interest rates.

Large public borrowing requirements have also facilitated the attainment of secondary financial policy objectives which might otherwise not have been actively pursued. For example, in Germany a new public debt instrument with a low minimum denomination has been introduced to improve the overall level of real returns on financial savings available to German households. These five-year special Federal bonds (Bundesobligationen), first issued only in 1979, accounted for 14 per cent. of outstanding German Federal debt at the end of 1983. The attractiveness of these bonds to households is due to the fact that unlike savings accounts they offer a market-related rate. Traditional savings depositories have responded to the competitive challenge posed by this public-sector financial innovation by improving their offering terms on household accounts.

Interest rate risk.

Heightened interest rate volatility in recent years has made economic agents more sensitive to the consequences of financial risk exposures, for example to those implicit in wider use of variable rate bank loans. As a means of enabling economic agents to manage their risk exposures, techniques have been developed that are designed to transfer foreign exchange and interest rate risk to those more willing (or able) to bear it. In this regard, the major financial innovation has been the organisation of futures exchanges for the trading of interest rate and currency futures contracts. The following discussion focuses on the trading of interest rate futures contracts.

Organisation of futures trading. An interest rate futures contract is a standard agreement between a buyer and a seller for the delivery of a fixed round lot of a specific financial instrument, such as a three-month, 1 million Euro-dollar time deposit, on a given future date at an agreed price. All trading in interest rate futures contracts must be executed on the trading floor of an exchange where all transaction prices are instantly made available by the exchange to all other market participants. This method of trading is described as one of open outcry.

An important characteristic of a futures exchange is that, although each contract involves a buyer and a seller, their obligation is not to each other but to the clearing house of the exchange. The clearing house guarantees the performance of every transaction conducted on the exchange. This is in marked contrast to over-the-counter markets, such as the international interbank money market, where there are no facilities for the pooling of credit risks.

The credibility of clearing houses' performance guarantees rests on the system of margin requirements imposed on futures-market participants. Both buyers and sellers of futures contracts have to put up margin to provide a cushion against adverse daily price movements of their outstanding (open) position in futures contracts. Every trader's futures account is adjusted daily to reflect profits and losses, and before the start of the next trading session every account either disburses or collects funds to complete the daily settlement process.

Potential contribution. To understand the potential contribution of interest rate futures markets to financial systems, one must first examine the economic capabilities of futures contracts: (i) to substitute for money and securities (cash) market transactions; (ii) to change the relationship between measures of aggregate wealth and interest rates; (iii) to insulate economic agents from changes in opportunity costs implied by changes in the level of interest rates; and (iv) to affect the efficiency of underlying cash markets.

Firstly, for interest-bearing securities, there is no futures contract whose economic characteristics cannot be duplicated in the cash markets. Financial futures markets are used because they offer lower transaction costs for standard (non-customised) types of contract. Futures exchanges give rise to organised markets for the trading of a particular contract, such as the three-month Euro-dollar time deposit, only if it appears that the prospective trading volumes justify the expenditure of real resources to support trading in the contract. An implication of this requirement is that the actual number of traded futures contracts will be limited, since a proliferation of contracts will tend to raise transaction costs. In fact, there are now only about ten types of actively traded interest rate futures contracts. In addition, for each of these contracts, the number of contract delivery months is limited to at most four per year, with trading in no contract extending beyond a three-year future delivery. Thus, interest rate futures markets have only limited capabilities for the hedging of the specific interest rate exposures of economic agents. Take, for example, a borrower of a variable rate loan with an interest cost based on the three-month LIBOR interest rate. Available evidence indicates that the hedging efficiency of sales of a Euro-dollar futures contract for such a borrower is negatively related to the time span between the loan repricing date and the subsequent Euro-dollar futures delivery date.

Secondly, the existence of an interest rate futures market cannot affect aggregate wealth. Only individual economic agents can change the relationship between the valuation of their financial holdings and interest rates through trading in interest rate futures contracts. The result of trading in interest futures can only be a re-allocation of interest rate risk among economic agents.

Thirdly, hedging interest rate risks through futures markets does not insulate participants from changes in interest rates once they have occurred. To illustrate this proposition, consider a firm that holds a goods inventory which is being financed by variable rate bank loans. By selling futures contracts, the firm protects (hedges) its inventory-financing costs against a possible rise in bank loan rates. Now suppose there is such an increase in these bank loan rates. The gain on the firm's futures position would tend to enable it to finance its current inventory level as if interest rates had remained the same. But a profit-maximising firm would still want to reduce its future planned inventory levels in response to the now higher interest costs of inventory investment.

Fourthly, the performance of cash markets for debt instruments may be influenced by the introduction of interest rate futures markets. Empirical studies on interest rate futures trading have found that trading in these instruments has, on average, either helped to stabilise cash-market prices or has had no effect on such stability. In addition, it has been found that price changes for futures contracts in Euro-dollar and domestic US money-market instruments exhibit contemporaneous behaviour, a relationship that has not been discovered for price changes in the underlying markets. This finding suggests that the establishment of futures markets in these money-market instruments may have further tightened the integration of the US domestic and Euro-dollar money markets.

Development of trading in interest rate futures.

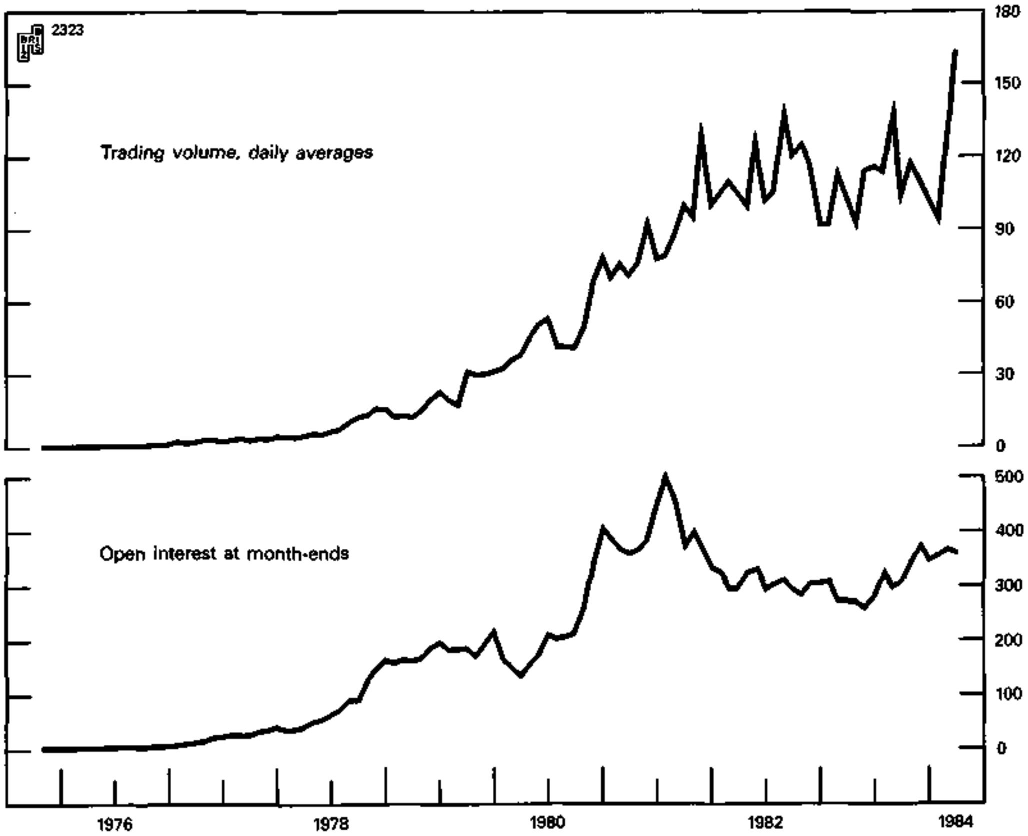
Trading in interest rate futures contracts for US dollar-denominated instruments was pioneered on the two Chicago commodity exchanges in the mid-1970s. Trading volumes on the two exchanges rose only modestly prior to the late-1970s. Since that time the volume of daily trading has surged from less than 20,000 to more than 160,000 contracts per day, totalling more than $40 billion in face values. However, it is interesting to note that the open interest total for interest rate futures (number of contracts outstanding) has not displayed a similarly strong upward trend. In fact, the total of open positions in interest rate futures was more than 25 per cent. below its mid-1981 peak at the end of the first quarter of 1984. The fall-off was more than accounted for by reduced outstanding positions in long-term interest rate futures and, therefore, most likely reflects the reduced divergence of opinion among market participants concerning expected movements of long-term US dollar interest rates.

Interest rate futures markets in the United States outside Chicago have not been successful. In particular, the New York Futures Exchange, which opened in 1980, failed to attract trading interest to any of four interest rate futures contracts. Nonetheless, interest rate futures trading in US dollar and sterling-denominated financial instruments appears to have become fairly well established on the recently opened (1982) London International Financial Futures Exchange. Interest rate futures trading has also been organised on domestic exchanges for Australian and Canadian dollar financial instruments. A further expansion of Euro-dollar futures trading, including a mutual offset link with one of the futures exchanges in Chicago, is scheduled for mid-1984 with the opening of the Singapore International Monetary Exchange.

Bank participation. Banks now actively participate in interest futures trading, primarily to manage their own money-market and investment securities positions and, secondarily, on behalf of customers. The extent of the internationalisation of trading interest in futures markets is indicated by the reported participation of forty-seven non-US-based banks from fifteen countries.

Trading activity in interest rate futures.*

Number of contracts, in thousands.



* Total of six interest rate futures contracts traded on the Chicago Board of Trade and the International Monetary Market.

Commercial-bank participation in US interest rate futures markets.

Contracts	US-based banks	Non-US-based banks	Total
	number of banks with a reported open position in 1983[1]		
Short-term			
Euro-dollar deposits	33	34	67
US Treasury bills	40	20	60
US domestic CDs	34	11	45
Long-term			
US Treasury bonds	35	19	54
GNMA[2]	19	1	20
US Treasury notes	24	4	28
One or more of above contracts	64	47	111

[1] Based on data on open positions of traders above minimum reporting levels for each type of contract. [2] Government National Mortgage Association, an agency that approves the issue of mortgage-backed securities with repayment of principal and payment of interest guaranteed by the US Government.

The data on open interest positions shown in the accompanying table suggest that US and non-US-based banks employ interest futures in connection with the management of their participation in the Euro-dollar money market. The very large long positions (purchases of Euro-dollar futures) of non-US-based banks, with a face value equal to $22 billion at the end of the first quarter of 1984, are thought to be primarily accounted for by banks choosing to hedge the interest risk attaching to term Euro-dollar deposits received from customers through purchases of Euro-dollar futures contracts rather than through interbank transactions. Participation by US-based banks in the three long-term interest rate contracts reflects their involvement as dealers in the US Treasury securities markets.

Distribution of open interest positions in US interest rate futures contracts at the end of the first quarter of 1984.

Contracts	Total face value of open positions	Distribution of open positions[1]					
		futures purchases			futures sales		
		commercial banks		all others	commercial banks		all others
		US-based	non-US-based		US-based	non-US-based	
	in billions of US dollars	as a percentage of total					
Euro-dollar deposits	62.0	28	36	36	14	1	85
US Treasury bills	48.8	10	1	89	9	1	90
US domestic CDs	31.0	19	2	79	16	1	83
US Treasury bonds	15.8	7	0	93	9	0	91
GNMA[2]	3.7	2	0	98	5	0	95
US Treasury notes	2.2	13	0	87	7	0	93

[1] Based on data on open positions of traders above minimum reporting levels for each type of contract. [2] Government National Mortgage Association, an agency that approves the issue of mortgage-backed securities with repayment of principal and payment of interest guaranteed by the US Government.

Overall, US and non-US banks have found it increasingly attractive to employ futures positions as well as interbank market positions to manage interest rate risk. Firstly, there have been reductions in commissions and improvements in the liquidity of futures markets. Secondly, futures positions are not reflected in banks' balance sheets. The use of futures tends to reduce the constraints imposed on banks' position-adjusting by market and regulatory restraints on gearing. To some observers, such preferential treatment of futures, as opposed to interbank, trading is justified by the smaller credit risks associated with the daily settlement procedures of organised futures exchanges.

Further expansion. Major securities exchanges in Germany, Japan and Switzerland have been exploring the feasibility of starting up interest rate futures trading denominated in Deutsche Mark, Japanese yen and Swiss francs respectively. Direct interest rate futures contracts would compete with, among other alternatives for interest risk management in these three currencies, the combined trading of currency and interest rate futures on the established exchanges in Chicago and London. The potential organisers of these exchanges are aware that the commitment of capital to such organisation efforts is very risky, given that the underlying demand of economic agents for specific financial exposure management techniques must be sufficient to justify the costs of organising and maintaining futures markets. In particular, there is a question about the need for, and viability of, interest rate futures markets in countries with historically stable interest rate environments. On the other hand, it is argued that even in these countries the sensitivity to interest rate risk has been considerably heightened in recent years. Moreover, in Japan the introduction of interest rate futures trading could positively affect the performance of the government securities market.

Policy issues raised by futures markets.

The emergence of markets for financial futures has raised a number of policy issues: firstly, the effect such contracts might have on the operation of monetary transmission mechanisms; secondly, the impact of financial futures markets on the soundness of financial systems; and thirdly, the effect of futures trading on the overall performance of financial markets.

Monetary policy. The spreading of futures-market participation and contracts could significantly affect, as other financial innovations have, the definition and measurement of the various broad monetary and credit aggregates. It has also been argued that the availability of interest rate futures may allow traditionally interest-sensitive economic sectors to insulate themselves from fluctuations in interest rates and, therefore, reduce the overall potency of monetary policy. However, as noted above, this argument has little foundation since futures do not change the opportunity costs of different activities.

Soundness. Financial futures reduce the cost of taking positions, but their availability does not bias an economic agent's choice in favour of either more or less interest rate risk. The introduction of interest rate futures has caused concern about the adequacy of financial reporting of interest rate exposure. In particular, bank supervisors are now addressing the problem of how to take into account a bank's position in interest rate futures when measuring its interest rate exposure.

Overall performance of financial markets. To the extent that financial futures markets contribute to a reduction of resources devoted to interest risk management, their use lowers the total resource costs of financial markets. The acceptance of the premise that financial futures improve the efficiency of financial markets has led to recommendations that various legal and regulatory restrictions on the use of futures, such as those applied by US state regulatory agencies to insurance companies, be removed. On the other hand, it has been argued that the acceptance by public agencies of such risk management techniques has the effect of weakening the pressure on monetary and fiscal authorities to conduct appropriate policies of their own.

IV. MONETARY POLICY AND INTEREST RATES.

Highlights.

Medium-term strategies aimed at moderating and stabilising inflation and inflation expectations continued to condition monetary developments last year. However, for a variety of reasons — the earlier decline in inflation and interest rates, continuing financial innovation and international movements of funds — the course of these developments, and changes in the monetary aggregates, were in some countries difficult to interpret. In the United States key aggregates rose rapidly in late 1982 and early 1983 under the influence of the marked slowdown in inflation, an apparent strong demand for precautionary balances and the introduction of major new financial instruments. The monetary authorities sought to make due allowances for these changes, however, and after mid-year more stable relationships between the money stock and economic activity seemed to be re-emerging. High rates of monetary expansion were also recorded in some other countries in the first half of 1983, but they were attributable mainly to disturbances of a temporary nature.

In the United States private demand for credit strengthened after mid-year, but the growth of key monetary aggregates slowed down under the influence of a return of consumer and business confidence and a correction of the policy course. By early 1984, with the recovery showing no signs of weakening and market pressures rising, monetary policy had to take into account fears that inflation would begin to quicken again. Rates of monetary expansion also slowed down in some other major countries in late 1983, and fairly generally the objectives for 1984 aimed at keeping the pace of monetary expansion quite moderate.

In the United States both short and long-term interest rates have risen over the past year. In several European centres and in Canada short-term rates stopped declining in the spring of 1983 and thereafter changed little on balance. However, although recovery forces in Europe remained subdued, bond yields began to rise in step with interest rates in the United States as the dollar strengthened. In Japan interest rates fell on balance in 1983, but the limited extent of the decline reflects exchange-market considerations which had to be taken into account in formulating monetary policy. In early 1984, with the dollar easing, there were further rises in interest rates in the United States but falls in some other countries. In the spring, however, higher US interest rates contributed to a strengthening of the dollar and interest rates rose in the United Kingdom and Canada.

With nominal interest rates firm as inflation rates fell, real interest rates in many countries rose further last year. In the United States, where the increase seems to have been particularly large, it reflected among other things the Government's huge present and prospective borrowing needs, combined with a recovery in private-sector credit demand as the economy picked up speed. Against the background of the fiscal demand stimulus, high real interest rates did not prevent a revival of private investment — but they helped to attract large capital inflows, thus contributing to the strength of the dollar and, therefore, to the growing imbalance in the US external current account. In other key countries structural budget deficits were being cut back with a view to preparing the way for a recovery in private investment and growth. Under more normal conditions such a retrenchment policy should have contributed to a lowering of real interest rates in Europe and Japan. Instead, these remained quite high in some countries, under the influence of rates in the United States and international markets, and contributed to a continuing low rate of fixed capital investment.

Developments in the money stock and in aggregate-oriented policies.

Developments in the monetary aggregates last year were again influenced by a variety of factors, permanent, temporary and purely random. At the same time, monetary aggregate control strategies have not lost sight of their medium-term orientation. Whether the objectives are published for several years in advance or year by year, they express the intention of avoiding systematic or continuing divergence of policy from a consistent course. In no country does monetary management now aim at close control over the aggregates over periods of less than several months or quarters. When monetary developments seem to be diverging from the target path, however, the monetary authorities have to consider whether the original objective is still appropriate or whether changes in the setting of policy instruments are called for. Many kinds of indicators may have to be taken into account in judging the response. Last year the nature of the disturbances encountered differed from one country to another. In most cases they appeared to be only temporary, although in the United States the influence on the demand for money of a decline in inflation expectations seemed to justify a once-over rise in the level of the money stock. On the whole, there were reasonable grounds for hoping that the difficulties would prove manageable and that the targeting approach, subject to careful interpretation of underlying influences, would remain useful in the future.

Through much of the first half of last year, key monetary aggregates in several of the industrial countries appeared to be expanding quite rapidly in relation to the authorities' objectives for the year. As in the United States, this seems in some cases to have reflected the effects of disinflation on inflationary expectations and the willingness to hold money balances. However, important differences have to be taken into account in interpreting these developments. In particular, large changes in the financial system were taking place in the United States and the United Kingdom, and to some extent also in various other countries. In Germany, on the other hand, monetary developments were influenced by domestic and external disturbances of a quite different kind. The objectives for some aggregates in the United States were adjusted during the year, but no change of this kind was made in other countries. In Germany and the United States the policy course was corrected, but the implied movement of interest rates was quite modest. Yet, fairly generally, by late 1983 and in early 1984 the expansion of the targeted aggregates was quite closely in line with the objectives, even though in most cases the pace of economic activity was quickening.

Monetary developments in the *United States* last year have to be viewed against the background of financial innovation and regulatory changes which had substantially altered the range of financial instruments available to the public.

In the course of 1982, in a context of recession and dramatic declines in inflation rates, the narrow money stock began to rise very rapidly and came to seem increasingly unreliable as a policy guide. Following the authorisation in late 1982 and early 1983 of two new types of interest-bearing accounts which households could use for transactions purposes — "super NOW" (negotiable order of withdrawal) and money-market deposit accounts — there was also a sharp upsurge in M_2. Reflecting the uncertainties in the situation, the growth ranges set in February 1983 by the Federal Reserve for M_1 and M_2 in 1983, at 4–8 and 7–10 per cent. respectively, were higher and wider than those used in 1982, while a February-March 1983 base (instead of the usual fourth-quarter one) was established for measuring M_2 growth. For the time being, the Federal Reserve announced, M_1 and total debt of domestic non-financial sectors would be monitored, but considerable weight would continue to be placed on the behaviour of the broad monetary aggregates.

In the spring the Federal Reserve became somewhat less accommodative in the provision of non-borrowed bank reserves. Between May and August the Federal funds rate rose by about one percentage point. Reflecting the view that the previous growth in M_1 should be regarded as a one-time phenomenon which should be neither reversed nor continued, a new base for measuring M_1 growth was established in July. In the second half of the year the growth in this aggregate slowed down, but, as revised statistics published in early 1984 revealed, its growth rate remained close to the centre of the target range.

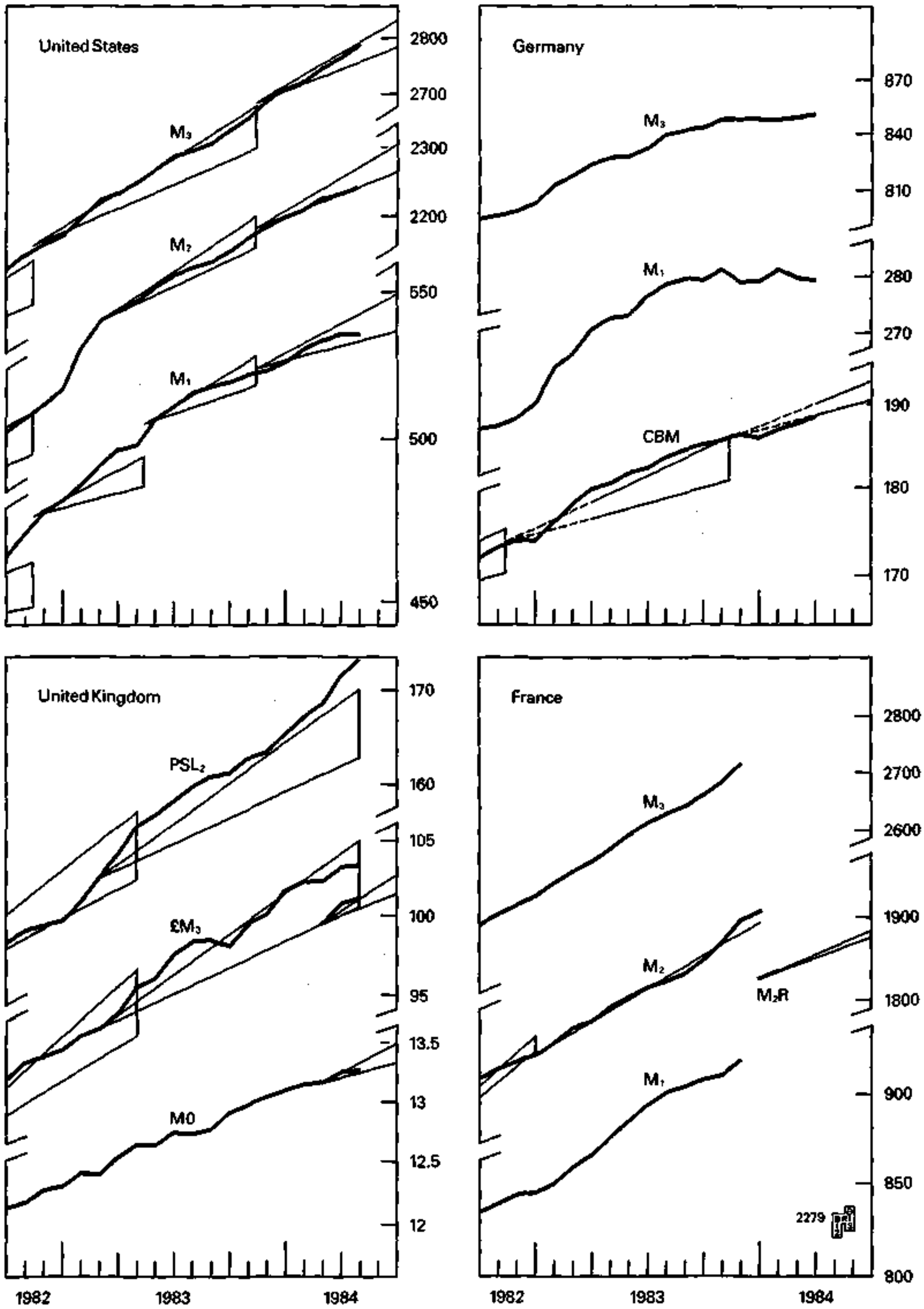
The growth ranges for the aggregates in 1984, published in February, were ½ to 1 percentage point lower than those set in 1983. For the time being, the Federal Reserve stated, it would be appropriate for the growth of M_1 to remain near the centre of the target range. In implementing policy, the Board would continue to give substantial weight to the broad aggregates.

Since mid-1982 the Federal Reserve's monetary control procedures, while still geared to the supply of bank reserves, have not entailed automatic responses to short-term movements in the money stock. No precise targets for interest rates have been set, but the Federal funds rate has generally been much less volatile than in the October 1979–June 1981 period. The change-over in February 1984 to a system of contemporaneous reserve-requirement accounting, as arranged much earlier, potentially permitted closer short-run control of the narrow money stock. However, taking into account the uncertainties associated with the change, and those still associated with interpreting developments in M_1, the Board decided not to make a substantial change in its operating procedures.

In *Germany* financial innovation has not seriously distorted monetary developments and, in particular, has not impaired the usefulness of the central-bank money stock as an intermediate objective of policy.

Monetary aggregates: Objectives and development.*

In billions of national currency units.



* Aggregates as defined in the table on page 63; semi-logarithmic scales. For France, centred three-month moving averages.

In 1982 the expansion of central-bank money had been in the upper half of the official target range, just as the Bundesbank had envisaged in setting the objective, and in early 1983 a similar outcome for last year was planned. Rapid monetary expansion in the early months of last year, as the Bundesbank recognised at the time, was mainly attributable to special influences — including inflows of funds in conjunction with exchange rate tensions in the European Monetary System. In addition, however, bank lending was beginning to expand rapidly and the growth in longer-term placements with banks was less fast. Under the influence of tighter money-market management from the spring onwards, the pace of monetary expansion slowed down, and for the year as a whole the rise in central-bank money was just within the target range. The upper limit of the target range set for 1984 was lower than that for 1983, but the new range could accommodate continued expansion of the aggregate at about the rate recorded in the second half of 1983. In January–March 1984 the growth rate of central-bank money was quite moderate.

In the *United Kingdom* most of the aggregates expanded at rates in excess of the upper limit of the authorities' target range in the spring and summer of 1983, with quite large increases being shown by the broad aggregates. Intensified competition among financial intermediaries for personal-sector deposits seems to have been one influence. Taking into account other indicators of financial conditions, the authorities refrained from taking corrective interest rate action and, in the event, the growth of the aggregates slowed down. For the 1984–85 targeting period a new, narrower range was set for sterling M_3 (redefined to exclude public-sector deposits), and a lower range was published for a narrow aggregate, M0, which includes only the liabilities of the monetary authorities – mainly notes and coin in circulation. The behaviour of these aggregates will be interpreted in the light of developments in M_2 (non-interest-bearing transaction accounts and retail deposits) and PSL_2 (private-sector liquidity) and in other financial indicators, including the exchange rate. In the budget speech, the Chancellor of the Exchequer also reaffirmed the Government's commitment to medium-term money stock stabilisation objectives by publishing progressively declining norms for monetary expansion for the yearly target periods up to 1988–89.

In *Japan* the growth of M_2 and CDs was quite moderate and stable throughout last year. Though the economy was growing only slowly, the Bank of Japan delayed a relaxation of monetary policy because of the weakness of the yen against the US dollar. The official discount rate was lowered from 5½ to 5 per cent. in October. In *France* bank credit was kept within tight bounds and non-monetary placements by the public rose strongly. However, in the context of a rise in the official foreign exchange reserves and disturbances late in the year the growth of M_2 in 1983 went beyond a highly restrictive limit which had been set by the Government in announcing its economic adjustment programme. For 1984 the objective refers to resident holdings of M_2 only (M_2R) and implies a marked slowdown in monetary and credit expansion. In *Switzerland* the growth of the monetary base quickened a little last year in the context of official intervention in the exchange market at a time when the Swiss franc was strengthening against other European currencies. An unchanged objective was set for 1984. In *Italy*, where the objective is for total domestic credit, the target for 1983 could not be met, because the Government's

Monetary and credit aggregates: Objectives and rates of expansion.

Countries	Monetary or credit aggregate[1]	Objective[2] for 1983[3]	Monetary or credit expansion[4] in 1983	Objective[2] for 1984[3]	Monetary or credit expansion changes over four quarters in quarterly averages: 1983 first quarter	1983 second quarter	1983 third quarter	1983 fourth quarter	1984 first quarter
		in percentages[5]							
United States	M_1	5–9	7.2	4–8	9.4	12.0	12.9	10.0	8.5
	M_2	7–10	8.3	6–9	12.5	13.3	12.7	12.1	8.4
	M_3	6½–9½	9.7	6–9	10.6	10.4	9.7	9.7	9.2
	TDND	8½–11½	10.6	8–11	9.1	10.0	10.1	10.6	11.5
Japan	M_2+CDs	7	6.8	8	6.7	7.4	7.6	6.8	7.8
Germany	CBM	4–7	7.0	4–6	7.1	7.5	7.7	7.0	5.4
France	M_2	9	10.2	5½–6½	11.4	9.8	8.1	9.7	.
United Kingdom . . .	M0	–	–	4–8	3.9	6.3	6.3	6.4	5.8
	M_1	7–11	10.5	–	11.6	15.2	13.2	11.2	11.3
	£M_3	7–11	10.0	6–10	9.8	11.0	10.8	9.9	10.1
	PSL_2	7–11	12.1	–	9.3	11.4	12.3	12.1	12.3
Italy	TDC	18	20.6	17½	20.4	20.6	20.4	20.6	.
Switzerland	CBMA	3	3.6	3	7.6	2.4	2.6	2.0	1.1

[1] TDND=total domestic debt of non-financial sectors; CBM=central-bank money; CBMA=adjusted central-bank money; £M_3=sterling M_3; PSL_2=private-sector liquidity; TDC=total domestic credit. [2] For Japan, projection only; for France, limits. For Italy, the percentages are based on limits expressed in terms of lire. [3] Periods running from the fourth quarter to the fourth quarter for the United States (except for M_1 and M_2 in 1983), Japan (1983) and Germany, and from December to December for Italy. Periods based on November–January averages for France and on February 1983 and 1984 for the United Kingdom. Annual averages for Switzerland. For the United States, the targets shown for M_1 and M_2 for 1983 are those established in July 1983 for periods running from February–March (M_2) and the second quarter (M_1) to the fourth quarter. In February 1984 the definition of M_3 was changed to include term Euro-dollars held by US residents. For Japan, for 1984 the second quarter to second quarter projection is shown. For France, the target for 1984 applies to M_2R, which includes only resident holdings of M_2 assets. For the United Kingdom, the definition of £M_3 for 1984–85 was changed to exclude public-sector deposits. [4] Calculated on the same basis as the objective. [5] At annual rates where the period is other than one year.

borrowing requirement again far exceeded the official estimate. A substantial rise in the public's holdings of securities, however, helped to moderate the growth of M_2 and, to a lesser extent, M_3. The mandatory ceiling on bank credit to the private sector was abolished in June, the intention being that in future monetary and credit control should rely more on influencing bank reserve positions.

Rapid rates of expansion of key aggregates were recorded in the first half of last year in some smaller European countries, including the *Netherlands*, *Austria* and *Denmark*. In most cases, however, the context was one of declines in nominal interest rates and in inflation, brought about with the help of non-accommodating monetary policy oriented more by other guides. In Denmark, where M_2 rose by 24 per cent. in 1983, bond yields fell sharply in relation to interest rates on deposits and the banks accommodated changes in the public's asset preferences by large net purchases of bonds.

None of the difficulties experienced last year in the countries targeting monetary aggregates proved to be insurmountable, and in all cases the usefulness of targets for the aggregates has been reaffirmed. In *Canada*, where the targeting of M_1 had to be terminated in 1982 because of ongoing financial innovation, the search for a more suitable aggregate continued last year. In several European countries objectives for monetary or credit aggregates are viewed as complementary to efforts to stabilise exchange rates in a regional context, and in the United States aggregate targeting has recently proved consistent with much more stability in interest rates than prevailed prior to mid-1982.

In recent years various kinds of policy régimes have been proposed as alternatives to aggregate targeting. These include schemes in which monetary policy would be geared to short-run objectives for nominal GNP, commodity prices or real interest rates, or to stabilising exchange rates on a worldwide plane. Over the past year, however, all of these variables have been strongly influenced by disturbances and imbalances of a non-monetary origin. Objectives for them, in the conditions prevailing last year, might have implied more expansionary monetary policies, which could have placed at risk the hard-won gains made in recent years in stabilising inflation expectations.

Monetary aggregate policies and the economic recovery.

Countries' objectives for rates of monetary expansion are designed to allow for a certain rate of economic expansion in real terms. This is the case, at least, insofar as the rate of inflation remains within intended bounds compatible with stable or declining rates of monetary expansion over the medium term.

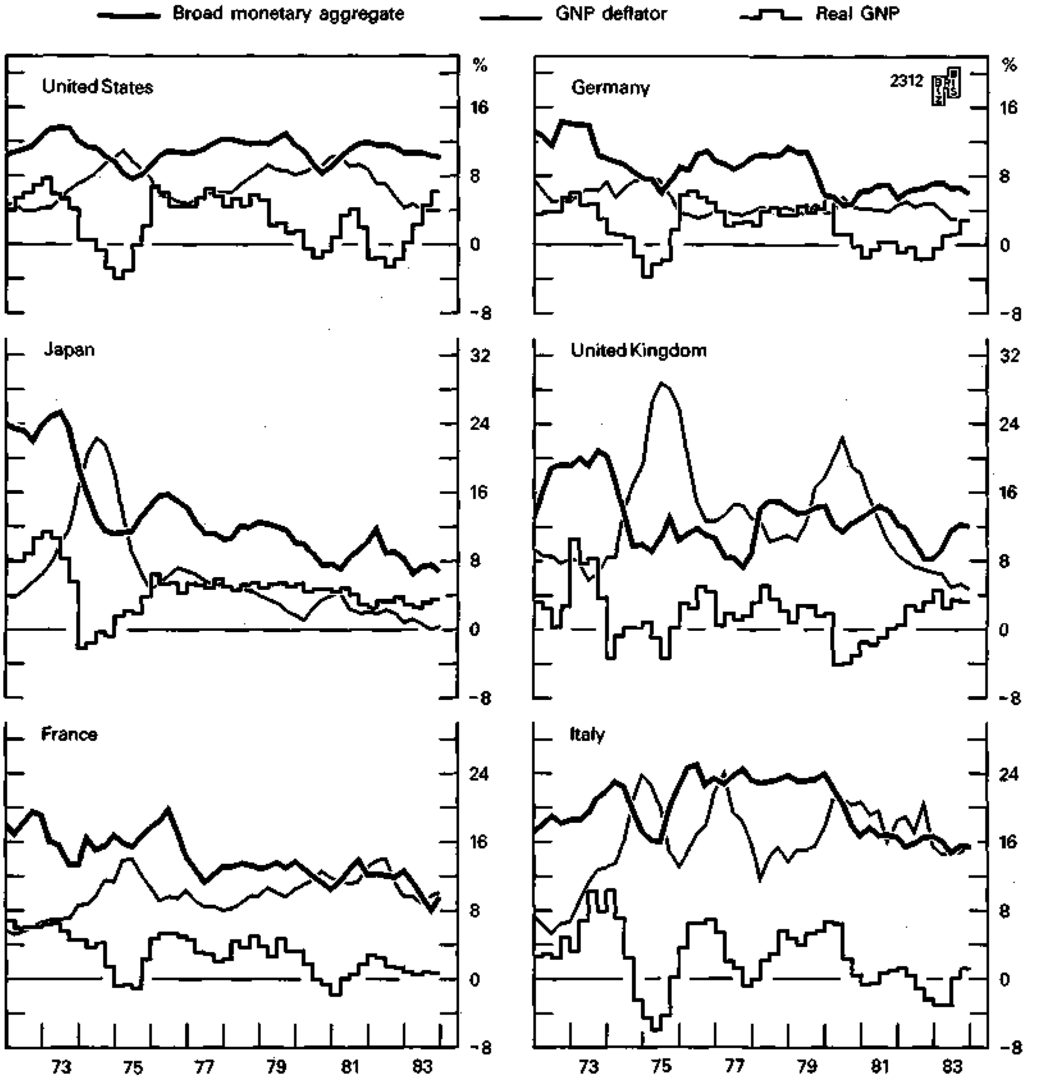
Under aggregate strategies there are some other ways in which monetary policy can contribute to supporting an incipient economic recovery, though only within quite narrow limits. Where annual monetary objectives are based on economic growth potential, they provide some built-in stimulus when actual output growth is below potential. The possibility of aiming at different parts of the target range can give a degree of flexibility. It is generally accepted that in some countries the relationship of the money stock and nominal GNP — the income velocity of the money stock — may alter permanently when inflation rates decline abruptly or temporarily in a context of financial fragility. Policy in the United States over the past two years has taken changes of this kind into account.

More generally, the relationship between the money stock, output and prices is conditioned by interest rates. To the extent that policy operates in a way which seeks to avoid unnecessary fluctuations in interest rates, it tends to accommodate changes in the demand for money over short periods of time. Monetary authorities are well aware, however, of the risks entailed in attempting to resist interest rate pressures caused by imbalances in the financial markets and by strong economic expansion which threatens to revive inflation expectations. It is precisely in these circumstances that monetary aggregate strategies can be potentially most useful in sustaining confidence and in helping to ensure that the need for appropriate monetary policy responses is recognised and generally understood.

Indeed, recent monetary developments seem to have differed significantly from those in earlier economic recoveries. This is illustrated by the graph showing rates of expansion of the broad monetary aggregates, growth rates of output and GNP deflators. Broad aggregates are not targeted directly in all countries, partly because they cannot usually be controlled as effectively as narrow aggregates by the monetary authorities when they rely mainly on interest rate instruments. In many cases, however, broad aggregates are less influenced by changes in the asset

Broad monetary aggregates, prices and GNP in real terms.

Changes over four quarters, in percentages.*



* Based on quarterly averages for the monetary aggregates (for the United States, L (broad liquidity); for Japan, M_2+CDs; for France, M_2; for Germany and Italy, M_3; for the United Kingdom, PSL_2).

preferences of the public associated with financial innovation. And for some purposes it is an advantage that these aggregates normally closely reflect changes in the government's budget position, in credit to the private sector and in the country's balance of payments.

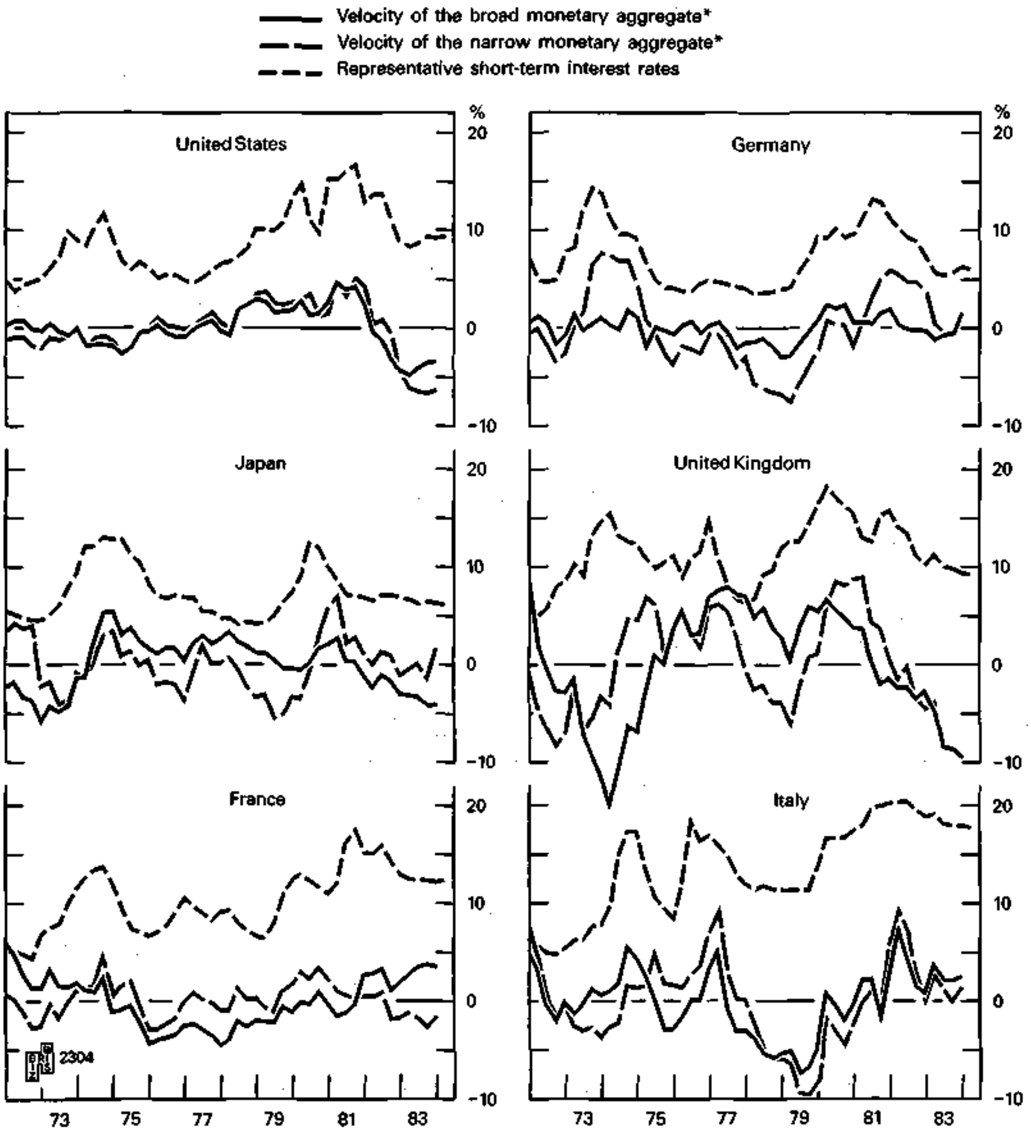
In most of the countries shown, rates of increase in the broad aggregates have been much more moderate on average in recent years than in the early 1970s. Whereas in the past a strong acceleration in rates of monetary expansion was often associated with a cyclical revival of output, rates of growth of the broad aggregates generally remained fairly moderate last year. Nonetheless, those rates seemed to be generous in relation to rates of inflation in some countries. As is well known, simple comparisons of this kind suggest that if large swings in the aggregates can be avoided, the risk of a resurgence of inflation rates will be reduced. They also suggest that when inflation rates have been low relative to rates of monetary expansion, an expansion of output has usually followed. Tentative though any conclusions based on such simplistic comparisons must be, they do illustrate the proposition that the constellation of moderate rates of broad money growth and relatively low rates of inflation seen last year in the major countries augurs well for the future — provided that these conditions prove to be sustainable.

More information on the interaction of the supply and demand for money can be derived from a consideration of movements in income velocity. In the graph percentage deviations in the velocity of broad and narrow aggregates from a fitted straight-line trend are set in relation to short-term interest rates. In general terms, the relationship of velocity to trends for the whole period, taken together with other information, suggests that, whereas in the United States, the United Kingdom, Japan, France and Italy there have been structural changes in the underlying relationships during the period, no major change of this kind has occurred in Germany. In some cases these structural changes clearly reflect financial innovation; in others they appear to be due mainly to changes in the control régime itself.

The close and consistent relationships between the velocity of M_1, in particular, and interest rates seen for Germany constrasts strikingly with the complex or weak relationships of this kind evident in some other countries. In some cases cyclical factors appear to play an important independent rôle — though one which differs from country to country. In the United States, for example, velocity normally falls in recession, while in some other countries (Japan, France) velocity usually seems to rise as credit-granting slows down, suggesting a relatively large repayment of that part of debt which represents a counterpart to the money stock. In France and Italy, where interest rates are still high, velocity now seems higher in relation to its trend than it has usually been in the past at the beginning of business recoveries. In Japan and Germany, however, it appears more in line with previous experience, and there are no indications either of excessive monetary expansion or that monetary policy has not been accommodating the economic recovery. In the United Kingdom financial innovation has clearly been an influence recently.

Of particular interest is the remarkable behaviour of the velocity of M_1 in the United States over the past two years. As the fall in 1982, which far exceeded that in any previous post-war recession, continued in early 1983, the rise recorded over the whole of last year was far smaller than usual in the first year of recovery. A corollary, of course, was that, although, as usual, the growth of M_1 heralded an economic recovery, it "over-predicted" by far the scale of the rise in output. This largely reflects the fact that M_1 includes negotiable order of withdrawal (NOW) accounts, which were authorised nationwide in 1981 and which served as a repository for savings and precautionary balances, especially when yields on more remunerative alternative assets declined.

For monetary control purposes, in a context of innovation, the question was not so much one of whether velocity was stable as of whether it was predictable, Interest rates and the income velocity of the monetary aggregates.



* Deviations from a fitted straight-line trend. Based on quarterly average data for the monetary aggregates, both broad (defined as in the graph on page 66) and narrow (M_1).

taking into account changes which were known to be taking place. The difficulty last year lay in determining how much of the change in late 1982 and early 1983 might be permanent. To the extent that the earlier decline in the velocity of M_1 reflected an unusual rise in precautionary balances in recession, the rebound in the second half of last year could be interpreted as simply reflecting a return of confidence. That the accompanying rise in short-term interest rates was modest suggests that the slowdown in M_1 growth was mainly due to a reversal in the demand for money and was not simply the result of policy restraint. Recent developments in the velocity of M_2 have been less out of line with previous experience, but as the composition of this aggregate has shifted markedly away from instruments bearing controlled interest rates to ones bearing market-related rates, M_2 has probably become very difficult to control. Even the velocity of broad liquidity (L) and that of total domestic debt of non-financial sectors have displayed some unusual developments over the last two years. They seem partly to reflect pressures coming from large government borrowing.

The Federal Reserve Board's monetary objectives for 1984 are conditional on the behaviour of velocity returning to patterns more in line with previous experience. Clearly, it was recognised when they were published that, should the budget deficit remain large and the economic recovery strong, avoiding further large rises in the aggregates might imply a need to accept higher interest rates.

Interest rate developments and exchange rate oriented monetary policies.

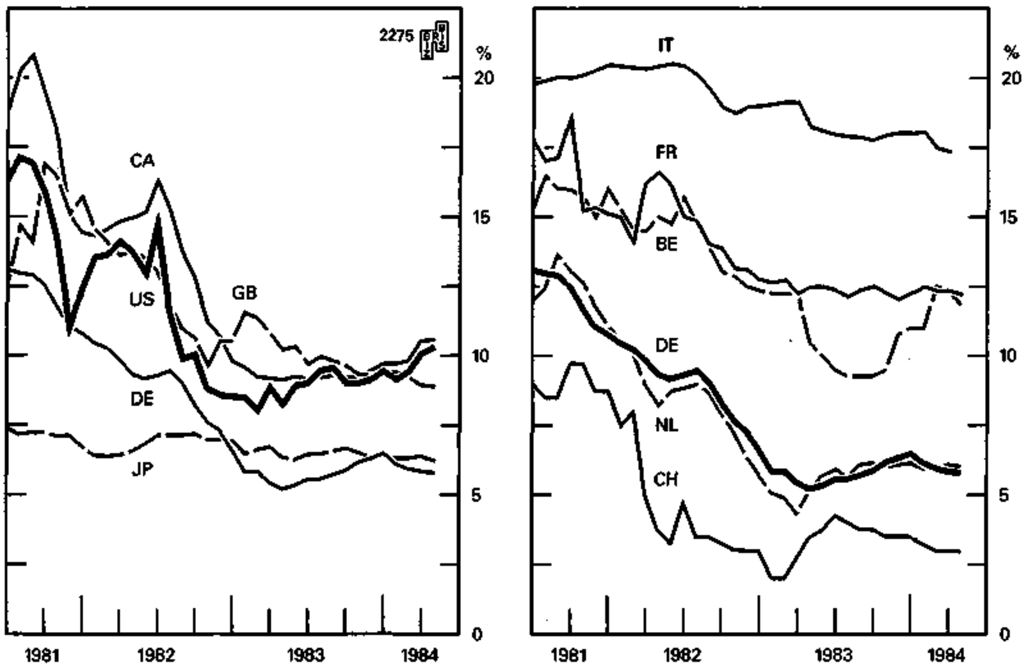
Developments in interest rates last year were conditioned by the recovery and the way in which monetary authorities applied and adapted their short-term interest rate instruments. They were also strongly influenced, however, by imbalances in the economy and by expectations and concerns related to possible future developments in the financial and exchange markets.

After declining sharply in 1982, interest rates in the United States and in many European centres moved back onto an upward path in the spring of last year. Small further declines took place in the course of 1983 in Japan, the United Kingdom and also in some continental European countries where interest rates had remained relatively high.

More striking than these movements, which were generally very small in comparison with those seen in the previous four years, was the high level of interest rates in many countries in relation to recorded rates of inflation. In the United States yields evidently continued to rise in real terms, exerting upward pressure on the dollar and on interest rates in the rest of the world. At the same time, however, the large US current-account deficit helped to spread economic recovery geographically.

Short-term interest rates. In the *United States,* where nominal interest rates normally decline in the first year of an economic recovery, underlying conditions on credit markets last year reflected a slowly changing balance of forces which included the Federal Government's large borrowing requirement, strong private demand for credit, improved financial positions in the business sector, favourable conditions for new equity issues and inflows of funds from abroad. By early 1984, with the recovery showing no signs of weakening and the dollar losing ground, the Federal Reserve became less accommodative in supplying bank reserves, and between late January and late April the Federal funds rate rose by more than one percentage point. Between March and May banks' prime lending rates, already raised from 10½ to 11 per cent. in August 1983, were put up to 12½ per cent. In April Federal Reserve discount rates, unchanged at 8½ per cent. since November 1982, were raised to 9 per cent.

Money-market interest rates.*



* Representative rates: for Italy, interbank sight deposits; for France, one-month interbank deposits; for Belgium, four-month certificates; for other countries, various three-month instruments.

In *Canada* the exchange rate had gained in importance as a policy guide even before objectives for the money stock had to be abandoned in late 1982. In early 1983, as the inflation and external position improved, it was possible to bring down short-term interest rates in relation to money-market rates in the United States. As from the autumn, however, short rates in Canada had to be raised in order to keep the currency reasonably stable in relation to the US dollar.

Most other industrial countries pursued independent objectives for the money stock last year or geared their monetary policies mainly to stabilising exchange rate relationships among European currencies. Yet in varying degrees they had to take US interest rates and the strength of the dollar into account in the conduct of monetary policy. Generally, this influence was reflected directly in interest rate strategies. In most countries other than the United States, the monetary authorities from time to time "leant against the wind" in the exchange market. However, considering that the US dollar remained strong throughout the year, the overall change in 1983 in the monetary authorities' net foreign assets was quite small in most cases. Typically, the changes that were recorded reflected mainly pressures on the exchange rates between the currencies of European countries.

In *Japan* exchange rate considerations largely explain why the decline in nominal interest rates last year was very small and less than the decline in the inflation rate. In *Germany* short-term interest rates served mainly as an instrument for helping to meet the monetary objective, but the rise during the summer and autumn of 1983 must also have contributed to limiting the weakness of the Deutsche Mark against the US dollar. In the *United Kingdom*, where the exchange rate was one of the policy guides being used by the authorities, the decline in money-market rates last year, though significant, has to be seen against the background of the rise in these rates in late 1982, when sterling had weakened under the influence of a fall in the price of oil.

External constraints played a large part in the design and implementation of monetary policy in *France, Italy, Belgium* and the *Netherlands* last year. That these countries have very open economies helps, along with their wage-fixing arrangements, to explain the important rôle exchange rate stabilisation objectives play in their monetary policies. Moreover, in France, Belgium and Italy, though external current-account positions improved last year, adjustment processes aimed at reducing budgetary and external imbalances and at restoring price stability still had far to go. The situation called for relatively high interest rates, but already high interest rate levels abroad accentuated the constraints on their policy options.

In January-March 1983 speculation on an exchange rate realignment within the European Monetary System was reflected only to a limited extent in the domestic money-market rates of the countries concerned. The resulting swings in the net foreign assets of their central banks were very large, however. After the realignment day-to-day interest rates were slightly lower for a brief period in Germany, but short-term interest rates in the Netherlands rose. In Belgium advantage was taken of whatever leeway was available to get domestic short-term rates down. Money-market rates in Belgium had to be raised sharply, however, when doubts about the progress made towards correcting structural imbalances re-emerged.

In early 1984, with the dollar easing, strains on exchange rate relationships in Europe re-emerged at times. The impact was felt both in movements in central banks' official external reserves and in money-market interest rates. In Germany, France and Italy short rates fell further, while in Belgium they rose. With the Canadian dollar weakening against the US dollar, money-market rates also rose in Canada.

In Germany, the Netherlands, France and Belgium large movements in the central bank's net foreign assets have, in recent years, been an important source of actual or potential disturbances on the money market. Much the same is true in Switzerland, where the central bank normally gives priority to a target for the adjusted monetary base but has periodically found it necessary to intervene in the exchange market to resist large short-run swings in the external value of the Swiss franc. In this situation the monetary authorities in these countries have developed various versatile instruments, including foreign exchange swaps, security repurchase agreements and special loans at market-related interest rates, for flexibly adjusting bank liquidity. Short-term changes in liquidity provided at the initiative of the central bank now mainly reflect the use of these instruments, which can be particularly helpful for fine-tuning money-market interest rates. Changes in reserve requirements no longer play a major rôle in policy responses to inflows and outflows of funds; reserve requirements have not been used at all in recent years in Belgium, the Netherlands or Switzerland, while in Germany the coefficients have been

Influences on central-bank money and on short-term interest rates.

Items and years	Japan	Germany	France	Belgium	Nether-lands	Switzer-land	Italy
	change as a percentage of central-bank money stock at beginning of period[1]						
Central-bank net foreign assets[2]							
1981	– 0.1	– 2.0	–18.8	–25.4	– 7.3	9.3	0.0
1982	– 9.9	1.0	–26.4	– 9.8	21.2	6.3	– 7.7
1983	– 0.3	– 1.4	3.3	– 5.8	0.3	5.1	10.3
January–March 1983	0.2	7.6	–18.9	–10.8	5.6	10.3	– 0.4
January–March 1984	0.1	2.7	.	– 9.3	– 5.6	5.0	– 2.2
Central-bank short-term liquidity-supplying operations[3]							
1981	–16.2	0.9	11.2	10.1	7.0	1.0	1.7
1982	7.2	0.2	42.2	– 0.2	–13.1	9.7	0.3
1983	10.2	2.5	–10.9	– 0.3	11.1	2.1	– 1.9
January–March 1983	– 1.3	– 6.2	13.2	– 1.4	– 6.5	– 9.6	2.1
January–March 1984	– 7.3	– 1.2	.	3.6	10.7	– 4.5	8.5
Government finances and other[4]							
1981	18.9	4.3	8.6	17.1	1.2	–13.7	11.4
1982	8.6	4.7	– 3.8	9.9	– 0.5	– 7.8	21.4
1983	– 4.9	5.7	8.6	9.8	1.2	– 6.2	6.6
January–March 1983	– 7.3	1.4	2.6	8.8	5.3	– 6.2	3.8
January–March 1984	– 0.6	– 0.1	.	2.6	– 6.0	– 4.6	– 3.6
Central-bank or reserve money[5]							
1981	2.6	3.2	1.0	1.8	0.9	– 3.4	13.1
1982	5.9	5.9	12.0	– 0.1	7.6	8.2	14.0
1983	5.0	6.8	1.0	3.7	12.6	1.0	15.0
January–March 1983	– 8.4	2.8	– 3.1	– 3.4	4.4	– 5.5	5.5
January–March 1984	– 7.8	1.4	.	– 3.1	– 0.9	– 4.1	2.7

[1] Flows net of valuation changes, partly estimated by the BIS. For Germany and France, based on monthly averages of daily figures; for other countries month-end data. [2] Excluding foreign exchange swaps used for the purpose of influencing bank liquidity. For Japan, operations of the Foreign Exchange Fund. [3] Lombard and (except for Germany) discount credit, foreign exchange swaps, security repurchase agreements and special loans at market rates. For Switzerland, excludes end-month accommodation. [4] Includes, inter alia, changes in central banks' portfolio of domestic securities. [5] Mainly currency of issue and central-bank deposits of banks and non-banks (including required reserve holdings). For Germany, central-bank money at constant reserve ratios; for Switzerland, adjusted central-bank money.

progressively reduced over time. In normal circumstances, however, posted interest rates on certain traditional types of central-bank credit still serve to underpin money-market rates and, over a period of time, the provision of central-bank money may be based largely on central-bank operations of a conventional kind.

In Belgium in recent years the National Bank's net foreign assets have declined and central-bank credit to the Government via the Securities Regulation Fund has increased. Moreover, the credit institutions have accumulated large holdings of liquid government securities. In Germany, the Netherlands and Switzerland, however, government finance is not normally a major influence on changes in the liquidity of the banking system. In Germany a transfer of profits from the Bundesbank to the Government complicated money-market management last year, but arrangements have been made to make payments in stages in 1984.

In the United Kingdom and Italy, in different ways, it is mainly to the vagaries of Treasury operations that money-market management has had to adapt. Here too, however, the rôle of open-market operations — in domestic securities and/or bills — has increased relative to that of conventional central-bank credit. The main effect, by and large, has been to increase the flexibility with which interest rates can be adapted to changing circumstances if necessary. In the United Kingdom, where one of the disadvantages seen in the over-funding of the Government's budget deficit in 1981 and 1982 was that it called for substantial offsetting through net purchases of commercial bills by the Bank of England, the Bank was able to reduce its bill portfolio through most of 1983. Net purchases became necessary again late last year and in early 1984, however. In Italy, where steps have been taken in recent years to limit the Bank of Italy's participation in auctions of government securities, the problem was the more familiar one of difficulties in financing a chronically large budget deficit so as to limit an excessive growth of the monetary base.

In Japan a number of measures introduced in recent years have increased the flexibility of the money market. Inter alia, the Bank of Japan has developed transactions in bills and government securities to influence bank liquidity, and interest rates in the interbank markets have been permitted to adapt more flexibly to changing conditions during the day. More important, markets in short-term paper in which non-banks participate — notably the CD market — have been developed. The growth of open money markets has been found very helpful in the conduct of monetary policy.

Long-term interest rates. The behaviour of long-term interest rates last year was strongly influenced by expectational factors and developments outside the monetary sphere. To a considerable extent, it reflected constraints under which monetary policy had to operate.

In early 1983 long-term interest rates generally continued to fall, but in some European centres their response to declines in money-market rates began to weaken. In the Netherlands bond yields rose when the unexpected change in the relationship of the guilder to the Deutsche Mark in the EMS currency realignment temporarily called the Dutch authorities' exchange rate intentions into question. The rise in bond yields in the United States between the spring and autumn, helping to strengthen the dollar, was accompanied by increases in long-term interest rates in nearly all other industrial countries, though most of them were still in recession. In the case of Germany, moreover, the rise came at a time when the Bundesbank's discount and lombard rates had just been lowered. Between April and August the margin between long and short-term interest rates also widened in Canada, the United Kingdom and Belgium. Later in the year, when the yield curve steepened in the United States, perhaps suggesting a firming of inflation expectations, bond yields in Germany fell slightly on balance, even though the lombard rate had been raised. Indeed, in August-December bond yields also declined in Canada, Japan, the United Kingdom, Italy and the Netherlands, coming closer to short-term interest rates.

One factor which might help to explain the close relationship between developments in long-term interest rates in different countries at a time when the dollar was strengthening was the risk that, particularly in countries with rigid wage-fixing arrangements, a depreciation of the domestic exchange rate could directly boost domestic inflation. In these circumstances the response of long rates to falls in

Long-term interest rates and the term structure.

Periods	United States	Canada	Japan	United Kingdom	Germany	Switzer-land	France	Italy	Nether-lands	Belgium
	in percentages									
Bond yields,[1] levels										
1981 peak month	15.49	19.08	9.15	16.11	11.20	6.13	17.32	21.33	12.30	14.18
December 1982	11.83	12.93	7.50	10.99	7.90	4.22	15.40	19.86	8.40	12.66
April 1984	12.81	14.16	6.68	10.57	7.90	4.64	13.81	15.08	8.45	11.90
	in basis points									
Bond yields,[1] changes										
June–December 1982 ...	−298	−493	−103	−260	−120	−100	− 58	− 89	−213	− 93
December 1982–April 1983	− 32	− 67	− 4	− 37	− 50	20	− 85	−209	6	−107
April–August 1983	100	93	8	50	90	31	− 59	3	57	− 13
August–December 1983 .	6	− 24	− 61	− 88	− 10	− 19	0	− 47	− 45	43
December 1983–April 1984	24	121	− 25	33	− 30	10	− 15	−225	− 13	19
Bond yields[1] minus money-market rates[2]										
December 1982	332	273	54	43	128	84	265	84	267	31
April 1983	298	301	111	40	220	17	205	− 45	320	114
August 1983	297	415	97	131	259	− 2	159	− 6	293	221
December 1983	304	338	48	83	172	66	171	− 70	240	89
April 1984	263	393	42	166	206	46	156	−215[3]	240	18

[1] Representative rates: for the United States, AAA corporate bonds; for the United Kingdom and the Netherlands, government bonds; for other countries, various public-sector bonds. [2] 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. [3] March 1984.

domestic money-market rates was limited. Once the external pressures eased, however, capital-market rates could respond more to domestic influences.

In early 1984, with sentiment in favour of the US dollar weakening, a further rise in bond yields in the United States was reflected only to a limited extent in yields in other countries, and between January and March yields in Japan, the United Kingdom, Germany, the Netherlands and Italy actually fell. In April, however, with the dollar again strengthening, bond yields rose slightly in Canada, the United Kingdom, the Netherlands and Switzerland.

Positive developments in the last two years included a marked decline in the short-run volatility of interest rates and significant falls in the risk premia which borrowers with less than the highest credit ratings had to pay. The margin between the rates financial institutions offer on placements and those they charge to borrowers also became narrower in many countries last year. The markets have remained very sensitive, however, to changing perceptions of uncertainty in the interest rate outlook. Thus, a renewed shortening of maturities and an increase in the use made of variable rate instruments could be seen in many markets in late 1983 when the pressures that were to be reflected in interest rates in early 1984 were building up.

Real interest rates.

With long-term interest rates stable or rising slowly in 1983 and recorded rates of price increase falling further, inflation-adjusted interest rates continued to rise in many countries. Even allowing for the possibility that, as survey evidence in some countries suggests, long-term inflation expectations are higher than recently recorded rates of price increase, real rates must now be strongly positive. In relation to their levels in previous economic recoveries, real rates seem particularly high at present in the United States and Canada. In some other countries, especially Germany, they seem less out of line with previous experience.

Real long-term interest rates.*

Year	United States	Canada	Japan	United Kingdom	Germany	France	Italy	Belgium	Switzer-land
	period averages, in percentages per annum								
1982	7.6	5.0	5.4	4.0	3.7	3.9	3.9	4.7	−0.8
1983	8.8	6.9	5.6	6.2	4.9	4.9	3.0	4.1	1.6
1984 1st quarter	7.8	8.1	4.4	5.2	5.0	5.0	3.6	5.2	1.6
Earlier recovery years									
1968	2.0	3.9	1.7	2.9	4.8	2.4	5.5	3.8	2.0
1972	3.9	3.5	2.2	1.9	2.4	2.0	1.7	1.6	−1.7
1976	2.7	2.9	−0.6	−2.3	3.5	0.9	−3.1	−0.1	3.3

* Based on monthly data. Representative long-term bond yields minus percentage changes over twelve months in consumer prices.

The revival of private investment in the United States last year in the face of record real interest rates has for many observers posed something of a paradox. Part of the explanation, no doubt, lies in the fact that generalised tax write-offs for interest costs were available to both enterprises and individuals. Moreover, the higher depreciation allowances for business fixed investment introduced by tax changes in 1981 provided significant benefits in terms of the profitability of business investment. Furthermore, the earlier decline in nominal interest rates had brought house ownership within the reach of a larger number of households, while the rise in the stock market had lowered the cost of equity capital to the corporate sector. Of more general importance, however, moderate wage settlements and a rapid expansion of aggregate demand accentuated by larger budget deficits substantially raised the prospective returns on many types of business investment.

In other countries conditions were different, though to varying degrees. In a number of them tax provisions favouring investment were introduced last year, and in some there are long-standing arrangements for subsidising export and housing credit. Typically, however, the range of tax-deductible interest payments by the personal sector is not as wide as in the United States, and in some cases weak profitability continued to prevent enterprises from taking full advantage of the available write-off provisions. Moreover, tax arrangements have little effect on the burden which high interest rates place on sovereign borrowers in the international markets. These high rates have greatly increased the scale of the adjustment problem in countries with large external indebtedness.

The policy mix, interest rates and the transmission mechanism.

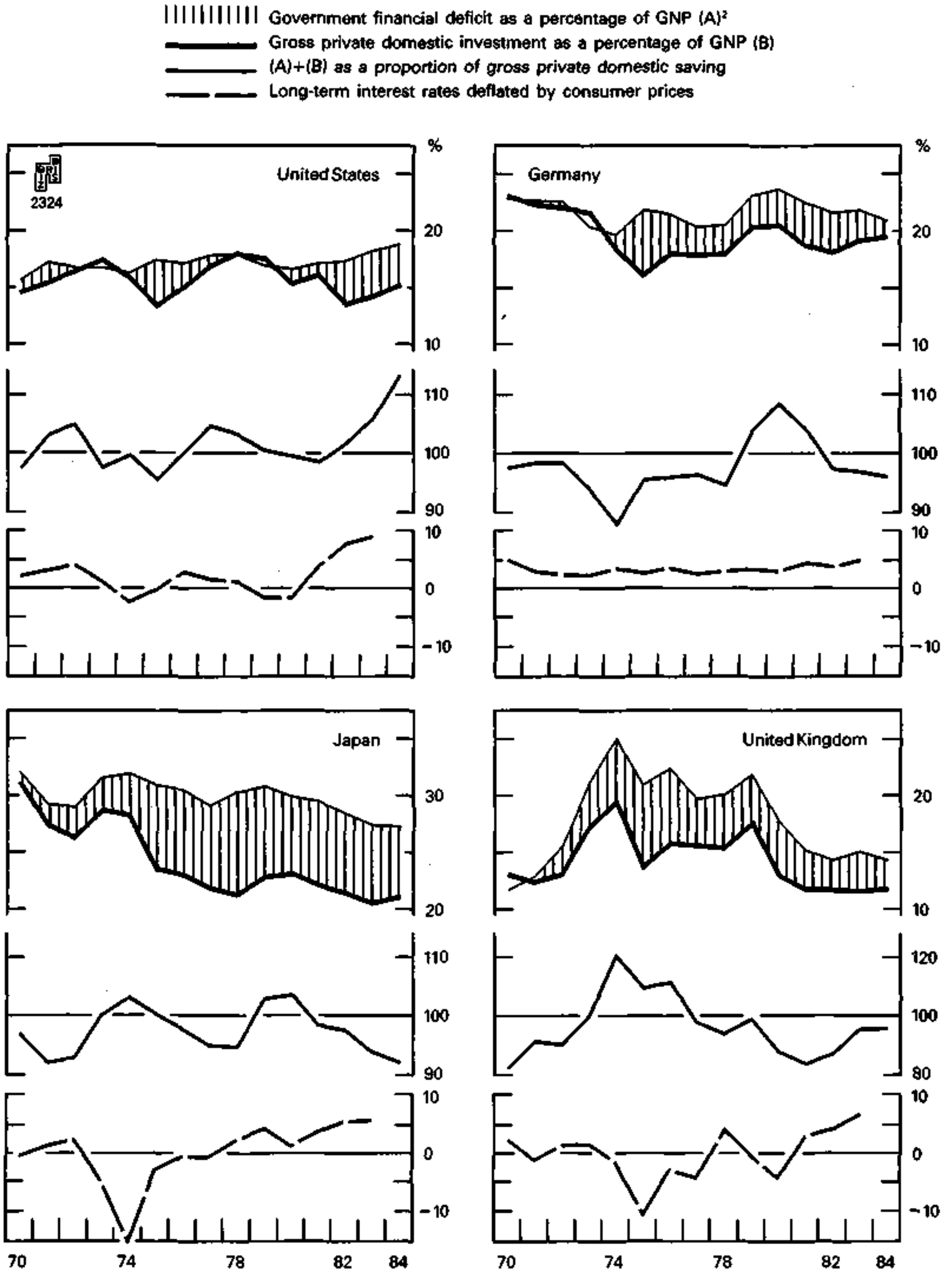
In the period ahead, it can be expected that monetary policies in the principal industrial countries will continue to be aimed at controlling the growth of key monetary aggregates and, in particular, the course of domestic inflation. Against this background, and partly reflecting the stance of fiscal policy, actual and prospective imbalances in domestic and external saving/investment behaviour will be a major influence on real as well as nominal interest rates. Here the plans of the public authorities, set in relation to private-sector saving, have become a major source of concern in the financial markets. Expectational factors of these kinds have dominated financial-market developments in the United States for some time now, and the reasonableness of the concerns has been borne out by events.

With respect to the interest rate transmission process, *short-term interest rates* generally react to domestic money-market conditions, which are to a large extent under the control of the monetary authorities. However, in formulating their policies the authorities have, when taking account of domestic considerations of policy, recognised that there is in varying degrees a trade-off between short-term interest rates and exchange rates. On the other hand, *long-term interest rates*, because they reflect to a greater extent market expectations and uncertainties about future financial developments, are less amenable to policy influences. A major factor here is the expected inflation rate, which may be influenced, for instance, by the risk of monetisation of government debt but also by the potential impact of large exchange rate changes on domestic cost performance. This may be of some importance even in the United States, but it is certainly of great significance in many other countries. This effect — and in some cases awareness in the markets of the constraints it places on exchange rate policy — may help to explain why nominal long-term interest rates in some countries have at times risen in the wake of rises in bond yields in the United States instead of following domestic money-market rates. And, to the extent that *real interest rates* in the United States were high and confidence in the dollar remained strong, it could be expected that real interest rates elsewhere would be affected.

In a context of monetary policies geared primarily to controlling inflation, however, real long-term interest rates tend to respond mainly to the current and anticipated demand and supply conditions in the domestic credit markets and to influences from abroad. This can be illustrated by the graph on page 76, which sets movements in long-term interest rates, deflated by recent rates of consumer price increase, in a context of developments in private investment, in government budget positions and in the associated balance of domestic saving. The relationship between private investment and government deficits, on the one hand, and private saving, on the other, indicates the extent to which the total call on saving made by the public and private sectors is met from domestic sources. A shortfall of domestic saving represents the net financial disinvestment of the country vis-à-vis the rest of the world — essentially, the external current-account deficit.

In the United States empirical evidence from the past, when budget deficits were generally of a cyclically induced nature, is of little help in judging the interest rate effects of today's current and prospective deficits. True, a deficit of the general-government sector helped in 1981–82 to compensate for a sharp fall in private investment and to support economic activity in much the same way as in the previous recession in 1975. What is different now is that deficits in the Federal Government budget are in the process of becoming structural in nature, since they

Budget deficits, saving/investment imbalances and real interest rates.[1]



[1] Based on national sources. Observations for 1983 and 1984 are preliminary and tentative. [2] Financial deficit (+); for the United States and Germany, general government; for Japan and the United Kingdom, public sector.

are projected to continue throughout the business cycle. This prospect, already perceived by the markets in 1982, contributed to keeping interest rates high in relation to current rates of inflation — probably in a number of different ways. The deficits gave rise to concerns about continuing strains on capital markets; they may have fuelled inflation expectations directly; and, in making the outlook for inflation more uncertain, they may also have increased the risk premia incorporated in long-term interest rates. It can be argued that high interest rates, new tax incentives for saving, or the expectation that the deficit would ultimately imply increases in taxation might tend to stimulate savings. But uncertainties with respect to the timing and magnitude of a possible forthcoming budget retrenchment package must also have weakened confidence in the political will to tackle the deficit problem in a decisive way.

Last year relatively high interest rates in the United States clearly helped — along with better profit prospects there and the economic and political risks perceived to exist in other countries — to attract funds from abroad and to push the dollar up further in the exchange markets. In these circumstances interest rates in the United States remained lower than they might otherwise have done, and private investment, shielded in various ways from the high cost of borrowing, could recover. The strength of the dollar helped improve the US terms of trade and moderate domestic inflation, while inflows of funds from abroad financed a growing current-account deficit which reflected both the comparative strength of aggregate demand in the United States and a loss of competitiveness in export and import-competing sectors.

In 1984 the Federal Government deficit is expected to be equivalent to more than a third of gross private domestic saving. With private investment concurrently rising, the resultant overall shortage of private saving implies a further large net inflow of funds from abroad to cover a widening current-account deficit. In view of the extent to which this process has already taken place, there is a growing possibility of a decrease in the willingness of non-residents to accumulate further dollar claims. This could in time be reflected in a weakening of the dollar and upward pressure on the inflation rate in the United States. Tensions in the credit market could become severe.

In Japan exports benefited from the US economic expansion and a strong dollar, but high real long-term interest rates were a dampener on the recovery of private investment. With fiscal policy pre-empted by the aim of reducing the structural budget deficit, monetary policy has been designed to support a domestic recovery. Nominal short-term interest rates have remained well below interest rates in the United States. The private saving ratio was still very high by international standards and helped to accommodate both the large financial deficit of the public sector (including the public corporations) and the growing external current-account surplus. Exchange controls having been liberalised earlier, Japanese savings flowed abroad in response to interest rate incentives and the desire for portfolio diversification. It would appear that high real interest rates in Japan have been strongly influenced by those in international markets, although financial deregulation, which has been proceeding at a rapid pace, may also have had an important influence.

In Germany and the United Kingdom direct trade with the United States is limited, but competition in third markets is important. In both countries considerable progress has been made in recent years in bringing down structural budget deficits, while money-market management has been geared largely to meeting the money stock objective. In Germany since 1981 and, particularly, early 1983 there has been a consistently large differential in favour of short-term dollar rates. In a context of a relatively low and declining inflation rate, long-term interest rates, though quite sensitive to developments in capital markets abroad, have remained remarkably stable in real terms. In the United Kingdom, where a sharp decline in the inflation rate from 1980 onwards outstripped the fall in nominal interest rates, the real long-term rate appears to have risen.

In all three cases — Japan, Germany and the United Kingdom — the level of real long-term interest rates would appear to be higher than one would expect on domestic grounds alone. In all three countries the monetary/fiscal policy mix has been broadly appropriate, while the pressure of domestic demand, as indicated in the graph by the ratio of the budget deficit and private investment to private domestic saving, has been quite low. The reason must be partly that, despite any cushioning effect that may have come from the exchange rate markets, the interest rates in these countries were influenced by those prevailing in the United States.

In general terms the effects of the US policy mix have been transmitted abroad through three main channels: firstly, the direct impact of aggregate demand on the external balance; secondly, the loss in competitiveness implied by the rise in the dollar exchange rate; and, thirdly — and most important in this context — via direct and expectational influences of US interest rates on those in international and foreign markets. What is unusual about the US case is the persistent strength of the currency in the context of a structural budget deficit of such disproportionate size. The credibility of the aggregate-oriented policy of the monetary authorities as a means of countering inflation, high real interest rates and the international rôle of the dollar all contribute towards an explanation. The importance of dollar-denominated assets in the world financial market implies that developments in interest rates in the United States are inevitably a major influence on financial developments and monetary and exchange rate policies elsewhere.

In the United States there is now a general risk that, should the economy continue to expand rapidly, inflation could reappear. Indeed, in the spring of 1984 evidence of tensions in financial markets was already beginning to accumulate, as interest rates moved upwards. Considering the potential implications for balanced expansion at home and for the highly indebted countries abroad, the prospect of another interest rate cycle was very unwelcome. There was a widespread consensus that effective measures to deal with the budget deficit seemed to afford the best chance of avoiding this. As far as various other countries are concerned, efforts to reduce structural budget imbalances and to maintain wage restraint can be expected to continue in the awareness that a better policy balance at home is also a precondition for lower interest rates and increased scope for domestic investment and growth.

V. INTERNATIONAL TRADE AND PAYMENTS.

Highlights.

Developments in world trade and balances of payments in 1983 showed two major positive features. Firstly, with the recovery of economic activity in the developed world, led by the vigorous growth of the US economy, the volume of world trade began to expand again, gathering momentum as the year went on. Secondly, the pick-up in world trade, combined with considerable adjustment efforts in deficit countries, resulted in some substantial improvements in the world pattern of external current-account balances. The biggest of these occurred in the aggregate current-account positions of the non-OPEC developing countries, where adjustment was most needed, and of the developed countries outside the Group of Ten. In addition, the current-account deficits of a number of Group of Ten countries were reduced, while during the course of the year the aggregate current-account position of the OPEC countries moved back into equilibrium.

On the other hand, in the world's two largest industrial economies very substantial imbalances on current account emerged during 1983. In the United States the unprecedented increase in the deficit chiefly reflected the influence of domestic economic recovery and a loss of international competitiveness. The increase in Japan's surplus was based on a combination of strong export growth and stable import demand due, in part, to increased efficiency in the use of imported raw materials.

While the progress that many countries made last year towards better balance on external current account was to a significant extent the result of import restraint, it would not have been possible without the surge in US import demand and the accompanying deterioration of the US current account. At the same time, the benefits of the US-led revival of world trade were not evenly distributed. In the industrial world, Japan was best placed to take advantage of the upturn. Among the developing countries, the export-oriented economies of Asia recorded rates of export growth that were sufficient to allow them to relax import restraints, while other countries, especially in Latin America, still had to rely on import cuts in order to improve their external position.

On capital account, the most striking single feature of developments in 1983 was that the financing of the rapidly growing US current-account deficit was accompanied by a further appreciation of the US dollar. This meant that the driving force behind the dollar's appreciation was capital inflows on an unprecedented scale, which themselves contributed to the aggravation of the US current-account deficit. Elsewhere, the narrowing of current-account deficits resulted in a major reduction in external financing requirements. However, in a number of very heavily indebted countries, especially in Latin America, the financing of current-account deficits had to be arranged under the aegis of the International Monetary Fund.

Despite last year's improvements, the world balance-of-payments outlook in the spring of 1984 remained clouded in several respects. Firstly, the structure of the US balance of payments is clearly unsatisfactory. The current-account deficit foreseen for 1984 and, by implication, the capital inflows required to finance it do not look sustainable and pose a potential threat to international financial stability. Secondly, the Japanese surplus seems likely to increase further, with the possibility of further trade friction, and, thirdly, the heavily indebted countries of Latin America are still far from achieving an autonomously financeable external balance that will permit a resumption of domestic economic growth.

World trade.

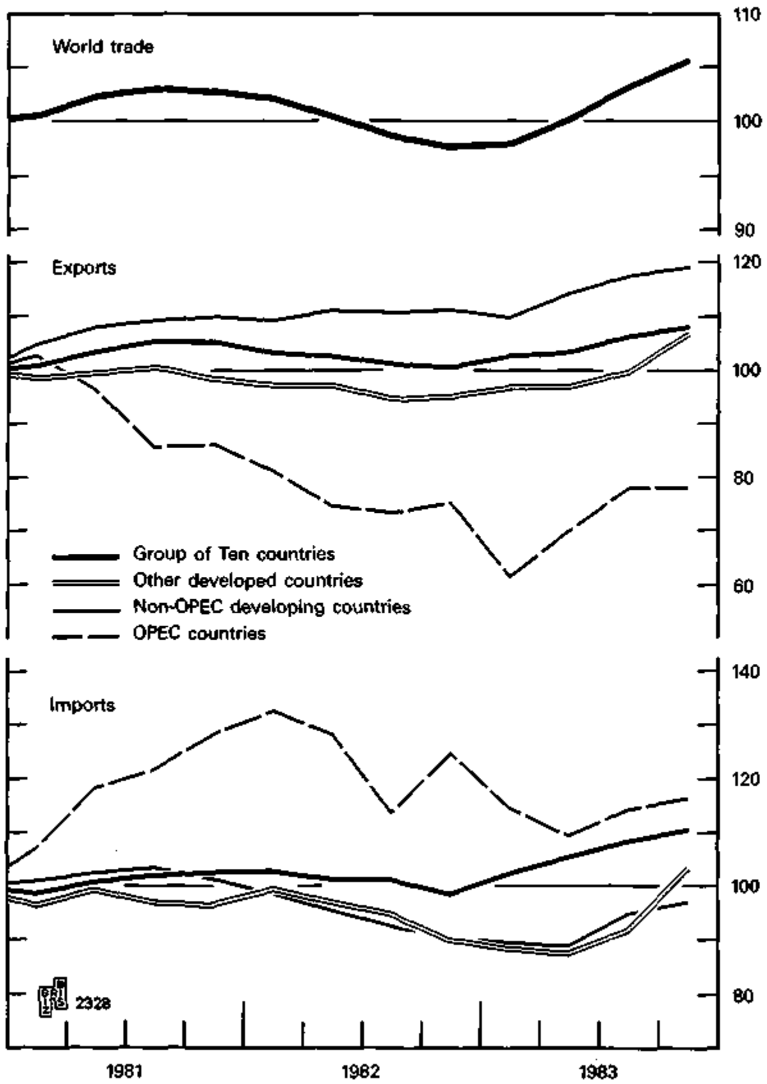
The volume of world trade expanded by 2 per cent. in 1983 after a fall of 2½ per cent. in the previous year. Nevertheless, trade has been more sluggish since 1979 than during any comparable period since the Second World War. Dollar prices of world trade fell by 4½ per cent. in 1983, the third consecutive decline, and its value shrank by about 2½ per cent. to $1,900 billion. The volume of trade in manufactures rose by nearly 4 per cent., but that in minerals (including oil) fell by a further 6 per cent.; trade in agricultural products expanded by 2 per cent.

For the year as a whole, the movement of trade volumes in the main groups of countries exhibited strikingly different patterns. The only countries to record an increase in the volume of imports, of over 5 per cent., were the Group of Ten countries, and two-thirds of this expansion was accounted for by the United States. In all other groups of countries, by contrast, the volume of imports decreased. In the developed countries outside the Group of Ten the reduction of about 2 per cent. was roughly the same as the year before. In the non-OPEC developing countries the decline was about 1½ per cent., substantially less than the 7 per cent. fall in 1982, although volume changes varied greatly from one country to another. Finally, in the OPEC countries, where real imports had still been rising in 1982, the emergence of external constraints led to a retrenchment of as much as 9 per cent. Export growth was more evenly distributed, occurring everywhere except in the OPEC countries, where sluggish demand for oil early in 1983 caused exports to fall further, by 6 per cent. over the year. In the Group of Ten countries a rise of 3 per cent. offset the previous year's contraction; in the smaller developed countries export growth accelerated to 4 per cent., and in the non-OPEC developing countries it more than doubled to 5 per cent.

However, as can be seen from the following graph, all groups of countries participated in the upswing as the year progressed. The resumption of world trade growth was triggered by the Group of Ten countries, where import demand, primarily from the United States, began to gather momentum late in 1982. Moreover, the corresponding export growth was initially confined to within the Group of Ten, generating a rise in intra-group trade of around 4 per cent. The impetus was then gradually transmitted to other groups of countries, where after the first quarter of 1983 export volumes began to rise appreciably, most of all in the OPEC countries. The delayed response of import volumes outside the Group of Ten must be ascribed primarily to the maintenance of policies of import restraint in

World trade volumes, 1981–83.*

Fourth quarter 1980=100.



* Seasonally adjusted.

many countries. Nonetheless, during the second half of last year the upturn was more broadly based, and world trade rose by nearly 6 per cent. compared with the first six months.

Finally, significantly diverging dollar prices of major categories of traded goods — the average price of manufactured products declined by 3 per cent. and that of oil by 12 per cent., while primary commodity prices increased by 7 per cent. — left their mark on the individual groups' terms of trade. A large deterioration, of

9 per cent., in OPEC countries' relative trade prices was mirrored primarily in terms-of-trade gains of about 2 per cent. in the developed countries. The non-OPEC developing countries recorded a small improvement of about 1/2 per cent. in their terms of trade, the first since 1977.

International balance-of-payments developments.

Last year's configuration of current-account balances — shown in the table on page 83 — reflects widespread adjustments, which led to a global payments structure that was in many respects better balanced than before. On the other hand, large imbalances developed in the United States and Japan. Moreover, the world current-account picture remains obscured by statistical discrepancies. Only about one-half of the sum of recorded improvements in current payments positions in 1983 had a counterpart in recorded deteriorations. Accordingly, the world current-account discrepancy declined by $28 billion, representing the reappearance of the traditional surplus on world trade account and a reduction in the global invisibles deficit.

The adjustment in aggregate current-account positions was particularly pronounced in the non-OPEC developing countries and the developed countries outside the Group of Ten, whose deficits were reduced by $21 and 13 billion respectively, to levels which in relation to GNP were not much higher than those recorded prior to the second oil shock. Within these groups the biggest improvements were in most cases achieved by countries which had previously had very large deficits. Substantial adjustment also took place in the OPEC countries, where the attainment of current-account balance in the second half of the year limited the annual deficit to $19 billion, not much more than the previous year's figure. The centrally planned economies recorded a sizable surplus for the second consecutive year, the bulk of which was accounted for by the USSR and China. In the Group of Ten countries, where the aggregate deficit doubled to $11 billion, significant reductions in several countries' current-account deficits were overshadowed by the emergence of a $41.3 billion deficit in the United States and a surplus of $20.8 billion in Japan.

With the exception of some major debtor countries, the financing of last year's current-account deficits did not pose difficulties. In the United States, owing primarily to exceptionally large net capital inflows through the banks, the rising deficit was financed with ease, as is demonstrated by the appreciation of the dollar's exchange rate. In the other Group of Ten countries aggregate capital outflows hardly changed in 1983, and in a number of countries improvements on current account were reflected largely in a strengthening of net official monetary positions. Elsewhere, the reductions in current-account deficits greatly facilitated their financing, and modest additions to official reserves were possible in both the non-OPEC developing countries and the developed countries outside the Group of Ten, in spite of sharply reduced inflows of funds from the international banking sector. However, for some of the countries with large external indebtedness international financing packages had to be arranged.

International current-account balances, 1981–83.[1]

Countries and areas	Trade balance (f.o.b.) 1981	1982	1983	Invisibles balance 1981	1982	1983	Current balance 1981	1982	1983
	in billions of US dollars								
BLEU	– 4.7	– 3.6	– 1.9	0.5	1.1	1.4	– 4.2	– 2.5	– 0.5
Canada	6.2	14.8	14.6	–11.0	–12.4	–13.3	– 4.8	2.4	1.3
France	–10.0	–15.8	– 7.7	5.2	3.7	3.9	– 4.8	–12.1	– 3.8
Germany	15.5	24.3	21.0	–21.3	–20.8	–17.0	– 5.8	3.5	4.0
Italy	–10.6	– 7.9	– 3.1	2.5	2.4	3.6	– 8.1	– 5.5	0.5
Japan	20.0	18.1	31.5	–15.2	–11.2	–10.7	4.8	6.9	20.8
Netherlands	3.8	4.6	4.0	– 1.0	– 1.0	– 0.6	2.8	3.6	3.4
Sweden	1.6	0.8	3.1	– 4.4	– 4.4	– 4.2	– 2.8	– 3.6	– 1.1
Switzerland	– 3.3	– 2.1	– 3.0	6.1	5.7	5.9	2.8	3.6	2.9
United Kingdom	7.5	4.2	– 0.8	7.5	5.5	3.9	15.0	9.7	3.1
United States	–28.1	–36.4	–61.1	32.7	25.2	19.8	4.6	–11.2	–41.3
Group of Ten countries	*– 2.1*	*1.0*	*– 3.4*	*1.6*	*– 6.2*	*– 7.3*	*– 0.5*	*– 5.2*	*–10.7*
Australia	– 2.3	– 2.7	0.1	– 6.0	– 5.9	– 5.5	– 8.3	– 8.6	– 5.4
Austria	– 4.8	– 3.3	– 3.4	3.3	3.7	3.3	– 1.5	0.4	– 0.1
Denmark	– 0.9	– 0.8	– 0.1	– 0.9	– 1.5	– 1.2	– 1.8	– 2.3	– 1.3
Finland	0.7	0.3	0.2	– 1.0	– 1.2	– 1.1	– 0.3	– 0.9	– 0.9
Greece	– 6.7	– 5.9	– 5.4	4.3	4.0	3.5	– 2.4	– 1.9	– 1.9
Ireland	– 2.2	– 1.6	– 0.6	0.1	0.1	0.2	– 2.1	– 1.5	– 0.4
Israel	– 3.5	– 3.3	– 4.1	2.1	1.2	1.8	– 1.4	– 2.1	– 2.3
New Zealand	– 0.0	– 0.2	0.9	– 1.4	– 1.2	– 1.5	– 1.4	– 1.4	– 0.6
Norway	3.0	2.4	4.4	– 0.8	– 1.7	– 2.2	2.2	0.7	2.2
Portugal	– 5.1	– 4.9	– 2.9	2.5	1.6	1.3	– 2.6	– 3.3	– 1.6
South Africa	– 0.2	0.7	3.9	– 4.3	– 3.7	– 3.6	– 4.5	– 3.0	0.3
Spain	–10.1	– 9.2	– 7.4	5.1	5.0	4.9	– 5.0	– 4.2	– 2.5
Turkey	– 3.1	– 2.0	– 2.4	1.3	1.2	0.4	– 1.8	– 0.8	– 2.0
Yugoslavia	– 3.1	– 2.0	– 1.3	2.2	1.5	1.6	– 0.9	– 0.5	0.3
Other developed countries	*–38.3*	*–32.5*	*–18.1*	*6.5*	*3.1*	*1.9*	*–31.8*	*–29.4*	*–16.2*
Total developed countries	*–40*	*–32*	*–22*	*8*	*– 3*	*– 5*	*–32*	*–35*	*–27*
OPEC countries[2]	126	63	44	–75	–78	–63	51	–15	–19
Non-OPEC developing countries[3]	–65	–45	–26	–17	–19	–17	–82	–64	–43
Total developing countries	*61*	*18*	*18*	*–92*	*–97*	*–80*	*–31*	*–79*	*–62*
Centrally planned economies[4]	2	14	15	– 5	– 2	– 0	– 3	12	15
Total	23	0	11	–89	–102	–85	–66	–102	–74

[1] On a transactions basis. [2] OPEC countries (Algeria, Ecuador, Gabon, Indonesia, Iran, Iraq, Kuwait, Libya, Nigeria, Qatar, Saudi Arabia, United Arab Emirates, Venezuela) plus Oman. [3] The group of non-OPEC developing countries comprises all countries not included in the other groups referred to in this table. However, this definition differs from that used in Chapters VI and VII, and the data on non-OPEC developing countries are therefore not fully comparable with those in the other two chapters. [4] Bulgaria, People's Republic of China, Czechoslovakia, German Democratic Republic, Hungary, Poland, Rumania and the USSR.

Sources: IMF, OECD, national sources and own estimates.

Given the large changes in the US external accounts in 1983 and their importance for other countries, the discussion of payments developments in the main groups and in individual countries commences with an analysis of the US balance of payments.

The balance of payments of the United States.

The deterioration in the *current account* of the United States, which began in the second half of 1982, accelerated sharply in 1983, when the deficit rose to $41.3 billion. By the final quarter of the year the shortfall had reached almost $64 billion at a seasonally adjusted annual rate, and in the first quarter of 1984 it is estimated to have increased further to more than $80 billion. While the bulk of the current-account deterioration in 1983 originated in the trade balance, there was also a $5.4 billion decline in the invisibles surplus, owing mainly to higher net expenditure on travel and a $3.7 billion reduction in net receipts from investment income. The latter reflected a marked rise in foreign earnings on direct investment in the United States and lower net income from US portfolio investment abroad, owing to both a widening differential between US and foreign interest rates and shifts in portfolio balances associated with large net banking inflows into the United States.

Last year's increase in the US foreign trade deficit marked the continuation of a process which had begun in 1981. Since then a number of factors, both positive and negative, have had major effects on the trade balance; estimates of the relative importance of these factors are presented in the following table.

United States:
Estimated components of changes in the foreign trade balance, 1981–83.

Years	Changes in the foreign trade balance	Reflecting changes in				
		oil imports	non-oil terms of trade	export markets[1]	domestic demand[2]	competitiveness and other factors
	in billions of US dollars					
1981	− 2.5	1½	15½	8½	− 9	−19
1982	− 8.3	16½	2½	−17½	3	−13
1983	−24.7	7½	6½	0	−14	−25
1981–83	−35.5	25½	24½	− 9	−20	−57

[1] The volume growth of imports by US trading partners weighted according to their shares in US exports. [2] Excluding oil imports.

Looking first at the positive factors, between 1981 and 1983 there was a decline of $25½ billion, or one-third, in US payments for imported crude oil and petroleum products. Although this reflected to some extent the fall in the average price of imported oil from $35 to $28.5 per barrel, it must be primarily ascribed to an impressive cutback in volume. Even in 1983, when US domestic demand expanded briskly, real oil imports contracted by 2 per cent., bringing their cumulative decline since 1980 to 28 per cent. This remarkable performance was made possible by conservation (oil consumption decreased in 1983 for the fifth consecutive year), reductions in stocks and a slight expansion in domestic production.

The US foreign trade balance also benefited substantially during 1981–83 from changes in the non-oil terms of trade. Mainly because of the strength of the US dollar, whose annual average effective exchange rate appreciated between 1980 and 1983 by 35 per cent., the non-oil terms of trade showed a cumulative improvement of 12 per cent. over the past three years, generating a trade balance gain of $24½ billion.

The influence of these positive factors, however, was more than outweighed by the adverse impact on trade volumes of shrinking export markets, domestic demand growth and other factors, primarily the loss of international competitiveness. As far as developments in US export markets are concerned, the fact that in 1981 Canada and Latin America together accounted for more than one-third of total US exports meant that the United States was particularly vulnerable to the subsequent weakness of these export markets resulting from the recession in Canada and debt problems in Latin America. In 1982 US export markets are estimated to have contracted by nearly 8 per cent., or three times as much as the decline in real world trade, thus producing an estimated export loss of $17½ billion. Although the decline came to a halt in 1983, US export markets remained sluggish in comparison with world trade growth. Had the evolution of demand in US export markets during the past three years kept pace with world trade, US exports would have been more than $9 billion higher than they were.

The adverse influence of weak export markets on the trade balance was generally reinforced by domestic demand pressures in the United States. While a 1 per cent. decline in demand in 1982 reduced imports by around $3 billion, the buoyancy of demand in 1981 and, particularly, in 1983 is estimated to have increased the volume of imports by as much as $23 billion.

By far the largest negative influence on the US foreign trade balance since 1981 must be ascribed to other factors, the most important of which was certainly the loss of international competitiveness arising from the lagged effect of the appreciation of the dollar's real effective exchange rate. This influence can be seen in the evolution both of major export categories and of the pattern of foreign trade with different groups of countries.

Looking at the evolution of major categories of US exports, the US share in total exports from OECD countries fell by 5 per cent. between 1981 and 1983 in the case of agricultural products and non-oil raw materials, while in the case of exports of manufactured goods — which are more sensitive to changes in international competitiveness — the decline was 9 per cent. Similarly, while the total volume of US agricultural exports shrank by 10½ per cent. over the last three years, that of non-agricultural products fell by as much as 22½ per cent. On the imports side, however, volume changes were — at least until the middle of 1983 — broadly in line with domestic demand movements, indicating that changes in competitiveness were reflected in changes in profit margins rather than in volumes. This would suggest that foreign competitors either regarded gains in competitiveness only as temporary, not warranting a significant expansion of capacity, or refrained from further import penetration in order not to precipitate trade restrictions.

United States: Changes in trade balances vis-à-vis groups of countries, 1981–83.

Years	Total trade balance	Industrial countries	*Canada*	*Japan*	OPEC countries	Non-OPEC developing countries	*Latin American countries*	Eastern Europe
	in billions of US dollars							
1981	− 2.5	−11.7	*1.0*	*− 5.4*	9.4	− 0.4	*1.9*	0.2
1982	− 8.3	−14.4	*− 6.9*	*− 1.2*	18.0	−11.7	*− 9.5*	− 0.2
1983	−24.2	−10.6	*− 1.2*	*− 2.6*	0.8	−13.2	*− 7.8*	− 1.2
1981–83	−35.0	−36.7	*− 7.1*	*− 9.2*	28.2	−25.3	*−15.4*	− 1.2

Worsening competitiveness, together with shrinking export markets, also affected the pattern of US foreign trade with various countries. As shown in the table above, the largest deterioration was in trade with other industrial countries, where the balance swung from a surplus of $9.3 billion in 1980 to a deficit of $27.4 billion in 1983. The second largest adverse shift occurred vis-à-vis the non-OPEC developing countries, where a small surplus in 1980 gave way to a $24.7 billion deficit in 1983. Most of this deterioration occurred as a result of adjustment policies in Latin American countries. In addition, more oil was imported from Mexico after 1981. The shift to non-OPEC sources of oil supply, together with the sharp reduction in overall oil imports, was the main reason for the marked improvement in the US regional trade balance with OPEC countries.

On *capital account*, there was a major change in the pattern of net inflows into the United States in 1983. Net banking inflows financed nearly two-thirds of the current-account deficit, while identified non-banking inflows and, to an even greater extent, unidentified inflows declined substantially from their 1982 levels.

Total identified non-banking inflows into the United States slowed down between 1982 and 1983 from $17.3 billion to only $2.8 billion. Net inflows on direct investment account fell by $11.5 to 1.9 billion, owing essentially to a resumption of net outward investment by US residents. In addition, net claims of US non-banking concerns on unaffiliated foreigners, which had been reduced in 1982 by $3.9 billion, rose in the first three quarters of last year by $4.2 billion, most of which represented a net acquisition of financial assets. Partly offsetting these movements, increased purchases of US securities by non-residents caused net inflows from portfolio investments to rise from $5.2 to 9.7 billion.

The statistical discrepancy in the US balance-of-payments accounts — which is considered to reflect in the main unrecorded capital transactions — had shown net inflows of over $40 billion in 1982. In 1983 these inflows declined to only $7.1 billion, virtually all of which was recorded in the first quarter of the year. It seems probable that one reason for this marked change was that inflows of flight capital into the United States, in particular from Latin America, subsided as stabilisation policies were adopted in some major debtor countries. Moreover, it is possible that the narrowing differential between short and long-term dollar interest rates may have induced foreign investors to shift towards short-term dollar investments, the statistical reporting of which is more complete. To the extent that such investments

United States: Capital-account transactions, 1981–83.

Items	1981	1982	1983 year	1983 first quarter	1983 second quarter	1983 third quarter	1983 fourth quarter
	in billions of US dollars						
Capital-account balance	−30.2	−27.8	29.1	− 4.6	8.8	12.4	12.4
Identified non-bank capital:	11.5	17.3	2.8	0.7	2.7	− 0.6	− 0.1
Direct investment (net):	12.3	13.4	1.9	2.4	1.3	− 1.4	− 0.4
abroad	*− 9.7*	*3.0*	*− 7.6*	*0.3*	*− 0.9*	*− 4.5*	*− 2.4*
in the United States	*22.0*	*10.4*	*9.5*	*2.1*	*2.2*	*3.2*	*2.1*
Securities transactions (net):	4.5	5.2	9.7	4.1	2.5	1.2	1.8
Foreign securities	*− 5.6*	*− 8.0*	*− 7.5*	*− 1.8*	*− 3.2*	*− 1.6*	*− 0.9*
US Treasury securities	*3.0*	*7.0*	*8.6*	*2.9*	*3.1*	*1.0*	*1.6*
Other US securities	*7.2*	*6.1*	*8.6*	*3.0*	*2.6*	*1.8*	*1.1*
Other non-bank private capital (net)	− 0.2	3.9	− 4.2[1]	− 4.5	− 0.3	0.6	.
Other public-sector capital (net)	− 5.1	− 5.2	− 4.6	− 1.3	− 0.8	− 1.0	− 1.5
Banking flows (net)	−41.7	−45.1	26.3	− 5.3	6.1	13.0	12.5
Statistical discrepancy	24.2	41.4	7.1	8.8	− 0.6	1.8	− 2.9
Changes in:							
Net official monetary position[2]	1.4	− 2.4	4.6	− 0.5	1.6	− 2.2	5.7
assets (−=increase)	*− 4.1*	*− 5.0*	*− 1.2*	*− 0.8*	*0.0*	*0.5*	*− 1.0*
liabilities (−=decrease)	*5.5*	*2.7*	*5.8*	*0.3*	*1.6*	*− 2.8*	*6.7*

Note: Individual items may not add up to totals owing to rounding.
[1] First three quarters. [2] Excluding SDR allocations and valuation adjustments; a minus sign indicates an improvement.

took the form of placements with banks outside the United States, the rechannelling of these funds back to the United States via interbank operations may have contributed to the decrease in the statistical discrepancy.

The most striking feature of the US capital account last year was the turnround in banking flows, from net outflows of $45.1 billion in 1982 to net inflows of $26.3 billion in 1983. As shown in the table overleaf, the growth of the gross external assets of banks in the United States was cut back very substantially, from $109.4 to 25 billion; the growth of their liabilities to non-residents, however, slowed down comparatively little, from $64.3 to 51.3 billion.

Care has to be taken in comparing US banking flows in 1982 and 1983, since the growth of the banks' gross external assets and liabilities was inflated in 1982 by the rebooking of business from other centres into the international banking facilities which were introduced towards the end of 1981. Nevertheless, the dramatic turnround in the direction of net US banking flows in 1983 appears to have resulted chiefly from two factors. Firstly, on the assets side, there was a substantial scaling-back of new international lending to developing countries. The influence of this factor can be seen not only in the reduction in new lending to non-banks, but also, to some extent, in the much bigger decline in the growth of claims on foreign banks. Banks in the United States increased their total claims on bank and non-bank borrowers in non-OPEC developing countries by only $9.8 billion in 1983, as compared with a figure of $34.8 billion in 1982, with nearly three-quarters of the reduction being in lending to Latin American countries.

United States: Banking flows by type of transaction, 1982–83.

Items	Years	All transactions: Total	All transactions: In foreign currencies	All transactions: In US dollars	Transactions in US dollars, for own account: Total	With non-banks	With foreign banks[1]	With own foreign offices	Other trans-actions[2]
		in billions of US dollars							
Banking flows (net)	1982	− 45.1	− 1.2	− 43.9	− 40.8	− 9.3	− 21.8	− 9.6	− 3.1
	1983	26.3	0.0	26.3	18.8	0.3	8.3	10.2	7.5
Changes in claims	*1982*	*−109.4*	*− 2.4*	*−106.9*	*−103.0*	*− 27.1*	*− 45.2*	*− 30.6*	*− 3.9*
	1983	*− 25.0*	*0.1*	*− 25.0*	*− 32.8*	*− 12.6*	*− 1.0*	*− 19.2*	*7.8*
Changes in liabilities	*1982*	*64.3*	*1.2*	*63.0*	*62.2*	*17.8*	*23.4*	*21.0*	*0.8*
	1983	*51.3*	*− 0.0*	*51.3*	*51.6*	*12.9*	*9.3*	*29.4*	*− 0.3*

Note: Individual items may not add up to totals owing to rounding.
[1] Unaffiliated banks only. [2] Comprises transactions on customers' account and changes in custody liabilities.

The second main factor behind the reversal of net US banking flows was relative liquidity conditions and interest rate levels in the United States and other major financial centres. In the course of the year the differential between three-month Euro-dollar interest rates and comparable domestic short-term rates narrowed considerably. Banks in the United States therefore took up large amounts of money in the Euro-dollar market — mainly directly from their own foreign offices — where liquidity conditions were favourably affected by the widening differential between interest rates on dollars and other major currencies. During the second half of 1983 net interbank inflows into the United States were running at an annual rate of $53 billion — nearly three times the total of such inflows during the year as a whole.

The sustainability of the US external position. The speed with which the US current-account deficit has increased since the middle of 1983 and the size which it has now reached raise obvious questions for the future. The immediate issue concerns the continued financing of the deficit. The rest of the world (excluding official monetary authorities) added some $36 billion to its net claims on the United States last year; will it be prepared to increase these claims by more than twice that amount in 1984 and, if so, would it require more favourable terms than before, to compensate for the risks inherent in a further shift of its portfolio into dollar assets? An improvement of the terms on which foreign investors can acquire claims on the United States could take one or both of two forms: a further widening of interest rate differentials in favour of dollar investments and/or the establishment of a cheaper price for the dollar in terms of other currencies. To the extent that private investors were not ready to finance the US current-account deficit, the result would be a fall in the dollar's exchange rate accompanied by financing of the deficit through an increase in foreign dollar reserves held in the United States.

In the longer run, a sizable reduction in the current-account deficit itself would require a combination of changes in relative cyclical and competitive positions of the United States and other countries. However, whether such changes would produce a smooth transition to a sustainable US current-account position would depend crucially on the stance of US fiscal policy. As has been described in Chapter IV, the fundamental cause of the external disequilibrium has to be sought in the imbalance between US domestic saving and investment arising from the huge budget deficit. Without a reduction in the public sector's dissaving, the brunt of an adjustment in the saving/investment balance would probably have to be borne by a reduction in private-sector investment, brought about by excessively high interest rates. This, however, would mean that the elimination of the external disequilibrium would have to come about primarily through the impact of a sharp recession on US import demand. Moreover, for as long as high interest rates continued to hold up the dollar's exchange rate, no support for the adjustment of the trade balance would come from an improvement in the US international competitive position.

Balance-of-payments developments in the other Group of Ten countries.

Current-account developments. With the exception of Japan, where a large surplus was recorded, current-account developments in 1983 in Group of Ten countries other than the United States were generally in the direction of better balance. Four countries which had recorded large deficits in 1981 and 1982 — France, Italy, Sweden and Belgium — considerably improved their current-account positions last year. All four strengthened their foreign trade balances through a blend of restrictive demand management policies and improved export performances, which, in some instances, were reinforced by favourable terms-of-trade developments. In two other countries, the United Kingdom and Canada, the surpluses on current account declined, as a result of a marked recovery in domestic demand, the effects of which, however, were significantly mitigated in Canada by the buoyancy of US demand for its exports. In the three remaining countries, Germany, the Netherlands and Switzerland, the current-account surpluses were little changed from 1982, as some weakening on trade account — partly a reflection of a pick-up in domestic demand during the year — was broadly offset by opposite changes in the invisibles balance. The main features of current-account developments in the individual countries are described in the following paragraphs.

Japan's current-account surplus more than tripled last year to $20.8 billion, a record for an oil-importing country. A large part of this rise must be ascribed to a strong export performance. The trade surplus widened from $18.1 billion in 1982 to $31.5 billion in 1983, with a peak, at a seasonally adjusted annual rate, of more than $34 billion being reached in the third quarter of the year. Export volumes increased by 9 per cent., and, with import volumes stagnating, the trade surplus widened in real terms by over $10 billion; in addition, there was a terms-of-trade improvement of 3 per cent. While the growth in real exports was impressive, it seemed to be broadly in line with export-market developments and the lagged effects of Japan's gains in international competitiveness during 1981 and 1982. A more striking feature, however, in view of the 3 per cent. growth in GNP, was the sluggishness of real imports. This was partly due to the relatively late upturn in domestic demand last year and slow inventory formation, but more important was increased efficiency in the use of imported energy and other raw materials, which together account for nearly two-thirds of total imports. Japan's success in economising on energy and other raw materials is a principal reason for its unusually low demand elasticity for imports. This means that, without a sizable real appreciation of the yen, a reduction of the external imbalance in coming years is highly unlikely, even if Japan's domestic demand growth were significantly to exceed that of other countries.

Among the four countries in the Group of Ten which substantially reduced their current-account deficits in 1983, the biggest improvement was recorded by *France*, with a cut of two-thirds to $3.8 billion. The change occurred almost entirely in the trade balance, where the deficit was more than halved to $7.7 billion, reflecting the combined effect of a 2 per cent. fall in the volume of imports, a rise in real exports of almost 4 per cent. and a terms-of-trade gain of 2 per cent. However, these influences varied greatly in the course of the year. In the first half, when, at an annual rate, the deficit was $3.4 billion smaller than in the corresponding period of 1982, the improvement was primarily the result of terms-of-trade developments. In the second half, the decline of $4.7 billion resulted mainly from a marked expansion in the volume of exports and a fall in real imports owing to the downturn in domestic demand. Customs data indicate that nearly one-half of the trade balance improvement in 1983 was vis-à-vis other industrial countries and much of the remainder vis-à-vis OPEC countries; by commodities, the principal change was a reduction in payments for energy imports, which accounted for over half of the total decline in imports.

In *Italy*, too, the achievement of a small current-account surplus of $0.5 billion in 1983 represented an impressive turn-round from the very large deficit of $8.1 billion recorded two years earlier. Part of last year's $6 billion improvement in the current account derived from a rise in the invisibles surplus, from $2.4 to 3.6 billion, primarily reflecting an increase in net travel receipts. The bulk, however, originated from a $4.8 billion cut in the trade deficit, predominantly attributable to Italy's relative cyclical position. The 5 per cent. volume expansion in exports owed much to the upturn in economic activity in North America and Germany. Real imports, on the other hand, stagnated as domestic demand remained sluggish for much of 1983. The effect of volume movements on the trade balance was reinforced by a terms-of-trade gain of 1½ per cent.

In *Sweden* the current-account deficit declined in 1983 by $2.5 to 1.1 billion, the lowest since 1978. There was a $2.3 billion increase in the trade surplus, with the volume of exports expanding by 11½ per cent. following the 16 per cent. devaluation of the krona in October 1982. At the same time, restrictive demand management policies limited the rise in the volume of imports to 1½ per cent. The influence of these favourable volume movements on the trade balance was, however, to some extent offset by a 1 per cent. deterioration in the terms of trade, which had worsened particularly sharply immediately after the devaluation.

The current account of the *Belgium-Luxembourg Economic Union* improved further last year, with a $2 billion decline in the deficit to only $0.5 billion, mostly on the strength of an improved trade performance. With the terms of trade practically unaltered, the fall of $1.7 billion in the trade deficit was wholly due to movements in volumes. Domestic demand — which has not risen since 1980 — contracted by about 2 per cent. in 1983, and the volume of imports fell by 3 per cent., also reflecting the regaining of market shares by Belgian firms. Energy imports declined by almost one-fifth, so that more than half of the overall improvement in the trade balance was vis-à-vis OPEC countries. Export volumes rose by almost 2 per cent., with sales to the faster-growing of Belgium's trading partners — the United States, Germany and the United Kingdom — showing the largest increases.

Of the two Group of Ten countries whose current-account surpluses declined in 1983, the *United Kingdom* recorded the larger fall. At $3.1 billion, the surplus was $6.6 billion less than in 1982, and the lowest for four years. A further increase of $2.6 billion in the surplus on oil account was overshadowed by a $7.6 billion rise in the non-oil trade deficit. In addition, there was a decline of $1.6 billion in the invisibles surplus.

Although the non-oil terms of trade worsened by over 1 per cent., the principal factor in the deterioration on trade account was an 8½ per cent. rise in the volume of non-oil imports, in strong response to the buoyancy of domestic demand. Exports rose in volume terms by less than 1 per cent., partly because of relatively weak demand for much of the year in western Europe, which is the United Kingdom's principal export market. When demand from these countries did pick up, it was reflected, in the fourth quarter of the year, in a rise of 9 per cent. in the volume of UK manufactured exports (excluding erratic items) and an increase of one-fifth in oil exports. On the basis of customs data, more than three-quarters of the additional imports in 1983 came from western Europe, and the UK deficit on trade with this area increased further.

All of the $1.6 billion decline in the invisibles surplus in 1983 occurred on investment income. Net earnings on direct investment fell by $1 billion, reflecting the relatively buoyant cyclical position of the United Kingdom in 1983. In addition, mainly because of the worldwide reduction in interest rates last year, net income from portfolio investment and other net earnings fell by $0.7 billion. The decline in the surplus on investment income to only $0.7 billion in 1983, or less than one-third of that in 1979, is, however, rather surprising, given that since then the net foreign investment position of the United Kingdom has improved in line with the cumulative current-account surplus of $36 billion.

In *Canada* the current payments surplus declined by $1.1 to 1.3 billion in 1983, mainly reflecting a deterioration in the invisibles balance arising from higher net travel expenditure and reduced net transfer receipts. The trade surplus, at $14.6 billion, was only marginally lower than in 1982, as diverging volume trends — imports expanded by 15 per cent., substantially more than the 9 per cent. growth of real exports — were offset by a 3 per cent. terms-of-trade gain. The increase in exports was entirely due to the US recovery: Canadian exports to the United States rose by $7 billion, despite some loss of competitiveness, whereas exports to other countries declined. The steep rise in the volume of imports, by far the largest in any Group of Ten country, was mainly attributable to the upturn in household spending, following the deep 1982 recession, and to the rebuilding of inventories, but the strong real appreciation of the Canadian dollar vis-à-vis the yen and a number of European currencies was also a contributory factor. This was illustrated by the fact that the expansion of imports was relatively more broadly based than that of exports, and the $2.6 billion rise in the bilateral trade surplus with the United States was accordingly offset by a decline in the surplus vis-à-vis the rest of the world.

Turning finally to the three traditional surplus countries whose current-account positions changed little last year, *Germany* recorded a modest increase in its current-account surplus to $4 billion, a $3.3 billion deterioration in the trade balance being more than offset by a $3.8 billion reduction in the invisibles deficit.

The trade account weakened throughout the year, the surplus declining, at a seasonally adjusted annual rate, from $27.2 billion in the first quarter to $17.7 billion in the fourth. The recovery of domestic demand produced a 5 per cent. increase in the volume of imports, while real exports, despite an increase in the last six months, were virtually unchanged over the year as a whole. Consequently, the trade balance worsened in real terms by $6.5 billion, of which roughly one-half was offset by a terms-of-trade gain of 2 per cent. The dominance of demand effects on trade flows was somewhat surprising in view of the preservation during the past two years of the large improvement in Germany's international competitive position that had occurred in 1980–81.

The reduction in the deficit on invisible transactions, including transfers, to $17 billion in 1983 was mainly the result of a $2.5 billion turn-round in the balance on investment income account to net receipts of $1.6 billion. This was attributable to a number of factors: firstly, Germany's net external assets increased in line with the surplus on current account; secondly, the Deutsche Mark's depreciation vis-à-vis the dollar lowered the dollar value of investment income payments to non-residents; and, finally, as the average maturity of foreign assets exceeds that of foreign liabilities, last year's changes in the worldwide pattern of interest rates tended to reduce investment income payments by more than receipts. In addition, there was a further reduction of $1.3 billion in net payments in respect of foreign travel and a $0.7 billion fall in official transfers owing to a decline in net EEC budget payments.

In the *Netherlands* the surplus on current account last year amounted to $3.4 billion, virtually the same as in 1982. A $0.6 billion decline in the trade surplus, to $4 billion, was all but offset by a reduction in the invisibles deficit due primarily to lower official transfer payments. The trade surplus widened in real terms, with the growth of 6 per cent. in export volumes exceeding that in import volumes by 2 percentage points, but this was more than outweighed by a 2 per cent. deterioration in the terms of trade. Dutch exporters benefited particularly from the recovery in Germany and from gains in their international competitive position since the end of 1982.

Switzerland's current-account surplus fell by $0.7 to 2.9 billion in 1983. With domestic demand recovering after the fall in 1982, a 4.5 per cent. rise in the volume of imports was the main reason for the increase in the trade deficit to $3 billion. Export volumes remained static, in the face of an 8 per cent. deterioration in competitiveness since 1981, as a rise of 7 per cent. in primary and semi-manufactured goods, chiefly on account of metals and chemicals, was offset by declines of 4 and 3 per cent. respectively in equipment and consumer goods. By regional distribution, export receipts from Japan, the United States and Germany were relatively buoyant, rising by 10–12 per cent.

Capital-account developments. While in 1983 the broad picture of aggregate capital flows of Group of Ten countries other than the United States was not significantly different from what it had been in 1982, there were two notable features of capital-account developments last year. Firstly, large capital outflows occurred in Japan, Germany, the United Kingdom, Switzerland and the Netherlands, which practically matched, or even exceeded, these countries' surpluses on current account. Secondly, substantial net inflows of capital, not least because of direct foreign borrowing by governments and officially induced banking inflows, continued in France and Italy and contributed, in combination with the improvement on current account, to a marked strengthening of net official monetary positions.

Capital flows and changes in net official monetary positions of Group of Ten countries other than the United States, 1982–83.

Countries	Years	Identified capital flows: Total	Direct investment	Securities[1]	Other long-term private sector	Official sector	Short-term banking	Short-term non-bank private sector	Balancing item	Changes in net official monetary position[2]
		in billions of US dollars								
BLEU	1982	1.8	1.5	−1.3	−2.0	5.6	−0.4	−1.6	−0.1	0.8
	1983	−0.3	0.5	−0.9	−2.8	2.2	1.5	−0.8	0.4	0.4
Canada	1982	0.3	−1.3	9.2	2.3	−2.7	−4.0	−3.1	−3.3	0.6
	1983	4.5	−1.9	5.0	0.2	−0.1	0.6	0.7	−5.3	−0.4
France	1982	7.9	−1.5	4.4	−1.0	1.8	2.0	2.2	−0.8	5.0
	1983	10.3	−0.2	4.1	−1.7	3.8	5.6	−1.3	−0.6	−5.9
Germany	1982	−1.8	−2.2	0.2	−2.7	−1.5	3.3	1.1	−0.5	−1.3
	1983	−8.2	−1.8	6.0	−4.9	−3.4	0.8	−2.9	0.7	1.6
Italy	1982	0.5	−0.3	−0.4	3.1	2.4	−2.3[3]	−2.0	0.9	4.3
	1983	5.2	−0.9	0.2	−0.3	2.2	3.3[3]	0.7	0.1	−5.8
Japan	1982	−16.6	−4.1	2.1	−12.6	−0.4	−0.0	−1.6	4.7	5.0
	1983	−21.1	−3.2	−1.9	−11.6	−1.0	−3.6	0.2	1.8	−1.7
Netherlands	1982	−1.2	−1.4	0.0	−1.8	0.1	2.5	−0.6	−0.6	−1.9
	1983	−2.5	−0.9	0.4	−1.6	−0.1	−0.7	0.4	−1.1	0.0
Sweden	1982	3.2	−0.8	0.2	1.2	2.5	0.4	−0.3	0.4	−0.0
	1983	1.0	−1.0	0.7	−0.1	2.4	0.4	−1.4	0.8	−0.7
Switzerland	1982	−17.0	.	−12.3	.	.	−4.7[3]	.	14.8	−1.3
	1983	−18.0	.	−13.7	.	.	−4.3[3]	.	15.2	−0.1
United Kingdom	1982	−6.3	−2.4	−10.2	−2.5	0.0	7.9	0.9	−6.3	2.9
	1983	−4.3	1.1	−7.0	−2.6	−1.4	5.8	−0.1	−1.2	2.4

Note: Individual items may not add up to totals owing to rounding.
[1] Includes private-sector and public-sector securities. [2] Excluding valuation adjustments; a minus sign indicates an improvement. [3] Includes long-term banking flows.

Turning to developments in individual countries, in *Japan* the current payments surplus was virtually counterbalanced by net outflows from identified capital-account transactions. The net official monetary position, excluding valuation adjustments, improved by $1.7 billion. The lion's share of total outflows took the form of private-sector long-term capital exports totalling $16.7 billion, $2.1 billion more than in 1982. There was a $4 billion turn-round in the balance on securities transactions to net outflows of $1.9 billion in 1983, which included a substantial increase of $6.3 billion in residents' purchases of foreign securities. The balance on other long-term transactions changed little, with total net loans granted to non-residents by Japanese financial institutions, which had increased sharply in 1982 in response to the progressive liberalisation of exchange and capital-market controls, remaining at the very high level of over $8 billion. Net outflows of short-term capital of $3.4 billion were more than accounted for by the banks, whose short-term external position had not changed in 1982.

The continuation of large net capital outflows for the second year in succession must be mainly ascribed to persistently large differentials between returns on yen and US dollar-denominated assets, which amounted on average in 1983 to 3 percentage points for shorter maturities and nearly 4 percentage points for government bond yields. Apart from being reflected in the sharply increased yen credits extended by Japanese financial institutions, the impact of rising differentials became particularly evident in residents' portfolio transactions during the course of the year. In parallel with a widening of the average differential between yields on yen and dollar bonds from 3.3 to 4.6 percentage points between the two halves of 1983, Japanese residents increased their purchases of foreign securities between these two periods from $6.5 billion to nearly $10 billion.

In *France* the large reduction in the current-account deficit, together with an increase of $2.4 billion in total identified capital inflows, resulted in an improvement of $5.9 billion in the net official monetary position, one-half of which was reflected in additions to official reserve assets. The increase in net inflows can be traced primarily to higher foreign borrowing by the public sector, together with a marked decline in net direct investment outflows. Net inflows of short-term capital from private-sector transactions, at $4.3 billion, were practically the same as in 1982, with net banking inflows alone amounting to $5.6 billion.

In *Italy* the situation on capital account was broadly similar to that of France. The net official monetary position strengthened by $5.8 billion, following the $4.3 billion deterioration in 1982, as the improvement on current account was accompanied by markedly higher net inflows of capital. As long-term net inflows declined, the increase in the total was more than accounted for by net banking flows and short-term non-bank flows, both of which became strongly positive. Persistently high real domestic interest rates, especially after the March 1983 EMS realignment, and new regulations introduced late in 1982 requiring exporters to finance with banks 70 per cent. of foreign currency trade credit granted, appear to have been the two principal reasons for these short-term inflows.

In *Belgium* the improvement on current account was accompanied by a slowdown in capital outflows through the private sector, enabling the Government to reduce its foreign borrowing markedly. Net capital exports by the private sector declined on balance by $1.3 billion; while net outflows of long-term capital increased slightly, short-term capital movements, mainly in the banking sector, turned round from net outflows of $2 billion in 1982 to net inflows of $0.7 billion in 1983. Net foreign borrowing by the Government, nearly all of which was in the form of foreign currency loans by Belgian banks, dropped to $2.2 billion, its lowest level since 1979. With the balancing item showing a small net inflow, the net official monetary position was practically unchanged.

In *Sweden* total identified net capital inflows declined substantially, from $3.2 billion in 1982 to $1 billion in 1983. The large reduction in the current-account deficit was, therefore, accompanied by only a modest improvement of $0.7 billion in the net official monetary position. The main reason for the decline in net capital inflows was unusually large net outflows on private capital account, primarily related to the extension of trade credits in parallel with the expansion of Swedish exports.

In the *United Kingdom* identified net capital exports declined by $2 billion in 1983, much less than the reduction in the current payments surplus. As, however, the negative balancing item fell very sharply between the two years, from $6.3 to 1.2 billion, indicating a substantial slowdown in unidentified capital outflows, the deterioration in the net official monetary position, at $2.4 billion, was little different from that in 1982.

On private long-term capital account, total net outflows, although still substantial at $8.5 billion, were $6.6 billion lower than in 1982. The balance of direct investment showed a swing of $3.5 billion to net inflows of $1.1 billion, mainly as a result of higher direct investment in the United Kingdom by non-residents. Non-residents also stepped up their portfolio investments in the United Kingdom last year, and this, together with smaller acquisitions of foreign securities by UK institutional investors, brought about a $3.2 billion fall in the net outflow on portfolio account.

Nearly half of the decline in long-term private capital outflows was offset by a $3.1 billion fall in short-term private inflows. In particular, net inflows through the banking system were $2.1 billion less than in 1982. In addition, the balance of official capital transactions, which in 1982 had been in equilibrium, showed net outflows of $1.4 billion last year.

In *Canada* total identified capital inflows increased from $0.3 billion in 1982 to $4.5 billion in 1983. Outflows through the public sector virtually disappeared, mainly because long-term export credits financed by the Government were repaid. More important, however, was a $8.4 billion swing to net inflows on short-term private capital account, reflecting a resumption of net foreign currency borrowing by banks and a withdrawal of foreign deposits by the non-bank sector. Other major categories of capital transactions, however, showed much smaller net inflows of funds than in 1982. The largest decline was in net inflows from securities transactions, which, primarily because of reduced net sales of long-term public-sector securities to non-residents, were nearly halved to $5 billion.

In *Germany* net identified outflows of capital, at $6.2 billion, were substantially higher in 1983 than they had been in 1982 and more than offset the current-account surplus. Despite a small positive balancing item, therefore, the net official monetary position, which had increased somewhat in 1982, declined by $1.6 billion last year.

The increase in identified capital outflows in 1983 came from two sources: firstly, net official capital exports rose — mainly because of repayments of short-term Euro-DM loans — from \$1.5 to 3.4 billion; and, secondly, the balance on short-term private capital account turned round between 1982 and 1983 from net inflows of \$4.4 billion to net outflows of \$2.1 billion. This reflected, in part, a \$2.5 billion expansion of short-term trade credits. More significantly, however, following the EMS realignment in March, short-term capital outflows began to expand strongly in response to interest rate differentials in favour of other EMS currencies.

These developments were partly offset by a \$4 billion reduction last year in net outflows of long-term private capital, owing to an unprecedented inflow of funds into the German capital market. Despite an average yield differential of 3½ percentage points in favour of long-term dollar investment, non-residents doubled their purchases of German securities to \$10 billion. By contrast, net outflows from other long-term private-sector transactions increased by \$2.2 to 4.9 billion, mainly because German corporations refrained from raising new loans abroad and because German banks stepped up their net lending to non-residents.

In the *Netherlands* the doubling of net outflows of identified capital, to \$2.5 billion, resulted from opposing movements in short and long-term capital flows. Net long-term capital exports by the private sector declined by \$1.1 billion, mainly owing to reduced outflows on direct investment account and the emergence of a small net inflow from securities transactions. By contrast, net short-term inflows of \$1.9 billion in 1982 gave way to net exports of \$0.3 billion in 1983. This swing was wholly attributable to a \$3.2 billion turn-round in banking flows. As the increase in identified capital outflows was accompanied by a rise in the negative balancing item to \$1.1 billion, the net official monetary position remained unchanged following the \$1.9 billion improvement in 1982.

In *Switzerland* identified net capital outflows increased by \$1 billion in 1983, owing to a rise in residents' purchases of foreign bonds. With a smaller current-account surplus, the improvement in the net official monetary position (excluding end-year dollar swaps by the Swiss National Bank with the commercial banks) amounted to only \$0.1 billion, as against \$1.3 billion in 1982.

Balance-of-payments developments in the other groups of countries.

In the *developed countries outside the Group of Ten* the aggregate current-account deficit was almost halved in 1983 to \$16 billion, the first large adjustment since the second oil shock. All of the improvement was in the trade account and, for the group as a whole, was mainly attributable to an average expansion of 4 per cent. in the volume of exports, a further cutback of 2 per cent. in the level of real imports and a terms-of-trade gain of about 2 per cent. However, in view of the heterogeneity of countries in the group, changes in trade volumes and prices varied greatly among countries.

In absolute terms, the biggest improvements, accounting for half of the total decline in the aggregate deficit, were achieved in Australia and South Africa, both of which had incurred unprecedentedly high deficits in the two previous years. In

Australia, where the current-account deficit was cut by \$3.2 to 5.4 billion, real imports shrank by more than 13 per cent. in 1983. In South Africa a decline of 15 per cent. in the value of imports and a \$1 billion increase in receipts from gold sales boosted the trade surplus by \$3.2 to 3.9 billion and put the current account into surplus. Relative to the size of their economies, the largest improvements, equivalent to roughly 7 per cent. of GDP, were recorded in Ireland and Portugal, where the volume of exports increased by 12½ and 20 per cent. respectively. Relatively buoyant export performance — growth in real terms amounted to 6½ per cent. — in combination with stagnating real imports more than offset Spain's 2½ per cent. terms-of-trade loss and helped to reduce the current-account deficit by \$1.7 to 2.5 billion. In Norway, the only country with a sizable surplus in this group, a \$1.5 billion improvement reflected primarily an expansion in the volume of oil exports of more than 25 per cent.

Total inflows of capital into the smaller developed countries declined in 1983 by \$11 billion to a total of \$19 billion. This was less than the improvement on current account, so that official reserves, which had remained unchanged in 1982, were built up by \$3 billion last year. The bulk of the decline in total inflows was accounted for by a reduction in net borrowing from the international banking sector, from \$17 billion in 1982 to \$8 billion in 1983.

The continuation of policies of import restraint, coupled with more favourable export markets in western countries and reduced interest payments, reflecting declines in interest rates and in indebtedness, contributed to a further rise of \$3 billion in the current payments surplus of the *centrally planned economies* in 1983. The improvement was accounted for in roughly equal measure by the USSR and the smaller Comecon countries in Europe, while China's surplus may have declined slightly to about \$6 billion. The current-account position of nearly all the smaller countries in eastern Europe strengthened, the largest improvements being recorded in Rumania, where the surplus is estimated to have widened by \$1.1 to 1.6 billion, and Hungary, where the deficit was almost halved to \$0.6 billion. These data, however, refer only to the balance on external transactions with market economies and do not take account of intra-Comecon settlements in convertible currencies, which result in sizable net receipts in Hungary. As in 1982, there was a decline in the eastern European countries' net indebtedness vis-à-vis BIS reporting banks; a reduction of \$1.2 billion in gross borrowing and an increase of \$2.9 billion in deposits brought the net figure down by \$4.1 billion. Moreover, China's net creditor position with the banks strengthened further in 1983, by \$1.3 billion, following a \$2.9 billion rise in 1982.

The *OPEC countries'* aggregate current-account deficit, which had emerged in 1982, widened only slightly last year, to \$19 billion, mainly because of a combination of increased import restraint and, in the latter part of the year, a rise in the demand for OPEC oil. Indeed, as the year progressed the current account came near to equilibrium. For the year as a whole, the trade surplus fell by \$19 billion, but much of this was offset by a \$15 billion reduction in the invisibles deficit, largely ascribable to cuts in services payments. The salient feature on trade account was a \$38 billion decline in export earnings, reflecting the combined effects of an 11 per cent. fall in export unit values and a 6 per cent. drop in volume. Oil exports fell last year to 15.9 mb/d, almost 50 per cent. below the level of 1979, and since then the OPEC countries' share in total oil production outside the centrally planned economies has dropped from 61 to 44 per cent. Increasingly faced with external constraints, the OPEC countries as a group began last year, for the first time since 1979, to cut back the volume of their imports — by 9 per cent. Particularly strong adjustment measures were made in countries with a high import absorption capacity, and their combined current-account deficit was reduced by $10 to 16 billion. By contrast, the other OPEC countries' current account deteriorated further, resulting in the first recorded deficit, of $3 billion.

OPEC countries: Financing of current-account deficits, 1982–83.

Items	1982	1983 year	1983 first half	1983 second half
	in billions of US dollars			
Current-account balance	−15	−19	−18	− 1
Identified capital flows[1] (− = capital outflows)	9	29	20	9
Long-term loans[2]	− 6	− 5	− 4	− 1
Investments[3]	−12	9	8	1
Change in net position with BIS reporting banks	27	25	16	9
(Claims on banks, − = increase)	(17)	(14)	(16)	(− 2)
(Liabilities to banks, + = increase)	(10)	(11)	(0)	(11)
Unidentified capital flows[4]	6	−10	− 2	− 8
Memorandum item:				
Change in official foreign exchange reserves	*−11*	*− 8*	*−11*	*3*

[1] Includes changes in official reserves held with banks or in the form of short-term government securities. [2] Loans to developing countries and international institutions. [3] Mainly portfolio investment and net changes in holdings of short-term government securities. [4] Includes changes in oil trade credits and errors and omissions.

As shown in the table above, the financing of the 1983 current-account deficit rested primarily on two categories of capital flows. Firstly, there was a withdrawal of $9 billion of funds previously placed in the industrial countries' financial markets. Most of these funds came from net sales of US Treasury securities, equivalent to $6.8 billion, reversing the sizable net acquisitions of preceding years. Secondly, large amounts were obtained from the international banking sector for the second successive year. In the first half of 1983 these mainly reflected withdrawals of deposits, but in the latter part of the year OPEC countries began to sharply step up their borrowing from banks.

The rather large discrepancy between identified capital flows and the recorded current-account deficit reflects, apart from unidentified transactions, capital flows related to changes in the level of oil trade credits. As the recording of exports precedes the corresponding payment flows by several months, the sharp decline in exports in 1982 and the concomitant reduction in outstanding trade credits resulted in inflows into the OPEC countries. Conversely, when oil exports began to grow in the middle of last year, the payment outflows arising from a build-up of trade credits showed up as a negative residual item. Nonetheless, the substantial swing in the residual item, especially the appearance of a negative residual in the first half of

1983, when oil exports were still falling, suggests that unidentified outflows of capital from OPEC countries may have increased last year.

For the second consecutive year the *non-OPEC developing countries* improved their aggregate current-account position. Following a decline of $18 billion in 1982, the deficit shrank last year by another $21 to 43 billion, which, in relation to GDP, was not much higher than before the second oil shock.

While the reduction of $19 billion in the trade deficit in 1982 was solely attributable to drastic cutbacks in imports, the improvement of almost the same magnitude in 1983 had three different sources. Firstly, for the year as a whole the volume of exports expanded by 5 per cent., as compared with only 2 per cent. in 1982, with growth becoming more pronounced as the year progressed. Secondly, partly because of strengthening commodity prices, the decline in export prices slowed down from 7 per cent. in 1982 to 2 per cent. in 1983. This contributed to a small improvement in the terms of trade, the first since 1977. Thirdly, the level of real imports, which had fallen by as much as 7 per cent. in 1982, declined further in the group as a whole, though by only 1½ per cent., as policies of import restraint were more selectively applied. The adjustment in the trade balance was reinforced by a $2 billion improvement in the invisibles account, reflecting a fall in the average interest rate on foreign debt from 10 per cent. in 1982 to 8.7 per cent. in 1983.

Current-account balances of non-OPEC developing countries in Latin America and Asia, 1981–83.

Areas	1981	1982	1983
	in billions of US dollars*		
Latin America			
Trade balance	− 11	3	18
Exports	78 (11)	72 (2)	73 (2½)
Imports	− 89 (2)	− 69 (−20½)	− 55 (−19)
Invisibles (net)	− 33	− 37	− 35
of which: interest payments	*− 29*	*− 35*	*− 33*
Current-account balance	− 44	− 34	− 17
Asia			
Trade balance	− 31	− 27	− 24
Exports	125 (7½)	123 (2½)	132 (10)
Imports	−156 (2)	−150 (−2)	−156 (9)
Invisibles (net)	8	8	9
of which: interest payments	*− 10*	*− 12*	*− 11*
Current-account balance	− 23	− 19	− 15

* Figures in brackets indicate annual percentage changes in volume.

As can be seen from the table above, the adjustment in the group's aggregate current account masks divergent developments in different areas and countries. About four-fifths of the total improvement in 1983 was achieved by countries in Latin America, which halved their combined deficit to $17 billion. This was entirely accounted for by the two most indebted countries: Brazil reduced its deficit by $8.6 to 6.2 billion, and in Mexico a deficit of $4.9 billion gave way to a surplus of $5.5 billion. The brunt of the adjustment in Latin America was borne once again by a very sharp cut in imports, which, at 19 per cent., was only marginally less than in 1982. At the same time, the volume of exports expanded moderately, by 2½ per cent. By contrast, countries in Asia expanded their exports in real terms by 10 per cent. This not only contributed significantly to the improvement of $4 billion in their combined current-account position but, more importantly, enabled them to increase their real imports by 9 per cent. in line with the long-term trend. The policy shift by Asian countries was made possible partly by their extremely strong export performance, but also because only 7 per cent. of total export earnings had to be devoted to interest payments on foreign debt. In Latin America, where this share amounts to one-third, the room for manoeuvre remained very limited despite the large improvement on current account.

Non-OPEC developing countries:
Estimated financing of current-account deficits, 1981–83.

Items	1981	1982	1983
	in billions of US dollars		
Current-account deficit	–82	–64	–43
Financing			
Direct investment (net)	10	7	5
Change in foreign debt (excluding IMF)	75	68	30
of which: long-term	*59*	*49*	*48*
short-term	*16*	*19*	*–18*
(bank lending)*	(42)	(26)	(10)
Net drawings on the IMF	5	5	11
Total	90	80	46
Change in foreign assets	8	16	3
of which: foreign exchange reserves	*– 1*	*– 8*	*5*
other assets	*9*	*24*	*– 2*

* Increase in claims of BIS reporting banks.

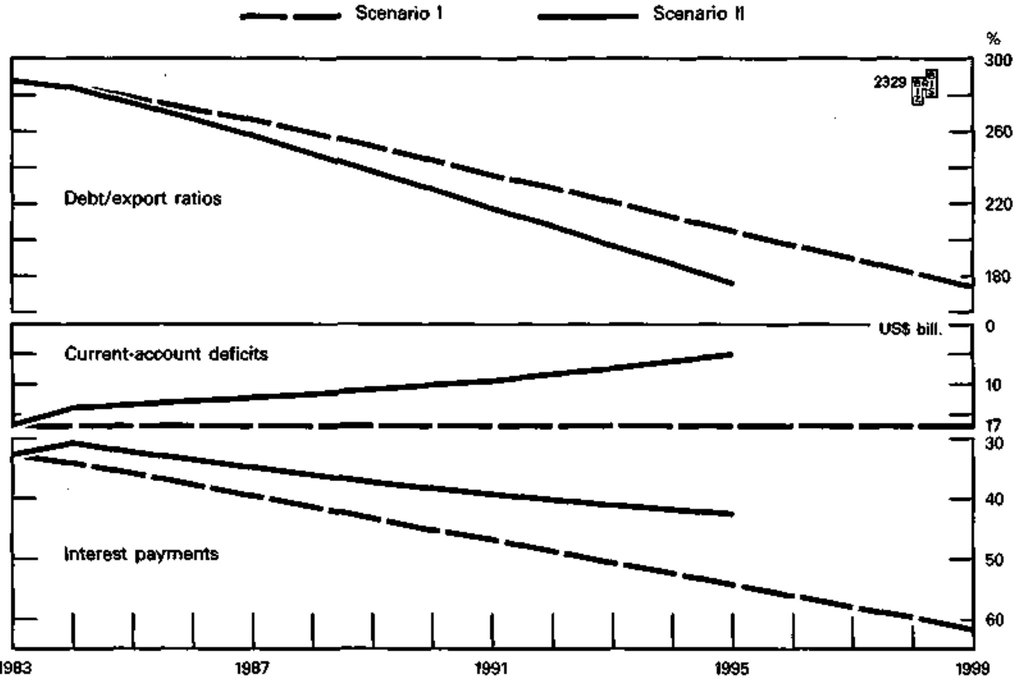
The improvement in the aggregate current-account position greatly facilitated the financing of the deficit. As shown in the table above, the main shifts in the pattern of financing flows observable in 1982 continued last year. Apart from a marked increase in funds provided by the IMF, all other major financing flows declined for the second consecutive year. Net inflows from direct investment, at $5 billion, have been reduced by half in the space of two years, partly as a result of the recession, but perhaps more as a consequence of the debt crisis. Despite a reduction in the financing requirement commensurate with the current-account improvement, net new borrowing of long-term funds remained virtually at the previous year's level. However, as indicated by the marked decline in short-term indebtedness, this must be attributed to a significant extent to rescheduling operations, which transformed part of the outstanding short-term debt into long-term debt and thus lengthened the average maturity of the non-OPEC developing countries' foreign indebtedness. Financing obtained from the international banking sector declined sharply for the second consecutive year, but concessional loans and other official flows are also estimated to have declined in 1983 by $2 billion to a total of $14 billion. There was no need for further recourse to financing from official reserves, which, after having been drawn down quite heavily in the previous two years, were built up by $5 billion in 1983.

The adjustment process in the longer run. The different adjustment patterns which became evident last year in Asia and in Latin America were primarily attributable to the influence of past policies on the level of indebtedness and export earning capabilities. While the ratio of foreign debt to earnings from exports of goods and services changed relatively little in Asia — at about 90 per cent. in 1983, it was at the same level as in 1973–74 and not much higher than in 1979 — it rose in Latin America from about 175 per cent. in 1973–74 to nearly 200 per cent. in 1979 and over 285 per cent. in 1983. The basic reason for this striking difference was that Asian countries were generally more successful in promoting exports than the Latin American countries, most of which favoured a strategy of import substitution. This is brought out clearly by the divergence in the trends of the two regions' exports and imports. From 1967 until the recession in 1981 the volume of merchandise exports expanded in Asian countries at an annual average rate of 10½ per cent., more than twice as fast as the 5 per cent. recorded in Latin America. This difference, which was not outweighed by slower real import growth in Latin America — 6½ per cent. per annum against 8 per cent. in Asia — and a more favourable terms-of-trade development, was the decisive factor behind the much weaker trade-account performance, the ensuing rise in indebtedness and the increase in the debt/export ratio of Latin American countries. Moreover, the external position in Latin America appears to have been severely aggravated by private-sector capital outflows. Between 1978 and 1983 new foreign borrowing exceeded these countries' financing requirement — the current-account deficit adjusted for changes in official reserves and non-debt-creating inflows of funds — by around $50 billion; by contrast, for Asian countries there is no such evidence of any sizable capital flight.

Clearly, a consolidation of the debt situation in Latin America cannot rely on cutting imports to unsustainable levels. Rather, it calls for an increase in export earnings which, in conjunction with manageable current payments deficits, will permit a modest increase in the level of imports over time.

The following graph illustrates two possible adjustment scenarios, which would bring the aggregate debt/export ratio for countries in Latin America down to 175 per cent., i.e. the level at which it stood in 1973–74. Scenario I assumes from 1984 onwards growth of the value of these countries' exports of goods and services at a constant annual rate of 7.5 per cent., net receipts from transfers and remittances unchanged at the 1983 level of $2 billion, a constant average interest rate on external indebtedness at the 1983 level of 10.9 per cent. and maintenance of the 1983 current-account deficit of $17 billion. Under these assumptions, the value of imports of goods and services would expand initially at an annual rate of 6 per cent. and gradually approach a growth rate of 7.5 per cent. Interest payments on external debt, which exceeded the current-account deficit in 1983 by $15 billion, would rise in line with the increase in the stock of foreign indebtedness, i.e. the current-account deficit, implying a continuously growing surplus on current-account transactions other than interest payments. However, the debt/export ratio would reach 175 per cent. only after fifteen years. More favourable assumptions about the growth of exports and the level of interest rates could significantly shorten the adjustment process or, alternatively, increase the supply of imported resources to the economy. For instance, a 1 percentage point drop in the interest rate would permit either a $3

Long-term adjustment scenarios for
non-OPEC developing countries in Latin America.



billion increase in the level of total imports or — as in Scenario II — a reduction in current-account deficits. As shown in the graph, a debt/export ratio of 175 per cent. could then be reached about four years earlier.

The two scenarios shown in the graph are purely illustrative. In particular, they should not be taken to suggest that these countries could not re-establish sustainable balance-of-payments positions without a reduction in the debt/export ratio to about its 1973–74 level. Nonetheless, they point to certain broad conclusions. Firstly, it will in any event take several years to achieve a marked decline in the debt/export ratio from its present level. Secondly, to hold the aggregate current-account deficit of these countries at its 1983 level, while allowing a reasonable growth of imports, necessitates much faster growth of their export earnings than in the past two years. Thirdly, the adjustment process is compatible with increasing foreign indebtedness, although only at a much lower rate than in past years. Fourthly, the debtor countries will have to finance a growing part of their debt-service payments from current export earnings rather than from new borrowing. Finally, given the probability of cyclical fluctuations of economic activity in the industrial countries and their repercussions on debtor countries' export performances, it is particularly important that any margin for manoeuvre offered by export growth during the present upswing be used to reduce the aggregate current-account deficit and thus the further growth of external indebtedness.

VI. THE INTERNATIONAL CREDIT AND CAPITAL MARKETS.

Highlights.

In 1983 the performance of the international financial markets was highly differentiated: in the international bond markets activity continued to be buoyant, despite pronounced interest rate uncertainties; in the international banking market, however, there was a further slowdown of both interbank business and final lending.

The slower growth of international banking activity, which had already set in in the second half of 1982, was essentially due to two factors: firstly, the international debt situation, which caused the banks to remain unwilling autonomously to expand their exposure vis-à-vis a number of heavily indebted countries, notably in Latin America; and, secondly, a partly cyclical, partly precautionary, slowdown in the demand for bank credit by corporate borrowers and countries of good credit-standing. On the other hand, on the sources side of the international banking market, there was no shortage of new funds, and the earlier large withdrawals of deposits by OPEC countries came to an end around mid-year. As a result of these various influences, the international banking sector remained very liquid. This meant that prime borrowers were much sought after by the banks and continued to command very fine credit conditions.

The predominant preoccupation in both private and official circles last year continued to be the international debt situation. Co-ordinated action by official monetary institutions, the banks and the debtor countries succeeded in containing the problems, while in addition some progress was made towards reducing the vulnerability of the system. The most heavily indebted countries managed to cut back their external current-account deficits quite substantially; improved earnings flows permitted in most cases a strengthening of the international banks' balance-sheet structures; and the implementation of the IMF quota increase, the enlargement of the General Arrangements to Borrow and certain other official credit arrangements have provided the resources for a continued active rôle of the International Monetary Fund in the management of the international debt situation.

Nevertheless, despite these positive developments, the situation remained a serious one. Owing to the persistently high level of dollar interest rates and slow export growth, interest payments on their external indebtedness continued to absorb well over one-third of Latin American countries' earnings from exports of goods and services. It was only through making further sharp import cuts that these countries succeeded in reducing their external financing requirements to manageable proportions. Persistent adjustment efforts, together with a favourable international economic environment, will therefore continue to be important conditions for a satisfactory management of the international debt situation.

Estimated net lending in international markets: Changes in external claims of banks and international bond issues.

	Flows excluding exchange rate effects[1]					Stocks at end-1983
	1979	1980	1981	1982	1983	
	in billions of US dollars					
Total international lending of reporting banks[2]	205.9	241.1	264.8	175.6	108.4	1,753.9
minus: double-counting due to redepositing among the reporting banks	80.9	81.1	99.8	80.6	23.4	668.9
A = Net international bank lending[3]	125.0	160.0	165.0	95.0	85.0	1,085.0
Euro-bond and foreign bond issues	38.9	39.4	49.0	71.7	73.5	.
minus: redemptions and repurchases[4]	10.9	11.4	12.5	13.2	14.5	.
B = Net international bond financing	28.0	28.0	36.5	58.5	59.0	345.0
A+B = Total bank and bond financing	153.0	188.0	201.5	153.5	144.0	1,430.0
minus: double-counting[5]	8.0	8.0	6.5	8.5	14.0	70.0
Total net bank and bond financing	145.0	180.0	195.0	145.0	130.0	1,360.0

[1] Non-dollar bank credits are converted into dollars at constant end-of-quarter exchange rates, non-dollar bonds at mid-month rates. [2] Banks located in the Group of Ten countries, Austria, Denmark and Ireland and the offshore branches of US banks located in the Bahamas, the Cayman Islands, Panama, Hong Kong and Singapore. [3] In addition to direct claims on end-users, these estimates include certain interbank positions: first, claims on banks outside the reporting area, 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 abroad; 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 very rough estimates and are inserted here mainly for illustrative purposes. Although the margins of error in these items are large, they are unlikely to alter significantly the figure for total net 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.

In the international bond markets an outstanding feature of 1983 was the expanding rôle of banks as buyers and issuers of bonds and the related buoyancy of the market in floating rate notes, which began increasingly to compete with the syndicated loan market. These developments meant that the borderline between the international bank credit and capital markets became rather blurred. The above table shows that after adjustment for the resultant increased overlapping between the two markets the total amount of new international credit extended last year amounted to $130 billion, down by one-third from its peak of $195 billion in 1981.

The international banking sector: main influences and the evolution of the international debt situation.

For the international banking sector 1983 was a year of slow growth and consolidation. The problems that had suddenly surfaced with the outbreak of the Mexican balance-of-payments crisis in the summer of 1982 — the excessive external vulnerability of some heavily indebted countries, the banks' consequent reluctance to increase their exposure vis-à-vis these countries, and the need nonetheless, in the interest of both creditors and debtors, to maintain the flow of credit — continued to be the dominant feature in the international financial markets last year.

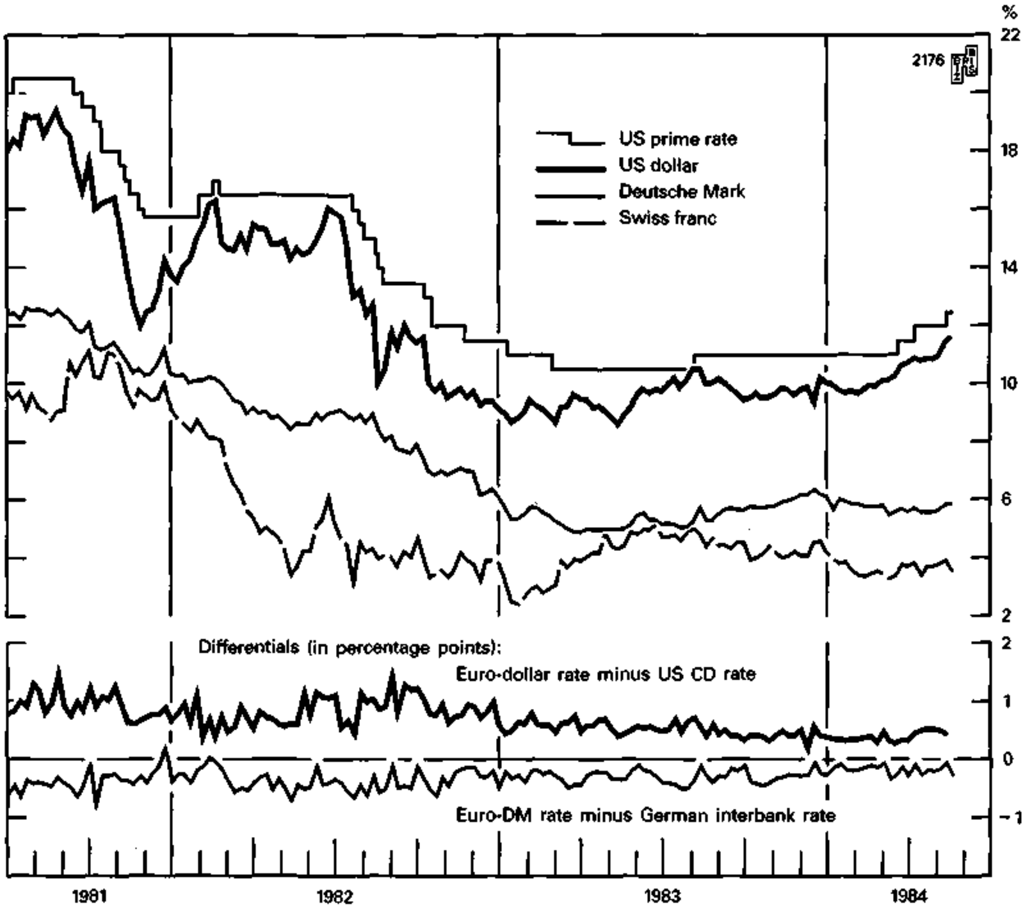
Although spontaneous lending to Latin America in general and certain other heavily indebted countries too has not resumed, the banks have kept their doors open to countries all around the world with reasonably sound policies and sustainable external payments positions. If, nevertheless, the overall flow of new credit to these countries has also slowed down, this has been due not only to greater caution and less growth orientation on the part of the banks, but also to more prudent policies and further adjustment measures on the part of a number of countries, a trend which is certainly in the interest of the stability of the international financial system. Moreover, reduced balance-of-payments deficits, cyclical factors, a strengthening of corporate cash flows and the receptiveness of the long-term capital markets kept down the demand for international bank credit in the main industrial countries as well.

While the smaller circle of eligible borrowers, together with their increased prudence and reduced financing requirements, moderated the growth of credit demand, there was on the sources side of the market no shortage of new funds. The earlier large withdrawals of deposits by OPEC countries came to an end around the middle of the year, while there were continued large inflows of funds to the banks from within the reporting area and, to a lesser extent, from other outside-area countries. This combination of buoyant supplies of loanable funds and lower credit demand meant that the international market continued to be very liquid. Prime borrowers were therefore much sought after by the banks and commanded very easy credit conditions, so that there may be a renewed risk of overlending to some countries. The surplus of loanable funds in the international market also exerted downward pressure on Euro-currency rates relative to comparable interest rates in the United States, with the result that in the course of 1983 banks in the United States switched from being major net suppliers to being large net takers of new funds in the international market.

The containment of the international debt situation in 1983 was made possible by a combination of factors: economic developments in the industrialised world; large-scale official financing flows to the problem debtor countries, with the key rôle being played by conditional IMF credits; debt rescheduling and the officially encouraged extension of additional credits by the international banks, many of which at the same time succeeded in strengthening their balance-sheet structures; and, last but not least, the continued adjustment efforts of the debtor countries themselves.

As regards the first of these factors, there can be no doubt that the economic recovery in the developed world, which began under the leadership of the United States and is now in progress in a number of other countries too, has contributed importantly to the containment of the debt situation — despite the fact that so far it has not been the very heavily indebted countries of Latin America that have derived the greatest direct benefits from the recovery. Over and above its direct effects, which have been felt most in the Asian developing countries, the recovery in the developed world has greatly improved the general economic climate within which the debt problems have had to be tackled. On the financial side, however, the picture has been less favourable. While, on average, dollar interest rates were lower

US prime rate, interbank rates on three-month Euro-currency deposits and differentials over domestic rates.



Note: Interbank rates and differentials are based on Wednesday figures.

in 1983 than in 1982, they began rising again towards mid-1983 and have gone up further in 1984, with a consequent renewed aggravation of debt-servicing burdens.

In the maintenance of an adequate flow of new funds to the problem debtor countries, the key rôle has been played by the International Monetary Fund. The Fund's approach to the problem has been a two-pronged one. Firstly, it has extended large-scale credits to the major problem countries, after having negotiated with them adjustment programmes designed to restore sustainable balance-of-payments situations. And, secondly, it has tried to ensure that the total external financing available to those countries remained adequate, by making the final approval of its own conditional credits dependent on the provision of new funds by the international banking system. The supervisory authorities in a number of countries have supported this second aspect of the Fund's strategy by making it clear to their banks that they saw no contradiction between their setting appropriately increased provisions against doubtful debts and at the same time increasing their exposure to debtor countries operating IMF-supported adjustment programmes.

Fund conditionality has also facilitated the handling of debt problems through the way in which its influence was brought to bear on negotiations between the debtor countries and their international bank creditors. During 1983 the banks were confronted with demands for both the rescheduling of existing debts and the provision of new finance from a considerable number of countries. The acceptance by the debtor countries of IMF conditionality became a key element in these negotiations, upon which the banks made their own acceptance of refinancing packages dependent. This co-ordinated approach of the Fund and the international banking system to the debt problems has certainly helped to bring about a greater consistency between banks' lending policies and countries' borrowing policies, on the one hand, and broad macro-economic requirements, on the other. Moreover, the experience thus gained may provide some lessons for the future, when the present need for the "arranged" financing of some countries' payments deficits is over.

The joint provision by the IMF and the international banking community of new finance to a number of problem debtor countries in 1983 enabled the bridging loans extended to these countries in 1982 and early 1983 by the BIS and the US monetary authorities to be repaid during the course of 1983. This applied to the $1.85 billion and $1.45 billion credits granted to the Bank of Mexico and the Central Bank of Brazil respectively, as well as to the $0.5 billion credit extended to the National Bank of Yugoslavia. The $0.5 billion standby facility made available to the Central Bank of Argentina in January 1983 expired without having been drawn on. (See Chapter VIII, pages 151–152.)

Co-ordinated official and private-sector flows to debtor countries last year were not limited to the financing packages put together by the IMF and the international banks. In a quite different area, the World Bank has made efforts to develop co-financing schemes with commercial banks. Such co-financing is intended to help widen developing countries' access to commercial-bank credit on reasonable terms for purposes that are more likely to contribute to economic development strategies than general balance-of-payments loans. It may be added that the parent supervisory authorities of the lending banks could help to improve the quality of their banks' international assets by giving prudential encouragement to such loans.

As far as the future is concerned, the Fund will continue to have a crucial rôle to play in handling the international debt situation and in seeking to avoid any impairment of the working of the international financial system. For these purposes it needs both to be able to put at member countries' disposal adequate conditional credit facilities and to have the resources to finance countries' use of them. From both these points of view the coming into force of the increase in IMF quotas under the Eighth General Review towards the end of 1983 was a most timely development, as was the reinforcement of the Fund's own credit lines through the enlargement of the General Arrangements to Borrow in December 1983 and the setting-up of credit lines totalling SDR 6 billion with Saudia Arabia, the BIS, Japan and Belgium in

April 1984 (see Chapter VIII, page 152). Efforts to strengthen the resources of the World Bank group of institutions, however, have so far not yielded results.

As regards the contribution of the international banks, the debt-rescheduling operations in which they engaged during 1983 encompassed no less than 22 countries and a total indebtedness of about $60 billion. In most cases the maturities of the rescheduled loans — which included not only longer-term credits but even short-term financial and trade credits — were extended for periods ranging from seven to nine years. In addition, new credits granted by the banks under Fund-related programmes came to $14 billion in 1983, of which nearly $10 billion had been actually drawn down by the end of the year. Brazil and Mexico alone accounted for over half of the rescheduled amounts and for two-thirds of the new credit packages. In contrast to the general pattern of negotiations covering the current year only, the rescheduling arrangements agreed upon between Mexico and its foreign creditor banks last year, which followed the provision of $5 billion of fresh money by the banks in March 1983, encompassed public-sector debt maturing up to the end of 1984 for a total of $22.5 billion. In the case of Brazil, the agreement reached in early 1983 provided for the rescheduling of $4.8 billion of public and private-sector debt falling due in 1983 and arranged for $4.4 billion of additional credits. In December 1983, moreover, Brazil and Mexico began negotiations with their creditor banks on the provision of $6.5 and 3.8 billion respectively of new money for 1984. These credit packages have in the meantime been finalised.

Despite their various contributions to the containment of the debt situation, the international banks mostly managed to strengthen their balance-sheet structures last year. Materially improved earnings performances not only permitted an accelerated pace of provisioning, either general or specific against doubtful country loans, but also left scope for an improvement in risk asset ratios, with the increase in the banks' own funds in most cases exceeding the average 5 per cent. rate of expansion in their exposure to non-OPEC developing countries. Moreover, the buoyancy of the bond markets made it easier for the banks to compensate, at least in part, for the reduced liquidity of some of their international claims. Thus, on the sources side of the banks' balance sheets there has been a shift away from short-term interbank funding to longer-term financing, in particular in the form of floating rate notes. It may be estimated that the banks raised $14 billion of funds in that way last year, after having obtained $13 and 8 billion respectively during 1982 and 1981. A substantial part of these issues, especially by US banks, was equity-linked, or was in the form of subordinated debt. Furthermore, on the assets side of the banks' balance sheets a larger share of lending took place through the issue of marketable debt instruments, with the acquisition of floating rate bonds issued by borrowers partly taking the place of syndicated loans. Finally, in order to avoid an excessive stretching of gearing ratios, banks have tended to reduce their participation in low-yielding interbank business.

The international banks' strong profit performance in 1983 in part reflected better results from their domestic business, as the recession gave way to recovery. In addition, however, in their international business banks fixed substantial spreads (over 2 per cent. on average) and front-end fees (over 1 per cent. on average) for rescheduled loans, although debt restructuring in combination with IMF

Estimated flows between the BIS reporting banks[1] and groups of countries outside the reporting area, 1978–83.

Items	Stocks at end-1977	Flows[2] 1978	1979	1980	1981	1982	1983	Stocks at end-1983
	in billions of US dollars at constant end-of-quarter exchange rates							
OPEC countries[3]								
Gross deposits	77.9	3.2	37.4	41.9	3.2	−18.2	−13.6	120.2
Gross borrowings	39.1	16.7	7.2	7.0	4.2	8.2	9.7	86.8
Net[4]	38.8	−13.5	30.2	34.9	− 1.0	−26.4	−23.3	33.4
Memorandum items:								
Foreign exchange reserves[5]	*69.6*	*−14.6*	*15.5*	*14.3*	*− 1.8*	*−11.6*	*− 9.3*	*61.6*
Current-account balances	.	*5.0*	*61.5*	*110.5*	*54.0*	*−12.5*	*−16.5*	.
Non-OPEC developing countries								
Gross deposits	60.8	14.6	12.3	3.9	9.4	4.9	10.5	110.9
Gross borrowings	97.2	22.8	35.3	39.0	39.9	19.8	12.4	256.2
Net[4]	−36.4	− 8.2	−23.0	−35.1	−30.5	−14.9	− 1.9	−145.3
Memorandum items:								
Foreign exchange reserves[5]	*43.5*	*11.3*	*8.6*	*− 1.7*	*0.1*	*− 2.0*	*8.4*	*68.2*
Current-account balances	.	*−28.0*	*−43.0*	*−64.5*	*−79.5*	*−59.0*	*−38.0*	.
Developed countries								
Gross deposits	28.2	8.7	7.0	5.7	3.8	− 0.1	1.5	48.9
Gross borrowings	55.5	5.7	7.5	15.4	16.8	15.9	7.5	116.4
Net[4]	−27.3	3.0	− 0.5	− 9.7	−13.0	−16.0	− 6.0	−67.5
Memorandum items:								
Foreign exchange reserves[5]	*15.9*	*6.5*	*3.2*	*1.3*	*− 1.5*	*1.2*	*2.4*	*29.1*
Current-account balances	.	*− 7.0*	*− 7.0*	*−16.5*	*−24.5*	*−23.0*	*−10.0*	.
Eastern Europe								
Gross deposits	8.4	1.7	4.7	0.9	0.1	2.0	2.9	18.5
Gross borrowings	38.3	5.7	7.2	6.8	4.8	− 4.6	− 1.2	48.9
Net[4]	−29.9	− 4.0	− 2.5	− 5.9	− 4.7	6.6	4.1	−30.4

Note: The definition of non-OPEC developing countries employed throughout this chapter differs from that used in Chapter V in two ways: firstly, it excludes offshore banking centres as well as Bahrain, Brunei and Trinidad and Tobago (which are included under the OPEC countries); secondly, it includes Israel and the centrally planned economies of China, North Korea and Vietnam.

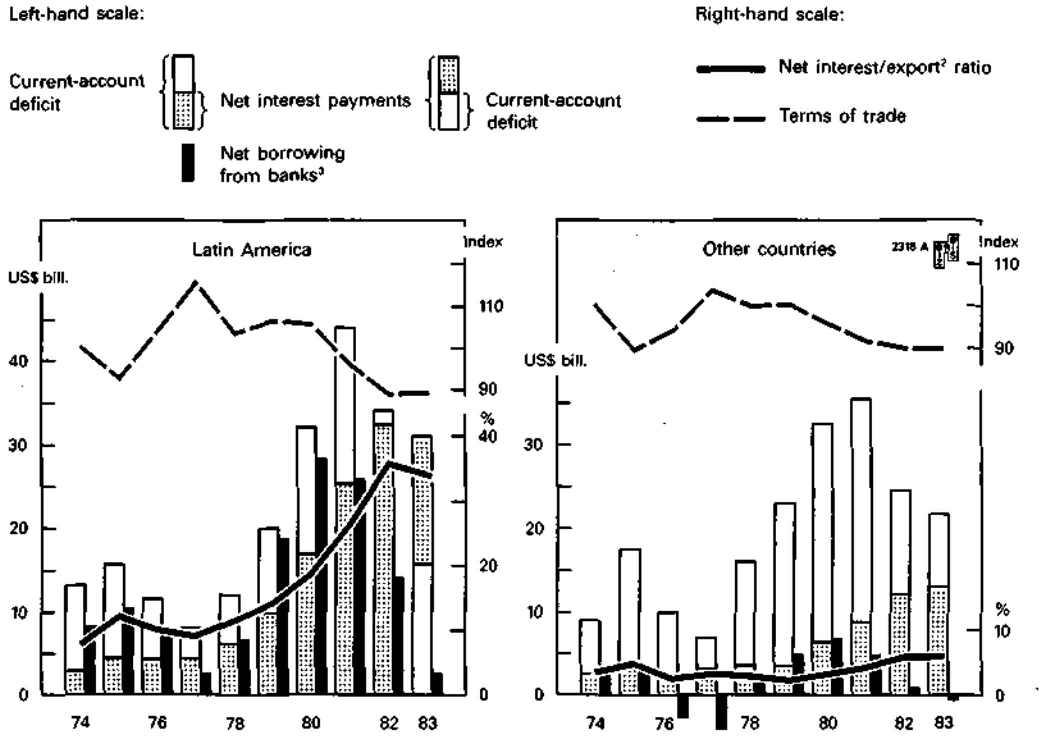
[1] The BIS reporting banks cover Austria, Belgium-Luxembourg, Canada, Denmark, France, the Federal Republic of Germany, Ireland, Italy, Japan, the Netherlands, Sweden, Switzerland, the United Kingdom, the United States and the offshore branches of US banks in the Bahamas, the Cayman Islands, Panama, Hong Kong and Singapore. From December 1981 onwards banks in the United States also include international banking facilities. [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.

conditionality should tend to improve borrowers' credit ratings. Indeed, it is of crucial importance that, once a debtor country's adjustment efforts begin to bear fruit, this should be promptly recognised through appropriate adjustments of the banks' lending conditions.

Finally, as regards the debtor countries themselves, the most encouraging development last year was the further reduction in the non-OPEC developing countries' aggregate current-account deficit from somewhat below $60 billion to around $38 billion.* Most of this improvement occurred where it was most badly needed, in the Latin American countries, whose combined current-account deficit was cut by over one-half last year to about $15.5 billion, its lowest level since before

* As data for offshore centres are excluded in this instance, the figures quoted in the rest of this section do not tally with those in Chapter V.

Factors influencing the borrowing needs and recourse to international bank finance of non-OPEC developing countries, 1974–83.[1]



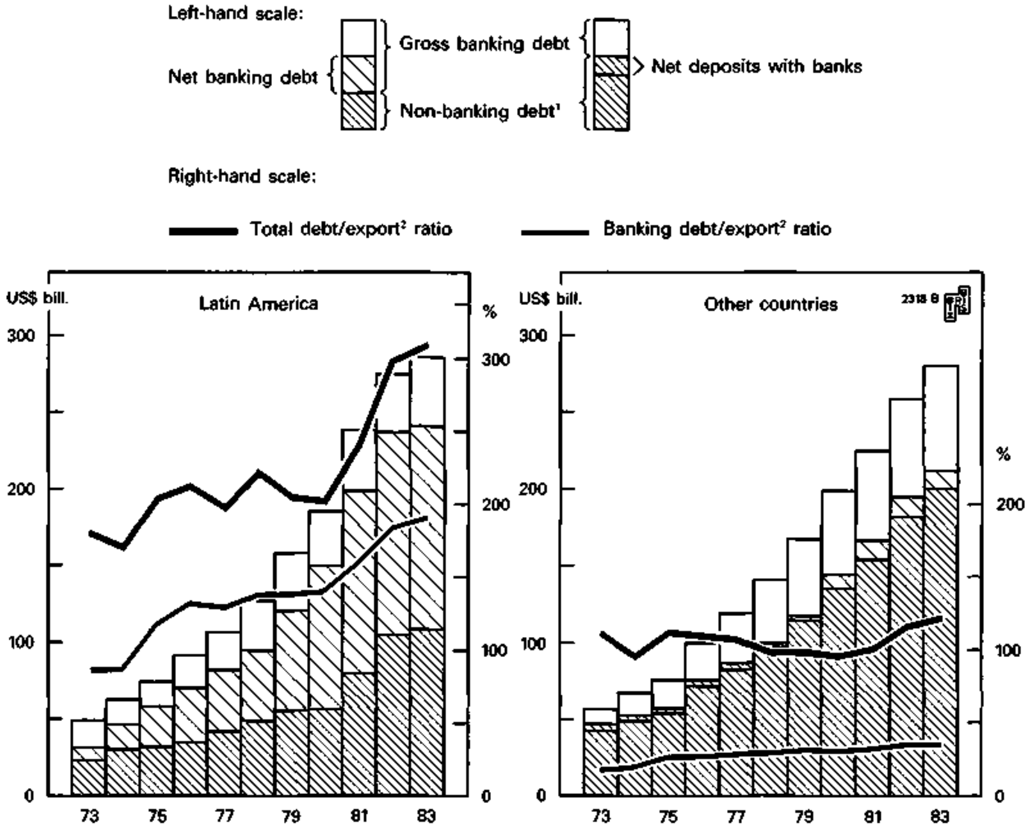
[1] Partly estimated. [2] Exports of goods and services. [3] Calculated in constant dollars.

the second oil price explosion. Mexico was able to shift from a $5 billion deficit to a $5.5 billion surplus, while Brazil's deficit was pruned from $15 to 6 billion.

Despite this strong improvement in their combined current account, however, the external payments situation of many Latin American countries remains very precarious. The continuing high level of dollar interest rates, combined with some further increase in indebtedness, meant that total Latin American net interest payments on external debt, at $31 billion (a figure which, of course, excludes the interest earned by flight capital), were almost as high as in 1982 and twice as large as their total current-account deficit. The improvement in these countries' current-account balance of payments had therefore to come through the achievement of very substantial trade surpluses. With their earnings from exports of goods and services rising by only about 1 per cent., 1983 saw a further 27 per cent. cut in total merchandise imports into Latin America, on top of the 30 per cent. reduction in 1982. Such a drastic import curtailment could not be achieved solely through market forces and entailed various elements of rationing which posed problems both for domestic and export production.

Furthermore, the persistently high level of interest obligations and lagging export performance meant that some of the key debt ratios in Latin America continued to deteriorate last year, the more so as there was no increase in non-debt-

Evolution of non-OPEC developing countries' international indebtedness, 1973–83.[1]



[1] Partly estimated. [2] Exports of goods and services.

creating capital flows to these countries. Thus the ratio of their total debt to exports of goods and services increased further from 300 to 308.5 per cent., and, despite the larger share of official credits, the banking debt/export ratio also edged up, from 185 to 190.5 per cent. The net interest payments/export ratio improved somewhat but, at over 33 per cent., remains very high. These ratios would be much higher if calculated on the basis of merchandise exports only. In both Brazil and Mexico interest payments amounted to about $10 billion in 1983, absorbing almost half of these countries' proceeds from merchandise exports.

There were, however, also some other encouraging aspects of developments in Latin America last year, in addition to the reduction of these countries' aggregate current-account payments deficits. Firstly, rescheduling improved the maturity profile of their external indebtedness. Secondly, capital flight, which from Latin America as a whole may be estimated to have amounted to at least $50 billion during 1978–82, appears to have fallen off dramatically in 1983, although there are as yet few signs of its being reversed. Thirdly, the improvement in Mexico's balance of payments last year enabled that country not only to recoup most of the reserve losses which it had suffered in 1982 but also to secure, by the end of 1983, significantly improved terms from the banks for its debt rescheduling.

As regards the other non-OPEC developing countries, last year's reduction in their aggregate current-account balance-of-payments deficit, from $24.5 to 22.5 billion, was quite modest. Countries in Asia, which were the only non-OPEC developing countries to achieve significant export growth last year, reduced their combined current-account deficit by $3 billion. Their banking debt/export ratio, which is less than one-sixth of that of Latin American countries, showed no further increase, and, with the single exception of the Philippines, debt service did not pose major problems. African countries were also able to cut their combined current-account deficit, but, as in the case of Latin America, this was achieved through a reduction in imports, whereas exports continued to decline. A further drop in exports and a corresponding deterioration in the banking debt/export ratio was, moreover, recorded by non-OPEC developing countries in the Middle East, whose current-account deficit widened last year. African and Middle Eastern countries together, however, account for only 12 per cent. of non-OPEC developing countries' international banking debt.

A further positive influence last year was the continued recovery of the eastern European countries' external payments situation. The combined current-account surplus of these countries may be estimated to have widened by a further $4.5 billion to $9 billion, the largest improvements having been achieved by the USSR, Rumania and Hungary. Eastern European countries' net indebtedness to the reporting banks, which had been reduced by $6.6 billion in 1982, was cut by a further $4.1 billion last year. In view of this lightening of the debt burden, the banks' attitude towards lending to these countries, which had hardened following the accentuation of Poland's external debt-servicing difficulties, became more accommodating again. With the exception of Poland, most of the countries in this group have regained, or seem to be regaining, access to international bank credit. Even Poland recently succeeded in alleviating its immediate external payments problems by obtaining agreement from its creditor banks on the rescheduling, over a period of ten years, of $1.6 billion of loans maturing in 1984–87 and the provision of $0.7 billion of new money.

To sum up the evolution of the international debt situation in 1983, on the economic side the current-account payments deficits of the non-OPEC developing countries narrowed substantially last year, thanks to a combination of these countries' own vigorous adjustment efforts and to the recovery of economic activity in the developed world. On the financing side, a continued flow of funds to the problem debtor countries has been assured through the co-ordinated actions of the IMF and the international banks, while at the same time the financial positions of both the Fund and the banks have been strengthened. Much remains to be done, however, if the progress made so far is to be extended and consolidated, and there is therefore a continued need for concerted action by all the major actors on the international financial scene.

The heart of the international debt problem is in Latin America, where the balance-of-payments adjustment process entailed overall cuts in imports of nearly 50 per cent. between 1981 and 1983, and where the costs of servicing external indebtedness remain very high. On the assumptions of continued economic growth in the developed world and of no further rise in dollar interest rates, further progress in bringing the debt situation under control should be possible. But, in addition, Latin American countries will need to achieve a more rapid growth of their export earnings if they are to restore sustainable balance-of-payments situations. For this to happen, two further conditions will have to be fulfilled. Firstly, these countries need to pursue domestic policies that are export-oriented; and, secondly, there must be adequate access for their exports to the markets of the developed countries.

The development of the main aggregates.

Following the outbreak of the Mexican payments crisis in the late summer of 1982 the growth of international bank credit had already begun to slow down in the latter part of that year. The slowdown continued well into 1983 and, although there were signs of a renewed pick-up in the last few months of the year, for 1983 as a whole the increases recorded in the international banking aggregates — both in absolute amounts and, especially, in terms of growth rates — were by far the lowest for many years. Expressed in constant dollars (unless otherwise stated, all flow figures in this section are adjusted so as to exclude the valuation changes resulting from exchange rate movements), the cross-border claims of the banks covered by the BIS reporting system expanded by $108 billion, or 6.5 per cent., to an end-year total of $1,754 billion, whereas in 1981 — comparisons with 1982 are less relevant, as it was a year of transition — the increase had amounted to $265 billion, or 20.5 per cent. (see the table on page 104).

Since the shift to more modest rates of expansion was particularly pronounced in interbank business within the reporting area, however, the gross figures quoted above somewhat overstate the slowdown in the underlying growth of international bank credit. After eliminating the double-counting resulting from the redepositing of funds between the reporting banks themselves, it may be estimated that the expansion in international bank credit slackened from $165 billion in 1981 to $85 billion last year, or from 21.5 to 8.5 per cent. Credit growth was particularly weak in the first half of 1983, when it amounted to barely $25 billion. In the second half it picked up to $60 billion, which, even though partly due to seasonal influences, was considerably more than the $45 billion expansion recorded in the second half of 1982.

In evaluating the real growth in international bank credit in 1983, it is important to take into account international price developments, such as the movement of the unit dollar value of internationally traded goods. On a fourth quarter to fourth quarter basis, this index declined in 1983 by 4–5 per cent., or roughly the same amount as in 1982. Compounding the 8.5 per cent. growth of international bank credit with this increase in the "real" international value of the dollar would give a growth rate of around 13 per cent. in 1983. This would not be so very different from the real rates of expansion recorded in earlier years, when the nominal growth rates were in the 20–25 per cent. range but the unit value index of internationally traded goods was also rising rather steeply. Moreover, taking into account the near-stagnation in the volume of international trade — which went up by only 2 per cent. in 1983 — and the high level of interest rates, it would appear that the relatively modest 8.5 per cent. nominal growth in international bank credit in 1983 may have entailed an increase in debt and debt-servicing burdens similar to that recorded in the late 1970s, when the nominal growth rates were very high.

Looking at *developments in individual market centres,* one outstanding feature last year was the sharp slowdown in the international business of banks in the United States. After increases of $75.7 and 107.1 billion in 1981 and 1982, the growth of their external assets in 1983 amounted to only $32.9 billion. This slowdown reflected three influences: the banks' increased perception of risks in their international lending business following the outbreak of the 1982 debt crisis; the gradual revival of US domestic credit demand in the course of 1983; and, to a large extent, the fact that in 1982 the growth of the external assets of banks in the United States had, for a time, been inflated by the opening of the new international banking facilities (IBFs). The table opposite shows that the external assets and liabilities of the IBFs expanded very strongly in the first half of 1982. By the second half of that year this growth had been more than halved, and in the first six months of 1983 it was again reduced by around 45 per cent.

The opening of the IBFs affected, in the first instance, the business of US banks' branches in the offshore centres. As can be seen from the table, after rising by nearly $32 billion in 1981, total external assets of these branches showed hardly any growth in 1982, before resuming a modest $7.7 billion expansion in 1983. Even these figures understate the extent to which business has been repatriated to the United States, since, within this overall stagnation, offshore branches' claims on the United States increased sharply, whereas their credits to residents of other countries declined. Between end-September 1981 and the end of 1983 external assets of US banks' offshore centre branches expanded by a total of only $13 billion, while at the same time their claims on the United States rose by $46.5 billion, implying a fall of $33.5 billion in outstanding claims on other countries. In particular, total credits to non-OPEC developing countries booked via US branches in offshore centres dropped by $21 billion, or nearly 50 per cent. In the second half of 1982 and in 1983 this transfer of business to the United States may have been due not only to the amenities offered by the IBFs, but also to confidence factors and to the advantages of centralising doubtful and rescheduled loans at head office.

Even more striking than the slowdown in the growth of the external assets of banks in the United States was the fact that these banks turned round from being net suppliers of new funds in the international market to net takers. Between the end of 1979 and the first quarter of 1983 the external net creditor position of banks in the United States had expanded from only $6 billion to $130 billion, dwarfing even the OPEC countries in their earlier position as suppliers of new funds to the international markets. In the second quarter of 1983, however, banks in the United States became small net importers of new funds, and these inflows accelerated sharply in the following two quarters, so that by the end of the year their external net creditor position had come down slightly below $100 billion. These inflows in the second half of last year resulted primarily from a sharp increase in the banks' external borrowing — mostly through their foreign affiliates — whereas their external assets continued to expand, although at a somewhat slower pace than in the earlier part of the year.

Changes in external assets and liabilities in domestic and foreign currency of banks in individual reporting countries, 1980–83.

	Stocks at end-1979	1980	1981	1982 1st half	1982 2nd half	1983 1st half	1983 2nd half	Stocks at end-1983
		Flows at constant end-of-quarter exchange rates						
	in billions of US dollars							
				Assets				
United States	136.4	40.4	75.7	68.1	39.0	18.6	14.3	396.0
of which: IBFs	–	–	*63.4*	*55.4*	*25.6*	*14.6*	*13.4*	*172.2*
Offshore branches of US banks[1]	127.6	13.6	31.9	– 0.8	2.2	3.2	4.5	179.8
European reporting countries	776.0	158.6	133.9	4.4	53.9	– 6.1	51.9	1,027.2
of which: United Kingdom	*285.5*	*75.0*	*79.5*	*13.4*	*21.5*	*9.5*	*21.5*	*482.7*
France	*123.6*	*24.9*	*9.1*	*– 3.8*	*14.3*	*–10.1*	*11.3*	*141.1*
Luxembourg	*80.8*	*13.6*	*6.2*	*2.3*	*3.5*	*– 0.5*	*1.9*	*85.4*
Germany	*69.3*	*10.3*	*7.4*	*– 3.4*	*3.3*	*– 2.7*	*2.5*	*63.1*
Belgium	*43.0*	*14.1*	*8.8*	*– 1.4*	*2.5*	*0.5*	*3.3*	*61.3*
Switzerland	*59.1*	*4.0*	*5.1*	*3.9*	*– 1.8*	*3.8*	*– 1.3*	*60.2*
Netherlands	*55.9*	*9.3*	*7.4*	*2.2*	*– 2.0*	*– 1.1*	*0.7*	*58.1*
Italy	*29.6*	*1.8*	*6.4*	*– 9.7*	*8.7*	*– 8.0*	*10.0*	*35.3*
Austria	*17.9*	*3.2*	*2.4*	*0.7*	*3.5*	*1.0*	*1.5*	*26.1*
Sweden	*5.8*	*2.2*	*0.1*	*0.2*	*– 0.2*	*0.7*	*– 0.1*	*7.1*
Denmark	*4.0*	*0.2*	*0.7*	*– 0.2*	*0.4*	*0.5*	*0.8*	*5.5*
Ireland	*1.5*	*0.5*	*0.5*	*0.2*	*0.4*	*0.1*	*– 0.2*	*2.3*
Japan	45.4	18.2	20.7	0.3	7.7	5.8	12.8	109.1
Canada	25.6	10.1	2.7	2.3	– 1.4	2.0	1.5	41.8
Total	1,111.0	241.1	264.8	74.2	101.4	23.5	84.9	1,753.9
Memorandum item: Non-reporting banks in offshore centres[2]	*135.0*	*42.0*	*62.0*	*7.0*	*8.0*	*1.0*	*15.0*	*270.0*
				Liabilities				
United States	130.1	9.3	38.3	56.5	11.9	8.7	42.1	296.8
of which: IBFs	–	–	*48.3*	*56.1*	*20.8*	*9.7*	*21.7*	*156.5*
Offshore branches of US banks[1]	128.8	14.4	33.5	– 0.3	4.0	3.1	3.2	184.8
European reporting countries	778.1	178.7	126.0	3.7	52.8	0.6	47.4	1,051.8
of which: United Kingdom	*302.0*	*76.9*	*78.7*	*19.8*	*24.1*	*12.0*	*24.9*	*514.2*
France	*106.2*	*28.1*	*14.9*	*– 5.4*	*13.0*	*– 7.8*	*9.6*	*138.7*
Luxembourg	*76.6*	*12.9*	*4.1*	*1.7*	*2.2*	*– 1.1*	*1.4*	*79.1*
Germany	*77.7*	*3.3*	*1.5*	*– 3.8*	*3.4*	*– 1.2*	*– 0.8*	*57.4*
Belgium	*50.1*	*18.0*	*9.8*	*– 0.2*	*2.8*	*3.7*	*2.8*	*72.6*
Switzerland	*38.2*	*7.2*	*2.8*	*0.3*	*– 2.9*	*0.6*	*– 0.8*	*38.8*
Netherlands	*55.6*	*11.8*	*4.6*	*1.6*	*– 0.5*	*– 3.2*	*– 0.3*	*55.5*
Italy	*38.1*	*9.6*	*4.4*	*–10.7*	*6.4*	*– 4.5*	*8.4*	*46.6*
Austria	*19.0*	*5.9*	*1.8*	*0.5*	*2.3*	*0.4*	*1.3*	*25.8*
Sweden	*8.7*	*3.2*	*1.9*	*– 0.7*	*1.3*	*0.8*	*0.4*	*14.0*
Denmark	*3.7*	*0.2*	*0.6*	*–*	*0.1*	*0.3*	*1.0*	*5.1*
Ireland	*2.0*	*1.5*	*0.7*	*0.7*	*0.3*	*0.4*	*– 0.2*	*5.0*
Japan	50.5	28.8	21.8	– 0.3	1.1	1.2	6.3	106.6
Canada	32.8	10.9	18.0	0.9	– 4.4	3.2	0.7	62.1
Total	1,120.3	242.2	237.7	60.3	65.5	16.8	99.7	1,702.1
Memorandum item: Non-reporting banks in offshore centres[2]	*125.0*	*41.0*	*60.0*	*9.0*	*7.0*	*– 1.0*	*17.0*	*258.0*

Note: Owing to rounding, figures may not add up to the totals.

[1] In the Bahamas, the Cayman Islands, Panama, Hong Kong and Singapore. [2] Estimates — at current exchange rates — for non-reporting banks in the five major offshore centres and for all banks located in Bahrain, Lebanon and the Netherlands Antilles.

Turning to the traditional Euro-market centres, the external assets growth of banks in the European reporting countries, which had already dropped off sharply in 1982, partly in conjunction with the setting-up of the IBFs in the United States, decelerated further, to $46 billion in 1983, or only about one-third of the 1981 figure. Two-thirds of the 1983 increase was accounted for by the United Kingdom alone, whereas in the two other principal Euro-market centres, France and Luxembourg, international banking business expanded very slowly. In France, Germany and the Netherlands the banks' cross-border claims in foreign currencies actually declined, growth of their external lending having been limited to domestic currency business, which tends to be largely trade-related. Apart from the United Kingdom, increases in external assets were shown by banks in Belgium ($3.8 billion), which were, however, net takers of external funds, banks in Switzerland ($2.5 billion), where nearly the whole of the increase was in domestic currency business, and banks in Austria ($2.5 billion). The figure for banks in Switzerland does not, however, include the trustee funds channelled by them to the international market, which may be estimated to have amounted to around $4 billion in 1983.

On an assets-minus-liabilities basis, the largest net takers of funds within the European reporting area last year were banks in the United Kingdom, whose net external liabilities increased by $5.9 billion to a total of $31.5 billion, and banks in Belgium and Italy, which showed increases in their external net debtor position of $2.7 to 11.3 billion and of $1.9 to 10.3 billion respectively. The increase in the Belgian and Italian banks' external net debtor positions reflected international borrowing by the public sector via the domestic banking system for balance-of-payments purposes.

Within the European reporting area the major net suppliers of new funds to the international market in 1983 were banks in the Netherlands ($3.1 billion) and in Switzerland ($2.7 billion excluding trustee funds). The Dutch banks' money exports resulted from a reduction in external liabilities, whereas those of the Swiss banks mainly reflected a build-up of external assets.

Japan was the only one of the major reporting countries where the banks' external assets growth in 1983, at $18.6 billion, was much faster than in 1982 and nearly as large as before the outbreak of the international debt crisis — a development which reflected the increasing rôle of Japanese banks in international finance. With domestic credit demand relatively weak and very large interest rate differentials in favour of the dollar, banks in Japan increased their net exports of new funds to the international market from $7.2 billion in 1982 to $11.1 billion in 1983, with the result that at the end of the year, for the first time since 1973, they showed an external net creditor position of $2.5 billion.

Looking at the *structural composition of the banks' new cross-border business*, the slowdown during 1983 in the growth of the international banking aggregates was due in large measure to the more leisurely pace of interbank activity. Interbank claims rose by $74.8 billion last year; excluding an unusually strong increase of $6.9 billion in claims on official monetary institutions, this was little more than half as much as in 1982 and only one-third of the 1981 total. Moreover, the slowdown in interbank business was in some respects even more pronounced than appears from

Bank/non-bank breakdown of international banking activity, 1980–83.

	Assets				Liabilities			
	Flows at constant end-of-quarter exchange rates				Flows at constant end-of-quarter exchange rates			
	1980	1981	1982	1983	1980	1981	1982	1983
	in billions of US dollars							
Total	241.1	264.8	175.6	108.4	242.2	237.7	125.8	116.5
Interbank[1]	172.1	183.8	119.9	74.8	198.7	165.8	84.2	78.8
of which:								
A. within the reporting area[2]	*135.6*	*160.7*	*107.8*	*64.0*	*161.4*	*155.2*	*97.6*	*82.4*
between banks in the United States and other reporting banks	*26.9*	*83.6*	*101.4*	*47.2*	*44.6*	*67.6*	*102.3*	*49.1*
between other reporting banks	*108.7*	*77.1*	*6.4*	*16.8*	*116.8*	*87.6*	*− 4.7*	*33.3*
B. vis-à-vis official monetary institutions[3]	*2.5*	*− 0.4*	*0.2*	*6.9*	*19.0*	*−13.9*	*−25.6*	*− 0.4*
booked in the United States	.	.	.	.	*− 0.1*	*− 1.1*	*0.3*	*3.7*
other	*2.5*	*− 0.4*	*0.2*	*6.9*	*19.1*	*−12.8*	*−25.9*	*− 4.1*
Vis-à-vis non-banks	69.0	81.0	55.7	33.6	43.5	71.9	41.6	37.7
booked in the United States	11.8	22.4	26.7	14.7	0.6	5.6	18.1	10.3
outside the United States	57.2	58.6	29.0	18.9	42.9	66.3	23.5	27.4
of which: in US dollars	*31.7*	*29.1*	*7.1*	*7.0*	*31.7*	*55.8*	*15.2*	*21.6*
in other foreign currencies	*16.3*	*18.0*	*7.6*	*2.5*	*7.5*	*6.6*	*3.7*	*1.9*
in domestic currency	*9.2*	*11.5*	*14.3*	*9.4*	*3.7*	*3.9*	*4.6*	*3.9*
Memorandum items:								
Foreign currency positions vis-à-vis residents[4]	*82.7*	*70.7*	*53.4*	*17.4*	*58.9*	*53.7*	*51.3*	*14.5*
of which:								
interbank[5]	*62.0*	*51.3*	*40.7*	*6.9*	*53.4*	*48.4*	*44.2*	*12.5*
vis-à-vis non-banks	*20.7*	*19.4*	*12.7*	*10.5*	*5.5*	*5.3*	*7.1*	*2.0*
of which: in US dollars	*9.2*	*15.8*	*7.6*	*4.4*	*4.0*	*0.8*	*4.1*	*1.7*

[1] Including positions vis-à-vis official monetary institutions except, on the assets side, in the case of banks in the United States and the offshore branches of US banks, for which, owing to the lack of an adequate breakdown, these positions are included under non-banks. [2] Including positions vis-à-vis banks in the Bahamas, the Cayman Islands, Panama, Hong Kong and Singapore. [3] See footnote 1. [4] Banks in Europe, Canada and Japan only. [5] Including positions vis-à-vis the Japanese non-bank sector not available separately.

these figures. Of the $74.8 billion total increase for 1983, $10.8 billion represented claims on banks outside the reporting area, while the lion's share of $47.2 billion was accounted for by claims on each other of banks in the United States and reporting banks in other countries. The large increase in this item was related to the heavy take-up of external funds for domestic use by banks in the United States. All other cross-border interbank claims within the reporting area expanded by merely $16.8 billion, the bulk of which represented claims of reporting banks in Europe on banks in Japan, and vice versa. By contrast, cross-border interbank claims within the narrowly defined Euro-market, i.e. between the European reporting countries themselves, showed no increase at all for the first time, whereas in 1981 they had expanded by over $28 billion. Moreover, domestic interbank claims in foreign currency within the individual European reporting countries, which in 1981 had grown by $26 billion, contracted by $13.6 billion last year, with London accounting for the whole of this decline. The smaller amount of final lending, banks' balance-sheet constraints and their greater use of off-balance-sheet futures contracts for covering interest rate risks (see Chapter III, pages 54–57), their greater selectivity, the tendency for some smaller banks to withdraw from the international market and the competition of the IBFs may all have contributed to this unusual stagnation of the interbank segment of the narrowly defined Euro-market.

Direct lending to non-banks also continued to slow down quite sharply last year, under the combined influence of cyclically weak credit demand in the reporting area itself, the competition of the bond markets and the reluctance of banks to increase their exposure vis-à-vis residents of certain outside-area countries. New cross-border lending of this type declined from $81 billion in 1981 to $55.7 billion in 1982 and $33.6 billion last year. In terms of growth rates the slowdown was particularly pronounced, from over 21 per cent. in 1980 and 1981 to a scant 7 per cent. last year.

Moreover, not only the volume but also the geographical location and the nature of lending to non-banks have changed drastically over the last few years. In 1980 only $11.8 billion, or 17 per cent., of new credits to non-banks had been booked in the United States, whereas by 1983 the US share had risen to $14.7 billion, or 44 per cent. Correspondingly, the share of banks outside the United States declined from 83 to 56 per cent., or from $57.2 to 18.9 billion over this four-year period. What is more, half of the latter figure represented conventional foreign lending in domestic currencies, which has not declined since 1980. This means that new Euro-currency credits to non-banks amounted to only $9.5 billion in 1983, or barely 20 per cent. of the 1980–81 figure, and were also much smaller than direct lending to non-banks out of the United States. The difference in the degree of buoyancy of the various market sectors appears particularly pronounced if expressed in terms of growth rates. Euro-currency credits expanded by only 3 per cent. last year, whereas both lending from the United States (the major part of which was through the IBFs) and traditional external lending in domestic currency from the other reporting countries grew by 14 and 12.5 per cent. respectively. The growth of Euro-market lending looks somewhat stronger, however, if domestic credits in foreign currency to non-bank entities are taken into account, as these, though much smaller than some years ago, still expanded by $10.5 billion, or 10 per cent., last year.

On the sources side of the market the situation was quite different. Direct new deposits by non-bank entities, at $37.7 billion, were only slightly down on 1982, still amounting to over 50 per cent. of the 1981 figure. Moreover, despite the introduction of attractive new deposit facilities in the United States, the decline in comparison with 1982 was more than accounted for by banks in that country, whose receipts of new foreign non-bank funds dropped from $18.1 to 10.3 billion. By contrast, the expansion in cross-border non-bank deposits with banks in the Euro-market accelerated between 1982 and 1983 from $18.9 to 23.5 billion. The bulk of these deposits was denominated in dollars, as the interest rate differentials in favour of the dollar were apparently large enough to outweigh possible exchange rate fears.

Another noteworthy feature last year concerned the Euro-market deposits of official monetary institutions. The latter had drawn down their deposits sharply in the two preceding years, but the decline came to a halt in the middle of 1983, and in the second half of the year deposits were built up again to some extent. As a result, withdrawals of official deposits amounted to only $4.1 billion for the year as a whole, compared with nearly $26 billion in 1982. (For a more detailed description of the behaviour of official Euro-market deposits see Chapter VII, pages 148–149.)

Adding together new Euro-deposits by non-banks and official monetary institutions, the supply of new funds to the international markets outside the United States from these two sources amounted to $19.5 billion in 1983, whereas in 1982 there had been a net withdrawal of $7 billion. This $26.5 billion turn-round in the supply of new funds, in conjunction with the falling-off of credit demand from non-banks, helps to explain why the narrowly defined Euro-market did not suffer from any shortage of liquidity last year and why, in accordance with the principle of communicating vessels, there was a large movement of funds from the Euro-markets to the United States during the second half of the year.

As regards the *currency composition of international banking activity*, the outstanding feature of recent years has undoubtedly been the sharp decline in dollar business booked outside the United States. In 1980 the growth of Euro-dollar assets had amounted to $126 billion; in 1982, following the establishment of the IBFs, it

Currency breakdown of international banking activity, 1981–83.

	Assets				Liabilities			
	Flows at constant end-of-quarter exchange rates			Stocks at end-1983	Flows at constant end-of-quarter exchange rates			Stocks at end-1983
	1981	1982	1983		1981	1982	1983	
	in billions of US dollars							
Total	264.8	175.6	108.4	1,753.9	237.7	125.8	116.5	1,702.1
in domestic currency	99.8	129.4	50.0	569.4	48.6	76.9	56.2	415.8
of which, banks in:								
United States	*74.4*	*104.1*	*33.0*	*388.7*	*38.4*	*66.8*	*50.2*	*291.6*
Germany	*4.8*	*1.3*	*0.7*	*43.4*	*0.2*	*0.4*	*– 0.4*	*36.4*
Switzerland	*2.6*	*3.1*	*2.4*	*31.2*	*2.4*	*– 1.6*	*– 1.3*	*9.0*
Japan	*5.2*	*5.2*	*5.1*	*30.8*	*1.7*	*1.7*	*– 0.2*	*14.1*
United Kingdom	*5.0*	*6.0*	*3.1*	*26.4*	*4.8*	*7.7*	*5.9*	*34.2*
France	*4.0*	*4.2*	*2.1*	*21.1*	*– 0.2*	*– 0.4*	*1.9*	*5.9*
Netherlands	*2.4*	*1.7*	*0.9*	*12.2*	*0.6*	*1.0*	*– 0.9*	*8.9*
other reporting countries	*1.4*	*3.8*	*2.7*	*15.6*	*0.7*	*1.3*	*1.0*	*15.7*
in foreign currencies	165.0	46.2	58.4	1,184.5	189.1	48.9	60.3	1,286.3
of which:								
US dollars	*118.0*	*19.6*	*33.1*	*902.1*	*148.2*	*35.5*	*30.8*	*1,005.6*
Deutsche Mark	*15.8*	*8.1*	*10.0*	*121.5*	*10.2*	*1.0*	*9.4*	*111.7*
Swiss francs	*11.2*	*3.5*	*2.7*	*57.8*	*15.8*	*– 3.0*	*4.7*	*61.8*
Japanese yen	*6.6*	*0.3*	*1.3*	*17.0*	*5.8*	*1.8*	*4.0*	*21.2*
pounds sterling	*3.7*	*0.2*	*0.6*	*12.0*	*0.3*	*– 0.9*	*– 0.5*	*14.1*
French francs	*– 1.0*	*1.2*	*3.2*	*9.7*	*– 0.2*	*1.6*	*2.3*	*11.2*
Dutch guilders	*1.6*	*1.5*	*3.0*	*10.7*	*2.1*	*2.0*	*2.5*	*11.5*
*other and unallocated**	*9.1*	*11.8*	*4.5*	*53.7*	*6.9*	*10.9*	*7.1*	*49.2*

* Including external positions in currencies other than the US dollar of banks in the United States and their branches in the five major offshore centres.

slowed down to a mere $20 billion; last year it picked up again to $33 billion, but this acceleration was more than accounted for by the offshore branches of US banks building up their claims on the United States and by banks in Japan. New cross-border dollar lending in the narrowly defined Euro-market slowed down further from $18.7 billion in 1982 to $13.3 billion, more than the whole of which represented an increase in interbank claims on the United States. Growth of the traditional kind of Euro-dollar lending thus appears to have come to a halt last year. Dollar lending out of the United States, which had accelerated from $39 billion in 1980 to $104 billion in 1982, dropped back sharply to $33 billion.

Euro-lending in other currencies kept up better than that in dollars. Although, at $25.3 billion, the expansion in 1983 remained well below the rise of $47 billion recorded in 1981, the rate of increase was still 10 per cent., as against 4 per cent. in the case of Euro-dollar lending. There were, however, wide differences between individual currencies. Euro-Swiss franc lending, which had already shrunk from $16 billion in 1980 to a mere $3.5 billion in 1982, slowed down further. Euro-Deutsche Mark lending, by contrast, picked up somewhat in comparison with 1982 and, at $10 billion, was not as far below its previous peak as Euro-lending in dollars and some other currencies. Unusually vigorous growth rates — of nearly 50 and 40 per cent. respectively — were shown last year by Euro-French franc and Euro-guilder assets, although expressed in absolute amounts the increases of $3.2 and 3.0 billion were not so impressive. A slight pick-up was also recorded in Euro-yen and Euro-sterling assets, whose growth had nearly come to a halt in 1982 after strong expansion in the preceding years. In addition, there was a substantial amount of yen and sterling lending from Japan and the United Kingdom respectively, whereas, as a result of the German banks' policy of reducing the weight of foreign business in their balance sheets, international Deutsche Mark lending from Germany increased only marginally.

Sources and uses of international banking funds.

The continued slowdown in the growth of the volume of international credit outstanding through the reporting banks from $95 billion in 1982 to $85 billion last year was essentially due to a further decline in lending to residents of countries outside the reporting area. The absorption of international banking funds within the reporting area, by contrast, accelerated from $45.5 to 47 billion. Identified new direct lending to non-bank entities within the reporting area, which had already dropped from over $50 billion in 1981 to $31 billion in the following year, receded further to $17 billion in 1983. However, this further decline was more than offset by a sharp increase in the reporting banks' own use of international banking funds for domestic lending. This development was fully accounted for by banks in the United States, which (as already described on page 114 above) became heavy net takers of international banking funds — to the extent of nearly $30 billion — during the second half of the year. The largest non-bank borrowers within the reporting area were entities in the United Kingdom ($3.4 billion), Belgium-Luxembourg ($2.9 billion), France ($2.8 billion) and Italy ($2.4 billion). US firms raised only $1.3 billion from banks abroad, as most of their international borrowing was done in the

Euro-bond markets. The same was true of Japanese firms, which obtained hardly any new credits from banks abroad, although they appear to have borrowed substantial amounts of foreign currency funds from banks in Japan; however, no figures are available on this.

On the sources side of the market, new funds supplied from within the reporting area totalled $74 billion last year, down from $95 billion in 1982. Direct deposits by non-bank entities within the reporting area, including funds channelled into the market via trustee accounts of banks in Switzerland, amounted to about $38 billion. An additional $5 billion came from official monetary institutions within the reporting area, while the remaining $31 billion represented the banks' own use of domestic funds for external lending. Banks in the United States were still heavy net exporters of funds during the first quarter of 1983, and banks in Japan also acted as substantial suppliers of new funds to the international market last year. Non-bank entities in the United States alone accounted for $16.6 billion, or nearly half of the total increase in non-bank deposits last year.

Identified new lending by the reporting banks to residents of countries located outside the reporting area decelerated from $39.5 billion in 1982 to $28.5 billion, whereas in 1981 it had still amounted to $66 billion. At the same time, outside-area countries, which in 1982 had drawn down their deposits with the reporting banks by $11.5 billion, added $1.5 billion to them in 1983. As a result, identified net capital flows from inside the reporting area via the reporting banks to countries outside the area slowed down even more sharply than gross flows, viz. from $51 billion in 1982 to $27 billion last year.

Nearly 75 per cent. of the $37.5 billion slowdown between 1981 and 1983 in the reporting banks' new lending to outside-area countries was vis-à-vis non-OPEC developing countries. In 1981 identified claims on these countries had increased by nearly $40 billion; in 1982 the expansion was reduced by half, and in 1983 there was a further slowdown to $12.4 billion, despite large officially backed financing packages designed to maintain credit flows to these countries. On an assets-minus-liabilities basis, the contraction in credit flows to the non-OPEC developing countries was even more pronounced, since in 1983 these countries added quite strongly to their deposits with the reporting banks; such net credit flows slowed down from $30.5 billion in 1981 to $15 billion in 1982 and barely $2 billion last year. If net interest payments are taken into account, this means that last year there was a large return flow of funds from non-OPEC developing countries via the banks to the reporting area.

The slower growth of outside-area lending was dominated by developments vis-à-vis Latin American countries, which constitute the largest group of debtors in the international banking market. Latin American countries kept up their heavy recourse to international bank credit until the outbreak of the Mexican debt crisis in the late summer of 1982, when the doors were suddenly closed. In the final quarter of 1982 Latin American countries actually had to reduce their debts to the banks. In 1983 the flow of new bank credit to these countries resumed, but at a very slow pace; at $8.6 billion, new credits for the year as a whole not only amounted to less

Geographical pattern of international banking flows, 1980–83.[1]

	Flows at constant end-of-quarter exchange rates						Stocks at end-1983
	1980	1981	1982		1983		
			1st half	2nd half	1st half	2nd half	
	in billions of US dollars						
Banks' claims on:							
Reporting area	136.4	142.4	30.6	64.9	4.7	50.5	923.3
Offshore banking centres[2]	32.6	50.0	14.5	17.5	8.1	8.6	283.8
Other developed countries	15.4	16.8	9.2	6.7	1.3	6.2	116.4
Eastern Europe	6.8	4.8	– 3.1	– 1.5	– 1.3	0.1	48.9
OPEC countries[3]	7.0	4.2	4.9	3.3	1.2	8.5	86.8
Non-OPEC developing countries	39.0	39.9	15.4	4.4	6.8	5.6	256.2
of which: Latin America[4]	*27.3*	*30.5*	*11.8*	*0.4*	*4.3*	*4.3*	*176.3*
Unallocated[5]	3.9	6.7	2.7	6.1	2.7	5.4	38.5
Total	241.1	264.8	74.2	101.4	23.5	84.9	1,753.9
of which: inside area, gross	*166.2*	*191.7*	*44.9*	*81.1*	*13.1*	*57.1*	*1,184.9*
inside area, net of double-counting[6]	*85.1*	*91.9*	*20.7*	*24.7*	*14.6*	*32.2*	*516.0*
outside area	*68.2*	*65.7*	*26.6*	*12.8*	*8.0*	*20.4*	*508.3*
unallocated[7]	*6.7*	*7.4*	*2.7*	*7.5*	*2.4*	*7.4*	*60.7*
Total net international bank lending	160.0	165.0	50.0	45.0	25.0	60.0	1,085.0
Banks' liabilities to:							
Reporting area	157.3	154.9	47.5	49.7	18.2	56.2	1,072.5
Offshore banking centres[2]	28.4	55.1	13.1	18.6	13.6	19.5	282.5
Other developed countries	5.7	3.8	– 0.3	0.2	– 1.3	2.8	48.9
Eastern Europe	0.9	0.1	– 2.4	4.4	0.6	2.3	18.5
OPEC countries[3]	41.9	3.2	– 6.6	–11.6	–15.3	1.7	120.2
Non-OPEC developing countries	3.9	9.4	3.6	1.3	3.2	7.3	110.9
of which: Latin America[4]	*– 1.0*	*4.8*	*– 0.4*	*– 1.4*	*2.0*	*4.1*	*43.1*
Unallocated[5]	4.1	11.2	5.4	2.9	– 2.2	9.9	48.6
Total	242.2	237.7	60.3	65.5	16.8	99.7	1,702.1
of which: inside area, gross	*183.7*	*205.0*	*60.0*	*65.5*	*31.6*	*74.3*	*1,321.9*
inside area, net of double-counting[6]	*101.5*	*132.3*	*49.7*	*45.0*	*39.8*	*34.6*	*704.8*
outside area	*52.4*	*16.5*	*– 5.8*	*– 5.8*	*–12.7*	*14.2*	*298.6*
unallocated[7]	*6.1*	*16.2*	*6.1*	*5.8*	*– 2.1*	*11.2*	*81.6*
Total net international bank lending	160.0	165.0	50.0	45.0	25.0	60.0	1,085.0

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. Flows for the year 1981 and the first and second halves of 1982 and 1983, as well as the stock figures for end-1983, include the external positions of international banking facilities.

[1] Geographical distribution of the changes in the external assets and liabilities of banks located in the Group of Ten countries, Austria, Denmark and Ireland and of the offshore branches of US banks located in the Bahamas, the Cayman Islands, Panama, Hong Kong and Singapore. [2] Bahamas, Barbados, Bermuda, the Cayman Islands, Hong Kong, Lebanon, Liberia, the Netherlands Antilles, Panama, Singapore, Vanuatu (formerly New Hebrides) and other British West Indies. [3] Includes, in addition, Bahrain, Brunei, Oman, and Trinidad and Tobago. [4] Including those countries in the Caribbean area which are not offshore banking centres. [5] Including international institutions other than the BIS. [6] Excluding redepositing among the reporting banks but including positions vis-à-vis the Bahamas, the Cayman Islands, Panama, Hong Kong and Singapore. [7] Including positions vis-à-vis the remaining offshore centres.

than 30 per cent. of the 1981 figure, but were fully accounted for by drawings under the lending packages negotiated in conjunction with the IMF support programmes.

One way in which Latin American countries had met their mounting borrowing difficulties in 1982 was by drawing on their deposits with the reporting banks, which represent a substantial proportion of their international reserves. However, from the second quarter of 1983 onwards, as a result of the improvement in their balance-of-payments positions brought about by stringent adjustment policies and the negotiated credit packages, some Latin American countries were able to rebuild their reserves and their deposits with the reporting banks. In fact, during the last nine months of 1983 as a whole, new deposits by Latin American countries exceeded their new borrowings.

The largest Latin American borrower last year was Mexico, which obtained $3.9 billion in new funds, but simultaneously built up its deposits by $4.1 billion. (Since valuation adjustments can only be made for some of the area aggregates, all flow figures for individual countries given in the rest of this section include, unless otherwise stated, exchange rate effects; because of the appreciation of the dollar, these tended in 1983 to understate the increases and to exaggerate the decreases in individual countries' assets and liabilities positions.) Brazil borrowed $1.3 billion and added $1.0 billion to its deposits. The largest net borrowers in 1983 were Colombia and Argentina, which received $1.5 and 1 billion respectively in new funds.

The situation was quite different with respect to non-OPEC developing countries in Asia (excluding the Middle East). They had scaled down their recourse to international bank credit well before the deterioration of the market climate in 1982, from $8.2 billion in 1979 to $4.7 billion in 1981 (including exchange rate effects). Although they have continued, with one exception, to have relatively free access to new bank credit, the clouds on the world economic horizon apparently persuaded them to follow more cautious policy courses, and their new takings declined further to $3.9 billion in 1982 and $3 billion in 1983. At the same time, they accelerated their deposit build-up from $1.9 billion in 1981 to $5 and 4.6 billion in 1982 and 1983, so that during these two years they actually became net suppliers of new funds to the reporting banks.

In this group the major depositors of new funds with the reporting banks in 1983 were Taiwan ($2 billion), China ($1.3 billion), India ($1.2 billion) and Pakistan ($0.7 billion), none of which were major borrowers. Taiwan actually reduced its gross banking debts by $0.5 billion last year. The largest takers of new funds were Malaysia and Thailand, which obtained $1.5 and 0.9 billion respectively, while simultaneously slightly reducing their deposits. South Korea, one of the largest borrowers in previous years, raised only $0.4 billion in new funds from the reporting banks in 1983, but at the same time drew down its deposits by $0.5 billion. The Philippines, which ran into a debt crisis in the second half of 1983, was a case apart, which, fortunately, did not strongly affect the credit-standing of the other countries in that area. Claims of the reporting banks on the Philippines went up by $0.6 billion in the first half of the year, but were reduced by $0.8 billion in the second half.

The situation of non-OPEC developing countries in Africa and the Middle East was in some respects closer to that of Latin America, except for the much smaller scale (at least in absolute amounts) of their outstanding banking debts. The reporting banks' claims on these two groups of countries, which had increased by $1.0 and 1.4 billion respectively in 1982, declined by $0.6 and 0.3 billion last year (including exchange rate effects). At the same time, Middle Eastern countries drew down their deposits with the reporting banks by $1.1 billion.

The reporting banks' claims on eastern European countries, which, following the outbreak of the Polish debt crisis, had been reduced by $4.6 billion in 1982, continued to decline in 1983, although at a much reduced pace (−$1.2 billion) and with signs of a turn-round towards the end of the year. At the same time, deposits with the reporting banks by eastern European countries, after showing hardly any change during 1981, expanded by $2 billion in 1982 and $2.9 billion in 1983. The turn-round from being net borrowers in earlier years to net suppliers of $6.6 and 4.1 billion in 1982 and 1983 respectively mainly reflected the underlying improvement in these countries' balance-of-payments position with western countries. Another factor behind the reported decline in claims on eastern European countries may have been debt write-offs and the banks' transfer of guaranteed export-related claims to the institutions guaranteeing these claims. This, in fact, may account for the bulk of the reduction in reporting banks' claims on Poland, which may be estimated at $2.5 billion (excluding exchange rate effects) in 1983. On the other hand, on an exchange rate adjusted basis, the Soviet Union may be estimated to have obtained $1.5 billion in new credits from the reporting banks last year. The main depositors of new funds (also estimated on an exchange rate adjusted basis) in 1983 were the German Democratic Republic ($1.4 billion) and Hungary ($0.6 billion). Over the recent years of rising dollar exchange rates, eastern European countries have benefited from the fact that a large part of their debt is denominated in currencies other than the dollar. Thus, at current exchange rates, the decline in the dollar value of their banking debt amounted to nearly $12 billion, instead of $5.8 billion, over the past two years.

Developed countries outside the BIS reporting area took up $7.5 billion in new credits from the reporting banks last year, less than half the amounts raised in 1982 and 1981. A few of the countries in this group faced somewhat stiffer market conditions in the first half of the year, but, except for Yugoslavia, whose predicament was similar to that of the Latin American debtor countries, the market climate seemed to improve again in the latter part of the year. Thus, the main reasons for the slower pace of borrowing were probably countries' more cautious policies and the attraction of alternative sources of finance. As in 1982, by far the largest borrowers in this group of countries were Australia and South Africa, which obtained $2.5 and 2.0 billion respectively in new credits. Spain, by contrast, which in 1982 had raised $1.3 billion, repaid $1.1 billion. An even larger reduction of its banking indebtedness (−$1.3 billion) was shown by Norway. But both Norway and Spain simultaneously reduced their deposits with the reporting banks, by $1.7 and 0.8 billion respectively.

OPEC members were the only group of outside-area countries to show a larger increase in their banking indebtedness last year ($9.7 billion) than in 1982 ($8.2 billion). At the same time, in the first half of the year OPEC countries continued to run down their deposits with the reporting banks. In the third quarter, however, they added somewhat to their deposits, and, thanks to a sharp increase in borrowing, there were hardly any further withdrawals in the fourth quarter. For the year as a whole, the decline in OPEC deposits, at $13.6 billion, was about $4.5 billion below the 1982 figure. In contrast to 1982, the withdrawals seem to have been made for the most part by the "low-absorbing" countries in the Middle East (−$11.5 billion, including exchange rate effects but excluding movements of deposits with banks in the United States and Switzerland), whereas the "high absorbers" reduced their deposits by only $3.5 billion. The drawing-down of Venezuelan deposits came to a halt in 1983, and Indonesia even added to its deposits with the reporting banks to some extent. On the uses side of the market, "low absorbers" in the Middle East were the largest takers of funds, but there was also substantial borrowing by the "high absorbers" in that area, as well as by Indonesia and Nigeria.

The international bond markets.

1983 was another record year on the international bond markets, with the total volume of new issues increasing from $71.7 billion in 1982 to $73.5 billion. Admittedly, activity receded slightly in the dollar sector — notably in the Euro-bond market, where dollar issues declined from an all-time record of $38.5 billion in

International bond issues.[1]

Borrowing countries or areas	Years	Euro-bond issues			Foreign issues		
		Total	of which US dollars	of which Deutsche Mark	Total	of which in United States	of which in Switzer-land
		in millions of US dollars					
Western Europe	1981	7,650	5,230	880	5,390	640	3,070
	1982	16,550	12,690	1,930	5,250	780	2,350
	1983	22,770	16,630	2,410	6,700	1,360	2,490
	1984/I	8,920	6,800	720	1,600	200	730
Canada	1981	5,500	4,550	130	5,450	4,310	870
	1982	6,920	5,600	100	4,440	2,700	1,330
	1983	3,840	2,660	360	2,910	1,630	1,220
	1984/I	1,290	1,070	–	540	200	110
United States	1981	6,050	5,890	30	700		700
	1982	13,020	12,340	530	1,790		1,470
	1983	6,070	5,680	220	1,240		1,180
	1984/I	3,770	3,160	210	340		280
Other developed countries[2]	1981	3,460	2,730	230	2,820	100	2,360
	1982	3,860	3,050	480	5,740	400	4,440
	1983	6,060	4,760	830	8,300	530	7,140
	1984/I	3,170	2,620	230	2,630	100	2,390
Rest of the world	1981	2,330	2,080	90	1,120	440	90
	1982	2,820	2,510	210	520	–	200
	1983	1,680	1,510	160	630	–	100
	1984/I	530	540	–	90	–	50
International institutions	1981	2,490	1,700	40	6,030	2,070	1,200
	1982	3,280	2,490	–	7,460	2,150	1,530
	1983	6,070	4,500	60	7,270	1,220	1,370
	1984/I	1,300	600	–	1,380	–	430
Total issues placed	1981	27,480	22,180	1,400	21,510	7,560	8,290
	1982	46,450	38,680	3,250	25,200	6,030	11,320
	1983	46,490	35,740	4,040	27,050	4,740	13,500
	1984/I	18,980	14,790	1,160	6,580	500	3,990

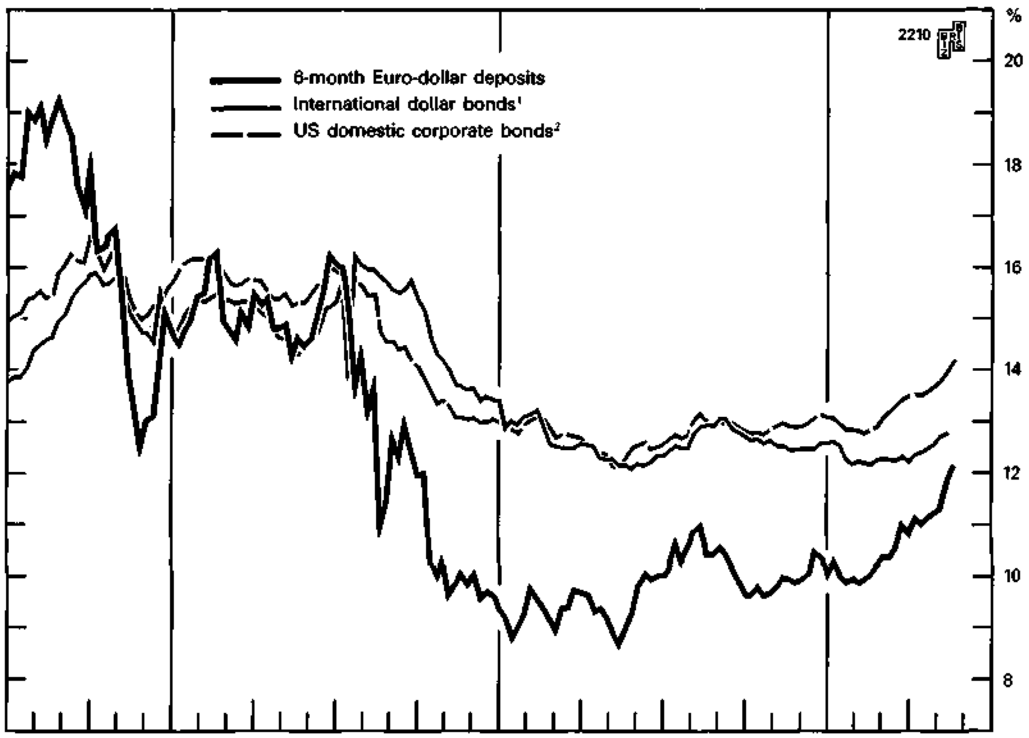
[1] Based on OECD sources. [2] Australia, Japan, New Zealand and South Africa.

1982 to $35.5 billion — but this was more than offset by increases in other sectors of the market, with growth being particularly strong in the Swiss franc, sterling and ECU sectors.

The failure of the Euro-dollar sector fully to match its 1982 performance was due both to smaller borrowings by US corporations and to interest and exchange rate uncertainties. Thanks to its flexibility and its innovative nature, the market once more proved able to adjust to an unpredictable environment. However, US interest rate imponderables and the ups and downs of the dollar were reflected in an erratic path of activity and shifts in issuing techniques in the course of 1983. During the first half of the year the fixed rate sector continued to benefit from the downward trend of US interest rates and the re-establishment of a normal yield curve. Euro-dollar bond yields had eased by May to 12 per cent., their lowest level for three years, and the positive yield curve which had emerged in the second half of 1982 widened to more than 2 percentage points. There were some hesitant moments during the first five months of the year, but on the whole activity was maintained at a high level, with the help of techniques such as interest rate swap issues by banks and the "partly paid" formula, which was successful for a time. Subsequently, the market climate deteriorated and increased uncertainty about the future course of

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

Wednesday figures, in percentages.



¹ Industrial companies, yields to average maturity. ² All industries, yields to final maturity.

interest rates led to a slowdown of more than seasonal proportions in new issuing activity. However, in the last few months of the year operations in the Euro-dollar bond sector picked up strongly. This was largely due to a revival of US corporate borrowing following a further widening of the premium of interest rates on domestic issues over those on Euro-bond issues and to the strength of the floating rate notes (FRN) sector, which not only became the main focus for Euro-dollar bond activity but even began to compete with the syndicated loan market.

International bond issues, by types of instrument.[1]

Items	1981	1982	1983					1984
			year	first quarter	second quarter	third quarter	fourth quarter	first quarter
	in billions of US dollars							
Total issues	49.0	71.7	73.5	20.8	19.6	13.1	20.0	25.6
of which:								
Fixed rate straight issues[2]	37.2	57.7	51.8	16.3	14.2	9.2	12.1	12.6
Floating rate notes	7.4	11.4	16.0	3.1	3.9	2.8	6.2	8.6
Convertible bonds	4.4	2.6	5.7	1.4	1.5	1.1	1.7	4.4

[1] Partly estimated. [2] Including zero coupon bonds and private placements.

The success of the FRN formula in the later months of last year has been given abundant publicity. In recent years, faced with mounting uncertainty about interest rates, banks had emphasised the use of FRNs as a means of securing long-term dollar funds at a cost tied to short-term interest rates. However, with the decline of US interest rates in the second half of 1982 and early 1983 and the related revival of the fixed rate sector, banks had tended to favour the cheaper fixed rate related swap technique, and the FRN sector lost some ground. After the summer of 1983 investors' disappointment with the course of dollar interest rates shifted the focus back to the floating rate formula. In the closing months of the year competition between lenders accelerated to a point where, in terms both of maturity and spreads, FRN issues were offering better conditions to prime borrowers than comparable syndicated bank credits. Borrowers were prompt to take advantage of this situation, not only to cover their current financing requirements but also to repay more costly bank loans ahead of maturity.

For the banks, the FRN market has essentially the following attractions. Firstly, as regards the sources side of their balance sheets, it has made it easier for them to obtain long-term dollar funding. Moreover, in contrast to interbank borrowing and CDs, in several countries bonds offer the advantage of being to some extent counted as part of capital for supervisory purposes. Total bond issues by banks, of which FRNs are the most important element, after having jumped from $8 billion in 1981 to $13 billion in 1982, rose further to $14 billion last year; and these figures do not include issues on the domestic capital market by US banks and by US subsidiaries of foreign banks, which recorded a parallel increase. Secondly, as regards the uses side of banks' balance sheets, the buoyancy of the FRN sector has widened banks' opportunities for liquid investments; with the market being restricted to prime names, at interest-setting dates such bonds tend to trade at par value, offering therefore nearly full protection against capital losses. Such investments by banks increased considerably last year. It may be estimated that banks absorbed as much as \$10 billion of international bonds in 1983, predominantly FRNs, or double the 1982 amount. In the main these operations are not covered in the BIS international banking statistics and tend increasingly to blur the distinction between the credit and capital markets.

Like its Euro-dollar counterpart, the volume of new foreign issues in the United States also contracted, for the second consecutive year, from \$6 billion in 1982 to \$4.7 billion in 1983, owing to reduced takings by the two largest borrowers, Canada and the World Bank. Cheaper funding opportunities in domestic currency made the US market less attractive for Canadian borrowers, while the World Bank stepped up its diversification policy.

Non-dollar sectors of the bond markets do not seem to have suffered much as a result of the appeal of high dollar interest rates. Since the bulk of new issues are made in national markets and are therefore essentially funded domestically, the interest cost to borrowers tends to be the overriding factor. Moreover, novel issuing techniques, formerly limited mainly to the dollar markets, have been spreading to other sectors as well. Finally, the international institutions' policy of diversifying into non-dollar financing lent support to these markets.

The buoyancy of the Swiss market for foreign issues — after jumping by 37 per cent. in 1982, the volume of new issues expanded by another 19 per cent. to reach \$13.5 billion last year — reflected these influences very clearly. Helped by the strong performance of the Tokyo stock exchange market, Japanese issuers, by far the largest group of borrowers in that market, considerably expanded their offerings of Swiss franc convertible paper. The perceived absence of major exchange rate risks and the low interest cost accounted for the appeal of the Swiss market to Japanese borrowers. As regards the foreign bond market in Japan, it attracted borrowers because of the low level of interest rate coupons, while the strength of the yen acted as a magnet to foreign investors. All in all, \$3.8 billion of foreign bonds was issued on the Japanese market last year, up from \$3.3 billion in 1982, but still half a billion less than in the record year of 1978. Exchange rate considerations played an even greater rôle in those currency sectors of the market where Euro-bond issues are important. Thus, the issue volume in the foreign and Euro-DM bond markets, which benefited from a somewhat improved outlook for the Deutsche Mark and slightly easier German domestic monetary conditions, expanded by 24 per cent. to a combined total of \$6.7 billion, one-third of which was accounted for by international institutions.

In relative terms, the most dynamic sectors last year were those denominated in ECUs and sterling, which expanded by nearly 170 and 60 per cent. respectively and appear to have been the major beneficiaries of the diversification process. Whereas in the case of the sterling sector the variety of issuing techniques used contributed to its performance, the appeal of ECU-denominated issues was based on their basket qualities.

By nationality of borrowers on the international bond markets, the share of OECD countries, despite the more than 50 per cent. contraction in issues by US companies, declined only marginally from 80 to 78 per cent. last year. Indeed, if the international European institutions are included, this share actually expanded from 85 to 87 per cent. Significant budget and balance-of-payments deficits prompted some countries to take advantage of the market's receptiveness to prime names. Moreover, benefiting from the success of FRNs in the latter part of 1983, some countries, such as Sweden, Denmark and Australia, shifted their funding from the syndicated loan market to the international bond market.

In the case of Japanese borrowers, who have traditionally kept out of the syndicated loan market, the surge in external bond offerings, from \$6.2 to 11.1 billion, was essentially related to the favourable climate for convertible issues in Switzerland and currency swapped bonds. With \$7.2 billion of new issues, France shared with US corporations the place of second-largest borrower. Nevertheless, this figure was still slightly below the 1982 total and has to be seen against the background of a sharp fall in the country's recourse to the syndicated loan market. Together with supra-national and sovereign borrowers, French banks were among the major issuers of FRNs. Takings by Canadian entities shrank from \$11.4 billion in 1982 to \$6.8 billion last year, owing to lower financing requirements and the more favourable conditions in the domestic bond markets.

Except for a few Asian countries which, in common with the developed countries, were able to benefit from the market's receptiveness to good signatures, the international bond market remained closed to most LDCs. Nor was there any increase in LDCs' indirect access to the market via the development agencies, since these reduced their takings from \$7.3 to 6.6 billion last year. But this modest decline primarily reflected the World Bank's greater emphasis on co-financing schemes with commercial banks.

In the first quarter of 1984 activity in the international bond markets accelerated further, with the issue volume reaching an unprecedented \$25.6 billion. The expansion was particularly marked in the convertible bond sector, where new borrowing was three times as large as the quarterly average for 1983, and in the FRN sector, where it was twice as large. The buoyancy of the convertible bond sector was in large measure due to a surge of issues by Japanese corporations, which benefited from the strong performance of the Japanese stock market, and US corporate borrowing in conjunction with merger activities. The FRN sector continued to attract business away from the Euro-credit markets with the strength of investors' demand for such paper creating borrowers' market conditions that could not be matched by the syndicated loan market. The volume of straight fixed rate issues was also up — though only slightly — on the preceding quarter, but with interest and exchange rate uncertainties about the dollar favouring issues denominated in other currencies.

VII. THE INTERNATIONAL MONETARY SCENE.

Highlights.

The dominant feature of the international monetary scene in 1983 — apart from the international debt problems described in Chapter VI — was the persistent strength of the US dollar in the exchange markets. Continuing favourable interest rate differentials, the dynamism of the US economy, the malaise in the international financial markets and international political unrest all combined to push the dollar's effective exchange rate up by a further 14 per cent. between January 1983 and January 1984 — despite both a very sharp deterioration in the US current-account balance of payments and the fact that the dollar had already appreciated by nearly 30 per cent. during the preceding two and a half years. While the market appeared to be having second thoughts about the longer-term outlook for the dollar in the first months of 1984, by early May the dollar had rebounded, under the influence of rising US interest rates, almost to its earlier peak. The strength of the dollar, together with some signs of greater convergence in member countries' economic performances, has also contributed to the relative stability of exchange rates in the European Monetary System since the last realignment, in late March 1983.

The combination of high dollar interest rates and a strong dollar exchange rate depressed private demand for gold in 1983 and, with it, the market price of gold. Western gold output continued to expand, but there was a sharp contraction in communist countries' sales, partly related to the weakness of the gold price.

International liquidity developments last year presented a mixed picture. On the positive side, total non-gold reserves of oil-importing countries, after their 1981–82 decline, began to increase again and reserve/import ratios generally improved somewhat, while the increase in IMF quotas and the enlargement of the General Arrangements to Borrow added substantially to official international credit facilities. On the other hand, the heavily indebted countries of Latin America found their access to new borrowing from the international banking system cut off, except in conjunction with conditional IMF credits, while the market value of total gold reserves was reduced as a result of the weakening of the gold price. The present international liquidity situation, therefore, is one in which many countries either hold adequate reserves or can borrow quite freely, while others are both short of reserves and limited in their access to external borrowing.

Exchange rate developments.

The floating currencies. During most of the period under review developments in the exchange markets were marked by the continued strength of the US dollar. Despite a quite sharp temporary weakening early in 1984, in mid-May the dollar stood 12 per cent. above its end-1982 level on a trade-weighted basis, while vis-à-vis European currencies it appreciated over this period by amounts ranging from 12 to

27 per cent. On the other hand, the Japanese yen appreciated by 2 per cent. vis-à-vis the US currency between end-1982 and mid-May 1984, while the Canadian dollar depreciated by only 5 per cent.

The further strengthening of the dollar against almost all other major currencies occurred despite a very substantial widening of the deficit on the current account of the US balance of payments, to an annual rate of over $60 billion in the final quarter of 1983. The performance of the dollar in the exchange markets was therefore by and large dominated by capital inflows to the United States. The size of these inflows reflected three main influences, the importance of which varied during the course of the period under review: firstly, the strong upswing of economic activity in the United States, which, in combination with the large deficit on the Federal Government's budget, produced a renewed rise in US interest rates; secondly, a very large decline in, and subsequent reversal of, net banking outflows from the United States, principally as a result of the external debt problems of many developing countries and of the gradual pick-up in credit demand in the United States itself; and, thirdly, the continued attractions of the US market as a safe haven for foreign funds.

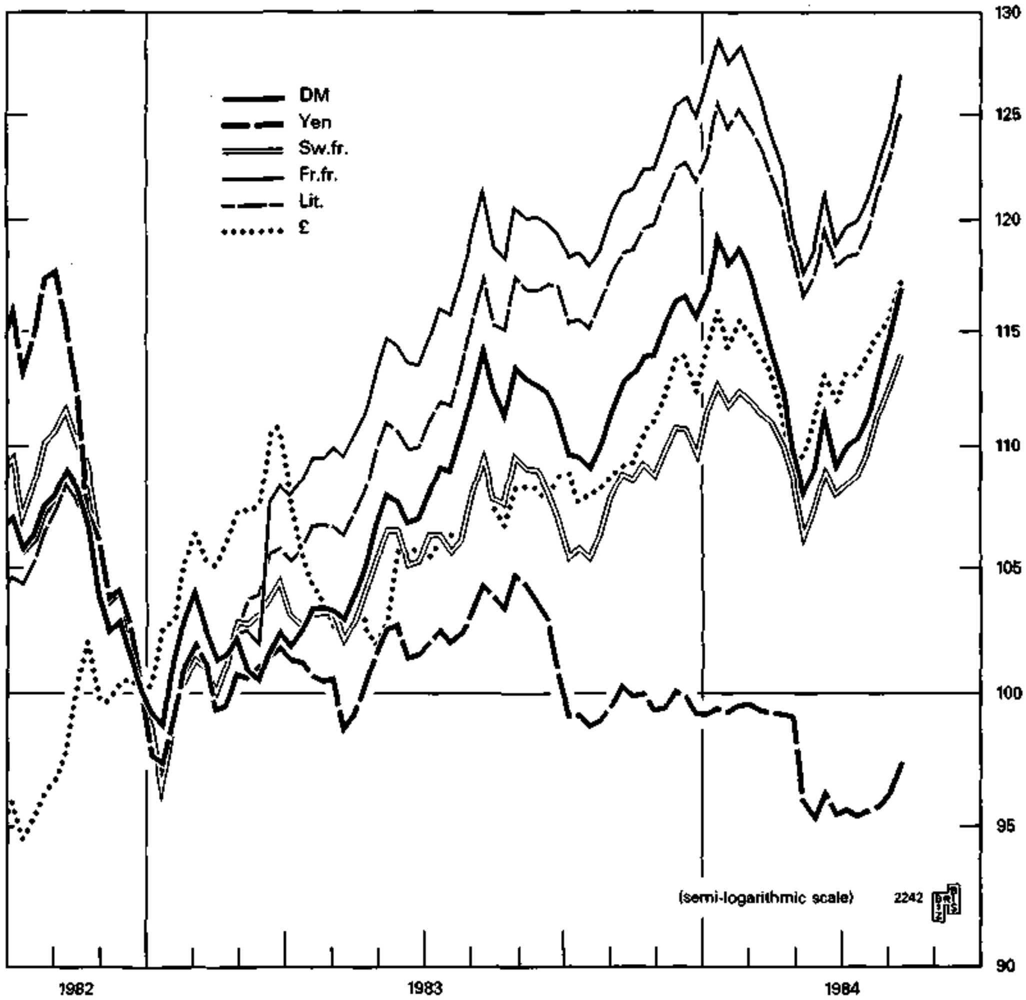
The performance of the Japanese yen reflected the strong fundamental situation of the Japanese economy, including the emergence of a large surplus on current external account, a low inflation rate and improved prospects for domestic economic growth. The Canadian dollar was helped by the relatively favourable foreign trade balance.

The year 1983 had opened with a weakening dollar, the effective exchange rate falling by 9 per cent. between early November 1982 and early January 1983, largely as a result of declining US interest rates and the prospect of a continued deterioration in the balance of payments on current account. This was followed by a short-lived strengthening of the dollar in the latter part of January as the decline of US interest rates came to a halt in the face of rapid growth of the US monetary aggregates. Subsequently, and until mid-May, there was relatively little movement in dollar exchange rates. While the dollar remained rather firm, helped by the level of domestic interest rates and continued concern about the external financial problems of many developing countries, uncertainty about the strength of the US economic recovery and, therefore, the outlook for dollar interest rates, as well as the prospect that the US current-account deficit would widen further during 1983, generated some expectations that the longer-term trend of the dollar would be downward. In addition, the market was anticipating the possibility of an agreement at the Williamsburg summit meeting in May on co-ordinated central-bank intervention in the dollar exchange market.

In mid-May the dollar resumed its upward trend as US interest rates began to rise again, reflecting expectations of a tightening of US monetary policy in response to the rapid growth of the monetary aggregates. In addition, the markets interpreted the clear evidence that was then becoming available of the strength of the US economic upswing as favouring the dollar in two different ways: firstly, that the upswing, coming on top of the large US Federal budget deficit, would lead to a further boost in interest rates; and, secondly, that the improved outlook for

Movements of bilateral exchange rates of the US dollar against selected other currencies, 1982–84.

Weekly averages, indices: end-1982 = 100.



corporate profits in the United States would enhance the attraction of the US economy for foreign investors. By contrast, the market appeared unconcerned about the likely consequences of the upswing for the current-account balance of payments. Between mid-May and mid-August three-month Euro-dollar interest rates rose by about 2 percentage points and the dollar's effective exchange rate went up by 8 per cent. to its highest level since floating began in March 1973. Over the same period the dollar gained 8 per cent. against the Swiss franc, 7 per cent. against the Japanese yen and 6 per cent. against sterling. Vis-à-vis the Deutsche Mark the dollar appreciated by as much as 12 per cent. The increase in Euro-dollar interest rates between May and August was rather fully reflected in a widening of the differential between Euro-dollar and Euro-DM rates from 3½ to over 5 per cent., while, in addition, market sentiment about the Deutsche Mark was affected by above-target domestic monetary growth and political developments in Germany.

Towards the end of July the upward movement of the dollar accelerated and disorderly conditions appeared in the exchange market, with sharp daily movements in rates. Against that background the US, German, Swiss and Japanese monetary authorities undertook co-ordinated exchange-market intervention. The US interventions, which took place between 29th July and 5th August, were limited to $254 million of dollar sales against Deutsche Mark and Japanese yen, whilst the German and Japanese authorities intervened on a much larger scale. The dollar continued to appreciate, however, for some days after these interventions, before easing somewhat around the middle of August.

The dollar began to weaken in September, when the growing current-account deficit in the United States appeared for a time to be affecting the market's view of the dollar's prospects. In addition, interest rate differentials between the dollar and other currencies narrowed, with the slower growth of the US monetary aggregates inducing some easing in US interest rates while some increase of rates occurred in Germany. Against this background, the dollar lost 3½ per cent. on the effective basis between the end of August and 10th October.

In late October, however, the dollar began to strengthen again, and it continued to appreciate until mid-January 1984. During this period it went up by 10 per cent. against the Deutsche Mark and 7 per cent. against the Swiss franc and sterling. There was, however, practically no change in the yen/dollar exchange rate. The dollar's effective rate repeatedly reached new record highs, and at its peak in mid-January 1984 it was 6 per cent. higher than in mid-October 1983 and 54 per cent. above the low point of October 1978. A number of factors combined to produce this further appreciation of the dollar. They included a renewed rise in US interest rates and increasing political tensions in the Middle East. In addition, there were a number of influences which tended to depress European currencies. Economic recovery in Europe was weak, and the outlook for corporate profits was less favourable than in the United States. Moreover, the substantial deterioration in the US current external account was not accompanied by the emergence of any large surplus in Europe. In the case of the Deutsche Mark the collapse of a large private German bank and domestic political factors were additional influences working in the dollar's favour.

Looking at the twelve-month period from mid-January 1983 to mid-January 1984, the Deutsche Mark was the weakest of the major currencies. Over that period it depreciated against the US dollar by 18 per cent., to DM 2.84, almost its lowest level since March 1973. On the effective basis, the depreciation of the Deutsche Mark amounted to 7 per cent., its decline against the dollar and the yen being partly offset by the March 1983 realignment of currencies in the EMS exchange rate system. The Swiss franc declined against the dollar by 15 per cent. over the same period, but, owing to its appreciation vis-à-vis the Deutsche Mark and most other European currencies, on the effective basis its fall was little more than 3 per cent.

Against the dollar, sterling fell by 14 per cent. between January 1983 and January 1984, almost as much as the Swiss franc, but its effective exchange rate hardly changed on balance over that period as a whole. During the first half of 1983, moreover, sterling followed a rather different course from other major currencies.

Between January and March 1983 it declined by about 10½ per cent. against the dollar and by 7½ per cent. on the effective basis, in connection with the March cut in official OPEC oil prices. Subsequently, sterling recovered almost the whole of its earlier loss against the dollar and appreciated by 12½ per cent. on the effective basis in April and May as the prospects of further declines in oil prices receded and in anticipation of the June election results. Later in the year sterling, together with other European currencies, came under pressure from the strong dollar.

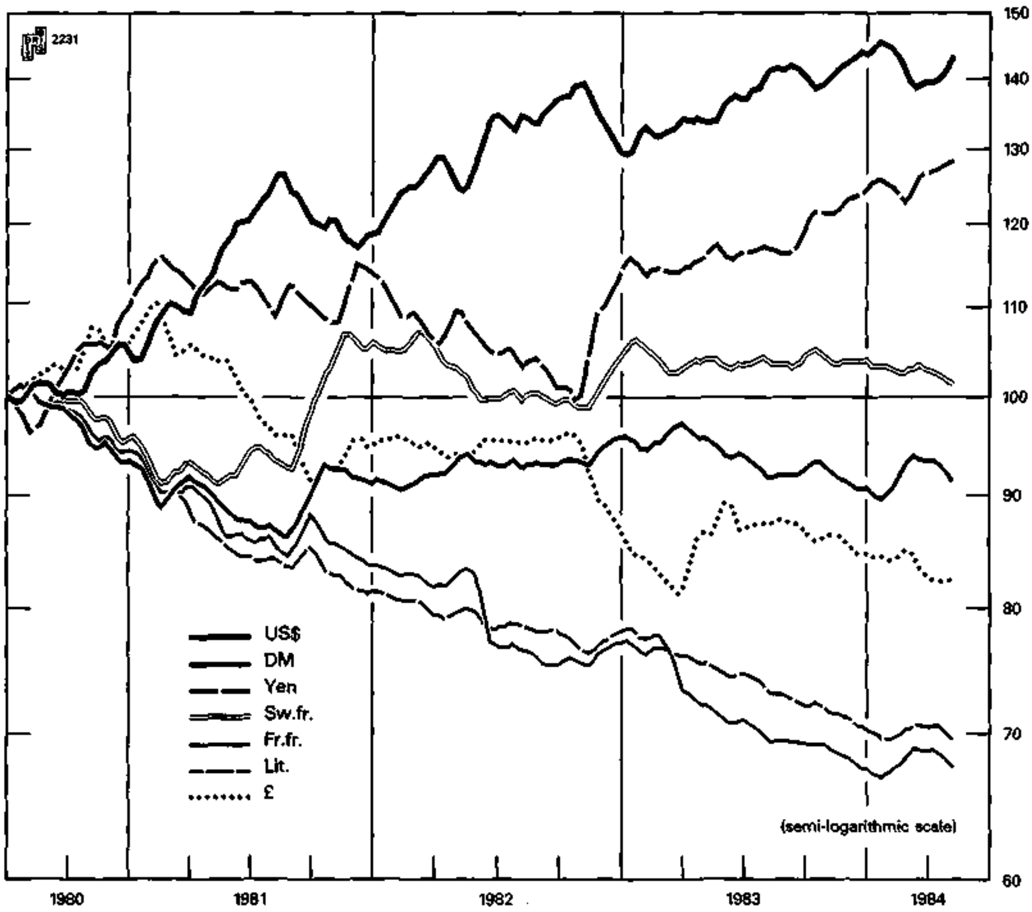
The Japanese yen was least affected by the strength of the dollar in 1983. During the twelve-month period up to mid-January 1984 it declined against the dollar by only 3 per cent., while on the effective basis it appreciated by 10 per cent. Against the Deutsche Mark it rose fairly steadily, from Yen 98.2 in early January 1983 to Yen 82.1 a year later, its highest level since the Second World War.

Towards the middle of January 1984 market sentiment about the dollar began to change rather rapidly. For this there were a number of reasons. Probably the most important of these were doubts about the possibility of financing, at the then prevailing exchange rates, a deficit on the current account of the US balance of payments that was forecast to reach $75 billion, or perhaps even more, in 1984. In addition, there was concern that present and prospective budget deficits, together with continued rapid economic growth, could lead to some rekindling of US inflation. Outside the United States, moreover, the outlook for economic growth in the rest of the industrial world, and particularly in Germany, appeared to be improving.

Against this background, the effective exchange rate of the dollar, after having reached a peak on 12th January, fell by about 6½ per cent. in less than two months. Against other major currencies the dollar's decline was greatest, at 10½ per cent., vis-à-vis the Deutsche Mark, which itself was also strengthening against other EMS currencies. Against the Swiss franc and sterling the dollar declined by 6½ per cent. between mid-January and early March and against the Japanese yen by 5 per cent. A particular feature of the January-March 1984 decline of the dollar was that it occurred at the same time as a further increase in dollar interest rates and in interest rate differentials favouring investment in dollars. This suggested that the market was more inclined than it had been earlier to look at the possible longer-term outlook for the dollar. Short-term dollar interest rates began to go up in early February, and by early March, when the dollar reached its low point, the three-month Euro-dollar rate had moved up from 9½ to over 10 per cent.

At that point the market situation reversed itself again and the dollar began to appreciate once more, as US interest rates continued to firm in response to the unexpectedly rapid growth of the economy and a surge in credit demands. In early April the Federal Reserve's official discount rate was increased, underlining the continued commitment to an anti-inflationary monetary policy, and by mid-May three-month Euro-dollar rates reached 11⅞ per cent., up by over 2 percentage points from the early February level. Interest rates in the other main industrial countries did not follow this pronounced upward movement, with the result that, for example, the differential between three-month Euro-dollar and Euro-DM rates widened from less than 4 per cent. in early February to nearly 6 per cent. Against

Selected industrial countries: Movements in effective exchange rates, 1980–84.
Three-week averages, indices: end-June 1980 = 100.



this background, between early March and mid-May the dollar appreciated by over 6 per cent. on the effective basis, by 9.5 per cent. against the Deutsche Mark, by 8½ per cent. against the Swiss franc and by 7½ per cent. against sterling. Vis-à-vis the yen, however, its appreciation was only 4 per cent. In addition to the upward movement of dollar interest rates, the renewed strength of the dollar was probably related to the emergence of industrial unrest in France, Germany and the United Kingdom.

Looking back over developments in the dollar exchange market since the end of 1982, two points stand out very clearly. The first is that monocausal theories of the behaviour of exchange rates do not hold water. Over the past eighteen months the relations between the dollar and other major currencies have been influenced by different factors at different times and, furthermore, the same factor, e.g. the US budget deficit or current external deficit, produced different effects at different times.

The second point is that, while the protracted rise of the dollar, which started in 1980, may now be near its end, the present level of the exchange rate poses a number of problems for the future. Through the international competitive distortions to which it is giving rise it is tending to strengthen protectionist forces, and it has also contributed to the emergence of an unsustainable US balance-of-payments structure. It is unlikely that a US current-account deficit of the present magnitude can be financed indefinitely at present rates of exchange, and when this proves to be the case, or when the markets realise that the present situation cannot be prolonged much further, there could be renewed instability in the dollar's exchange rate and accompanying international financial disturbances.

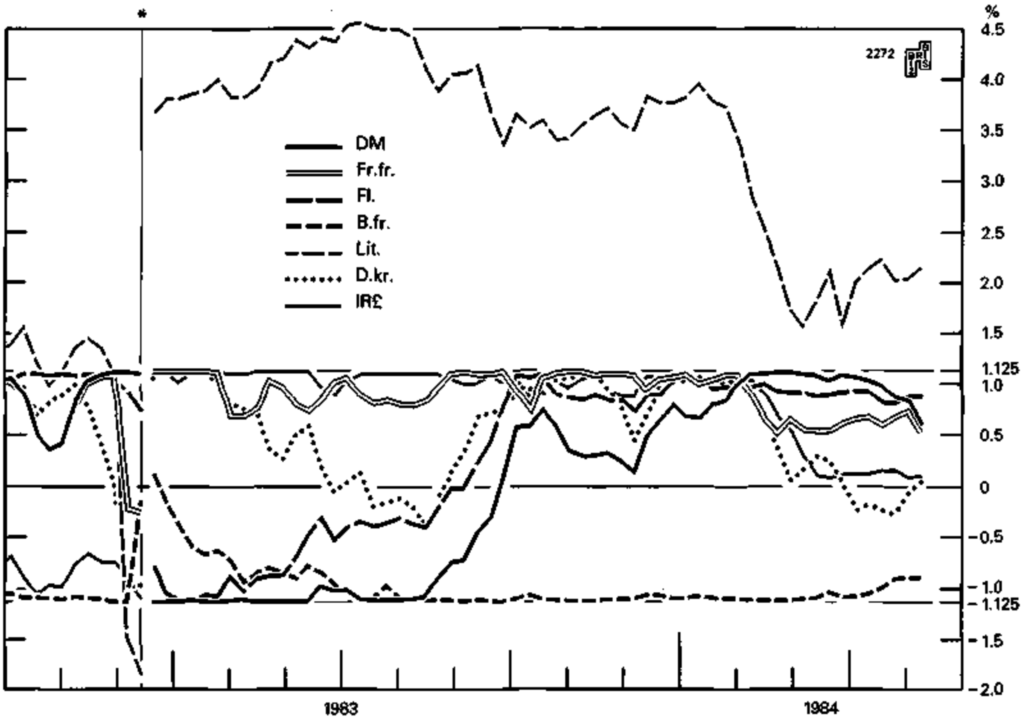
Exchange rate developments within the EMS. During the period under review there was one realignment of exchange rates within the European Monetary System, in late March 1983. The events which led up to it had their origin in a strengthening of the Deutsche Mark against the US dollar in late 1982, which was accompanied by a rapid improvement of the Deutsche Mark's position within the EMS band. By December 1982 the Mark had joined the Dutch guilder at the top of the band, and after the elections in Germany and France in early March 1983 the French franc came under heavy pressure, which continued despite cuts in the official discount rates in Germany and the Netherlands. Following a one-day suspension of official foreign exchange trading by the EMS countries on 21st March, the realignment was carried out: with effect from that date the Deutsche Mark, the Dutch guilder, the Danish krone and the Belgian franc were revalued by 5.5, 3.5, 2.5 and 1.5 per cent. respectively, while the French franc and the Italian lira were each devalued by 2.5 per cent. and the Irish pound by 3.5 per cent.

As on earlier occasions, the realignment was immediately followed by a reversal of nearly all participating currencies' previous positions inside the band. With the unwinding of the speculative flows of funds that had occurred before the realignment, the Deutsche Mark and the Dutch guilder fell to the lower limit of the new exchange rate band, while the French franc, the Danish krone and the Irish pound all went to their upper limits and the Italian lira rose sharply into the upper half of its wider band. The Belgian franc, on the other hand, very soon began to decline from about its central rate, joining the Deutsche Mark at the bottom of the band in July. From May onwards, the Danish krone began to move down, and the Dutch guilder to move up, towards the middle of the band, whilst the lira, the French franc and the Irish pound remained the strongest currencies in the system.

During the rest of the period under review the behaviour of the currencies within the band, notably that of the Deutsche Mark, was strongly influenced by the performance of the dollar in the exchange markets. When the dollar began to ease in the course of August, the Deutsche Mark, the guilder and the Danish krone started to appreciate, and by early October all the participating currencies, with the exception of the Belgian franc, were well within the upper half of the band, where they remained until late February 1984. The renewed strengthening of the dollar in October was accompanied by some weakening of the Deutsche Mark in the EMS system until early December. Subsequently, the Mark began to move up again and in early February it replaced the French franc at the top of the band, with the guilder becoming the next strongest currency. However, with the come-back of the dollar, the Mark began to detach itself from the top of the band in the course of April, and towards the end of the month it ceded first place to the guilder.

Spot exchange rates in the EMS exchange rate mechanism, 1983–84.

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

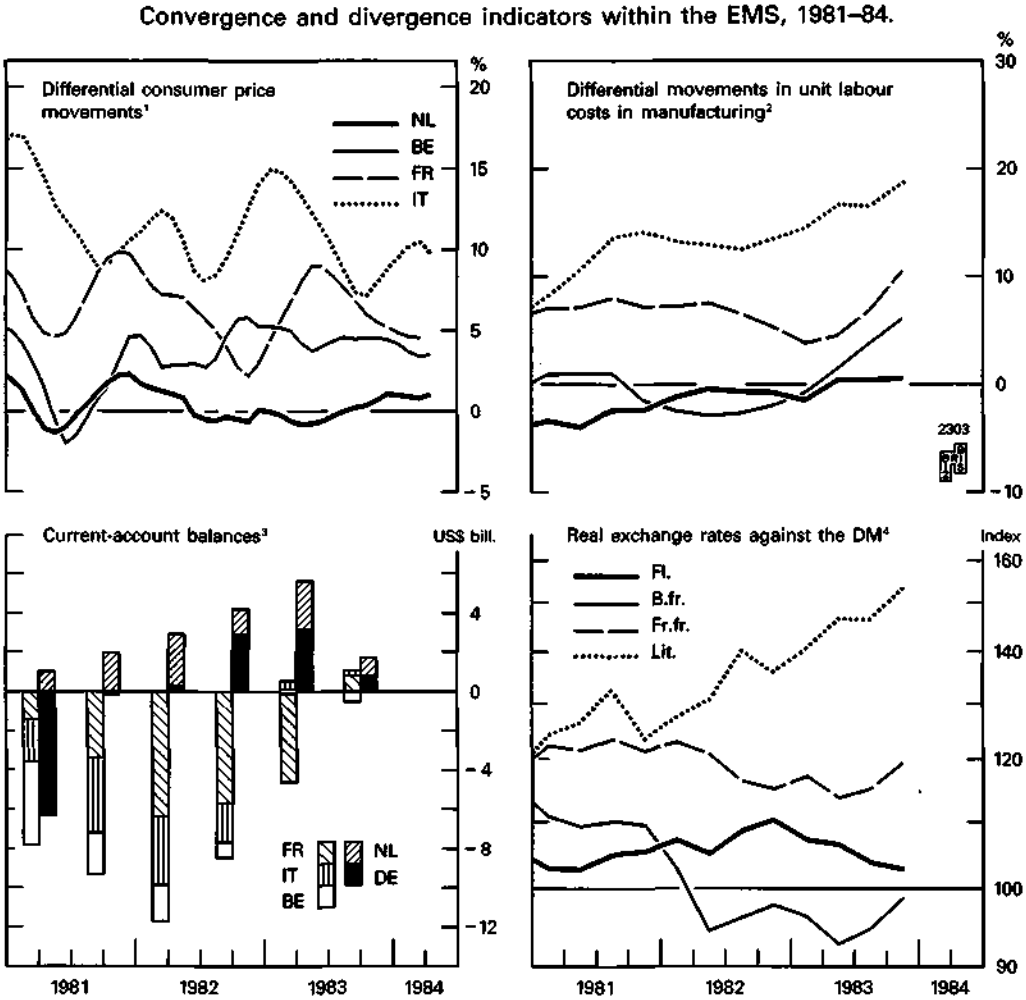


* Realignment of central rates with effect from 21st March 1983.

The temporary strength of the Deutsche Mark in the early months of 1984 was not accompanied by any dramatic weakening of other currencies. The French franc and the Italian lira stayed within the upper half of their respective bands, owing partly to substantial intra-marginal intervention, and the Belgian franc remained the only currency in the lower half of the band. By early March the Belgian franc had been at, or very close to, its lower limit for nearly ten months, despite increases of 1 per cent. in the official discount rate of the National Bank of Belgium in November 1983 and again in February 1984. The persistent weakness of the Belgian franc was the result of continuing large capital outflows, the current account of the balance of payments having improved significantly during 1983. From mid-March onwards, however, the strains on the Belgian franc began to ease, and in the course of April it gradually detached itself from the bottom of the band.

By late May 1984 fourteen months had passed since the last realignment of central rates, making this one of the longest periods of nominal exchange rate stability within the system since its inception in March 1979. This stability of rates has been due to a number of factors. Firstly, the March 1983 realignment was one of the largest in the history of the EMS, with bilateral changes in central rates of up to 9 per cent. Secondly, the strength of the dollar against all EMS currencies, including the Deutsche Mark, during most of the period since March 1983 has exerted a stabilising influence on the system.

Convergence and divergence indicators within the EMS, 1981–84.



¹ Domestic minus German prices calculated as annualised percentage changes over six months of three-month moving averages. ² Domestic minus German unit labour costs calculated as percentage changes over four quarters of three-quarter moving averages. ³ Half-yearly seasonally adjusted values. ⁴ In terms of relative unit labour costs in manufacturing; indices: first-half 1979 = 100 (semi-logarithmic scale).

In addition, however, it is noteworthy that the system was not subject to major tensions during the period from mid-January to early March 1984 when the dollar weakened quite sharply against the Deutsche Mark and the Mark itself again became temporarily the strongest of the participating currencies. This was attributable to the achievement of a greater degree of convergence in some aspects of member countries' economic performance. As the above graphs show, this convergence was apparent both in balance-of-payments and in price developments. On the current account of the balance of payments, there was a major improvement during 1983 in France's position, as well as smaller, but still significant, ones in Belgium-Luxembourg, Denmark, Ireland and Italy. At the same time the surplus on Germany's current external account remained moderate. One factor contributing to this convergence of balance-of-payments positions was the March 1983 realignment of exchange rates in the system. The graphs also show that there has been some progress towards greater convergence of rates of increase in member countries' consumer prices.

So far as unit labour costs in manufacturing industry are concerned, however, less progress towards convergence appears to have been made, and recently the real exchange rates of the lira, the French franc and the Belgian franc against the Deutsche Mark, estimated in terms of changes in relative unit labour costs, have all been appreciating. The progress made so far towards convergence of economic performance in member countries therefore needs to be continued and extended, and it remains to be seen how great the capacity of the EMS exchange rate system would be to withstand the effects of a longer-lasting decline of the dollar's exchange rate, should that occur.

Gold production and the gold market.

Gold developments during the period under review were marked by a further weakening of prices. With the expected easing of US interest rates and of the dollar exchange rate failing to materialise, the recovery of the gold price which had set in in the second half of 1982 came to a halt in early 1983 and was subsequently partly reversed. The attraction of other investment outlets and the lack of any visible revival in industrial demand meant that the market was unable to absorb even a reduced volume of new gold without a renewed price fall. However, except for a very sharp drop in prices in the last week of February 1983, the weakening of the gold price during the period under review was on a much smaller scale than in 1981 and the first half of 1982. Moreover, the strength of the dollar meant that, expressed in terms of the principal European currencies, the price of gold was relatively stable last year. In contrast to earlier periods, therefore, the high level of US interest rates and the strength of the dollar did not give rise to large-scale liquidations of gold holdings; on the other hand, they undoubtedly tended to neutralise any positive effects on gold prices which might otherwise have been exerted by world political and financial developments.

The reduction in the supply of new gold coming on the market between 1982 and 1983 was more than accounted for by a decline in communist countries' sales and western official transactions. Estimated world gold production (excluding that of the USSR, other eastern European countries, China and North Korea) increased

Estimated market sources and uses of gold.

Items	1979	1980	1981	1982	1983
	in metric tons				
Production	955	950	970	1,020	1,085
Estimated sales by communist countries	290	90	300	200	80
Estimated changes in western official gold stocks *through market transactions** (– = *increase*)	620	– 55	– 65	95	75
Total (= estimated non-monetary absorption)	1,865	985	1,205	1,315	1,240

* Changes in South Africa's gold reserves have been excluded from the movements of official gold stocks in all the years covered in the table, since they are believed to have largely reflected the execution or unwinding of gold swaps between the South African Reserve Bank and commercial banks in other countries.

Estimated world gold production.

Countries	1946	1953	1970	1979	1980	1981	1982	1983
	in metric tons							
South Africa	371.0	371.4	1,000.4	705.4	675.1	657.6	664.2	679.5
Canada	88.5	126.1	74.9	51.1	50.6	52.0	64.7	70.7
United States	49.0	60.9	54.2	29.8	30.2	42.9	45.0	50.4
Brazil	4.4	3.6	9.0	25.0	35.0	35.0	35.0	50.0
Australia	25.6	33.4	19.3	18.6	17.0	18.4	27.0	32.2
Philippines	–	14.9	18.7	16.7	20.4	23.4	29.5	31.5
Chile	7.2	4.1	1.6	4.3	6.5	12.2	18.9	19.8
Papua New Guinea	.	.	0.7	19.7	14.3	17.2	17.8	18.4
Colombia	13.6	13.6	6.3	10.0	17.0	17.7	15.9	17.9
Zimbabwe	16.9	15.6	15.6	12.0	11.4	11.6	13.4	14.1
Ghana	18.2	22.7	22.0	11.5	10.8	13.0	13.0	11.8
Dominican Republic	.	.	–	11.0	11.5	12.8	11.8	11.2
Peru	4.9	4.4	3.3	4.7	5.0	7.2	6.9	9.9
Mexico	13.1	15.0	6.2	5.5	5.9	5.0	5.2	5.5
Total listed	612.4	685.7	1,232.2	925.3	910.7	926.0	968.3	1,022.9
Other countries	53.6	68.3	38.8	31.2	37.8	42.5	49.7	62.1
Estimated world total*	666.0	754.0	1,271.0	956.5	948.5	968.5	1,018.0	1,085.0

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

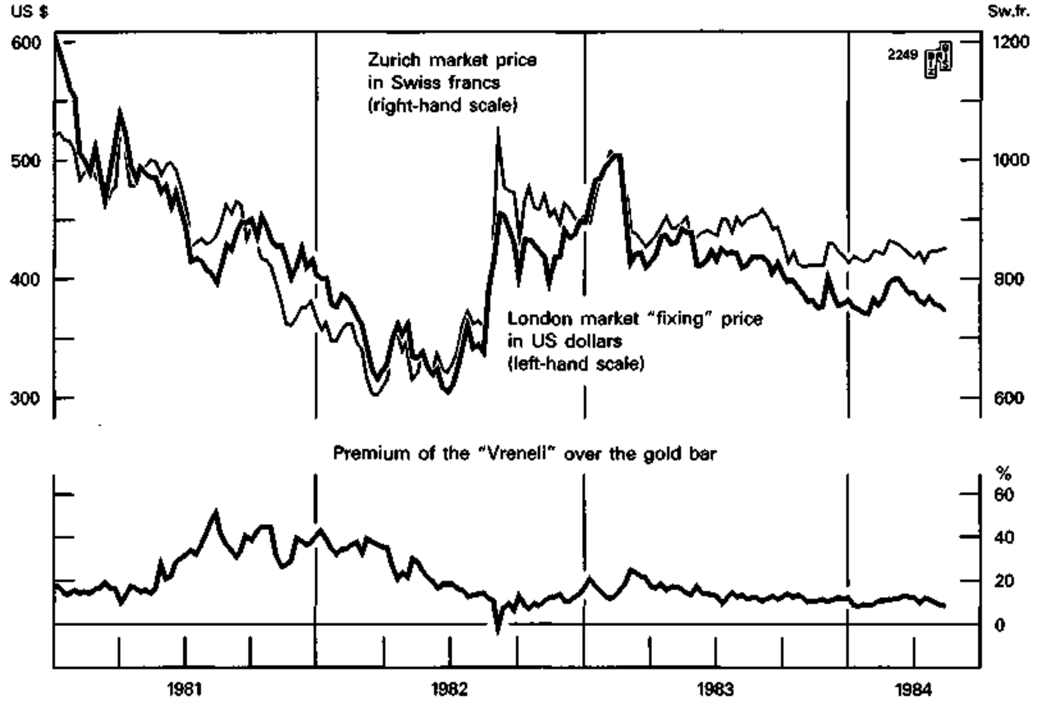
significantly last year, from 1,018 to 1,085 metric tons. This represented an accentuation of an upward trend of output which had begun in 1981 after an almost uninterrupted decline of production over the preceding decade. Total gold output last year, however, was still 14½ per cent. below the 1970 peak.

The major factor behind the earlier long-term decline of world gold production had been the shift to mining of lower-grade ore in South Africa following the rise in the market price of gold; in contrast, the recent revival of output has been more broadly based. In 1983 production was on the rise almost everywhere, with above-average increases in the output of marginal producing countries. Among the major producers the largest rates of increase in gold output were recorded in Brazil (+43 per cent.) and Australia (+19 per cent.). The 1983 rise in South African production, on the other hand, amounted to less than 2½ per cent., as the increase in the quantity of ore milled in that country continued to be partly offset by the decline in the average grade of ore. As a result, the South African share slipped further last year to 63 per cent. of the estimated total of world gold production, as against a record 79 per cent. in 1970.

Estimated gold sales by communist countries decreased sharply between 1982 and 1983, from 200 to 80 tons. A better balance-of-payments situation and the weak performance of the price of gold resulted in a major reduction of gold sales by the USSR. Estimated sales from western official stocks also contracted slightly, from 95 tons in 1982 to 75 tons. The reduction in official gold stocks last year was more than fully accounted for by three countries, Portugal and the Philippines (which sold about 50 tons each) and the United States (which reduced its gold stock by 20 tons). On the other hand, and in contrast to 1982, two major indebted countries, Brazil and Mexico, added 12 and 7 tons respectively to their gold stocks, while Taiwan raised its holding by 12 tons. In addition, Hungary almost fully recouped the 32 tons it had sold in 1982, while Colombia increased its gold reserves by a further 12

Market prices of gold in US dollars and Swiss francs, 1981–84.

Friday figures, per fine ounce.



tons. In Brazil and Colombia the increases in official gold stocks reflected primarily the absorption of domestically produced gold, although in the case of Brazil the major part of last year's gold output of 50 tons appears to have been sold on the market.

The net result of these developments was to reduce the estimated total volume of gold available for non-monetary absorption from 1,315 to 1,240 tons. This reduction in supply, however, did not prevent a renewed erosion in the price of the metal. Indeed, the lower level of communist countries' gold sales in 1983 was itself partly a reflection of the weakening of demand. Moreover, whatever the total volume of gold actually reaching the market, the publicity given to official gold sales tends, especially in a period of acute debt difficulties and where futures markets play a growing rôle, to have a depressive influence on the market. Nevertheless, the most important factors behind the weakness of the gold price last year were the persistence of high US interest rates and a strong dollar exchange rate, overshadowing any possible bullish impact of international political and financial disturbances.

The year 1983 had opened with the London market fixing price a little above $450 per ounce, quotations having risen from a low point of just under $300 in mid-1982, under the combined influence of falling dollar interest rates and concern about the international debt situation. The upward movement of prices continued during the first weeks of the year, with quotations reaching $511.50 per ounce on 15th February 1983, the highest price recorded during the year and over 70 per cent.

above the mid-1982 low point. In the face of weakening oil prices, a very sharp reaction then set in which brought market prices at one point down below $400 per ounce at the end of February. The market then settled for a while in the $410-440 range, with no definite discernible trend for the dollar or US interest rates. The price rose to $443 per ounce at one point in April in reaction to events in Lebanon and concern about Brazil's external payments problems, and remained close to that level until the end of May. The subsequent renewed strengthening of the dollar, together with rising US interest rates, caused the gold price to drift downwards to $400.25 at the London fixing on 7th June. It then stayed well above the $400 level throughout the summer, reaching $430 per ounce in July, when demand was stimulated by renewed concern about developing countries' debt problems.

After the summer the renewed firmness of US interest rates and of the dollar became the overriding influence on the market. The gold price fell below $400 per ounce in early October, and on 21st November a low point of $374 was reached. After a short-lived rally to just above $400, the downward trend of prices was resumed, until quotations bottomed out at $364 per ounce on 9th January 1984, the lowest level since August 1982. The long-anticipated weakening of the dollar which then set in brought some recovery in gold prices, and in early March the London market fixing price went above $400 per ounce as a result of concern about a possible interruption of Middle Eastern oil supplies. By mid-March, however, prices had fallen below the $400 level again, and, with US interest rates once more moving up, in early May quotations were back to around $375 per ounce.

Reserves and international liquidity.

International liquidity developments in 1983 showed no uniform global pattern, either by groups of countries or by the various components in the light of which international liquidity, broadly defined, can be assessed. Looking at gross international liquidity in the narrow sense of monetary reserves, countries' total non-gold reserves, after having declined in 1981 and 1982, increased last year; on the other hand, there was a fall in the value of gold reserves, in line with the renewed weakening of the market price of gold. So far as net international liquidity is concerned, i.e. reserves minus external liabilities, non-gold reserves increased by less than external banking debt in most Latin American countries, as well as in the smaller developed countries. On the other hand, the net international liquidity position of non-OPEC developing countries in Asia improved.

In addition to official monetary reserves, international liquidity in the broader sense also includes international credit facilities, i.e. the resources potentially available to countries for financing payments deficits. Here, too, developments showed no uniform pattern last year. Total official international credit facilities were enlarged in 1983 as a result of the coming into force of the general increase in IMF quotas; but at the same time a rather clear split emerged in the market for international bank credit. In general, no new bank credits were available to Latin American countries, except in conjunction with conditional IMF credits, while the rest of the world, with some exceptions, maintained its capacity to go further into debt with the international banking system.

Finally, there was a widespread improvement during 1983 in the ratio of non-gold reserves to imports, both in the developed and in the developing countries. But in parts of the developing world, notably Latin America and Africa, this improvement reflected further emergency cuts in imports and could, therefore, hardly be described as a strengthening of these countries' international liquidity positions.

Turning to the details of last year's reserve developments, countries' aggregate reported holdings of non-gold reserves, which had declined by $48 billion in current dollar terms during the previous two years, showed an increase of $15.7 billion to a total of $381 billion at the end of 1983. This modest 4 per cent. growth of global non-gold reserves, in which all groups of oil-importing countries shared, occurred at the same time as a 4.5 per cent. fall in the dollar unit value of internationally traded goods. In real terms, therefore, the growth of non-gold reserves was greater than the nominal figures would suggest. And since, at the same time, the volume of world trade expanded by only 2 per cent., there was, as already mentioned, a widespread improvement in reserve/import ratios last year.

The weakness of the dollar prices of internationally traded goods was partly related to the further appreciation of the dollar on the exchange markets, and this also reduced the value, expressed in current dollars, of non-gold reserve assets denominated in currencies other than the dollar. Calculated at constant dollar exchange rates, therefore, the increase in total non-gold reserves last year came to nearly $30 billion.

In contrast to the increase in non-gold reserves, last year's 15 per cent. fall in the market price of gold meant that (in conjunction with a slight fall in total gold stocks) the market value of countries' total gold reserves, which had increased by $43.7 billion in 1982, declined by $63.5 billion in 1983. It is not possible to measure the overall effect of this development on international liquidity. The lower price of gold mainly affected the reserves of industrial countries, which hold the bulk of official gold stocks. For the non-OPEC developing countries, the fall in the total value of their gold reserves was substantially less than the increase in the current dollar value of their other reserve assets.

By *categories of reserve assets*, the 1983 growth of countries' non-gold reserves was largely accounted for by IMF reserve positions, which increased by $12.9 billion in current dollar terms. This development resulted partly from the increase in Fund quotas and partly from the growth of the Fund's lending operations. In current dollar terms, new quota subscriptions added $5.9 billion to total Fund reserve positions, and the Fund's lending operations (together with other relatively minor transactions such as the balance of interest payments and receipts) an amount of $7 billion.

The IMF quota increase under the Eighth General Review became effective at the end of November 1983, when it had been ratified by countries accounting for 70 per cent. of total Fund quotas. By the end of the year, over 97 per cent. of all quota increases had been subscribed, thereby raising total Fund quotas by SDR 27.4 to 88.5 billion. At the same time the percentage limits, in relation to quotas, on countries' access to Fund credit were reduced so as to leave essentially unchanged the amounts that could normally be drawn by individual countries under the enlarged quotas.

Total net new drawings on the IMF in 1983 amounted to SDR 12.1 billion, a new annual record. 80 per cent., or SDR 9.7 billion, represented net drawings by non-OPEC developing countries. In that group the largest net drawings were made by Brazil (SDR 2.4 billion), India (SDR 1.5 billion), Argentina (SDR 1.3 billion) and Mexico (SDR 1 billion). For the first time since 1973, OPEC countries made sizable net drawings on the Fund last year. These amounted to SDR 1 billion, over 60 per cent. of which was accounted for by Indonesia. Developed countries' net drawings totalled SDR 1.3 billion, of which Portugal and Yugoslavia accounted for SDR 0.4 billion each and Hungary for SDR 0.3 billion. Parallel with this large-scale use of the Fund's resources there was a marked increase during 1983 in the Fund's lending commitments, from SDR 14.1 to 22.9 billion. The largest new credit facilities were granted to Brazil, Mexico and Argentina. At the end of the year undrawn balances under lending commitments totalled SDR 12.4 billion.

The main currencies used to finance the Fund's net lending operations last year were US dollars (SDR 5.3 billion) and Saudi Arabian riyals (SDR 1.7 billion). Net drawings in SDRs totalled SDR 2.6 billion. A significant part of last year's total drawings on the Fund was financed with funds borrowed from Saudi Arabia and a number of industrial countries. Moreover, the credit lines available to the Fund were substantially increased in December 1983 by an expansion, from about SDR 6.4 billion to SDR 17 billion, in the aggregate credit commitments of countries participating in the General Arrangements to Borrow. In parallel with the enlargement of the GAB, Saudi Arabia extended a new credit line of SDR 1.5 billion to the Fund, to be used for the same purposes and under the same circumstances as the GAB credit lines. In addition, in April 1984, new credit lines totalling SDR 6 billion were extended to the IMF by Saudi Arabia, the BIS, Japan and Belgium.

In contrast to the increase in IMF reserve positions, countries' total holdings of SDRs declined by $4.5 billion in 1983, as drawings on the Fund credit lines made in SDRs were more than offset by the use of $6.3 billion of SDRs for the increased quota subscriptions.

Apart from the changes in Fund reserve positions and SDR reserves, aggregate movements in other types of non-gold reserve assets were rather limited. In current dollar terms, total official holdings of foreign exchange and ECUs went up by only $3.7 and 3.6 billion respectively. Measured at constant dollar exchange rates, however, the increases came to $10.7 and 8.3 billion respectively. Last year's increase in exchange reserves followed a $21.8 billion decline (in current dollars) in 1982.

As regards the *geographical composition* of the growth of non-gold reserves in 1983, the Group of Ten countries, whose reserves had declined by $35 billion over the two preceding years, recorded an increase of $8.8 billion. The non-gold reserves of the United States showed a small decline last year, a $3.7 billion rise in its SDR holdings and IMF reserve position being more than offset by a $3.9 billion contraction in its foreign exchange reserves. The decline in US exchange reserves

Changes in global reserves, 1981–83.

Areas and periods	Gold		Foreign exchange	IMF reserve positions	SDRs	ECUs	Non-gold total
	in millions of ounces	in billions of US dollars[1]					
Group of Ten countries							
1981	− 0.5	−140.4	− 11.6	2.3	2.3	− 13.6	− 20.6
1982	− 0.3	35.4	− 10.8	3.3	1.8	− 8.4	− 14.1
1983	− 0.7	− 49.4	1.5	7.2	− 3.1	3.2	8.8
Amounts outstanding at end-1983	*738.4*	*281.7*	*98.1*	*24.9*	*11.2*	*44.2*	*178.4*
Other developed countries							
1981	− 3.1	− 19.9	− 2.7	− 0.2	0.4	− 0.2	− 2.7
1982	− 2.8	3.3	0.4	− 0.5	− 0.2	–	− 0.3
1983	− 0.5	− 6.3	3.0	1.0	− 0.4	0.4	4.0
Amounts outstanding at end-1983	*92.0*	*35.1*	*40.0*	*2.2*	*1.0*	*0.8*	*44.0*
Non-OPEC developing countries[2]							
1981	1.1	− 13.4	1.1	− 0.3	0.8		1.6
1982	− 1.7	2.8	0.2	− 0.2	− 1.3		− 1.3
1983	− 0.4	− 5.0	8.5	0.2	− 0.3		8.4
Amounts outstanding at end-1983	*72.4*	*27.7*	*79.8*	*1.9*	*1.2*		*82.9*
Total oil-importing countries							
1981	− 2.5	−173.7	− 13.2	1.8	3.5	− 13.8	− 21.7
1982	− 4.8	41.5	− 10.2	2.6	0.3	− 8.4	− 15.7
1983	− 1.6	− 60.7	13.0	8.4	− 3.8	3.6	21.2
Amounts outstanding at end-1983	*902.8*	*344.5*	*217.9*	*29.0*	*13.4*	*45.0*	*305.3*
OPEC countries[3]							
1981	1.6	− 7.1	− 1.8	1.5	0.5		0.2
1982	0.4	2.2	− 11.6	0.7	0.2		− 10.7
1983	0.1	− 2.8	− 9.3	4.5	− 0.7		− 5.5
Amounts outstanding at end-1983	*42.8*	*16.3*	*61.6*	*12.0*	*1.7*		*75.3*
All countries							
1981	− 0.9	−180.8	− 15.0	3.3	4.0	− 13.8	− 21.5
1982	− 4.4	43.7	− 21.8	3.3	0.5	− 8.4	− 26.4
1983	− 1.6	− 63.5	3.7	12.9	− 4.5	3.6	15.7
Amounts outstanding at end-1983	*945.6*	*360.8*	*279.5*	*41.0*	*15.1*	*45.0*	*380.6*

[1] Gold reserves valued at market prices. [2] Including (unlike Chapter V) China, Israel and (unlike Chapter VI) the offshore centres. [3] Including Bahrain, Oman and Trinidad and Tobago.

essentially resulted from three transactions: the redemption of the remaining $1.7 billion of Carter bonds still outstanding; the unwinding of $1.6 billion of currency swaps with Mexico and Brazil; and the use of $0.7 billion worth of Deutsche Mark and yen balances to finance part of the increase in the US quota at the IMF.

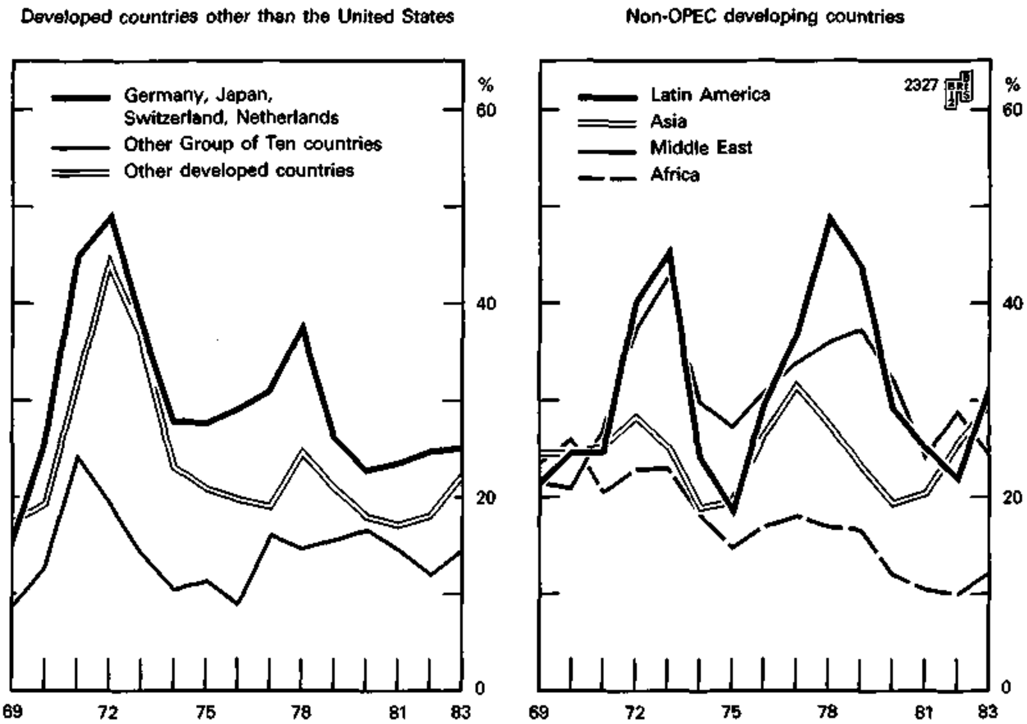
The non-gold reserves of other Group of Ten countries increased by $9 billion during 1983. Their foreign exchange and ECU holdings expanded by $5.4 and 3.2 billion respectively, while a $3.3 billion expansion of their IMF reserve positions was largely offset by a $2.9 billion reduction in their SDR holdings.

The reserve gains of the Group of Ten countries other than the United States were largely concentrated on Italy ($6 billion) and France ($3.3 billion), both of which countries recouped reserve losses sustained in earlier years. Italy's and France's reserve gains were essentially demand-determined in the sense that in both countries the public sector borrowed heavily abroad, either directly or via the domestic banking sector. The situation was similar in Belgium and Sweden, which, despite current-account balance-of-payments deficits, recorded reserve gains of $0.8 and 0.5 billion respectively. Among the Group of Ten countries with current-account surpluses in 1983, only Japan and Canada showed sizable reserve accretions — of $1.3 and 0.5 billion respectively. Germany and the United Kingdom, on the other hand, experienced reserve losses of $2.1 and 1 billion respectively.

Non-gold reserves of the "Other developed countries" increased by $4 billion in 1983 after a $3 billion decline over the preceding two years. The largest gain was recorded by Australia ($2.5 billion), which experienced substantial capital inflows before its authorities decided to float the currency on 12th December 1983. Denmark also recorded a strong increase ($1.4 billion) in its non-gold reserves. In addition, a number of the lower-income countries within this group recovered all or part of the losses of the preceding year: Hungary's non-gold reserves went up by $0.5 billion in 1983 after a drop of the same size in 1982; Turkey's by $0.3 billion after a $0.4 billion decline; and Yugoslavia's by $0.2 billion after a $0.8 billion decline in 1982.

In the group of non-OPEC developing countries, despite the external financing difficulties which many of these countries were experiencing, total non-

Selected groups of countries:
Ratios of non-gold reserves to merchandise imports, 1969–83.



gold reserves, after having shown on balance no increase over the three preceding years, rose by $8.4 billion in 1983. The whole of this increase represented additions to foreign exchange reserves. In large measure, the reserve gains were concentrated on a limited number of Asian countries with no net indebtedness to the international banking system. China's reserves rose by $3.5 billion, Taiwan's by $3.3 billion and those of Pakistan and India by $1 and 0.6 billion respectively. The Philippines, however, lost $0.9 billion, or more than half of its reserves. The most dramatic development was certainly the $3.1 billion increase in Mexico's reserves, which reversed the losses it had suffered during the 1982 crisis. Elsewhere in Latin America, Brazil and Chile recorded modest reserve gains, but the reserves of Colombia and Argentina declined by $2 and 1.3 billion respectively.

Both in Asia and in Latin America, the reserve/import ratios of non-OPEC developing countries improved last year, but for different reasons. In Asia, where the ratio went up from about 25 to nearly 30 per cent., the improvement was due mainly to reserve gains. In Latin America, where the international liquidity situation continued to be generally very tight, the reserve/import ratios nevertheless showed a much larger increase during 1983, from 21.8 to over 30 per cent. But, apart from Mexico's large reserve gains, this improvement resulted from further reductions in

Selected groups of countries: Ratios of non-gold reserves to external banking indebtedness, 1978–83.[1]

Groups	Ratio of reserves to debt at up to 1 year	Ratio of reserves to total debt
	at end of period, in percentages	
Developed countries outside the BIS reporting area		
1978	89.1	36.5
1979	92.8	35.0
1980	83.7	31.8
1981	66.3	26.5
1982	59.1	23.9
1983 June	53.0	21.4
Non-OPEC developing countries[2]		
1978	109.2	45.6
1979	96.7	41.2
1980	68.3	32.0
1981	56.7	26.7
1982	48.9	22.8
1983 June	53.7	24.6
of which:		
Latin America		
1978	*85.2*	*31.1*
1979	*76.6*	*29.4*
1980	*47.6*	*20.9*
1981	*35.3*	*15.5*
1982	*20.5*	*9.0*
1983 June	*21.8*	*9.5*
other non-OPEC developing countries		
1978	*140.7*	*72.4*
1979	*124.2*	*62.1*
1980	*101.1*	*53.0*
1981	*92.1*	*48.8*
1982	*96.7*	*49.6*
1983 June	*108.5*	*54.3*

[1] Debt to banks in the BIS reporting area. [2] Excluding offshore centres.

imports to levels which will not be sustainable in the longer run. A more meaningful indicator of the international liquidity situation in Latin America is provided by the ratio of reserves to external debt; in most Latin American countries this ratio remained very low in 1983, despite their reduced access to international bank credit.

OPEC countries' reported non-gold reserves declined by a further $5.5 billion in 1983, after losses of $10.7 billion in 1982. However, data on OPEC foreign exchange reserves are incomplete, since the latest available figures for Iran and Iraq date back to 1980 and 1977 respectively. The aggregate deficit on current account of the OPEC countries widened only a little further in 1983, but its country composition changed markedly. The "low absorbing" countries' current-account balance moved from surplus into deficit, while the deficit of the "high absorbing" countries was reduced by domestic adjustment programmes. Since, however, the "low absorbing" countries had no difficulty in borrowing from the international banking system, the deterioration in their current-account balance was only partly reflected in reserve movements.

Among the "low absorbing" countries, Saudi Arabia's non-gold reserves went down by $2.3 billion in 1983, a somewhat smaller decline than in the previous year. In Kuwait, however, non-gold reserves declined by $0.7 billion, after having risen by $1.8 billion in 1982. The narrowing of the "high absorbing" OPEC countries' current-account payments deficits produced smaller reserve losses in 1983 than in 1982. In Nigeria and Algeria non-gold reserve losses came down between the two years from $2.3 and 1.3 billion respectively to only $0.6 and 0.5 billion respectively. Indonesia and Venezuela, which had recorded reserve losses of $1.9 and 1.6 billion in 1982, actually added $0.6 and 1 billion to their reserves last year.

As regards the *deployment of exchange reserves* in the various markets and currencies, identified foreign official dollar holdings in the United States expanded by $6.4 billion during 1983, whereas exchange reserves held in the Euro-currency market and in national markets outside the United States showed, on balance, a further decline of $7.2 billion. However, the decline of official foreign exchange reserves held outside the United States continued only until mid-year. Official Euro-currency deposits, in particular, after being reduced by $10.5 billion in the first half of 1983 — bringing their cumulative decline since end-1980 to $52.7 billion or over 40 per cent. — were built up by $4.6 billion during the second half of the year. Furthermore, nearly the whole of the $1.3 billion decline in exchange reserves held in national markets outside the United States occurred in the first half of the year. The main reason for the turn-round was probably the behaviour of OPEC funds. In the first half of 1983 OPEC deposits (both official and private) with banks outside the United States were drawn down by $16.2 billion, while in the second half the decline came virtually to a halt. Another reason was that the reserve gains of oil-importing countries were much larger in the second than in the first half of last year.

The drawing-down of official funds in the Euro-market affected dollar deposits only (−$8.4 billion), whereas the stock of Euro-deposits denominated in other currencies expanded by $2.5 billion in current dollar terms, or by about $5 billion at constant exchange rates. The appreciation of the dollar against other currencies

The pattern of investment of exchange reserves, 1981–83.

Items	Flows 1981	Flows 1982	Flows 1st half 1983	Flows 2nd half 1983	Amounts outstanding at end-1983
	in billions of US dollars				
1. Deposits with banks in European countries,[1] Canada and Japan:					
(a) In national markets	− 1.4	− 3.8	− 1.2	− 0.1	10.9
Deutsche Mark	− 1.6	− 0.8	− 0.4	− 0.5	1.5
Swiss francs	1.1	− 1.3	− 0.4	–	1.0
Yen	0.8	− 0.4	− 0.5	0.2	4.7
Pounds sterling	− 0.9	− 0.1	0.2	0.2	2.2
French francs	− 0.8	− 0.2	0.1	− 0.1	0.5
Other currencies	–	− 1.0	− 0.2	0.1	1.0
(b) In Euro-markets	−17.6	−24.6	−10.5	4.6	74.3
Dollars	− 8.7	−12.3	−11.0	2.6	50.5
Deutsche Mark	− 5.4	− 6.9	0.5	1.5	13.9
Swiss francs	− 1.1	− 3.0	− 0.4	− 0.1	3.6
Yen	–	− 0.8	0.6	0.8	2.5
Pounds sterling	− 1.1	− 0.6	0.2	− 0.3	0.4
French francs	− 0.8	− 1.4	–	− 0.1	0.3
Other currencies	− 0.5	0.4	− 0.4	0.2	3.1
2. Deposits with certain offshore branches of US banks[2]	− 0.6	− 1.8	− 0.1	0.2	3.3
Total 1+2	−19.6	−30.2	−11.8	4.7	88.5
of which: In dollars	*− 9.2*	*−14.0*	*−10.9*	*2.9*	*53.4*
in other currencies	*−10.4*	*−16.2*	*− 0.9*	*1.8*	*35.1*
3. Exchange reserves identified as being held in the United States (= reported US liabilities to foreign official institutions), excluding dollars swapped against ECUs	4.9	2.8	1.8	4.6	163.6
4. Other	− 0.3	5.6	1.0	3.4	27.4
Total exchange reserves	−15.0	−21.8	− 9.0	12.7	279.5

Note: The figures in the table include changes in the dollar value of reserves held in other currencies resulting from movements in exchange rates.

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

last year, moreover, accounted for the bulk of the decline in official deposits in national markets outside the United States. Contrary to what had happened during the two preceding years, therefore, in 1983 changes in the currency composition of exchange reserves do not appear to have added to the upward pressures on the dollar. The increase in official placements in the non-dollar sectors of the Euro-market was limited to Euro-DM deposits (nearly $4 billion in constant dollar terms) and Euro-yen deposits ($1.3 billion).

Looking at the international liquidity situation as it presented itself in the spring of 1984, three groups of countries can be broadly distinguished. The first group includes a number of industrial countries, as well as the "low absorbing" members of OPEC. These countries' international liquidity positions are comfortable. Their official reserves are at present more than sufficient, their international credit-standing is very high and their external liquid liabilities present no problems, although in the secondary reserve currency centres these liabilities are a factor that has always to be taken into account by the authorities. At the other end of the spectrum is the second group, consisting of those countries, mainly in Latin America and Africa, whose international liquidity position is clearly inadequate. Both their actual reserves and their creditworthiness in the international markets are very low, while their reserve/import ratio and reserve/debt ratio are unfavourable. In between these two groups are the remaining countries of the world. In many of them reserve/debt ratios are, at present, low by historical standards; but their international creditworthiness remains unimpaired, so that their present liquidity situation can be said to be adequate, although a number of these countries are potentially vulnerable to further increases in their external indebtedness.

In this situation the deficit on the current account of the US balance of payments is at present adding substantially, quarter by quarter, to the rest of the world's net claims on the United States, mostly in liquid form. So far the US deficit has not greatly increased the rest of the world's official reserves, since it has been financed essentially by private capital inflows. Should the volume of private inflows of funds to the United States decline, or even be reversed, there would, ipso facto, be substantial additions to the rest of the world's official reserves. Firstly, exchange-market intervention would lead to increases in the dollar reserves of industrial countries, including those of the secondary reserve centres; and, secondly, the liquidity of the international banking system would be increased, with the likelihood of derived reserve gains in a number of countries whose capacity to go further into debt remains unimpaired. By contrast, the effects of the US deficit on the liquidity situation of the most heavily indebted countries with difficult access to new bank credit will be limited. Any significant improvement in their liquidity situation will have to come from a restoration of sustainable balance-of-payments situations and a recovery of their international creditworthiness.

VIII. ACTIVITIES OF THE BANK.

1. Financial assistance to central banks.

Last year's Report referred to the well-publicised financial assistance provided by the BIS on an unprecedented scale to a number of central banks. The year under review has seen a large reduction in this activity, all the credits mentioned last year having been repaid by the end of November. It may be recalled that all these facilities were granted with the support of varying numbers of central banks for the explicit purpose of providing bridging assistance to some central banks faced with severe liquidity problems in what may be called the first acute phase of the international debt crisis.

The following summary thus completes the account given in last year's Report under this heading. It is limited to the special facilities involving the co-operation of a number of central banks and does not refer to the more normal credit operations undertaken by the Bank in its own name and at its own risk, usually with little or no publicity.

In August 1982 the Bank of Mexico had received a facility of US$ 925 million, to be disbursed in three tranches, which paralleled a credit of a similar amount provided by the US monetary authorities direct; the BIS had the support of a large number of central banks in this operation. The policies pursued by the Mexican authorities within the framework of the stabilisation programme worked out in close contact with the IMF contributed to a major swing into surplus of Mexico's trade balance. This development, coupled with the availability of cash from the IMF, so improved the Bank of Mexico's external liquidity that it was able without difficulty first to make a modest advance repayment to the BIS and then to settle the balance of its obligation on the due date in August 1983.

The bridging facility in favour of the Central Bank of Brazil had totalled US$ 1,450 million and had the backing of a large group of central banks and the US monetary authorities. The first repayments took place before the end of the Bank's last financial year. However, following Brazil's failure to meet the IMF targets and a consequent suspension of disbursements of IMF loan funds, the Central Bank advised the Bank that it would be unable to make some of the subsequent repayment instalments on the due dates. Given the difficulty of setting new deadlines while negotiations between the Brazilian authorities and the IMF were in progress, but without wishing to agree formally to an indefinite postponement of the Central Bank's repayment obligations, the Bank decided that, while not granting any formal extension of the repayment dates, it would not call upon the supporting central banks to implement their guarantees. In reaching this decision account was taken of encouraging reports from the Fund about the progress of its negotiations. By the end of November, however, which was the time at which the last instalment was originally due, the negotiations had been completed and the IMF was able to resume disbursements to Brazil. The Central Bank of Brazil was thus able to complete the repayment of the BIS bridging loan on the final maturity date despite the difficulties encountered during the life of the facility in meeting the maturity dates of individual instalments.

The US$ 500 million facility in favour of the National Bank of Yugoslavia was also backed by a group of central banks which included the US monetary authorities. US$ 300 million was disbursed fairly rapidly; but the conditions which would permit the disbursement of the remaining US$ 200 million could not be met until mid-September, when problems in connection with negative pledge clauses on gold collateral were resolved. A combination of inter-governmental credits and disbursements of IMF funds enabled the National Bank to complete repayment of the facility by mid-November.

The fact that all the special facilities arranged during 1982–83 either expired unused (Argentina) or were repaid during the calendar year 1983 does not, of course, mean that the problems of international debt have been solved, nor that the BIS no longer has any interest in the subject. It does, however, indicate that the sort of first-aid treatment which characterised the BIS interventions is no longer called for. As is outlined in the Conclusion to this Report, solutions must be sought which imply the establishment of confidence in the longer-term viability of the borrowers' economies and the provision of funds of appropriate maturity. The BIS is not a suitable vehicle for the realisation of such aims; in particular, its resources, representing as they do an essentially liquid element in central banks' reserves, cannot be immobilised in medium or long-term lending. Within certain limits, however, and with appropriate safeguards, the Bank can play an indirect rôle by helping the IMF to fulfil its task of promoting adjustment and of providing financial support for stabilisation programmes.

In this context it may be recalled that in 1981, as part of a larger programme of IMF financing, the BIS, with the backing of ten central banks, made available to the IMF a standby facility for a total of SDR 675 million. That facility was designed to help the Fund to bridge a possible gap in its resources in anticipation of the completion of the eighth review of quotas; it has been fully used and all drawings are to be repaid not later than January 1985.

The prospect of much increased lending by the IMF under its policy of "enlarged access", whereby the Fund's own resources are supplemented by borrowed funds, had widened the gap between the amounts the Fund expects to lend and the borrowed resources available to it. In order to cover this "commitment gap" the Fund has again had recourse to borrowing from monetary authorities. Once more the BIS was not only the focal point of discussions among the central banks of the industrialised countries but also the institutional counterparty of the Fund in a major lending arrangement. Seventeen central banks have joined with the BIS in a facility of SDR 2,505 million, while the monetary authorities of two other countries are providing SDR 495 million on a bilateral basis, the whole making a total of SDR 3 billion which matches a similar commitment made by the Saudi Arabian Monetary Agency. The BIS facility is available for drawings by the Fund during the twelve months beginning 30th April 1984; all drawings are to be repaid within two and a half years of having been made.

2. 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, the Bank has organised periodic meetings of central-bank officials to examine matters such as the development of the gold and foreign exchange markets and the Euro-currency market and to study and exchange information on other economic, monetary, technical and legal questions of interest to central banks. The Euro-currency Standing Committee has continued, in accordance with the mandate given to it by the Group of Ten central-bank Governors in 1980, its regular monitoring of international banking developments. The Bank also continued to assemble, survey and distribute statistical data on international banking developments and to provide 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 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 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.

The Bank continued to provide the Secretariat for the Committee of Governors of the Central Banks of the Member States of the European Economic Community and for the Board of Governors of the European Monetary Co-operation Fund — EEC 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, being confined to representatives from the EEC countries when dealing with the European Monetary System (EMS), for example, and at other times extended to include participants from other industrialised countries such as Canada, Japan, Norway, Sweden, Switzerland and the United States); and a group commissioned to examine periodically the monetary policies pursued by member states and their Community-wide co-ordination, and also to make ad hoc studies of particular questions — for example, in 1983, the economic policy implications of the development of public finances in the EEC countries.

As in previous years, these committees and groups held a large number of meetings in 1983–84, mostly in Basle and generally in preparation for discussions among the Governors. On the basis of their work the Committee of Governors itself and the Board of Governors of the European Monetary Co-operation Fund, each within the framework of its competence and functions, which are closely related and complementary, are able to take various decisions relating to the monetary arrangements between central banks or to prepare reports and opinions, on a regular or ad hoc basis, mostly for the Ministers of Finance of the EEC countries or for the Commission of the European Communities.

In the financial year 1983–84 a major part of the activity of the Committee of Governors, and consequently of its sub-committees and groups of experts, was concerned with the administration of the EMS established on 13th March 1979. The principal tasks were:

- ensuring that the arrangements governing the system were properly applied;
- subsequent to the realignment of central rates in March 1983, examining certain aspects of the working of the system, in particular intervention techniques and realignment procedures;
- 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.

In addition, the Committee of Governors was involved, in March 1984, in drawing up an assessment of the first five years' experience of the EMS and embarked on a study of the issues raised by the EEC central banks' activities in the private ECU markets.

The Group of Computer Experts of the central banks of the Group of Ten countries, for which the Bank continues to provide the Secretariat, devoted a substantial proportion of its work to studying telecommunication networks specialising in the routing of financial and payment messages. It paid particular attention to cataloguing and analysing the security and compatibility problems to which the proliferation of this type of network in the banking sector could give rise. The Group also initiated an examination of the implications for the central banks of the increasingly widespread use of distributed processing.

The Bank also provides the Secretariat for the Group of Experts on Payment Systems. During the year under review this Group continued its work in two areas. Firstly, it took a number of measures designed to promote the exchange between central banks of key information concerning the evolution which is currently taking place in the fields of payment media and systems in the majority of the Group of Ten countries. Secondly, it embarked on an analysis of interbank relations in the payments field, initially paying particular attention to the question of risks. Finally, it commenced the revision of the book on "Payment Systems in Eleven Developed Countries".

Central banks of the Group of Ten countries made further progress over the past year in expanding their reporting of statistics to the BIS data bank. In addition to a substantial increase in macro-economic data, there were continuing advances towards the automated transmission of Euro-currency figures. Under the guidance of the central-bank Group of Experts on Monetary and Economic Data Bank Questions, for which the BIS provides the Secretariat, a review is being made of the detailed arrangements for supplying data over the telecommunication links with the BIS Computer Centre. In anticipation of the data bank's becoming fully operative, particular attention is being given to the questions of timeliness and quality control of data transmissions, which are two of the project's main concerns in developing a useful service for the participating central banks.

3. Operations of the Banking Department.

The Balance Sheet of the Bank and the Profit and Loss Account at 31st March 1984, certified by the auditors, are reproduced at the end of this Report; both are expressed in gold francs.*

At 31st March 1984 the balance-sheet total amounted to	GF 21,276,333,080
whereas at 31st March 1983 it had stood at	GF 20,357,855,817
There was thus an increase of	GF 918,477,263

This increase would have been slightly greater but for the depreciation in terms of gold francs of most currencies other than the US dollar.

In the course of the year the balance-sheet total remained very stable, moving generally between 21 and 22 billion gold francs. However, it reached a peak of 22,568 million gold francs on 31st December 1983 and dropped to a low of 20,868 million on 31st January 1984. Apart from the sharp fall recorded between these two dates, the monthly movements were small. As a proportion of the balance-sheet total, resources in currencies (i.e. excluding those in gold) rose slightly to 76.4 per cent. from 74.6 per cent. at the end of the previous financial year.

As is shown in the following table, the changes in the balance-sheet total recorded at the end of the past three financial years (1982–84) were small, whereas in 1980 and 1981 the movements had been much sharper.

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 gold francs		in percentages
1980	24,409	+ 5,308	+ 28
1981	19,726	− 4,683	− 19
1982	19,057	− 669	− 3
1983	20,358	+ 1,301	+ 7
1984	21,276	+ 918	+ 5

* The gold franc (abbreviated to GF) 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.

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 as described in Section 6 below;

(iv) gold under earmark held by the Bank for the account of various depositors. At the end of the financial year under review this item amounted to the equivalent of 1,232 million gold francs, a reduction over the year of 409 million. It had stood at 1,290 million gold francs on 31st March 1982 and 1,641 million on 31st March 1983.

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 gold francs			
1980	887	23,239	283	24,409
1981	937	18,539	250	19,726
1982	987	17,778	292	19,057
1983	1,037	18,987	334	20,358
1984	1,088	19,805	383	21,276

A. Capital, reserves and miscellaneous liabilities.

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

The Bank's authorised capital remained unchanged at 1,500 million gold francs; there was likewise no change 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* GF 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 1983–84 GF 477,552,793

This compares with 457.2 million gold francs on 31st March 1983; the difference of 20.4 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* GF 21,530,055

The total of this Fund has remained unchanged since the end of the financial year 1981–82.

(4) *Free Reserve Fund*

after allocation of the net profit for 1983–84 GF 263,330,236

This compares with 232.7 million gold francs on 31st March 1983, the amount it is proposed to transfer to this Fund from the net profit being 30.6 million gold francs.

The total amount of the Bank's reserves, after allocation of the net profit for 1983–84, is thus raised to GF 792,483,397 from 741.5 million gold francs at the beginning of the financial year. The increase, representing the allocation from the profit, amounts to 51 million, which compares with an appropriation to reserves of 50 million at the end of each of the three preceding financial years.

(c) The item "Miscellaneous" stood at GF 366,213,911

against 317.8 million gold francs on 31st March 1983, showing a rise of 48.4 million.

(d) Profit and Loss Account, *before* allocation GF 67,492,877

This figure represents the net profit for the financial year 1983–84.

Details of the proposed allocation of the net profit, in accordance with the provisions of Article 51 of the Statutes, are given in Section 4 below. A sum of 16,492,877 gold francs, compared with 15,826,173 gold francs in the preceding financial year, is to be set aside in respect of the dividend of 145 Swiss francs per share payable on 1st July 1984; it appears on the liabilities side of the Balance Sheet. The amount of the dividend paid per share in 1983 was 135 Swiss francs.

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 1983	Financial years ended 31st March 1984	Movement
	in millions of gold francs		
Deposits of central banks	18,474	19,178	+ 704
Deposits of other depositors	513	627	+ 114
Total	18,987	19,805	+ 818

The increase in resources reflects the receipt of new deposits both from central banks and from other depositors. The rise in deposits from central banks represents the difference between net inflows in currencies and a reduction in deposits in gold. The growth in deposits from other depositors resulted from the receipt of new funds from international organisations, whereas short-term borrowings made on the market were repaid. At the end of the previous financial year borrowings on the market had accounted for a relatively large proportion of resources received from other depositors.

At the end of the financial year under review, deposits of central banks represented 96.8 per cent. of total resources, compared with 97.3 per cent. on 31st March 1983.

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

Term	Deposits in gold			Deposits in currencies			Total		
	Financial years ended 31st March 1983	Financial years ended 31st March 1984	Movement	Financial years ended 31st March 1983	Financial years ended 31st March 1984	Movement	Financial years ended 31st March 1983	Financial years ended 31st March 1984	Movement
	in millions of gold francs								
Sight	4,355	4,225	− 130	1,096	346	− 750	5,451	4,571	− 880
Not exceeding 3 months	145	141	− 4	12,049	13,679	+1,630	12,194	13,820	+1,626
Over 3 months	–	–	–	1,342	1,414	+ 72	1,342	1,414	+ 72
Total	4,500	4,366	− 134	14,487	15,439	+ 952	18,987	19,805	+ 818

There was a decline in sight deposits both in gold and in currencies. Time deposits in currencies, in particular those with a residual term to maturity of not more than three months, showed a substantial rise. In fact, it was the rise in this category that was responsible for the overall increase in resources.

As a result of the development of the various items shown in the above table, it may be noted that at the end of the financial year 1983–84

- the proportion of deposits in gold in relation to total resources was 22 per cent., compared with 23.7 per cent. a year earlier, while that of deposits in currencies was 78 per cent., against 76.3 per cent.;
- sight deposits accounted for 23.1 per cent. of total deposits, compared with 28.7 per cent. a year earlier, and time deposits for 76.9 per cent., against 71.3 per cent.

(a) Deposits in gold GF 4,366,219,991

There was a relatively substantial fall in sight deposits and a much smaller one in time deposits.

(b) Deposits in currencies GF 15,439,219,779

This item increased by 952 million gold francs, or 6.6 per cent., whereas in the previous financial year it had risen by 10.7 per cent.

As mentioned above, the further expansion was entirely due to the rise in time deposits. Sight deposits, which had recorded an appreciable increase at the end of the financial year 1982–83, were at a much lower level at the end of the financial year under review.

ASSETS (EMPLOYMENT OF RESOURCES).

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

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

Nature	Financial years ended 31st March				Movement	
	1983		1984			
	in millions of gold francs					
Sight assets						
Gold	5,184		5,049		– 135	
Currencies	17	5,201	11	5,060	– 6	– 141
Treasury bills						
Currencies		474		757		+ 283
Time deposits and advances						
Gold	21		19		– 2	
Currencies	12,751	12,772	13,513	13,532	+ 762	+ 760
Securities at term						
Currencies		1,884		1,909		+ 25
Total						
Gold	5,205		5,068		– 137	
Currencies	15,126	20,331	16,190	21,258	+ 1,064	+ 927

(a) Gold GF 5,049,253,599

This item declined by 135 million gold francs. The movement was entirely due to a reduction in funds on sight account. Some gold that had been placed on the market was repaid.

(b) Cash on hand and on sight account with banks GF 10,911,458

On 31st March 1983 this item had shown a balance of 16.5 million gold francs.

(c) Treasury bills GF 756,966,277

These holdings increased by 283 million gold francs, owing chiefly to the purchase of bills issued by the US Treasury.

(d) Time deposits and advances GF 13,532,492,317

This compares with a figure of 12,772 million gold francs at the end of the previous financial year, giving an increase of 760 million.

Whereas in the previous financial year there had been an exceptional increase in facilities granted to various central banks, last year there was an appreciable decline. In fact, as mentioned at the beginning of this chapter, the main credits granted by the Bank were repaid during the financial year.

(e) Securities at term GF 1,908,883,064

This represents a small rise over the figure of 1,884 million gold francs at 31st March 1983.

Various changes occurred, however, in the composition of this portfolio, with an increase in the volume of US Treasury securities and a reduction in holdings of certificates of deposit issued by banks located in the United States and of public-sector securities.

A breakdown according to residual term to maturity of investments in time deposits and advances (in currencies and gold) and in securities at term is given in the following table.

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

Term	Financial years ended 31st March 1983	1984	Movement
	in millions of gold francs		
Not exceeding 3 months	11,275	12,521	+1,246
Over 3 months	3,381	2,920	− 461
Total	14,656	15,441	+ 785

The development of these two categories of investments was similar to that recorded during the previous financial year, with an appreciable rise in investments with not more than three months to run and a decrease in those at longer term.

These fluctuations reflected changes in the maturities both of time deposits and advances and of securities at term.

Operations at not more than three months represented 81.1 per cent. of total investments at the end of the financial year 1983–84, compared with 76.9 per cent. at the end of the financial year 1982–83, and transactions at longer term 18.9 per cent., against 23.1 per cent.

(f) Miscellaneous GF 17,826,364

This compares with 26.5 million gold francs on 31st March 1983. The reduction, which was appreciably smaller than that recorded in 1983, was again due to various book-keeping adjustments.

Forward gold operations.

These transactions, the volume of which is indicated in Note 2 to the Balance Sheet, resulted in a negative balance of GF 40,251,531 compared with a negative balance of 43 million at the beginning of the financial year.

The slight difference was chiefly attributable to the maturing of operations in the form of swaps of gold (received spot) against currencies concluded with central banks.

4. Net profits and their distribution.

The accounts for the fifty-fourth financial year ended 31st March 1984 show a net operating surplus of 67,934,268 gold francs, compared with 66,643,810 gold francs for the preceding financial year. The improved financial result for the year under review reflects the increased volume of funds available to the Bank for investment, whereas the yield on the Bank's own funds held in currencies was somewhat lower than in 1982–83.

The net operating surplus is shown after deduction of 15,354,329 gold francs in respect of costs of administration, the decrease from the previous year's figure of 15,869,433 gold francs reflecting the fall during the year in the gold franc value of the Swiss franc, in which currency most of the Bank's expenditure is incurred; in terms of Swiss francs the total administrative costs actually rose marginally.

The Board of Directors has decided to transfer 441,391 gold francs to the Provision for Exceptional Costs of Administration. As a result of this transfer the net profit amounts to 67,492,877 gold francs, against 65,826,173 gold 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 67,492,877 gold francs be applied by the General Meeting in the following manner:

(i) an amount of 16,492,877 gold francs in payment of a dividend of 145 Swiss francs per share;

(ii) an amount of 20,400,000 gold francs to be transferred to the General Reserve Fund; and

(iii) an amount of 30,600,000 gold 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 1984 to the shareholders whose names are contained in the Bank's share register on 20th June 1984.

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 1984 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.

5. 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.

During the financial year 1983–84 the amounts received by the Bank for the service of the only outstanding loan — the 5¼ per cent. Secured Loan (15th Series) 1961–86 for a nominal amount of L.fr. 100,000,000, corresponding at the rate applicable at the end of March 1984 to 977,000 gold francs — came to the equivalent of about 11,000 gold francs in respect of interest and about 67,000 gold francs in respect of redemption; by the end of the financial year the principal amount due had thus been reduced to the equivalent of approximately 144,000 gold 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 1980 Annual Report of the Bank.

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

The Bank continued to perform the functions of Agent for the European Monetary Co-operation Fund which it has been executing since 1st June 1973. This Community institution was set up on 6th April 1973 by the member states of the European Economic Community to administer the Community exchange rate, or "snake", arrangement introduced in April 1972 and the reciprocal credit facilities already in existence or established in connection with the "snake". These activities were extended with the conclusion, in March and April 1976, of the first Community 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 EMS; and, on the other, those relating to the execution of financial operations in connection with Community borrowing and lending for the purpose of balance-of-payments support for EEC member countries.

(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. During the period from 1st April 1983 to 31st March 1984 such interventions amounted to over ECU 5 billion in all;
- the 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 (except that of Greece, which does not participate in the EMS) involving the transfer of ECUs to the institutions in question against the contribution 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. At 31st March 1984 the Fund had issued in this way a total of more than ECU 52 billion, corresponding to approximately US$ 45 billion at the rate of exchange prevailing at that date;
- 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, of voluntary transactions between the central banks participating in the EMS, and of the payment of interest calculated on these central banks'

net positions in ECUs. In the period under review the gross amount of such transfers totalled nearly ECU 3 billion.

(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.

(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 and March 1981, 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 1983–84 the Bank in its capacity as Agent for the Fund received from France and Italy and distributed to the creditors vis-à-vis the Community the sums due in respect of interest and commission on outstanding loans. The greater part of the loans placed by the European Economic Community in 1976 and 1977 had been redeemed by 31st March 1984. Of the initial operations totalling US$ 1.6 billion and DM 0.5 billion, the balance outstanding on that date amounted to no more than US$ 300 million. This amount, representing the second (7.75 per cent.) tranche of a US$ 500 million loan, was repaid by Italy on 1st June 1984.

By virtue of the Decision of the Council of the European Communities of 16th May 1983 and under the terms of Regulation (EEC) No. 682/81 adjusting the Community loan mechanism designed to support the balance of payments of member states, the Community granted to the Republic of France a loan in the amount of ECU 4 billion, or its equivalent in other currencies. The four financial operations in connection with this loan, which were completed in the course of July and August 1983, were as follows:

1. Public issue of seven-year floating rate notes (LIBOR + 1/8 per cent.), amounting to US$ 1,800 million.
2. Public issue of four-year fixed-interest bearer notes (11 per cent.) in the amount of US$ 350 million.

3. Public issue of fixed-interest bonds, denominated in ECUs, for a total of ECU 150 million made up of three tranches:
   - ECU 80 million at four years and $11^1/_8$ per cent.,
   - ECU 40 million at seven years and $11^1/_4$ per cent.,
   - ECU 30 million at ten years and $11^1/_2$ per cent.
4. A *seven-year* syndicated bank loan at a variable rate of interest (LIBOR + $^3/_8$ per cent.), for a total amount of US$ 1,240 million, in two instalments (US$ 650 million and US$ 590 million).

As a result of the transactions in connection with the ECU 4 billion Community loan, the total of outstanding Community borrowing and lending operations under the terms of Council Regulations (EEC) No. 397/75 and No. 682/81 stood at ECU 150 million and US$ 3,690 million on 31st March 1984, corresponding, with the exception of the above-mentioned sum of US$ 300 million repayable by Italy, to the operations on behalf of France.

7. Changes in the Board of Directors.

On 1st July 1983 Mr. Robert Leigh-Pemberton succeeded Lord Richardson of Duntisbourne as Governor of the Bank of England and became an ex officio member of the Board in his place.

At the Board Meeting held on 12th July 1983 the Chairman announced that, in accordance with Article 27(2) of the Statutes, Mr. Leigh-Pemberton had appointed Lord Richardson of Duntisbourne as a member of the Board to fill the vacancy caused by the retirement of Lord O'Brien of Lothbury at the end of June 1983. The Chairman also expressed the Board's pleasure that Lord Richardson, who had been an ex officio Director since July 1973, should continue to be one of its members. Lord Richardson's appointment was originally for the unexpired period of Lord O'Brien's term of office ending on 6th May 1984, but at the April meeting he was re-appointed by Mr. Leigh-Pemberton for a period of three years under Article 27(2) of the Statutes.

The mandate of Mr. Bengt Dennis as a member of the Board being due to expire on 31st March 1984, he was re-elected under Article 27(3) of the Statutes at the meeting of the Board held on 13th March 1984 for a further period of three years ending on 31st March 1987.

* * *

The Bank learned with deep regret of the death of M. Emmanuel Monick on 23rd December 1983. M. Monick had been Governor of the Bank of France and an ex officio member of the Board from October 1944 until January 1949.

CONCLUSION.

The persistently high level of unemployment in most industrial countries and the international debt situation are clearly the two main problems that policy-makers are facing today. Admittedly, the two problems are in many respects different in origin and therefore call for specific remedial action. On the other hand, what they do have in common is that they are both the outcome of long-term developments and are therefore unamenable to quick remedies. But one thing is sure at all events: neither can find a lasting solution in the absence of steady and moderate growth in the western industrial world — indeed, without such growth, both would almost certainly assume unmanageable proportions.

The good news that has emerged gradually over the last year is that recovery is now well under way in the greater part of the OECD area. The most important single policy objective for the western industrial world should be to ensure that this recovery evolves into durable and balanced growth. Both attributes are equally crucial. The recovery should not be allowed to come to a premature halt; but nor should it be allowed to develop in ways which, without necessarily cutting it short, would eventually produce an even deeper and more disruptive recession than that from which the world is now so painfully emerging. For we should not deceive ourselves: cyclical fluctuations, with upswings giving way to recessions, remain a characteristic of the market economy — but it will make a great deal of difference whether the next reversal comes later rather than sooner and whether it is a normal, inevitable, relatively short-lived cyclical downturn rather than one of the "boom and bust" or, even worse, "structural" variety.

To ensure that neither of these highly damaging possibilities materialises, three interconnected problem areas need to be watched with particular care. Firstly, the possible revival of inflationary pressures. Secondly, all those developments whose effect has been to inhibit business capital formation, or to steer it principally towards labour-saving investment. Thirdly, the level of dollar interest rates, with its repercussions on growth, external balances, exchange rates and the external debt burden. The first of these problem areas should be of fairly universal concern; the second is of greater importance for Europe than for either the United States or Japan; and while the third is also of general concern, dealing with it is the responsibility of the United States.

Inflation rates have declined significantly in most industrial countries and dramatically in some of them. As a result, in a good number of cases they are now lower than they were during the first year of the last cyclical upswing and in several countries have fallen to levels not seen since the mid-1960s. But the decline seems to have come to a halt; and there is also some evidence, both direct and indirect, that inflationary expectations have remained higher than the actual rate of price increases. Any marked re-acceleration of inflation would in itself, and as a result of the corrective policy measures that would have to be taken, endanger the pursuit of recovery. As experience has shown time and again, policy-makers should be feeling concerned about inflation in the present stage of the business cycle, i.e. in preventive terms, rather than be faced with having to take counter-inflationary action at a later stage, which would necessarily entail an unavoidably high social cost.

Preventive policy means first and foremost persevering with the conservative monetary policies that have yielded such good results in the recent past in reversing inflationary trends. With the usual increase in velocity during the upswing, monetary authorities should not worry unduly about the need to accommodate the additional demand for money arising out of growing real output. In countries following a targeting strategy, a continued gradual decline in the rate of growth of monetary aggregates, in line with medium-term policy targets, would therefore seem still to be justified. Targeting in this way would also underscore the authorities' determination to persevere in their earlier efforts and could therefore have a dampening effect on inflationary expectations.

But this is not enough. The process of disinflation in all industrial countries has until recently been helped along by falling commodity prices. With this development having come to an end, the industrial countries as a group will have to rely even more than they have done so far on the moderation of inflationary impulses of domestic origin. The critical area in this respect is the labour market. If experience is any guide, explicit incomes policies are unlikely to be effective, except in helping to set standards via a moderation of public-sector pay increases. Wage indexation should be abandoned or modified; where this has already happened, any revival in unqualified form should be resisted. But some of the most promising, if least spectacular, policy measures could be those aimed at relieving the specific bottlenecks that are likely to develop in the fastest-growing industries and areas. Inter-occupational and inter-regional labour mobility should be speeded up in order to combat, simultaneously, unemployment and the possible revival of wage-push inflation.

Longer-term studies of economic development have all come to a number of convergent conclusions concerning the development of fixed capital formation in the industrial countries over the last ten years. Firstly, since 1973 there has been a gradual trend decline in the overall rate of investment. Secondly, the increase in the cost of energy and, more recently, the large shifts in the international division of labour — the emerging industrial strength of some major developing countries — combined with the cumulative impact of the recessionary years have led to massive capital obsolescence. So far this has not been offset by any sufficient acceleration of investment in growth industries. Thirdly, as a result of the sharp rise in real wages and indirect labour costs, the little net investment that has taken place has been directed heavily towards labour-saving. The conclusion is that on the basis of the existing capital stock, even if it were more fully used, there is faint hope of achieving an acceptable rate of employment of the labour force.

The situation in these respects is particularly worrying in western Europe. Unemployment is not a problem of comparable dimensions in Japan, and in the United States it has declined significantly, probably under the combined influence of a ten-year pause in real wage growth, much greater labour and entrepreneurial mobility, and considerably improved profit rates. Admittedly, some features of the US developments, which stand in marked contrast with Europe, may have acted as a restraint on improvements in labour productivity and therefore add to the risk of an early revival of inflation. Admittedly, also, much of the additional employment has gone into services — an example that can hardly be followed by those European countries which have run into balance-of-payments constraints and therefore need to concentrate more on the sector of internationally traded goods, i.e., in the main, manufacturing industries. On the other hand, the US experience is not without lessons for Europe, which badly needs higher profits, a lower price of labour in relation to the cost of capital, a friendlier environment for entrepreneurial initiatives and greater flexibility in the labour markets. To call these problems "Euro-sclerosis" would be going too far — but they are nevertheless serious and seemingly indigenous. There are the beginnings of positive developments in the right directions, but unless the remedial action — which will necessarily take time — is taken further there is a real risk that recovery will not be able to run its full course in many European economies. It will not, in other words, become sufficiently autonomous as a result of expanding domestic investment to persist after the inevitable, and even desirable, slackening of the US upswing.

While dollar interest rates had, by the spring of 1983, declined quite sharply from their record 1981–82 levels, they have remained disturbingly high when compared with observed inflation rates. And in nominal terms they are now notably higher than they were a year ago.

The US economy itself has so far proved remarkably resilient in the face of these unusual interest rate levels. Comprehensive fiscal deductibility of interest charges may have something to do with this resilience, although this benefit is not new and is a partial explanation at best, the more so as, with the 1981 tax changes, other benefits have become more important in motivating corporate investment. One plausible line of argument is that the improvement in current and expected profitability has more than offset the negative influence of high real interest rates. This may well be the case. But, unfortunately, one cannot rule out another possibility, namely that part of this resilience may also reflect the persistence of inflationary expectations, so that in terms of expected, as opposed to observed, inflation real interest rates are perhaps not so very high. The point is, however, that neither of these interpretations inspires much optimism as regards the evolution or duration of the US recovery if interest rates should remain at their present high levels, let alone rise further. The reason is evident if in the event actual inflationary developments were to validate the expectations implied by the high interest rates. If, on the other hand, the present rates were genuinely high real ones, it is difficult to imagine that the expected return on investment could outstrip them for very long.

The international implications of high and rising US interest rates are also a source of grave concern. Because of the size of the US domestic financial market and of the share of dollar-denominated financial instruments in the world's financial assets, US interest rates are bound to affect those in other countries; they also have a distorting influence on exchange rates and, hence, on the international configuration of current-account balances; last but not least, they directly determine, via the floating rate component of external debt, much of the interest burden of indebted countries. But these influences should be put in proper perspective. In the first place, whatever the level of US interest rates, western Europe would still have to deal with the more purely domestic problems mentioned above and LDCs would still have to undertake major domestic adjustment efforts of their own. In the second place, the substantial contribution of the rapid cyclical recovery and the large current-account deficit in the United States to easing the problems encountered both by Europe and by the LDCs has so far been offset only partially by the level of US interest rates.

In fact, the concern — and it is a serious one — is more about the future than the past. It arises both from recent interest rate developments in the United States and from an analysis of what lies behind them. This Report shares the widely held view that the main reason for the current level of US interest rates is the high and rising structural component of the US budget deficit. The deficit began to strike root in late 1982, and is expected to persist even in the advanced stages of cyclical recovery, thus implying an unusually high public-sector borrowing requirement at a time when private credit demand follows its accustomed upward cyclical path. This has been having and will have a direct influence on US interest rates, and may have an indirect one, too, by strengthening inflationary expectations in the United States. The level of US interest rates imposes a heavy additional adjustment effort on the debtor countries. It also contributes to the overvaluation of the dollar, which, in combination with the strong US recovery, is in the process of creating a monumental current-account deficit. The counterpart — the net financial inflow into the United States — is likely to "finance", in 1984 as a whole, about one-half of the US Government's net borrowing requirement, or one-third of the total demand for funds arising from the budget deficit and the net financing needs of the corporate sector. By any standards, these are very high ratios indeed.

A financial situation such as this, combining large public-sector and current-account deficits, high interest rates and substantial capital inflows, can hardly be considered sustainable. It should be a source of concern to any country, and in particular to the world's dominant economy. The fact that, for a number of reasons, good or bad, the United States does not come up against balance-of-payments constraints as quickly as other countries do, does not mean that such constraints do not exist, as was amply demonstrated during the 1970s. Only an early and major reduction of the structural component of the US budget deficit could steer the US economy, with the prospect of a "soft landing", towards better internal and external balance, and therefore slower but more durable growth. Without such a reduction the imbalances will still be corrected — but the danger is that the process could well involve higher interest rates, worldwide economic, financial and exchange rate disturbances and, eventually, a sharp downturn in economic activity. Given the size of the US economy, and the predominance of the dollar, the policy mismatch in the United States is bound, sooner or later, to exert a serious destabilising influence on the world economy.

It would be idle to discuss which of these three problem areas — the danger of a revival of inflationary pressures, the "structural" problems of Europe or the level of current and prospective US interest rates — deserves priority treatment. All three are of great consequence, and remedial action in all three directions needs to be undertaken, or carried further, at once. But there is one important difference between them. Policies aimed at improving the European environment for labour-using investment or at promoting wage flexibility and labour mobility are unlikely to yield results in the short run. A change in the US fiscal policy stance could, via its impact on expectations, have an almost immediate effect on US interest rates.

Durable and balanced growth in the western industrial world, while a necessary condition for handling the international debt crisis, is not a sufficient one, either for its short-term containment or for a lasting solution. As is shown in this Report, co-operation among all the major actors on the international financial scene, which was initiated in 1982, has continued in 1983 and the early months of 1984, with the result that the global debt crisis has so far been contained. At the same time, thanks to adjustment measures and to the US-led recovery in the industrial world, even the medium-term outlook has become relatively encouraging for a number of debtor countries, notably in Asia and Europe. For several reasons, however, the situation remains more immediately preoccupying in most of the Latin American countries. Firstly, because on average debt/export ratios are higher there than elsewhere, and, with most of the debt being dollar-denominated and carrying floating interest rates, the impact of the recent rise in short-term dollar interest rates on the debt-service burden is significant. Secondly, in most countries of the western hemisphere adjustment efforts began far too late; and, thirdly, they have focused very heavily on import cuts. Last but not least, substantial capital flight has aggravated, and is perhaps still aggravating, the external financial problems of some of the Latin American countries.

While the future course of dollar interest rates lies largely in the hands of the United States, the other features of the Latin American debt crisis underline the importance of appropriate policies by the debtor countries themselves. There is now hope that the spreading recovery in the industrial world will bring appreciable relief to these countries in terms of export earnings, via growing demand for their products and by improving their terms of trade. It would be regrettable if this were not matched by sustained domestic efforts to facilitate the required external adjustment.

The present breathing-space, in other words, should be used as an opportunity to steer policies increasingly towards genuine domestic adjustment, and adjustment of the kind calculated to improve export performance both now and in the future. In too many Latin American countries import reductions have been accomplished through administrative measures rather than as a result of domestic macro-economic adjustment, while insufficient attention has been given to strengthening export incentives and potential. Two clear lessons can be learned from the past year's striking contrast between the Asian and Latin American countries as regards the pattern of balance-of-payments adjustment — a contrast that has not escaped the attention of the lending banks. One is that macro-economic policies designed to alleviate the pressure of domestic demand and put a brake on inflation are a prerequisite for a sustainable level of current-account deficit. But the second is that countries which have at the same time kept their markets open and built up highly competitive export industries have benefited to a much greater degree from the resumption of growth in the industrial countries than those which have implemented inward-looking development policies based on import substitution.

Finally, those Latin American countries whose residents have been exporting capital on a massive scale would be well advised to put their house in order so as to end this capital outflow and even, hopefully, to draw some of the flight capital back. It is too much to expect the rest of the world — whether multilateral institutions, governments, banks or corporations — to perform the development functions that these countries' own nationals refuse to assume. Clearly, the burden of interest charges would look much less frightening if it could be calculated in terms of *net* interest owed to the rest of the world, i.e. the interest to be paid on external debt *minus* the income received (but not necessarily repatriated) by the owners of the exported capital.

The counterpart of the more suitably designed adjustment policies by the debtors should be, on the part of the industrial countries, the genuine opening of their domestic markets. The growing pressures to erect protectionist barriers between industrial countries themselves harbour grave dangers for the world economy. Barriers aimed at imports of industrial and agricultural products from the LDCs are more than a grave danger — they are an explosive one. The industrial countries have as much at stake, financially and politically, in securing a solution to the debt problem as the debtor countries themselves. A lasting solution is inconceivable without a vigorous development of LDC exports to the industrial world.

No amount of soundly based adjustment by the debtor countries as a group, however, even if it were combined with growth and liberal import policies in the industrial world, could eliminate their current-account deficit entirely. And indeed it is questionable whether the complete elimination of the LDCs' current-account deficit would be at all desirable from the point of view of the balanced growth of the world economy. For with the heavy interest burden assumed by the debtors, any return to current-account equilibrium would in fact imply that they would have to run abnormally large trade surpluses — a situation which, if it persisted for any length of time, would not only be detrimental to the development process but would also fly in the face of political common sense.

This raises the question of how to finance the "warranted" future current-account deficits of the developing countries. In the short run, banks will have little option but to provide additional funds, be they in the form of new credits or partial capitalisation of interest charges. There is an impressive list of arguments for and against each of the two techniques, and the choice will have to be hammered out by the banks themselves, probably on an ad hoc basis, in the light of what seems feasible and least objectionable to the parties involved. But there can be no doubt that banks will in one way or another have to accept, in their own interest, some increase in their outstanding claims on those countries which have committed themselves to IMF-managed programmes and have demonstrated their ability to implement them. They will also have to face up to another necessity. Countries which have achieved visible success in improving their current accounts, and in particular those which have managed to do so through the right kind of domestic adjustment, can lay just claim to a material improvement in financing conditions, in terms of both cost and maturity. The market cannot function properly unless there is a substantial differentiation in credit conditions, far beyond that which has rather hesitantly taken place so far. It would be helpful if the authorities of lending countries themselves accepted and encouraged more differentiation, especially in the field of export finance.

It must be recognised, however, as was already pointed out in last year's Annual Report, that such lending policies are no more than stop-gap measures. Experience has clearly shown that for a number of reasons — variable interest rates, short maturities, excessive competition carrying with it the danger of overlending, lack of conditionality — general-purpose balance-of-payments financing by the banks is not a desirable way of securing the transfer of real resources to developing countries. It is even questionable whether, especially in the case of countries with a high propensity to export their own capital, there is much justification for general balance-of-payments financing of *any* kind, except within the framework of an IMF-supervised adjustment programme. In the longer run, the financial flows to LDCs should be of the kind that would establish a persuasive link between capital imports and domestic development. Funds are, of course, fungible; there is no way of being sure that capital inflows assuming the form of project financing will, in a macro-economic sense, have as a domestic counterpart an increase in investment. The probability of this happening is, however, greater with project financing than with capital inflows not specifically linked to domestic investment. There is a variety of financial flows that are more or less directly tied to investment: credits financing imports of capital goods; direct investment; loans by multilateral development organisations, such as the World Bank; co-financing projects between the official institutions and banks; and bilateral development assistance. Given the size of the problem, all these channels deserve to be used and developed. The most promising seem to be those — for example, the recent co-financing schemes devised by the World Bank — which establish effective co-operation between private and official lenders.

There are those who argue that the international debt problem has assumed such proportions that, even on the assumption of balanced growth in the industrial countries and appropriate policies on the part of both debtors and creditors, it defies any lasting solution without drastic global surgery. This Report does not share such "systemic" pessimism; not only on the negatively pragmatic grounds that there does not seem to be any workable alternative to the case-by-case approach that has been adopted so far, but also for a number of more positive reasons.

The most important of these is that the events of the last twelve months have demonstrated beyond any doubt that what may have looked like a global, fairly homogeneous debt problem in the autumn of 1982 in fact masks a great diversity of situations among the debtors. There are one or two very difficult cases in eastern Europe and Asia, alongside a majority of countries that have shown their willingness and ability to undertake external adjustment and which are in the process of reaping the benefits of the recovery in the industrial world. While Latin America contains a high concentration of the most difficult cases, diversity exists there too, in terms of the degree of adjustment achieved, of export diversification, of the position in relation to oil and of the amount of domestic capital that has been exported. As for the heavily indebted countries of Africa, their situation is altogether different from that of the indebted medium-income LDCs; most of them could not afford to take on new loans at market rates even if they were available; they need soft loans or grants. How could any global surgery be brought to apply to such a diversity of situations?

Moreover, it would be quite wrong to consider the indebted countries "insolvent" simply because *as a group* they are unlikely to be able, even in the longer run, to repay the principal owed. It is a simple economic fact — an inherent part of the saving/investment process — that total outstanding debt continues to grow. What matters is that each individual debtor country should (a) in the longer run keep the growth of its debt in line with its ability to service it, and (b) in the shorter run demonstrate (for the benefit of its watchful creditors) its control over its indebtedness by bringing its growth periodically to a halt, or even by paying off part of it. The number of countries that satisfy one or both of these criteria has grown encouragingly since the beginning of 1983. This does not mean that the international debt problems are behind us; they clearly are not. But it does mean that the passage of time has, so far, borne out the validity of the current way of handling them.

Through close co-operation between the borrowers, the lending banks, governments and international institutions, this approach has successfully encouraged the formulation of mutually agreed programmes in which adjustment and financing have gone hand in hand. While this co-operation will have to be continued and developed, it would be wrong to try to replace it by unworkable global schemes. However, it clearly needs to be supported by two courses of action in order to safeguard its continued efficiency. In the longer perspective the flow of finance to LDCs has to be put on a sounder footing — hence the insistence in this Report on investment-linked financing. At the same time, the sustainability of the current approach hinges critically on the pursuit of durable and balanced recovery in the industrial countries — hence the need for appropriate policies in that part of the world.

GÜNTHER SCHLEIMINGER
General Manager

BALANCE SHEET AND PROFIT AND LOSS ACCOUNT

AT 31st MARCH 1984

BALANCE SHEET

ASSETS (Before and after

		Gold francs
Gold		5,049,253,599
Cash on hand and on sight account with banks		10,911,458
Treasury bills		756,966,277
Time deposits and advances		
Gold		
Not exceeding 3 months	19,333,968	
Currencies		
Not exceeding 3 months	11,386,473,981	
Over 3 months	2,126,684,368	
		13,532,492,317
Securities at term		
Not exceeding 3 months	1,115,748,176	
Over 3 months	793,134,888	
		1,908,883,064
Miscellaneous		17,826,364
Land, buildings and equipment		1
		21,276,333,080

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 1984, gold payable against currencies on forward contracts amounted to 40,251,531 gold francs.

AT 31st MARCH 1984

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 … … … … … … …	457,152,793		*477,552,793*
Special Dividend Reserve Fund … … … … … …	21,530,055		*21,530,055*
Free Reserve Fund … … … … … … … …	232,730,236		*263,330,236*
		741,483,397	*792,483,397*
Deposits (gold)			
Central banks			
Sight … … … … … … … … … …	4,192,310,651		
Not exceeding 3 months … … … … …	140,876,655		
Other depositors			
Sight … … … … … … … … … …	33,032,685		
		4,366,219,991	*4,366,219,991*
Deposits (currencies)			
Central banks			
Sight … … … … … … … … … …	334,315,448		
Not exceeding 3 months … … … … …	13,131,268,608		
Over 3 months … … … … … … …	1,379,084,966		
Other depositors			
Sight … … … … … … … … … …	12,195,974		
Not exceeding 3 months … … … … …	547,470,922		
Over 3 months … … … … … … …	34,883,861		
		15,439,219,779	*15,439,219,779*
Miscellaneous … … … … … … … … … … …		366,213,911	*366,213,911*
Profit and Loss Account … … … … … … … …		67,492,877	—
Dividend payable on 1st July 1984 … … … … … … … …		—	*16,492,877*
		21,276,333,080	*21,276,333,080*

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 1984 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, 4th May 1984

PRICE WATERHOUSE & CO.

PROFIT AND LOSS ACCOUNT
for the financial year ended 31st March 1984

		Gold francs
Net interest and other income		83,288,597
Less: Costs of administration:		
Board of Directors	243,160	
Management and Staff	11,362,579	
Office and other expenses	3,748,590	15,354,329
Net operating surplus		67,934,268
Less: Amount transferred to Provision for Exceptional Costs of Administration		441,391
Net Profit for the financial year ended 31st March 1984		67,492,877

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: 145 Swiss francs per share on 473,125 shares	16,492,877
	51,000,000
Transfer to General Reserve Fund	20,400,000
	30,600,000
Transfer to Free Reserve Fund	30,600,000
	—

MOVEMENTS IN THE BANK'S RESERVES
during the financial year ended 31st March 1984

in gold francs

I. Development of the Reserve Funds resulting from allocations for the financial year 1983–84

	Legal Reserve Fund	General Reserve Fund	Special Dividend Reserve Fund	Free Reserve Fund
Balances at 1st April 1983, after allocation of Net Profit for the financial year 1982–83	30,070,313	457,152,793	21,530,055	232,730,236
Add: Allocations for the financial year 1983–84 ...	—	20,400,000	—	30,600,000
Balances at 31st March 1984 as per Balance Sheet	30,070,313	477,552,793	21,530,055	263,330,236

II. Paid-up Capital and Reserve Funds at 31st March 1984 (after allocation) were represented by:

	Paid-up Capital	Reserves	Total
Net assets in			
Gold	295,703,125	366,412,920	662,116,045
Currencies	—	426,070,477	426,070,477
	295,703,125	792,483,397	1,088,186,522

BOARD OF DIRECTORS

Dr. Fritz Leutwiler, Zurich	Chairman of the Board of Directors, President of the Bank
Bernard Clappier, Paris	Vice-Chairman

Prof. Paolo Baffi, Rome
Dr. Carlo Azeglio Ciampi, Rome
Bengt Dennis, Stockholm
Dr. W.F. Duisenberg, Amsterdam
Jean Godeaux, Brussels
Renaud de la Genière, Paris
Robert Leigh-Pemberton, London
Karl Otto Pöhl, Frankfurt a/M.
The Rt. Hon. Lord Richardson of Duntisbourne, London
Dr. Johann Schöllhorn, Kiel
Baron de Strycker, Brussels

Alternates

Dr. Lamberto Dini, Rome, or
Dr. Giovanni Magnifico, Rome
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

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	Deputy 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