# BANK FOR INTERNATIONAL SETTLEMENTS

## FIFTY-FIFTH ANNUAL REPORT

1st APRIL 1984 – 31st MARCH 1985

BASLE

10th June 1985

# TABLE OF CONTENTS


Page

Introduction . . . . . 1

I. New Challenges to Sustained Growth . . . . . 3

Unemployment and inflation *(p. 4);* structural changes in financial markets *(p. 5);* exchange rate developments and external imbalances *(p. 7);* the international debt situation *(p. 9).*

II. The Progress of Recovery and Structural Adjustment . . . . 12

Highlights *(p. 12);* output and demand *(p. 13): GNP cycles and the foreign sector (p. 17), GNP cycles and selected domestic demand components (p. 19);* inflation *(p. 20): commodity prices, exchange rates and import prices (p. 22), wages and labour costs (p. 24);* employment and unemployment *(p. 26): the growth of unemployment in a medium-term perspective (p.28), employment (p. 30);* fiscal policy and policy mix *(p. 33): retrenchment efforts in 1984 (p. 34), international aspects of the policy-mix configuration (p. 36).*

III. The Changing Structure of Financial Markets . . . . . 38

Highlights *(p. 38);* changes in sectoral financial balances *(p. 39): cyclical versus structural flows (p. 42);* developments in the demand for credit *(p. 43): total credit expansion (p. 45), funds raised through the banking system (p. 45);* changes in sectoral portfolio size and distribution *(p. 47): ratios of financial wealth to GNP (p. 47), developments in portfolio distribution (p. 49);* changing financial patterns: competition and innovation *(p. 53): the growth of direct (non-intermediated) credit transactions (p. 53), the competitive response (p. 56), blurring of boundaries (p. 57);* policy issues *(p. 59).*

IV. Monetary Policy and Interest Rates . . . . . 62

Highlights *(p. 62);* developments in the money stock and in aggregate control strategies *(p. 63): interpreting developments in the monetary aggregates (p. 67), interpreting credit developments (p. 69);* developments in targeting strategies and monetary control procedures *(p. 71): the specification of objectives (p. 71), direct credit control mechanisms (p. 72), government debt management (p. 73), money-market procedures (p. 74);* exchange rate objectives and interest rate developments *(p. 76): short-term interest rates (p. 76), long-term interest rates (p. 80), real interest rates (p. 80), international interaction of policies (p. 85).*

V. International Trade and Payments . . . . . 86

Highlights *(p. 86);* world trade *(p. 87);* international balance-of-payments developments *(p. 89);* balance-of-payments developments in the United States and Japan *(p. 91): United States (p. 91), Japan (p. 97);* balance-of-payments developments in the other Group of Ten countries *(p. 101);* balance-of-payments developments in the other groups of countries *(p. 104): developed countries outside the Group of Ten (p. 104), eastern Europe (p. 104), non-OPEC developing countries (p. 105), the state of the adjustment process in the non-OPEC developing countries (p. 107), OPEC countries (p. 108).*

Page

VI. The International Credit and Capital Markets . . . . . 109

Highlights *(p. 109);* the development of international banking activity in 1984 *(p. 110): the development of the overall aggregates (p. 110), developments in individual market centres (p. 114), development of the reporting banks' business with countries outside the reporting area (p. 116);* the international bond markets *(p. 119);* longer-term changes in the structure of the international financial markets *(p. 123);* the rôle of the ECU in international banking activity *(p. 127);* the international debt situation *(p. 133).*

VII. The International Monetary Scene . . . . . 140

Highlights *(p. 140);* exchange rate developments *(p. 140): the floating currencies (p. 140), increasing volatility of dollar exchange rates (p. 146), the evolution of the dollar in a longer-term perspective (p. 147), exchange rate developments within the EMS (p. 150);* gold production and the gold market *(p. 154);* reserves and international liquidity *(p. 157).*

VIII. Activities of the Bank . . . . . 163

Development of co-operation between central banks and international organisations *(p. 163);* operations of the Banking Department *(p. 166): liabilities (composition of resources) (p. 167), assets (employment of resources) (p. 170), forward gold operations (p. 172);* net profits and their distribution *(p. 172);* 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 *(p. 173);* changes in the Board of Directors and in the Management *(p. 174).*

Conclusion . . . . . 176

* * *

Balance Sheet and Profit and Loss Account at 31st March 1985.

# LIST OF TABLES AND GRAPHS

(Graphs are indicated by an asterisk)


Page

## The Progress of Recovery and Structural Adjustment

Industrial production* . . . . . 14
Changes in real GNP and its components . . . . . 15
US imports of goods and services . . . . . 16
Cyclical comparisons of contributions to GNP growth . . . . . 17
Nominal exchange rates, competitiveness and export growth . . . . . 19
Changes in consumer prices . . . . . 21
Consumer price performance in a cyclical context . . . . . 22
Commodity prices and import unit values* . . . . . 23
Contribution of exchange rate and commodity price movements to changes in import prices . . . . . 24
Industrial wage costs and wholesale prices . . . . . 25
Unemployment . . . . . 26
Unemployment rates* . . . . . 27
The labour force, employment and unemployment . . . . . 29
Broad trends in labour supply and demand, 1960–84 . . . . . 30
Nominal and real GNP growth . . . . . 31
Unemployment, wages and fixed investment growth* . . . . . 32
General-government budget balances . . . . . 34
General-government expenditures and interest payments . . . . . 35

## The Changing Structure of Financial Markets

Sectoral financial balances* . . . . . 40
Funds raised by domestic non-financial sectors . . . . . 44
Changes in bank credit and the broad money stock . . . . . 46
Financial asset and liability stocks of the household and company sectors . . . . 48
Portfolio distribution: Households* . . . . . 50
Portfolio distribution: Non-financial companies* . . . . . 52
Changing patterns of borrowing and financial intermediation* . . . . . 55

## Monetary Policy and Interest Rates

Monetary aggregates: Objectives and development* . . . . . 64
Monetary and credit aggregates: Objectives and rates of expansion . . . . . 65
Monetary aggregates and GNP in nominal and real terms* . . . . . 68
Money-market indicators* . . . . . 75
Short and long-term interest rates* . . . . . 77
Influences on central-bank money and on short-term interest rates . . . . . 79
Real long-term interest rates . . . . . 81
Saving/investment imbalances, real interest rate differentials and real exchange rates* . . . . . 83

Page

## International Trade and Payments


World trade, 1981–84* . . . . . 88
International current-account balances, 1982–84 . . . . . 90
United States: Estimated components of changes in the trade balance, 1983–84 . 91
United States: Changes in trade balances vis-à-vis groups of countries, 1983–84 . 93
United States: Summary of capital-account transactions, 1983–84 . . . . . 94
United States: Identified non-bank private capital flows, 1983–84 . . . . . 94
United States: Banking flows, 1983–84 . . . . . 95
United States: Regional distribution of identified capital flows, 1983–84 . . . . . 96
Japan: Changes in trade by commodity groups, 1983–84 . . . . . 98
Japan: Changes in the regional distribution of trade, 1983–84 . . . . . 99
Japan: Capital-account transactions, 1983–84 . . . . . 100
Group of Ten countries: The pattern of capital flows, 1983–84 . . . . . 103
Current-account balances of non-OPEC developing countries in Asia and Latin America, 1982–84 . . . . . 106
Non-OPEC developing countries: Estimated financing of current-account deficit, 1982–84 . . . . . 106


## The International Credit and Capital Markets


Estimated net lending in international markets: Changes in external claims of banks and international bond issues . . . . . 110
Selected features of international banking activity, 1980–84 . . . . . 111
Three-month interbank rates on Euro-currency deposits, differentials and US prime rate* . . . . . 113
Developments in individual market centres, 1981–84 . . . . . 115
The reporting banks' business with individual groups of non-OPEC developing countries, 1977–84 . . . . . 116
Estimated flows between the BIS reporting banks and groups of countries outside the reporting area, 1978–84 . . . . . 118
International bond issues . . . . . 120
Euro-currency deposit rates and yields of US dollar bonds on the international and domestic markets* . . . . . 121
International bond issues, by types of instrument . . . . . 122
Trends in international financial markets, 1981–84* . . . . . 124
The ECU and the Euro-market. (Domestic and cross-border positions in foreign currencies and ECUs) . . . . . 128
The structure of the ECU banking market . . . . . 130
The rôle of individual market centres in ECU banking operations at end-December 1984 . . . . . 131
Factors influencing the borrowing needs and recourse to international bank finance of non-OPEC developing countries, 1974–84* . . . . . 134
Evolution of non-OPEC developing countries' international indebtedness, 1973–84* . . . . . 135


## The International Monetary Scene


Movements of bilateral exchange rates of the US dollar against selected other currencies, 1983–85* . . . . . 142
Selected industrial countries: Movements in effective exchange rates, 1980–85* . 145
Daily variability of selected dollar exchange rates . . . . . 146
Real bilateral dollar exchange rates and the US current-account balance, 1972–85* 148

Page

Spot exchange rates in the EMS exchange rate system, 1983–85* . . . . . 150
Convergence and divergence indicators within the EMS, 1982–85* . . . . . 153
Estimated world gold production . . . . . 155
Estimated market sources and uses of gold . . . . . 155
Market prices of gold in US dollars, Swiss francs and South African rand, 1982–85* 156
Changes in global reserves, 1982–84 . . . . . 158
The pattern of investment of exchange reserves, 1981–84 . . . . . 161

## Activities of the Bank

Development of the balance-sheet total over the past five financial years . . . . . 167
Development of the composition of resources over the past five financial years . 167
Borrowed funds, by origin . . . . . 169
Borrowed funds, by nature and term to maturity . . . . . 169
Distribution, by nature, of sight assets and other investments . . . . . 170
Time deposits and advances and securities at term, by term to maturity . . . . . 171

# FIFTY-FIFTH ANNUAL REPORT

submitted to the

ANNUAL GENERAL MEETING

of the

BANK FOR INTERNATIONAL SETTLEMENTS

held in

Basle on 10th June 1985

Ladies and Gentlemen,

I have the honour to submit herewith the fifty-fifth Annual Report of the Bank for International Settlements for the financial year which began on 1st April 1984 and ended on 31st March 1985.

The net profit for the year amounted to 68,366,633 gold francs, after transfer of 2,839,801 gold francs to the Provision for Exceptional Costs of Administration. This compares with a net profit for the preceding year of 67,492,877 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 13,366,633 gold francs in payment of a dividend of 145 Swiss francs per share.

The Board further recommends that 22,000,000 gold francs be transferred to the General Reserve Fund and the remainder of 33,000,000 gold francs to the Free Reserve Fund.

If these proposals are approved, the Bank's dividend for the financial year 1984–85 will be payable to shareholders on 1st July 1985.

# I. NEW CHALLENGES TO SUSTAINED GROWTH.

The upswing in the western industrial world is now well into its third year. It was set in motion by the US economy in the late months of 1982 and has depended heavily upon this stimulus ever since. The recovery process has now spread not only to all industrial countries but also to a large part of the developing world.

There can be no doubt about the immensely beneficial effects of renewed expansion on the world economy. It marked a turn-round from the longest, and in some countries the deepest, post-war recession. It has seen the US economy create millions of new jobs and has at least halted the deterioration in the European labour-market situation. It has greatly assisted the external adjustment efforts of the debtor countries and helped to defuse the debt crisis. In this environment the banking systems of the industrial countries have succeeded in strengthening their capital base.

At the same time the current recovery has exhibited some other encouraging features. Foremost among these is a relatively impressive inflation performance. The need to resort to anti-inflationary demand restraint which has so often bedevilled past recoveries after only a few years of growth has not arisen this time. This is largely due to the moderation of nominal wage increases. Moreover, as a corollary of the fairly satisfactory unit labour cost developments, corporate profitability has improved substantially in most industrial countries. Investment activity has picked up, vigorously in the United States but also quite well in Japan and in parts of western Europe. At the same time, many governments have made major and often successful efforts towards reducing both the public-sector deficit and the burden of government spending, and they have been equally assiduous in trying to remove or reduce structural rigidities in labour and product markets. Finally, even the sharply increased volatility, and the recent decline, of the dollar exchange rate do not so far appear to have disrupted the favourable international business climate; nor have they created tensions within the European Monetary System.

Against this broadly encouraging background — one that would have been considered highly improbable by even the most sanguine forecasters during the crisis months of 1982 — this Report proposes to look at some of the underlying problem areas that might well store up trouble for the future. Some of them could directly jeopardise the industrial countries' growth performance or even bring about a premature recession. Others could make for greater financial instability and turbulence which would ultimately lead to the same result.

In this Report four potentially serious problem areas are brought to the reader's attention: the twin problems of unemployment and inflation; the implications for the conduct of monetary policy and prudential supervision of

internationally integrated, innovative and progressively deregulated financial markets; exchange rate developments and the external imbalances among the industrial countries; and the international debt situation.

**Unemployment and inflation.**

One component of the first of these problem areas is, of course, immediately obvious, at least in western Europe, where the level of unemployment is of direct concern to all policy-makers. What is, however, less clearly perceived is that, when measured against the background of such vast under-utilisation of human resources, the success achieved in the fight against inflation begins to look more modest, and legitimate questions can be asked about how decisive and sustainable this success really is. True, price behaviour has been satisfactory when compared with the high rates of inflation recorded a few years ago and has perhaps also been better than expected. But this relative success in the process of disinflation cannot be judged in isolation from the high levels of unemployment prevailing, especially in western Europe. Whilst in this respect the US performance has been comparatively good, it can for various reasons scarcely be regarded as fully satisfactory. The US inflation rate has not accelerated so far, despite the sizable drop in unemployment — but what if the dollar should decline to more normal levels? On the other hand, inflation performance in western Europe has been quite remarkable, despite the strength of the dollar — but at what unemployment levels? Perhaps only Japan can claim with some justification that neither inflation nor unemployment constitutes a major problem for its economy.

This situation raises fundamental questions, both for economic analysis and for policy, which cannot be left unanswered for much longer. Two disturbing facts should serve as a starting-point for the badly needed innovative thinking in both fields. The first is that macro-economic anti-inflationary policies have now been in place in most western countries for almost five years without having succeeded in eradicating inflation. The second is that recovery has progressed far without having done more than halt the rise in unemployment in Europe and bring only partial and unevenly distributed relief in the United States. Worse still, in Europe there is little prospect of any really substantial reduction in unemployment even if growth were to continue at a moderate pace for some years to come.

These two facts combined suggest, quite bluntly, that something has gone basically wrong in the way prices are set in many western industrial countries, first and foremost in the labour market but also elsewhere: they do not perform their market-clearing function in the face of excess supply, while they react quite quickly and asymmetrically to excess demand. Why is this so? Because the experience of a long period of full employment, accompanied by creeping inflation and an official commitment to counteracting recessions, has introduced a bias in price expectations? Because the institutional framework in which the labour markets operate — minimum wages, generous and prolonged unemployment allowances, the high cost of shedding excess labour — have fundamentally disturbed the mechanics of wage formation? Because indexation has protected large segments of the population from

the income-eroding effects of inflation? Because market participants still do not trust the authorities' recent commitment to pursuing anti-inflationary policy? Or because they simply do not believe that restrictive monetary policies, unaided by other policy measures, will be able to eradicate inflation?

It would be unwise to claim to know the answers to these questions, but one major conclusion from the policy point of view nevertheless seems warranted: unless we can restore a greater degree of two-way flexibility to price and wage formation, it would be vain to expect our industrial economies to achieve a growth performance fast enough to absorb unemployment in the foreseeable future. Any marked acceleration of growth achieved solely through a relaxation of macro-economic policies would be very likely to rekindle inflation, and this would soon put an end to the growth process itself. On the other hand, growth rates which are sufficiently modest to allow inflation to be kept under control would be likely to go hand in hand with productivity increases rather than expanding employment — especially in Europe, where labour-market rigidities could well continue to steer capital formation towards labour-saving investment. The sad conclusion is that, given the existing characteristics of labour and product markets, there is no *macro*-economic policy of any shape or combination capable, by itself, of leading simultaneously to full employment and price stability. Or, to put it more positively: the precondition for restoring the effectiveness of macro-economic policies is a much greater flexibility of markets.

**Structural changes in financial markets.**

A second area of concern has to do with the structural changes that have been taking place for some time now in the activities of the financial intermediaries and the operation of the financial markets. These changes are of three kinds and to some extent are interrelated. Firstly, there are financial innovations, i.e. the emergence of new financial techniques and instruments. They occur in response to a variety of stimuli, the most important of which derive from the desire of market participants to minimise the costs arising from taxation and regulations and to seek protection against the uncertainty generated by unexpected interest and exchange rate fluctuations. Technological progress in many instances facilitates the implementation of innovative ideas. Prime examples of such innovations are the spreading use of contracts with floating interest rates, interest and currency swaps, bond or note issues linked to various mobilisation and underwriting commitments, and markets for financial futures.

A second kind of change can be conveniently labelled "institutional despecialisation", that is, the erosion of the demarcation lines between categories of financial institution or between financial institutions and the rôle played by open markets. Some of this despecialisation has been taking place gradually, within the framework of existing regulations, often precisely as a result of new financial instruments being used simultaneously by different categories of financial intermediary. Another impetus to despecialisation comes from deliberate moves towards deregulation by the authorities. Still another is the rapid growth of financial

saving and the related efforts of individual financial institutions to broaden their range of customer services.

The third type of structural change affecting the activities of intermediaries and markets has been their internationalisation — a process that had already started in the 1960s and may by now have slowed down. But it has reached proportions that have radically altered the nature of financial intermediation. In its broadest sense, this can be seen in the vast expansion of cross-border capital flows, with striking consequences for exchange rate developments as discussed below. More specifically, the process of internationalisation has most visibly affected the banking systems of the industrial countries. Banks' international exposure has increased dramatically over the last fifteen years. This is reflected in the high share of external claims and liabilities in their balance sheets, in the often still growing proportion of balance-sheet items denominated in foreign currencies, in the sometimes huge reliance on international interbank funding, and in the high ratio of country risks to equity.

These changes run wide and deep, affecting the whole framework in which the financial markets and the financial intermediaries operate, particularly in the United States and the United Kingdom, although the financial systems of other industrial countries are also strongly affected, if only through the large-scale innovations occurring in the international segment of their activities. At the same time, all financial systems have had to live with a process of disinflation which, almost by definition, carries with it shocks and risks at both the domestic and the international level, as well as with large interest rate fluctuations and sharply increased exchange rate volatility. This is a situation with no historical precedent and no guide to analysis can therefore be found in past experience.

A positive aspect of these structural changes is that they all lead to sharper competition and to the supply of a wider range of better designed financial services to non-financial customers. In short, they should tend to lower transaction costs and improve the allocative efficiency of financial markets. However, they also give rise to questions of some concern, two of which stand out quite clearly. One relates to the operative efficiency of monetary policy, in particular in those countries which have adopted monetary aggregates as intermediate targets. With the widening range of debt instruments and the blurring of demarcation lines between institutions, it has become difficult to decide which liabilities of which institutions should be chosen as the target variable by the authorities; and, given the greater substitutability among financial assets, hitting the target has itself become a delicate exercise. In addition, the transmission mechanism, that is, the way in which the intermediate target influences the "real" economy, may also have been affected by this new financial environment. It is not obvious, for instance, how and to what extent floating interest rates, or the possibility of hedging against interest rate changes through financial futures contracts, will affect investment decisions. In short, the simple beauty of targeting — if that beauty was ever simple — might well give way to a great deal of technical complexity liable to undermine one of the main virtues of targeting, namely its ability to influence the inflationary expectations of market participants. In these circumstances the credibility of monetary action comes increasingly to depend upon the final results achieved, which puts a very heavy burden indeed on monetary policy.

The second concern arising from these changes has to do with their potential effect on financial stability. It may well be that fully deregulated, highly competitive and innovative financial markets are as stable as, or perhaps even more stable than, markets operating under strict rules enforced through tradition or official regulation — although, as pointed out above, such a hope can rest only on theory, not on past experience. However, this is in any case beside the point. Deregulation and innovation, especially in an international framework, will not produce an entirely free market overnight. They are part of a long process which is likely to bring substantial changes in the profitability of whole categories of financial intermediaries, subject managements to a hard period of learning and adjustment and cloud the transparency of financial institutions, transactions and markets, which is of such importance for market participants' risk-taking decisions. Prudential supervision, which must be relied upon to exert a countervailing stabilising influence, faces a challenging time in such a period of transition.

**Exchange rate developments and external imbalances.**

One of the most striking features of 1984 and the early months of 1985 was the combination of a very strong dollar and a rising US current-account deficit. Between January 1980 and early March 1985 the real effective exchange rate of the dollar rose by almost 60 per cent.; about one-quarter of this appreciation took place between June 1984 and early February 1985. For the year 1984 the US current-account deficit reached the staggering figure of $100 billion, though this was equivalent to "only" 2¾ per cent. of US gross national product, a percentage comparable with that of the Japanese current-account surplus.

The story behind these facts is, up to a point, fairly straightforward and uncontroversial. Part of the US external imbalance — perhaps as much as one-half — is due to the substantial cyclical lead of the US economy over the rest of the industrial world. Foreign protectionism has certainly hurt many US industries, but this is not a radically new development and is, therefore, unlikely to have been a major factor in the deterioration of the US external accounts. The bulk of this deterioration has been brought about by the appreciation of the dollar, which has dramatically undermined the competitiveness of the entire internationally traded goods sector of the United States. Since the appreciation of the dollar has gone hand in hand with a growing deficit on goods and services, it can only be explained by the vigour of capital inflows.

It is at this point that the analysis becomes controversial. Some argue that the attraction of the dollar has mirrored that of the United States as an investment outlet. As a result of the tax-cutting and supply-side policies implemented by the Administration and the consequent strong growth performance of the US economy, the prospective yield on investment in the United States has become much more favourable than that elsewhere. Evidence supporting this view can be found in the vigorous upturn in US domestic investment activity itself.

Others would stress the rôle of interest rates and of the US fiscal deficit. The attraction of the dollar has rather been underpinned by the existence of an

uninterrupted, albeit fluctuating, interest rate differential, both long and short-term, in favour of dollar-denominated financial assets. According to this view, the high level of nominal and real interest rates in the United States should be attributed primarily to the large and expanding "structural" component of the US budget deficit. At the same time, strong domestic credit demand, coupled with the reluctance of US banks to increase their external claims on high-risk countries at the rate they were doing some years ago, has brought about an inflow of funds into the United States through banking channels. The capital account of the US balance of payments seems to bear out this view. It shows that banking flows have indeed contributed massively to capital movements into the United States; it also shows that the rôle of interest-sensitive financial flows has been much more important than that of direct investment or of purchases of equity. Finally, it can also be argued, in particular when one looks at the greatly increased volatility of the dollar during the early months of 1985, that at levels so divorced from the underlying fundamentals an exchange rate may take on a life of its own — in other words, that speculation can for some time become a self-perpetuating force.

These differences in analysis naturally affect opinions as to policy prescriptions. They are perhaps not as crucial when it comes to assessing the dangers inherent in the current situation. These come under three headings.

The first, and most immediate, concern relates to the position of the internationally traded goods sector in the United States itself. The rising trend of the dollar and the deteriorating current account of the United States are mirrored in the fact that the strong expansion of domestic demand has barely had any stimulating effect on the production of those goods that face world competition. For instance, US industrial production remained practically unchanged during the ten months to March 1985. As a corollary, much of the employment-stimulating benefit of the US recovery has accrued to those sectors — mainly services — that are not exposed to foreign competition. This raises justified concern about the longer-term implications for movements in the labour market of a return to more normal exchange rate levels. Meanwhile, the more immediate concern is about the tide of protectionist pressures that has been building up in the United States and which could be severely detrimental to the future development of international trade. On the whole, however, these pressures have so far been wisely and successfully contained by the Administration.

On the assumption that this resistance remains effective, the second preoccupation, voiced outside the United States, about the effects of a high dollar on the rest of the world should not be exaggerated. Admittedly, the strength of the dollar has led in many industrial countries to upward pressure on import prices and has, therefore, impeded governments' disinflationary policies, although this influence has to some extent been attenuated by the correlative weakness of commodity prices denominated in dollars. Admittedly, too, the uncoupling of interest rates could not be as successful in these circumstances as would have been desirable, given the weakness of domestic investment demand in a number of industrial countries. Real interest rates have therefore remained relatively high outside the United States as well. But both of these adverse influences emanating

from the United States have been more than offset by the benefits bestowed on the rest of the world by the locomotive rôle of the US economy, without which there would have been no recovery in world trade, and by the huge US current-account deficit, without which the external adjustment efforts of the deficit countries would have been both less effective and more painful.

The real international concern should lie not so much in the present as in the future — that is, in the potentially disruptive nature of the unwinding of the current situation. It is clear that at its present level the US current-account deficit is not sustainable: it implies the speedy deterioration of the US international investment position, which has already brought the richest country of the world to the position of net external debtor. While no one can foresee the quantitative or temporal limits of such a development, there can be no doubt that such limits do exist. Given the high degree of integration of the international financial markets and the customary speed with which asset markets adjust themselves to shifting expectations, the danger lies in a sudden reappraisal by market participants of the advantages in further increasing their holdings of dollar-denominated assets. Should this go beyond certain limits, the domestic interest rate level in the United States would be bound to be affected, given the massive rôle played by external capital flows in the financing of the US economy. Since markets for goods and services do not react quickly, the current-account deficit is relatively rigid — and hence *will* be financed through capital inflows. But at what interest and exchange rate levels? At the cost of what real or financial shocks? And what if this adjustment should coincide with a natural slowdown or perhaps even a recession in the US economy? Would it not prevent any substantial decline in US interest rates, vital to help mitigate both the domestic and the international impact of a weakening of the US economy?

At the time of sending this Report to the printer — on 13th May — the dollar had fallen by 8 per cent. in effective terms from the peak level registered in the second half of February and had lost even more ground against sterling and the main EMS currencies. While its decline was at times abrupt, with a sharp increase in day-to-day and even hour-to-hour volatility, it did not yet set in motion such a potentially disruptive sequence of events. It is, moreover, impossible to judge the likelihood of this happening in the future: the possibility of a smooth, orderly decline from the still high and unsustainable current exchange rate level cannot be precluded. But the stakes are high, and it is the duty of policy-makers to do everything to avoid financial disturbances of the kind outlined above, even if no one can attach any — even approximate — degree of probability to such an occurrence. Preparing the way for an orderly unwinding of the US external imbalance should figure as a priority item on policy-making agendas.

**The international debt situation.**

The positive developments in the international debt situation which were noted in last year's Annual Report have since been confirmed. Rescheduling and financing negotiations between the major debtor countries and the banks, under the auspices

of the International Monetary Fund, have on the whole been proceeding in an orderly way. The hurdles have not been easy to overcome, but in the end a sense of responsibility prevailed on both sides of the negotiating table. These agreements would not have been possible without the continued external adjustment efforts of many debtor countries. Of course, their success in achieving often very large trade surpluses owes a great deal to the vigorous expansion of domestic demand in the United States and to the large US trade deficit, as well as to the generalised recovery in the rest of the industrial world. At the same time, individual debtor countries have continued to display striking differences in the scale and the nature of their adjustment efforts and achievements — a fact suggesting that the case-by-case method of dealing with the debt problems has been justified.

Despite this progress, however, the problems encountered by a number of debtor countries, heavily concentrated in Latin America and Africa, can hardly be said to have met with a lasting solution. The reasons for sounding a warning in this regard relate both to the domestic situation prevailing in the countries concerned and to possible developments in the international environment.

The domestic problems of debtor countries in Africa fall into a totally different category from those in Latin America. Many African countries face an external adjustment task with large segments of their population living in absolute poverty, a drought-stricken agricultural base and years of economic mismanagement behind them, which have turned a timid development process into one of economic decay. In such a situation, whatever domestic short-term adjustment is feasible should go hand in hand with domestic policies aimed at long-term development, underpinned by international assistance.

Most debtor countries in Latin America have long been on the path of development, possess vast and well-educated human resources and a more or less diversified industrial base, and many are also generously endowed with natural resources, including in some cases energy. They have, moreover, demonstrated their ability to turn their trade accounts around with remarkable speed. But there is legitimate concern about whether the external adjustment has been accompanied by sufficient internal adjustment to be sustainable. There are two sources of preoccupation, their relative importance varying in the individual countries. One is inflation, which is still virtually out of control in many of the countries concerned; indeed, in several of them the situation has even worsened. It is doubtful, to say the least, that a durable external adjustment is possible unless this problem, and what probably lies behind it in terms of lax monetary policies, negative real interest rates and wage indexation, is tackled. The second, in such striking contrast with experience in the Asian countries, is the still inward-looking, protectionist industrial policy aimed at import substitution rather than export growth. There have been signs of positive developments in some countries, but they are far from being general.

That being said, the sheer magnitude of the debt problem for a great number of Latin American countries, and for some others outside Latin America, is such that adjustment efforts, whatever their intensity and nature, can only yield sustainable results if the international environment remains relatively favourable. In

the case of the most heavily indebted countries, external debt amounts to more than three times annual export earnings. At an annual interest charge of 11–12 per cent. this means that complete current-account balance, i.e. the ability to service interest payments fully without adding to external debt, requires a current surplus (exclusive of interest payments) equivalent to more than one-third of export receipts. This ratio improved a little on average last year, which lends support to the view that, even in cases of such heavy external indebtedness, the locomotive rôle of the US economy *has* outweighed the negative influence of the high dollar interest rates. It is of crucial importance that this development should not be reversed, but if possible taken even further. This is a striking illustration of the need for achieving a "soft landing" of the US economy, that is, a situation in which the worldwide effects of a slowdown in US growth are to a large extent offset by a better growth performance in the rest of the industrial world, with a decline in the level of dollar interest rates.

However, even if this were to happen, the numbers in question clearly suggest that a sustainable external balance cannot be achieved by the most heavily indebted countries by relying solely on positive current-account developments. These countries also need a favourable turn in spontaneous capital flows of a nature that would not add to the external interest burden. There are two types of capital flow that would satisfy this criterion: direct or equity investment and the repatriation of flight capital. Both depend heavily on confidence, the prime condition for the re-establishment of which is an appropriate set of domestic policies.

# II. THE PROGRESS OF RECOVERY AND STRUCTURAL ADJUSTMENT.

## Highlights.

On the face of it, 1984 was one of the better years the industrial world has seen for some time. At an average of almost 5 per cent., the rate of growth in the Group of Ten countries was one of the highest recorded since 1973, while at the same time some further progress was made in the fight against inflation.

On the other hand, the degree of international imbalance again increased, and in Europe unemployment remained high. Consequently, growing attention was focused on the US/European macro-economic policy contrast. One view was that the US policy approach was basically sound and might perhaps be "exportable". Another stressed the risks — for the world as a whole — inherent in the US fiscal and current-account deficits, as well as the need for other countries to persist with their medium-term policies of structural adjustment.

The United States continued to lead the recovery in 1984 as it had done in 1983. Extremely rapid growth of domestic demand combined with the effects of yet further appreciation of the dollar to impart an unusually large stimulus to the rest of the world. Japan and Canada were particularly affected in this regard. In Europe growth also accelerated, though it was still relatively slow on average. The slowdown in US growth which began in mid-1984 and which became more clearly apparent early this year was thus cause for some concern.

Inflation tended either to remain low last year or, where it was still high, to come down further. The latter was particularly the case in some European countries, despite exchange rate weakness. It seems that, in addition to displaying an unexpected degree of underlying softness, dollar commodity prices also adapted somewhat to changes in the value of their numeraire. More important, and potentially significant, was continued moderation in wage costs, which went hand in hand with some further rebuilding of profit margins.

Following a sharp decline in 1983, unemployment fell more slowly in the United States last year. In Europe, however, no major inroads have yet been made into high unemployment levels, although in some cases employment has begun to increase again.

Longer-term fiscal, demographic and wage cost factors play an important rôle in the unemployment problem in western Europe. In view of the structural policies being pursued, growth may for a time continue to depend partly on the stimulus of external markets. If so — and given the instability of the dollar seen in March and April — early attention to the policy imbalance in the United States would seem to be vital. Such a policy correction could prevent disruptive developments in the United States itself from abruptly reversing the stimulus received by the rest of the world from this source over the past two years.

In turn, longer-term measures, aimed in particular at public expenditure control, tax reduction and labour-market flexibility, could then be pursued further, with a view to reinforcing the self-sustaining capabilities of the European recovery.

**Output and demand.**

Total output in the Group of Ten countries rose by nearly 5 per cent. on average last year. This was one of the best results for a single year since 1973. It also followed, and took further, the recovery which was already under way in 1983. During the first half of the year growth was particularly rapid in the United States — some 8¼ per cent. per annum. Indeed, it could be that, for the industrial world as a whole, the peak growth rate for this upswing has now passed. Nevertheless, fears of a serious slowdown in the United States following the publication of the sharply lower third-quarter GNP figures proved premature. After an annualised growth rate of only 1¾ per cent. was recorded in that quarter, the rate rebounded to 4¼ per cent. in the fourth quarter. But in the first three months of 1985 the signs seemed to point more clearly to a decline in the underlying momentum of US growth.

Short-term fiscal effects on the demand side have no doubt played a rôle in the recent upswing in the United States. It is important, however, that they should not be over-emphasised, nor viewed in isolation from longer-term structural characteristics of the US economy or from the wider policy context. To begin with, one should also mention monetary policy, which contributed decisively to the success in bringing down inflation after 1979. In turn, this meant that some relaxation of monetary stance could be both permitted and effective when it was implemented in the second half of 1982. More fundamentally, one might also cite a degree of underlying supply-side resilience in the US economy, something which the overall policy framework has recently been attempting to revive and enhance.

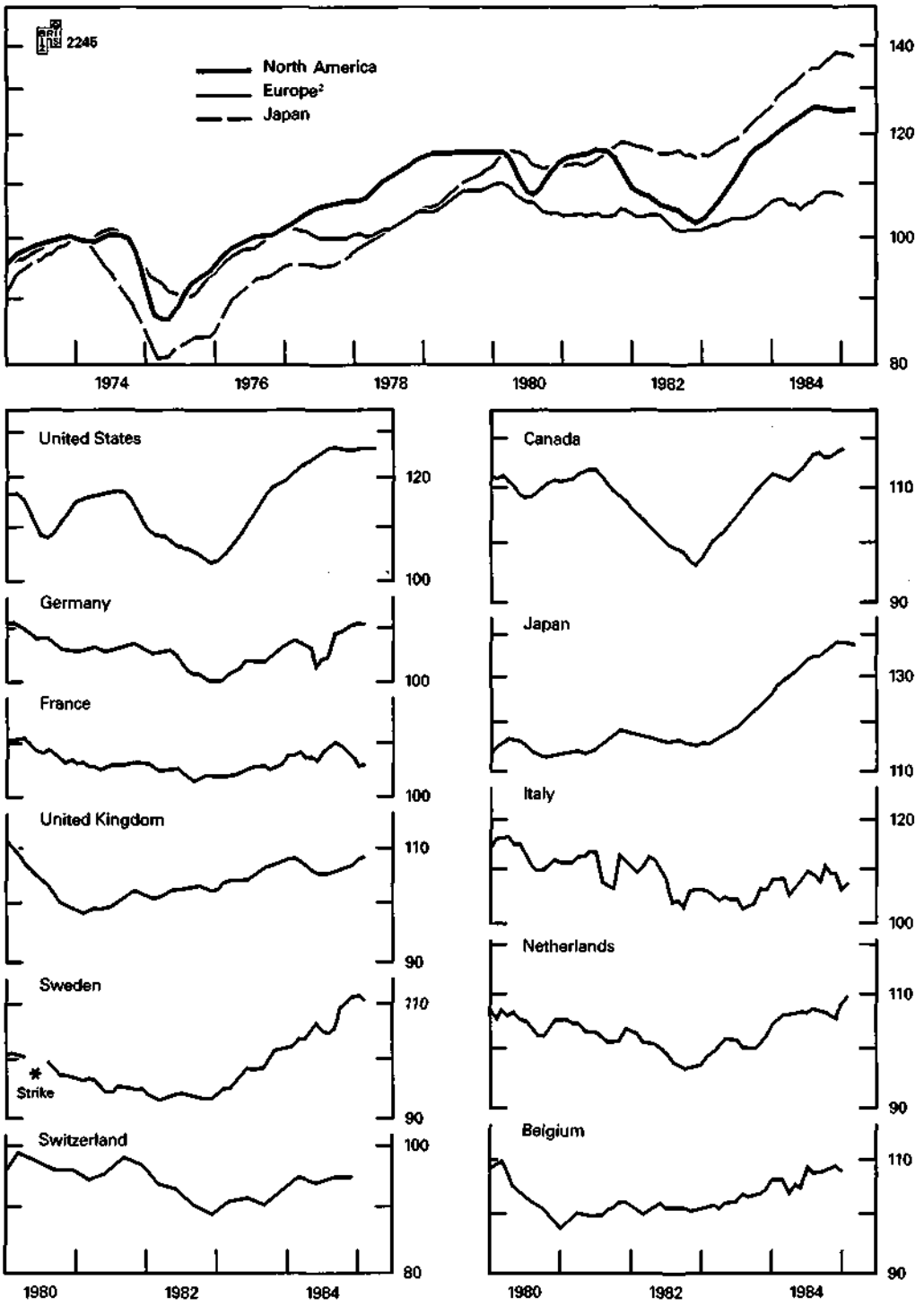
Outside the United States, growth was also comparatively rapid last year in Japan and Canada (see the table on page 15). In both cases exports played an important rôle, and in Japan so did business fixed investment.

In Europe the acceleration in growth was more modest, from 1¼ per cent. on average in 1983 to 2½ per cent. last year. Export demand was, of course, an important factor in this development, especially in Germany (where total export volume grew by some 10½ per cent. between the fourth quarters). In addition, in those countries which have made the most progress towards their longer-run fiscal goals, the *rate* of budgetary retrenchment — with its concomitant short-term demand effects — has now slowed down.

That said, however, it remains true, especially in contrast to the United States, that European authorities have by and large continued to be motivated by the need for further progress in cutting back budget deficits. But, whereas earlier in the disinflation process the short-term demand effects of fiscal retrenchment had in several cases found a significant offset in declining saving ratios (probably chiefly as a result of much lower inflation), such a support to consumer spending was much

## Industrial production.[1]

December 1973 = 100.




[1] Three-month moving averages; the indices for North America and Europe were calculated using weights proportional to GDP and exchange rates of the preceding year. [2] Comprises Belgium, France, Germany, Italy, the Netherlands, Sweden, Switzerland and the United Kingdom.

**Changes in real GNP and its components.[1]**

| Countries | Years | Real GNP | Consumption | | Gross fixed investment | | | Exports | Imports | Change in stock-building[2] |
|---|---|---|---|---|---|---|---|---|---|---|
| | | | private | public | private non-residential | private residential | public | | | |
| | | annual volume changes, in percentages | | | | | | | | |
| United States .... | 1981 | 2.5 | 2.0 | 0.9[3] | 5.5 | – 5.5 | | 0.7 | 7.0 | 1.1 |
| | 1982 | – 2.1 | 1.3 | 2.0[3] | – 4.7 | –15.0 | | – 7.8 | 1.3 | – 1.4 |
| | 1983 | 3.7 | 4.8 | – 0.3[3] | 2.5 | 41.7 | | – 5.6 | 7.6 | 0.5 |
| | 1984 | 6.8 | 5.3 | 3.5[3] | 19.8 | 12.2 | | 4.7 | 27.0 | 1.9 |
| | 1984 IV | 5.7 | 4.2 | 7.6[3] | 15.8 | 2.4 | | 4.3 | 15.4 | 0.6 |
| Japan ..... | 1981 | 4.1 | 0.7 | 5.2 | 5.6 | – 2.5 | 4.3 | 15.9 | 5.4 | – 0.1 |
| | 1982 | 3.4 | 4.3 | 1.8 | 3.7 | – 0.6 | 0.4 | 3.6 | 2.7 | 0.0 |
| | 1983 | 3.4 | 3.4 | 3.0 | 3.3 | – 5.6 | – 0.4 | 4.6 | – 4.5 | – 0.5 |
| | 1984 | 5.7 | 2.7 | 2.2 | 11.1 | – 1.1 | – 1.6 | 18.1 | 12.5 | 0.3 |
| | 1984 IV | 6.4 | 2.2 | 2.1 | 12.5 | 0.9 | – 0.9 | 17.7 | 7.2 | 0.1 |
| Germany ..... | 1981 | – 0.2 | – 0.6 | 1.5 | – 2.8 | – 4.5 | – 8.7 | 8.4 | 0.7 | – 1.6 |
| | 1982 | – 1.0 | – 1.4 | – 1.0 | – 3.7 | – 4.2 | – 9.3 | 4.6 | 2.2 | 0.0 |
| | 1983 | 1.3 | 1.1 | 0.2 | 5.0 | 4.7 | – 8.2 | – 1.3 | 0.5 | 0.7 |
| | 1984 | 2.6 | 0.6 | 2.0 | 1.3 | 2.4 | – 1.4 | 7.9 | 5.7 | 0.6 |
| | 1984 IV | 2.8 | 0.3 | 3.0 | | 1.4[4] | | 10.4 | 4.9 | – 0.2 |
| France ..... | 1981 | 0.2 | 2.0 | 2.2 | – 2.4 | – 0.1 | – 1.8 | 5.3 | 1.6 | – 1.8 |
| | 1982 | 2.0 | 3.5 | 2.6 | – 0.4 | – 3.4 | 5.6 | – 2.2 | 6.3 | 1.6 |
| | 1983 | 0.7 | 1.1 | 1.8 | – 2.4 | – 2.6 | 2.2 | 3.8 | – 0.7 | – 1.9 |
| | 1984 | 1.8 | 0.5 | 0.9 | 0.4 | – 6.0 | – 3.0 | 6.9 | 2.9 | 0.9 |
| | 1984 IV | 2.0 | 0.0 | 0.1 | – 0.1 | – 6.4 | – 0.7 | 4.6 | 3.9 | 2.2 |
| United Kingdom[5] . | 1981 | – 1.4 | – 0.3 | 0.2 | – 5.7 | – 5.6 | –16.3 | – 1.8 | – 3.4 | 0.1 |
| | 1982 | 2.0 | 0.8 | 0.7 | 9.1 | 9.2 | 0.1 | 1.0 | 3.9 | 0.7 |
| | 1983 | 3.1 | 3.9 | 2.5 | – 1.3 | 9.6 | 12.5 | 1.4 | 5.5 | 0.7 |
| | 1984 | 2.4 | 1.5 | 1.0 | 11.6 | 1.0 | 3.7 | 6.5 | 8.7 | – 0.4 |
| | 1984 IV | 2.3 | 1.0 | 1.5 | 13.9 | – 4.4 | – 5.2 | 9.5 | 9.8 | 0.2 |
| Italy ..... | 1981 | 0.2 | 0.5 | 3.3 | | 0.0[4] | | 5.2 | – 5.3 | – 3.1 |
| | 1982 | – 0.5 | 0.5 | 2.6 | | – 5.2[4] | | 0.7 | 1.5 | 0.0 |
| | 1983 | – 0.4 | – 0.3 | 2.4 | | – 3.8[4] | | 3.3 | 0.1 | – 0.7 |
| | 1984 | 2.6 | 1.8 | 2.7 | | 4.1[4] | | 7.0 | 9.6 | 0.6 |
| | 1984 IV | 1.7 | 2.4 | | | 5.4[4] | | 6.1 | 12.2 | . |
| Canada ..... | 1981 | 3.3 | 1.7 | 2.5 | 7.7 | 3.9 | 2.4 | 3.1 | 4.5 | 1.0 |
| | 1982 | – 4.4 | – 2.0 | 0.7 | – 9.1 | –21.0 | 4.2 | – 1.6 | –11.2 | – 3.3 |
| | 1983 | 3.3 | 3.1 | 0.3 | –12.4 | 24.7 | 1.1 | 6.4 | 8.1 | 2.6 |
| | 1984 | 4.7 | 3.4 | 2.8 | 0.5 | – 3.8 | 7.0 | 19.7 | 15.5 | 0.6 |
| | 1984 IV | 3.7 | 3.1 | 2.0 | 0.4 | 1.2 | 7.4 | 12.5 | 5.9 | – 0.7 |
| Group of Ten countries[6] .. | 1981 | 1.8 | 1.2 | 1.7 | | 0.8 | | 4.9 | 1.5 | 0.0 |
| | 1982 | – 0.5 | 1.4 | 1.4 | | – 3.0 | | – 0.4 | 1.7 | – 0.6 |
| | 1983 | 2.7 | 3.3 | 0.8 | | 3.7 | | 1.0 | 2.5 | 0.2 |
| | 1984 | 4.9 | 3.4 | 2.9 | | 8.5 | | 8.5 | 12.1 | 1.1 |
| | 1984 IV[7] | 4.7 | 2.8 | 4.8 | | 7.5 | | 9.0 | 9.3 | . |

[1] Figures for 1984 are still preliminary. Those for 1984 IV refer to changes over four quarters. [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.

less in evidence last year. Indeed, in the three largest European countries consumer spending actually grew more slowly last year than it had done in 1983.

Finally, in Germany and the United Kingdom major strikes affected output in 1984. In the former case the effect was mainly on the quarterly pattern of growth. In the United Kingdom, however, the miners' strike reduced output for the year as

a whole, possibly by as much as 1–1½ per cent. The relatively large leakage of demand into imports (which rose by nearly 9 per cent.) was in part, though only in part, a reflection of this disturbance.

The foregoing survey does not, of course, bring out sufficiently the disparity in performance, particularly that between short-term developments in the United States, on the one hand, and in Europe on the other. The simple facts are themselves striking. Over the two years to the fourth quarter of last year output in the United States rose at the fastest rate for any such period for twenty years — 6.1 per cent. per annum. More significant for the world as a whole is the fact that total domestic demand in the United States grew materially faster than domestic output itself — the difference, of course, spilling over into imports as a demand stimulus to the rest of the world. Last year US domestic demand rose by 8¾ per cent., following a rise of 5 per cent. in 1983. This implies that over the last two years the United States has accounted for just over 70 per cent. of the increase in aggregate demand in the whole OECD area, against its weight in output of some 40 per cent.

US imports of goods and services.

| Periods | Change in volume of imports | Contributions of | | | Change in imports | |
|---|---|---|---|---|---|---|
| | | change in total domestic demand[1] | trend factors[2] | residual[3] | in billions of US dollars[4] | as a percentage of non-US GNP[5] |
| | as a percentage over two years | | | | | |
| 1967 1st half to 1969 1st half ..... | 21.7 | 9.1 | 6.7 | 5.9 | 10.3 | 1.1 |
| 1971 1st half to 1973 1st half ..... | 20.8 | 11.3 | 5.5 | 4.0 (−16.2) | 27.9 | 1.2 |
| 1975 1st half to 1977 1st half ..... | 29.8 | 12.8 | 5.8 | 11.2 (+ 2.9) | 57.9 | 1.7 |
| 1982 2nd half to 1984 2nd half ..... | 43.4 | 15.2 | 4.3 | 23.9 (+27.1) | 113.7 | 3.0 |

[1] Assuming an elasticity of unity. [2] Calculated assuming a linear trend in the ratio of imports to total domestic demand. [3] Figures in brackets show the change in the dollar's nominal effective exchange rate over the three years to the end of the period. [4] Change in the seasonally adjusted annual rate of imports. [5] OECD area excluding the United States.

The corollary of this is that the past two years have witnessed what is, by a considerable margin, the fastest growth in US imports in the whole post-war period, some 43½ per cent. in total. And, as the table suggests, although the unusually strong US demand growth has been an important factor, the rise of the dollar and the accompanying severe loss of US competitiveness have also played an important rôle.

While the relative weight of the US economy has declined over the post-war period, it is also the case that the share of imports in US GNP has risen steadily. Consequently, the rise of more than $110 billion in the annual rate of imports into the United States since the second half of 1982 represents a large real demand impulse abroad. It is difficult to measure precisely the volume effect relative to the

size of other industrial economies, but it is almost certainly a record — possibly as much as 3 per cent. of non-US OECD GNP.

For the United States itself the increase in the trade deficit involved, of course, much more than a siphoning-off of extremely rapid aggregate demand growth, however appropriate that might have been. The loss of competitiveness in tradable goods industries entailed the risk that otherwise viable production capacity might be lost for some time and/or that pressures for protection would intensify and in some cases be acceded to for a longer period than would be appropriate. For the rest of the world, however, the pluses have seemed up to now to outweigh the minuses.

*GNP cycles and the foreign sector.* The joint impact of the US recovery and the accompanying change in competitiveness has generally been seen more in export than in import developments in the rest of the world. In terms of exports, Japan and Canada have been the main beneficiaries, even though Europe has experienced much of the counterpart gain in real effective cost and price competitiveness since 1980.

Cyclical comparisons of contributions to GNP growth.[1]

| Countries and periods | GNP | Foreign sector | | | Domestic sector | | | | |
|---|---|---|---|---|---|---|---|---|---|
| | | exports | imports[2] | net foreign balance | total domestic demand[3] | private consumption | public expenditure[4] | business fixed investment | change in stockbuilding |
| | changes as a percentage of GNP in the base period | | | | | | | | |
| United States | | | | | | | | | |
| 1982 IV–1984 IV .. | 12.4 | 0.7 | – 3.2 | – 2.5 | 14.9 | 6.7 | 0.7 | 3.5 | 2.8 |
| previous cycles .. | 10.7 | 1.1 | – 1.6 | – 0.5 | 11.2 | 6.6 | 0.6 | 1.4 | 1.1 |
| Japan | | | | | | | | | |
| 1982 IV–1984 IV .. | 10.6 | 6.2 | – 1.7 | 4.5 | 6.2 | 2.6 | 0.3 | 3.4 | 0.4 |
| previous cycles .. | 18.8 | 3.3 | – 2.9 | 0.4 | 18.4 | 9.0 | 2.6 | 4.6 | 0.4 |
| Germany | | | | | | | | | |
| 1982 IV–1984 IV .. | 6.0 | 4.7 | – 3.7 | 1.0 | 5.0 | 0.8 | 1.1[5] | 1.4[6] | 1.7 |
| previous cycles .. | 10.2 | 4.8 | – 3.6 | 1.2 | 9.0 | 4.4 | 1.1[5] | 1.8[6] | 1.7 |
| France | | | | | | | | | |
| 1982 IV–1984 IV .. | 2.9 | 2.7 | – 1.1 | 1.6 | 1.3 | 0.5 | 0.2 | – 0.2 | 1.3 |
| previous cycles .. | 10.9 | 3.9 | – 5.1 | – 1.2 | 12.1 | 6.6 | 1.1 | 1.6 | 1.6 |
| United Kingdom | | | | | | | | | |
| 1982 IV–1984 IV .. | 5.4 | 3.6 | – 5.5 | – 1.9 | 7.2 | 2.7 | 1.0 | 1.5 | 2.2 |
| previous cycles .. | 5.8 | 3.7 | – 2.9 | 0.8 | 5.0 | 1.7 | 1.0 | 1.2 | 1.3 |
| Italy | | | | | | | | | |
| 1982 IV–1984 IV .. | 2.9 | 4.3 | – 4.2 | 0.1 | 2.8 | 2.2[7] | | 0.6[6] | . |
| previous cycles .. | 12.1 | 4.3 | – 2.2 | 2.1 | 10.0 | 7.4[7] | | 2.6[6] | . |
| Canada | | | | | | | | | |
| 1982 IV–1984 IV .. | 11.1 | 9.0 | – 7.5 | 1.5 | 9.5 | 5.1 | 0.9 | – 1.4 | 3.8 |
| previous cycles .. | 11.2 | 4.1 | – 5.3 | – 1.2 | 12.4 | 7.2 | 1.5 | 0.3 | 1.5 |
| Sweden | | | | | | | | | |
| 1982 III–1984 III .. | 4.8 | 4.3 | – 0.4 | 3.9 | 0.9 | – 0.4 | 0.7 | 0.5 | 0.6 |
| previous cycles[8] .. | 7.6 | 5.0 | – 5.0 | 0.0 | 7.6 | 1.9 | 1.5 | 0.3 | 3.5 |

[1] The current upswing is compared with the average performance in the corresponding two-year period of three previous cycles. For all countries except Sweden, the first of these previous cycles was taken to start from the second quarter of 1975 (Sweden, fourth quarter 1977). The starting dates for the second were: United States and Canada, fourth quarter 1970; France, second quarter 1971; Japan, third quarter 1971; Germany and Sweden, fourth quarter 1971; United Kingdom, first quarter 1972; Italy, third quarter 1972. For the third, the starting dates were: United States, Canada, Japan, Germany, France and Italy, second quarter 1967; United Kingdom, third quarter 1966. [2] A minus sign denotes an increase in imports. [3] Including residential investment. [4] Total public expenditure on goods and services, current and capital. [5] Excludes public investment. [6] Includes public investment and residential construction. [7] Including changes in stockbuilding. [8] Two cycles only.

The primary reason for this apparent contradiction is, of course, the dominant influence of the pre-existing pattern of trade. Following a deep recession, and with the bulk of Canadian exports going to the United States, it is not surprising that Canada experienced the largest rise in exports of all Group of Ten countries over the two years to the end of 1984. And this despite the fact that, with a relatively large increase in domestic costs, competitiveness has probably not been a helpful factor (see the table on page 19). In addition, Canadian imports also rose strongly, partly as a result of buoyant domestic demand growth.

In Japan the upturn has been most clearly led by the foreign sector. Although changes in competitiveness appear not to have played much of a rôle, the US market accounts for around one-third of Japanese exports. At the same time, the proportion of domestic output exported (measured at constant prices) had already risen to nearly 20 per cent. by 1982, twice the figure only twelve years previously. Consequently, although the rate of increase in Japanese exports has not been a record, their (arithmetic) contribution to GNP growth has been greater than on average during the three previous upturns (see the table on page 17). Even so, with an overall rise in output of 10½ per cent. over eight quarters, the upturn has been much below previous upswings, when much higher secular rates of growth were anyway the norm. As the table shows, the relative weakness of domestic demand contributed to this outcome.

In Europe exports to the United States account for less than 10 per cent. of the total, the United Kingdom being the only major exception. On the other hand, as already noted, exchange rate weakness vis-à-vis the dollar has implied here, on average, some gain in price/cost competitiveness which will presumably have affected not just exports to the United States but also performance in dollar-related third markets as well. And indeed, as the table suggests, within what was generally a slow recovery by past standards, the contribution of exports — though not fully apparent until last year — has not been far short of past averages. However, for the United Kingdom and Germany especially, an important corollary of this is that the *initial* stirrings of recovery were domestically generated — no doubt partly as a result of the firm commitment to disinflation.

On the whole, though, the current European upturn is by now proving to have a sizable export component. Indeed, fears have been expressed that this may be excessively so in the sense that either productive structures might be inappropriately adjusted to what may be a temporary demand pattern (some of the counterpart of the problems being experienced by US tradable goods industries) or, alternatively, there would be no major investment response, either in export industries themselves or elsewhere in the economy (where demand remains for the most part relatively slack). Both these possibilities are, of course, connected with the issue of the recovery's medium-term sustainability.

However, as noted above, the overall export contribution to European demand has not been unusually large compared with previous cycles. And unless the composition of exports to the United States (which have naturally grown the fastest) is substantially different from the overall average, no especially concentrated pressures on certain sectors would seem to be implied. In addition, improvements

Nominal exchange rates, competitiveness and export growth.

| Countries | Nominal effective exchange rate | Unit labour costs: domestic currency | Real effective exchange rate based on | | Cumulative export growth 1982 IV to 1984 IV[2] |
|---|---|---|---|---|---|
| | | | relative unit labour costs | relative export unit values | |
| | indices: 1980 = 100[1] | | | | in percentages |
| United States | 147 | 111 | 139 | 136 | 9 |
| Japan | 124 | 99 | 106 | 102 | 32 |
| Canada | 112 | 131 | 130 | 100 | 45 |
| Germany | 89 | 106 | 80 | 82 | 16 |
| Netherlands | 88 | 102 | 78 | 92 | 13 |
| France | 66 | 144 | 84 | 86 | 10 |
| Italy | 67 | 166 | 99 | 90 | 20 |
| Belgium | 71 | 107 | 66 | 81 | 8[3] |
| Sweden | 71 | 122 | 76 | 85 | 20 |
| United Kingdom | 77 | 121 | 81 | 87 | 14 |
| Switzerland | 99 | 107 | 91 | 91 | 11 |

[1] Third quarter 1984. [2] Goods only; volume, preliminary figures. [3] First three quarters of 1982 to first three quarters of 1984.

in profitability should provide a more general degree of encouragement to investment.

One reason for the unexceptional export performance in Europe, namely the comparative smallness of the US market for European exports, has already been noted. Another is that any improvements in export cost and price competitiveness in Europe have also been concentrated on a relatively small portion of the overall export market. In some cases, too, such as Germany and the Netherlands, exchange rate changes within Europe have tended to counteract the effect of the rising dollar so far as overall competitiveness is concerned. In these cases the nominal effective exchange rate has changed relatively little since 1980 (see the table above). In other cases, such as France and Italy, a large nominal effective depreciation has been heavily offset by continuing inflation of domestic costs. And in yet others, for example in the Belgian and Swedish cases, the table suggests that devaluation has been the occasion for some rebuilding of margins in the export sector. Indeed, in the US market it is probable that there has been a more widespread increase in margins, which is not so visible at the aggregate level.

In sum, while it remains true that the European recovery has come to be appreciably dependent on exports, it does not seem to be so to a wholly unusual extent. This would seem to imply that the recovery's sustainability is not especially — or abnormally — at risk on this account. But, given that the United States is unlikely to be able to play a leading rôle indefinitely, it is nevertheless necessary that the recovery elsewhere should become increasingly self-supporting domestically. In this respect, the rôle of business fixed investment will be especially important.

*GNP cycles and selected domestic demand components.* The table on page 17 also shows the comparative movement of domestic demand and some of its components. Taking investment first, the table demonstrates the extremely strong

showing of this item in the current upswing in the United States. It also suggests that this performance may not be just an early bunching of the (normally lagged) investment response to a general cyclical upturn. For in the first two years of recovery US business investment has already risen by an appreciably greater amount than in the first three years of previous cycles. Investment performance in Japan, Germany and the United Kingdom must also be judged to have been encouraging.

In the context of medium-term commitments to public expenditure restraint, no notable contribution would, of course, be expected directly from public spending. And by and large, as the table suggests, this seems to have been the case. Similarly, in the case of stockbuilding, the greater the reliance of the upswing so far on a cyclical rebound of stocks, the larger the question mark might be over the sustainability of the recovery. However, only in the case of Canada does this contribution look unusually large, given the size of the overall recovery. On the other hand, of all the industrial countries Canada experienced the steepest recession in 1982, in which a major rôle was played by a sharp stock adjustment.

All in all, and looked at purely in terms of the composition of demand, the upturn seems so far to display few signs of any particular fragility apart, of course, from the question mark overhanging the dollar. The recovery is still relatively slow on average in Europe but, given the slow growth of capacity in recent years, this may be as much a strength as a weakness. It may well be that inflation performance will be a more important factor governing the longer-term outlook for the recovery in most countries.

**Inflation.**

Despite the continuing and spreading upswing in activity and some further rebuilding of profit margins, inflation remained generally under control in the Group of Ten countries last year. In some cases, especially in Europe, further noticeable progress was made in the direction of price stability, even in the face of a further rise in the value of the dollar. International commodity price developments were, however, somewhat weaker than in past cyclical recoveries. More importantly, wage cost pressures remained for the most part subdued. However, the early months of 1985 saw concern increasing somewhat in Europe that any further rise in the US dollar might threaten to undermine inflation performance.

On a weighted average basis, consumer prices in the Group of Ten countries rose by little more than 4 per cent. over the twelve months to December last year. This not only represented a further small improvement over the 1983 performance, it also signalled the continuation of a downward trend in price increases two years into the recovery. And while last year's result is not yet a return to the experience of the first half of the 1960s, it is certainly the best performance since before the first oil shock.

In the United States, where, in the face of a very strong upswing in demand, inflation performance has been favourably influenced by the opposing effect of a

**Changes in consumer prices.**

| Countries | Changes over twelve months ending December | | | | | | 1985 March[1] |
|---|---|---|---|---|---|---|---|
| | 1977 | 1980 | 1981 | 1982 | 1983 | 1984 | |
| | in percentages | | | | | | |
| United States | 6.8 | 12.4 | 8.9 | 3.9 | 3.8 | 4.0 | 3.7 |
| Japan | 4.8 | 7.5 | 4.3 | 1.8 | 1.8 | 2.6 | 1.6 |
| Germany | 3.5 | 5.5 | 6.8 | 4.6 | 2.6 | 2.0 | 2.5 |
| France | 9.0 | 13.7 | 13.9 | 9.7 | 9.3 | 6.7 | 6.4 |
| United Kingdom | 12.1 | 15.1 | 12.0 | 5.4 | 5.3 | 4.6 | 6.1 |
| Italy | 14.8 | 21.1 | 17.9 | 16.3 | 12.8 | 8.8 | 8.6 |
| Canada | 9.5 | 11.2 | 12.1 | 9.3 | 4.5 | 3.8 | 3.7 |
| Sweden | 12.7 | 14.1 | 9.2 | 9.6 | 9.2 | 8.2 | 7.9 |
| Netherlands | 5.1 | 6.7 | 7.2 | 4.3 | 3.0 | 2.8 | 2.4 |
| Belgium | 6.3 | 7.6 | 8.1 | 8.1 | 7.2 | 5.3 | 5.7 |
| Switzerland | 1.1 | 4.4 | 6.6 | 5.5 | 2.1 | 2.9 | 3.9 |
| *Group of Ten countries*[2] | 7.2 | 11.4 | 9.1 | 5.2 | 4.5 | 4.1 | 3.9 |

[1] Change from March 1984. [2] Consumer expenditure weights and exchange rates of the preceding year.

rising exchange rate, consumer prices again rose by 4 per cent., much the same as during the previous two years. And in Japan, although there was, technically, some slight acceleration in the rate of price increase, the absolute figure remained very low.

In Europe, of course, exchange rate factors tended to work in the opposite direction from those in the United States. Nevertheless, especially among those countries with above-average inflation rates and/or which had tended to begin their recoveries late or slowly, further disinflationary progress was sometimes quite marked. For example, as the table shows, in both Italy and France inflation declined noticeably last year and, especially in the French case, at a more rapid rate than during the previous year.

One way of attempting to assess inflation performance during the recovery process is to compare it with price developments during the equivalent phase of previous cycles. The figures for previous cycles shown in the table overleaf refer, for the majority of countries, to the two upswings of 1971–73 and 1975–77 and to a representative upswing of the late 1960s. The first two are, of course, influenced by the price effects of the first oil and commodity price shock — though in opposite directions. The 1971–73 period led up to a big external price shock; but the 1975–77 one was accompanied for a time by declining non-oil commodity prices.

Looking first at the change in the inflation rate — its acceleration or deceleration — since the beginning of the upturn, the table shows, not surprisingly, that on this occasion inflation performance has improved, in some cases dramatically. Previously it had tended to worsen slightly during the first two years of recovery, although, at only 1½ percentage points, the average difference is not great. Indeed, on this comparison, the US inflation performance has not been quite

Consumer price performance in a cyclical context.

| Countries | Current cycle | | | Average of three previous cycles[1] | | |
|---|---|---|---|---|---|---|
| | Inflation rate at beginning of cycle | Inflation rate after 2 years | Change in inflation rate over 2 years | Inflation rate at beginning of cycle | Inflation rate after 2 years | Change in inflation rate over 2 years |
| | in percentages per annum | | | | | |
| United States | 3.9 | 4.0 | 0.1 | 5.9 | 5.3 | − 0.6 |
| Japan | 1.8 | 2.6 | 0.8 | 7.8 | 9.7 | 1.9 |
| Germany | 4.6 | 2.0 | − 2.6 | 4.5 | 4.6 | 0.1 |
| France | 9.7 | 6.7 | − 3.0 | 6.5 | 7.9 | 1.4 |
| United Kingdom | 5.4 | 4.6 | − 0.8 | 12.5 | 12.2 | − 0.3 |
| Italy | 16.3 | 8.8 | − 7.5 | 9.1 | 15.7 | 6.6[2] |
| Canada | 9.3 | 3.8 | − 5.5 | 5.2 | 6.0 | 0.8 |
| Sweden | 9.6 | 8.2 | − 1.4 | 10.0 | 8.7 | − 1.3[3] |
| Netherlands | 4.3 | 2.8 | − 1.5 | 7.0 | 7.7 | 0.7 |
| Belgium | 8.1 | 5.3 | − 2.8 | 7.1 | 6.5 | − 0.6 |
| Switzerland | 5.5 | 2.9 | − 2.6 | 4.9 | 2.5 | − 2.4[3] |
| Group of Ten countries[4] | 5.2 | 4.1 | − 1.1 | 6.6 | 7.1 | 0.5 |

[1] As defined in the table on page 17. For Belgium, the Netherlands and Switzerland, the first cycle is taken to date from the second quarter of 1975. The starting dates for the second cycle were: Belgium and the Netherlands, fourth quarter 1971; and Switzerland, second quarter 1968. For the third cycle the dates were: Belgium, fourth quarter 1967; and the Netherlands, second quarter 1967. [2] Acceleration particularly influenced by the first oil price shock. [3] Two cycles only. [4] 1982 GNP weights and exchange rates for the current cycle and 1973 weights for earlier cycles.

as good as the marginal decline recorded previously at this stage. On the other hand, in Canada, where recovery has also been quite strong, a large decline in inflation has been registered on this occasion.

In Europe inflation has on the whole tended to decline more rapidly during the present upswing; and although the later and more restrained nature of the recovery has presumably been a factor here, budgetary and labour-market policies have almost certainly also played an important rôle.

The significance of any particular acceleration or deceleration of inflation is not, however, independent of the level from which it starts. And in the latest cycle the starting-point was on average somewhat lower than in the three previous cycles, early progress in bringing down inflation having been seen especially in the United Kingdom and (even earlier) in Japan, but also in the Netherlands and the United States itself.

This, combined with the fact that some of the larger declines in inflation were recorded where they were most needed, implies that the overall inflationary situation at the end of the first two years of recovery was clearly superior to that at comparable points in the relatively recent past. On average, in the Group of Ten countries at the end of last year inflation was running at a rate some 3 percentage points lower than the previous norm for this stage of the cycle.

*Commodity prices, exchange rates and import prices.* Taking the industrial countries as a whole, 1984 was again a year of comparatively little international price pressure. The official price of crude oil had already been reduced early in 1983, and it fell again early this year. Other commodity prices had picked up during 1983 —

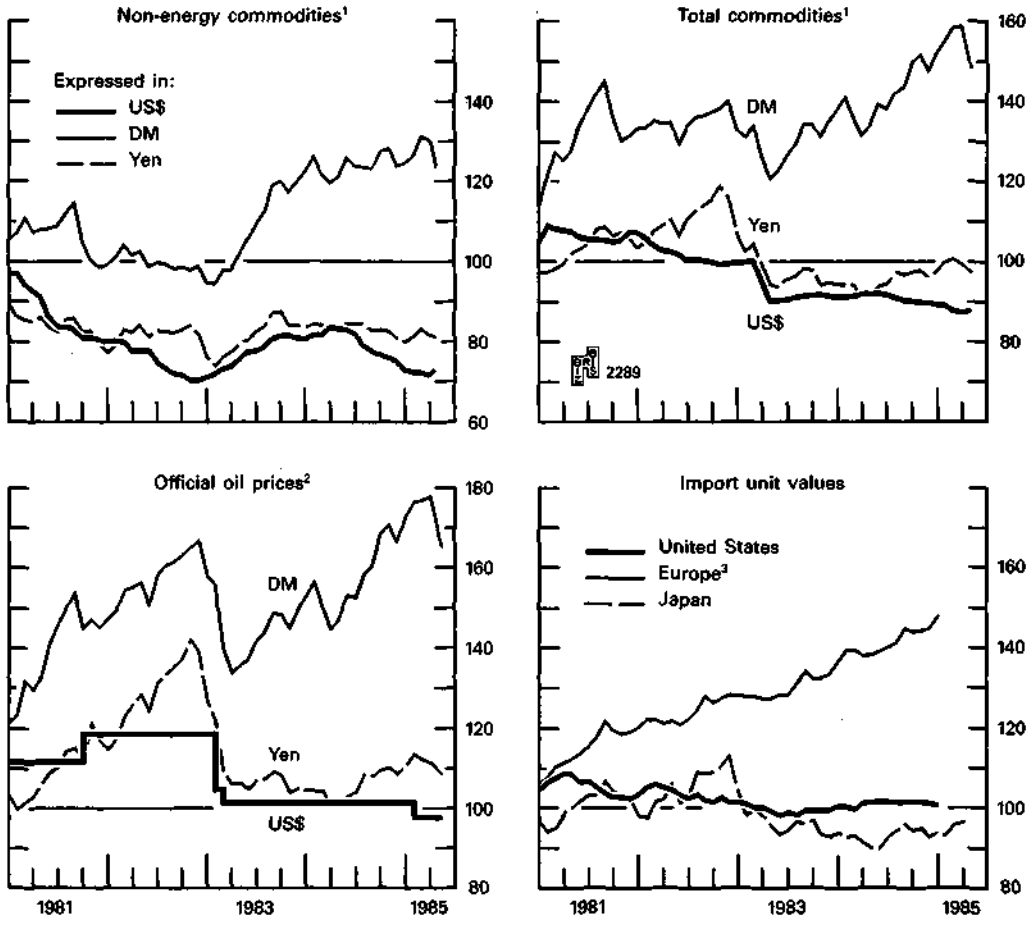
though at a much more subdued rate than during some previous cycles — but from the middle of last year they began, somewhat surprisingly, to weaken again. By the end of the year these prices, in dollar terms, had fallen by nearly 10 per cent., thus reversing much of the previous year's increase.

Nevertheless, with the dollar continuing to rise strongly, the benefits of this situation were not equally shared. In the United States import prices rose by only 1½ per cent. over the year to the fourth quarter and, indeed, were then 2 per cent. below their level at the end of 1980. In Japan, where oil weighs relatively heavily in imports, import prices actually fell on average last year. But in Europe import costs showed noticeable increases last year — in nearly all cases greater than the overall rate of inflation.

As the table overleaf suggests, the movement of exchange rates is, of course, an important part of the explanation of differing international price pressures on individual countries, particularly in the years 1980–84. Even so, the difference

Commodity prices and import unit values.

Indices: 1980 = 100.




¹ HWWA US dollar-based index. ² Arabian light crude. ³ Comprises Belgium, France, Germany, Italy, the Netherlands, Sweden, Switzerland and the United Kingdom.

Contribution of
exchange rate and commodity price movements to changes in import prices.[1]

| Countries | 1976–80 | | | | 1980–84 | | | |
|---|---|---|---|---|---|---|---|---|
| | US dollar exchange rate[2] | Oil and non-oil commodity prices[3] | Other factors[4] | Total import prices | US dollar exchange rate[2] | Oil and non-oil commodity prices[3] | Other factors[4] | Total import prices |
| | as an average annual percentage | | | | | | | |
| United States | 1.5 | 3.6 | 10.4 | 15.5 | – 6.6 | – 1.0 | 7.0 | – 0.6 |
| Japan | – 6.2 | 8.3 | 6.3 | 8.4 | 3.1 | – 2.0 | – 1.6 | – 0.5 |
| Germany | – 2.1 | 4.3 | 5.5 | 7.7 | 4.6 | – 1.6 | 1.4 | 4.4 |
| France | – 1.5 | 4.6 | 6.2 | 9.3 | 10.5 | – 1.8 | 2.7 | 11.4 |
| United Kingdom | – 2.7 | 4.7 | 6.6 | 8.6 | 5.6 | – 1.9 | 6.1 | 9.8 |
| Italy | 0.8 | 6.8 | 9.7 | 17.3 | 13.7 | – 2.4 | 1.9 | 13.2 |
| Canada | 3.6 | 2.0 | 9.4 | 15.0 | 2.3 | – 0.6 | 1.4 | 3.1 |
| Belgium | – 1.4 | 3.1 | 6.0 | 7.7 | 6.0 | – 1.2 | 6.4 | 11.2 |
| Netherlands | – 1.3 | 4.2 | 4.8 | 7.7 | 3.7 | – 1.5 | 3.1 | 5.3 |
| Sweden | 0.2 | 4.1 | 9.8 | 14.1 | 7.1 | – 1.3 | 3.8 | 9.6 |
| Switzerland | – 3.0 | 2.8 | 3.5 | 3.3 | 3.5 | – 1.4 | 0.0 | 2.1 |

[1] Calculated on the basis of estimated equations for import unit values. [2] Nominal exchange rates except for the United States (index of effective rates). [3] HWWA US dollar-based index. [4] Including average inflation in major industrial countries, country-specific trend factors and carry-over effects from earlier periods.

between import price increases in Europe and the United States may well give an exaggerated impression of the potential *absolute* effect of the dollar's rise on European inflation. Two mitigating factors may have been at work. Firstly, dollar commodity prices may themselves have been reduced to some extent as a result of the increase in the international value of their numeraire. And secondly, especially as domestic cost developments were apparently permitting some rebuilding of margins in Europe, some external cost increases may have been partially absorbed rather than being passed on in full into final prices.

Nevertheless, European countries tended to feel some degree of external cost pressure during the period under review, pressure which possibly led to a slightly more restrained policy stance than might otherwise have been appropriate given domestic cost performance.

*Wages and labour costs.* It was particularly noteworthy that, for most countries, developments in 1984 either consolidated or took further the sizable improvement in domestic cost behaviour already seen in 1983. In this area, the break from the experience of the last fifteen to twenty years is now sharper than for overall price performance. And if this cost improvement could be maintained beyond the period of necessary rebuilding of profit margins, the prospects for establishing a much less inflationary medium-term environment would clearly be substantially enhanced.

The two important contributors to unit labour cost developments are nominal wages and labour productivity. However, it is worth noting that in some countries, as part of the overall attempt to rein back public expenditure growth and tax burdens, some reductions have also been made in, for example, social charges which also figure in employment costs.

Industrial wage costs and wholesale prices.

| Countries | Years | Nominal wages[1] | Productivity[2] | Unit labour costs[3] | Wholesale prices[4] |
|---|---|---|---|---|---|
| | | percentage changes, fourth quarter to fourth quarter | | | |
| United States | 1982 | 7.2 | 1.3 | 5.8 | 3.7 |
| | 1983 | 3.9 | 3.9 | 0.0 | 0.8 |
| | 1984 | 4.3 | 2.4 | 1.8 | 1.7 |
| Japan | 1982 | 5.2 | – 1.4 | 6.8 | 1.6 |
| | 1983 | 3.4 | 9.8 | – 5.8 | – 3.3 |
| | 1984 | 4.2 | 8.3 | – 3.8 | 0.5 |
| Germany | 1982 | 5.1 | 0.6 | 4.4 | 3.2 |
| | 1983 | 3.8 | 7.4 | – 3.3 | 0.8 |
| | 1984 | 3.0 | 3.9 | – 0.9 | 1.3 |
| France | 1982 | 13.1 | 3.2 | 9.6 | 8.5 |
| | 1983 | 10.5 | 3.1 | 7.2 | 14.6 |
| | 1984 | 6.5 | 3.6 | 2.8 | 10.5 |
| United Kingdom | 1982 | 9.2 | 3.6 | 5.4 | 6.5 |
| | 1983 | 9.7 | 9.0 | 0.7 | 5.6 |
| | 1984 | 8.4 | 2.5 | 5.8 | 6.1 |
| Italy | 1982 | 15.5 | – 1.8 | 17.6 | 12.4 |
| | 1983 | 15.3 | 2.8 | 12.2 | 9.1 |
| | 1984 | 8.0[5] | 7.5[5] | 0.5[5] | 8.8 |
| Canada | 1982 | 9.2 | 0.6 | 8.5 | 4.5 |
| | 1983 | 4.8 | 12.6 | – 7.0 | 3.5 |
| | 1984 | 5.0 | 8.6 | – 3.2 | 3.7 |
| Sweden | 1982 | 6.1 | 0.6 | 5.5 | 12.1 |
| | 1983 | 9.2 | 10.2 | – 0.9 | 9.9 |
| | 1984 | 11.0[5] | 7.5[5] | 3.2[5] | 7.8 |
| Netherlands | 1982 | 6.5 | 0.9 | 5.5 | 4.7 |
| | 1983 | 1.6 | 8.9 | – 6.7 | 2.0 |
| | 1984 | 2.0 | 8.2 | – 5.7 | 3.9 |
| Belgium | 1982 | 4.6 | 3.0 | 1.5 | 6.2 |
| | 1983 | 8.3 | 6.0 | 2.2 | 9.0 |
| | 1984 | 7.0[5] | 6.1[5] | 0.8[5] | 3.1 |
| Switzerland | 1982 | 5.7 | 1.2 | 4.4 | 1.4 |
| | 1983 | 3.1 | 4.9 | – 1.7 | 0.9 |
| | 1984 | 1.5 | 2.0 | – 0.5 | 3.3 |
| Group of Ten countries[6] | 1982 | 7.7 | 0.9 | 6.7 | 4.5 |
| | 1983 | 5.5 | 6.0 | – 0.5 | 2.4 |
| | 1984 | 4.8 | 4.3 | 0.5 | 3.0 |

[1] For the United States, Italy, Sweden and Belgium, total labour costs; for other countries, wages and salaries or earnings. [2] For Japan, the United Kingdom, Italy, Canada, the Netherlands and Switzerland, output per person; for other countries, output per hour. [3] Calculated from nominal wages and productivity. [4] For France, industrial products; for the United States, the United Kingdom, Sweden and the Netherlands, producer prices; for other countries, general index of wholesale prices. [5] Third quarter. [6] GDP weights and exchange rates of the preceding year.

The table shows that an important part of the improvement in cost performance over the past year or more has come from moderate nominal wage behaviour. Sweden is perhaps the major exception, where last year the Government experienced difficulties in its attempt to bring the two sides of industry to a satisfactory wage agreement. In Italy and France a further, and necessary, decline in the rate of wage settlements occurred as, in the former case, attempts to modify the indexation system were pursued further and, in the latter case, efforts continued to influence overall wage developments rather more indirectly via the activities of the National Price Commission and restraint on public-sector wages. In the United Kingdom, however, some disappointment was apparent at the failure of nominal

wage increases to decelerate further and more definitely, especially in the light of the unemployment situation.

Given these nominal wage developments, the more spectacular unit cost performances tended to be demonstrated by those countries which enjoyed particularly good productivity growth. For most countries such high rates of productivity growth no doubt contain a purely cyclical element which cannot be relied on for the medium term. Nevertheless, a decline to more sustainable rates of productivity growth might be offset in part — so far as prices are concerned — by the completion of the profit margin rebuilding process. If so, for those countries where nominal wage increases are already down to relatively low figures, this could imply that a satisfactory inflation performance in the longer run would require only the maintenance of the current degree of nominal wage moderation. Elsewhere, however, notably in Italy, Sweden, France and the United Kingdom, further nominal wage deceleration would seem to be required if inflation is to be held in check satisfactorily.

## Employment and unemployment.

After declining at an unusually rapid pace in 1983 unemployment in the United States fell more slowly last year, from about 8½ to just over 7 per cent. between fourth quarters. With European unemployment rates continuing to drift upwards on average, the overall rate of unemployment among the industrial countries fell only marginally further during the course of last year.

Unemployment.

| Countries | 1974 | 1976 | 1979 | 1981 | 1982 | 1983 | 1984 | 1985 March |
|---|---|---|---|---|---|---|---|---|
| | annual averages, as a percentage of the labour force | | | | | | | |
| United States | 5.6 | 7.7 | 5.8 | 7.6 | 9.7 | 9.6 | 7.5 | 7.3 |
| Japan | 1.4 | 2.0 | 2.1 | 2.2 | 2.4 | 2.6 | 2.7 | 2.6 |
| Germany | 2.6 | 4.6 | 3.8 | 5.5 | 7.5 | 9.1 | 9.1 | 9.4 |
| France | 2.3 | 4.3 | 6.0 | 7.8 | 8.8 | 9.0 | 10.2 | 10.6 |
| United Kingdom | 2.6 | 5.2 | 5.1 | 9.9 | 11.6 | 12.4 | 12.6 | 13.0 |
| Italy | 5.4 | 6.7 | 7.7 | 8.5 | 9.1 | 9.9 | 10.4 | 10.6[1] |
| Canada | 5.3 | 7.1 | 7.5 | 7.6 | 11.0 | 11.9 | 11.3 | 11.2 |
| Sweden | 2.0 | 1.6 | 2.1 | 2.5 | 3.1 | 3.5 | 3.1 | 3.0 |
| Netherlands[2] | 3.3 | 5.5 | 5.1 | 9.1 | 12.6 | 17.0 | 17.2 | 16.0 |
| Belgium | 3.0 | 6.4 | 8.2 | 10.9 | 12.8 | 14.1 | 14.2 | 14.2 |
| Switzerland | 0.0 | 0.7 | 0.3 | 0.2 | 0.4 | 0.8 | 1.1 | 1.1 |
| Group of Ten countries | 3.7 | 5.5 | 5.0 | 6.6 | 8.2 | 8.6 | 8.0 | 8.0 |

[1] First week of January. [2] New series as from January 1983.

While US experience during the current cycle has clearly been unique, unemployment has also fallen, more modestly, from its latest peak in Canada, Sweden and, during the course of 1984, in Italy and the Netherlands. In Germany,

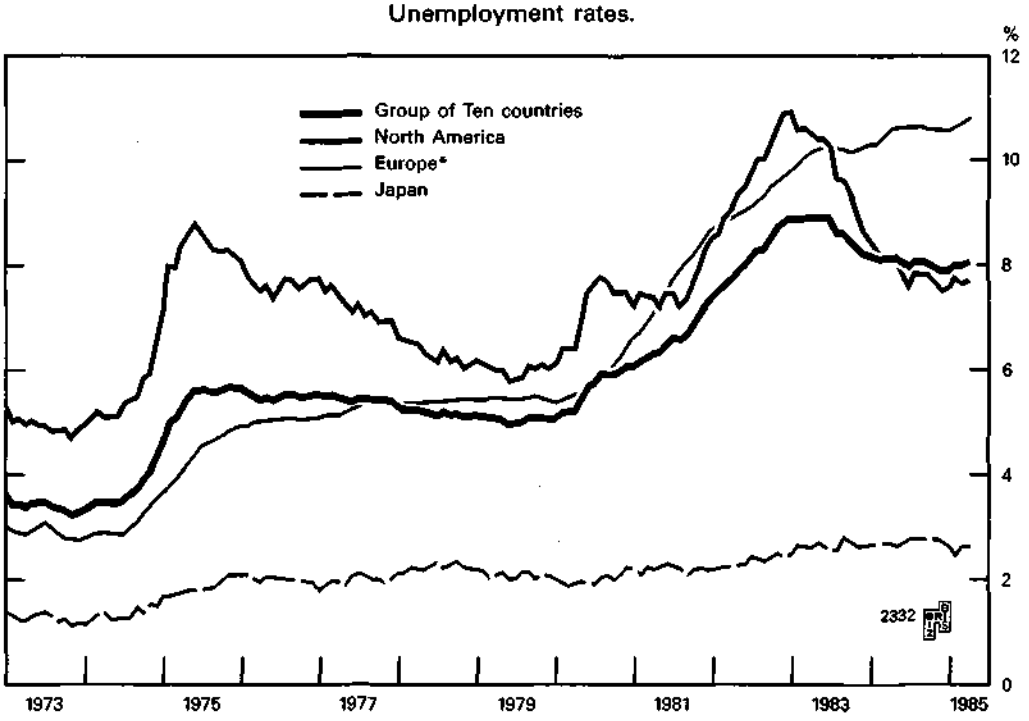
too, a mild downward trend apparently set in in mid-1983 but was interrupted early last year; and a renewed decline at the end of the year was again interrupted in January 1985, no doubt largely as a result of the unusually severe weather conditions then obtaining. Perhaps more encouraging is the fact that after three to four years of decline, total employment in Germany began to rise again in the middle of last year.

In the United Kingdom the total employed labour force has been rising more strongly and for a longer period. An appreciable part of the rise has been due to an increase in self-employment but there has also been a significant rise in the part-time employment of married women not previously on the unemployment register. In France, too, unemployment continued to rise during the period under review, though here the reason was no doubt France's relatively late start on the recovery process.

In Japan, where rather different organisational features obtain in the labour market, unemployment has remained at a relatively low level, even though the recovery has apparently so far stimulated a somewhat greater rise in labour force participation than in employment.

In sum, recent unemployment performance exhibits some encouraging features. Nevertheless, in Europe unemployment remains exceptionally high, and may not fall appreciably for some time. This has given rise to the suggestion from some quarters that European policy-makers should follow more closely the kind of supply-side policy package which the United States has introduced. However,

Unemployment rates.




* Comprises Belgium, France, Germany, Italy, the Netherlands, Sweden, Switzerland and the United Kingdom.

irrespective of the advantages and disadvantages of such an approach for the United States, it is far from clear that it would be appropriate elsewhere. Diagnosis of the causes of unemployment in Europe is both difficult and controversial. For, while it is true that short-term movements in aggregate demand and output do seem to exert a noticeable influence on the unemployment figures, such a conclusion does not necessarily rule out the possibility that other, longer-term, structural factors have also been at work or, indeed, that such factors may by now be dominant. If this is so, the analysis of the present unemployment problem would need to be set in a wider and longer-term context with the implication, too, that any solution to the problem is likely to require both time and a broader array of policy approaches than was once the norm.

*The growth of unemployment in a medium-term perspective.* The fact that, conceptually, unemployment can be thought of simply as the difference between the supply of and demand for labour offers a convenient starting-point for analysis. Taking first the supply side, potentially the most fundamental longer-run factor would of course seem to be the growth of the total population. In fact, however, population growth has, if anything, tended to slow down slightly in the industrialised world since 1973. Two other factors have, though, proved to be more important, namely changes in the age structure of the population and changes in rates of participation, particulary those of women.

As the so-called post-war "baby boom" generation has matured, the growth in the population of working age has tended to outstrip that in the population as a whole. The phenomenon first appeared in North America and has by now passed its peak there. In Europe, however, it has come later; indeed, it probably reached its peak during the early 1980s. For Europe especially, this development has of course been most unfortunately timed, coinciding as it has done with the worst recession experienced since the war.

The labour force implications of the growth in the population of working age depend on the proportion of that segment of the population which chooses to seek work. And here the virtually universal increase in the proportion of women of working age seeking employment would seem at first sight to be a dominant factor. In North America, for example, between 1968–73 and 1979–82 female participation rates rose from 41 per cent. to 58 per cent. in Canada and from 50 per cent. to 62 per cent. in the United States. In Sweden the rate has risen to as much as 75 per cent. Elsewhere, however, the rise has not been so steep.

These comparatively more moderate changes in female participation rates in Europe have to some extent offset the differential developments in the population of working age. In addition, however, male participation rates have tended to fall in Europe as compared with North American and Japanese experience. No doubt in the period since 1979 some of this decline has been cyclical — due to the so-called "discouraged worker" effect. And the same may have been true, to a lesser degree, even in the 1973–79 period when European employment conditions did little better than stabilise. Government measures, for example to encourage early retirement, have probably also exerted an influence. In the cases of Switzerland and Germany in particular the decline in male participation was also in part a reflection of the net

The labour force, employment and unemployment.

| Countries | Years | Total population | Population aged 15–64 | Participation rates[1] | | | Labour force | Total employment | Unemployment rate (end of period)[2] |
|---|---|---|---|---|---|---|---|---|---|
| | | | | men | women | total | | | |
| | | percentage changes per annum, or percentages | | | | | | | |
| United States .... | 1968–73 | 1.1 | 1.8 | 90.0 | 50.1 | 69.7 | 2.4 | 2.1 | 4.8 |
| | 1973–79 | 1.0 | 1.7 | 88.4 | 55.7 | 71.8 | 2.6 | 2.5 | 5.8 |
| | 1979–82 | 1.0 | 1.2 | 87.9 | 61.8 | 74.6 | 1.6 | 0.3 | 9.5 |
| Canada ..... | 1968–73 | 1.3 | 2.3 | 87.3 | 41.4 | 64.2 | 3.1 | 2.8 | 5.5 |
| | 1973–79 | 1.3 | 2.2 | 87.0 | 50.0 | 68.4 | 3.2 | 2.9 | 7.4 |
| | 1979–82 | 1.2 | 1.6 | 87.2 | 58.3 | 72.7 | 2.1 | 0.8 | 10.9 |
| Japan ..... | 1968–73 | 1.5 | 1.2 | 89.6 | 54.8 | 71.9 | 1.0 | 1.0 | 1.3 |
| | 1973–79 | 1.1 | 0.8 | 89.5 | 53.0 | 71.0 | 0.8 | 0.7 | 2.1 |
| | 1979–82 | 0.7 | 0.8 | 89.1 | 55.3 | 72.1 | 1.0 | 1.0 | 2.4 |
| Germany ..... | 1968–73 | 0.8 | 0.8 | 91.5 | 48.4 | 69.2 | 0.7 | 0.7 | 1.0 |
| | 1973–79 | – 0.2 | 0.3 | 86.7 | 49.5 | 67.4 | – 0.2 | – 0.6 | 3.3 |
| | 1979–82 | 0.2 | 1.4 | 82.8 | 50.0 | 66.2 | 0.7 | – 0.5 | 6.7 |
| France ..... | 1968–73 | 0.9 | 0.9 | 87.3 | 49.8 | 68.3 | 1.2 | 1.0 | 2.6 |
| | 1973–79 | 0.4 | 0.7 | 85.0 | 53.1 | 68.0 | 0.8 | 0.2 | 5.9 |
| | 1979–82 | 0.5 | 1.1 | 82.0 | 56.8 | 68.8 | 0.5 | – 0.2 | 8.0 |
| United Kingdom . | 1968–73 | 0.3 | 0.0 | 93.4 | 53.4 | 73.4 | 0.2 | 0.2 | 2.2 |
| | 1973–79 | 0.0 | 0.3 | 90.7 | 57.8 | 74.0 | 0.6 | 0.2 | 4.6 |
| | 1979–82 | 0.0 | 0.4 | 88.8 | 59.5 | 74.1 | 0.2 | – 1.9 | 10.4 |
| Italy ..... | 1968–73 | 0.7 | 0.4[3] | 82.2 | 29.0 | 55.0 | – 0.1 | – 0.2 | 6.2 |
| | 1973–79 | 0.6 | 0.8[3] | 80.3 | 31.2 | 55.7 | 1.2 | 1.0 | 7.5 |
| | 1979–82 | 0.2 | 0.8[3] | 80.5 | 40.2 | 59.7 | 1.0 | 0.5 | 8.9 |
| Sweden ..... | 1968–73 | 0.6 | 0.2 | 90.2 | 60.5 | 75.9 | 0.8 | 0.7 | 2.5 |
| | 1973–79 | 0.3 | 0.1 | 90.4 | 68.9 | 79.7 | 1.2 | 1.3 | 2.1 |
| | 1979–82 | 0.1 | 0.4 | 89.0 | 75.1 | 82.5 | 0.7 | 0.3 | 3.1 |
| Netherlands ..... | 1968–73 | 1.1 | 1.3 | 89.1 | 28.3 | 58.9 | 0.6 | 0.5 | 2.2 |
| | 1973–79 | 0.7 | 1.4 | 81.4 | 31.7 | 56.8 | 1.1 | 0.5 | 5.4 |
| | 1979–82 | 0.6 | 1.3 | 80.0 | 37.2 | 58.9 | 3.3 | 1.1 | 11.4 |
| Belgium ..... | 1968–73 | 0.2 | 0.4 | 86.0 | 40.8 | 63.3 | 1.0 | 1.1 | 2.2 |
| | 1973–79 | 0.2 | 0.7 | 82.8 | 45.2 | 63.8 | 0.9 | 0.0 | 7.1 |
| | 1979–82 | 0.1 | 0.1 | 80.4 | 48.0 | 64.1 | 0.3 | – 1.2 | 11.2 |
| Switzerland[4] ..... | 1968–73 | 1.0 | 0.8 | 103.4 | 52.5 | 77.5 | 1.1 | 1.1 | . |
| | 1973–79 | – 0.2 | 0.2 | 97.2 | 49.6 | 73.4 | – 1.2 | – 1.3 | 0.3 |
| | 1979–82 | 0.6 | 1.2 | 93.1 | 50.0 | 71.4 | 0.8 | 0.8 | 0.4 |

[1] Averages for the periods 1968–73, 1974–79, 1980–82. [2] Defined as total number of unemployed as a percentage of the total labour force, which may differ from national definitions as used in the table on page 26. [3] Population aged between 14 and 64 years. [4] Foreign seasonal workers included in the labour force but not in population data.

Sources: OECD Historical Statistics; OECD Labour Force Statistics.

return migration of guest workers to their home countries, particularly during the inter-oil-shock period.

The net result of demographic, participation and migration effects is the change in the labour force itself. The overall situation by major region is summarised in the table overleaf, which also demonstrates the difficulty of assessing the precise rôle of labour force movements in the rise in unemployment. As the table shows, the two possible points of comparison — namely a country's previous history and contemporary developments elsewhere — lead to conflicting conclusions. For example, throughout the period covered, European labour force growth has been appreciably slower than that in the United States (and slower still than that in

Canada), suggesting if anything an inverse correlation between labour force growth and the unemployment problem. On the other hand, compared with its own history — which is perhaps the more instructive comparison — recent European labour force growth has been relatively high, though in the first phase, 1968–73, this was not accompanied by a serious deterioration in the unemployment situation.

**Broad trends in labour supply and demand, 1960–84.**

| Countries/area | Years | Growth of | | | | Unemployment rates[2] |
|---|---|---|---|---|---|---|
| | | total labour force | output | productivity | total employment[1] | |
| | | in percentages per annum | | | | in percentages |
| United States ..... | 1960–68 | 1.6 | 4.6 | 2.7 | 1.8 | 5.5 |
| | 1968–73 | 2.4 | 3.5 | 1.4 | 2.1 | 3.6 |
| | 1973–82 | 2.3 | 1.9 | 0.1 | 1.8 | 4.9 |
| | 1983 | 1.2 | 3.7 | 2.4 | 1.3 | 9.7 |
| | 1984[3] | 1.8 | 6.9 | 2.6 | 4.2 | 7.5 |
| OECD Europe ..... | 1960–68 | 0.3 | 4.7 | 4.5 | 0.2 | 2.9 |
| | 1968–73 | 0.7 | 4.9 | 4.3 | 0.6 | 3.4 |
| | 1973–82 | 0.8 | 1.9 | 1.9 | 0.0 | 3.5 |
| | 1983 | 0.5 | 1.3 | 1.9 | – 0.5 | 9.2 |
| | 1984[3] | 0.4 | 2.5 | 2.7 | – 0.2 | 10.7 |
| Japan ..... | 1960–68 | 1.4 | 10.5 | 8.9 | 1.5 | 1.7 |
| | 1968–73 | 1.0 | 8.8 | 8.1 | 1.0 | 1.2 |
| | 1973–82 | 0.9 | 3.8 | 3.0 | 0.8 | 1.3 |
| | 1983 | 2.0 | 3.4 | 1.7 | 1.7 | 2.4 |
| | 1984[3] | 0.5 | 5.7 | 5.1 | 0.5 | 2.7 |

[1] Including armed forces. [2] Selected years: 1960, 1968, 1973, 1982, 1984. [3] Preliminary.

At all events, when account is taken both of the fact that the North American unemployment situation is not as severe as that in Europe despite a period of more rapid labour force growth, and of the contrary implications of the historical comparison within Europe, it is clear that some consideration of demand-side developments is also required.

*Employment.* On the demand side, too, one must take greater account of the price of labour as a possible factor contributing to unemployment. Probably the most striking fact in this area is the well-known comparison between North American and European employment performance. Over the whole period since 1973 the number of jobs in both Canada and the United States has risen by around one-quarter. In Europe there has, on average, been no increase at all.

This contrast can be explained — arithmetically — in the following rather striking way. In the United States an average growth rate of the labour force of something over 2 per cent. per annum has been combined with an average rate of productivity growth of only ½ per cent. per annum. Hence, the rate of growth of output needed to keep the growth of employment in line with that of the labour force was about 2½ per cent. per annum, virtually identical — for the period as a whole — to the recorded result.

In Europe labour force growth has averaged only 3/4 per cent. per annum, but, with productivity growth at nearly 2 per cent., the required rate of output growth was over 2 1/2 per cent. per annum — that is, only slightly higher than that in the United States. The difference is that the rate achieved in Europe fell short of this required rate by a little over 3/4 per cent. per annum. However, this does not necessarily mean that employment growth in Europe could have matched that of the labour force with a rate of productivity increase 3/4 per cent. per annum or so less than it actually was — that is, closer to the US result. The need to improve efficiency and competitiveness in Europe was pressing.

It is not obvious either that demand and output growth should, or even could, have been stimulated. There is first the question of what might have been the consequences for Europe's external accounts — something which might be particularly relevant when the bulk of the counterpart to the US deficit is to be found outside Europe. More fundamentally, as the table below illustrates, by comparison with the United States there is an important sense in which European demand growth has in any case been relatively high. Even over the last two years of sharp decline in unemployment in the United States, nominal demand in Europe has grown at almost precisely the same rate on average as it has there. The difference is that much more of this growth went into real output — and much less into price rises — in the United States.

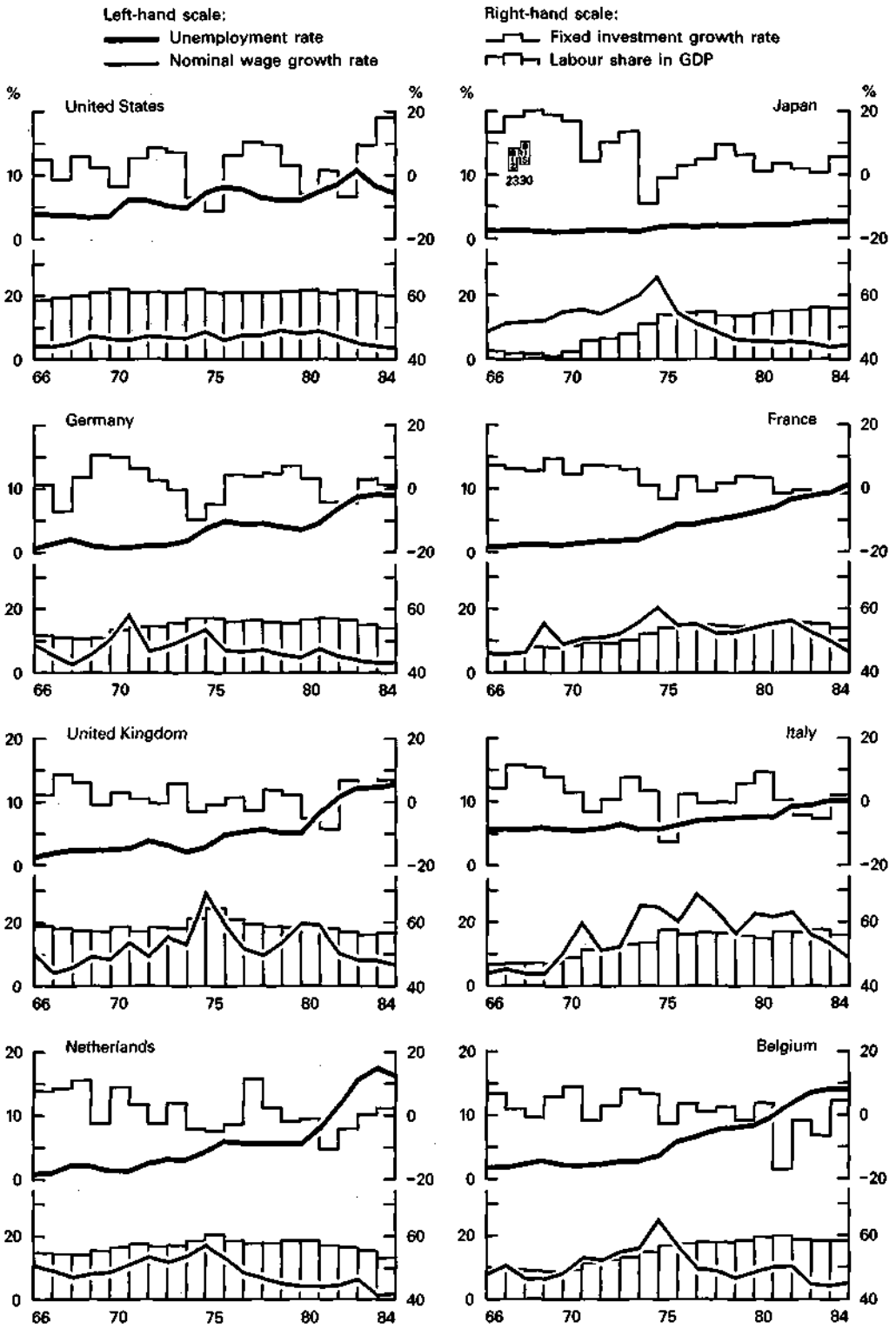
Nominal and real GNP growth.

| Countries/area | Items | 1968–73 | 1973–79 | 1979–82 | 1982–84 | 1973–84 |
|---|---|---|---|---|---|---|
| | | percentage growth per annum | | | | |
| United States ..... | Nominal GNP | 8.7 | 10.5 | 8.3 | 9.3 | 9.7 |
| | Real GNP | 3.5 | 2.8 | 0.0 | 5.3 | 2.5 |
| OECD Europe ..... | Nominal GNP | 12.2 | 14.1 | 15.5 | 9.5 | 13.6 |
| | Real GNP | 4.9 | 2.5 | 0.7 | 1.9 | 1.9 |
| Japan ..... | Nominal GNP | 16.3 | 11.7 | 6.6 | 5.1 | 9.1 |
| | Real GNP | 8.8 | 3.6 | 4.0 | 4.5 | 3.9 |

It is almost certainly in the factors making for this adverse nominal demand "split" that the fundamental sources of slow growth and high unemployment in Europe are to be found. The list of such factors is a long one, but it consists basically of a whole set of rigidities in the labour market itself, inflation and — partly as a result — a lack of incentives to enterprise and effort in the private sector of the economy. Perhaps one of the most important manifestations of the problem has been seen in wages and labour costs.

It is not just that wages were not sufficiently flexible in the face of the real income losses inevitably implied by sharp rises in the price of a crucial imported commodity. Nominal wage behaviour had itself already become an important source of inflationary cost pressures — especially in the late 1960s. Consequently, once it became imperative to rein back inflation generally, there was always the risk that one of its most important components would not respond sufficiently, or in a sufficiently rapid manner.

Unemployment, wages and fixed investment growth.



In addition to the nominal wage phenomenon, many observers have also pointed recently to the behaviour of real wage costs and their implications for profitability. The relevant magnitude here is the cost to the employer, a cost which in many cases has included sharply rising social charges made necessary by rapidly expanding public expenditures. Hiring and — especially — firing costs have also increased as a result of various changes in employment-related legislation. The result, for many countries, can be seen in a rising share of total employee remuneration in national income. And, as the graph on page 32 shows, just as nominal wage inflation in the United States did not reach some of the extremes seen in parts of Europe, neither did labour's share in national income increase so sharply. The implication drawn by many observers is that US wage behaviour has been relatively flexible and more appropriately adapted to employment needs. In this respect the situation has probably been even more favourable in Japan.

Finally, nominal and real wage phenomena have almost certainly combined to reduce sharply the rate of growth of fixed investment, as the graph also illustrates. From this perspective the overall growth slowdown has probably come to feed on itself to some extent. In turn — and again in some contrast with the US situation — the slowdown in the growth of the capital stock no doubt implies now that more of the current unemployment has taken on a structural dimension, and one which it might be difficult to deal with without substantial investment expenditures of a capital-widening nature.

**Fiscal policy and policy mix.**

For some time now there has been a general recognition of the need for greater fiscal discipline. Public-sector deficits have been alarmingly high, especially since 1979, and, despite attempts to curb it, public expenditure growth has tended not to adapt sufficiently to the much slower growth of overall resources since the early 1970s.

Against this background, 1984 was prima facie a year of some contradiction. On the one hand, there was, on average, a more definite decline in general-government deficits as a proportion of GNP following some slippage in 1983. There were signs, too, that public expenditure ratios may at last be coming under better control. On the other hand, in an underlying, or structural, sense the disparity between the fiscal stance in the United States and that in Japan and Europe widened further. At the same time, with nominal interest rates still exceeding nominal GNP growth by several percentage points, especially in Europe, public-sector debt-servicing costs remained on a disturbing upward track.

Thus, in terms of medium-term policy objectives — and despite some apparent progress last year — the fiscal situation remains generally in need of further correction. One of the reasons is, of course, the fact that public expenditure ratios still remain very high relative to previous experience, especially in Europe. But another lies in growth performance. In the United States the decline in the general-government deficit ratio, and that in the public expenditure ratio, naturally owed

General-government budget balances.

| Countries | 1968–73 | 1974–78 | 1979–80 | 1981 | 1982 | 1983 | 1984 |
|---|---|---|---|---|---|---|---|
| | as a percentage of GNP | | | | | | |
| United States | – 0.3 | – 1.4 | – 0.3 | – 0.9 | – 3.8 | – 4.1 | – 3.4 |
| Japan | . | – 3.4 | – 4.1 | – 4.0 | – 3.6 | – 3.5 | – 2.6 |
| Germany | 0.2 | – 3.1 | – 2.9 | – 3.8 | – 3.4 | – 2.8 | – 2.3 |
| France | 0.7 | – 1.1 | – 0.2 | – 1.8 | – 2.5 | – 3.3 | – 3.3 |
| United Kingdom | – 0.6 | – 4.1 | – 3.4 | – 3.1 | – 2.4 | – 3.5 | – 3.9 |
| Italy | – 5.6 | – 9.2 | – 8.7 | –11.8 | –12.7 | –12.4 | –13.8 |
| Canada | 0.9 | – 1.7 | – 2.2 | – 1.6 | – 5.0 | – 6.2 | – 6.4 |
| Sweden | 4.4 | 2.0 | – 3.4 | – 5.0 | – 6.4 | – 4.9 | – 3.5 |
| Netherlands | – 0.1 | – 2.2 | – 3.9 | – 5.4 | – 7.2 | – 6.4 | – 5.8 |
| Belgium | – 4.9[1] | – 7.2 | –10.4 | –16.3 | –14.8 | –15.6 | –13.8 |
| Switzerland | . | . | – 0.6 | – 0.2 | – 0.7 | – 0.9 | – 1.2[2] |

[1] 1970–73. [2] Budget estimate.

much to the automatic effects of strong growth. The structural, or high employment, deficit in fact worsened sharply again. Japan, too, experienced some budgetary improvement as a result of higher growth, but in addition the authorities were evidently able to take further advantage of this situation to continue their efforts towards medium-term fiscal reform.

In Europe, however, the situation was somewhat different. True, real growth accelerated on average, but not yet sufficiently to bring appreciable automatic stabiliser benefits. At the same time, thanks largely to the further decline in inflation, nominal GNP growth hardly accelerated at all; indeed, in some cases it actually declined. Hence, with nominal interest rates tending to remain high, taking the year as a whole, the actual and prospective debt-servicing situation continued to look disturbing, despite the implementation of further retrenchment measures. (Technically, insofar as the average rate of interest on accumulated government borrowing — after allowing for offsetting receipts of tax on interest incomes — exceeds the growth rate of nominal national income, the ratio of interest payments to GNP will — *ceteris paribus* — continue to rise indefinitely. In this case, either the budget deficit itself will grow further or other budgetary expenditures and/or revenues will have to be adjusted — ideally by enough to induce a decline in interest rates and hopefully a modest pick-up in growth. Otherwise, the "adjustment" risks taking the form of an acceleration in inflation and thus, possibly, a lowering of the real burden of public debt.)

*Retrenchment efforts in 1984.* The fact that problems still remain to be solved in the universal attempt to regain control of the fiscal system should not be allowed to obscure the steps which continued to be taken in this direction in 1984.

In the case of the United States, faced with the prospect of a further increase in the so-called current services deficit (from an estimated $225 billion to nearly $250 billion including off-budget items) in the fiscal year ending September 1984, the President had already proposed further expenditure cuts in his budget message

General-government expenditures and interest payments.

| Countries | Total expenditure | | | | | Interest payments | | | |
|---|---|---|---|---|---|---|---|---|---|
| | 1962 | 1973 | 1982 | 1983 | 1984 | 1973 | 1982 | 1983 | 1984 |
| | as a percentage of GNP | | | | | | | | |
| United States | 28.4 | 30.6 | 35.5 | 35.3 | 34.4 | 2.2 | 4.4 | 4.6 | 5.0 |
| Japan | 18.2[1] | 20.9 | 32.4 | 33.0 | 32.5 | 0.9 | 4.0 | 4.4 | 4.6 |
| Germany | 33.6 | 40.1 | 47.7 | 46.7 | 46.5 | 1.1 | 2.8 | 3.0 | 3.0 |
| France | 34.0 | 35.6 | 47.9 | 48.6 | 49.6 | 0.8 | 2.2 | 2.6 | 3.0 |
| United Kingdom | 34.0 | 39.6 | 45.5 | 45.8 | 46.2 | 3.7 | 5.2 | 4.8 | 5.1 |
| Italy | 30.5 | 36.9 | 53.4 | 56.0 | 57.2 | 2.5 | 8.4 | 9.1 | 9.8 |
| Canada | 28.8 | 34.5 | 45.7 | 46.2 | 47.2 | 3.9 | 7.3 | 7.2 | 7.9 |
| Sweden | 31.1 | 44.2 | 67.4 | 67.1 | 65.0 | 1.9 | 7.1 | 7.5 | 7.7 |
| Netherlands | 31.7 | 43.7 | 58.5 | 59.9 | 58.1 | 2.8 | 5.2 | 5.8 | 6.1 |
| Belgium | 30.3 | 38.9 | 59.6 | 59.8 | 58.8 | 3.3 | 9.4 | 9.6 | 9.8 |
| Switzerland[2] | 18.5 | 24.2 | 27.7 | 28.1 | 28.4 | 1.5 | 1.7 | 1.7 | 1.7 |

[1] 1965. [2] Interest payments and 1984 expenditures are estimated.

in early 1983. And while, in the event, the actual deficit was reduced to $185 billion, its growing structural component led Congress to pass the so-called Deficit Reduction Act of 1984. The effects of this are relatively small, however, rising to some $25 billion per annum by 1988. Thus, early this year the President proposed yet further measures, including a selective one-year freeze for many programmes and in cost-of-living adjustments. If enacted — and if the Administration's assumptions about growth and interest rates are accurate — these measures would reduce the Federal deficit from $222 billion in the current fiscal year to $180 billion in 1986 and, eventually, to $82 billion in 1990. Compared with the prospective costs of maintaining current programmes, this represents a set of expenditure reductions whose annual impact would rise from $50 billion in fiscal 1986 to over $100 billion in 1988.

Even so, despite amendments since it was passed, much of the revenue effect of the original Economic Recovery Tax Act of 1981 remains. For example, as compared with the revenues which would have been generated by the pre-1981 tax system in the current fiscal year, actual revenues are likely to be running over $100 billion lower. In the context of a major build-up in defence expenditures and a steep upward curve of interest payments, a very large problem still remains to be tackled by Congress.

Elsewhere, efforts to curb budget expenditure have persisted. In Japan relatively weak domestic demand developments in 1983 had prompted the authorities to relax slightly what had previously been described as the most stringent budget for several decades. But, as the economy picked up momentum, less need was felt last year for such measures. Hence the general-government deficit fell from 3½ to 2½ per cent. of GNP. And for the 1985–86 fiscal year further expenditure restraint is to be implemented; indeed, excluding interest payments and transfers to local authorities, the planned rise in expenditures is the lowest since the end of the war.

In Europe the need to reduce the total burden of public expenditure is seen in many countries to be the first priority, being necessary in its own right and also as a pre-financing of the tax reductions needed to encourage the supply side of the economy. In Germany and the United Kingdom policy is now set in an explicitly medium-term framework, which Belgium is also attempting to emulate. In the case of Germany, as the table shows, a noticeable levelling-out of the expenditure/GNP ratio has now been achieved. And, together with medium-term plans to hold public expenditure growth below output growth, some income tax reductions are envisaged for 1986 and 1988 in the context of yet further declines in the budget deficit ratio.

In the United Kingdom, however, the miners' strike adversely affected both the expenditure and overall deficit ratios last year, although local authority expenditures also overshot their targets. Even so, present plans are to hold the volume of public expenditure constant over the next three years. In the meantime, considerable progress has been made in "privatising" previously publicly-owned enterprises. Fiscal measures have also been aimed at supporting employment, for example through the elimination of the employers' National Insurance surcharge and, more unusually, through the phased ending of capital investment allowances.

In France and Italy, against a background of relatively muted recovery, the turning-point in expenditure ratios has not yet arrived in the aggregate, though it is noteworthy that a sizable proportion of last year's increase, especially in Italy, was due to interest payments. Even so, deficit control attempts have perforce precluded any major progress on tax reduction. In France the previous "solidarity surtax" was replaced by a surcharge on high incomes, and some public works increases were financed by higher levies on petrol. Italy, too, has been unable to avoid some increase in indirect taxation in addition to measures aimed at reducing tax evasion.

However, among the smaller countries, some of which have experienced the most severe fiscal problems, 1984 could mark something of a turning-point. While some increase in taxation has not been avoided entirely, the brunt of retrenchment efforts fell last year on expenditures. In the Netherlands particular restraint is now being applied to transfer expenditures and to the costs of public administration, while in Belgium some switch away from current to capital expenditures of the public sector is also being implemented. In Sweden, which has had one of the highest expenditure ratios of all countries, a particularly large fall in the ratio was achieved last year and a further slight fall even in nominal expenditures is budgeted for this year.

*International aspects of the policy-mix configuration.*That the desire for fiscal retrenchment is universal is clear. Nonetheless, the fiscal situation remains sharply differentiated between the United States and elsewhere. It is not just that doubts remain as to whether, in the United States, the Administration and Congress can find a mutually satisfactory package of expenditure reductions of sufficient magnitude for the future. It is also that, already over the past two to three years, a highly differentiated set of underlying policy stances has wrought major effects on the international economy. The most important of these, namely the US support to demand, has no doubt been beneficial so far. But, accompanied as it has been by an astonishing rise in the dollar and a record US current-account deficit, it is clearly not

something which can be expected to be helpful indefinitely. Indeed, without some major change in the United States, many observers fear that at some point the balance of advantage, both for the United States itself and for the rest of the world, could swing sharply in the opposite direction.

Less apocalyptically, as the growth of net imports into the United States slows down, as it must, it should be possible for monetary authorities, especially in Europe, to return more completely to their desired mix of fiscal and monetary policies. Even in the context of medium-term objectives for budgetary policy and monetary growth, there could be more room for manoeuvre with respect to interest rates. Lower rates can be seen both as an encouragement to investment spending and as part of the remedy for the debt-servicing difficulties which authorities currently face within their overall fiscal problem.

As this chapter has shown, Europe has, in any case, experienced a smaller overall net export stimulus than either Japan or Canada, while at the same time finding itself increasingly vulnerable to the potentially inflationary impact of the dollar's earlier rise. This fact, however, not only placed certain constraints on the behaviour of domestic interest rates; it also served to reinforce the keen perception of European authorities that they were not in a position to risk emulating the US policy-mix example. For them, the reduction of public expenditure has been seen as a vital prerequisite of tax reductions. That is, precisely because of the very high levels of public-sector spending they had concluded that any attempt to stimulate the economy from the fiscal side risked inflaming inflationary expectations, and would thus have proved ineffective anyway.

Given the protracted nature of the expenditure reduction process under way in Europe, it is therefore important that the international demand effects of US policy should not be abruptly reversed as a result of a premature recession. For even if, in circumstances involving a weakening dollar, interest rates elsewhere could then be reduced somewhat, it is not clear that the effect would be sufficiently large in the absence of the taxation reductions which are a longer-term aim of policy. Thus, ideally, a major and early adjustment of US fiscal policy is desirable, together with as rapid a completion as possible of the programme of public expenditure restraint elsewhere. This would facilitate a return to lower interest rates internationally and might in time give European authorities scope for supply-side tax measures when and if these are seen to be appropriate.

# III. THE CHANGING STRUCTURE OF FINANCIAL MARKETS.

**Highlights.**

In 1984 financial developments were strongly influenced by differences in policy stance as well as by cyclical and longer-term structural factors. Thus, in the United States the underlying demand for credit by the public sector continued to grow, while the more advanced stage of the upswing was mirrored in high levels of borrowing by the private sector. Doubts can be raised about the sustainability of the recent rate of credit expansion in that country, given the unprecedented capital inflows and changes in yields that have accompanied the expansion. Apart from Germany, which also saw growth in net corporate demand for finance, most other industrial countries experienced consolidation in corporate and public-sector balance sheets. In European countries this reflected the early stage of the investment cycle and continuing fiscal stringency, while in Japan sharply increased profits enabled firms to undertake considerable investment and at the same time to improve their financial positions.

In a long-term perspective structural changes in sectoral balances are closely linked to trends in the accumulation of financial assets and liabilities. Households in most of the major countries have built up net financial wealth in recent years at a rate in excess of national income growth, while firms have focused more on the parallel expansion of both financial assets and debt. Underlying these developments, significant changes in portfolio holdings have also been in evidence, reflecting changes in risks and returns as well as other structural factors. For example, the share of deposits with market-related interest rates has risen, and indirect holdings by households of equities, bonds and property have increased. Instruments such as time deposits have in effect been given shorter maturities, and thus made more liquid, but offsetting shifts in portfolio distribution may have left the liquidity of agents more or less unchanged.

Such long-run trends exert a key influence on the development of financial markets and are also affected by changes in the financial system, notably financial innovation, aspects of which were analysed in depth in the Annual Reports published in 1983 and 1984. In this Report innovation is treated in the wider context of changes in the overall demand for and supply of financial assets and the channelling of funds both through financial intermediaries and directly through markets.

In a number of countries open financial markets have in recent years assumed a more important rôle than in the past. Banks and other financial institutions have tended to turn to the markets to a greater extent, not least to defend their share in total credit flows. Thus, these institutions increasingly price both their assets and

liabilities in the light of market conditions. More generally, liberalisation and growing competitiveness are altering the transmission channels of monetary policy and affecting the money creation process. For a variety of reasons these developments have in recent years been less in evidence in Germany and some neighbouring countries.

The policy issues raised by the changes in the nature and locus of intermediation relate to efficiency, stability and the design of policy instruments. It is clear that the main financial prices — interest rates and exchange rates — are now more responsive to the interplay between supply and demand and may thus contribute to a more efficient allocation of resources. At the same time, however, a narrowing of competitive margins and greater volatility of financial prices may raise questions about the stability of financial markets. The greater rôle of markets and market-related pricing has implications for the design and application of both monetary and prudential policy, which have become more interdependent as a result of the evolution in financial conditions.

**Changes in sectoral financial balances.**

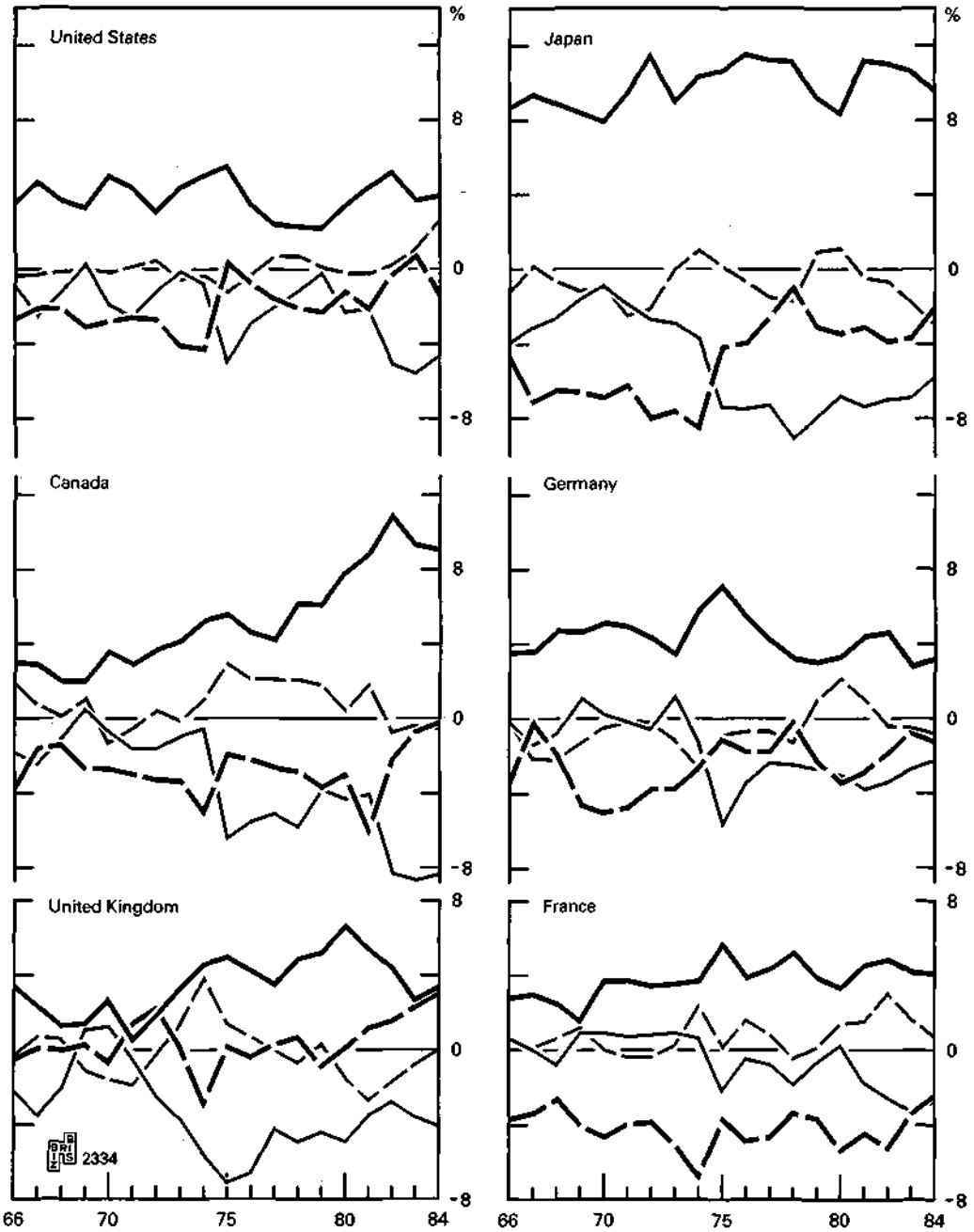
Changes in sectoral financial balances can be seen as the interface between the real and financial spheres of the economy and are an important indicator of financial activity. This is because a net surplus, reflecting the balance of saving and investment, can be used to add to financial assets or to reduce financial liabilities, while a net deficit must be financed by selling financial assets or borrowing. To some extent, these changes can be explained in terms of cyclical behaviour, but they may also reflect balance-sheet adjustments to longer-term developments as well as evolutionary changes in the structure of the financial system.

In the course of 1984 the financial position of non-financial companies improved in most of the Group of Ten countries except the United States and Germany, with the financial improvement in certain countries, such as the Netherlands, being particularly marked in the export sector. This improvement was due to a cyclical upswing in profitability combined, in countries other than Japan, with a still relatively weak recovery of investment. Given the early stage of the recovery in most of these countries, output growth has been achieved so far largely by higher capacity utilisation and more extensive overtime. Firms have used this opportunity to rebuild their liquidity and reduce their debt burden. Although changes in firms' financial balances were similar in all these countries, the actual levels of balances differed. Extreme examples are the United Kingdom and the Netherlands, where companies continued to run a financial surplus in contrast to the deficits typical of other countries. A main exception to the tendency towards financial consolidation has been the United States, where the recovery has been more advanced and robust than in Europe. Such a pattern was also evident in Germany, where firms are investing more heavily in both fixed capital and inventories than in most other European countries. In Japan the improvement in the corporate financial position was due to exceptional increases in profits and occurred *despite* heavy investment and borrowing.

## Sectoral financial balances.[1]

As a percentage of GNP.

Private sector: households
Private sector: non-financial companies
Public sector[2]
External sector




[1] Based on flow-of-funds or financial statistics. 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 and graphs of this Report. Data for 1984 are preliminary. [2] For Canada, Germany, Japan and the United Kingdom, includes public-sector enterprises.

Households tend to increase their saving and accumulation of financial wealth during an upturn, as consumption of non-durable items typically responds with a lag to increases in income. In some countries, however, there may be countervailing effects from a speeding-up of purchases of durable goods and housing investment during a recovery.

It appears that in 1984 these offsetting mechanisms were dominant in Canada and Japan, where a decline in the household-sector surplus occurred, despite increasing personal incomes. This outcome appears to be mainly a result of purchases of durable goods. By contrast, in France, Belgium and Sweden the weakness of personal incomes resulting from continuing effects of the recession together with policy measures of fiscal adjustment has been the main reason for the decline in net household asset accumulation. In the United States the household-sector surplus increased, reflecting the more rapid income growth and the lagged response of consumption growth characteristic of the advanced stage of the cycle. A similar pattern was discernible in Germany (where "households" include the housing sector) and the United Kingdom despite the earlier stage of the recovery.

An improvement in the public-sector balance occurred in most countries during 1984. To some extent this was cyclical, as the automatic stabilisers caused tax revenues to rise and transfers to the unemployed not to increase so quickly or even to fall. However, many industrial countries have also pushed ahead with further measures of fiscal adjustment, notably reductions in public spending, but also some increases in taxation. On the other hand, declining inflation, discussed in Chapter II, has led to a reduction in fiscal drag, while most countries face continuing problems of unemployment and sharply rising interest payments on outstanding debt. In France, as in several other countries, social security payments, the interest burden and low tax revenue were thought to be reasons for the smaller than expected improvement in the public-sector deficit. In the United Kingdom the public-sector deficit increased, but this was due mainly to the exceptional circumstances of the miners' dispute. In recent years the United States has stood apart from other countries in its recourse to discretionary fiscal stimulus. Tax rates were brought down substantially even in the face of accelerating defence expenditure. Therefore, whereas in most other countries the structural public-sector deficit has been reduced, in the United States it has increased sharply. Combined with the strong US economic recovery and a widening company-sector deficit, the slight cyclical decline in the nominal public-sector deficit that has occurred has been insufficient to avert a large rise in the overall domestic financial deficit.

The counterpart to this has been a substantial growth in net capital inflows into the United States, corresponding to a rising financial surplus of the external (or overseas) sector. This growth has partly reflected increased net borrowing by non-financial firms and a marked reduction in bank lending to the external sector. In most other countries the improving public-sector position and the weakness of the domestic recovery, which has restricted imports, have gone hand in hand with an improvement in the net foreign balance. Capital outflows from the Netherlands, Germany, Canada and Belgium have risen mainly for cyclical reasons, while outflows from Japan, which has now become the largest exporter of capital, should

perhaps be seen as largely structural, given the long-run configuration of financial flows in that country, discussed in detail below.

*Cyclical versus structural flows.* Important insights into the strength and sustainability of current shifts in sectoral positions can be obtained by comparing them with those that occurred in the upturns of 1970–74 and 1976–79.

The graph on page 40 suggests that the financial position of the corporate sector has historically tended to deteriorate sharply only in the later stages of each cycle. Indeed, Germany experienced an improving company-sector position throughout the upturn of 1970–74, though this was influenced by speculation concerning currency appreciation. Recent changes are thus broadly similar to those in earlier recoveries, considering the difference in the position of Europe vis-à-vis the United States and Japan in the cycle. The recovery nonetheless remains weak in most European countries when judged in terms of net corporate borrowing.

In earlier cycles rising inflation has sometimes tended to increase financial asset accumulation by households, while more recently falling inflation has led to less buoyant accumulation. This pattern, reflecting wealth effects on saving, can be observed in varying degrees in a number of countries. It is only in the United Kingdom that the present recovery has involved unprecedented declines in the household sector's surplus. This appears to reflect structural changes in the financial system (see below) rather than different cyclical behaviour.

In the public sector improvements in the financial balance have historically been greater than those observed so far in this cycle. In the United States this is the result of a still growing structural deficit even as private-sector credit demand accelerated. In most European countries the patterns reflect economic weakness, despite continuing efforts aimed at medium-term consolidation. In other words, except in the major cases of the United States, Japan and to some extent Germany, the public-sector deficit in 1984 was heavily influenced by continuing private-sector balance-sheet restructuring, resulting from relatively low investment growth and a general weakness of this cyclical upturn compared with those of the 1970s.

For the external sector, cycles in the 1970s typically involved an increase in inward financial flows during cyclical upturns as current-account deficits increased, though in the Japanese case this tended to occur late in the cycle and may have been related to oil and commodity price rises. In contrast, last year's experience of capital outflows from many countries other than the United States reflects the influence of the unusual configuration of exchange rates and the de-synchronisation of cycles between Europe and the United States.

Structural features independent of the cycle are also evident in the sectoral flows, although the exceptional nature of the recent recession makes them unusually hard to distinguish from cyclical factors. Households have traditionally run a financial surplus as they build up wealth for investment and retirement, and for precautionary reasons. Of course, individual countries' behaviour in these respects varies widely. The Japanese household sector has run a persistently large surplus of around 10 per cent. of GNP, while the surpluses in the United States, Germany, the United Kingdom and France have tended to be far lower, at 3 per cent., and the

Swedish household sector has tended to be in deficit. The causes of the Japanese surplus seem to be related to the bonus wage system, the low level of pensions, the increasing number of elderly people, the restricted availability of credit to households, the high cost of housing and educational needs, all of which augment liquidity and investment needs. It is anticipated that the ageing of the population will substantially reduce the surplus over the next decade. In the Swedish case, by contrast, disincentives to household saving derive from existing pension arrangements and generous tax write-offs for interest payments, though the latter have been reduced in scope in recent years.

Although the comparative sizes of household-sector balances differ, in most cases the structural surpluses in inflation-adjusted terms have remained relatively stable, as a proportion of both personal incomes and GNP. The principal exceptions to this are the United Kingdom and Canada, where changes have occurred as the result of liabilities-side stock adjustments. In the United Kingdom an atypically low surplus resulted from a surge in borrowing due to market liberalisation. In Canada the recent unusually high surplus is a reflection of an accumulation of liabilities during the 1970s, when real interest rates were low, which left households exposed to a subsequent rise in interest rates. The present surplus reflects an attempt to reduce debt burdens, with 1982 even having seen an absolute reduction in liabilities. Sectoral balances of these extremes are unlikely to be sustained for long. In the United Kingdom constraints on borrowing should come into play as interest burdens increase, but household debt-service limits have probably not yet been reached. In Canada the repayment of debt is unlikely to continue at present rates, as evidenced by positive gross borrowing in 1983 and 1984.

The company sector tends as a rule to run a deficit as fixed investment and changes in stocks exceed profits. The United Kingdom and the Netherlands are atypical in that non-financial companies do not consistently do so. In the United States, Japan and Germany structural company-sector deficits have also appeared to diminish over recent years, perhaps owing to earlier declining rates of return on fixed investment, and a consequent fall in investment itself.

The structural public-sector deficit increased in virtually all countries from the early 1970s onwards, though more recently fiscal consolidation has lowered it in most European countries. These deficits partly reflect both greater non-cyclical unemployment and higher debt interest payments. Gross outstanding public-sector debt in all of the Group of Ten countries is now equivalent to over 30 per cent. of GNP, and in Italy and Belgium it is over 75 per cent. of GNP.

**Developments in the demand for credit.**

A cyclical element in gross credit flows in 1984 can be discerned in many countries if account is taken of both the phase of the cycle and sometimes important secular trends or structural features. The rise in total credit during the current upswing can be attributed to increasing confidence, higher propensities to consume and a greater willingness to extend balance sheets or alter their structure in favour of physical capital. Although changes in asset holdings must be considered as well,

## Funds raised by domestic non-financial sectors.

| | 1975 | 1976 | 1977 | 1978 | 1979 | 1980 | 1981 | 1982 | 1983 | 1984 |
|---|---|---|---|---|---|---|---|---|---|---|
| | as a percentage of GNP | | | | | | | | | |
| **United States** | | | | | | | | | | |
| Households | 3.5 | 5.3 | 7.3 | 8.0 | 7.4 | 4.6 | 4.3 | 3.1 | 5.3 | 6.6 |
| Companies (including farm sector) | 3.3 | 4.7 | 5.9 | 5.9 | 6.0 | 5.3 | 5.0 | 4.2 | 4.7 | 4.6 |
| General government | 6.3 | 4.8 | 3.6 | 3.2 | 2.3 | 3.7 | 3.2 | 6.3 | 6.8 | 6.3 |
| Total | 13.1 | 14.8 | 16.8 | 17.1 | 15.7 | 13.6 | 12.5 | 13.6 | 16.8 | 17.5 |
| *of which: bonds and securities* | *8.1* | *6.5* | *5.5* | *5.0* | *4.0* | *5.4* | *5.1* | *7.5* | *7.8* | *8.4* |
| *equities* | *0.6* | *0.6* | *0.1* | *0.0* | *−0.3* | *0.5* | *−0.4* | *0.4* | *0.9* | *−2.0* |
| **Canada** | | | | | | | | | | |
| Households | 8.5 | 10.2 | 9.5 | 8.5 | 10.5 | 7.5 | 6.3 | −1.8 | 4.2 | 4.0 |
| Corporate firms | 4.3 | 4.1 | 3.2 | 5.6 | 5.6 | 5.9 | 10.4 | 3.7 | 1.0 | 3.3 |
| Public sector | 7.9 | 7.9 | 7.7 | 10.6 | 4.8 | 7.4 | 8.0 | 10.1 | 9.6 | 9.3 |
| Total | 20.7 | 22.2 | 20.5 | 24.6 | 20.9 | 20.8 | 24.7 | 12.1 | 14.8 | 16.6 |
| *of which: bonds and short-term securities* | *6.5* | *4.7* | *7.5* | *7.4* | *5.7* | *8.3* | *6.9* | *10.1* | *10.3* | *6.5* |
| *equities* | *0.5* | *0.5* | *1.3* | *2.5* | *1.3* | *1.3* | *1.5* | *1.2* | *1.5* | *0.7* |
| **Japan** | | | | | | | | | | |
| Households | 7.1 | 6.4 | 5.4 | 5.5 | 5.8 | 5.8 | 4.2 | 4.0 | 4.6 | 4.8[1] |
| Corporate firms | 11.9 | 10.1 | 7.5 | 6.0 | 6.0 | 7.5 | 8.8 | 8.6 | 8.0 | 8.9[1] |
| Public sector | 9.3 | 10.5 | 10.4 | 13.8 | 10.6 | 10.8 | 10.4 | 8.4 | 9.6 | 7.1[1] |
| Total | 28.3 | 27.0 | 23.3 | 25.2 | 22.3 | 24.0 | 23.5 | 21.0 | 22.2 | 20.7[1] |
| *of which: securities* | *6.8* | *7.7* | *8.4* | *11.0* | *7.8* | *8.2* | *8.4* | *6.3* | *7.2* | *6.1[1]* |
| *equities* | *0.8* | *0.6* | *0.6* | *0.6* | *0.6* | *0.6* | *0.8* | *0.8* | *0.5* | *0.6[1]* |
| **Germany** | | | | | | | | | | |
| Households[2] | 3.0 | 3.7 | 4.2 | 5.1 | 5.7 | 4.9 | 4.1 | 3.4 | 4.2 | 3.6 |
| Companies | 4.2 | 5.8 | 5.0 | 4.1 | 5.3 | 6.0 | 6.2 | 4.9 | 4.5 | 4.9 |
| General government | 6.3 | 4.2 | 3.1 | 3.4 | 3.0 | 3.7 | 4.9 | 4.3 | 3.4 | 2.7 |
| Total | 13.5 | 13.7 | 12.3 | 12.6 | 14.0 | 14.6 | 15.2 | 12.6 | 12.1 | 11.2 |
| *of which: securities* | *1.9* | *1.1* | *1.7* | *0.9* | *0.4* | *0.1* | *0.1* | *2.3* | *2.0* | *1.7* |
| *equities* | *0.4* | *0.4* | *0.3* | *0.3* | *0.3* | *0.4* | *0.2* | *0.3* | *0.4* | *0.3* |
| **France** | | | | | | | | | | |
| Households | 3.9 | 5.9 | 4.6 | 4.1 | 6.1 | 4.3 | 4.4 | 3.9 | 4.1 | 3.1 |
| Companies | 6.9 | 8.4 | 8.8 | 6.9 | 7.5 | 8.8 | 8.4 | 9.4 | 6.8 | 6.5 |
| General government | 4.9 | 3.5 | 3.3 | 4.6 | 2.9 | 1.7 | 4.3 | 6.8 | 3.4 | 5.0 |
| Total | 15.7 | 17.8 | 16.6 | 15.5 | 16.5 | 14.8 | 17.1 | 20.1 | 14.3 | 14.6 |
| *of which: securities* | *3.4* | *1.1* | *1.3* | *2.1* | *1.5* | *1.5* | *2.7* | *4.4* | *3.9* | *4.2* |
| *equities* | *1.1* | *1.2* | *1.0* | *1.2* | *1.1* | *1.7* | *1.7* | *1.2* | *1.3* | *1.8* |
| **United Kingdom** | | | | | | | | | | |
| Households | 3.1 | 3.6 | 4.0 | 4.6 | 5.4 | 4.5 | 5.7 | 6.9 | 6.7 | 6.7[1] |
| Companies | 3.2 | 3.2 | 3.8 | 2.3 | 4.4 | 4.6 | 3.9 | 3.0 | 2.3 | 2.1[1] |
| Public sector | 9.5 | 7.1 | 10.7 | 3.8 | 7.2 | 5.9 | 4.5 | 3.4 | 3.6 | 4.0[1] |
| Total | 15.8 | 13.9 | 18.6 | 10.8 | 17.1 | 15.0 | 14.0 | 13.3 | 12.6 | 12.8[1] |
| *of which: securities* | *6.1* | *5.0* | *6.7* | *4.2* | *6.0* | *4.4* | *3.7* | *2.3* | *4.2* | *2.9[1]* |
| *equities* | *0.9* | *0.6* | *0.5* | *0.5* | *0.5* | *0.4* | *0.6* | *0.3* | *0.6* | *0.3[1]* |
| **Italy** | | | | | | | | | | |
| Households | 0.8 | 0.7 | 0.9 | 0.9 | 1.1 | 1.4 | 0.9 | 0.8 | 0.8 | . |
| Companies | 11.5 | 13.5 | 8.5 | 9.7 | 10.0 | 10.6 | 11.6 | 8.2 | 9.8 | . |
| Public sector | 14.7 | 11.2 | 10.2 | 15.2 | 11.8 | 11.1 | 13.4 | 16.3 | 17.0 | 16.6 |
| Total | 27.0 | 25.4 | 19.6 | 25.8 | 22.9 | 23.1 | 25.9 | 25.3 | 27.6 | . |
| *of which: securities* | *12.8* | *7.9* | *11.4* | *12.0* | *7.1* | *7.4* | *10.6* | *12.8* | *15.4* | . |
| *equities* | *1.9* | *1.9* | *1.6* | *2.9* | *1.7* | *2.0* | *2.8* | *2.6* | *3.8* | . |
| **Belgium** | | | | | | | | | | |
| Households | 9.2 | 3.9 | 3.7 | 3.8 | 4.1 | 2.6 | 0.9 | 0.7 | 1.0 | 5.2[3] |
| Companies | | 6.5 | 6.5 | 5.5 | 5.6 | 4.8 | 5.2 | 3.2 | 4.2 | |
| General government | 6.5 | 8.0 | 8.0 | 8.4 | 9.3 | 11.5 | 15.9 | 16.0 | 15.0 | 12.6[3] |
| Total | 15.8 | 18.4 | 18.2 | 17.7 | 19.0 | 18.9 | 22.0 | 19.9 | 20.2 | 17.8[3] |
| *of which: bonds* | . | *6.2* | *8.0* | *7.6* | *6.2* | *4.0* | *3.4* | *4.3* | *10.5* | *8.4[3]* |
| *equities* | . | *0.0* | *0.3* | *0.3* | *0.2* | *0.0* | *0.0* | *0.4* | *1.1* | *0.1[3]* |
| **Netherlands** | | | | | | | | | | |
| Households and companies | 8.3 | 8.7 | 9.3 | 10.2 | 8.1 | 6.8 | 4.7 | 4.1 | 2.8 | 2.6 |
| General government | 3.8 | 3.8 | 3.2 | 2.7 | 3.3 | 4.7 | 7.1 | 8.6 | 9.0 | 8.0 |
| Total | 12.1 | 12.5 | 12.4 | 12.9 | 11.4 | 11.6 | 11.8 | 12.7 | 11.8 | 10.6 |
| *of which: securities* | *2.0* | *1.3* | *1.0* | *0.7* | *0.8* | *1.7* | *2.5* | *4.4* | *5.4* | *5.3* |
| *equities* | *0.1* | *0.0* | *0.0* | *0.1* | *0.0* | *0.1* | *0.0* | *0.0* | *0.2* | *0.3* |
| **Sweden** | | | | | | | | | | |
| Households[2] | . | . | 14.7 | 7.2 | 7.2 | 6.1 | 5.6 | 6.3 | 5.7 | 5.4[3] |
| Companies | . | . | | 6.0 | 5.4 | 7.3 | 6.6 | 6.3 | 6.5 | 8.9[3] |
| General government | . | . | 5.1 | 8.5 | 9.8 | 10.6 | 12.2 | 13.7 | 12.2 | 9.4 |
| Total | . | . | 19.8 | 21.7 | 22.4 | 24.0 | 24.4 | 26.4 | 24.4 | 23.7 |
| *of which: bonds* | . | . | *5.5* | *11.5* | *10.0* | *8.6* | *13.4* | *11.4* | *10.7* | *11.3* |
| *equities* | . | . | *1.2* | *1.2* | *1.0* | *1.4* | *1.4* | *1.8* | *2.0* | *2.2* |

[1] First three quarters only. [2] Including housing sector. [3] Estimated.

it would seem that most changes in sectoral balances last year largely reflected movements in credit rather than variations in financial asset holdings. Thus, many of the explanations for the shifting sectoral balances also account for the gross credit flows.

*Total credit expansion.* Last year total credit expansion in relation to GNP remained near its historical peak in the United States as economic recovery sustained corporate demand for finance, household borrowing rose and heavy public-sector borrowing persisted. Although the US Government's absorption of credit-market funds was equivalent to no more than 7 per cent. of GNP, it must be borne in mind that it has risen rather suddenly from only 3 per cent. of GNP in 1981 and represents a disproportionate claim on relatively low national savings. Indeed, the US public-sector deficit since 1982 has contributed to a sharp increase to 1.6 in the ratio of non-financial sectors' total debt to GNP, which had been roughly constant at 1.4 since the Second World War, though evidence for other countries suggests that constancy of this ratio is not a universal feature. In Japan, the United Kingdom, Canada and Germany secular trends or structural changes in the proclivity of the government and household sectors to use credit have tended to dominate in the recent past, and total credit expansion has remained lower than in the 1970s.

Outside the United States company-sector credit demand was not strong, though in Japan and Germany there were also indications that companies had begun to borrow more for investment purposes. However, even in these countries increased fund-raising was not reflected in equity issues, as companies relied instead mainly on bond issues and bank borrowing.

In general, countries that in 1984 recorded faster rates of total credit expansion, such as the United States, also experienced a deterioration in their external accounts, while the contrary was true of those, such as Japan, Germany and the Netherlands, where total credit expansion slowed down.

*Funds raised through the banking system.* Under conditions of heavy public-sector borrowing and high long-term interest rates, bank credit is now in most countries the principal source of credit for the company sector. Such credit has long been a key variable or indicator in monetary policy formulation, earlier in its own right but for certain countries in recent years also because it is a counterpart of money supply growth. It has also been extensively affected by deregulation and financial innovation, which have sharpened competition between banks, other financial institutions and financial markets. For these reasons, bank lending reflects supply factors as well as the influence of demand.

The increase in total domestic bank credit during 1984 exerted a more expansionary influence than before on the growth of the broad money stock in Canada, Japan, Italy, the Netherlands, Sweden, Switzerland and the United Kingdom. Of the other countries only France and Belgium saw a significant decline in contributions to monetary growth.

Private-sector demand for credit from the banking system accelerated markedly in Japan, Canada, Switzerland, Italy and the United Kingdom. In Italy the abolition of credit ceilings also led independently to greater bank competition in

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

| Countries | Years | Contributions to changes in the broad money stock of changes in | | | | | Changes in broad money stock[6] |
|---|---|---|---|---|---|---|---|
| | | credit to private sector[2] | credit to public sector[3] | total domestic bank credit | net foreign assets[4] | other items[5] | |
| | | December to December or fourth quarter to fourth quarter, in percentage points | | | | | in percentages |
| United States | 1981 | 3.0 | 0.4 | 3.4 | 9.0 | | 12.4 |
| | 1982 | 3.2 | 1.0 | 4.2 | 5.2 | | 9.4 |
| | 1983 | 3.8 | 2.4 | 6.2 | 4.2 | | 10.4 |
| | 1984 | 6.0 | 0.0 | 6.0 | 4.9 | | 10.9 |
| Canada | 1981[7] | 23.9 | 2.0 | 25.9 | − 2.6 | − 7.5 | 15.8 |
| | 1982 | 0.7 | 1.1 | 1.8 | 1.5 | 4.6 | 8.0 |
| | 1983 | − 5.7 | 4.1 | − 1.6 | 0.2 | 4.9 | 3.4 |
| | 1984 | 9.4 | − 2.2 | 7.2 | − 1.5 | 1.4 | 7.0 |
| Japan | 1981 | 9.5 | 2.6 | 12.1 | − 0.2 | − 0.7 | 11.1 |
| | 1982 | 8.4 | 1.3 | 9.6 | − 0.6 | − 1.2 | 7.8 |
| | 1983 | 8.3 | 0.6 | 8.9 | 0.5 | − 2.2 | 7.2 |
| | 1984 | 9.2 | 1.4 | 10.6 | − 1.3 | − 1.5 | 7.8 |
| Germany | 1981 | 11.2 | 6.7 | 17.9 | 2.1 | −15.0 | 5.0 |
| | 1982 | 8.5 | 4.9 | 13.4 | 0.4 | − 6.8 | 7.1 |
| | 1983 | 11.0 | 2.5 | 13.5 | 0.7 | − 8.9 | 5.3 |
| | 1984 | 10.0 | 2.0 | 12.0 | 1.0 | − 8.3 | 4.7 |
| France | 1981 | 11.7 | 2.5 | 14.2 | − 2.3 | − 1.5 | 10.4 |
| | 1982 | 15.2 | 2.2 | 17.4 | − 3.5 | − 3.2 | 10.8 |
| | 1983 | 12.1 | 3.5 | 15.6 | − 1.8 | − 2.6 | 11.2 |
| | 1984 | 9.0 | 1.0 | 10.0 | 0.0 | − 2.3 | 7.7 |
| United Kingdom | 1981 | 16.6 | − 0.8 | 15.8 | 0.4 | − 2.5 | 13.6 |
| | 1982 | 21.3 | − 6.8 | 14.5 | − 2.6 | − 2.6 | 9.3 |
| | 1983 | 14.0 | 0.9 | 14.9 | − 0.6 | − 3.9 | 10.5 |
| | 1984 | 16.2 | − 1.0 | 15.2 | 0.9 | − 6.0 | 10.2 |
| Italy | 1981 | 4.5 | 12.5 | 17.0 | 0.4 | − 1.4 | 16.0 |
| | 1982 | 3.7 | 15.5 | 19.2 | − 0.6 | − 1.4 | 17.2 |
| | 1983 | 4.6 | 11.2 | 15.8 | 0.8 | − 2.0 | 14.6 |
| | 1984 | 6.4 | 10.2 | 16.6 | 0.1 | − 2.9 | 13.7 |
| Belgium | 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 | − 2.0 | 8.1 |
| | 1984 | 1.2 | 7.8 | 9.0 | − 5.4 | 0.8 | 4.4 |
| Netherlands | 1981 | 9.7 | 3.6 | 13.3 | 3.6 | −10.0 | 6.8 |
| | 1982 | 4.9 | 3.8 | 8.7 | 3.8 | − 5.2 | 7.3 |
| | 1983 | 5.8 | 4.6 | 10.4 | 2.3 | − 1.8 | 10.8 |
| | 1984 | 6.6 | 5.1 | 11.7 | 5.0 | − 7.9 | 8.8 |
| Sweden | 1981 | 4.3 | 12.3 | 16.6 | 1.4 | − 4.2 | 13.8 |
| | 1982 | 6.7 | 2.8 | 9.5 | 1.2 | − 2.5 | 8.2 |
| | 1983 | 6.6 | 0.6 | 7.2 | 2.0 | − 1.1 | 8.1 |
| | 1984 | 6.2 | 5.1 | 11.3 | − 0.3 | − 3.7 | 7.3 |
| Switzerland[8] | 1981 | 9.3 | 0.4 | 9.7 | 1.3 | − 8.5 | 2.5 |
| | 1982 | 3.8 | 0.0 | 3.8 | 0.8 | 0.0 | 4.6 |
| | 1983 | 6.5 | 0.2 | 6.7 | 0.7 | − 0.5 | 6.9 |
| | 1984 | 9.4 | − 0.1 | 9.3 | 1.1 | − 5.9 | 4.5 |

[1] Based on 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 Canada, commercial banks' net foreign currency liabilities to residents and non-residents; for Switzerland, official reserves only. [5] Including non-monetary bank liabilities. [6] For Canada, Belgium and the Netherlands, $M_2$; for France, $M_2$ held by residents; for Japan, $M_2$ plus CDs; for the United States, Germany, Italy, Sweden and Switzerland, $M_3$; for the United Kingdom, sterling $M_3$. [7] Twelve months to October. [8] Definition of $M_3$ revised in 1985.

lending. A subsequent burst of bank credit growth occasioned new restrictions on external borrowing as from July. In most other European countries demand for bank credit by the private sector remained weak. In Sweden, where the public sector had renewed recourse to the banking system, private-sector loans were restrained for

fear of excessive liquidity creation. In countries such as Belgium, on the other hand, firms have turned increasingly to equity and bond issues.

Reduced lending to the public sector was the main reason for the sharp decline in the contribution of total bank lending to monetary growth in Belgium and France, where the public sector instead increased its direct funding through the markets. Despite large budget financing needs in the United States, Canada and Japan, the public sector's net recourse to bank credit was low or negative. The public sector in the Netherlands had greater recourse to the banks through security sales, which increased the degree of long-term bank funding of the deficit and led to concern about future lending potential. And in Sweden the public sector placed significantly more securities with the banking system than in the two previous years, with the central bank itself being the principal counterparty. This tendency was partly offset by restrictive liquidity measures with respect to banks and the corporate sector.

In the United States the contribution of domestic bank credit to the money supply remained constant because of offsetting changes in the demand for bank credit by the private and public sectors. Business borrowing was strong because of the need for investment finance and funds for mergers and corporate "buy-outs" (where a firm's management purchases outstanding equity from shareholders). Bank lending to the public sector was negligible as the banks responded to private-sector demands by sharply reducing their acquisitions of government securities.

**Changes in sectoral portfolio size and distribution.**

Portfolio decisions are based on *stocks* of assets and liabilities, which are affected by fluctuations in market value, in addition to flow changes. This is because it is the stock of assets and liabilities which is relevant to the long-term income or viability of the household or company. Portfolio analysis also gives important insights into sectoral liquidity, intermediation patterns and the extent to which sectoral financing has affected portfolio size and composition. Private-sector financial portfolio data covering the period since 1966 are available for the United Kingdom, the United States, Germany and Japan, for which stocks of most marketable assets have been estimated at market prices. Owing to differences in definitions and asset valuation, and to changes in the nature of assets, conclusions must be mainly qualitative.

*Ratios of financial wealth to GNP.* The financial wealth of the household sector (as defined in the table overleaf) in relation to GNP has developed differently in the United Kingdom and the United States than in Japan and Germany. In the former countries the wealth/GNP ratio tended to decline from the mid–1960s before recovering more recently. By contrast, the latter countries have experienced a broadly continuous increase in this ratio. Part of the explanation lies in the larger share of equities and long-term fixed rate bonds in portfolios in the United Kingdom and the United States. The economic crisis of the mid-1970s caused a sharp fall in the market value of these assets. The resulting decline in household wealth has not been fully made up despite sharp growth in equity prices over the last few years and

continuing financial surpluses. Moreover, there is evidence that households have to some extent shifted into tangible assets over this period.

In Germany and Japan, by contrast, the financial systems are "bank-oriented" and assets tend to be more monetary. Hence the wealth/GNP ratio, while affected by an inflationary erosion of the real value of such assets, does not display strong market valuation effects. The comparatively high growth rate of accumulation in Japan is apparent, while the German household sector (including the housing sector) appears to have an atypically *low* level of net financial wealth, but this is partly a reflection of the predominantly non-funded pension arrangements and relatively low shareholding. On the liabilities side, household-sector behaviour is surprisingly similar in all the countries, the level having risen to 50–60 per cent. of GNP. This similarity puts in perspective the impression of widely differing asset and liability preferences and constraints on borrowing. These perceptions are often based on the recent *growth* of the liability position in relation to GNP. In the United Kingdom, in particular, the household-sector liabilities/GNP ratio has grown unprecedentedly over the years 1980–84, though it still remains below levels observable in the United States. This change reflects a removal of credit rationing resulting from the abolition both of restrictions on the expansion of banks' balance sheets and of controls on consumer credit.

Financial asset and liability stocks of the household and company sectors.[1]

| Countries | Years | Households[2] | | | Companies[3] | | |
|---|---|---|---|---|---|---|---|
| | | financial assets | liabilities | net financial wealth | financial assets[4] | liabilities[4] | liabilities[4] (excluding equity) |
| | | as a percentage of GNP | | | | | |
| United States | 1966 | 1.94 | 0.51 | 1.43 | 0.18 | 1.27 | 0.36 |
| | 1970 | 1.95 | 0.51 | 1.44 | 0.18 | 1.30 | 0.38 |
| | 1975 | 1.66 | 0.52 | 1.14 | 0.20 | 0.96 | 0.38 |
| | 1980 | 1.72 | 0.59 | 1.14 | 0.20 | 1.00 | 0.38 |
| | 1983 | 1.83 | 0.60 | 1.24 | 0.20 | 1.04 | 0.39 |
| | 1984 | 1.75 | 0.58 | 1.17 | 0.20 | 0.95 | 0.38 |
| United Kingdom | 1966 | 1.91 | 0.39 | 1.52 | 0.39 | 1.05 | 0.42 |
| | 1970 | 1.83 | 0.39 | 1.44 | 0.40 | 1.15 | 0.48 |
| | 1975 | 1.33 | 0.39 | 0.94 | 0.38 | 0.86 | 0.47 |
| | 1980 | 1.28 | 0.39 | 0.89 | 0.33 | 0.74 | 0.39 |
| | 1983 | 1.56 | 0.49 | 1.07 | 0.42 | 0.88 | 0.41 |
| | 1984[5] | 1.61 | 0.51 | 1.10 | 0.43 | 0.89 | 0.41 |
| Germany | 1966 | 0.66 | 0.36 | 0.30 | 0.29 | 0.75 | 0.53 |
| | 1970 | 0.77 | 0.38 | 0.39 | 0.34 | 0.81 | 0.58 |
| | 1975 | 0.92 | 0.42 | 0.50 | 0.37 | 0.84 | 0.63 |
| | 1980 | 1.00 | 0.50 | 0.50 | 0.37 | 0.79 | 0.63 |
| | 1983 | 1.13 | 0.56 | 0.57 | 0.45 | 0.89 | 0.68 |
| | 1984 | 1.15 | 0.57 | 0.58 | 0.46 | 0.88 | 0.68 |
| Japan | 1966 | 0.98 | 0.36 | 0.62 | 0.48 | 1.17 | 0.89 |
| | 1970 | 0.99 | 0.38 | 0.61 | 0.43 | 1.09 | 0.85 |
| | 1975 | 1.21 | 0.46 | 0.75 | 0.54 | 1.25 | 0.93 |
| | 1980 | 1.47 | 0.54 | 0.93 | 0.53 | 1.16 | 0.87 |
| | 1983 | 1.74 | 0.60 | 1.14 | 0.63 | 1.36 | 0.94 |
| | 1984[6] | 1.75 | 0.61 | 1.14 | 0.66 | 1.36 | 0.93 |

[1] For this table and the following graphs equities and bonds are at market value, except for bonds in the United States and Japan, which are at book value. [2] For Germany, including the housing sector, of whose assets about 20 per cent. is attributable to the company sector; for the United Kingdom and Japan, including non-incorporated business. [3] For the United States and Japan, non-financial corporate sector; for the United Kingdom, industrial and commercial companies; for Germany, enterprises excluding the housing sector. [4] Excluding trade credits and debits. Liabilities for the United States include equities of financial corporations. [5] End-June. [6] End-September.

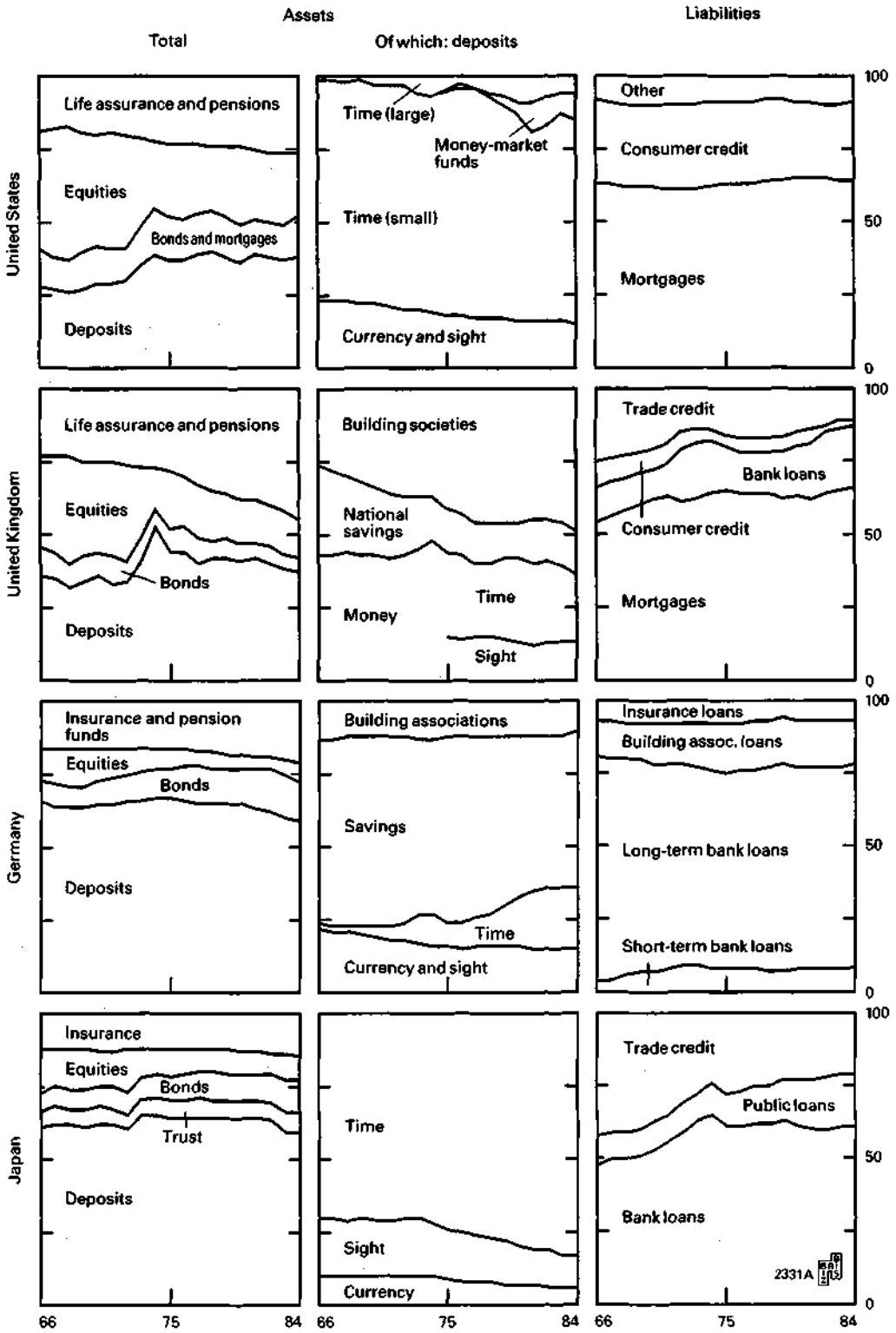
With regard to company-sector financial stocks in the United Kingdom and the United States, the behaviour of gross liabilities has been dominated by the effect of valuation changes on equity. This feature is less marked in the case of Germany and Japan, perhaps because of traditional reliance on bank borrowing, the thinness of the equity market and the resultant small size of the equity base. It can be argued that the incentive to carry out fixed investment is enhanced as the ratio of equity prices to the replacement cost of the capital stock rises. The recent rise in equity prices may therefore have raised corporate investment incentives, particularly in the United States. Firms have tended gradually to increase their debt (excluding equity) in relation to GNP (except in the United Kingdom). This may reflect the development of credit markets over this period. However, gross asset holdings have also tended to rise, leaving the net position excluding equity fairly constant. The relation between gross liabilities including and excluding equity reveals a decline in equity ratios which has been characteristic of many countries. Restoration of past ratios has become a major policy concern, notably in Germany, Belgium and the Netherlands.

*Developments in portfolio distribution.* The composition of household portfolios reflects important differences in financial systems. The portfolio shares are presented in the graphs overleaf, in which some estimates for 1984 are used (comparable trade credit data for Germany are not available). The United States and the United Kingdom show an unusually high share of equity in the portfolio. At the same time, direct equity holdings have been falling since the mid-1960s, while the proportions of deposits and of indirect asset holdings via life assurance and pension funds have increased. In principle, insofar as an investor can choose the distribution of his portfolio freely and without cost, asset shares will depend on risk and expected return, though factors such as demography, legislation and taxation also play a rôle.

Thus the greater volatility of and decline in share prices in the mid–1970s led to an increase in perceived risk and a fall in the expected return on equity. As a result, households shifted to indirect holdings of equity, particularly via life assurance companies, pension funds and investment trusts. This implied a spreading of risks, and holdings entailed tax advantages that raised expected returns; moreover, pension funds were growing for demographic reasons. The share of company and government bonds declined for similar reasons. The shift towards higher deposit shares was also reinforced by lower relative risk (despite inflation) and higher returns arising from financial innovation and deregulation. An increase in the share of deposits in financial wealth implies a rise in liquidity, which may have been induced partly by greater economic uncertainty and also helped to offset decreases in the liquidity of total wealth portfolios caused by rising *tangible* asset values in conditions of inflation and the growth in the share of wealth held indirectly via investment institutions.

In Japan and Germany portfolio shifts between broad categories of assets have been relatively minor. Deposits have remained the dominant instrument, though they have shown some relative tendency to decline recently. Increases have occurred in insurance holdings and in bonds, and in Japan in equity holdings (including

Portfolio distribution: Households.



securities investment trusts). In Japan these shifts are related both to the expansion of government bond issues and to the creation of new instruments and new conduits, such as the 'WIDE' accounts for holding bank debentures, but the graphs show that innovation has yet to have a major impact on the composition of household portfolios.

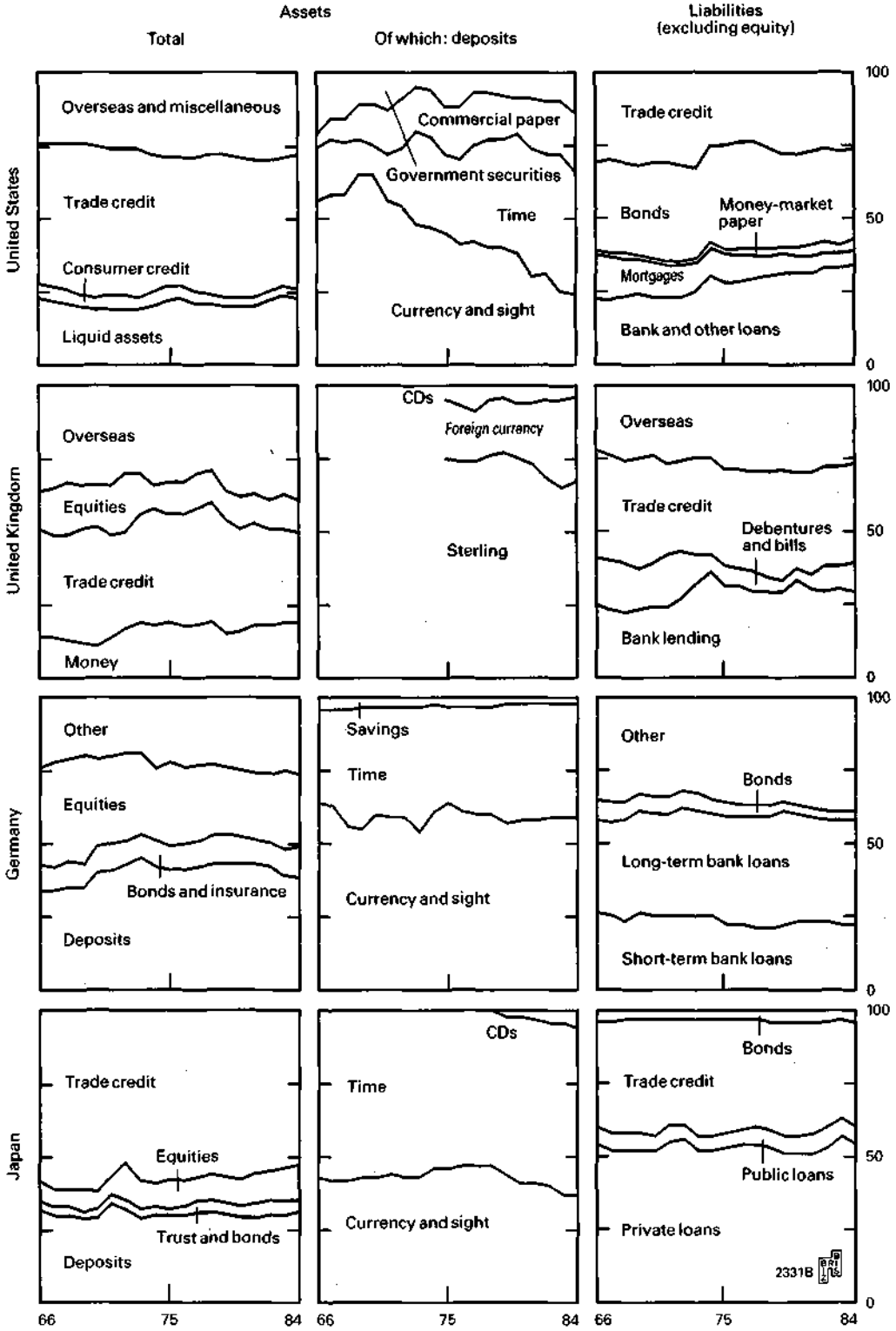
The interplay of these factors is also evident in the behaviour of household deposits. In general, there has been a structural shift from sight to time and savings deposits, and from traditional and/or regulated time deposits to those with market-related returns. Thus, the United States has seen a growth in time deposits, especially more recently in money-market deposit accounts (MMDAs) with banks, as well as money-market mutual funds managed by non-bank financial institutions. The latter, unavailable before the late 1970s, amounted at the end of 1982 to about 10 per cent. of the $M_2$ money stock, but their recent growth has been reduced by the rapid expansion since 1982 of the banks' MMDAs, which amounted at end-1984 to over 17 per cent. of $M_2$.

A similar and more sustained change has occurred in the United Kingdom, with building societies increasing their portfolio share over the period from 25 to 50 per cent. of deposits, mainly as a result of tax advantages, greater innovation and strong demand for mortgage loans. In Germany, by contrast, the switch into time deposits has occurred largely *within* the banking sector, owing to its "universal" character. Hence the switch may have different implications for funding within an institution, and for competition in the financial market-place. The same is true in the case of Japan, to the extent that individuals have moved to higher-return (though still regulated) "maturity designated time deposits" offered by their banks. However, the increasing importance of postal savings accounts, related to the tax advantages offered on time deposits, has represented a significant long-run shift between institutions.

The liabilities side of households' portfolios shows relatively constant shares of long and short-term borrowing and other liabilities in the case of the United States and Germany. The United States has a higher level of identified consumer credit, fostered by the tax deductibility of interest charges, the relative absence of credit-rationing effects (though periodic "credit crunches" have occurred on earlier occasions) and low saving ratios. The United Kingdom and Japan show greater shifts, in the context of a transition from unorganised credit markets (e.g. trade credit) to organised and intermediated markets as credit rationing has declined. In the United Kingdom tax-subsidised lending (mortgages) has increased relative to more expensive forms (consumer credit).

Non-financial companies might be expected to show more financial sophistication than households, being less habit-bound in their portfolio distribution and facing lower transaction costs. In general, the graphs confirm that portfolio shifts have been faster and portfolios more volatile. Several common tendencies are discernible on the assets side. In both the United Kingdom and the United States firms have over time increased their proportions of external assets (including direct investment), the UK share going up sharply in the years 1979–81 after the abolition of exchange controls. Against a background of uncertainty, the liquidity of the

Portfolio distribution: Non-financial companies.



corporate wealth portfolio has also tended to rise. Japan is an exception, perhaps because the stability of interest rates since 1977 has reduced the need for risk avoidance. Trends in the composition of liquid assets in the United States reveal a sharp shift away from sight deposits to what have become fairly liquid time deposits and commercial paper, implying an increase in returns without a significant decline in liquidity.

In Germany, where "universal" banking prevails and financial innovation has not been an issue, a relative stability of shares in deposits is observable, though some funds have recently been shifted into time deposits. In Japan, too, changes have so far occurred only on a minor scale. The Japanese CD market, though growing rapidly, still accounts for only 5 per cent. of firms' deposits.

The recent economic recovery has to some extent reversed the decline of the equity share in firms' liabilities in the United States and the United Kingdom. This is the result of increases in equity prices and a related rise in financing through new equity issues. In the United States, however, a large volume of leveraged buy-outs resulted last year in a considerable substitution of debt for equity. The trend in non-equity liabilities has been towards bank borrowing and away from bonds, particularly since 1976. High and volatile interest rates have encouraged firms to turn to short-term or variable rate bank loans, though, more recently, there has been some tendency to return to the bond market, particularly in Japan, where banks also depend partly on bond issues to fund loans to companies. Despite these changes, the share of bonds in total debt is an indicator of the degree of market activity. In Germany and Japan the proportion of long-term corporate bonds in firms' liabilities is below 5 per cent., while in the United States it remains as high as 25 per cent. Another development in the United Kingdom and the United States is the growth in the issue of short-term market instruments in competition with bank lending. While this reflects a growing sophistication of the markets, it should be noted that the rapid expansion of the commercial bill market in the United Kingdom may have been encouraged by official money-market operations in the context of "overfunding" in the gilt-edged market.

**Changing financial patterns: competition and innovation.**

Changes in the pattern of financial flows and the nature of intermediation over recent years have been the result of cyclical and structural factors affecting the demand for and supply of finance as well as the competitive ability of banks, other financial institutions and financial markets to channel finance between ultimate agents. These changes are important for the efficiency of resource allocation, the stability of the financial system and the conduct of monetary policy. Before discussing these issues, this section will consider recent financial changes in the light of events over a longer period under three headings: (i) the growth of direct credit transactions; (ii) the competitive response of financial institutions; and (iii) the blurring of the distinctions between different institutions, instruments and methods of intermediation.

*The growth of direct (non-intermediated) credit transactions.* The graph on page 55 compares (i) the respective shares of the private and public sectors in funds

raised by domestic non-financial sectors and (ii) the proportion of total credit-market lending (to non-financial domestic and external sectors and, to some extent, to other financial institutions) accounted for by domestic financial intermediaries. Thus, while the two series have a somewhat different basis, they help to shed light on the links, structural and cyclical, between the pattern of credit demand and the degree of financial intermediation. Broadly speaking, the graph can be seen as suggesting that direct credit transactions as a proportion of total credit flows have, over the period as a whole, tended to increase in some countries.

The growth of government demand for credit discussed above has tended to underpin the expansion of direct credit transactions. Governments are able to tap securities markets more easily than other borrowers because their creditworthiness is relatively easy to assess. Moreover, concern about price stability has led to a determination to avoid having governments finance themselves on a substantial scale through the banking system or to ensure that such funding does not excessively boost money creation. In most Group of Ten countries public-sector financing needs met by the banking sector have tended to decline since 1980, if not earlier (see also the table on page 46). The authorities in the United Kingdom have, in fact, overfunded, i.e. sold more securities than would have been needed to meet present government borrowing requirements.

Even when public-sector deficits have been financed by recourse to the financial institutions, the growth of the secondary markets has often been encouraged and the scope for subsequent direct credit transactions thereby increased. In the case of Italy, once active markets had emerged, direct sales to the public were stepped up. In Japan the banks have continued to take up government debt. However, they have been gradually granted greater scope to sell the bonds in secondary markets, which helps to create a market standard for terms on new issues, both private and public. In Sweden a number of changes in portfolio regulations have been made in recent years largely to facilitate the financing of the government deficit. Previously financial institutions were obliged to buy and hold certain quantities of specified securities. Since 1984 the institutions now subject to the obligation — the National Pensions Institute and the large insurance companies — have been permitted, after undertaking the required purchases from the original issuer, to sell securities at their discretion in the secondary market.

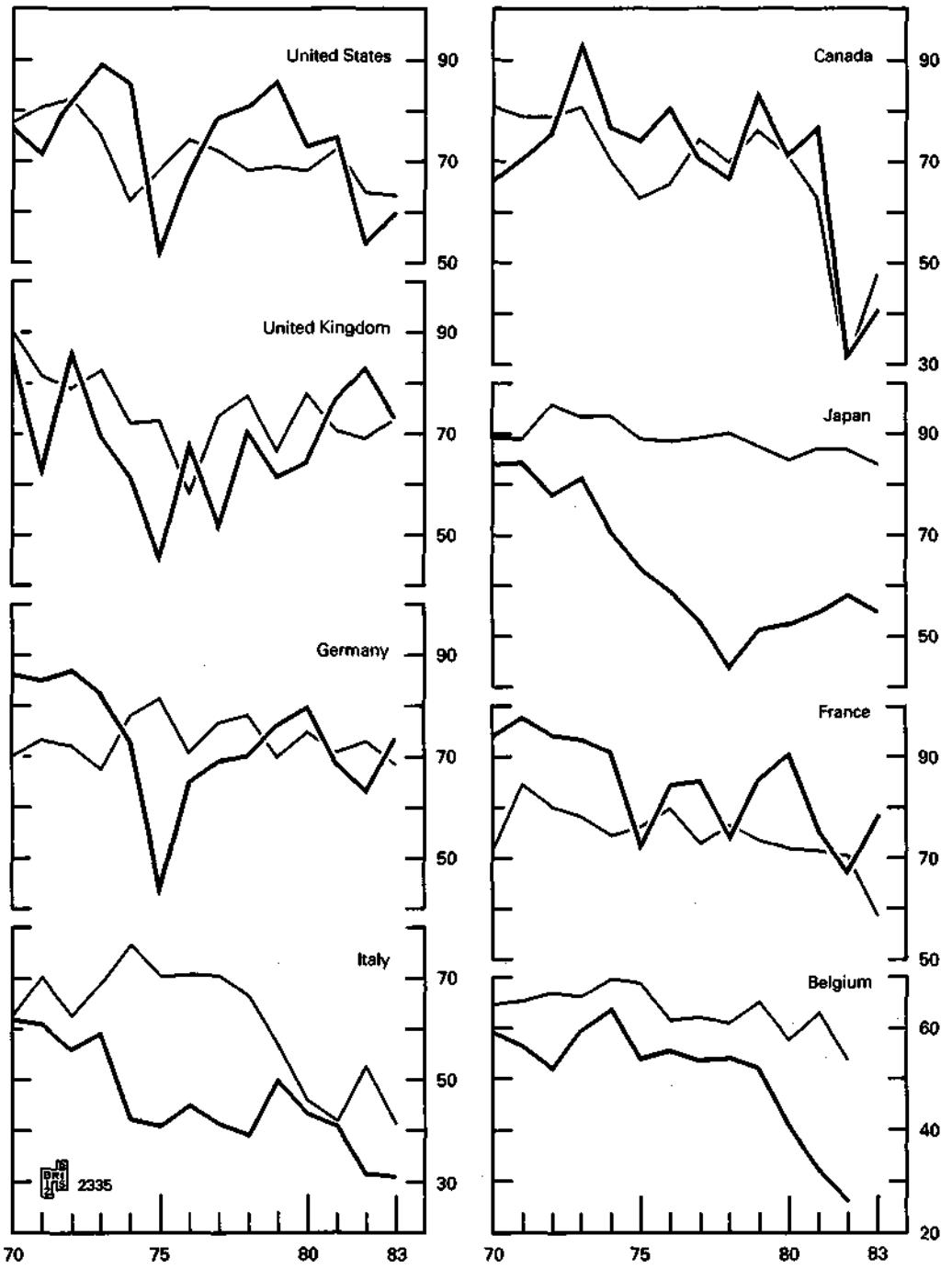
In addition, governments in some countries have contributed to the growth of direct borrowing by devising new instruments. In a few cases, such as France, Italy and Sweden, governments have in fact been quite innovative. In France a range of public-sector bonds with warrants, options and other riders giving the purchaser various alternatives have been offered. By and large, these enable the lender to avoid some of the capital risk associated with a conventional fixed rate issue. In Italy the Government took the lead in issuing variable rate and short-term debt, a lead soon followed by the financial institutions. Similarly, in Sweden the Government has introduced new medium and shorter-term instruments to be sold to domestic non-bank investors.

In the recent past credit ceilings, reserve requirements and interest rate restrictions have not been a major stimulus to the growth of direct credit

Changing patterns of borrowing and financial intermediation.

Private-sector borrowing as a proportion of credit-market funds raised by domestic non-financial sectors

Financial institutions' share of total credit-market funds supplied




Source: OECD, Financial Accounts of OECD Countries.

transactions, whereas earlier they tended to be. The authorities have relied on such controls less than in the past or have made them more comprehensive to discourage circumvention. In Italy credit ceilings were abolished in 1983, and a similar step was taken in France in 1984. However, in the latter case a progressive reserve requirement on bank assets not funded by bond or equity issues was introduced at the same time. This measure, like the credit ceilings formerly used in France, encourages greater use of the markets by both ultimate borrowers and banks.

Direct access to funds has been improved in the last few years by the relaxation of administrative controls on financial instruments and markets. In the United Kingdom, the United States, Japan, Germany, France and Switzerland changes in regulation, taxation and established practices that augment competition in the market have been implemented or discussed during the past year. For example, in France, Germany, Japan and the United States the abolition of withholding taxes on interest earned by foreign holders of bonds stimulated the expansion of the market. In the United Kingdom the stamp duty on transactions in the financial market was halved in 1984, and the abolition of minimum commissions on overseas stock transactions foreshadows further changes that will give a fillip to the financial markets. In Germany the rules governing the lead management of foreign issues of bonds denominated in Deutsche Mark were modified as from May 1985. Now any bank legally domiciled in Germany can lead manage such issues as long as they are of certain minimum maturities and, if the bank is foreign-owned, as long as German-owned banks have similar rights in the home country of the bank in question. Previously, foreign-owned banks, even if domiciled in Germany, were not allowed to lead manage foreign Deutsche Mark issues. The creation of bond investment conduits and the easing of restrictions on the issue of CDs in France and Japan are two further examples of the relaxation of administrative controls. In France tax and regulatory changes have made it possible for financial institutions to attract funds that are then placed in negotiable securities. Apart from stimulating the growth of the market, these measures encourage a shift in the composition of the wealth portfolio towards the less liquid end.

The growth of mutual funds and the rise in contractual saving have, by increasing the funds available to institutional investors, also given impetus to the expansion of the markets, but this means that institutions, albeit often ones radically different from banks, stand between ultimate borrowers and lenders. Indeed, as was noted above, the growth of the share of financial wealth held in the form of pension, insurance and mutual fund claims is one of the most prominent changes in the composition of total asset holdings. Technological change and increased competition in the securities market have lowered, and are continuing to lower, transaction costs, in particular of block trading. In the United States the removal of restrictions on competition in commissions in the first half of the 1970s allowed institutions to pass on the cost savings to large customers. The rapid expansion of money-market mutuals from the mid-1970s in response to regulations on deposit rates also boosted the rôle of non-bank institutions in the markets.

*The competitive response.* For banks and other deposit-taking institutions the growth of direct credit transactions has been significant for two reasons. First, in a

number of countries such institutions have increasingly turned to markets, which are now deeper and more active than in the past, to fund their lending. This in itself is not a new phenomenon. Banks had earlier collected funds in the market when interest rate controls, penal reserve requirements and other administrative measures made traditional funding through deposits difficult or costly. The main changes are that recourse to the markets is no longer so volatile and that national differences in the importance of such funding are smaller. Secondly, the emergence of less regulated and more active markets has meant that a growing share of traditional bank deposits and loans has come to bear market-determined or market-related terms.

Financial markets have come to provide a more important benchmark for the valuation and determination of the terms on bank assets and liabilities. It is now more difficult to depart from market terms without the risk that the custom of those able to tap the markets will be lost. In the United States, for example, the movement away from the use of the prime rate in commercial and industrial lending was partly the result of the greater ability of companies to raise funds directly by issuing commercial (money-market) paper. Between 1977 and 1984 the outstanding volume of commercial paper issued by non-financial corporations increased nearly fivefold (see the graph on page 52). In due course the practice of linking the banks' commercial lending rates to market rates tended to spread to loans to firms without obvious access to such markets. This was a result of keener competition in the United States between commercial banks and other financial institutions, in particular foreign banks, and because the adoption of this practice enabled the banks to reduce their interest rate risk.

The extent to which market rates are paid on small deposits varies from one country to another. In the United States, the United Kingdom, Italy and Canada the minimum size, maturity and withdrawal restrictions are now so insignificant that liquid deposits paying market rates are available to the average household. In some other countries banks with large deposit bases have not been eager to see the spread of market rates to the small deposits constituting the bulk of their funding. This issue is also of concern to the monetary authorities because it is a major determinant of the size of changes in interest rates needed to influence monetary aggregates.

*Blurring of boundaries.* Recent years have also witnessed the continuation of a further fundamental change in financial intermediation: the blurring of distinctions between different types of financial institution, between different types of contract and, indeed, between intermediated and direct market transactions. The first change is the result of increased competition over the full range of financial services and greater penetration by institutions into one another's traditional domains. It has been particularly noticeable in the United States, Japan, the United Kingdom, Italy, France and Canada. Perhaps because the United States is the only Group of Ten country with important geographical restrictions on banking, it has experienced more extensive institutional interpenetration in the domestic sphere than many other countries. As with other financial changes, the blurring of distinctions has been negligible in Germany, the Netherlands and Switzerland, where universal banking has long existed.

In the United States a para-banking sector has gradually developed on the periphery of the traditional institutions, which have responded by extending their geographical and product ranges. Some of the new institutions such as the "non-bank banks" are the progeny of differential regulations which reflect the division of responsibility characteristic of a federal system or which were conceived at a time when financial innovation was relatively dormant. Exploitation by core banks of different local laws and regulations has also led to increased interpenetration, as has the acquisition of one type of financial institution by another, a phenomenon that can also be observed in Canada, France and the United Kingdom. In these countries banks, securities houses and insurance companies have joined forces in varying combinations to form financial conglomerates.

Recently the authorities in some countries have contributed more actively to the blurring of distinctions between institutions by relaxing restrictions governing the type of business they can conduct and the conditions on which they can conduct it. This has been done to promote efficiency and to create equitable competitive conditions for different types of institution. In the United Kingdom, for example, the tax treatment of all deposits was made identical in 1985, thus placing private deposit-taking institutions of all types on a more equal footing. Building societies had previously been the only institutions to pay interest net of a standard or composite rate tax. Dividing lines have also been obscured in Italy between banks and special credit institutions and in Japan between banks and securities companies.

One of the more recent examples of a blurring of distinctions is that between different types of financial contract. Not only were financial contracts previously generally held to maturity, the purchase or sale of a contract, when it occurred, also involved the transfer of all its features. Now new techniques enable banks or other institutions to "unbundle" financial contracts, to retain some of the elements and to pass others on. Currency and interest rate swaps, futures contracts, forward-market operations, options, trading in interest entitlements and insurance of credit risk are examples of the new techniques. As yet, some are of only limited significance outside the United States and the Euro-markets, where a substantial proportion of fixed rate Euro-bond deals involve swaps, but there are clear signs of their gradual extension. Financial futures exchanges, discussed more extensively in last year's Annual Report, exist or are being developed in Australia, Canada, France, Luxembourg, the Netherlands, the United Kingdom and the United States, and their activity and range of products have been increasing, albeit often from a very small base. In other countries, such as Germany and Switzerland, where financial markets have not undergone such rapid changes, unbundling in domestic transactions appears to have played a minor rôle.

The final blurring of distinctions — that between financial institutions and markets — is in large measure a consequence of increased competition, the greater use of markets by both ultimate borrowers and financial institutions and the unbundling of the terms in the financial contract. When interest rates on bank assets and liabilities move with market rates and full charges are levied on financial services, when banks hive off unwanted features of financial contracts, such as excessive interest rate risk, through unbundling techniques and when instruments

that were previously held until maturity can be sold at will, the distinction between intermediation through institutions and direct flows in markets — a distinction that is sometimes considered the cornerstone of monetary control — becomes much more problematic. It does not, however, disappear. Bank interest rate margins remain larger than spreads between selling and buying rates in financial markets because banks provide a range of services, such as risk assessment and customer screening, that markets alone do not, and indeed cannot, perform.

One important financial innovation, variable rate lending, was discussed in the Annual Report published in 1983. It is worth noting that in the intervening period the re-emergence of fixed rate contracts and interest rate transformation has been modest despite lower inflation and more stable interest rates. In the United States some recovery in fixed rate lending occurred in 1984. This was perceptible in the corporate bond market and later in the year in the mortgage market, but for the year as a whole the share of adjustable rate mortgage lending, at about two-thirds of the total, was higher than in either 1982 or 1983. Moreover, swap transactions were involved in some of the fixed rate borrowing, which means that interest rate risk may not have been increased. Similarly, last year Canada witnessed a modest rise in lending at interest rates fixed for terms of three to five years. In Italy the use of variable rate contracts by special credit institutions continued to expand, and in France financial institutions also tended to favour this type of lending. In countries which have long practised it, such as the United Kingdom, no major changes occurred.

Continued reliance on techniques for reducing interest rate risk allows of several explanations. One is that expectations of future interest rates are still coloured by exceptional uncertainty. In this case, a more lasting assumption of interest rate risk by the banks and greater willingness by ultimate borrowers and lenders to conclude fixed rate contracts could be expected once underlying financial and economic conditions have become more stable. A second explanation is that banks are unwilling to abandon new-found practices which allow them to reduce their interest rate exposure, particularly when the interaction with other risks such as credit, currency and country risk has become more dynamic. Indeed, it can be claimed that the major change that has occurred in bank risk management is not in the nature or even in the aggregate amount of risk, but rather in the greater ability of the banks to alter its composition. In this case, a general resurgence of fixed rate lending would depend on changes in other risks and on the operational decisions of financial intermediaries.

**Policy issues.**

The financial changes of recent years raise a number of policy issues, though their topicality for individual countries varies in line with the speed and scope of the changes. One of the most important issues is the question of efficiency. Increased competition in the financial market is generally believed to promote efficiency not only in the narrow area of banking and finance but also in the overall allocation of resources. The relaxation of various restrictions has allowed the banks and other

institutions to respond to changes in market conditions more flexibly than before. Transaction costs have been reduced and portfolio holdings can now be changed more easily. However, if adjustment elsewhere in the economy is slow and difficult to predict, prices in financial markets may not always be at or even near their equilibrium levels, which may well complicate investment and saving decisions and hamper the efficient allocation of resources. Moreover, although the increased range of activities undertaken by different types of financial institution may lead to external economies in processing information and screening customers, the potential for conflicts of interest, exploitation of privileged positions and concentration of financial power grows, which may be inimical to efficiency.

The changes in financial conditions of the recent past and the accompanying intensification of competition have great bearing on another policy concern: financial stability. Stiff competition may spur risk-taking and reduce margins, thus increasing the likelihood of problems in individual institutions. Since national and international interdependence has increased, such problems could pose a threat to financial stability more generally. Monetary and prudential regulatory systems must be designed in the light of the changing conditions. It is now often recognised that restrictions on banks' ability to meet the needs of the market may reduce the resilience of the financial system. Regulation sometimes merely diverts competition into areas where it is less conspicuous and where adjustment is more costly and slower. However, for example, ensuring that institutions have, and are perceived to have, sufficient capital and competent management systems is essential in an environment of enhanced competition, involving a wider range of products in a larger number of sometimes unfamiliar markets.

While in various countries it is accepted that the liberalisation of financial markets should move ahead, the pace of desired change is both difficult to determine and politically sensitive. If prices and the structure of flows are near their equilibrium levels, the overnight abolition of regulations on pricing or portfolio composition may be warranted. But if financial systems have been cosseted by regulations and a stable technological environment for decades, the sudden abolition of controls on pricing and products could lead to such a rapid restructuring of the financial system that its stability could be in jeopardy. In these circumstances gradual change, coupled with measures to ensure capital adequacy, will not only tend to accord with the vested interests of particular segments of the community that benefit from the restrictions but will also tend to reduce the likelihood of financial instability.

A third area of concern in some countries is how changes in the financial system bear upon the planning and formulation of monetary policy. There is ample evidence that the demand for money may shift as a result of financial innovation, the growth of the scope for direct credit transactions and the deepening of financial markets. The existence of a deep and well-functioning market increases the liquidity of individual claims and thus endows the agent holding them with more liquidity than if they could only serve as collateral for a loan. In a large number of countries the financial changes that have blurred the distinction between monetary and non-monetary claims have altered attitudes towards the use of monetary aggregates. In

some countries a wider range of aggregates, not all of them monetary, are now employed. Moreover, there is a tendency to use them in a more conditional or judgemental fashion because in an environment of change past relationships do not always provide an accurate guide to the future.

The growth of direct credit markets also affects the transmission of policy through the financial system and has a bearing on domestic monetary autonomy. Substitution between different financial assets, domestic and foreign, becomes easier as markets become deeper. Administrative controls on credit expansion, interest rates and portfolio composition become less effective as flows are diverted into the growing range of alternative channels. It is widely recognised that interest rates then assume a greater rôle in policy transmission. In addition, risk, the second main determinant of the portfolio decision, also comes to play a more important rôle. Lenders, for example, become increasingly conscious of the impact of high and volatile interest rates on the ability of borrowers to service loans. This in turn engenders caution on the part of the lenders, which underpins a restrictive policy working through interest rates.

Finally, it is important to note that the changes in banking and finance which have occurred in some countries do not merely affect prudential and monetary policy on their own, they also make co-ordination of these policies more imperative but at the same time easier than in the past. As the emphasis in monetary policy in most countries has been shifted away from fine-tuning of counter-cyclical policy, the original raison d'être of central banking, the maintenance of underlying stability in prices and in financial conditions, has come to the fore. The changes in financial markets that have occurred also mean that the distinction between the instruments of prudential and monetary policy has become more tenuous. When markets are well developed and profits bulk large in the constellation of bank objectives, the effectiveness of monetary policy measures depends on the extent to which they have an impact on interest rates. These in turn affect bank earnings and the accumulation by banks of own capital, which has an increasingly important prudential bearing.

# IV. MONETARY POLICY AND INTEREST RATES.

## Highlights.

Monetary policy continues to be formulated in the stable framework provided by money stock control in the larger industrial countries and an exchange rate orientation in most others. These strategies have been designed to help achieve a return to non-inflationary growth, and in some respects economic developments last year were encouraging. With inflation rates low or falling, moderate rates of monetary expansion consistent with keeping inflation expectations in check provided scope for a recovery of output and seem likely to continue to do so. But, at the same time, in the United States, in conjunction with a large external current-account deficit, the total domestic debt measure expanded much faster than the monetary aggregates.

While the basic objectives of monetary aggregate strategies have tended to converge over time, control procedures still differ from country to country, particularly in the importance attached to influencing the domestic and external counterparts of money creation. Last year a new credit control system was introduced in France, while in Japan evolution towards an interest rate based control mechanism continued. In some countries management of the public debt has posed problems for monetary control. In the United States, Japan, the United Kingdom and Germany changes in the authorities' money-market operating techniques and procedures have influenced the way short-term interest rates respond to policy and market influences.

Given divergent developments in budgetary policies and in the economy, the interest rate implications of moderate monetary growth rates also differed from country to country. In 1984 interest rates in the United States first rose and then fell as the economy weakened. But in Germany and Japan yields remained remarkably stable or moved down slightly. Sensitive to external influences, interest rates in the United Kingdom and Canada underwent large swings during the year. In France, Italy and Belgium a strengthening of exchange rates against the Deutsche Mark contributed to both a slowdown in domestic inflation and a decline in interest rates. In early 1985, with a further surge in the dollar beginning to test the continuing effectiveness of other countries' counter-inflationary strategies, renewed rises in US interest rates placed pressures on capital-market rates almost everywhere. In March and early April this picture underwent rapid change as the dollar abruptly weakened following large-scale intervention and signs of slower US growth.

In relation to inflation rates long-term interest rates still seem high, though more so in North America than in Japan or in some continental European countries. Budgetary imbalance and the strength of the recovery have kept the saving/investment balance in the United States under strain. High real yields in the United States have tended to exert upward pressure on real yields elsewhere, but it was possible for long-term real rates in most other countries to be decoupled to some

extent, partly because the market took into account the risk of a depreciation of the dollar.

Developments last year emphasised the interdependence of countries' economies and the way in which the effectiveness of monetary policy, even in large countries, is influenced by interaction with economic developments and policies elsewhere. Although the outcome last year remained broadly favourable, continuing imbalance in the US policy mix, particularly if now combined with dollar weakness, raises new concern about the problems that may lie ahead.

**Developments in the money stock and in aggregate control strategies.**

Consistent with medium-term objectives, norms and rates of expansion for representative monetary aggregates were brought down further last year. In the United States the expansion in $M_1$, which the Federal Reserve could view as a more reliable policy guide again after an unstable phase, moved irregularly as recovery advanced, but for the year as a whole was comfortably within the target range. The growth of $M_3$ and the broad debt measure quickened, however. In other countries where norms are published the expansion of broad monetary aggregates generally remained moderate or declined, as intended, and growth rates of narrow aggregates were even lower. In the United Kingdom all the main aggregates other than the broad monetary base expanded fairly rapidly, but concurrent changes in the financial system made their development difficult to interpret.

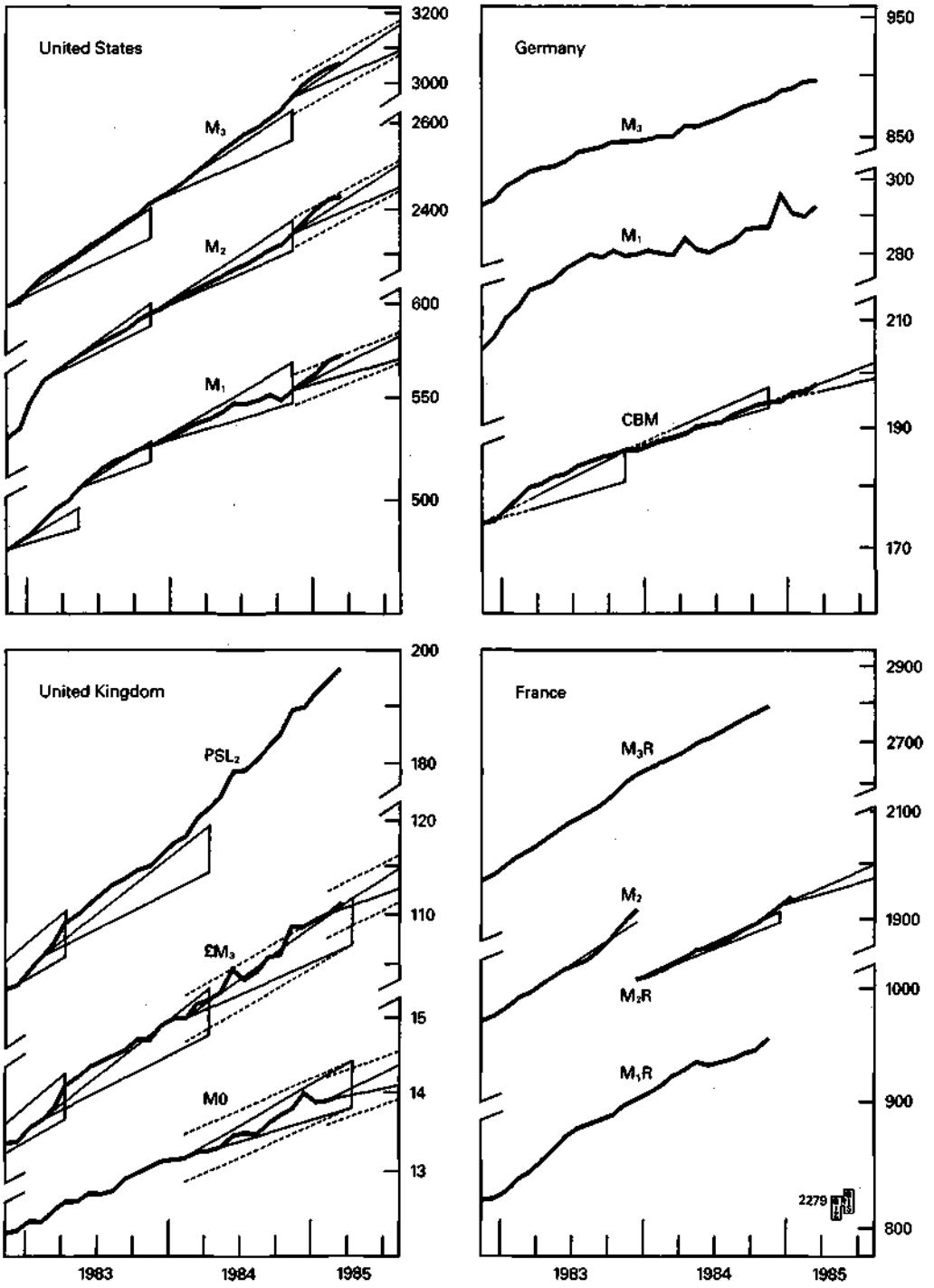
In the *United States* the monetary aggregates — and in particular $M_1$ — had risen steeply in 1982 and early 1983 in a context of abating inflation, disturbances in the financial markets and regulatory change, but had then slowed down to remain within rebased targets for 1983. Consistent with the view that the impact of the distortions had passed but should not be offset, the Federal Reserve set objectives which implied a further slowdown in the growth of $M_1$ and $M_2$ in 1984, and reaffirmed them in July.

Under the more judgemental approach to policy adopted as from mid-1982 the monetary aggregates were freer to respond in the short run to economic and financial developments. In 1984 the monetary aggregates grew rapidly until mid-year but slowed down from July onwards in a context of policy restraint on the supply of bank reserves and a deceleration in bank lending. Then, in the autumn, when it was clear that economic activity was also slowing down, the Federal Reserve became more accommodative in supplying bank reserves. To underpin declines in short-term money-market rates, Federal Reserve discount rates, which had been raised from 8½ to 9 per cent. in April, were lowered to 8 per cent. in two stages in November and December.

By early 1985 faster growth in the aggregates, rises in short-term interest rates and signals from the economy indicated that the situation had again changed. In February the Chairman of the Federal Reserve reported to Congress that policy with respect to bank reserves had become more cautious. At the end of 1984 the increase

## Monetary aggregates: Objectives and development.*

In billions of national currency units.




* CBM = central-bank money; $PSL_2$ = private-sector liquidity; MO = wide monetary base; R = holdings of residents only; semi-logarithmic scales. For France, centred three-month moving averages.

over four quarters in $M_1$ and $M_2$ was close to the centre of the target ranges, the rise in balances on interest-bearing cheque accounts, which had expanded explosively in 1983, having slowed down sharply. The growth rates of $M_3$ and the broad debt aggregates, however, were above the upper limits of their target ranges. For 1985 the upper limits of the target ranges for $M_1$ and $M_2$ were lowered. Those for $M_3$ and the broad debt aggregates were raised but the new limits implied slower growth rates than those actually recorded in 1984.

Monetary and credit aggregates: Objectives and rates of expansion.

| Countries | Monetary or credit aggregate[1] | Objective[2] for | | | Monetary or credit expansion | | | | |
|---|---|---|---|---|---|---|---|---|---|
| | | | | | Target period[4] | | Change over four quarters based on quarterly averages | | |
| | | | | | | | first quarter | | |
| | | 1983[3] | 1984[3] | 1985[3] | 1983 | 1984 | 1983 | 1984 | 1985 |
| | | in percentages[5] | | | | | | | |
| United States ..... | $M_1$ | 5–9 | 4–8 | 4–7 | 8.5 | 5.2 | 9.4 | 9.0 | 6.3 |
| | $M_2$ | 7–10 | 6–9 | 6–9 | 8.5 | 7.7 | 12.1 | 8.7 | 9.0 |
| | $M_3$ | 6½–9½ | 6–9 | 6–9½ | 10.0 | 10.5 | 10.2 | 9.5 | 10.8 |
| | TDND | 8½–11½ | 8–11 | 9–12 | 10.8 | 13.4 | 9.3 | 11.8 | 13.4[6] |
| Japan ..... | $M_2$+CDs | 7 | 8 | 8 | 6.8 | 7.9 | 6.7 | 7.8 | 7.9 |
| Germany ..... | CBM | 4–7 | 4–6 | 3–5 | 7.0 | 4.6 | 7.1 | 5.5 | 4.9 |
| France ..... | $M_2$R | 9 | 5½–6½ | 4–6 | 9.9 | 7.0[7] | 10.5 | 8.9 | 7.1[6] |
| United Kingdom ... | M0 | – | 4–8 | 3–7 | – | 5.7 | 3.9 | 5.8 | 5.4 |
| | $M_1$ | 7–11 | – | – | 14.1 | – | 12.1 | 11.9 | 14.4 |
| | £$M_3$ | 7–11 | 6–10 | 5–9 | 10.0 | 11.9 | 9.5 | 10.3 | 9.9 |
| | $PSL_2$ | 7–11 | – | – | 12.6 | – | 9.5 | 12.2 | 15.1 |
| Italy ..... | TDC | 18 | 17.4 | 16.2 | 20.6 | 20.0 | 20.3 | 21.3 | 20.2[6] |
| | $M_2$ | – | – | 10 | – | – | 16.7 | 12.9 | 11.8[6] |
| Switzerland ..... | CBMA | 3 | 3 | 3 | 3.6 | 2.5 | 7.6 | 1.1 | 2.4 |

[1] TDND = total domestic debt of *non-financial sectors*; CBM = *central-bank money*; $M_2$R = $M_2$ holdings of residents; MO = wide monetary base; $PSL_2$ = private-sector liquidity; TDC = total domestic credit; CBMA = adjusted central-bank money. [2] For Japan, projection only. [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 (1983–84) and Germany, and from December to December for Italy. Periods based on November–January averages for France and on February to April the following year 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 1985 the second quarter to second quarter projection is shown. For France, the target for 1983 applied to $M_2$, which included non-resident holdings of $M_2$ assets. For the United Kingdom, the definition of sterling $M_3$ for 1984–85 was changed to exclude public-sector deposits. [4] *Calculated on the same basis as the objective.* [5] At annual rates. [6] 1984 fourth quarter. [7] Preliminary.

In *Germany* the fast rate of growth of the central-bank money stock recorded in 1983 reflected disturbances encountered early in the year. In 1984, although the temporary slowdown in the pace of the economic recovery early in the year left some trace, central-bank money basically expanded steadily along the course established in mid-1983. The target range for 1985 is lower than that for 1984 but is designed to permit continued expansion of central-bank money during the year at a rate of 4 per cent. This rate was calculated to be consistent with an expected year-on-year growth of productive potential of just over 2 per cent. in real terms and to help consolidate the slowdown in inflation which took place during 1984. Only minor adjustments in the settings of policy instruments were made during the year; an increase from 4 to 4½ per cent. in the Bundesbank's discount rate in June 1984

and a rise from 5½ to 6 per cent. in the lombard rate in January 1985 were aimed solely at allowing a restructuring of the way in which central-bank money is supplied by the Bundesbank.

In *Japan*, too, settings of interest rate instruments were kept essentially unchanged last year. The rate of increase of $M_2$ + CDs remained remarkably stable in line with the official projections, even though many new non-monetary financial instruments were introduced. The forecast rate allows for the trend decline in the velocity and is broadly consistent with the economy's growth potential and minimal increases in the general price level.

In *France* and the *United Kingdom* a progressive lowering over time of the norms for monetary expansion has clearly reflected the authorities' intentions. Because of structural changes, however, recent developments in the aggregates have been difficult to interpret.

In *France*, in setting the targets for $M_2R$ in 1984 and 1985, some allowance was made for the growth of the public's placements in mutual funds and unit trusts which are not included in the aggregate. An acceleration in the growth of $M_2R$ at the end of 1984 mainly reflected temporarily unfavourable developments in the capital market. By eliminating the unutilised margins available for new lending which the banks had accumulated over time under the old credit ceilings, the new credit control system announced in late 1984 (see page 72) should be helpful in restraining bank credit when the demand for it strengthens.

In the *United Kingdom* difficulties were experienced last year both in specifying objectives for the aggregates and in the implementation of policy. To some extent the authorities could anticipate the very rapid rates of expansion recorded last year as banks and building societies intensified their competition for personal-sector deposits. This was true not only for $M_1$, where the increase was disproportionately weighted towards new types of interest-bearing accounts, but also for $M_2$ (transactions balances and retail deposits) and $PSL_2$ (broad private-sector liquidity). Targets for last year were set only for M0 and sterling $M_3$. The growth of sterling $M_3$ was influenced by an uneven profile of the government borrowing requirement and erratic movements associated with the sale of British Telecom, but also reflected fast rates of expansion of bank credit to the private sector. It remained close to the top of the target range during the year and broke out of it on two crucial occasions when sterling was under pressure in the exchange market for other reasons. On each occasion unusual policy procedures were adopted: in June 1984 the Bank of England issued a statement to the effect that monetary policy was on course, and in January 1985 minimum lending rate was reintroduced, for the first time since 1981, for one day. Sharp increases in short-term interest rates had to be acceded to and banks' base rates, which had stood at 8½ per cent. in April 1984, reached 14 per cent. at the end of January 1985. The growth of M0 (consisting mainly of bank-notes and coin) remained within the target range, but it is difficult to know how much importance can be attached to developments in this aggregate alone. In keeping with the Government's medium-term strategy, new, lower target ranges for M0 and sterling $M_3$ were announced by the Chancellor in his March 1985 Budget speech.

In *Italy* credit to the public sector continued to expand strongly last year. The growth of bank credit to the private sector accelerated sharply in a context of economic recovery and following the termination, in December 1983, of the credit guidance which had been in effect since the ten-year-old credit ceilings were abolished in mid-1983. With nominal interest rates in most other countries lower than those in Italy and the prospects for exchange rate stability in the European Monetary System favourable, foreign currency credits, refinanced abroad by the banks, expanded very strongly, and in July a ceiling was placed on banks' net external debtor positions. In September, when the situation was reappraised, it was decided to attempt to limit the expansion of credit to the private sector in 1984, then threatening to rise by 16½ per cent., to 14 per cent., compared with an original objective of 12½ per cent. At the same time the official discount rate, which had come down from 17 to 15½ per cent. between February and May 1984, was raised to 16½ per cent. The growth in total credit subsequently slowed and for 1984 as a whole was broadly in line with the revised objective. Inflows of funds continued, however, and the rise in $M_2$ came to 12 per cent. In January 1985, following a further decline in the inflation rate, the discount rate was brought down to 15½ per cent.

In *Switzerland* the rise in the adjusted central-bank money stock in 1984 was below the target. The implied increase in short-term interest rates was regarded as appropriate for preventing an excessively rapid increase in aggregate demand. The long-term objective is to limit the expansion of central-bank money to a rate of 2–2½ per cent. per annum.

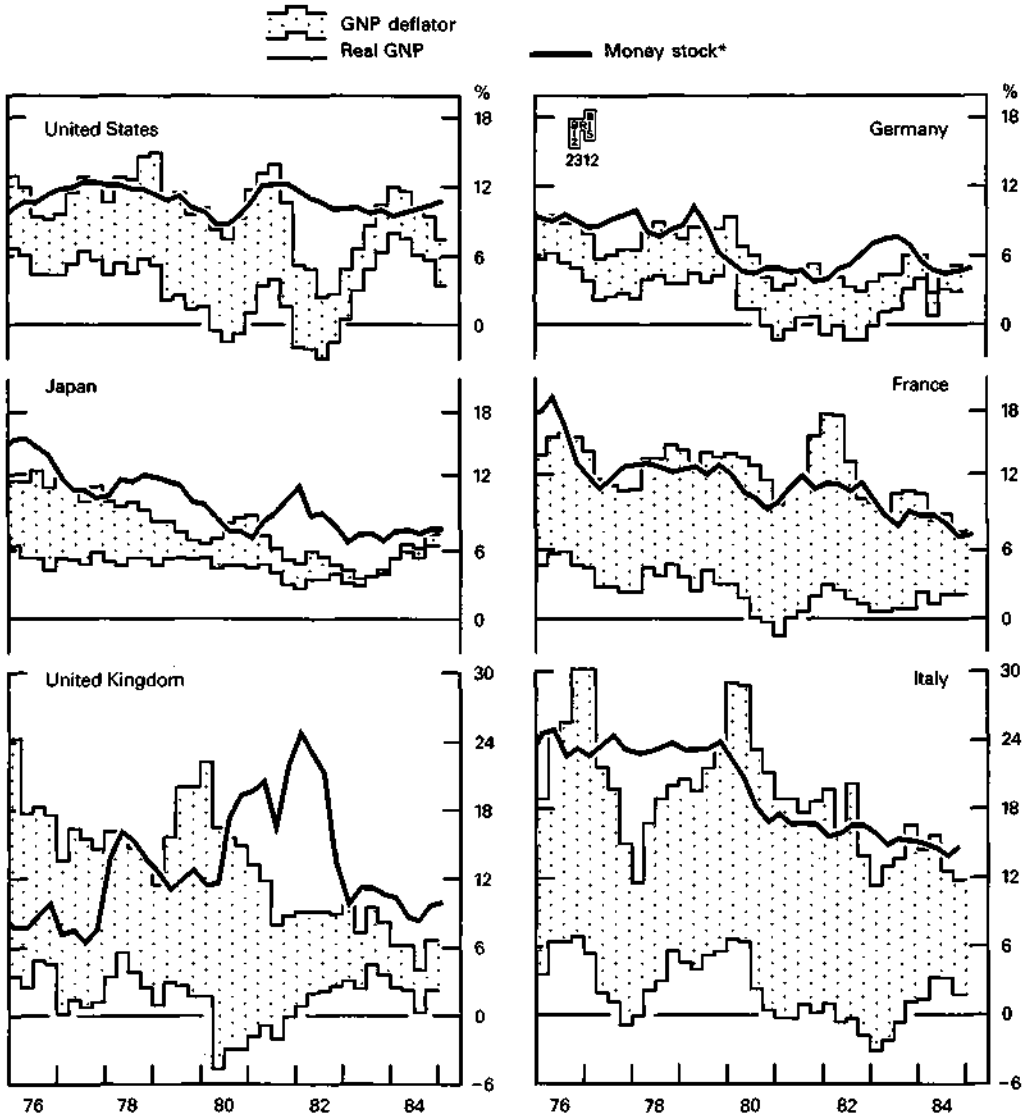
In *Canada*, where targets for monetary expansion have not been in use since 1982, deposit-shifting continues to make targeting of the narrow aggregates impossible, and the controllability of the broad aggregates is still open to question. For the time being, monetary policy remains, to a considerable extent, exchange rate and interest rate oriented, but the Bank of Canada continues to monitor developments in the aggregates along with those in other financial and economic indicators.

*Interpreting developments in the monetary aggregates.* The monetary aggregate strategies applied in recent years have, in varying degrees, a medium-term orientation, and monetary developments have mainly to be seen in the light of policies designed to establish and maintain price stability as a basis for sustainable economic expansion. At the limit, the credibility of such policies would seem to call for aiming at eliminating inflation. In practice, of course, annual targets are related to some estimate of the potential for a non-inflationary rise in output and have normally made allowance for an increase in the general price level. Some rise in price indices may come about, even in non-inflationary conditions, in a context, for instance, of changes in relative prices or of increases in prices set by the public authorities.

As indicated in the graph, over the past two years rates of increase of key aggregates have remained moderate or slowed down, while rates of inflation have declined steeply. In other words, an acceleration in the growth of the nominal money stock, characteristic of previous recoveries, has largely been avoided, but in

**Monetary aggregates and GNP in nominal and real terms.**

Changes over four quarters, in percentages.




*Based on quarterly averages (for the United States and Italy, M1; for Germany, central-bank money; for Japan, M2 + CDs; for France, M2R; for the United Kingdom, sterling M3).

inflation-adjusted terms rates of expansion of the aggregates have increased. In all the countries shown they have been significantly positive for some time. In the most general terms, therefore, developments in the money stock seem to indicate a monetary policy conducive to recovery, whatever the transmission mechanisms involved.

In considering policy objectives allowance needs to be made for other factors which have altered the relationship between the money stock and nominal GNP in

the short run. The fairly general fall in the income velocity of broad as well as narrow monetary aggregates recorded in 1982–83 was influenced, depending on the country under consideration, by a rise in the demand for precautionary balances in recession and for low-interest-bearing transactions instruments as inflation rates and interest rates came down, by financial innovation or by other disturbances. However, even to the extent that monetary policy simply accommodated a rise in the demand for liquidity in relation to GNP it provided scope for economic recovery.

Subsequently, a more normal relationship between changes in money stock and in nominal GNP was apparently re-established. In the United States the decision of the Federal Reserve to refrain from attempting to bring about a reversal of the earlier unusual rise in the money stock (and fall in velocity) clearly did not, in retrospect, cause a resurgence of inflation. In the course of last year policy was flexibly adjusted again once it had become clear that the recovery was slowing down. The response was, to a degree, judgemental. In Germany, where financial and economic developments have been more stable, the objectives for monetary expansion have been consistently related, over a long period, to developments in productive potential. In recent years central-bank money has tended to rise, on balance, in relation to recorded output, and an increase in velocity could be expected on the basis of past experience to help accommodate economic recovery. In Japan the activation of idle balances has also been helping to make stable monetary developments consistent with strong recovery of the economy.

In interpreting developments in velocity, account must also be taken of the changes in the financial system. Last year these helped to shift funds towards market instruments and thus to slow down the growth of $M_2R$ in France, though the demand for credit was also weak. In the United States the surge in issues of large CDs as banks competed actively for funds to finance strong growth in credit had a strong impact on $M_3$.

*Interpreting credit developments.* In the United States last year the rise in the broad debt aggregate far exceeded that in all the money stock measures. The Federal Reserve publishes a "monitoring" range for this aggregate, and the question arises as to what its development indicates about the stance of monetary policy. Though not the principal instrument or intermediate objective of policy, credit expansion may closely reflect economic and financial developments, particularly where there is an external balance-of-payments problem or where financial innovation is in progress.

Total credit-market debt of domestic non-financial sectors includes the bulk of the funds raised by domestic households, firms and government units in debt markets in the United States. It includes debt securities placed directly with non-financial investors as well as funds lent by banks and other financial intermediaries. Equity financing and some items such as trade credit are excluded, however. For many years the ratio of the broad debt aggregate to nominal GNP was relatively stable, but, as in the case of the monetary aggregates, this relationship changed markedly in late 1982 and early 1983. However, whereas the velocity of the monetary aggregates has since developed more normally, the income velocity of the broad debt aggregate recorded a further steep fall last year.

Much of the rise in the broad debt aggregate between the fourth quarter of 1983 and the fourth quarter of 1984 was accounted for by a 17 per cent. rise in Federal Government borrowing — most of it in non-liquid forms. This reflected a growth in structural budgetary financing requirements unprecedented in an advanced phase of economic recovery. The overall increase in the other components, at nearly 13 per cent., was less out of line with experience in previous recoveries. Lending to the personal sector and short-term credit to business rose strongly, with the latter mainly reflecting huge growth in the commercial paper component. The expansion of bank credit was inflated by an unusual volume of mergers and "leveraged buy-outs" early in 1984 but slowed down subsequently. The rise during the year in total bank loans and investments came to only about 11½ per cent.

The large government deficit would have tended to have a moderating effect on private credit demand had the large external current-account deficit not served as a buffer. The increase of $715 billion in the broad debt measure last year occurred in the context of an external current-account deficit of over $100 billion. About $70 billion of funds from abroad are included together with domestic asset formation as direct and indirect sources of funds to credit markets. The difference broadly matches the discrepancy in the balance-of-payments accounts, though large recorded inflows and outflows of equity and other direct investments are excluded from the credit-market aggregates. Of the recorded uses of foreign funds, banking inflows amounted to over $20 billion. A small proportion of this was included in the measured change in the US monetary and bank credit aggregates. The remainder — essentially changes in interbank positions — could serve as a basis for credit-granting while helping to moderate the growth of the banks' domestic monetary liabilities. This consideration was taken into account by the Federal Reserve in evaluating developments in the aggregates.

In short, therefore, it can be said that the fast rate of expansion of total credit last year mainly reflected the twin imbalances in the economy — the budget deficit and the balance-of-payments deficit. These imbalances could not appropriately have been rectified by monetary policy alone. The development in credit nevertheless tends to confirm that monetary policy provided scope for economic recovery at home and abroad.

In countries other than the United States *broad* credit aggregates play a more limited rôle as policy guides. In Italy, where the limits set for total credit expansion imply concern about an external current-account constraint, separate norms for credit to the public and private sectors reflect the way in which meeting the objective depends on fiscal as well as monetary policy. Most other countries still pay close attention to developments in bank credit — in varying degrees objectives for credit and external currency flows are explicitly taken into account in formulating norms for the monetary aggregates. In the United Kingdom erratic developments in bank lending to the private sector and in the funding of the public-sector borrowing requirement contributed to the difficulties experienced last year in keeping sterling $M_3$ on target. In Germany and Japan conditions in bank credit markets were calmer: the rate of expansion of total bank credit to the public and private sectors in 1984 as a whole was moderate and closely in line with that of the broad monetary

aggregates. Much the same can be said for net domestic credit, i.e. credit financed from monetary resources, in France.

**Developments in targeting strategies and monetary control procedures.**

Unpublished targets for the aggregates were first employed as guides in policy-making in the United States in the early 1970s, and it is now over ten years since targets were first published in Germany, Switzerland and the United States. Published norms have been in use for only slightly shorter periods in the United Kingdom, France and Japan. Over time, and especially since 1979, countries' basic objectives in targeting the aggregates seem to have converged. Procedures have been revised — much more extensively in some countries than in others — in response to experience, to changes in the financial environment and to ideas about how the objectives might be better achieved. Some common trends can be detected, but the techniques used, and the problems to which they are prone, still differ widely from country to country.

While a tendency for monetary authorities to rely increasingly on market mechanisms in the monetary control and transmission processes has been fairly general, the starting-point and the pace of change have also varied among countries. In a few cases the control instruments have had to be adapted to cope with a comprehensive dismantling of interest rate, credit and exchange controls required by a commitment to deregulation. In a wider range of countries limited steps have been taken to broaden access to money markets and to encourage more flexible adjustments of short-term interest rates.

*The specification of objectives.* Last year ongoing changes in the financial system (see Chapter III) resulted in further shifts in the weight attached to particular aggregates as policy guides in the United States and the United Kingdom. In some other countries essentially the same aggregates have been relied upon for many years. The reason is not that technological progress or innovation in the use of instruments has failed to occur in these countries but rather that changes in regulations and in bank behaviour have taken place at an orderly pace. The usefulness of particular aggregates as targets or indicators does not depend only on the predictability of their relationships to output, inflation and interest rates. In the United States the Federal Reserve has usually attached most weight to a measure of transactions balances which can be amenable to fairly close control by manipulation of interest rates. Earlier experience there and in Canada, where a narrow money objective had to be abandoned some years ago because of the impact of financial innovation, suggests that there may be a risk, where the demand for the target aggregate is highly interest-elastic, that interest rates will not be raised far or fast enough to check aggregate demand in a way that effectively counters inflation. In some institutional contexts, too, it has become increasingly difficult to distinguish transactions from savings balances.

Most countries attach importance to developments in broad aggregates which can serve to check that developments in related variables — bank credit to the

private sector, monetary financing of the government and external currency flows — are on course. In most cases bank credit is still a large and volatile component of total credit to the private sector, and institutional arrangements call for keeping a close watch on monetary financing of the government. Moreover, external currency flows remain relevant in a context of managed floating. Although only a few countries now seek to influence bank credit directly, developments in it must be monitored even when interest rates are the principal instrument of monetary control.

Minor amendments have been made over the years in countries' targeting procedures — in the use made of point objectives, target zones or annual averages, in the specification of target periods, and so on. In the United States, for instance, the objectives for 1985 were first shown in graphic presentations in the form of "bands" as well as "cones". Matters of this kind can clearly be regarded as secondary, provided not too much attention is paid to very short-term developments in the money stock. All countries base their norms on actual outcomes in the previous target period and, in effect, incorporate the latest information available in the standard of reference. Where this implies base drift — as in the case of $M_3$ and the broad debt aggregate in the United States in 1985 — the reasons for it could readily be explained. Perhaps indicative of more significant differences between the procedures in major countries are differences in the extent to which trend rather than cyclical developments enter into the formulation of norms and into the interpretation of ongoing monetary developments by the authorities and the public.

*Direct credit control mechanisms* are no longer in use in most industrial countries. The systems in operation in Japan and France have recently undergone significant changes.

In *France* a fairly rigid system of credit ceilings fixed monthly for individual banks, embodying a complex system of privileges for particular types of credit, had been in operation for more than a decade. It was replaced in January 1985 by new arrangements designed to permit the banks to exercise more initiative in managing their balance sheets and to give them some scope for competition. Under the new regulations the authorities will closely monitor credit granted by the whole banking system to the extent that it is financed from monetary resources. Individual banks will be free to expand their market shares, either by raising new capital and issuing bonds or by accepting the burden of holding non-interest-bearing reserves with the Bank of France in relation to their credit-granting. The reserve coefficients are scaled to rise in steep progression in relation to credit-granting. However, concessions may be granted, depending on the prospects for monetary expansion. The array of special régimes for particular types of credit, which had, in effect, rendered the old system unworkable, was abolished. Initially, under the new arrangement, 70 per cent. of the growth of privileged credit will be counted as credit expansion. To help establish a closer link between credit-granting and changes in the interest costs of financing it, the reserve requirement was made contemporaneous.

In *Japan* over the past two years "window guidance" has changed in nature from a rigid credit control device to an expression of the central bank's views on the short-term prospects for credit expansion. Over a longer period, with the business

sector tending to become more liquid and the share of banks in financial intermediation declining, less and less reliance has come to be placed on window guidance for achieving monetary control. With the development of money markets accessible to non-banks, the monetary policy transmission mechanism can at present rely to some extent on changes in the level of financial intermediation induced by shifts in money-market rates in relation to less flexible deposit rates. In the longer run, as deregulation of deposit interest rates proceeds and new instruments are authorised, the effectiveness of monetary policy is expected to depend more on the interest elasticity of expenditure.

Changes announced last year, in part related to the opening of the financial markets internationally, included further liberalisation of CD issuing activity, the authorisation of money-market certificates, the removal of limits on the swapping by exchange banks of foreign currency into yen, and a freeing of forward exchange transactions, which gave banks and non-banks much greater scope for asset and liability management. As a result international interest parity relationships involving the yen have come to hold much more precisely. The deregulation process has been gradual and has not impaired the effectiveness of $M_2$ + CDs as a policy guide. Further liberalisation of deposit interest rates calls for the co-operation of the postal savings system and for agreement on arrangements for easing transitional problems of small banks.

In many countries *government debt management* has, in effect, to serve as an instrument of monetary policy. The banking system does not normally purchase long-term government securities but effectively meets the government's residual financing needs by purchasing Treasury bills or through other special arrangements. Few large countries now use portfolio constraints for financial institutions to limit the monetary or interest rate impact of government financing. In a few countries tax privileges or interest rate controls still give advantages to Treasury instruments.

In the *United Kingdom* in recent years net sales of public-sector debt to non-bank residents have, on average, exceeded the public-sector borrowing requirement — a relationship which has come to be known as "overfunding". Purchases of government securities by life assurance companies and pension funds, in particular, have been very large. The context has been one in which bank credit to the private sector has expanded at a rate far in excess of the official norm for banks' sterling $M_3$ liabilities and in which banks have not issued long-term liabilities on a large scale. Strains in the money market which have arisen in the process have been relieved, after the banks' stock of Treasury bills had become depleted, by purchases by the Bank of England of commercial bills from banks. To some extent the Bank has used the proceeds of deposits placed with it by the Treasury for this purpose. The choice of instrument has partly reflected the "market-oriented" spirit of the changes in official money-market procedures made in 1981. However, bill purchases on a scale large enough to influence the structure of money-market rates could distort bank credit and the money stock by stimulating bill arbitrage — borrowing by non-banks against bills to finance the constitution of deposits. Concern has also been expressed that the implied maturity transformation by the Government and the central bank, taken together, could involve a net cost to the Treasury if long-term interest rates

exceed short-term rates on average and, more important, that it might have an impact on the term structure which could discourage non-financial companies from lengthening the structure of their liabilities.

Many elements of this situation can be found elsewhere. Declines in net lending by the banking system to the public authorities have at times been recorded in the Netherlands under policies designed to limit the public authorities' recourse to monetary financing. Claims on the private sector have long been a significant component of the monetary authorities' assets in Japan and in many continental European countries. In Germany, the Netherlands, Switzerland and Canada the Government has traditionally held a net credit balance at the central bank: in Germany and Canada action to shift these balances to the market can be used as an instrument of money-market management. More important, in few countries have bond issues by non-financial enterprises been very large in recent years, though in many cases enterprises have other alternatives to short-term bank credit. In the United Kingdom action was taken with the budget this year to facilitate the issue of one to five-year corporate bonds. Whether the recent increases in short-term interest rates will also help to bring about a different balance in the structure of public and private-sector financing remains to be seen.

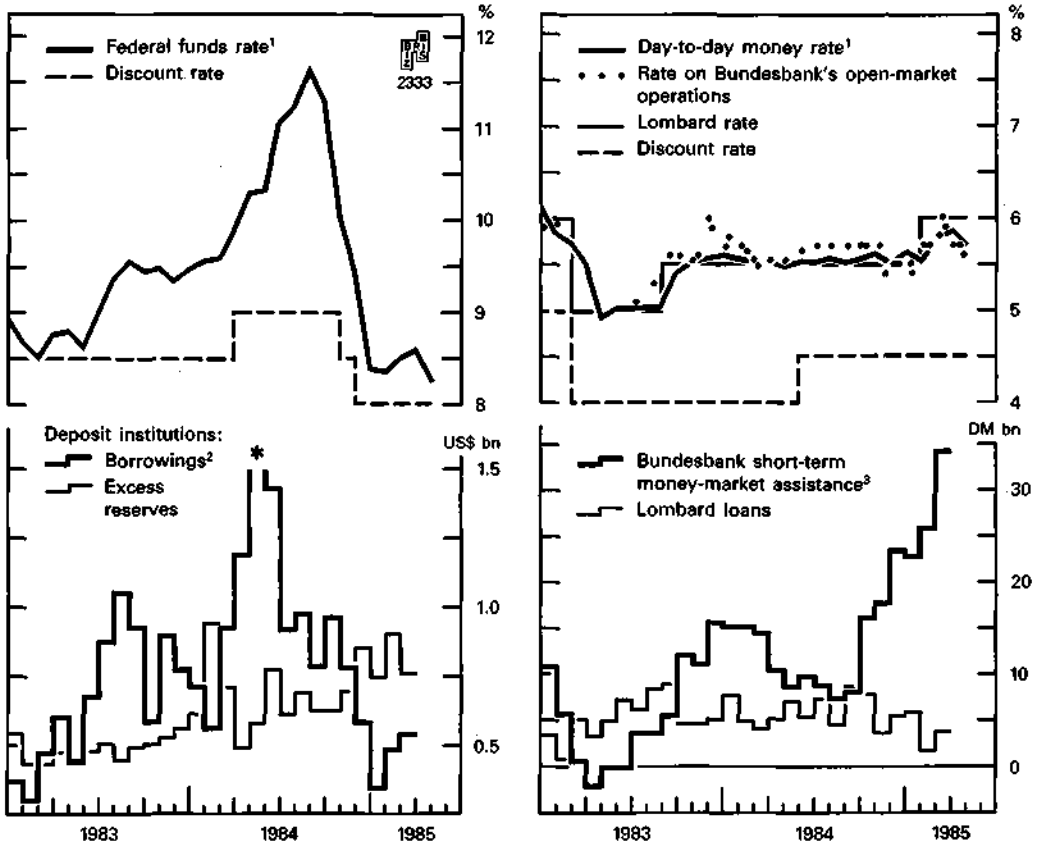
In some other countries the main problem in public debt management has been the traditional one of containing the liquidity impact of large government borrowing requirements. In *Italy* the termination in 1981 of the arrangements under which the Bank of Italy took up government securities not placed with the public or the banks has contributed to more effective monetary control. Over the years, however, a large stock of short-term Treasury bills and government securities with variable interest rates has accumulated in the hands of non-banks. In *Belgium* a build-up in the banks' holdings of short-term government securities and, at times, the liquidity impact of government borrowing abroad have significantly influenced the operation of monetary policy. In *Sweden*, where a variety of new public debt instruments have been developed in recent years, the investment requirements for insurance companies were changed in September 1984 and were extended to the National Pension Fund. Thereafter, the coefficients, which had previously specified minimum net holdings of priority bonds (issued for financing the public sector, housing and agriculture), applied to gross quarterly purchases from the National Debt Office.

As for more indirect control instruments, the authorities' *money-market procedures* have undergone extensive changes in many countries in recent years. In the *United States* the procedures introduced in 1979 were designed to permit closer control over bank reserve positions, but since mid-1982 they have been operated less rigidly. Contemporaneous reserve accounting was introduced in February 1984. At the same time the reserve-holding period was extended to two weeks, with the result that the Federal funds rate became more sensitive in the short run to banks' yield expectations. Under the procedures used since 1982 the Federal Reserve has tended, in the short run, to adapt its provision of non-borrowed reserves in order to keep borrowing at Reserve banks (or, more technically, free reserves) within a certain range, thereby tending to stabilise the Federal funds rate. Last year, however, the relationship between the Federal funds rate and borrowing at the Federal Reserve

weakened. In the spring of 1984 borrowing rose in advance of Federal Reserve action to tighten bank reserve positions. Then, with policy merely aimed at stabilising the level of borrowing, the Federal funds rate rose steeply further, but it subsequently turned down before policy was eased. Reserve positions were still quite easy when the funds rate rose again in early 1985. In circumstances in which it was widely supposed that Federal Reserve policies would be conditioned by the strength of the economy the market seems to have anticipated policy adjustments, thereby contributing to the timeliness of the interest rate adaptation. It is possible, however, that the rise in short-term interest rates in the summer of 1984 partly reflected uncertainties in the financial markets.

Elsewhere the objective has been rather to make interest rates more flexible and more effective in the control mechanism. In *Japan* the call-money rate has become more responsive to supply and demand conditions since the ending of the official posting in 1979. Steps are now being taken to broaden the range of open markets in which the Bank of Japan can effectively intervene. The establishment of a market for yen-denominated bankers' acceptances has been announced, and the creation of an effective Treasury bill market, which is under discussion, would be consistent

Money-market indicators.




* Observation affected by emergency accommodation granted to a major bank.
¹ Monthly averages. ² At Federal Reserve banks, excluding extended credit. ³ Mainly open-market transactions in securities under repurchase agreements and foreign exchange swaps and repurchase agreements.

with the move towards more reliance in monetary policy on interest rate mechanisms. In the *United Kingdom* continuous posting of the minimum lending rate ceased in 1981 in a context of wider procedural changes (described in earlier Reports) which were designed to give more scope for the play of market forces in the determination of short-term interest rates. In *Belgium* the National Bank announced in May 1985 that in future the discount rate would be set each week in relation to the rate on three-month Treasury certificates. In *Canada* a variable discount rate, linked to the Treasury bill tender rate, has been in operation since 1980.

In *Germany* the changes have been more limited, but, as in the other countries, the use made of market-related instruments, including security repurchase agreements, currency swaps and other special facilities which can permit "fine-tuning" of the money market, has increased. Last year, against the background of much more stable domestic monetary conditions, the Bundesbank placed the temporary accommodation granted earlier to the banks on a more durable basis by increasing rediscount quotas in July. It thereafter took account of external considerations to some extent by supplying central-bank balances on a reversible basis by means of security repurchase operations at interest rates just above the lombard rate. Funds were offered in December at the lombard rate, but banks' recourse to lombard credit remained high and increased further in early 1985 in a context of interest rate uncertainty associated with the further rise in the dollar. In these circumstances the Bundesbank, in a new departure, raised the lombard rate and guided the day-to-day money-market rate to a level below it by means of repurchase operations. The banks' lombard indebtedness was quickly wound down, though interest rate developments were distorted for a time by the liquidity impact of official intervention in the foreign exchange market. In the long run the new rate relationship should ensure that the rôle of lombard credit remains more limited and should permit the Bundesbank to guide money-market interest rates more flexibly as required.

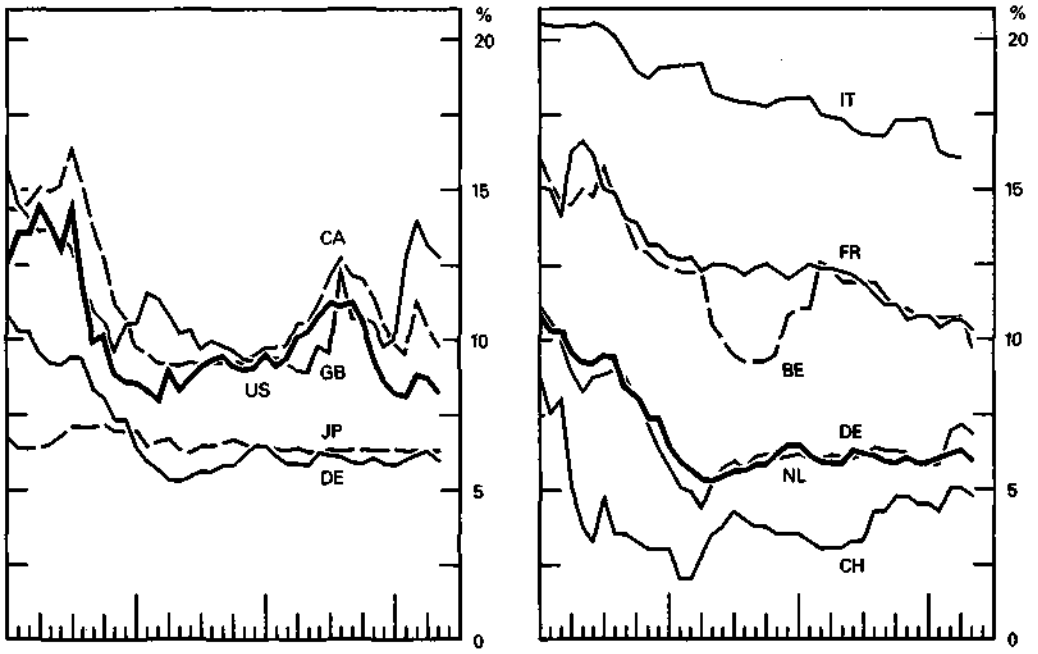
**Exchange rate objectives and interest rate developments.**

*Short-term interest rates.* Money-market rates in the larger industrial countries have been strongly influenced by the efforts of the monetary authorities to meet their domestic monetary objectives. However, they have also increasingly become responsive to market expectations of future economic developments and policies both at home and abroad. In particular, sentiment in the money markets in most countries has continued to be affected by events in the United States and by the way the domestic monetary authorities were expected to react to them. At the same time, there have, of course, been marked differences in the behaviour of short-term interest rates in the other major centres. These must be largely put down to differences, based on past experience, in the degree of confidence which markets expressed in the ability and willingness of the monetary authorities to steer a non-inflationary course.

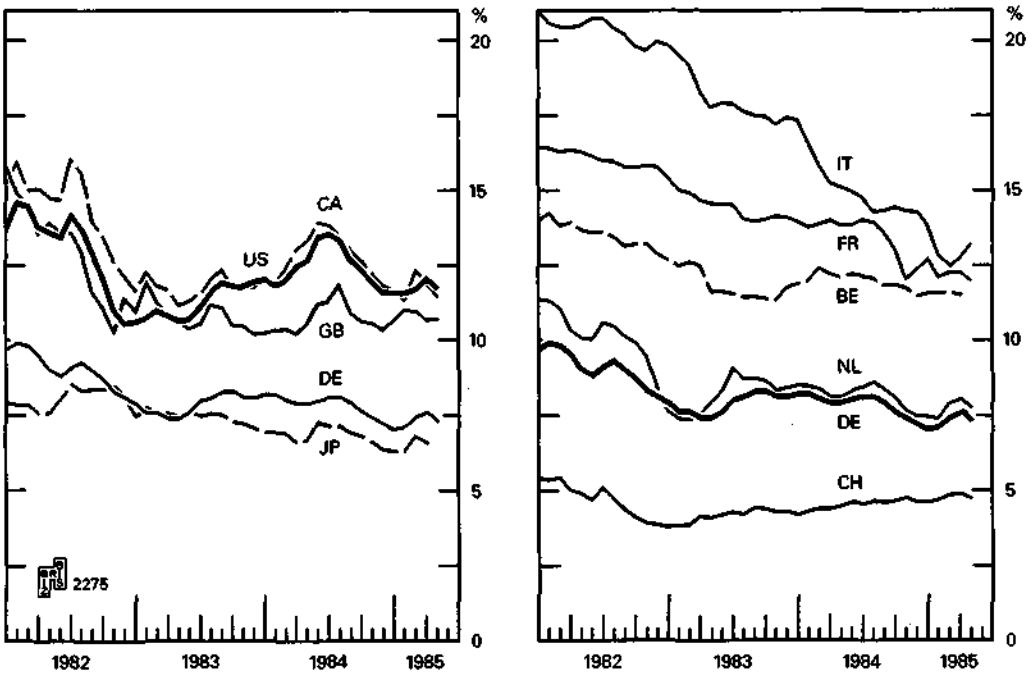
In *Germany* and *Japan* short-term interest rates were largely unaffected by the rise and fall in money-market rates in the *United States* in the course of last year. With the divergences came a substantial depreciation, on balance, of the Deutsche

## Short and long-term interest rates.

Money-market rates[1]




Bond yields[2]




[1] 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. [2] Representative rates: for Germany, France and Italy, public-sector bonds; for other countries, government bonds.

Mark and the yen against the dollar. However, markets remained confident that any domestic inflationary impact would remain limited and that policies geared mainly to controlling the domestic money stock were on course and would be effective in keeping inflation under control.

In the *United Kingdom* monetary and credit developments at times gave cause for concern. Against a background of weak oil prices and the long miners' strike, uncertainty seems to have developed about the authorities' attitude to the sterling exchange rate. The view apparently gained ground that, in attempting to bring interest rates down, the authorities had been proceeding faster than was justified by either domestic or external circumstances. To restore confidence, sharp adjustments in short-term interest rates became necessary.

In *Canada* the authorities attempted in early 1984 to protect domestic money-market rates from the impact of rises in interest rates in the United States. At the same time, they sought to keep the implied depreciation of the Canadian dollar within bounds by intervention in the exchange market. These aims came into conflict with each other, however, given the recent experience of high inflation rates in Canada and the close links between the US and Canadian financial markets. It was thus very doubtful whether there was scope for bringing about a sustainable interest rate differential vis-à-vis the United States by means of a moderate depreciation of the Canadian dollar, and the risks involved in trying to do so were large. Subsequently, in fact, short-term interest rates in Canada had to be kept above the level of those in the United States in order to stabilise the exchange rate. In *Sweden,* too, money-market rates were adjusted downwards in relation to short-term US interest rates in early 1984 but subsequently, with inflows of funds giving place to outflows, had to move to levels above those of comparable dollar interest rates.

The comparative weakness of the Deutsche Mark vis-à-vis the US dollar last year changed the nature of the external monetary constraint in countries pursuing DM-related exchange rate policies. Against a background of declines in high inflation rates it was possible for short-term interest rates to be brought down gradually in *France, Italy* and *Belgium.* Policy was geared, however, to preventing too sharp a fall in relation to domestic inflation rates. As the prospect of currency realignments in the European Monetary System — such as might otherwise have been indicated by changes in competitive positions — receded, relatively high nominal short-term interest rates began to attract inflows of funds. The resulting strength of these countries' currencies helped to place downward pressure on their domestic inflation rates. In Belgium, where relatively unattractive bond yields were reflected in net outflows of long-term funds, money-market rates had to be kept high enough to encourage large inflows of private short-term funds, even though the Treasury continued to borrow abroad. In Italy a policy dilemma of an unusual kind emerged in the second half of 1984, when inflows of funds induced by interest rate differentials contributed to rapid monetary expansion even though the external current-account deficit increased.

In the *Netherlands,* where the inflation rate and nominal interest rates were relatively low, the guilder weakened vis-à-vis other European currencies despite a

large current-account surplus. To help strengthen the currency, the official discount rate was raised from 5 to 5½ per cent. in early 1985.

In *Switzerland*, too, though policy was geared mainly to controlling the central-bank money stock, a weakening of the Swiss franc, not only against the US dollar but also against most European currencies, contributed to a rise in money-market rates in 1984 and early 1985. Interest rates in Switzerland remained very low, however, in absolute terms and in relation to a very moderate inflation rate. The weakening of the Swiss franc against other European currencies could be seen as a correction following the earlier strong appreciation. However, in early 1985 it began to have repercussions on the domestic price level.

The unusual exchange rate configuration in the European Monetary System was reflected in central banks' net purchases and sales of foreign assets. In France, Italy and Belgium advantage was taken of the relative strengthening of the domestic currency to recoup part of earlier losses of foreign exchange reserves, while in the Netherlands a decline in the central bank's net foreign assets partly reflected the guilder's weakness vis-à-vis other European currencies. The Bundesbank sold dollars on a considerable scale in late 1984 and early 1985. By contrast, in Japan and Switzerland there was very little change last year in the central banks' net foreign assets. In Canada and the United Kingdom there was a decline in 1984 and early 1985. Changes in the central banks' net foreign assets, where they occurred, had little impact on domestic money-market conditions since they were largely offset by movements in the domestic assets of the monetary authorities. In operations of this type many of the central banks concerned made extensive use of short-term market instruments of the kind that has become so prominent in recent years.

**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] | | | | | | | |
| 1982 | − 9.9 | 1.0 | −26.4 | − 9.8 | 20.4 | 6.2 | − 7.7 |
| 1983 | − 0.3 | − 1.2 | 3.3 | − 5.8 | − 1.6 | 5.1 | 10.6 |
| 1984 1st quarter | 0.1 | 2.7 | 0.9 | − 9.3 | − 1.9 | 5.0 | − 2.7 |
| 2nd quarter | − 0.5 | 0.7 | 3.5 | 13.0 | 5.8 | 2.4 | 3.2 |
| 3rd quarter | − 0.6 | − 2.4 | 9.7 | 11.4 | 0.7 | 0.8 | 2.6 |
| 4th quarter | 0.0 | − 3.0 | 2.7 | 1.9 | − 1.9 | 0.9 | 2.1 |
| 1985 1st quarter | − 0.5 | − 6.3 | . | . | − 5.3 | 8.4 | . |
| Central-bank short-term liquidity-supplying operations[3] | | | | | | | |
| 1982 | 7.2 | 0.2 | 42.2 | − 0.2 | −12.9 | 9.7 | 0.3 |
| 1983 | 10.2 | 2.5 | −10.9 | − 0.3 | 12.7 | 2.1 | − 2.0 |
| 1984 1st quarter | − 7.3 | − 1.2 | − 1.6 | 3.6 | 9.3 | − 4.5 | 8.7 |
| 2nd quarter | −12.0 | − 1.9 | − 3.3 | − 4.1 | −14.7 | − 0.9 | − 3.9 |
| 3rd quarter | 8.4 | 0.8 | 0.1 | −15.3 | − 6.0 | 2.4 | − 2.9 |
| 4th quarter | 14.2 | 6.3 | − 3.2 | − 2.2 | 10.6 | 9.4 | 0.2 |
| 1985 1st quarter | −12.0 | 4.6 | . | . | 2.6 | − 6.7 | . |

[1] Flows net of valuation changes, partly estimated by the BIS. For Germany, France and Switzerland, 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.

That the constraint on monetary policy implied in the weakness of other currencies against the dollar remained manageable is partly explained by the weakness of commodity prices. Further appreciation of the dollar in late 1984 and early 1985 clearly revealed a potential threat to the continuing success of some countries' efforts to control inflation — one which they sought to meet by exchange-market intervention geared to curbing speculative exchange rate movements. However, in the circumstances they could not envisage basic changes in the thrust of monetary policies which had so painstakingly paved the way for economic recovery.

*Long-term interest rates.* In the *United States* developments in long-term yields last year continued to be strongly influenced by concern about the actual and prospective borrowing needs of the Federal Government. In other respects, however, sentiment in the financial markets changed markedly on several occasions during the year. The rise in bond yields in the first half of 1984 and their subsequent decline mirrored changes in the strength of credit demand. The abrupt change in July, preceding a downturn in short-term interest rates and followed by a renewed strengthening of the dollar, seems to have been a sign of subsiding inflation expectations.

Bond yields in other countries were influenced to some extent by the rise in yields in the United States in the first half of last year. Then, confirming the view that lower inflation rates, continued fiscal consolidation and improved external current-account positions warranted lower yields, bond prices in many countries began to rise once long-term interest rates in the United States turned down. The announcement in the autumn that *Germany* and *France* would follow the United States in abolishing withholding taxes for non-resident holdings of domestic bonds and the indication that other countries were considering similar moves helped to maintain the downward trend in bond yields.

The relative weakness in bond prices in the *United Kingdom* in certain periods mainly reflected the tensions in the money and exchange markets, while in *France* changing yield expectations temporarily unsettled the capital market in early December. Long-term interest rates in *Switzerland* moved marginally higher in the course of last year but were scarcely affected by developments in other markets.

In early 1985 upward pressures on long-term interest rates developed in capital markets in nearly all countries. In many cases this may have reflected concern about the potential impact on inflation rates of a further appreciation of the dollar and speculation about whether a tightening of monetary conditions was in prospect. In the *United States* it had become evident that the likelihood of a substantial reduction of the budget deficit in the near future was small, and that monetary policy would not accommodate it. As a result real interest rates could be expected to remain high as long as the economy continued to expand.

*Real interest rates.* In relation to current rates of inflation long-term interest rates fell slightly, on balance, in the United States, Canada and Italy between early 1984 and early 1985 and rose during the same period in the United Kingdom and France. In North America and in the United Kingdom these rates remain high in

comparison with previous experience at any phase of the business cycle. They also remain high, though not unprecedentedly so, in most other countries. Inflation expectations may at times differ from recorded rates of price increase, particularly in periods in which the latter are volatile. At present, confidence that recent declines in inflation rates can be consolidated may not be fully established. However, alternative measures of real interest rates based on official inflation forecasts, survey data of price expectations and time series analysis, all of which have limitations, broadly confirm the impressions given by the simple measures shown in the table.

**Real long-term interest rates.***

| Years | United States | Canada | Japan | United Kingdom | Germany | France | Italy | Belgium | Switzerland |
|---|---|---|---|---|---|---|---|---|---|
| | period averages, in percentages per annum | | | | | | | | |
| 1965–69 | 1.8 | 2.6 | 2.1 | 3.1 | 4.7 | 3.2 | 4.3 | 3.2 | 1.0 |
| 1970–74 | 0.7 | 1.8 | −3.4 | 1.0 | 3.2 | 1.3 | −0.7 | 1.0 | −1.3 |
| 1975–79 | 0.3 | 0.4 | 0.5 | −2.2 | 3.0 | 0.5 | −3.2 | 1.3 | 1.6 |
| 1980–84 | 4.9 | 4.6 | 4.1 | 2.9 | 4.2 | 3.6 | 1.1 | 5.2 | 0.3 |
| 1983 | 8.1 | 5.9 | 5.6 | 6.2 | 4.6 | 4.9 | 2.9 | 4.1 | 1.2 |
| 1984 | 8.2 | 8.4 | 4.5 | 5.8 | 5.4 | 5.7 | 4.2 | 5.6 | 1.6 |
| 1985 1st quarter | 8.2 | 8.2 | 4.6 | 5.4 | 5.0 | 5.8 | 4.1 | 6.2 | 1.0 |

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

Real long-term rates normally reflect an important element in the expectations relevant for most investment decisions. There is widespread agreement that in present circumstances the key to explaining unusual pressures on real interest rates must be sought in developments in the United States. The resilience of private investment there seems to be indicative of high rates of return on capital in at least some US industries. Few observers are convinced, however, that this is the full explanation of high real rates. Moreover, there is so far little solid evidence of a large increase in the economy's long-run growth potential.

It is also difficult to believe that monetary policy has much to do with explaining persistently high ex ante real long-term interest rates. Current and expected monetary conditions, as affected by monetary policy, have, directly and through their impact on inflation expectations, an influence on nominal long-term interest rates. In recent years monetary policy has contributed to the establishment of a stable financial environment in which real interest rates are less likely than in the past to be negative for long periods of time. Declines in inflation expectations might have been expected over time to permit a corresponding fall in nominal interest rates. Last year, with the strong rise in the dollar helping to stabilise the domestic price level, monetary policy in the United States could accommodate an unusually strong recovery of overall demand without running the risk of reviving inflationary pressures. There is reason to suppose that monetary policy will continue to be geared towards permitting full use of the scope for non-inflationary economic expansion available in the circumstances.

Fiscal policy can have a more lasting influence on real rates through its actual and expected effects on the saving/investment balance. Apart from questions about offsetting cyclical or structural effects in the private sector, the basic issues here

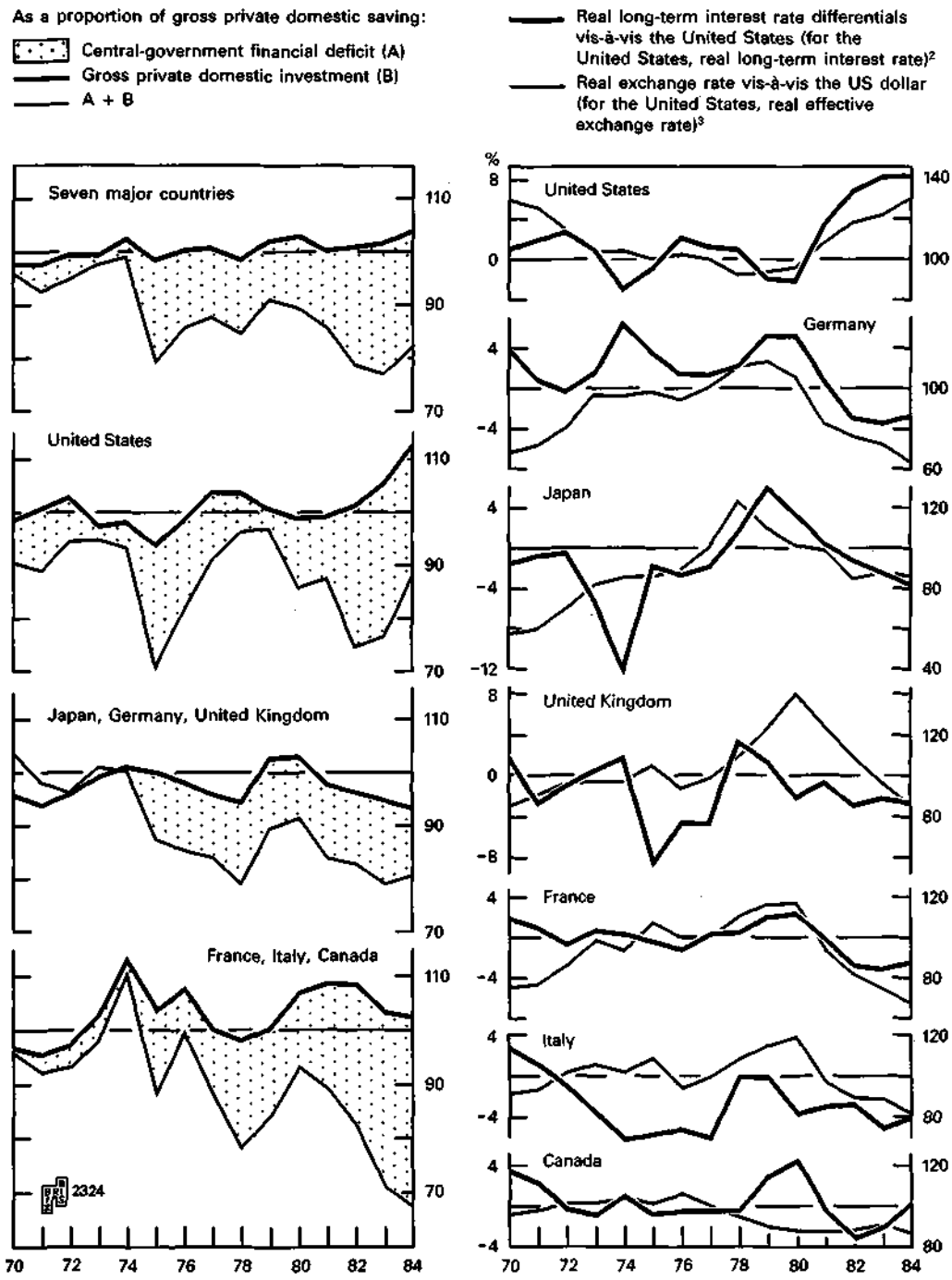
relate to the extent to which real interest rate pressures are likely to be transmitted from one country to another. In addition, there is the question of how far, in the aggregate, the effects of budgetary developments in the United States could be expected, in terms of real interest rates internationally, to have been counteracted by those of budgetary retrenchment elsewhere.

Developments in the United States and in groups of major countries in central-government budget balances and in gross private investment, both expressed as percentages of gross private domestic saving, are shown on the left-hand side of the graph on page 83. Thus, the distance between the upper curve for each country or country group and the reference line measures domestic "absorption" as a percentage of gross private domestic saving. When this is above 100 per cent. it is indicative of the net contribution of the rest of the world to the saving/investment balance of the countries concerned, and vice versa. While inflation or cyclically adjusted budget balances may be useful for some purposes, unadjusted measures, together with changes in private investment, can be expected to be more helpful, in practice, in explaining developments in financial markets. Similarly, the relationship of these measures to private saving would seem to be more relevant than those to GNP, and in comparing the weight of developments in financial markets in different countries nominal values converted at current exchange rates would seem appropriate. Actual and prospective balances in *central-government* budgets are widely publicised, and their impact on financial markets can be different from that of deficits of other government units and agencies, which in many countries are subject to constraints. Here, these are subsumed in private saving.

The measures used show developments in budget balances in recent years in terms of three contrasting examples: (i) the United States; (ii) Canada, France and Italy; and (iii) Japan, Germany and the United Kingdom. However, the aggregates for the largest seven industrial countries strongly suggest that the weight of budget deficits in the overall saving/investment balance in the industrial world has risen sharply since 1978, the year prior to the second oil shock. Moreover, with the liberalisation of financial markets, the impact on real interest rates of actual and expected budget deficits may have increased over time. There is little evidence that larger budget deficits have led to major changes in private-sector saving behaviour: over the last decade total private savings in the seven countries have remained fairly stable in relation to GNP.

The view is widely held that the saving/investment imbalance in the United States, as influenced by the Federal Government's huge structural demand for credit, has been reflected not only in domestic interest rates but also in a large rise in the dollar in the exchange markets and in large-scale imports of savings from abroad. The graph, as it relates to the United States, would seem to provide strong support for this view. Between 1979 and 1984 the share of the US central-government deficit in the total of the central-government deficits in the largest seven industrial countries rose from about 10 to around 50 per cent., while its claim on their aggregate gross private savings rose from under 2 to more than 11 per cent. While the large US external current-account deficit helped in the spread of economic recovery, the corresponding international savings flows must have served both to moderate

## Saving/investment imbalances, real interest rate differentials and real exchange rates.[1]




[1] Based on national sources. Real variables calculated by using changes in consumer prices. [2] Left-hand scale.
[3] Indices: 1977 = 100; right-hand scale.

upward pressures on real interest rates in the United States and to transmit them to other countries.

In Japan, Germany and the United Kingdom governments have sought for some years now to reduce their deficits. Although these countries benefited from strong export demand, the recovery in their private investment lagged behind that of the United States and exerted less pressure on the supply of private domestic savings. Until late 1984, at least, depreciation of these countries' currencies posed little threat to the success of domestic counter-inflationary policies. While in these circumstances domestic factors would favour declines in real interest rates, the influence of high interest rates abroad, in the United States in particular, would work in the opposite direction.

In the event, the rise in long-term nominal interest rates in Germany and Japan since the late 1970s has been much smaller than that in the United States and real interest rates, though they have risen, have moved up less than in the United States. Moreover, as can be seen in the graph, a gradual widening took place over time in the margin between real interest rates in these countries and those in the United States and it went hand in hand with a progressive appreciation of the dollar against the yen and the Deutsche Mark in real terms. Thus, given impediments of various kinds to international savings flows, real interest rates in these countries responded to some extent to an improvement in the domestic saving/investment balance which came about against a background of stable monetary policies. Conceivably, the decoupling may have been facilitated by a feeling among capital-market participants that the dollar's real value could prove unsustainable and that some allowance should be made for possible future exchange rate losses on dollar investments in comparing yields on long-term placements in different currencies. In the United Kingdom long-term real interest rates also moved up less than real yields in the United States in the 1978–84 period. However, the differential was not closely related to changes in the real dollar exchange rate of sterling, which was influenced, inter alia, by the changing outlook for oil prices.

In France, Italy and Canada the policy options in recent years have been limited. Private investment has for some time been comparatively weak, but large structural budgetary imbalances have called for corrective action which in the prevailing economic situation had less effect on the actual deficit than it might otherwise have had. Influenced by the EMS arrangements, real bond yields in France and Italy seem to have become more closely linked with real long-term rates in Germany, and in recent years the French franc and the Italian lira have depreciated in real terms against the dollar along with the Deutsche Mark, though to a smaller extent. In Canada, on the other hand, real long-term yields rose between 1979 and 1984 by the full extent of the rise in real US yields, and the real US dollar exchange rate of the currency changed little on balance over this period.

Positive real interest rates may, of course, help to encourage savings. They may also help to ensure that the most profitable, and perhaps relatively labour-intensive, types of investment are undertaken. High costs of borrowing have not so far brought the economic recovery to a halt, though concern that investment may be more adversely affected in some countries than in others probably remains valid.

Certainly real rates seem high in relation to many countries' growth potential. High real rates can imply heavy burdens in servicing public and private-sector debt and complicate the task of containing public expenditure. They also continue to burden sovereign debtors in international markets.

*International interaction of policies.* It has long been recognised that exchange rate flexibility does not remove the external constraint on monetary policy but only changes its nature. In recent years the basic objectives of monetary policy in the major countries have tended to converge, as has their price performance. However, as indicated above, a major divergence between US fiscal policy and that in other countries has been reflected in real exchange rate movements and in real interest rate differentials.

By last year it had become obvious that even the largest and least open economies can be significantly affected by external developments and that policy must take this into account. Exchange rates may be largely determined by portfolio decisions of private investors in the financial markets, but they have a strong influence on countries' growth and inflation performance. In the United States the impact on the domestic price level of the dollar's appreciation has enabled monetary policy to accommodate strong rises in aggregate demand, but the rise in net imports has clearly begun to undermine the progress of the domestic recovery. Although other countries have benefited from strong export growth, by early 1985 imported price rises and interest rate pressures were beginning to weigh more heavily in the balance.

What has been becoming increasingly evident is the vulnerability of the non-inflationary recovery of the world economy and the limits to what monetary policy can do to sustain it in the absence of appropriate support from other kinds of policy. The downward adjustment of the US dollar in March and April has given some scope for declines in interest rates elsewhere, but the options in monetary policy are bound to remain restricted. Experience clearly demonstrates that monetary policy in the larger countries can be effective only if it continues to aim at maintaining stable, non-inflationary domestic monetary conditions. Recent experience has also shown that exchange-market intervention to counter speculative excesses may prove a useful adjunct to monetary policy. More fundamental, by wide agreement, is the necessity for budgetary action to rectify the balance of saving and investment in the United States. Any further adjustment of the dollar would make this need, if anything, more urgent than before.

# V. INTERNATIONAL TRADE AND PAYMENTS.

## Highlights.

Developments in the United States were the most important influence on world trade and balances of payments in 1984. A 26 per cent. increase in US imports, resulting from the combination of strong domestic demand growth and a further deterioration of the US international competitive position, was the basic driving force, both directly and through its effects in stimulating trade between other countries, behind an acceleration of the growth in world trade volume to 9 per cent. This rate was roughly in line with that observed in past periods of economic recovery.

The surge in US import demand produced an unprecedented $60 billion increase in the US current-account deficit and the concomitant strengthening of current-account balances in many other countries, both developed and developing. In the developing world the non-OPEC developing countries recorded a further significant decline in their aggregate current-account deficit. In Asia the improvement was accompanied by rapid export and import growth, and in Latin America aggregate imports, after the very sharp cutbacks of the two preceding years, showed a modest increase. In the developed world large export gains by Japan boosted that country's current-account surplus by a further $14 billion, and most other countries, too, recorded smaller gains on current account. At the same time, however, the current-account balances of the United Kingdom and Italy and a few other countries deteriorated.

The most striking feature of international capital movements remained the large-scale net inflows into the United States, which for a second consecutive year not only financed the growing deficit on current account but pushed up further the external value of the dollar. A large part of investments in dollar-denominated assets appears to have come from other major industrial countries, most notably Japan, which recorded a very substantial increase in net long-term outflows, primarily on portfolio capital. Outside the Group of Ten, the improvements in many countries' current-account positions reduced their external financing requirements, so that despite a further decline in private capital inflows some developing countries were able to replenish their official reserves significantly. However, a number of debtor countries continued to be dependent on "organised" financial flows and relief provided under debt restructuring arrangements.

Taken as a whole, these developments present a mixed picture. On the positive side was the acceleration of world trade growth and the improvements, some of them much needed, in many countries' external balances on current account. These encouraging developments would not have been possible without the sharp increase in US imports. On the other hand, the large and still growing US current-account deficit is unsustainable in the longer run, it has already given rise to a strengthening

of protectionist pressures in the United States and its orderly financing continues to depend on very large spontaneous capital inflows from the rest of the world; Japan's record surplus constitutes another major element of disequilibrium in the global payments structure; and the external situations of a number of developing countries are still very vulnerable.

The existence of these actual, or potential, elements of imbalance in the present situation entails certain risks for the future. Firstly, a change in market sentiment towards the dollar might reduce, or even reverse, capital inflows into the United States. This could exert upward pressure on dollar interest rates and thus exacerbate debt-servicing problems. Secondly, the strengthening of many countries' external positions during the past two years has been heavily dependent on the upswing in the United States, and a slowdown in US import demand, if not compensated by more rapid demand growth in other industrial countries, is likely to make further progress in external adjustment more difficult.

**World trade.**

As world economic recovery gained momentum, the growth in the volume of world trade accelerated last year to 9 per cent., compared with only 2½ per cent. in 1983. Dollar prices of traded goods fell by 2 per cent., the fourth consecutive annual decline in the wake of the continued appreciation of the US dollar. This moderated the expansion of world trade in current dollar terms to 6½ per cent., bringing it to a level of close to $2,000 billion.

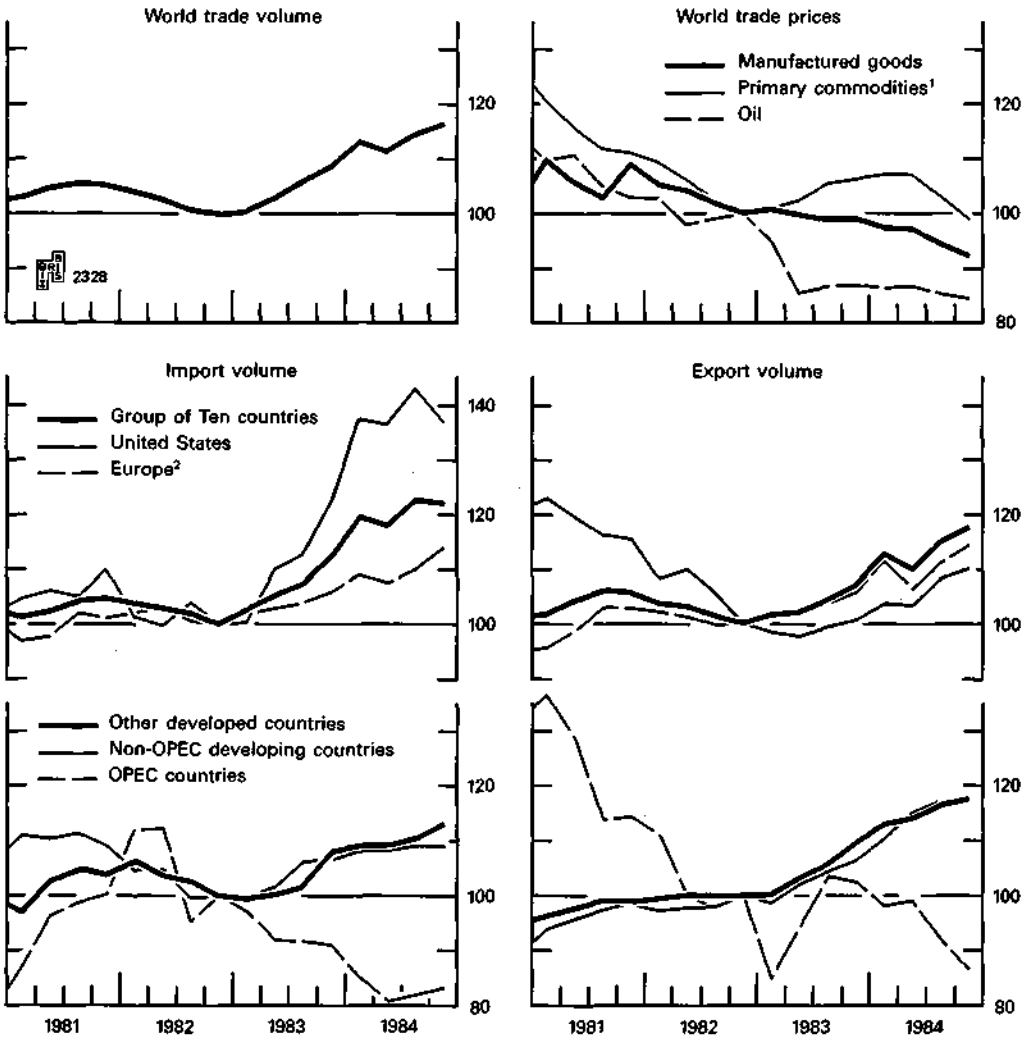
By major groups of commodities, the volume of trade in manufactured products and non-oil primary commodities expanded by 12 and almost 5 per cent., respectively, roughly in line with rates experienced in past periods of economic recovery. Trade in oil, by contrast, remained relatively sluggish as most of the 4 per cent. annual increase in volume reflected the cessation of stock drawdowns which had been very large early in 1983. The overall decline in world trade prices resulted from a fall in the prices of both manufactured products and oil, of around 3 per cent. Other commodity prices rose on average by less than 1 per cent., but those of most non-oil commodities peaked early in the year and declined sharply thereafter.

As the following graph shows, the overall rise in world trade owed most to the strength of import demand in the Group of Ten countries, in particular in the United States, where, for the year as a whole, the vigorous growth in import volume of 26 per cent. accounted for more than one-half of the group's increase in real imports, which averaged 12½ per cent. Canadian and Japanese imports, too, grew rapidly, but imports into European countries expanded by less than 7 per cent. However, as the year progressed import growth in the non-European Group of Ten countries tapered off to rates similar to those in Europe.

With the exception of the OPEC countries, where the 11 per cent. cutback in real imports was only slightly less than in the preceding year, all other main groups recorded a pronounced upturn in imports. In the smaller developed countries and in the non-OPEC developing countries import growth rebounded to 8 and 5 per cent.

**World trade, 1981–84.**

Seasonally adjusted indices: fourth quarter 1982 = 100.




¹ Excluding oil. ² Comprises Belgium, France, Germany, Italy, the Netherlands, Sweden, Switzerland and the United Kingdom.

respectively, after having stagnated in 1983. However, the expansion was rather unevenly distributed. While Asian countries, for example, increased their imports by 8 per cent., countries in Latin America were in general able to relax their policies of import restraint only cautiously. Nonetheless, the widespread resort to import cuts in these countries came to a halt last year.

On the export side, increased sales in the US market were in many cases directly responsible for a revival of export volume growth significantly in excess of countries' import increases. Real exports from the Group of Ten countries rose by 9 per cent. in 1984, compared with only 2 per cent. in 1983, with particularly high growth rates being recorded in Canada and Japan. Elsewhere, too, the increase in the volume of exports

accelerated markedly in 1984. In the other developed countries the rate doubled to 10 per cent. and in the non-OPEC countries it also doubled to 11½ per cent., with the lion's share being accounted for by Asian countries. OPEC countries, by contrast, were faced with a 2½ per cent. further decline in their export volume. This was, however, considerably less than the annual average decline of 14 per cent. over the preceding four years.

**International balance-of-payments developments.**

International balance-of-payments developments in 1984 presented two markedly different features. On the one hand, the external imbalances in the two largest economies, the United States and Japan, worsened substantially; on the other hand, there were widespread improvements in many developed and developing countries' current-account positions. The principal reasons for these developments were the strength of the upswing in the United States and the continued rise of the dollar, which caused the US current-account deficit to increase by $60 billion to over $100 billion. Within the Group of Ten, the main counterpart to the deterioration in the United States was the rise in Japan's current-account surplus to a record $35 billion. These overall changes in the two countries' external positions point to their close bilateral trading relationships but, more fundamentally, are an indication of their profound imbalance vis-à-vis the rest of the world. Improvements in the current accounts of other countries in the group were largely counterbalanced by deteriorations in the United Kingdom and Italy, and the combined current payments deficit of the Group of Ten widened from $9.1 billion in 1983 to $53.5 billion in 1984.

All other main groups of countries recorded improvements in their aggregate current-account positions in 1984. The non-OPEC developing countries were able to lower their aggregate current payments deficit by $13 billion to $22 billion, but the improvements were rather unevenly distributed within the group. The OPEC countries cut back their deficit by $11 billion, the largest adjustments being made by countries outside the Middle East. In the smaller developed countries the improvement totalled more than $3 billion. Eastern European countries, which as a group have been running a comfortable surplus with the rest of the world since 1982, increased their aggregate current-account surplus by $2 billion.

About two-thirds of the increase in the combined current-account deficit of the Group of Ten countries was mirrored in 1984 by corresponding changes in the other main groups of countries. The remainder cannot be accounted for and gave rise to a $16 billion increase in the negative statistical discrepancy on world current account. As exports are recorded, on average, roughly four weeks before imports, the rise of $2 billion in aggregate net world exports is attributable mainly to the resumption of world trade growth. The reasons for the $18 billion increase in the global invisibles deficit, which for several years has fluctuated around an upward trend, are, on the other hand, not clear. The bulk of the increase in recent years can be traced to the under-recording of investment income receipts and of net receipts from services rendered by foreign contractors and consultants.

International current-account balances, 1982–84.[1]

| Countries and areas | Trade balance (f.o.b.) | | | Invisibles balance | | | Current balance | | |
|---|---|---|---|---|---|---|---|---|---|
| | 1982 | 1983 | 1984 | 1982 | 1983 | 1984 | 1982 | 1983 | 1984 |
| | in billions of US dollars | | | | | | | | |
| BLEU | − 3.6 | − 1.9 | − 1.2 | 0.9 | 1.5 | 1.5 | − 2.7 | − 0.4 | 0.3 |
| Canada | 14.4 | 14.4 | 16.1 | −12.3 | −13.0 | −14.6 | 2.1 | 1.4 | 1.5 |
| France | −15.5 | − 8.4 | − 4.1 | 3.4 | 4.0 | 4.0 | −12.1 | − 4.4 | − 0.1 |
| Germany | 24.5 | 21.5 | 21.4 | −21.2 | −17.3 | −15.4 | 3.3 | 4.2 | 6.0 |
| Italy | − 8.0 | − 3.1 | − 6.1 | 2.5 | 3.7 | 3.0 | − 5.5 | 0.6 | − 3.1 |
| Japan | 18.1 | 31.5 | 44.4 | −11.2 | −10.7 | − 9.4 | 6.9 | 20.8 | 35.0 |
| Netherlands | 4.6 | 4.3 | 5.3 | − 0.9 | − 0.5 | − 0.5 | 3.7 | 3.8 | 4.8 |
| Sweden | 0.8 | 3.1 | 4.7 | − 4.3 | − 4.0 | − 4.6 | − 3.5 | − 0.9 | 0.1 |
| Switzerland | − 2.8 | − 3.8 | − 3.9 | 6.8 | 7.3 | 7.6 | 4.0 | 3.5 | 3.7 |
| United Kingdom | 3.5 | − 1.8 | − 5.5 | 5.1 | 5.7 | 5.5 | 8.6 | 3.9 | 0.0 |
| United States | −36.5 | −61.1 | −107.4 | 29.4 | 19.5 | 5.7 | − 7.1 | −41.6 | −101.7 |
| *Group of Ten countries* | *− 0.5* | *− 5.3* | *−36.3* | *− 1.8* | *− 3.8* | *−17.2* | *− 2.3* | *− 9.1* | *−53.5* |
| Australia | − 2.6 | 0.0 | − 0.8 | − 5.5 | − 5.8 | − 7.2 | − 8.1 | − 5.8 | − 8.0 |
| Austria | − 3.3 | − 3.4 | − 3.5 | 3.9 | 3.6 | 2.9 | 0.6 | 0.2 | − 0.6 |
| Denmark | − 0.8 | 0.2 | − 0.2 | − 1.5 | − 1.4 | − 1.5 | − 2.3 | − 1.2 | − 1.7 |
| Finland | 0.3 | 0.2 | 1.7 | − 1.1 | − 1.1 | − 1.7 | − 0.8 | − 0.9 | 0.0 |
| Greece | − 4.8 | − 4.3 | − 4.3 | 2.9 | 2.4 | 2.1 | − 1.9 | − 1.9 | − 2.2 |
| Ireland | − 1.1 | − 0.2 | − 0.2 | − 0.8 | − 0.9 | − 0.7 | − 1.9 | − 1.1 | − 0.9 |
| New Zealand | − 0.1 | 0.2 | 0.0 | − 1.4 | − 1.3 | − 1.2 | − 1.5 | − 1.1 | − 1.2 |
| Norway | 2.4 | 4.3 | 5.3 | − 1.7 | − 2.1 | − 1.8 | 0.7 | 2.2 | 3.5 |
| Portugal | − 4.9 | − 2.4 | − 1.4 | 1.6 | 1.4 | 0.9 | − 3.3 | − 1.0 | − 0.5 |
| South Africa | 0.7 | 4.0 | 1.9 | − 3.8 | − 3.7 | − 2.6 | − 3.1 | 0.3 | − 0.7 |
| Spain | − 9.3 | − 7.4 | − 4.0 | 5.1 | 4.9 | 6.0 | − 4.2 | − 2.5 | 2.0 |
| Turkey | − 2.7 | − 3.0 | − 3.0 | 1.8 | 1.2 | 1.6 | − 0.9 | − 1.8 | − 1.4 |
| Yugoslavia | − 2.0 | − 1.2 | − 0.7 | 1.5 | 1.5 | 1.2 | − 0.5 | 0.3 | 0.5 |
| *Other developed countries* | *−28.2* | *−13.0* | *− 9.2* | *1.0* | *− 1.3* | *− 2.0* | *−27.2* | *−14.3* | *−11.2* |
| *Total developed countries* | *−29* | *−18* | *−46* | *− 1* | *− 5* | *−19* | *−30* | *−23* | *−65* |
| OPEC countries | 62 | 44 | 55 | −79 | −65 | −65 | −17 | −21 | −10 |
| Non-OPEC developing countries | −43 | −20 | − 3 | −20 | −15 | −19 | −63 | −35 | −22 |
| *Total developing countries* | *19* | *24* | *52* | *−99* | *−80* | *−84* | *−80* | *−56* | *−32* |
| Eastern European countries[2] | 13 | 13 | 15 | − 6 | − 5 | − 5 | 7 | 8 | 10 |
| Total | 3 | 19 | 21 | −106 | −90 | −108 | −103 | −71 | −87 |

[1] On a transactions basis. [2] Bulgaria, Czechoslovakia, German Democratic Republic, Hungary, Poland, Rumania and the USSR.

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

The dominant feature of international capital movements last year was the unabated inflow of capital into the United States, an unprecedented amount of which resulted from portfolio transactions. These inflows not only sufficed to

finance the growing US current-account deficit, but also put upward pressure on the dollar. A sizable share of these inflows appears to have originated in other Group of Ten countries, most notably in Japan, where net long-term capital outflows increased almost threefold.

In the other main groups of countries the improvements in current payments positions greatly eased financing problems and helped a number of countries to replenish official reserve holdings on a sizable scale. New private-sector lending to developing countries continued to contract as total financing needs declined. Moreover, the structure of external debt improved somewhat, as in some countries payments arrears and short-term debt were reduced, and new loans were contracted on easier terms. However, there are still a number of countries which remain effectively excluded from international capital markets.

**Balance-of-payments developments in the United States and Japan.**

The deterioration in the current account of the *United States* accelerated further last year, when the deficit widened by $60.1 billion, or twice as much as in 1983, to reach an unprecedented $101.7 billion. The rapidly growing deficit on merchandise trade alone accounted for three-quarters of the current-account deterioration, but there was also a further sharp fall in the traditional invisibles surplus. Whereas as late as 1982 the invisibles surplus had offset most of the trade deficit, by the end of 1984 the trade and current-account deficits were virtually identical. More than half of last year's decline of $13.8 billion to a modest $5.7 billion in the invisibles surplus can be ascribed to larger import-related payments for transport and insurance and to the reduction in net foreign investment income.

The massive increase in the trade deficit, from $61.1 billion in 1983 to $107.4 billion in 1984, basically reflected a further strengthening of domestic demand pressures — the expansion of real domestic demand accelerated last year to almost 9 per cent., about 6 percentage points greater than the average demand growth of all other industrial countries — and a further rise in the dollar's real effective exchange rate of 6 per cent. The following table provides an approximate order of magnitude of trade balance changes by main components.

United States: Estimated components of changes in the trade balance, 1983–84.

| Years | Changes in the trade balance | Reflecting changes in | | | | | |
|---|---|---|---|---|---|---|---|
| | | oil imports | non-oil terms of trade | export volume | | non-oil import volume | |
| | | | | total | *due to export-market growth* | total | *due to domestic demand* |
| | in billions of US dollars | | | | | | |
| 1983 | −24½ | 7½ | 6 | −12 | *5* | −26 | *−15* |
| 1984 | −46½ | − 3½ | − 5 | 17 | *17* | −55 | *−30* |

Note: A minus sign indicates a decline in exports and an increase in imports.

On the import side, the most striking feature was the surge in the volume of non-oil imports. As real import growth soared from 14 per cent. in 1983 to more than 26 per cent. in 1984 the negative influence on the trade account more than doubled to $55 billion. Roughly one-half of the increase in import volume in each of the past two years can be attributed to the strength of US domestic demand, while the remainder reflected the influence of other factors, most notably of course foreign suppliers' gains of competitiveness vis-à-vis domestic producers.

As domestic demand growth slowed down during 1984, the growth in the volume of non-oil imports decelerated markedly, from over 14 per cent. in the first half of the year to 5 per cent. in the second half. However, in the first quarter of 1985, when domestic demand expanded by only about 1 per cent., real non-oil imports rose at a seasonally adjusted rate of more than 15 per cent., suggesting that the influence of the weakening US competitive position had become more pronounced. Indeed, while the volume growth extended in 1984 over all major categories of non-oil imports, it was strongest in manufactured products, which are particularly sensitive to changes in international competitiveness. Imports of capital goods, also driven by the strength of US investment spending, rose in volume terms by 38½ per cent., but imports of consumer goods, too, advanced strongly by 30 per cent. in 1984. As a consequence, the process of import penetration in the US manufacturing sector began to speed up considerably last year. While the share of imported manufactured goods had risen only slowly from 7 to 8 per cent. between 1981 and 1983, it jumped to nearly 10 per cent. last year, when almost one-quarter of the increase in US demand for manufactured products was met by additional imports.

The value of imports of crude oil and petroleum products rose last year by about $3½ billion. This first increase in the oil import bill since 1980 resulted entirely from an 8½ per cent. rise in volume, reflecting both growth of real oil consumption of about 4 per cent. — the first increase in six years — and the absence of large inventory drawdowns which had depressed imports in the previous years.

On the export side, the most noteworthy development was the surprising rebound of US export volume in 1984, which exerted a favourable impact equivalent to $17 billion on the trade balance. This first increase in real exports since 1980 partly reflected the spreading of the recovery of economic activity among the industrial countries and the pick-up in import demand in some of the United States' major trading partners in the developing world. The growth of US export markets quickened from 2½ per cent. in 1983 to about 8½ per cent. in 1984 and the volume effect arising from market growth was equivalent to $17 billion, compared with $5 billion in the previous year. More importantly, however, while in 1983 the United States had suffered a significant loss of market shares, last year the volume of exports increased in line with the growth of US export markets. Given the continued climb of the dollar and the consequent erosion of US international competitiveness throughout 1984, the reasons for this remarkable performance are not entirely clear. Several factors are worth noting, however. Firstly, as indicated by particularly large gains in the export of capital goods, the rise in volume may be partly attributable to sales of products in which US industry enjoys a strong technological advantage.

Secondly, a significant portion reflected trade in parts and finished products within US firms, especially in the automobile, electronics and textile sectors, with production sites located in Canada, Mexico and Asia. Thirdly, traditional trading links appear to have favoured US exports to Latin America, which rose 5 percentage points more than total Latin American imports. Finally, US exporters seem to have made strong efforts to retain market shares, in particular in Europe, even at the expense of considerably lower profit margins.

Movements in the non-oil terms of trade, which had helped to trim the increase in the trade deficit in 1983 by $6 billion, gave way last year to a negative effect of about $5 billion as import prices rose by about 1½ percentage points more than export prices. The fact that the terms of trade deteriorated in spite of an 8 per cent. appreciation of the dollar's effective exchange rate was primarily a reflection of the different demand conditions prevailing inside and outside the United States. However, it also suggests that foreign suppliers were either exercising self-restraint or, for other reasons, preferred to raise prices rather than to exploit fully the potential for volume increases in the US market. By contrast, US exporters had little scope for adjusting their export prices to offset domestic cost rises. US export prices of non-agricultural products remained virtually constant for the second consecutive year.

United States: Changes in trade balances vis-à-vis groups of countries, 1983–84.

| Years | Total trade balance | Industrial countries | *Canada* | *Japan* | OPEC countries | All other countries | *Latin America* | *Asia* |
|---|---|---|---|---|---|---|---|---|
| | in billions of US dollars | | | | | | | |
| 1983 | −24.6 | −11.0 | *− 1.2* | *− 2.6* | 0.8 | −14.4 | *− 8.2* | *− 6.2* |
| 1984 | −46.4 | −33.3 | *− 5.0* | *−14.4* | − 2.8 | −10.3 | *− 1.0* | *− 9.5* |

Turning briefly to the regional distribution of trade, the marked shifts in the trade balance vis-à-vis groups of countries between the last two years, shown in the above table, primarily resulted from the strong expansion last year in imports of manufactured products into the United States. Whereas in 1983 the bulk of the counterpart to the total trade deficit was found in the developing world, last year saw a substantial increase in the deficit with industrial countries, most notably Japan. Indeed, of the total rise in the trade deficit of $46.4 billion in 1984, virtually all occurred vis-à-vis industrial countries and the more advanced developing economies in Asia, the two groups which were best placed to meet the rapidly expanding demand for manufactured products.

The broad pattern of capital flows shown in the following table reveals that last year's record rise in the deficit on current account was financed by a substantial increase in non-bank private capital inflows and the re-emergence of a large statistical discrepancy, which is considered to reflect mainly unrecorded capital transactions. The balance on net capital imports by banks remained roughly at the 1983 level.

United States: Summary of capital-account transactions, 1983–84.

| Items | 1983 | 1984 | | | | |
|---|---|---|---|---|---|---|
| | | year | first quarter | second quarter | third quarter | fourth quarter |
| | in billions of US dollars | | | | | |
| Capital-account balance | 37.6 | 102.1 | 23.3 | 26.1 | 35.1 | 17.7 |
| Identified capital flows | 28.3 | 72.1 | 16.1 | 22.3 | 21.5 | 12.2 |
| Non-bank private capital (net) | 9.4 | 57.0 | 7.3 | 22.9 | 11.6 | 15.1 |
| US Government capital (net) | – 4.8 | – 5.1 | – 1.9 | – 0.8 | – 1.6 | – 0.8 |
| Banking flows (net) | 23.7 | 20.2 | 10.7 | 0.2 | 11.5 | – 2.1 |
| Statistical discrepancy | 9.3 | 30.0 | 7.2 | 3.8 | 13.6 | 5.5 |
| Changes in net official monetary position (– =improvement) | 3.9 | – 0.6 | – 3.7 | – 1.4 | – 1.5 | 6.0 |

The most striking feature on the capital account was the sixfold increase in non-bank private capital inflows, from $9.4 billion in 1983 to $57 billion in 1984. Most of this reflected a marked rise in net inflows of non-resident funds. In particular, net foreign purchases of US securities (excluding shares) tripled to $37.4 billion, and foreign borrowing by the US corporate sector through various other channels amounted to $20.3 billion. By contrast, the balance on direct investment and portfolio transactions in shares changed only little.

United States: Identified non-bank private capital flows, 1983–84.

| Items | 1983 | 1984 | | | | |
|---|---|---|---|---|---|---|
| | | year | first quarter | second quarter | third quarter | fourth quarter |
| | in billions of US dollars | | | | | |
| Direct investment (net)[1] | – 4.3 | 1.0 | – 4.8 | 2.2 | 2.9 | 0.6 |
| Other equity investment (net) | 2.4 | – 1.7 | 1.6 | – 0.0 | – 1.7 | – 1.5 |
| Bonds and other securities (net) | 13.4 | 37.4 | 3.3 | 9.8 | 8.5 | 16.0 |
| Foreign bonds | – 3.7 | – 3.7 | 0.3 | – 0.8 | – 0.6 | – 2.5 |
| US Treasury securities | 8.7 | 22.5 | 1.4 | 6.5 | 5.1 | 9.5 |
| Other US bonds[2] | 8.4 | 18.6 | 1.6 | 4.1 | 4.0 | 9.0 |
| Other non-bank private capital (net)[3] | – 2.1 | 20.3 | 7.2 | 10.9 | 1.9 | 0.0 |
| Total | 9.4 | 57.0 | 7.3 | 22.9 | 11.6 | 15.1 |
| *US assets abroad* | *–24.1* | *–10.2* | *– 3.6* | *– 0.5* | *1.2* | *– 7.3* |
| *Foreign assets in the United States* | *33.5* | *67.2* | *10.9* | *23.4* | *10.4* | *22.4* |

[1] Excludes inter-company flows and other transactions between US corporations and their finance companies in the Netherlands Antilles. [2] US bonds other than US Treasury securities plus net proceeds from Euro-bond sales channelled by finance companies in the Netherlands Antilles to US corporations. [3] Includes residual transactions with finance companies in the Netherlands Antilles, other inter-company flows and changes in net claims on unaffiliated foreigners.

The vigorous demand for US securities, both US Treasury bonds and other bonds, can be ascribed to several factors. The first was undoubtedly interest rate considerations. For example, in 1984 US public-sector bond yields were on average more than 4½ and 5½ percentage points respectively higher than the yields on public-sector bonds in Germany and Japan. Moreover, although spreads narrowed in the final quarter of 1984, demand for bonds was apparently boosted by the

market's expectation of capital gains from a further decline in US interest rates. A second factor favouring investments in the US bond market was a shift to risk-free government securities away from certificates of deposit which occurred in the second quarter when difficulties were experienced by some US banks. Thirdly, the abolition of the US withholding tax on interest paid to non-resident holders of securities issued after mid-July also enhanced the attractiveness of US securities to non-residents. Moreover, this measure eliminated to a large extent the tax advantages of Euro-bond issues through finance companies set up by US corporations in the Netherlands Antilles. As a result, the flow of net proceeds from finance companies' bond sales to US corporations virtually dried up in the second half of 1984, while direct sales of Euro-bonds contributed significantly to the record capital inflows on account of corporate securities during this period. Finally, the liberalisation of financial regulations in Japan in recent years is likely to have opened up new sources of demand for US securities.

As shown in the table below, net banking inflows into the United States declined by $3.5 billion last year to $20.2 billion, with a sharp deceleration in the growth of both claims and liabilities arising from banks' dollar transactions for their own account. On the assets side, the principal reason for the slowdown was the turn-round between 1983 and 1984 in gross lending to foreign non-banks, from an increase of $13.7 billion to a cutback of $1.2 billion. The bulk of the reversal was attributable to a further marked scaling-back of new lending to non-OPEC developing countries, which last year obtained only $3.2 billion of new funds, including the lending in connection with stabilisation programmes or rescheduling arrangements. The slower expansion of banks' foreign liabilities occurred because US banks' borrowing from their foreign branches, which had accounted for about one-half of total gross banking inflows in 1983, virtually came to a halt last year.

**United States: Banking flows, 1983–84.**

| Items | 1983 | 1984 | | | | |
|---|---|---|---|---|---|---|
| | | year | first quarter | second quarter | third quarter | fourth quarter |
| | in billions of US dollars | | | | | |
| Banking flows (net) | 23.7 | 20.2 | 10.7 | 0.2 | 11.5 | – 2.1 |
| Changes in claims | –25.4 | – 7.3 | 2.0 | –20.6 | 16.9 | – 5.6 |
| Transactions for own account in dollars | –31.8 | – 7.3 | 4.3 | –20.7 | 13.7 | – 4.6 |
| with own foreign offices | –16.7 | – 9.3 | – 1.5 | – 9.6 | 6.2 | – 4.4 |
| with other banks | – 1.4 | 0.8 | 3.8 | – 8.6 | 6.9 | – 1.3 |
| with non-banks | –13.7 | 1.2 | 2.0 | – 2.5 | 0.6 | 1.1 |
| Other transactions* | 6.4 | – 0.0 | – 2.3 | 0.1 | 3.2 | – 1.0 |
| Changes in liabilities | 49.1 | 27.6 | 8.8 | 20.8 | – 5.4 | 3.4 |
| Transactions for own account in dollars | 48.9 | 24.5 | 8.2 | 19.0 | – 5.5 | 2.8 |
| with own foreign offices | 25.6 | 2.1 | 1.5 | 10.8 | –10.8 | 0.6 |
| with other banks | 9.9 | 14.4 | 4.2 | 5.1 | 3.0 | 2.2 |
| with non-banks | 13.4 | 7.9 | 2.5 | 3.1 | 2.3 | 0.0 |
| Other transactions* | 0.2 | 3.1 | 0.6 | 1.8 | 0.1 | 0.6 |

* Includes transactions in foreign currencies, banks' domestic customers' external claims and banks' custody liabilities.

The pattern of US banking flows during the year was, as discussed in greater detail in Chapter VI, affected by three main developments. Firstly, the short-term interest rate differential between the dollar and other major currencies widened progressively until July 1984 and provided a strong incentive during this period for inflows of deposits into banks in the United States. Secondly, large gross outflows occurred in the second quarter (and were reversed subsequently) when US banks compensated their foreign offices for the withdrawals of dollar deposits that were triggered by concern regarding potential losses on some US banks' domestic loan portfolios. In addition, there were sizable outflows to consortia of foreign banks which were arranged to finance large-scale merger activities in the United States. Thirdly, towards the end of the year risk and interest rate considerations seem to have prompted foreign investors to shift from bank deposits to investments in the US securities markets.

Looking briefly at the distribution of identified capital flows between the United States and major regions, the table below indicates that in the past two years the bulk of net flows into the United States (excluding US Government transactions and movements in official assets and liabilities) originated in industrial countries, especially western Europe. The most striking feature, however, was the emergence of Japan as a major supplier of funds to the United States. Total net flows from Japan to the United States expanded from $2 billion in 1983 to $12.4 billion in 1984, a rise which accounted for one-quarter of the increase in total net capital inflows identified in the table. Virtually all of this change represented new investment of non-resident funds and much of it is believed to have been in the form of portfolio investment. There was also a very large increase, from $6.5 billion in 1983 to $26.3 billion in 1984, in net inflows of funds from non-industrial countries. While the bulk of the change reflected a cutback in US residents' investment in these countries, the continued attractiveness of the dollar induced non-residents to place sizable amounts with banks in the United States and in the US securities market.

United States: Regional distribution of identified capital flows, 1983–84.

| Items | Total | | Western Europe | | Japan[1] | | Other industrial countries[1,2] | | Other countries | |
|---|---|---|---|---|---|---|---|---|---|---|
| | 1983 | 1984 | 1983 | 1984 | 1983 | 1984 | 1983 | 1984 | 1983 | 1984 |
| | in billions of US dollars | | | | | | | | | |
| US non-bank private sector (net) ..... | 0.7 | 34.5 | 2.8 | 12.9 | 2.9 | 3.1 | – 4.5 | 8.0 | – 0.5 | 10.5 |
| Other private sector (net)[3] . | 32.4 | 42.7 | 18.6 | 17.8 | – 0.9 | 9.3 | 7.7 | – 0.2 | 7.0 | 15.8 |
| Total ..... | 33.1 | 77.2 | 21.4 | 30.7 | 2.0 | 12.4 | 3.2 | 7.8 | 6.5 | 26.3 |

[1] Partly estimated. [2] Australia, Canada, New Zealand and South Africa. [3] US banking flows (net) and net acquisitions of US Treasury securities by non-residents.

The unidentified inflows of funds indicated by the re-emergence of a very large positive statistical discrepancy in the US balance of payments cannot, by definition, be attributed with certainty to particular categories of capital transactions. However, two of the main sources of last year's capital inflows into the United States — non-

residents' purchases of US securities and foreign borrowing by US corporations — are items that are not very accurately reported in balance-of-payments statistics and it may therefore be that part of these inflows was not identified as such.

For a second consecutive year the large current-account deficit has been financed entirely by the acquisition of net claims on the United States by private non-residents and the dollar's effective exchange rate has appreciated in the past two years by 14 per cent. This indicates that the capital inflows were "autonomous" and themselves contributed to the current payments deficit by pushing up the value of the dollar. The marked shift in the relative importance of short-term banking inflows and long-term non-bank inflows that occurred between 1983 and 1984 might be taken as a sign that the financing of the current-account deficit was put on a less volatile and potentially more durable basis last year. However, this conclusion can be justified only to the extent that net purchases of US securities reflect a process of portfolio adjustment. A certain part of last year's inflow on portfolio account can be attributed to such a restructuring of portfolios and it is possible that this process will continue for some time. However, in general the acquisition of foreign securities is governed by the same considerations as apply to other private international capital transactions, namely the assessment of relative returns on assets denominated in different currencies. The balance of transactions in these securities, which are marketable, can turn around as quickly and sharply as flows from transactions in short-term assets. Moreover, half of the counterpart to the US current-account deficit in 1984 consisted of notoriously volatile banking flows and unidentified capital movements, and in addition there were substantial net inflows into the US corporate sector, which fluctuate mainly in line with credit demand and borrowing conditions in domestic and international financial markets.

The preponderance of easily reversible capital inflows into the United States during 1984 does not mean that prospective current-account deficits, which in any case could not be rapidly reduced, might not be financed with the same ease as in the past or, at any rate, without an abrupt change in exchange-market and financial-market conditions. At the same time, however, the persistence of a huge current-account deficit could become an increasingly important factor affecting market participants' confidence in dollar-denominated assets, and sentiment regarding the future course of the dollar might alter rapidly. In that event a large change in relative interest rates and exchange rates could be required in order to induce private investors to continue adding substantially to their existing stock of dollar-denominated assets.

Balance-of-payments developments in *Japan* in 1984 were, broadly speaking, the mirror image of those in the United States. Not only were there large shifts in opposing directions in the two countries' current and capital-account balances, but also a significant part of the changes in each country's external account had a direct counterpart in that of the other. Japan's current-account surplus rose last year by more than $14 billion to a new record of $35 billion. Owing primarily to higher net receipts on investment income, the invisibles deficit fell by $1.3 billion. The lion's share of the current-account improvement, however, resulted from a steep rise in the trade surplus.

The increase in net merchandise exports, from $31.5 billion in 1983 to $44.4 billion in 1984, was partly attributable to a terms-of-trade gain of 2½ per cent., but in the main it reflected movements in trade volume. Export volume growth nearly doubled to 16 per cent. and thus exceeded the growth of Japanese export markets for the second consecutive year by about 5 percentage points, despite an appreciation of the yen's real effective exchange rate of 6 per cent. over the past two years. However, this average change concealed a real depreciation of 3 per cent. against the dollar which was more than outweighed by a rise of 13 per cent. vis-à-vis the major European currencies. Exports to the United States, which alone account for one-third of Japan's foreign sales, are estimated to have expanded in volume terms in the last two years by about 70 per cent., or almost twice as fast as the growth of real US import demand. Exports to Europe were much less buoyant, increasing in volume terms by nearly 20 per cent. Nonetheless, this was much faster than the expansion of European countries' import volume and implied a marked gain of market shares.

The extraordinary performance of Japanese exporters must be partly ascribed to the competitive edge which Japan's industrial sector has gained from structural adjustment to changes in relative prices and technical progress during the past decade. The success in re-orienting the pattern of industrial production away from basic raw-material processing to lines of production with higher value added and high-technology products, especially in the electronics sector, became particularly evident in the past two years, when Japanese producers were in a position to respond vigorously to an upturn in foreign demand which was certainly much stronger in high-technology products than the overall growth of imports by Japan's trading partners.

Japan: Changes in trade by commodity groups, 1983–84.*

| Years | Exports | | | Imports | | | | |
|---|---|---|---|---|---|---|---|---|
| | Total | Machinery and equipment | Other | Total | Raw materials | Mineral fuel | Manu-factured products | Foodstuffs |
| | in billions of US dollars | | | | | | | |
| 1983 | 8.1 | 9.0 | – 0.9 | – 5.5 | – 0.7 | – 6.7 | 1.5 | 0.4 |
| 1984 | 23.2 | 20.2 | 3.0 | 10.1 | 1.3 | 1.4 | 6.3 | 1.1 |

* Customs data; imports c.i.f.

Changes in the commodity composition of Japan's exports show clearly the influence of structural adjustments which enabled Japanese exporters to enter newly developing and more buoyant markets for particular products. As can be seen from the above table, virtually all of the $31.3 billion increase in exports over the past two years can be traced to sales of machinery and equipment, which have expanded by 32 per cent. since 1982 and whose share in total manufactured exports rose from 72 per cent. in 1982 to 77 per cent. in 1984. By contrast, the more traditional exports such as textiles and chemicals have increased only moderately or, as for example in the case of metal products, declined.

Changes in the dollar value of trade by region, shown in the table below, indicate that $23.6 billion, or 75 per cent. of the total increase in exports in the last two years, went to the US market. The value of exports to South-East Asia rose by 28 per cent., while sales in Europe expanded by a comparatively modest 11 per cent., as the influence of relatively sluggish demand conditions in this area was reinforced by the relative strength of the yen against the major European currencies.

Japan: Changes in the regional distribution of trade, 1983–84.[1]

| Years and items | Grand total | Industrial countries | | | | Developing countries | | | | Eastern Europe |
|---|---|---|---|---|---|---|---|---|---|---|
| | | Total | United States | Western Europe | Other | Total | South-East Asia[2] | Middle East | Other | |
| | in billions of US dollars | | | | | | | | | |
| Exports | | | | | | | | | | |
| 1983 | 8.1 | 8.6 | 6.5 | 1.5 | 0.6 | 0.4 | 4.1 | 0.2 | – 3.9 | – 0.9 |
| 1984 | 23.2 | 19.9 | 17.1 | 0.9 | 1.9 | 4.0 | 4.6 | – 3.0 | 2.4 | – 0.7 |
| Imports | | | | | | | | | | |
| 1983 | – 5.5 | 0.9 | 0.5 | 0.9 | – 0.5 | – 6.3 | – 2.2 | – 4.0 | – 0.1 | – 0.1 |
| 1984 | 10.1 | 5.4 | 2.2 | 2.0 | 1.2 | 4.6 | 4.8 | – 0.7 | 0.5 | 0.1 |

[1] Customs data; imports c.i.f. [2] Includes the People's Republic of China.

The volume growth of imports also accelerated strongly, from slightly more than 1 per cent. in 1983 to about 11 per cent. in 1984. Real imports of raw materials and mineral fuels rose by 4 and 8 per cent. respectively, but the biggest increase, of 20 per cent., was recorded in imports of manufactured goods. The volume growth in raw materials and mineral fuels occurred primarily in the earlier part of the year and reflected mainly the restocking of inventories. When in the second half of the year domestic demand became the principal force behind the recovery, imports of manufactured products advanced quickly. This development during the year reaffirmed the continuation of the movement in the composition of imports away from raw materials and mineral fuels to manufactured products which has been taking place for some time. As a consequence, the share of raw materials and mineral fuels in total imports declined further in 1984, to 59 per cent. compared with 64 per cent. two years earlier. By region, the increase in imports originated in roughly equal parts in the industrial countries and the developing countries in South-East Asia.

The increase in the current payments surplus in 1984 was almost fully matched by a $13.4 billion rise in net outflows of capital from Japan, and the net official monetary position improved by $2.4 billion.

While Japan's high propensity to save has been the principal reason for its traditional rôle as a net exporter of capital — except for brief periods, the capital account has shown deficits since the early 1970s — the marked rise and concurrent shifts in the composition of outflows in 1984 reflected the influence of two other factors. Firstly, throughout the year domestic interest rates were considerably lower than interest rates on US dollar-denominated assets and, for the greater part of the year, the differential widened substantially in favour of dollar investments. Secondly, a number of measures were introduced in late 1983 and early 1984 to

liberalise further Japan's capital markets, providing, on balance, an additional impetus to net capital exports.

Japan: Capital-account transactions, 1983–84.

| Items | 1983 | 1984 | | | | |
|---|---|---|---|---|---|---|
| | | year | first quarter | second quarter | third quarter | fourth quarter |
| | in billions of US dollars | | | | | |
| Capital-account balance | −21.3 | −36.9 | − 4.2 | − 8.8 | −11.0 | −12.9 |
| Long-term capital (net) | −17.7 | −49.8 | − 5.8 | −14.3 | −12.4 | −17.3 |
| Resident capital | −32.5 | −56.9 | − 9.4 | −13.7 | −14.3 | −19.5 |
| *of which:* | | | | | | |
| *direct investment abroad* | *− 3.6* | *− 6.0* | *− 1.6* | *− 1.8* | *− 1.4* | *− 1.2* |
| *trade credits* | *− 2.6* | *− 5.1* | *− 1.2* | *− 1.0* | *− 1.2* | *− 1.7* |
| *loans* | *− 8.4* | *−11.9* | *− 2.5* | *− 2.7* | *− 4.6* | *− 2.1* |
| *securities* | *−16.0* | *−30.8* | *− 3.9* | *− 6.6* | *− 6.8* | *−13.6* |
| Non-resident capital | 14.8 | 7.1 | 3.6 | − 0.6 | 1.9 | 2.2 |
| *of which:* | | | | | | |
| *securities* | *8.5* | *− 0.2* | *1.7* | *− 2.9* | *− 0.0* | *1.1* |
| *external bonds* | *5.7* | *7.4* | *1.9* | *2.1* | *2.2* | *1.1* |
| Short-term capital (net) | − 3.6 | 12.9 | 1.6 | 5.5 | 1.4 | 4.4 |
| *of which:* | | | | | | |
| *banking flows* | *− 3.6* | *17.6* | *3.7* | *5.5* | *3.4* | *5.0* |
| Errors and omissions | 2.1 | 4.3 | 0.0 | − 0.9 | 2.4 | 2.8 |
| Changes in net official monetary position (−=improvement) | − 1.6 | − 2.4 | − 0.6 | − 0.3 | − 0.1 | − 1.4 |

As indicated in the above table, the most striking feature was the sharp increase in residents' purchases of foreign securities, from $16 billion in 1983 to $30.8 billion in 1984. This consisted entirely of investment in bonds, roughly 15 per cent. of which represented foreign bonds floated in the Japanese market. Apart from the incentives provided by high yields on foreign securities, the outflow on portfolio capital appears to have been stimulated by recent measures enhancing non-residents' access to the Japanese capital market. More importantly, perhaps, the liberalisation of capital flows at the end of 1980 has offered large institutional investors the chance to diversify their portfolios. Although prudential regulations limit investment in foreign-currency-denominated securities to 10 per cent. of the portfolio, rapid growth of assets has allowed life assurance companies and trust banks to substantially expand their holdings of foreign securities. For example, in the twelve-month period ended October 1984 life assurance companies acquired an additional $8.6 billion of foreign securities, while trust banks added $6 billion to their stocks of foreign securities in 1984.

In addition to the large outflows on residents' portfolio capital, direct investment abroad rose by $2.4 billion, not least because of Japanese producers' efforts to counter protectionist pressures by shifting production to other countries, and new long-term trade credits nearly doubled to $5.1 billion, reflecting both interest rate factors and the pick-up in foreign trade. Long-term loans — the bulk of which represents bank lending denominated in yen — rose by $3.5 billion, partly

because of the attraction of relatively low domestic interest rates, but also because the guidelines on the basis of which the Ministry of Finance used to monitor overseas lending were suspended after September 1983 and finally abolished on 1st April 1984.

Non-resident investment of long-term funds in Japan is traditionally in the form of portfolio investment. The decline in portfolio inflows, from $14.2 billion in 1983 to $7.2 billion in 1984, was entirely attributable to very large liquidations of equity holdings. Settlements data point to non-residents' net sales of shares of $7.2 billion in 1984. By contrast, inflows from sales of external bonds rose by $1.7 billion to $7.4 billion in 1984, in part because the relaxation of guidelines on the issuance of foreign-currency-denominated bonds with swap arrangements into yen, which became effective on 1st April 1984, prompted Japanese corporations to step up their issuance activity.

The large outflows of long-term capital were to some extent offset by net short-term banking inflows which caused the balance on short-term capital to swing from net outflows of $3.6 billion in 1983 to net inflows of $12.9 billion in 1984. These net inflows may have been stimulated by the growing domestic credit demand and by the removal of the limits on the banks' conversions of foreign currency into yen.

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

The changes in the current-account balances of other Group of Ten countries during 1984 were on a much smaller scale than those of the United States and Japan. In general, current-account positions tended to strengthen last year, most notably in France, but there were also rather sharp deteriorations in the United Kingdom and Italy.

On foreign trade account, as already indicated, volume growth quickened considerably in 1984, and the rise in real exports in most countries exceeded that of real imports by a considerable margin. However, the impact of higher volume growth was largely offset by declining dollar unit values, brought about by the appreciation of the dollar, and trade values in current dollars therefore showed only little change. The rapid expansion of real exports was generally the result of accelerating export-market growth and of gains in international competitiveness, which favoured in particular sales in the United States and, to a lesser extent, Japan. The upturn in import volume growth was largely attributable to the recovery of economic activity.

In *France* the current account improved by $4.3 billion in 1984 and moved into balance. Virtually all of the change occurred in the trade account, where the deficit declined mainly under the influence of domestic demand restraint. Import volume expanded by only 2½ per cent., much less than in any other Group of Ten country. The increase in export volume of 5½ per cent. did not keep pace with export-market growth, largely because of losses of competitiveness vis-à-vis some EEC trading partners. A strengthening of the trade balance was also the basic reason

for improvements of about $1 billion in the current-account positions of the *Netherlands*, *Belgium* and *Sweden*. The Netherlands' surplus on current account reached $4.8 billion and was, in relation to GNP, the biggest of any Group of Ten country. In Belgium and Sweden the current accounts showed, for the first time since the mid-1970s, small surpluses.

In *Germany* and *Switzerland* the rise in the current-account surplus of $1.8 and 0.2 billion respectively essentially reflected changes in invisibles balances that were related to developments on investment income account. However, both countries also experienced a sharp improvement in the trade balance in volume terms which offset almost fully the impact of deteriorating terms of trade. In Germany export volume rose by 9 per cent., reflecting some gain of shares in main trading partners' markets, especially in the United States, where sales soared in value terms by almost 28 per cent. Imports increased in real terms by 5 per cent. but their growth slowed down in the course of the year. The seasonally adjusted trade surplus increased by $3.2 billion between the first and second halves of 1984.

In *Canada* the current-account surplus was virtually unchanged, a $1.7 billion increase in the trade surplus outweighing a $1.6 billion widening in the invisibles deficit. The improvement on the trade account owed much to the upswing in the United States, which boosted in particular bilateral trade in motor vehicles and parts. The steep rise of trade in these products was the main reason for export and import volume growth of 22 and 20 per cent. respectively.

Two major European Group of Ten countries, the *United Kingdom* and *Italy*, recorded marked deteriorations in their current payments positions last year. The UK current-account surplus disappeared, partly owing to the adverse effects of the miners' strike on the oil and non-oil trade balances. The surplus on oil trade fell by $0.7 billion and the non-oil trade deficit widened by $3 billion, a large part of which was accounted for by increased net imports of manufactured products. While export volume growth of manufactured products rebounded strongly to 10 per cent. last year, it was outpaced by the 11 per cent. expansion in real imports, despite more favourable relative cyclical conditions and a further decline in the pound's real effective exchange rate. In Italy the current account swung back into a deficit of $3.1 billion. A marked upturn in domestic demand caused import volume to grow by 9 per cent., while losses of international competitiveness vis-à-vis European trading partners held real export growth back to 5 per cent.

The table on the next page briefly summarises the capital accounts of the Group of Ten countries in 1983–84. Leaving aside the United States, two groups of countries are distinguished. Japan, Germany, the United Kingdom, Canada, the Netherlands and Switzerland, all of which recorded current payments surpluses and sizable net capital exports in the past three years, are classified as "capital-exporting countries". The other countries in the Group of Ten, classified as "capital-importing countries", had current-account deficits and recourse to foreign borrowing during this period.

The sharp rise in capital inflows into the United States in 1984 was accompanied by a marked increase in net outflows of long-term capital from certain

Group of Ten countries: The pattern of capital flows, 1983–84.

| Countries and items | 1983 | 1984 |
|---|---|---|
| | in billions of US dollars | |
| United States[1] | 37.6 | 102.1 |
| Other Group of Ten countries | −21.6 | −42.3 |
| Long-term capital (net) | −38.3 | −82.3 |
| Capital-exporting countries[2] | −43.8 | −84.4 |
| *of which: Japan* | *−17.7* | *−49.8* |
| Capital-importing countries[3] | 5.5 | 2.1 |
| Short-term capital (net)[4] | 16.7 | 40.0 |
| Capital-exporting countries[2] | 5.1 | 31.9 |
| *of which: Japan* | *− 1.5* | *17.2* |
| Capital-importing countries[3] | 11.6 | 8.1 |

[1] Total long-term and short-term capital, including the statistical discrepancy. [2] Japan, Germany, the United Kingdom, Canada, the Netherlands and Switzerland. [3] France, Italy, Belgium and Sweden. [4] Includes errors and omissions.

other Group of Ten countries, to some extent offset by net short-term capital inflows. While the changes in aggregate capital flows were dominated by the developments in Japan discussed earlier, there were also significant movements in the same direction in some of the other countries' capital-account balances.

Net long-term outflows increased considerably in the United Kingdom and Germany last year. In the *United Kingdom* they rose from $9.6 to 16.4 billion between 1983 and 1984, owing mainly to a sharp increase, of $3.7 to 9.3 billion, in banks' net purchases of floating rate notes and other marketable instruments. Conventional long-term lending by banks in foreign currency virtually dried up last year. The process of portfolio adjustment by non-banks, which had been one of the principal sources of long-term capital exports since the removal of exchange controls in 1979, slowed down appreciably in 1984, when net new purchases of foreign securities totalled only $2 billion, or about one-third of the 1980–83 average. In addition, the acquisition of a US subsidiary by an oil company contributed in both the United Kingdom and the Netherlands to markedly higher net direct investment outflows. In *Germany*, on the other hand, the increase in net long-term outflows, from $3.2 billion in 1983 to $4.7 billion in 1984, reflected a $3.7 billion reduction in net inflows on portfolio transactions, which more than offset a decline in other net long-term capital exports. Residents' purchases of foreign securities rose by $1.2 billion in 1984, while non-residents' new investments in German securities fell by $2.5 billion. All of this reflected reduced purchases of official borrowers' notes, whereas foreign investment in German bonds, the "coupon tax" on which was abolished in 1984, was slightly higher than in 1983.

Among the countries which were importers of capital in the past three years, *France* recorded the largest change: net long-term capital inflows, mostly through the public sector, shrank in line with the decline in the current-account deficit from $5.5 billion in 1983 to $0.5 billion in 1984. In *Sweden* net inflows from foreign borrowing by the Government fell from $2.5 billion in 1983 to virtually nil in 1984.

The marked increase in net short-term capital inflows into the Group of Ten countries other than the United States, though partly attributable to the reversal in

Japan's short-term banking flows, resulted mainly from a $11.6 billion rise in foreign currency borrowing by banks in the United Kingdom to fund their large-scale purchases of floating rate notes.

**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 reduced further last year by $3.1 billion, to $11.2 billion. All of the improvement originated in the trade account and reflected favourable trade volume movements. Export volume growth doubled for the group as a whole to 10 per cent. At the same time, however, the export-led recovery in many countries in this group also stimulated a rapidly growing demand for imports, which, after having contracted slightly in 1983, leaped in volume terms to about 8 per cent. in 1984.

Within the group by far the biggest improvement was achieved by Spain, where a combination of domestic demand restraint and the lagged effects of real exchange rate depreciation caused the current-account balance to swing by $4.5 billion to a surplus of $2 billion. Most of the change occurred in the trade balance, where export volume growth of 18 per cent., a modest rise in import volume and a terms-of-trade gain of 3 per cent. resulted in a $3.4 billion cutback in the deficit. Broadly similar, though less pronounced, developments also caused Portugal's current payments deficit to decline by $0.5 billion. In Norway the surplus on current account rose further, by $1.3 billion, to $3.5 billion, equivalent to 6½ per cent. of GNP. A very large terms-of-trade gain of 7 per cent., arising mainly from a decline in the unit value of Norway's imports, more than offset a small deterioration in the trade surplus in volume terms. In Finland weak demand for imports, in combination with buoyant western export markets, was the main reason for the $0.9 billion improvement in the current account.

The largest current-account deterioration was recorded in Australia, where the deficit widened by $2.2 billion to $8 billion, or 4½ per cent. of GNP. The volumes of both imports and exports rose steeply, by 19 and 17 per cent. respectively, as the strong domestic demand coincided with rapid growth in export markets. The deterioration in the real trade balance was reinforced by a 3 per cent. decline in the terms of trade. In addition, higher interest rates and a growing stock of net foreign liabilities raised the invisibles deficit by $1.4 billion.

Total inflows of capital into these other developed countries in 1984 remained at $17½ billion, the same level as in the previous year. The improvement in the aggregate current-account position was thus fully reflected in a correspondingly larger build-up of official reserves, which rose last year by $6½ billion, compared with an increase of $3 billion in 1983. External debt owed to the BIS reporting banks was reduced at the same time by $2 billion, suggesting that other types of capital inflows expanded by over $6 billion between the last two years.

In *eastern Europe* the combined current-account surplus from convertible currency transactions is estimated to have increased by a further $2 billion in 1984,

to $10 billion. The growth of trade with the western market economies, which had been particularly buoyant in 1983, slowed last year. Exports continued to rise faster than imports, however, and the trade surplus increased by $2 billion, an improvement attributable in roughly equal parts to the USSR and the other eastern European countries. The invisibles deficit remained practically unchanged, the impact of higher dollar interest rates on the dollar-denominated part of total outstanding debt having been largely offset by the gains from a reduction in total net indebtedness. As in 1983, the decline in net indebtedness in convertible currency mainly took the form of a build-up of deposits with BIS reporting banks, which, adjusted for valuation changes, increased by $4.2 billion. The reporting banks' claims on eastern European countries, which had declined by $1.3 billion in 1983, increased last year by $0.5 billion, most of which reflected new lending to the USSR.

The current-account deficit of the *non-OPEC developing countries* continued to narrow in 1984, by $13 billion, to $22 billion. All of the improvement occurred in the trade balance, whereas higher interest payments on external debt increased the invisibles deficit by $4 billion. The 1983 trade deficit of $20 billion almost disappeared in 1984. Real exports expanded by 11½ per cent., or more than twice as fast as in 1983. Import-volume growth, too, accelerated last year to 5 per cent., compared with only 1 per cent. in the previous year.

Differences between countries in the structure of exports and the ability to respond quickly to the growth of world demand produced important differences in current-account performance between two groups of non-OPEC developing countries in 1984 shown in the following table. Countries in Asia (including China), many of which have been developing an industrial base for more sophisticated manufactured goods, benefited from export volume growth of 14 per cent., which, together with a small rise in average dollar prices, boosted the value of exports by $27 billion. Their sales to the United States and Australia expanded particularly rapidly, by more than 30 per cent., but their inter-regional trade and exports to the rest of the world also grew faster than world trade in general. Imports, too, increased considerably, by $18 billion, owing essentially to an acceleration in volume growth to 8 per cent., but lagged behind the impressive increase in exports. As a result, the trade deficit of Asian countries was halved to $8 billion, two-thirds of which was reflected in an improvement in the current-account balance.

In Latin America, including the Caribbean area, real export growth nearly doubled, to almost 8 per cent., but the rise fell far short of that achieved by countries in Asia. Import volume increased by only 1½ per cent., and the corresponding improvement in the real trade balance was the principal reason for the decline in the current payments deficit, by $6 billion to $8 billion. The modest rise in import volume, however, was in sharp contrast to the 40 per cent. contraction in the level of these countries' imports in the two preceding years. Changes in this region's total current-account balance were dominated by developments in the two largest countries. In Brazil the current-account deficit was again sharply reduced, from $6.8 billion in 1983 to $0.7 billion in 1984, export earnings going up by $5.1 billion, while import payments fell by $1.5 billion. The import cuts, which took

*Current-account balances of non-OPEC developing countries in Asia and Latin America, 1982–84.*

| Areas | 1982 | 1983 | 1984 |
|---|---|---|---|
| | in billions of US dollars | | |
| Asia | | | |
| Trade balance | −22 | −17 | − 8 |
| Exports | 145 | 154 | 181 |
| Imports | −167 | −171 | −189 |
| Invisibles (net) | 10 | 10 | 7 |
| *of which: interest payments* | *−11* | *−11* | *−12* |
| Current-account balance | −12 | − 7 | − 1 |
| Latin America | | | |
| Trade balance | 5 | 20 | 27 |
| Exports | 73 | 74 | 81 |
| Imports | −68 | −54 | −54 |
| Invisibles (net) | −40 | −34 | −35 |
| *of which: interest payments* | *−35* | *−31* | *−32* |
| Current-account balance | −35 | −14 | − 8 |

place in the face of an upturn in domestic output of 4½ per cent., were helped considerably by a 25 per cent. reduction in oil import volume, largely made possible by a 40 per cent. expansion of domestic oil production. Non-oil imports remained constant in real terms. In Mexico imports rose by 30 per cent. to $11.3 billion. Export receipts increased by $1.8 billion, a small increase in oil revenues being reinforced by a 20 per cent. expansion in exports of manufactured goods. On the strength of a trade surplus of $12.8 billion, the current account showed a comfortable surplus of $4.1 billion. In both countries, however, the trade balance appears to have deteriorated in the first quarter of 1985.

Elsewhere in Latin America, as well as in the rest of the developing world, the situation changed little and, while some export gains were made, there was generally not much scope for relaxing import restraint.

Non-OPEC developing countries: Estimated financing of current-account deficit, 1982–84.

| Items | 1982 | 1983 | 1984 |
|---|---|---|---|
| | in billions of US dollars | | |
| Current-account deficit | 63 | 35 | 22 |
| Increase in foreign assets | 26 | 24 | 28 |
| of which: exchange reserves | − 2 | 9 | 18 |
| other[1] | 28 | 15 | 10 |
| Financing requirement | 89 | 59 | 50 |
| Direct investment (net) | 11 | 9 | 8 |
| Increase in other foreign liabilities | 78 | 50 | 42 |
| of which to: | | | |
| official creditors (long-term) | 28 | 34 | 28 |
| *(of which: drawings on IMF (net))* | *(5)* | *(8)* | *(4)* |
| banks[2] | 20 | 12 | 9 |
| other | 30 | 4 | 5 |
| of which by maturity: | | | |
| long-term | 60 | 68 | 51 |
| short-term | 18 | −18 | − 9 |

[1] Includes errors and omissions in balance-of-payments accounts. [2] BIS reporting banks.

The total external financing requirement of the non-OPEC developing countries, defined as the sum of the current payments deficit, reported increases in foreign assets (including official reserves) and unidentified capital outflows, is estimated to have declined further, from $59 billion in 1983 to $50 billion in 1984. The breakdown of financing flows by creditors and maturity indicates that the repercussions of the international debt crisis continued to shape the pattern of capital flows to these countries. By category of creditor, $28 billion, or two-thirds of total new lending to these countries last year, comprised long-term funds supplied by official creditors (including the IMF). This proportion was twice as high as it had been in the years before the debt crisis. The remaining one-third, or $14 billion, consisted of new borrowing from the BIS reporting banks totalling $9 billion, down from $12 billion the year before, and of other private capital inflows totalling $5 billion, mainly in the form of suppliers' credits and lending by financial institutions outside the BIS reporting system. The breakdown of lending by maturity shows that, as in the preceding year, the inflow of long-term funds was partly offset by the repayment of short-term debt. This was to a significant extent the consequence of debt restructuring arrangements which resulted, for the second consecutive year, in a lengthening of the average maturity of non-OPEC developing countries' external indebtedness.

The stock of total external debt of non-OPEC developing countries increased in current dollar terms by $30 billion, slightly less than in the previous year, to more than $600 billion. Total interest payments are estimated to have risen by $2 billion to $51 billion. The average interest rate paid on foreign debt remained unchanged in 1984, despite a 1½ percentage point increase in six-month Euro-dollar interest rates. The proportion of relatively low-cost debt from official sources increased last year and many countries were able to negotiate more favourable terms on their debt from private sources, either in normal borrowing in international credit markets or in the context of debt restructuring arrangements. Since, at the same time, the non-OPEC countries' export earnings increased considerably, interest payments in relation to exports of goods and services declined for the second consecutive year, from 15 per cent. in 1982 to 13 per cent. by 1984. Of course, these aggregate numbers conceal wide differences between countries and regions of the world. Even in Latin America, however, where the average proportion of interest payments to export receipts is six times that in Asia, this critical measure of debt burden declined by 2 percentage points in 1984.

*The state of the adjustment process in the non-OPEC developing countries.* All the basic indicators point to significant progress in the consolidation of the international debt situation in 1984. The aggregate current-account position of the non-OPEC developing countries improved considerably and allowed many countries cautiously to relax restrictive domestic policies and to increase imports and revert to domestic output growth. Moreover, liquidity pressures eased and inflows of funds into the group as a whole permitted a substantial addition to official reserves.

However, this encouraging picture for the group as a whole is largely dominated by the success of the dynamic economies in Asia which were able for a second consecutive year to raise their relative share in world output and world trade.

Elsewhere in the group the attainment of sustainable external positions is in many instances not yet assured. In Africa and in the Middle East many countries have not been able to benefit significantly from the upturn in world demand, and the persistent weakness of external positions does not leave room for domestic demand stimulus. Similarly, in Latin America most of the improvement has taken place in Brazil and Mexico, and several countries have not yet implemented domestic stabilisation policies. Finally, even in Brazil and Mexico, where an impressive external adjustment has been taking place over the past two years, two developments might endanger the consolidation process. Firstly, nearly all of the substantial rise in the two countries' export earnings was attributable to the upswing in US import demand, and further progress in external adjustment would become more difficult in the event of a slowdown in the US economy. Secondly, since adjustment of domestic imbalances has not kept pace with the improvements in the external accounts, the foundation for a sustainable external position has not yet been established.

In the *OPEC countries* the combined current-account deficit narrowed from $21 billion in 1983 to $10 billion in 1984. The improvement was more than accounted for by a decline in imports, which were pared by 11 per cent. in volume terms, only slightly less than in the preceding year. The value of exports shrank for the fourth consecutive year, from a peak of $300 billion in 1980 to only $173 billion in 1984, as the impact of a 2½ per cent. decrease in volume was reinforced by a decline in export unit values. The decline in volume occurred despite a 1½ per cent. rise in world oil consumption, reflecting mainly the first increase in consumption in the industrial countries since 1979, so that OPEC's share of world oil supply fell further, to 30 per cent.

The underlying weakness in oil-market conditions in 1984 caused the Middle Eastern OPEC countries with a low absorptive capacity to cut their oil output and absorb export declines of the order of $5 billion. At the same time, these countries reduced their imports by an estimated $9 billion and lowered their combined current-account deficit by $4 billion to $3 billion. The other OPEC countries, too, curtailed their imports and, benefiting from a small increase in export earnings, were able to halve their current-account deficit to about $7 billion in 1984. The largest improvement was achieved by Nigeria, where import cuts in combination with higher oil export earnings caused the trade balance to swing from a $1.7 billion deficit in 1983 to a surplus of more than $2 billion.

The deficit of the Middle Eastern countries appears to have been financed largely by using official reserves, which declined by approximately $4½ billion in 1984. By contrast, in the other OPEC countries the improvement in the current-account position was accompanied by a build-up of official reserves of $2½ billion. As the current payments position improved, OPEC countries as a group again became net suppliers of funds to the international banking system. Following a drawdown of $23 billion in 1983, the OPEC countries increased their net asset position with the BIS reporting banks last year by $3.5 billion, most of which reflected new deposits by those countries which recorded the largest reserve gains.

# VI. THE INTERNATIONAL CREDIT AND CAPITAL MARKETS.

## Highlights.

After two years of contraction, the overall amount of new credit channelled through the international financial markets rose slightly last year. This was due entirely to a surge in the volume of international bond issues, there being no sign of a pick-up in the underlying growth of international bank credit. Moreover, with the banks' growing participation in the bond markets, not only as intermediaries but as borrowers and investors, the borderlines between the two markets have become increasingly blurred.

It may be estimated that, net of double-counting resulting from the redepositing of funds between the reporting banks, new international credit extended by banks in the BIS reporting area amounted to $85 billion last year, about the same as in 1983. The volume of international bond issues by contrast, net of redemptions and repurchases, expanded by over 40 per cent., to about $84 billion. Excluding the very substantial amount of overlapping between the two markets, the combined volume of new credit amounted to an estimated $145 billion, up by $15 billion on 1983 but well below the previous peak of $195 billion in 1981.

International bank lending continued to be characterised by what could be called a split market. The banks were unwilling spontaneously to increase their exposure vis-à-vis certain groups of heavily indebted countries, while, in view of the ample availability of new funds, a borrowers' market existed for lending to prime addresses in the industrial countries and some parts of the developing world. However, in most countries outside the reporting area that had easy access to international bank credit, improved current-account balances and more cautious borrowing policies kept demand for credit down. Despite a substantial amount of "involuntary" lending under officially sponsored credit packages, the banks' total lending to developing countries and other countries outside the reporting area slackened and, on an assets-minus-liabilities basis, for the first time these countries became large-scale net suppliers of new funds to the reporting banks. The 1984 growth in international bank credit therefore largely reflects new lending within the reporting area, particularly the large capital flows to the United States.

The unprecedented boom conditions in the international bond markets last year were due to a number of influences: a pronounced positive yield curve and, in conjunction with abating fears of inflation, expectations of a decrease in long-term interest rates; the innovativeness and flexibility of the capital markets; deregulatory moves, especially the abolition of the US withholding tax on non-resident income from US securities; a decline in the perceived comparative safety of bank deposits as a result of credit problems at home and abroad, which meant that some of the large sovereign borrowers could raise funds more cheaply in the capital markets than

**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-1984 |
|---|---|---|---|---|---|---|
| | 1980 | 1981 | 1982 | 1983 | 1984 | |
| | in billions of US dollars | | | | | |
| Total international lending of reporting banks[2] | 241.1 | 264.8 | 180.3 | 105.2 | 125.4 | 2,153.2 |
| minus: double-counting due to redepositing among the reporting banks | 81.1 | 99.8 | 85.3 | 20.2 | 40.4 | 888.2 |
| A = Net international bank lending[3] | 160.0 | 165.0 | 95.0 | 85.0 | 85.0 | 1,265.0 |
| Euro-bond and foreign bond issues | 39.4 | 49.0 | 71.7 | 73.5 | 107.7 | . |
| minus: redemptions and repurchases | 11.4 | 12.5 | 13.2 | 14.5 | 23.7 | . |
| B = Net international bond financing | 28.0 | 36.5 | 58.5 | 59.0 | 84.0 | 410.0 |
| A+B = Total bank and bond financing | 188.0 | 201.5 | 153.5 | 144.0 | 169.0 | 1,675.0 |
| minus: double-counting[4] | 8.0 | 6.5 | 8.5 | 14.0 | 24.0 | 85.0 |
| Total net bank and bond financing | 180.0 | 195.0 | 145.0 | 130.0 | 145.0 | 1,590.0 |

[1] Non-dollar bank credits are converted into dollars at constant end-of-quarter exchange rates, non-dollar bonds at mid-month rates. [2] Up to 1983 the reporting area includes banks in the Group of Ten countries, Luxembourg, Austria, Denmark and Ireland, plus the offshore branches of US banks in the Bahamas, the Cayman Islands, Panama, Hong Kong and Singapore. As from 1984 the reporting area includes in addition Finland, Norway and Spain as well as non-US banks engaged in international business in the Bahamas, the Cayman Islands, Hong Kong and Singapore, all offshore units in Bahrain and all offshore banks operating in the Netherlands Antilles. [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. [4] Bonds taken up by the reporting banks, to the extent that they are included in the banking statistics as claims on non-residents; bonds issued by the reporting banks mainly for the purpose of underpinning their international lending activities.

via the banks; and the banks' own preference for marketable assets and longer-term funding.

In addition to describing current developments, this chapter surveys structural changes in the pattern of international financial intermediation from a somewhat longer-term perspective; it describes the ECU-denominated banking and securities markets, which showed very strong growth over the last two years; and it reviews the international debt situation, highlighting the improvements that were achieved last year but also pinpointing the problems and dangers that remain.

## The development of international banking activity in 1984.

*The development of the overall aggregates.* The acceleration in the expansion of the BIS reporting banks' gross external assets shown in the following table, from $105 billion in 1983 to $125 billion last year, was more apparent than real; it resulted from a broadening of the statistical coverage of the international banking data (see footnote 2 to the table above). Excluding the effects of this change in coverage, growth was about the same as in 1983 and much slower than in preceding years. The estimates for net new international bank credit extended by the BIS

reporting banks, which suggest identical increases of $85 billion for both years, are less affected by this statistical change, since they had already made some allowance for the earlier gaps in the coverage of the data. Nevertheless, in percentage terms the underlying growth of international bank credit appears to have slowed down from about 8.5 per cent. in 1983 to 7 per cent. last year.

On the assets side of the market the relative weakness of the pace of growth was due solely to developments in business with countries outside the banks' own area. New lending to these countries, which had already contracted quite sharply over the preceding years, declined further to $15.6 billion. This corresponded to less than one-quarter of the 1980 figure. As in 1982 and 1983, the slowdown reflected the banks' reluctance to add to their exposure vis-à-vis certain groups of countries, as well as reduced external financing requirements, more cautious borrowing policies and a preference for capital-market borrowing on the part of other countries.

On the sources side of the market developments were exactly the reverse. The liabilities of the reporting banks vis-à-vis countries outside the reporting area, which after a $11.4 billion decline in 1982 had edged up only marginally in 1983, soared by $34 billion last year. This surge in the inflow of new deposits from these

**Selected features of international banking activity, 1980–84.**

| Items | Assets | | | | | Liabilities | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | 1980 | 1981 | 1982 | 1983 | 1984 | 1980 | 1981 | 1982 | 1983 | 1984 |
| | exchange rate adjusted flows, in billions of US dollars | | | | | | | | | |
| Cross-border positions vis-à-vis: | | | | | | | | | | |
| 1. countries outside the reporting area ..... | 68.2 | 65.7 | 39.4 | 27.6 | 15.6 | 52.4 | 16.5 | −11.4 | 1.2 | 34.0 |
| 2. banks within the reporting area ..... | 135.6 | 160.7 | 107.6 | 64.6 | 99.4 | 161.4 | 155.2 | 97.7 | 80.2 | 104.5 |
| 3. *non-banks within* the reporting area ..... | 30.6 | 31.0 | 18.3 | 5.8 | 11.2 | 22.3 | 49.8 | 27.7 | 23.5 | 13.1 |
| 4. unallocated ..... | 6.7 | 7.4 | 15.0 | 7.2 | – 0.8 | 6.1 | 16.2 | 16.7 | 5.9 | – 1.1 |
| Total cross-border positions | 241.1 | 264.8 | 180.3 | 105.2 | 125.4 | 242.2 | 237.7 | 130.7 | 110.8 | 150.5 |
| Domestic positions in foreign currency: | | | | | | | | | | |
| 5. interbank ..... | 62.0 | 51.3 | 36.4 | 11.8 | 13.6 | 53.4 | 48.4 | 39.1 | 14.6 | 14.0 |
| 6. vis-à-vis non-banks ... | 20.7 | 19.4 | 12.1 | 10.9 | 11.5 | 5.5 | 5.3 | 6.8 | 2.0 | 5.6 |
| Total domestic positions . | 82.7 | 70.7 | 48.5 | 22.7 | 25.1 | 58.9 | 53.7 | 45.9 | 16.6 | 19.6 |
| Estimate of total net international bank lending* . | 160.0 | 165.0 | 95.0 | 85.0 | 85.0 | 160.0 | 165.0 | 95.0 | 85.0 | 85.0 |

Note: Since end-1983 the reporting area has been enlarged to include banks in Finland, Norway, Spain, Bahrain and the Netherlands Antilles as well as banks in the Bahamas, the Cayman Islands, Hong Kong and Singapore. As from that date, therefore, the first five of these countries are newly included in the reporting area, whereas the other four market centres mentioned, for which previously only data for the branches of US banks were available, were already part of the reporting area.

* Sum of items 1, 3 and 6, plus parts of items 2 and 4.

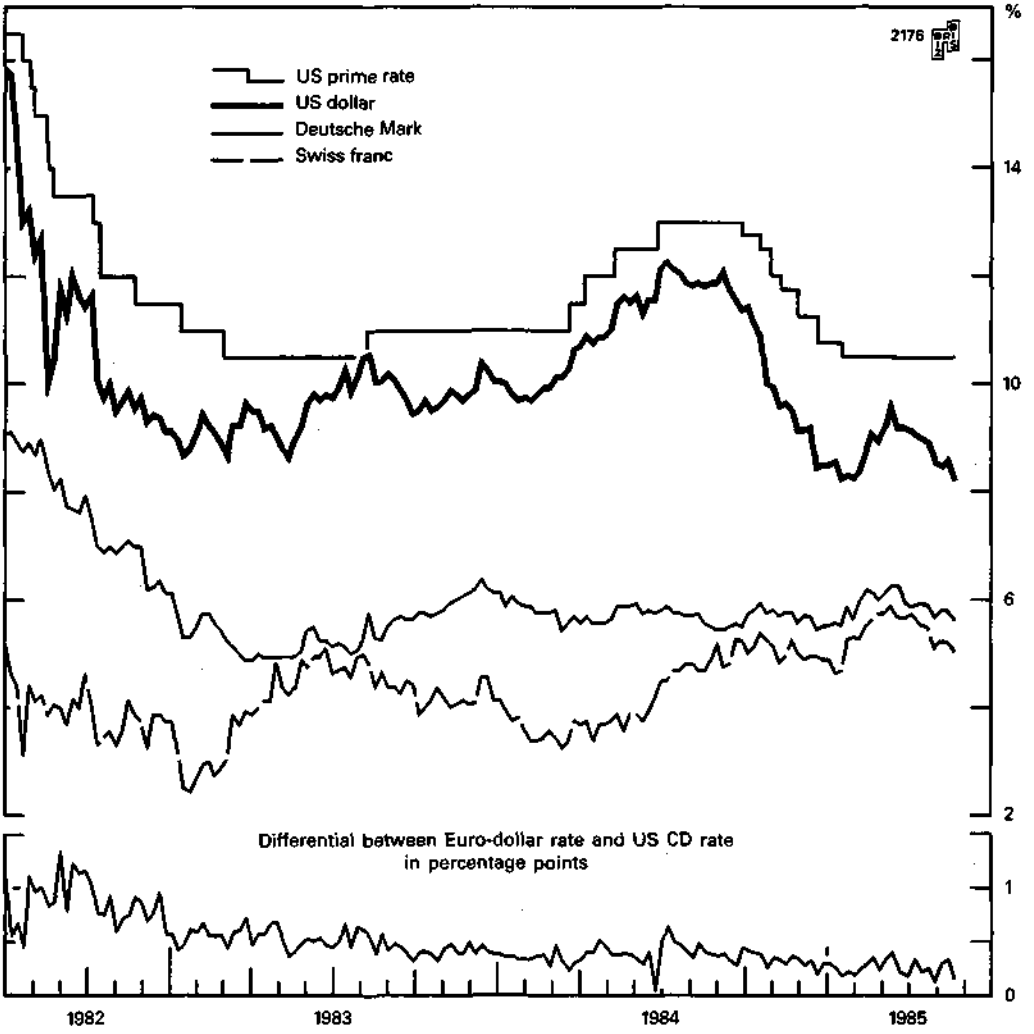
countries was partly the result of the improved balance-of-payments positions of some important debtor countries and their related accumulation of official reserves. But it undoubtedly also reflected private capital outflows encouraged both by the high level of dollar interest rates and by the upward trend of the dollar in the exchange markets.

These developments meant that, in contrast to their traditional rôle as a channel for net capital flows from the main industrial countries to the rest of the world, the reporting banks last year became net takers of funds from outside-area countries, to the extent of $18.5 billion. In 1981 they had been net providers to the tune of $49 billion. This $67.5 billion turn-round largely reflected the impact of the international debt crisis and its various ramifications on the pattern of international capital flows. The only two previous years in which the banks had been net receivers of funds from outside the reporting area, although on a much smaller scale than last year, were 1974 and 1979, when, following the oil price increases, the flow of new deposits was swollen by the investment of the OPEC surpluses. In 1984, however, OPEC countries added only modestly to their deposits with the reporting banks.

The mirror image of the slowdown in lending to countries outside the reporting area was an increase to $70 billion in the absorption of international banking funds within the reporting area itself. Identified direct cross-border lending to non-bank entities in the reporting area accelerated from the unusually low level of $5.8 billion in 1983 to $11.2 billion, which, however, was still only about one-third the amount recorded in 1980–81. Moreover, this acceleration was more than accounted for by a rise from $1.3 to 10.2 billion in new lending to US non-bank entities, which implies that new cross-border lending to residents of other countries inside the reporting area amounted to a mere $1 billion last year, whereas in 1980, for example, it had reached $28 billion. The main reasons for this drastic slowdown in lending to non-US non-bank entities were probably: the weakness of corporate borrowing demands resulting from improved profits; relatively weak investment activity and ample availability of domestic funds; and reduced public-sector borrowing as a result of improved balance-of-payments positions as well as a shift of borrowing to the capital markets. It may, however, be noted that, in contrast to the virtual absence of cross-border lending other than to US non-bank customers, local Euro-currency lending to non-bank residents, which is also included in the estimates of the net volume of international bank credit, held up quite well last year, probably because of its closer linkage to foreign trade finance. It amounted to $11.5 billion (see lower half of the table on page 111), which was only 45 per cent. less than its previous 1980 peak level. The 1984 acceleration in lending to US non-bank entities must be seen against the background of the relatively strong US domestic credit demand and the — in relation to domestic interest rates — low level of Euro-dollar rates.

The largest movement recorded on the uses side of the reporting banks' balance sheets was, as usual, in cross-border claims on other banks within the reporting area, which rose by $99.4 billion last year. This item is obtained as a residual by subtracting identified claims on non-banks from total cross-border claims within the reporting area and contains a large amount of double-counting

Three-month interbank rates on Euro-currency deposits, differentials and US prime rate.




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

which is netted out for purposes of estimating the amount of net international bank credit outstanding. Nevertheless, it also contains a substantial amount of unidentified claims on non-banks and claims on financial institutions, such as foreign trade banks and investment banks, which, from the point of view of the Euro-currency statistics, should really be regarded as end-users of international banking funds. Moreover, these interbank figures include a quite considerable amount of lending to banks, such as banks in the United States other than IBFs, which use the funds for local lending in domestic currency. In this case, too, from the point of view of the Euro-currency statistics the banks have to be considered as end-users of funds. For 1984 it may be estimated that of the $99.4 billion of "interbank" claims somewhat over $45 billion had a final user counterpart, while the remainder, together with the $13.6 billion of local interbank lending, has to be considered as

interbank activity related to final lending that is already otherwise covered by the statistics and which can therefore be disregarded from the point of view of the overall credit volume. The largest single element in this $45 billion was lending to US banks which used the funds for domestic credit expansion.

On the sources side of the market, developments inside the reporting area were quite different. The volume of new cross-border deposits received by the banks from non-bank entities within the reporting area fell from $23.5 billion in 1983 to $13.1 billion. This slowdown was, however, more than accounted for by a turn-round amounting to $22 billion in the rôle played by US non-bank entities. In 1983 they had added $16.7 billion to their deposits with the reporting banks, whereas in 1984 they drew down their deposits by $5.5 billion. These withdrawals were, however, confined to the second and third quarters and were probably related in part to the problems of one major US bank, which seem to have given investors the impression that their deposits were more likely to be covered by the US official protective umbrella if they were held in the United States. Together with the sharp acceleration in borrowing, this switch on the deposit side of the market meant that the US non-bank sector, which had on balance supplied $15.4 billion of new funds to the market in 1983, was a net taker of funds to about the same extent last year. This turn-round of $31 billion in the US non-bank sector's credit relations with the Euro-market was undoubtedly one of the main factors contributing to the extraordinary strength of the dollar in 1984.

Additions to the cross-border Euro-currency deposits of non-bank residents of other reporting countries accelerated quite sharply last year, from $6.8 billion in 1983 to $18.6 billion. The bulk of this increase was in dollars and reflected the twin attractions of high interest rates and the strength of the dollar in the exchange markets. There was also a rise, from $2 to 5.6 billion, in new Euro-currency deposits received by the banks from local residents.

*Developments in individual market centres.* As regards the rôle of individual market centres, it can be seen from the table on the opposite page that the faster expansion of the gross banking aggregates last year was due in large measure to an acceleration, from $41.8 to 73.5 billion, in the growth of the cross-border claims of banks in the European reporting area. However, developments in individual countries differed quite markedly. In the United Kingdom, the largest market centre, external asset growth slowed down further from $27.1 billion in 1983 to $24.7 billion in 1984, or about 30 per cent. of its 1981 level. The main reason for this development was the scaling-down during the second and third quarters of the international books of the London affiliates of US banks, following the difficulties at a large US bank. In a number of the other major European market centres, by contrast, external asset growth moved up sharply in 1984, from $1.2 to 8.1 billion in France and from $5.2 to 18 billion in Belgium-Luxembourg. Banks in Germany and the Netherlands, which in the two preceding years had refrained from expanding their international assets, also showed substantial growth, of $7.5 and 3.1 billion respectively. The external assets of banks in Switzerland recorded an increase of $2.3 billion, but this figure does not include the funds channelled by them into the international market via trustee accounts, which may be estimated to have amounted to about $10 billion last year.

Developments in individual market centres, 1981–84.

| Banks in: | Flows at constant end-of-quarter exchange rates | | | | | | | | Stocks at end-1984 | |
|---|---|---|---|---|---|---|---|---|---|---|
| | Assets | | | | Liabilities | | | | Assets | Liabilities |
| | 1981 | 1982 | 1983 | 1984 | 1981 | 1982 | 1983 | 1984 | | |
| | in billions of US dollars | | | | | | | | | |
| United Kingdom | 79.5 | 39.5 | 27.1 | 24.7 | 78.7 | 48.8 | 33.2 | 35.8 | 489.3 | 531.5 |
| France | 9.1 | 10.5 | 1.2 | 8.1 | 14.9 | 7.6 | 1.9 | 6.6 | 141.5 | 138.4 |
| Luxembourg | 6.2 | 5.8 | 1.4 | 7.3 | 4.1 | 3.9 | 0.3 | 5.8 | 85.6 | 79.5 |
| Belgium | 8.8 | 1.1 | 3.8 | 10.7 | 9.8 | 2.6 | 6.5 | 12.6 | 68.3 | 80.1 |
| Germany | 7.4 | −0.1 | −0.2 | 7.5 | 1.5 | −0.4 | −2.0 | 5.4 | 64.2 | 57.6 |
| Netherlands | 7.4 | 0.2 | −0.4 | 3.1 | 4.6 | 1.1 | −3.5 | 0.7 | 56.5 | 52.4 |
| Switzerland | 5.1 | 2.1 | 2.5 | 2.3 | 2.8 | −2.6 | −0.2 | 1.0 | 52.8 | 33.7 |
| Italy | 6.4 | −1.0 | 2.0 | 3.0 | 4.4 | −4.3 | 3.9 | 6.7 | 36.7 | 49.5 |
| Other European reporting countries[1] | 4.0 | 4.9 | 4.4 | 6.8 | 5.2 | 4.7 | 4.1 | 9.4 | 66.2 | 85.7 |
| Total European reporting countries | 133.9 | 63.0 | 41.8 | 73.5 | 126.0 | 61.4 | 44.2 | 84.0 | 1,061.1 | 1,108.4 |
| US IBFs | 63.4 | 81.2 | 28.1 | 16.8 | 48.3 | 77.1 | 31.6 | 17.7 | 188.6 | 174.0 |
| Other banks in the United States | 12.2 | 25.9 | 5.4 | −2.3 | −9.9 | −8.7 | 17.1 | 13.3 | 221.0 | 150.7 |
| Total banks in the United States | 75.6 | 107.1 | 33.5 | 14.5 | 38.4 | 68.4 | 48.7 | 31.0 | 409.6 | 324.7 |
| Canada | 2.7 | 0.9 | 3.5 | 2.1 | 18.0 | −3.5 | 3.9 | 1.6 | 43.3 | 63.0 |
| Japan | 20.7 | 8.0 | 18.6 | 22.0 | 21.7 | 0.8 | 7.5 | 23.8 | 126.9 | 127.0 |
| Other reporting countries[2] | 31.9 | 1.3 | 7.8 | 13.3 | 33.6 | 3.6 | 6.5 | 10.1 | 512.3 | 494.9 |
| Total | 264.8 | 180.3 | 105.2 | 125.4 | 237.4 | 130.7 | 110.8 | 150.5 | 2,153.2 | 2,118.0 |

[1] Includes, up to 1983, Austria, Denmark, Ireland and Sweden and, as from 1984, also Finland, Norway and Spain.
[2] Includes, up to 1983, the branches of US banks in the Bahamas, the Cayman Islands, Panama, Hong Kong and Singapore. As from 1984 this item also covers non-US banks in these market centres, except Panama, plus all offshore units in Bahrain and all offshore banks operating in the Netherlands Antilles.

On an assets-minus-liabilities basis, banks in the United Kingdom and Italy added very substantially to their external net debtor positions, namely $11.1 and 3.7 billion respectively. In the United Kingdom this may in large measure have reflected the banks' use of external funds for investment in longer-term international securities which are not included in the UK banking figures. Banks in the Netherlands and Germany were the largest net exporters of funds.

Outside Europe, the growth in the external assets of banks in the United States, which had totalled $107.1 billion in 1982, the first full year after the opening of the IBFs, slowed down further to $14.5 billion last year. More than the whole of this asset growth occurred in the IBFs, which still expanded at a rate of around 10 per cent. Conventional external assets, by contrast, contracted by $2.3 billion, this being the first decrease since the dismantling of the US balance-of-payments restraint programme in 1974. The external liabilities of banks in the United States increased more than their assets, so that their external net creditor position, which had already contracted by $15.2 billion in 1983, showed a further decrease of $16.5 billion. Nevertheless, it still amounted to $85 billion at the end of the year.

In terms of growth rates, the strongest expansion of external assets among the major market centres, of 21 per cent., was recorded by banks in Japan, over half of the increase being in yen assets, which, partly as a result of the April 1984 deregulation measures, soared at a rate of 42 per cent. With their external liabilities showing an even larger increase, banks in Japan, in sharp contrast to the non-bank sector there, were net importers of external funds in 1984, to the extent of $1.8 billion.

The acceleration in external asset growth shown in the table for the "Other reporting countries" was more than accounted for by the broadening of the statistical coverage. Previously this item had encompassed only the activities of the branches of US banks in the major offshore centres of the Caribbean and Far East, whereas the new series covers the activities of all banks in these offshore centres (except Panama) plus the operations of offshore units in Bahrain and the Netherlands Antilles.

*Development of the reporting banks' business with countries outside the reporting area.* In 1984 one of the salient features of banks' dealings with countries outside the reporting area was the further slowdown, from $8.1 billion in 1983 to $3.6 billion, in new lending to non-OPEC Latin American countries, once the largest group of outside-area borrowers. Moreover, this new lending was significantly less than the $10.5 billion of new funds obtained by these countries from the reporting banks under IMF-sponsored credit packages, which implies that there were some offsetting reductions of other bank credits. Despite their reduced recourse to new international bank credit, these countries built up their deposits with the reporting banks by $11.5 billion last year, compared with $5.9 billion in 1983. This meant that, on an assets-minus-liabilities basis, non-OPEC Latin American countries, which in 1980 had been net takers of $28 billion of new funds

**The reporting banks' business with individual groups of non-OPEC developing countries, 1977–84.**

| | Estimated flows at constant end-of-quarter exchange rates | | | | | | | | Stocks at end-1984 |
|---|---|---|---|---|---|---|---|---|---|
| | 1977 | 1978 | 1979 | 1980 | 1981 | 1982 | 1983 | 1984* | |
| | in billions of US dollars | | | | | | | | |
| Assets | | | | | | | | | |
| Latin America | 5.1 | 14.7 | 23.2 | 27.3 | 30.5 | 12.2 | 8.1 | 3.6 | 211.0 |
| Middle East | 0.1 | 1.2 | 1.2 | 2.1 | 2.3 | 1.7 | 0.1 | 0.4 | 15.5 |
| Africa | 0.9 | 3.1 | 2.7 | 2.0 | 2.0 | 1.7 | 0.3 | 0.2 | 18.7 |
| Asia | 3.5 | 3.8 | 8.2 | 7.6 | 5.1 | 4.2 | 3.4 | 4.6 | 84.1 |
| Total | 9.6 | 22.8 | 35.3 | 39.0 | 39.9 | 19.8 | 11.9 | 8.8 | 329.3 |
| Liabilities | | | | | | | | | |
| Latin America | 2.5 | 8.1 | 5.0 | −1.0 | 4.8 | −1.8 | 5.9 | 11.5 | 68.5 |
| Middle East | 2.9 | 3.3 | 1.7 | 2.7 | 1.4 | 1.9 | −0.9 | −1.4 | 20.3 |
| Africa | 1.3 | 0.6 | 1.8 | 0.7 | 0.5 | −0.8 | 0.2 | 1.0 | 9.6 |
| Asia | 4.4 | 2.6 | 3.8 | 1.5 | 2.7 | 5.6 | 5.1 | 10.7 | 72.1 |
| Total | 11.1 | 14.6 | 12.3 | 3.9 | 9.4 | 4.9 | 10.3 | 21.8 | 170.5 |

* As from 1984 the coverage of the figures has been enlarged to include the changes in position of banks in Finland, Norway, Spain, Bahrain and the Netherlands Antilles, as well as all banks in the Bahamas, the Cayman Islands, Hong Kong and Singapore.

from the reporting banks, last year became net suppliers to the extent of $8 billion. The greater part of the new deposits probably reflected the very substantial additions to official reserves which some of the major Latin American borrower countries were able to make last year.

As regards individual Latin American countries, Brazil was by far the largest borrower, obtaining $4.7 billion of new funds from the reporting banks, but this was nearly $2 billion less than the amount drawn by that country under the officially sponsored credit packages. Brazilian deposits with the reporting banks rose by $5.6 billion, or by nearly one-half, which compares with an increase of over $7 billion in the country's official exchange reserves. Mexico's banking debt expanded by only $0.7 billion despite $3 billion of drawings under the officially sponsored credit packages, which suggests, as in the case of Brazil, that there were major reductions of other bank credits. Nevertheless, Mexican deposits with the reporting banks soared by $4.8 billion last year. On an assets-minus-liabilities basis, the only major net borrower of new funds in Latin America was Chile, which received $0.8 billion, all of which was under an officially sponsored credit package, while at the same time reducing its deposits by $0.2 billion. On the other hand, the banks reported a $1 billion reduction in their claims on Argentina, which obtained no new funds under officially sponsored loan packages.

The banks' claims on non-OPEC developing countries outside Latin America expanded by $5.2 billion, which was somewhat more than in 1983, but this "acceleration" may well have been due to the fuller coverage of the new reporting system. Claims on countries in Asia grew by $4.6 billion, whereas credits to Middle Eastern and African countries showed only marginal increases. However, among these three groups of borrowers only Middle Eastern countries were net takers of funds, drawing down their deposits by $1.4 billion. Countries in Asia and Africa, by contrast, added $10.7 and 1 billion respectively to their deposits with the reporting banks.

The development of the banks' business with non-OPEC Middle Eastern countries was strongly influenced by Israel, which drew down its deposits with the reporting banks by $1.7 billion but also reduced its debts by $0.6 billion. The only major borrower was Egypt, which received $0.7 billion of new credits. In Asia the principal borrowers of new funds were South Korea ($1.8 billion), China ($1.4 billion), Thailand and India ($0.8 billion each). China also built up its deposits by $2.8 billion, thereby adding further to its very considerable net creditor position vis-à-vis the reporting banks, although this process was partly reversed during the final quarter of the year when the country stepped up its borrowing and reduced its deposits. The largest supplier of funds to the reporting banks was, however, Taiwan, which added $5.5 billion to its deposits while at the same time reducing its debts by $0.8 billion. As a result, its net claims on the reporting banks more than doubled to $11.4 billion last year.

The reporting banks' business with OPEC countries (see the table overleaf) also showed a large turn-round in 1984. After lending $9.6 billion in 1983, the banks reduced their claims on these countries by $0.6 billion last year. At the same time, new deposits received from OPEC countries amounted to $3.1 billion,

**Estimated flows between the BIS reporting banks[1] and groups of countries outside the reporting area, 1978–84.**

| Positions of reporting banks vis-à-vis: | Flows at constant end-of-quarter exchange rates | | | | | | | Stocks at end-1984 |
|---|---|---|---|---|---|---|---|---|
| | 1978 | 1979 | 1980 | 1981 | 1982 | 1983 | 1984 | |
| | in billions of US dollars | | | | | | | |
| OPEC countries[2] | | | | | | | | |
| Claims | 16.7 | 7.2 | 7.0 | 4.2 | 8.2 | 9.6 | – 0.6 | 105.5 |
| Liabilities | 3.2 | 37.4 | 41.9 | 3.2 | –18.2 | –13.5 | 3.1 | 140.6 |
| Net[3] | 13.5 | –30.2 | –34.9 | 1.0 | 26.4 | 23.1 | – 3.7 | –35.1 |
| *Memorandum items:* | | | | | | | | |
| *Foreign exchange reserves[4]* | *–14.6* | *15.5* | *14.1* | *– 1.9* | *–11.7* | *– 9.4* | *– 3.4* | *56.1* |
| *Current-account balances* | *5.0* | *61.0* | *110.5* | *53.0* | *–15.0* | *–19.5* | *– 8.0* | . |
| Non-OPEC developing countries | | | | | | | | |
| Claims | 22.8 | 35.3 | 39.0 | 39.9 | 19.8 | 11.9 | 8.8 | 329.3 |
| Liabilities | 14.6 | 12.3 | 3.9 | 9.4 | 4.9 | 10.3 | 21.8 | 170.5 |
| Net[3] | 8.2 | 23.0 | 35.1 | 30.5 | 14.9 | 1.6 | –13.0 | 158.8 |
| *Memorandum items:* | | | | | | | | |
| *Foreign exchange reserves[4]* | *11.3* | *8.6* | *– 1.7* | *– 0.1* | *– 2.5* | *8.5* | *15.3* | *82.8* |
| *Current-account balances* | *–27.5* | *–43.0* | *–65.0* | *–78.5* | *–61.0* | *–32.5* | *–20.5* | . |
| Other developed countries | | | | | | | | |
| Claims | 5.7 | 7.5 | 15.4 | 16.8 | 16.0 | 7.4 | 7.5 | 89.7 |
| Liabilities | 8.7 | 7.0 | 5.7 | 3.8 | – 0.1 | 1.5 | 4.8 | 30.3 |
| Net[3] | – 3.0 | 0.5 | 9.7 | 13.0 | 16.1 | 5.9 | 2.7 | 59.4 |
| *Memorandum items:* | | | | | | | | |
| *Foreign exchange reserves[4]* | *6.5* | *3.2* | *1.3* | *– 1.6* | *1.2* | *2.6* | *– 0.8* | *14.3* |
| *Current-account balances* | *– 7.5* | *– 7.5* | *–16.5* | *–25.0* | *–24.0* | *–14.5* | *–13.5* | . |
| Eastern Europe | | | | | | | | |
| Claims | 5.7 | 7.2 | 6.8 | 4.8 | – 4.6 | – 1.3 | – 0.1 | 47.9 |
| Liabilities | 1.7 | 4.7 | 0.9 | 0.1 | 2.0 | 2.9 | 4.3 | 22.2 |
| Net[3] | 4.0 | 2.5 | 5.9 | 4.7 | – 6.6 | – 4.2 | – 4.4 | 25.7 |

*Note:* The country groupings used in this table have been imposed by the structure of the Euro-currency statistics and therefore differ from those employed in Chapters V and VII. This applies in particular to the group of "Other developed countries", which only includes countries which are not part of the reporting system.

[1] Up to the end of 1983 the BIS reporting area covered banks in 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. As from end-1983 the reporting area includes in addition banks in Finland, Norway and Spain as well as non-US banks engaged in international business in the Bahamas, the Cayman Islands, Hong Kong and Singapore, all offshore banking units in Bahrain and all offshore banks operating in the Netherlands Antilles. As a result, the first three of these countries are no longer included under "Other developed countries", while Bahrain is no longer included under "OPEC countries", except as regards the positions of banks in the United States. [2] Includes in addition Bahrain (up to end-1983), Brunei, Oman and Trinidad and Tobago. [3] A minus sign (–) equals net deposits. [4] At current exchange rates.

whereas in 1983 there had been withdrawals of $13.5 billion — altogether a turn-round of nearly $27 billion, which is only partly explained by a $11.5 billion reduction in these countries' combined current-account deficits. There were, however, wide differences in the behaviour of individual groups of OPEC countries. In the Middle East the low-absorbing countries reduced both their deposits and their borrowings. The Middle Eastern "high absorbers", by contrast, added $1.7 billion to their debts, while at the same time drawing down their deposits by $1.8 billion. Elsewhere, Venezuela, which continued to show a comfortable current-account surplus, was a large net supplier of new funds to the reporting banks, adding $2.9 billion to its deposits and repaying $1.7 billion of banking debt. Indonesia was both a depositor and borrower, in each case to the extent of about $1 billion.

The reporting banks' claims on eastern European countries, which had declined substantially in the wake of Poland's debt-servicing problems, showed only

a marginal decrease last year. At the same time, these countries, which achieved another increase in their combined current-account surplus, continued to build up their deposits with the reporting banks. As a result their external net debtor position vis-à-vis the reporting banks declined by a further $4.4 billion to stand at $25.7 billion at the end of 1984, down from $45.5 billion in 1981. Claims on Poland contracted by a further $1.4 billion to $9 billion, probably largely as a result of banks' debt write-offs and the transfer of claims to domestic public-sector credit guarantee institutions. The largest borrower was the Soviet Union, which obtained $1.5 billion in new credits but also increased its deposits by a similar amount. The German Democratic Republic added $1.5 billion to its deposits, while borrowing only $0.4 billion.

Developed countries outside the reporting area, which continued to post large current-account deficits, were, along with the non-OPEC Middle Eastern countries, the only major outside-area group of net borrowers, obtaining $7.5 billion in new funds and increasing their deposits by $4.8 billion. Australia ($3.5 billion), Greece ($1.2 billion) and New Zealand ($1 billion) were the largest receivers of new credits. Portugal ($1 billion) and New Zealand ($0.9 billion) were the largest depositors.

**The international bond markets.**

After several years of uninterrupted expansion, issuing activity in the international bond markets surged by a further 46.5 per cent. to a total of $107.7 billion last year. This was the highest rate of growth recorded since the market's early beginnings. The upswing was particularly pronounced in the second half of the year when long-term interest rates were heading downwards. It was concentrated above all on the Euro-dollar bond sector, where the volume of issues jumped from $35.7 billion in 1983 to $64.3 billion. Otherwise, it encompassed mainly the smaller sectors of the international bond market, notably those in sterling, the Canadian dollar, the ECU and the yen. By contrast, the shares of the Euro-Deutsche Mark sector and the foreign issues markets in the United States and Switzerland contracted, and in the last two cases the volume of new issues was actually smaller than in 1983 (see table overleaf).

Because of its depth, the Euro-dollar bond sector was the main beneficiary of the general trend towards "securitisation" in international financial markets, as well as of the proliferation of innovative features. While the high level of dollar interest rates, the positive yield curve, declining inflationary expectations and the strength of the dollar were a powerful attraction to investors, the supply of bonds was boosted by the return of US borrowers on a massive scale, particularly following the abolition of the US withholding tax on non-resident income from investment in US securities. Japanese firms, too, attracted by its various innovative features, stepped up their recourse to the Euro-dollar bond market.

In view of continued pronounced uncertainties about the longer-term US interest rate outlook, 1984 was above all the year of floating rate notes (FRNs), with

International bond issues.[1]

| Borrowing countries or areas | Years | Euro-bond issues | | | Foreign issues | | |
|---|---|---|---|---|---|---|---|
| | | Total | of which | | Total | of which | |
| | | | US dollars | Deutsche Mark | | in United States | in Switzerland |
| | | 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 | 33,310 | 26,370 | 2,160 | 7,190 | 2,180 | 2,130 |
| | 1985/I | 10,830 | 8,270 | 800 | 1,000 | 200 | 580 |
| 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 | 4,490 | 2,650 | 180 | 1,760 | 450 | 1,040 |
| | 1985/I | 1,930 | 1,330 | 60 | 190 | 150 | 40 |
| 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 | 23,100 | 21,210 | 540 | 1,460 | | 1,220 |
| | 1985/I | 8,570 | 7,210 | 40 | 480 | | 480 |
| 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 | 13,080 | 10,450 | 1,270 | 8,450 | 150 | 7,180 |
| | 1985/I | 4,830 | 3,670 | 340 | 1,680 | – | 1,550 |
| 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 | 2,040 | 1,810 | 30 | 990 | – | 170 |
| | 1985/I | 1,770 | 1,650 | 30 | 260 | – | 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 | 4,220 | 1,800 | 140 | 7,580 | 1,000 | 1,380 |
| | 1985/I | 1,610 | 900 | 30 | 2,440 | 600 | 420 |
| 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 | 80,240 | 64,290 | 4,320 | 27,430 | 3,780 | 13,120 |
| | 1985/I | 29,540 | 23,030 | 1,300 | 6,050 | 950 | 3,120 |

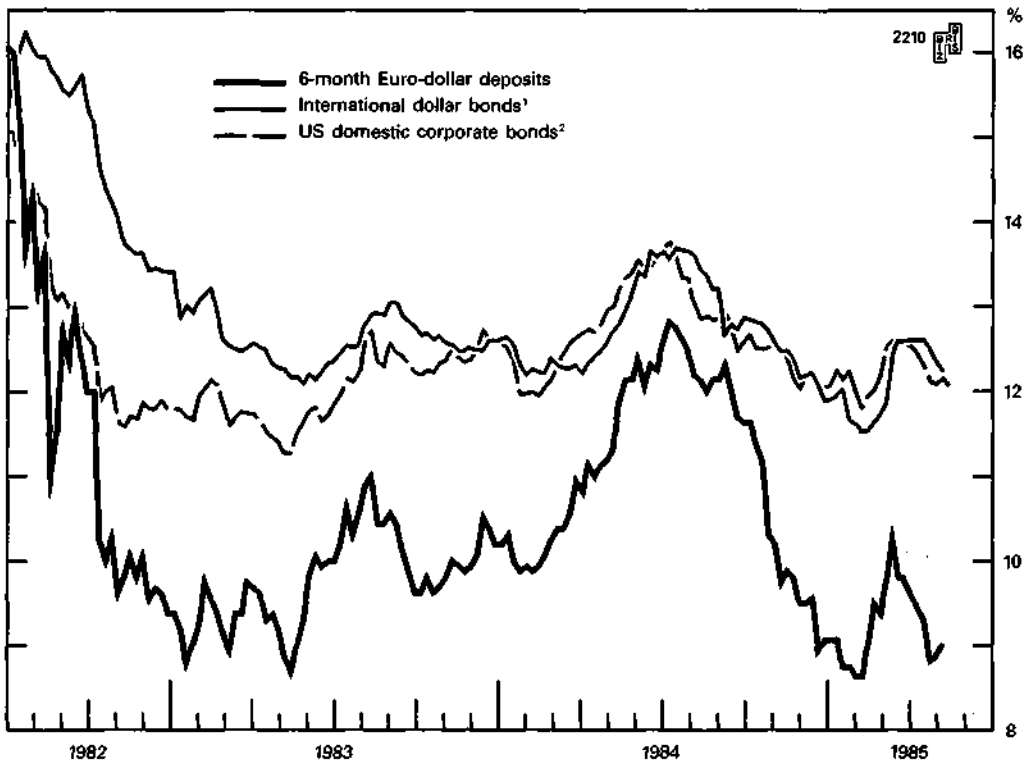
[1] Data based on OECD sources, but excluding certificates of deposit. [2] Australia, Japan, New Zealand and South Africa.

their issue volume more than doubling, from $15.9 to 34.4 billion. The liquidity of such paper, as well as the high credit-standing of the issuers, appealed to a wide spectrum of investors. The banks themselves, in an effort to improve the marketability of their assets and for profit reasons, appear to have absorbed nearly 50 per cent. of new issues of such paper, taking advantage of the steepness of the yield curve at the shorter end of the market.

Competition between the banks for new issuing business was strong and the FRN sector accommodated a wide variety of borrowers, with market conditions moving more and more in their favour. In addition to their rôles as investors and

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

Wednesday figures, in percentages.




¹ Industrial companies, yields to average maturity. ² Aaa corporate bonds, yields to final maturity.

issuing houses, the banks themselves continued to be the largest borrowers in this market, using it to strengthen their capital base. Governments also stepped up their recourse to this form of borrowing, not only to cover their current financing needs but also to replace more expensive banking debt. In fact, such restructuring gathered pace in the course of the year under increasingly advantageous borrowing conditions: the LIBOR-based interest rates tended to be abandoned in favour of lower benchmarks, contractual fees narrowed, maturities lengthened to encompass even some "perpetual" notes, and a variety of new kinds of options, tailored to the specific needs of borrowers and investors, were introduced.

The fixed rate Euro-dollar bond sector, which also expanded quite strongly, from $17.4 to 27.2 billion, received substantial support from the use of the swap technique, the counterpart of which is usually a syndicated credit based on LIBOR. Banks, in particular, were keen to avail themselves of these interest swaps in order to secure long-term funds at rates below LIBOR. In addition, the fixed rate bond sector benefited from the increasing use of currency swaps and of warrants. Zero coupon issues also made a reappearance in the second half of the year owing to their favourable tax treatment in some countries and to the circumstance that a large proportion of them represented a bearer-form counterpart to US Treasury securities.

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

| Items | 1981 | 1982 | 1983 | 1984 | | | | | 1985 |
|---|---|---|---|---|---|---|---|---|---|
| | | | | year | first quarter | second quarter | third quarter | fourth quarter | first quarter |
| | in billions of US dollars | | | | | | | | |
| Total issues ..... | 49.0 | 71.7 | 73.5 | 107.7 | 26.0 | 21.6 | 24.6 | 35.5 | 35.6 |
| *of which:* | | | | | | | | | |
| Fixed rate straight issues[2] | 37.2 | 57.7 | 49.6 | 62.4 | 13.4 | 12.1 | 15.2 | 21.7 | 19.9 |
| Floating rate notes ..... | 7.4 | 11.4 | 15.9 | 34.4 | 8.6 | 6.4 | 7.6 | 11.8 | 13.0 |
| Convertible bonds ..... | 4.4 | 2.6 | 8.0 | 10.9 | 4.0 | 3.1 | 1.8 | 2.0 | 2.7 |

[1] Data based on OECD sources, but excluding certificates of deposit. [2] Including zero coupon bonds and private placements.

Equity-linked issues, on the other hand, were more a feature of the first half of the year, when the main world stock exchanges were fairly buoyant.

The strong expansion of the Euro-dollar bond market contrasted with the continuing slowdown of foreign issues in the United States. This slowdown was caused by the tendency of the two traditionally largest groups of borrowers in the US market, international institutions and Canadian entities, to cover a greater part of their financing requirements in non-dollar form.

This tendency towards increased currency diversification was shared by other groups of borrowers, but met with some investor resistance as far as Deutsche Mark and Swiss franc issues were concerned. The demand for paper denominated in these two currencies was negatively affected by the relatively low interest yields and by the dollar's strength. On the other hand, interest rate and/or exchange rate considerations boosted issuing activity in the sterling, ECU, Canadian dollar and yen sectors. The increase was particularly pronounced in sterling ($2.6 billion) and yen ($2 billion) issues, the latter benefiting from the various liberalisation measures implemented by the Japanese authorities in the course of the year.

In terms of the nationality of borrowers, the main feature of 1984 was the large-scale return of US entities to the international bond market. After having reduced their recourse to the market by half in 1983, they more than tripled the volume of their issues last year. The $24.6 billion raised by these entities, mostly in the form of Euro-dollar issues, represented nearly one-quarter of the total issues volume. The bulk of the borrowing took place in the second half of the year, following the abolition of the 30 per cent. US withholding tax. $2 billion represented paper placed abroad by the US Treasury, and another $6 billion was made up of bonds, mostly FRNs, issued by US banks for the purpose of strengthening their capital base. In the case of Japanese entities, the second largest group of borrowers last year, the $16 billion of new issues represented a 43 per cent. increase over 1983. Although convertible issues, notably in Switzerland, continued to be the major vehicle for Japanese corporations' international capital-market borrowing, their use of the Euro-dollar sector was largely based on other techniques, especially currency swaps, for which the Japanese banks provided an active market.

While borrowers from the United States and Japan exerted a dominant influence on the overall development of the market, borrowers of other nationalities also significantly stepped up their recourse to international bond issues. In some countries, such as Sweden and Denmark, the main incentive was the renegotiation of outstanding banking debt on more favourable terms, notably through the issue of FRNs. Another important influence was the policy of banks of various nationalities to lengthen the maturity structure of their dollar-denominated liabilities. French and UK banks, in particular, accounted for nearly 45 and 60 per cent. respectively of all the international bonds issued by residents of the two countries. Outside the OECD area, access to the market was limited essentially to international institutions and to a few Asian countries, such as South Korea and Malaysia, which took advantage of the widening of the market for FRN issues.

During the first quarter of 1985 issuing activity on the international bond market, although at times affected by pronounced interest rate and exchange rate uncertainties, continued at the unusually high level attained in the last few months of 1984. A strong increase in issues by Japanese firms, continued heavy borrowing by US firms and a wave of debt refinancing in the form of FRN issues were the main supportive factors. Activity in the Euro-bond market was heavily concentrated on the dollar, but in percentage terms the largest increase (55 per cent.) was in Euro-yen issues, which benefited from the further liberalisation measures adopted by the Japanese authorities in December 1984. The trend towards deregulation continued into 1985, with the removal as from April of the 20 per cent. withholding tax payable by Japanese issuers of Euro-yen bonds on interest paid to non-resident investors, the re-opening by the French authorities in early April of the Euro-French franc issues market and the easing in May of the issuing rules for international DM bonds, including the admittance of new types of capital-market paper (such as FRNs and zero coupon bonds) in Germany.

**Longer-term changes in the structure of the international financial markets.**

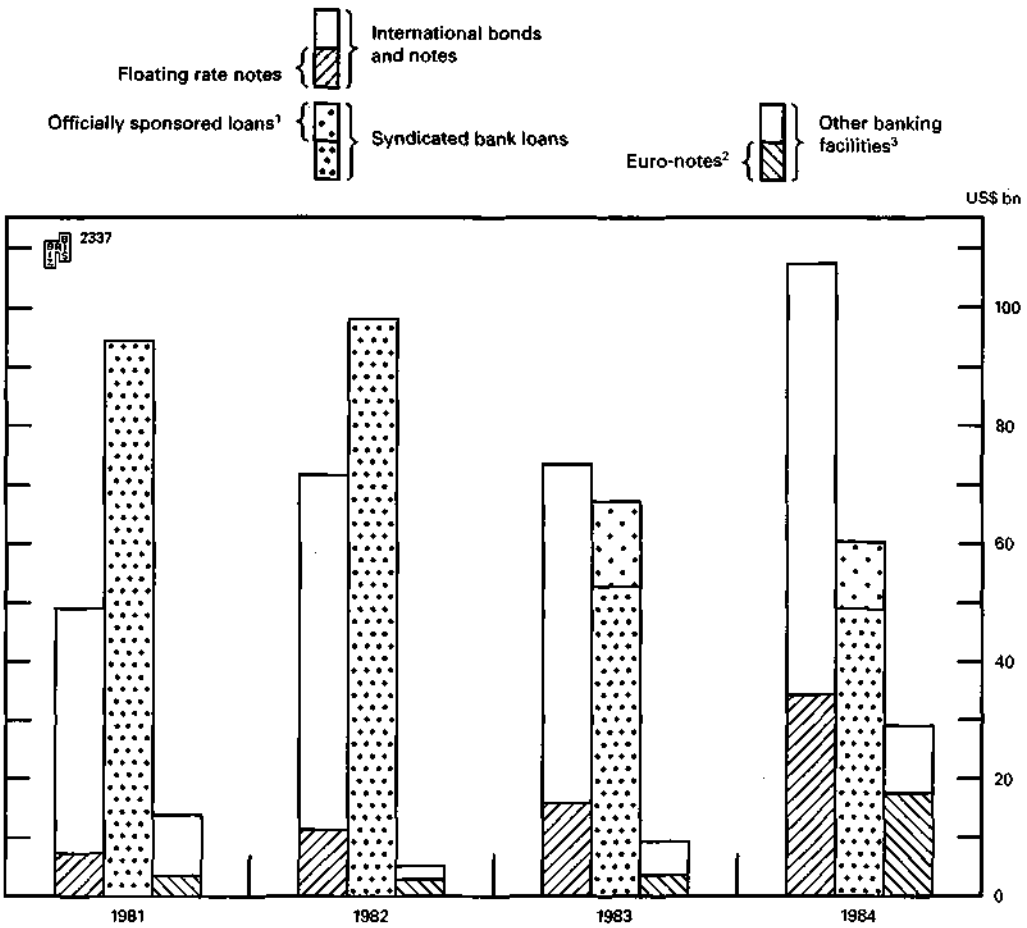
In addition to the profound changes in the geographical pattern of international capital flows, a prominent feature of the international financial developments of recent years, which became particularly evident in 1984, has been the changes in the composition and the forms of financial intermediation. The main components of these changes have been: a decline in the importance of more traditional forms of international bank lending such as syndicated loans; a gain in the importance of the securities markets; a proliferation of financial innovations and an increase in the rôle of off-balance-sheet items, such as back-up facilities and guarantees, as a source of bank income; and — as a result of these various developments — a blurring of the borderlines between bank credit and capital markets, between the domestic and the international markets and between financial intermediaries and their customers.

The graph on the following page illustrates the quantitative aspects of some of these developments. It shows the spectacular expansion of the bond markets, the

volume of new issues on which more than doubled between 1981 and 1984, from less than $50 billion to nearly $108 billion, while the amount of new syndicated bank credit contracted from $95 to 60 billion. Over the same period, new off-balance-sheet back-up facilities granted by the banks more than doubled from $14 to 29 billion.

Moreover, the composition of each of these three aggregates has also changed. In the bond markets issues of FRNs soared from $7.5 to 34.5 billion, to represent nearly one-third of the total issue volume in 1984. Moreover, a very large proportion of fixed rate bonds has been swapped by the original issuers, usually banks, against other forms of floating rate debt. Within the smaller volume of new syndicated loans, a substantial amount, over $10 billion in 1984, is accounted for by credits granted within the framework of officially sponsored rescheduling packages. Moreover, in view of the growing tendency of borrowers in industrial countries to replace outstanding bank debt in advance of maturity with negotiable capital-market

Trends in international financial markets, 1981–84.




[1] Loans granted within the framework of officially sponsored credit packages. [2] Includes certificates of deposit and multiple-component facilities. [3] Excludes special merger-related facilities.

paper, the 1984 volume for new syndicated loans overstates the actual additions to international bank credit. Finally, as regards back-up facilities, virtually the whole of the expansion in new offerings since 1981 has been in relatively new instruments, such as note issuance facilities (NIFs), revolving underwriting facilities (RUFs) and multiple-component facilities. The relative importance of more conventional instruments, such as acceptances and back-ups for commercial paper issues, has declined.

Unfortunately, the graph cannot illustrate some other features of structural change and innovation, such as the increasing complexity and diversification of the instruments used, the growing importance of Euro-currency futures and of currency and interest rate options, the decline of the interbank market as a source of funding for international bank lending and the growing interpenetration of the national and international financial markets.

Previous Annual Reports have examined some of these developments and illustrated the way in which several specific techniques have affected the volume and structure of activity in the credit and capital markets. The remainder of this section presents a brief survey, from a longer-term perspective, of the factors accounting for various structural changes and innovations, and briefly assesses their overall significance for the process of international financial intermediation and economic policy.

The debt crisis may be taken as a turning-point for recent developments in international financial markets. It meant that the growth of spontaneous sovereign lending to a number of developing countries in the form of syndicated credits came to a virtual halt. At the same time the adjustments undertaken by several countries whose credit-standing was good reduced their demand for bank credit. Furthermore, as a result of rescheduling and involuntary lending under officially sponsored credit packages, banks found themselves holding large blocks of portfolios of immobilised assets, and were faced with the need to obtain longer-term funding for them. Thus, banks have significantly reduced the volume of their syndicated loan activity and at the same time changed their funding techniques by relying to a lesser extent on the interbank market and issuing instead longer-term FRNs, or fixed rate bonds which could then be swapped against floating rate debt.

At the same time, banks' competitiveness and intermediation potential has been impaired by the perceived weakening of their balance-sheet structures in connection with international and domestic problem loans. This has resulted in the so-called "flight into quality" by non-bank investors, who have shifted part of their portfolios away from bank deposits towards securities whose issuers have traditionally been of high credit-standing. Some of the largest issuers, such as Sweden, have in turn taken advantage of the very favourable capital-market conditions prevailing for them and reduced their interest costs through refinancing operations involving a reduction of their outright banking debts.

The debt crisis also coincided with a number of international macro-economic developments affecting the structure of financial intermediation. Some of these, such as the disappearance of the OPEC surplus and the emergence of large financial

surpluses in Europe and Japan, influenced the form and direction of international financial flows. While OPEC investors displayed a preference for bank deposits, investors in Europe and Japan — especially institutional investors — have been more interested in marketable securities, often because of institutional constraints and because these instruments more closely matched the maturity structure of their liabilities. At the same time the emergence of huge US budget deficits and the related official financing requirements tended to crowd out US corporate borrowers from the domestic market, shifting their financing to the Euro-bond market where they were met with an enthusiastic welcome.

Another important macro-economic factor has been the increase in the volatility of interest rates and exchange rates. This has induced financial institutions to match the structure of their balance-sheet assets and liabilities more closely by issuing FRNs or undertaking interest and currency swaps. In addition, the banks' attention has increasingly turned to the futures markets, options and other instruments, such as forward rate agreements, which could provide equally effective hedges against adverse interest and exchange rate developments. More generally, volatility has been largely responsible for the growing importance of highly complex types of bonds giving implicit options to borrowers and investors as to which risks they wish to cover or bear. Finally, other general macro-economic developments, such as the gradual decline in inflationary expectations and in long-term interest rates, as well as steeply upward-sloping yield curves, have also contributed to the buoyancy of the issues markets, particularly in the straight fixed rate bond sector.

However, the debt crisis and macro-economic events cannot wholly explain the changing structure of international financial markets. The movement away from direct bank intermediation towards a greater reliance on securities, shared also by the domestic markets, should be ascribed to more deep-rooted factors reflecting changes in the regulatory framework and the competitive environment, which are likely to outlast the present favourable market climate. Almost all national markets with international counterparts have been affected, although the changes in question have been very different from country to country. In some instances they took the form of tax reductions, in others the abolition of exchange controls, in yet others a breaking-down of the customary distinctions between the types of activity in which different categories of financial intermediary are permitted to engage. These liberalisation and deregulation measures have had several consequences for the nature of the business which banks and non-banks are willing, and able, to conduct. They have, in particular, led to greater competition between financial institutions and a consequent decline in the margins of intermediation for the most creditworthy borrowers.

One consequence of these changes in financial markets has been that supervisors have encouraged banks to pay increased attention to their capital ratios and to make provisions against their doubtful loans. In view of the high cost of equity capital, banks have responded to these requests in a variety of ways: on the sources side of their balance sheets, by having recourse to subordinated debt issued largely in the form of FRNs which were taken up in the main by other banks; and on the uses side by restructuring their portfolios towards business subject to less

*stringent requirements, such as* off-balance-sheet business in the form of guarantees and back-up facilities, as well as by reducing their exposure to specific groups of customers, in some instances by selling off part of their loan books.

The implications of these changes in the financial markets are manifold. From the point of view of economic policy, the most important is the greater integration of markets: domestic and Euro-markets, credit and capital markets and markets for different currencies. As a result of the greater substitutability to which this integration has led, the effectiveness of official policies and the precision of certain micro and macro-economic policy instruments may have been impaired.

The second major implication of these changes has been the blurring of institutional as well as functional distinctions between different types of financial intermediary. In some countries banks have expanded their activities into areas such as the underwriting of securities in which they were not traditionally involved. Likewise, the writing of options by banks for their customers is akin to providing a form of insurance. As a result of these developments, the nature of the risks incurred by individual groups of market participants, especially the banks, has changed and so has the distribution of the risks. For example, in the case of some back-up facilities banks are no longer running a credit risk which is clearly identifiable in terms of a balance-sheet exposure. The risk that the bank will be called upon to provide the back-up is contingent on a possible change in the credit-standing of the borrower and/or a widening of the interest margins he might have to concede to the market. In addition, the underwriting associated with some of the new instruments entails market-related risks, whose management is in some respects quite different from that required in traditional commercial banking.

Such changes in risks and their distribution are to be welcomed if they mean that the risks are ultimately borne by those agents best able to assess and bear them. However, the heightened competition between financial intermediaries, the squeeze on earning margins, the novel and highly involved features of some of these new instruments and the resultant loss in transparency of the markets might entail the emergence of new danger areas. It is all the more important for the central banks and supervisory authorities to monitor carefully these various changes in financial structures and instruments and to provide guidance or introduce preventive measures where necessary.

**The rôle of the ECU in international banking activity.**

After a slow start in the late 1970s, the use of the ECU as a unit of account in international financial transactions has increased rapidly during the last three years. Admittedly, in terms of amounts outstanding the contribution of ECU-denominated assets to total international credit is still a fairly modest one. At $28 billion, the European reporting banks' claims in ECUs at the end of 1984 amounted to less than 2.5 per cent. of their total domestic and cross-border claims in foreign currency; similarly, at the longer-term end of the maturity spectrum, the total volume of ECU bonds issued up to the end of 1984, at around $6 billion, amounted

to somewhat over 2 per cent. of the total volume of Euro-bonds outstanding. But despite these relatively modest dimensions, there are several reasons why the use of the ECU as a unit of account in international financial transactions should not be dismissed as a kind of institutional curiosity.

Firstly, the ECU market already ranks as one of the bigger sectors of the Euro-banking market. Although much smaller than their Euro-dollar, Euro-DM and Euro-Swiss franc assets, the ECU-denominated assets of the European reporting banks are already considerably larger than their Euro-currency assets in sterling, French francs and Dutch guilders. In the Euro-bond market the stock of outstanding ECU issues at the end of 1984 was larger than that in any currency other than the dollar, the Deutsche Mark, sterling and the Canadian dollar.

**The ECU and the Euro-market.**
**(Domestic and cross-border positions in foreign currencies and ECUs.)**

| Currencies | Stocks at | | | | | | Flows* end-1982 to end-1984 | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | end-December 1982 | | end-December 1983 | | end-December 1984 | | at current exchange rates | | at constant end-1984 exchange rates | |
| | Assets | Liabilities | Assets | Liabilities | Assets | Liabilities | Assets | Liabilities | Assets | Liabilities |
| | in billions of US dollars | | | | | | | | | |
| Deutsche Mark .... | 155.9 | 141.6 | 151.7 | 136.0 | 144.2 | 133.7 | −15.8 | −11.6 | 23.1 | 23.7 |
| Swiss francs ..... | 79.0 | 71.5 | 77.0 | 70.7 | 66.9 | 61.5 | −14.3 | −12.9 | 4.1 | 3.9 |
| Japanese yen ..... | 30.6 | 31.8 | 28.9 | 33.4 | 32.1 | 31.4 | 1.3 | − 0.9 | 3.3 | 1.1 |
| ECUs ..... | 6.5e | 5.5e | 11.9 | 10.0 | 28.0 | 22.3 | 21.5e | 16.8e | 23.2e | 18.3e |
| Pounds sterling ... | 15.5 | 18.0 | 14.8 | 16.4 | 16.5 | 17.5 | 0.2 | − 1.2 | 4.7 | 4.0 |
| French francs ..... | 13.5 | 15.7 | 15.3 | 15.5 | 13.3 | 13.5 | − 1.0 | − 2.9 | 3.1 | 2.0 |
| Dutch guilders .... | 14.3 | 13.8 | 15.7 | 14.0 | 13.1 | 12.3 | − 1.4 | − 1.5 | 2.3 | 2.1 |
| Belgian francs .... | 7.1 | 6.3 | 7.1 | 6.0 | 7.9 | 7.2 | 0.7 | 0.8 | 2.5 | 2.4 |
| Italian lire ..... | 2.7 | 3.6 | 3.3 | 3.8 | 4.2 | 4.8 | 1.3 | 0.8 | 2.1 | 2.0 |
| *Memorandum item:* | | | | | | | | | | |
| *US dollars ...* | *831.6* | *868.6* | *867.3* | *906.6* | *888.5* | *936.7* | *25.7* | *36.8* | *25.7* | *36.8* |

Note: Positions of banks in Europe only. e = Estimated.
* Because of some breaks in series, these flow figures cannot be derived from the stock figures given in the table.

Secondly, the growth of the ECU market in the last three years has been particularly strong when seen against the background of the slowdown in the overall growth of international bank credit. In current dollar terms, the ECU-denominated assets of the European reporting banks at the end of 1984 exceeded their level of two years earlier by $21.5 billion. By contrast, the current dollar value of their Euro-DM and Euro-Swiss franc assets declined by $16 and 14 billion over this period, while that of their yen assets increased by only $1 billion. Only their dollar assets showed — in absolute amounts — a somewhat stronger expansion than that of ECU-denominated assets, namely one of $26 billion. This picture, it is true, has been influenced by valuation effects resulting from the appreciation of the dollar.

But even if it is assumed — rather unrealistically — that over a two-year period the share of individual currencies held in asset portfolios would not be influenced by changes in their dollar value and the end-1982 holdings are therefore recalculated on the basis of end-1984 exchange rates, the $23 billion growth in the reporting banks' ECU assets was of the same order of magnitude as that in their Deutsche Mark assets and much larger than that in their Swiss franc and yen assets. In the Eurobond markets there were no ECU-denominated issues prior to 1981, the first such offering being made in April 1981. In 1982 the new issue volume amounted to $0.8 billion, whereas in 1984 it came close to $3 billion.

Thirdly, the rapid growth of the ECU market has gone hand in hand with diversification and increasing sophistication of the types of instruments used. Instruments are available covering the whole maturity spectrum at fixed and floating interest rates, and the bond market offers, in addition to conventional straight issues, zero coupon bonds, paper with profit participation warrants and convertible bonds. Moreover, market participants are not confined to EEC countries but include, for example, eastern European countries and North America.

What accounts for the fast-growing use of the ECU as a unit of account in international financial operations, and how may future growth prospects be evaluated? To answer these questions it may be useful first to examine more closely the banking market in ECUs, for which the figures are particularly impressive.

The table overleaf provides a structural breakdown of the European reporting banks' ECU positions. One feature that leaps to the eye is the relatively modest amount of direct business with non-bank entities, in particular on the sources side of the market, where liabilities to non-banks amounted at the end of 1984 to only $2 billion out of total liabilities of $22.3 billion. At $7.9 billion, direct claims on non-banks were considerably larger than liabilities, but still less than 30 per cent. of total ECU assets. It is, moreover, striking that the major part ($4.8 billion) of lending to non-banks represented domestic lending in ECUs, notably to residents of Italy and France (as can be seen from the table on page 131). Italian borrowers also took up over one-third of the $3.1 billion of ECU-denominated cross-border lending to non-banks, whereas the remaining $2 billion was rather broadly spread, including some non-European borrowers. On the sources side of the market local residents supplied $0.9 billion of ECU-denominated deposits, over three-quarters of which came from residents of the Benelux countries. Cross-border deposits by non-banks totalled $1.1 billion, with residents of the Benelux countries accounting for nearly 45 per cent. and the rest being very widely distributed. Overall, it appears that on the uses side of the market well over half, viz. about 55 per cent., of total lending to non-bank entities was to Italian residents, while on the sources side of the market residents of the Benelux countries supplied nearly 60 per cent. of total non-bank deposits.

The very considerable difference of $6 billion between the banks' total claims and liabilities vis-à-vis non-banks at the end of 1984 also largely explains why the banks' overall ECU liabilities are considerably smaller than their ECU assets. It means essentially that, since they have been unable to rely on a sizable non-bank deposit base, the banks themselves have ultimately had to generate most of the

The structure of the ECU banking market.

| | Assets | | Liabilities | |
|---|---|---|---|---|
| | end-1983 | end-1984 | end-1983 | end-1984 |
| | in billions of US dollars | | | |
| Positions vis-à-vis non-banks: | | | | |
| domestic | 2.7 | 4.8 | 0.6 | 0.9 |
| cross-border within the EEC | 0.8 | 1.7 | 0.4 | 0.6 |
| cross-border with non-EEC residents | 0.2 | 0.8 | 0.1 | 0.4 |
| unallocated | 0.2 | 0.6 | 0.1 | 0.1 |
| Total positions vis-à-vis non-banks | 3.9 | 7.9 | 1.1 | 2.0 |
| Positions vis-à-vis banks: | | | | |
| domestic | 2.3 | 5.2 | 2.6 | 5.3 |
| cross-border within the EEC | 5.3 | 12.7 | 5.7 | 13.1 |
| cross-border with non-EEC residents | 0.3 | 1.3 | 0.6 | 1.4 |
| unallocated | 0.1 | 0.9 | 0.1 | 0.5 |
| Total interbank positions | 8.0 | 20.1 | 8.9 | 20.3 |
| Total | 11.9 | 28.0 | 10.0 | 22.3 |

ECUs required for funding their final ECU-denominated lending. They did this either by borrowing the corresponding basket of currencies or simply by currency switching and covering the resultant exchange rate risks in the forward markets.

The modest extent of cross-border business with non-banks has meant that in its truly international dimensions the ECU market has been first and foremost an interbank market. Particularly if only interbank claims within the reporting area are taken into account, the share of the interbank market in total cross-border activities has been considerably larger than in most other currency sectors of the Euro-market, particularly the Euro-dollar, the Euro-Deutsche Mark, the Euro-Swiss franc and the Euro-guilder markets.

The reasons for this preponderance of interbank positions may become somewhat clearer if one looks at the ECU market from the point of view of the rôle of individual market centres. It can be seen from the following table that at the end of 1984 banks in four market centres, namely France, Belgium-Luxembourg, Italy and the United Kingdom, accounted for nearly the whole, viz. about 94 per cent., of total ECU activity. On the other hand, none of these centres was really predominant, whereas in the other sectors of the Euro-market activity tends to be heavily focused on one or two centres (usually the United Kingdom).

The rôles of these four ECU market centres were, however, quite different as regards their business with non-banks. Banks in Italy alone accounted for 42 per cent. of total claims on non-banks, with virtually the whole of their $3.3 billion of non-bank lending being domestic. At the same time, mainly because of foreign exchange restrictions, banks in Italy were not able to attract a substantial amount of ECU deposits from domestic non-banks. Instead, they funded their local ECU lending mainly through net borrowing in the ECU interbank market abroad.

**The rôle of individual market centres in ECU banking operations at end-December 1984.**

| Items | Assets | | | | | Liabilities | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | Total | *of which vis-à-vis* | | | | Total | *of which vis-à-vis* | | | |
| | | non-residents | | residents | | | non-residents | | residents | |
| | | banks | non-banks | banks | non-banks | | banks | non-banks | banks | non-banks |
| | in billions of US dollars | | | | | | | | | |
| Banks in: | | | | | | | | | | |
| Belgium | 4.8 | 3.5 | 0.6 | 0.7 | – | 2.9 | 1.8 | 0.3 | 0.6 | 0.2 |
| Luxembourg | 2.2 | 0.9 | 0.8 | 0.4 | 0.1 | 2.1 | 0.9 | 0.3 | 0.6 | 0.3 |
| France | 9.1 | 4.9 | 0.7 | 2.4 | 1.1 | 6.1 | 3.5 | 0.1 | 2.4 | 0.1 |
| Italy | 5.6 | 1.7 | – | 0.6 | 3.3 | 5.8 | 5.2 | 0.1 | 0.5 | – |
| United Kingdom | 4.8 | 3.0 | 0.6 | 1.1 | 0.1 | 3.9 | 2.6 | 0.1 | 1.1 | 0.1 |
| Others* | 1.5 | 0.9 | 0.4 | – | 0.2 | 1.5 | 1.0 | 0.2 | 0.1 | 0.2 |
| Total | 28.0 | 14.9 | 3.1 | 5.2 | 4.8 | 22.3 | 15.0 | 1.1 | 5.3 | 0.9 |

* Austria, Denmark, Germany, Ireland, the Netherlands, Spain and Sweden.

Banks in Belgium-Luxembourg, on the other hand, accounted for a very large share (45 per cent.) of total cross-border lending to non-banks and were also the only ones able to attract a sizable amount of deposits from non-banks, apparently largely from small depositors. Overall, the Belgian banks held a substantial net asset position in ECUs and acted as net suppliers of funds to the cross-border interbank market in ECUs.

Banks in France were in an intermediate position. The interest of a few large national companies in ECU borrowing has enabled them to build up some $1.1 billion of ECU claims on non-bank residents. But, in the absence of a wide range of domestic customers, they have tended to focus on their cross-border lending in ECUs, including notably the funding of the domestic operations of banks in Italy. On the liabilities side, foreign exchange restrictions on residents have led them to rely almost exclusively on currency switching or on borrowing abroad in the ECU interbank market. In fact, with an overall net asset position of $3 billion, banks in France were the largest "generators" of ECUs among the four principal market centres.

Banks in the United Kingdom, lacking even the limited non-bank deposit base of the Belgian and Luxembourg banks and without the domestic demand enjoyed by the Italian and, to a lesser extent, the French banks, have tended to specialise in the interbank market. This has been facilitated by the presence in London of a large number of affiliates of foreign banks, some of which have contributed substantially to the United Kingdom's increasing involvement in ECU operations.

In other centres for which data are available the volume of ECU operations has remained quite small. The aggregate total both of assets and of liabilities in these countries at the end of 1984 was $1.5 billion, virtually all vis-à-vis non-residents.

By broadening the geographical base of the ECU banking sector, the complementary rôles of the major market centres were an important influence behind the quantitative preponderance of interbank operations. Another influence

has been the apparent concentration of ECU creation on a limited number of banks acting as market-makers. This has tended to add an additional dimension to the mesh of interbank relations. Moreover, the desire of some peripheral banks, partly for reasons of prestige, to be present in this rapidly expanding market may also have had such an effect.

Summing up, it appears that the impetus for the growth of the ECU banking market has come mainly from its assets side, with nearly three-quarters of the borrowing being conducted by Italian and French non-bank entities. Non-bank deposits, by contrast, have not played a major rôle in the growth of the market and have been constituted in significant amounts only by residents of the Benelux countries. In view of this very limited supply of non-bank deposits, the ECUs fuelling this final lending have largely had to be generated by the banks themselves, with banks in France and Belgium playing the leading rôle.

Turning briefly to the ECU bond markets, official European institutions appear to have accounted for about 30 per cent. of total issues up to the end of 1984. The position of second largest borrower, with a share of just under 24 per cent., was taken by French entities, in large measure public-sector entities or firms. The World Bank and Italian borrowers each accounted for another 5–6 per cent. of total issues. No precise information is available on the nationality of the holders of these bonds, but it appears again that Belgian investors were important buyers. Moreover, in view of the availability of domestic ECU issues and of the partial relaxation of exchange controls for such purposes, Italian and French investors also seem to be holders of ECU bonds. As regards countries outside the EEC, it appears that Swiss and Japanese investors in particular have shown considerable interest in ECU-denominated paper, and more recently some ECU issues — the first non-dollar issues ever — were made in the US domestic market.

Among the factors that have over recent years led to rapid growth of the ECU as a unit of account in international financial transactions, one of the most important has probably been its relative stability. Being composed of a basket of currencies, it is likely to fluctuate less than individual EEC currencies against other EEC currencies or the dollar, and its interest level is bound to be more stable. In case of risk aversion, the ECU can therefore offer advantages for both borrowers and investors, particularly in a world in which dollar exchange and interest rates have been fluctuating very strongly. As regards borrowers, the ECU denomination seems to have attracted above all firms and entities from countries with high domestic nominal interest rates for which it constituted a cheaper alternative to borrowing in dollars — cheaper because of its lower interest cost and, except in recent months, because of its perceived lower appreciation potential. Moreover, for firms with affiliates in several EEC countries, borrowing in ECUs may have been more convenient and less costly than borrowing piecemeal in the national markets. Finally, it appears that in some EEC member countries an increasing amount of foreign trade is being invoiced and in part even settled in ECUs, which quite naturally brings with it a certain amount of ECU borrowing for trade finance.

For investors the ECU offers a convenient means of diversifying away from the dollar without having to accept the relatively low Deutsche Mark or Swiss franc

interest rates. ECU holdings would, of course, be particularly attractive as an alternative to domestic currency investments for residents of countries with relatively high domestic inflation rates; but here the use of ECUs tends to be narrowly circumscribed by foreign exchange regulations, which are undoubtedly the main reason for the very modest size of non-bank ECU deposits in the international banking market. Finally, and notably in the Benelux countries, there have been first signs that the ECU is being used as a payment medium in the form of, for example, credit cards, travellers' cheques and customers' accounts.

Another important factor contributing to the increased use of ECUs in international transactions has been official sponsorship and encouragement. As already mentioned, a substantial share of ECU-denominated bonds has been issued by institutions of the European Communities and by public-sector entities of EEC member countries. Moreover, in France there has recently been some easing of foreign exchange regulations to permit residents to invest in ECU bonds. On the other hand, in Germany the private use of the ECU continues to be constrained by law.

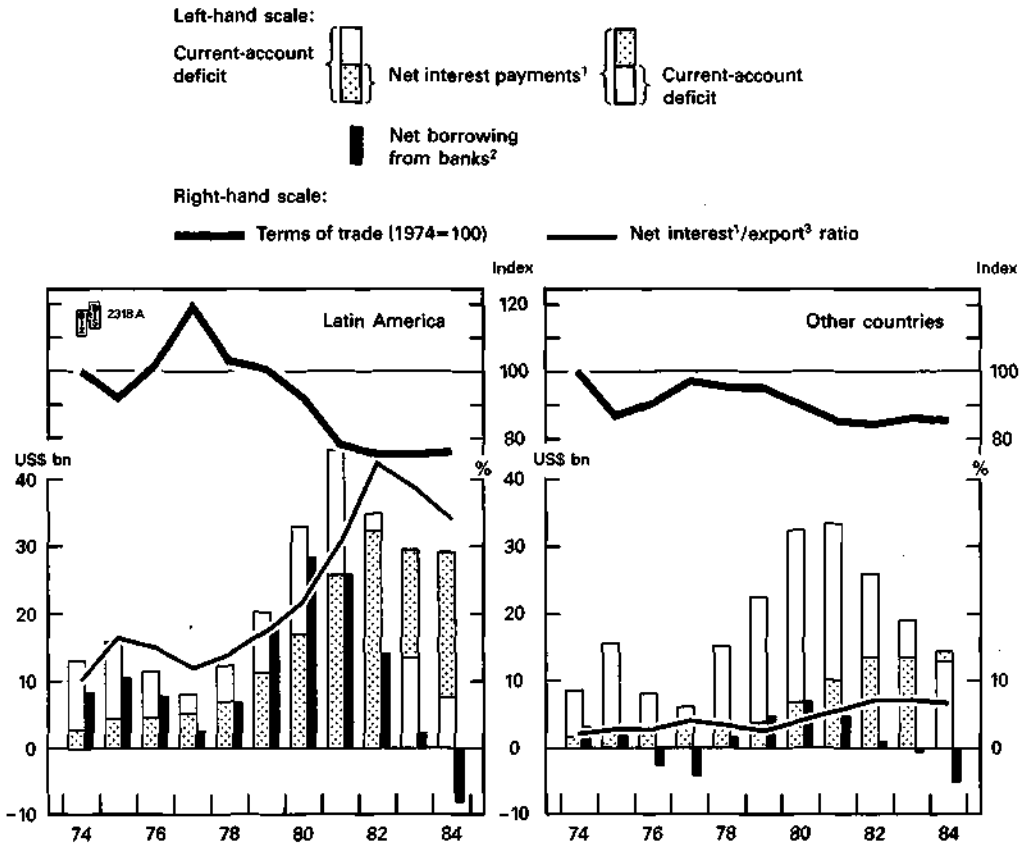
In view of the high degree of diversity of the ECU market and its broad institutional underpinning, there can be little doubt that the use of the ECU will be a lasting feature of the international financial markets. The question is rather whether the ECU market can continue to expand at the same rapid rate as in the last two years and ultimately catch up with the Euro-Swiss franc or even the Euro-Deutsche Mark, or whether its growth will settle down to somewhere around the average of the growth rates observed in the other sectors of the Euro-market. One condition for continued growth of the ECU banking market well above the average would seem to be an expansion of the scope of lending operations well beyond Italy and France and a broadening of its non-bank deposit base beyond the Benelux countries. And, as regards in particular the ECU bond market, another condition may well be the continuation of the present situation in which the exchange rates between the EMS member countries are more stable than those between these currencies and the US dollar. Whether this second condition will be fulfilled depends not only on the future performance of the US dollar in the exchange market but also on continued convergence in the field of price stability among the EEC member countries themselves.

**The international debt situation.**

The US-led cyclical upswing in the industrialised world, persistent adjustment efforts by a number of debtor countries and the pragmatic policies of the creditor banks combined to produce some improvements in the international debt situation last year, while the diversity of individual debtor countries' situations continued to validate the case-by-case approach to debt problems that has been followed since 1982.

The non-OPEC developing countries as a whole achieved a substantial further strengthening of their external payments positions in 1984, their aggregate current-

Factors influencing the borrowing needs and recourse to international bank finance of non-OPEC developing countries, 1974–84.



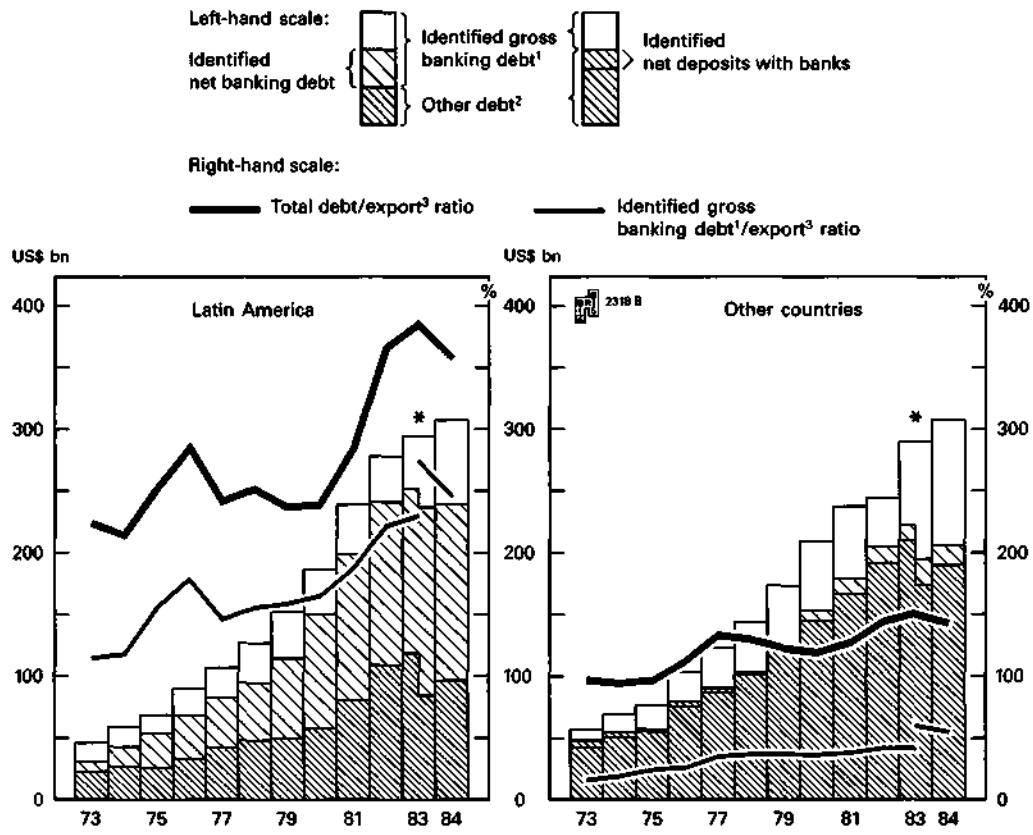

¹ Estimated. ² Calculated in constant dollars. ³ Exports of goods and services.

account deficit declining further, by $12 billion, to $20.5 billion. Moreover, in contrast to 1983, this improvement, thanks to a marked increase in exports, permitted many countries to expand their imports and to enjoy some recovery in domestic economic activity.

Most importantly, from the point of view of the international debt situation, some of the non-OPEC countries in Latin America, where banking debt ratios are a large multiple of those in the rest of the developing world and where the need for further adjustment was particularly pressing, shared in this improvement. The extent of the adjustment which these countries have achieved is perhaps most clearly reflected in the fact that, if net interest payments are excluded, they recorded a current-account surplus of nearly $22 billion last year, whereas in 1981 they had recorded a deficit of about $20 billion.

The overall picture for non-OPEC Latin America was, of course, heavily influenced by developments in the three largest countries in this group, Brazil, Mexico and Argentina, which all recorded substantial merchandise trade surpluses

Evolution of non-OPEC developing countries' international indebtedness, 1973–84.




* Break in series due to the broadening of the coverage of the BIS international banking statistics.
[1] Vis-à-vis banks located in BIS reporting countries. [2] Estimated. [3] Exports of goods and services.

last year (see Chapter V, pages 105 and 106). The strong expansion of exports in Brazil and Mexico meant that for Latin America as a whole the ratio of debt to exports of goods and services decreased for the first time since 1979. Likewise, although for the year as a whole the average level of dollar interest rates was higher than in 1983, the net interest/export ratio, which had already begun to come down in the preceding year, declined to 34 per cent., which represents a reduction of 20 per cent. from the peak of 42.4 per cent. recorded in 1982. The sharp decline in dollar interest rates in the latter part of 1984 suggests that this ratio should show a further substantial decrease in 1985.

In the rest of the non-OPEC developing world, where the debt burden is in general not as heavy as in Latin America, the situation evolved particularly favourably in most South-East Asian countries. With their export-oriented economies, these countries benefited more than proportionately from the overall revival of world trade; and (with the exception of the Philippines) their generally better credit-standing made it possible for them to attract new funds on very favourable terms. On the other hand, the situation has remained serious in most

African countries, which have not been able to participate in the general export upswing to any great extent and have had to rely primarily on continued import restraint to improve their external payments position. However, here international bank credit has not played such a large rôle as in Latin America, and the banks' exposure vis-à-vis non-OPEC African countries is on the whole relatively modest.

Eastern European countries showed a further strengthening of their current-account balances and for the third year running reduced their net banking indebtedness. As a result, with the exception of Poland, most of these countries have regained, or are in the process of regaining, free access to the western credit markets.

A second although certainly not unrelated factor contributing to the alleviation of the international debt problems last year was the flexible attitude of the creditor banks themselves. Recognising that, despite the impressive balance-of-payments improvements achieved by the debtor countries, it would take years to restore a normal market situation, they increasingly moved away from annual or bi-annual arrangements with the debtor countries to multi-year reschedulings. In September 1984 the steering committee representing Mexico's creditor banks reached an agreement with Mexico under which $48.7 billion of the country's public-sector debt initially maturing in 1982-90 would be rescheduled over a period of fourteen years, with the margin charged over LIBOR reduced to 1⅛ per cent. and no front-end fees or commission. Following an agreement between Mexico and the IMF on a new economic package, a first $28.6 billion tranche of this scheme was finally ratified by all the creditor banks in March 1985. The agreement between Mexico and the banks represented a real breakthrough in dealing with the debt problems, since it clearly showed the banks' willingness to honour solid adjustment progress with much improved terms for future debt service. In December 1984 Argentina and the steering committee representing its creditor banks agreed on a proposal to reschedule $16 billion of the country's debt over twelve years at a margin of 1⅜ per cent. over LIBOR and to provide $4.2 billion in new funds. In Brazil a tentative agreement reached in February 1985 with the creditor banks' steering committee envisaged the rescheduling of $45.3 billion of the country's debt over sixteen years at 1⅛ per cent. over LIBOR. However, neither of these agreements is yet operational.

Comparable schemes were negotiated with a number of other countries inside and outside Latin America, for example Poland and the Philippines. In the case of non-OPEC LDCs in Latin America the amounts covered were equivalent to over one-half of total banking debt outstanding at the end of 1984. In addition to stretching out the maturity profile of the debt, the arrangements included, in all instances, a significant reduction of the margins charged by the banks. Moreover, parallel negotiations were often conducted on the rescheduling of debt owed to foreign governments within the framework of the Paris Club and/or the provision of new funds by the IMF.

By reducing debt-servicing burdens to more manageable proportions, the restructuring packages are not only designed to provide vital relief to problem debtor countries but will tend to be of benefit to the creditor banks themselves. For one thing these packages should help to improve debtor countries' ability to honour

their (renegotiated) contractual obligations vis-à-vis the banks and thereby safeguard the balance-sheet status of the banks' claims on these countries by recognising their effectively long-term nature. Secondly, by eliminating the need for frequent debt-rescheduling negotiations and the adverse consequences for market sentiment to which they can give rise, they may facilitate the return to more normal market conditions.

Another development which contributed materially to the reduction in the vulnerability of the creditor banks was the continued endogenous strengthening of their balance sheets. Favourable profit results permitted the banks to build up further their reserves and provisions against loan losses. Moreover, as described earlier in this chapter, they took advantage of the favourable conditions prevailing in the international bond markets to issue securities for the purpose of strengthening their capital base and reducing their dependence on interbank finance, and to improve the quality of their international assets portfolio, which had been impaired by the effective freezing of many of their claims on developing countries, by purchasing floating rate notes issued by first-class borrowers.

One concession on which non-US-based banks have tended to insist in debt restructuring negotiations is an option to change the currency denomination of their claims from dollars to domestic currency. This has the advantage for these banks that they can switch the funding of their claims on problem debtor countries from the international dollar market to their domestic markets. For the debtor countries such a shift of the denomination of part of their debt into currencies such as the Deutsche Mark, the yen and the Swiss franc means, under present circumstances, a considerable reduction in their interest burden; on the other hand, it exposes them to the risk of an increase in their debt burdens in the event of a turn-round of the dollar in the exchange markets, which, in the short run, could by far outweigh the interest rate advantages. Moreover, a switch in non-US banks' funding from the dollar markets to the domestic market will tend to contribute to the strength of the dollar in the exchange markets.

Despite the progress that was made last year, however, the international debt situation continues for a number of reasons to be a matter for concern, requiring the full attention and co-operation of all the parties involved.

Firstly, in most cases the multi-year rescheduling arrangements have not yet been ratified by all the creditor banks concerned and put into operation. The complexity of the deals and the large number of banks involved have been partly responsible for these delays. But, in addition, domestic economic or political difficulties have emerged in some countries, resulting in non-fulfilment of the policy conditions negotiated with the IMF and a suspension of the dialogue with the banks pending the putting-into-place of a new IMF programme. This has been the case notably in Brazil and Argentina.

Secondly, implementation of policy adjustments, except in the field of exchange rates and foreign trade, has in fact been slow. Efforts to reduce budget deficits, while impressive in comparison with the success achieved in this area by some of the industrial countries, have in most cases not gone far enough, and little

or no progress has been made in the fight against inflation. Indeed, the rate of price increases accelerated last year in Argentina and Brazil, whilst even in Mexico, where the inflation rate was cut from 100 to 65 per cent., progress fell short of the target previously agreed with the Fund. Partly as a result of these unsettled financial conditions, the much needed revival of domestic investment activity largely failed to materialise. As a proportion of GNP, there were either only marginal increases, as in Brazil and Mexico, or even a decline, as in the case of Argentina.

Thirdly, the limited success in adjustments on the domestic economic front has to be seen in relation to the massive reverse resource flows which the non-OPEC developing world has been experiencing for almost three years. In 1984, for the first time since the 1973 oil shock, and despite the new loans extended within the framework of rescheduling packages, the BIS reporting banks' net claims on non-OPEC LDCs in Latin America contracted by nearly $8 billion. In addition, interest payments (net of interest earned on official foreign exchange reserves) by these countries on their gross external debt may be estimated to have amounted to nearly $30 billion last year. Of course, in theory interest payments should be met out of the proceeds of past investments financed with the foreign capital and should therefore not be regarded as an additional burden on the debtor countries. However, most of these investments were made when interest rates were much lower than they are at present, some of them were not well chosen, or have not been validated by subsequent world economic developments and trade policies in the industrial countries, and a substantial part of past borrowing was not used to finance a larger volume of investment activity but to pay for the higher cost of oil imports or had as a counterpart unauthorised private capital outflows, the interest proceeds from which tend to remain abroad.

Inverse flows of the order of magnitude witnessed in 1984 are clearly unsustainable, and some form of net capital flows to these countries needs to be restored as soon as possible to offset part of their interest payments. The combination of weak raw-material prices and relatively high interest rates continues to weigh heavily on the problem debtor countries. It is therefore of the utmost importance that the banks, not least in their own interest, should continue to show patience and flexibility and resist the — perhaps all too natural — temptation to withdraw altogether from lending to certain groups of debtor countries.

Even in the event of a return to normal market conditions, however, prudential considerations will tend to limit the scope for further bank lending to these countries more or less to the overall rate of growth in the banks' balance sheets. The extent to which other types of capital flows can take over from bank credit will depend on the debtor countries' ability to restore confidence and stable domestic financial conditions. Convincing progress in these areas would help to attract more foreign equity investment and to open up access to the international capital markets. Moreover, it would also reduce the incentives for further capital flight and might even lead to the repatriation of some of the funds, although in recent years unusually high real interest rates and the pronounced strength of the dollar were admittedly a combination that was difficult for the debtor countries to match.

Finally, as developments during 1984 have once again underlined, a necessary condition for a market-oriented solution of the international debt problem is a favourable economic environment in the industrial countries themselves. Unless the industrial countries, by keeping their markets open and maintaining an adequate rate of economic growth, provide sufficient scope for the growth of debtor countries' export markets, it is rather doubtful whether these countries could meet their debt service obligations without a degree of domestic retrenchment that would be bound to have negative effects on their economic growth and political and economic stability in the long run. The fact that the recent slowdown of the US economy was so promptly reflected early this year in a pronounced weakening of the export performance of some of the most important debtor countries illustrates the fragility of the international debt situation and the degree of interdependence the world economy has reached. Even a temporary growth recession in the industrial countries could probably only be weathered without a renewed deterioration in the international debt situation if it were accompanied by a further reduction in dollar interest rates.

Apart from the responsibility of the industrial countries for a favourable world economic environment and for keeping their markets open to developing countries' exports, there will be a continued need for direct aid and support by governments and international institutions. This is particularly true in the case of some of the smaller countries in Africa, for example, where there is little hope that market forces alone could produce the required improvement.

To conclude on an optimistic note, after the successes that some of them have achieved on the external payments front, the further adjustments and more market-oriented policies needed by the major debtor countries would be in the interests of their own longer-term economic growth potential. Similarly, in the case of the industrial countries, the domestic policies necessary to encourage private investment, reduce rigidities and bring down the intolerably high levels of unemployment would also tend to produce a favourable economic environment for the developing countries. In other words, there is hardly any clash of policy requirements between debtor and creditor countries for bringing about a further improvement in the international debt situation.

# VII. THE INTERNATIONAL MONETARY SCENE.

## Highlights.

This chapter describes developments in three areas of the international monetary scene — the exchange markets, gold and international liquidity — all of which were strongly influenced by the evolution of the US balance of payments, analysed in Chapter V.

Exchange-market developments in the period under review were characterised by two main features. Firstly, the substantial further appreciation of the dollar, by over 20 per cent. on the trade-weighted basis, during 1984 and the first two months of 1985 — a rise that was propelled by an increasing volume of spontaneous capital inflows into the United States, notwithstanding a record deficit on the current account of the US balance of payments and a narrowing of interest rate differentials favouring the dollar. Secondly, the rather abrupt change in sentiment about the dollar that occurred in March 1985, following the largest co-ordinated official intervention witnessed in the exchange markets for a number of years, and which produced the most marked reversal yet seen of the dollar's upward progress. Since mid-April the dollar has recouped some of the terrain lost, but market conditions have remained rather unsettled and day-to-day exchange rate fluctuations have been unusually large. In addition to reviewing these, and other, currency developments in 1984 and the first months of 1985, the chapter also looks at the strength of the dollar in a longer-term perspective.

In the gold market the evolution of prices in dollar terms during the period under review provided something of a mirror image of the dollar's movements against other currencies, the market weakening in 1984 and early 1985 and showing some recovery in prices since then. In terms of some other leading currencies, however, the market price of gold has been relatively stable.

As far as international liquidity is concerned, there were two main developments in 1984. On the one hand, official international liquidity, as measured by countries' total non-gold reserves, showed some further increase, including a rebuilding of exchange reserves in some of the largest debtor countries. This increase in reserves, however, was quite modest in relation to the outflows of funds to the rest of the world coming from the US current-account deficit. On the other hand, the US deficit did give rise to a large build-up of the rest of the world's private dollar assets, much of it in liquid or marketable form. Part of this increase in private international liquidity could find its way into official reserves if there were to be a major weakening of confidence in the dollar.

## Exchange rate developments.

*The floating currencies.* Exchange-market developments during the period under review were dominated by the movements of the US dollar. Between end-

1983 and late February 1985 the dollar's trade-weighted exchange rate rose by a further 22 per cent. On a bilateral basis its advance during that period against major European currencies ranged from 27 to 38 per cent., while vis-à-vis the yen and the Canadian dollar it was, at 13 per cent., less pronounced.

A salient feature of the dollar's continued rise was that it occurred against the background of certain developments which, taken together, might have been expected to weaken its position. Firstly, the US current-account deficit widened to over $100 billion or nearly 3 per cent. of GNP for the year 1984. Secondly, US real economic growth slowed down markedly after the spring of 1984, while at the same time there was some pick-up in growth in most other industrial countries. Thirdly, the decline in interest rates which took place after mid-1984 was, on balance, more pronounced in the United States than in any other major industrial country, particularly at the shorter end of the market. Despite these developments, however, international capital continued to flow into the United States, partly through banking channels, partly through purchases of dollar securities and partly in unidentified forms. These flows considerably, and increasingly, outweighed trade-related flows during most of the period under review and, by pushing up the dollar on the exchange markets, themselves contributed to the further deterioration in the US current-account position.

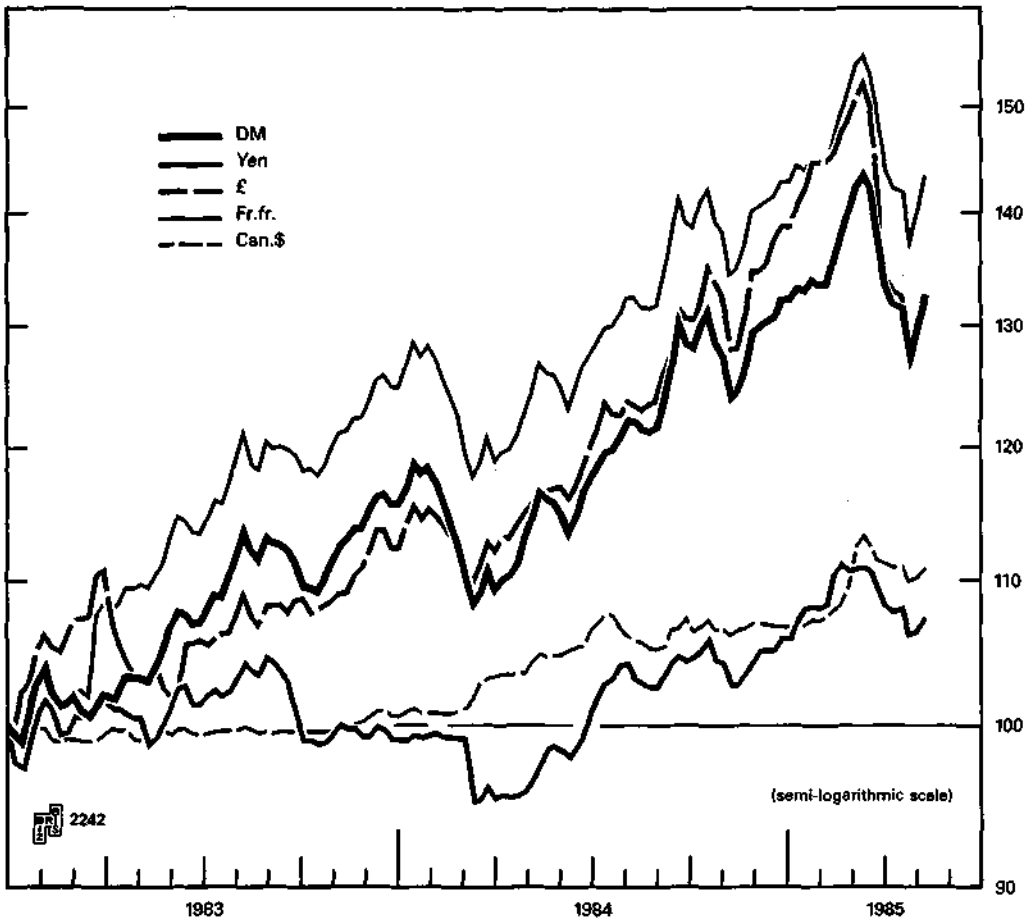
The period under review opened with the dollar entering a phase of temporary weakness in January 1984. There were a number of reasons for this development: doubts about the possibility of spontaneously financing the mounting US current-account deficit at the then prevailing exchange rates; concern that the combination of strong economic growth and a persistent government budget deficit in the United States would sooner or later lead to some rekindling of US inflation; and, outside the United States, growing evidence of economic recovery in other major industrial countries. Against this background, the dollar depreciated between mid-January and early March 1984 by 6½ per cent. on an effective basis, despite a renewed upward movement of dollar interest rates from early February onwards and a consequent widening of interest rate differentials in favour of dollar investments.

In March, however, the dollar began to appreciate again, and the renewed upward trend persisted until late September, except for a short period in late May and early June. US interest rates went on rising until early July, while in April the Federal Reserve raised its discount rate by ½ percentage point, underlining its continued commitment to fighting inflation. Moreover, US economic indicators showed stronger than expected expansion, while the emergence of some industrial unrest in France, Germany and the United Kingdom in the spring of 1984 overshadowed the outlook for these countries' economic recovery. Further support for the dollar came from the US Treasury's abolition of the withholding tax on interest income on foreign-owned bonds and reports on the creation of new US Government debt instruments for foreign investors, as well as from expectations that President Reagan would be re-elected.

During the first three weeks of September the upward movement of the dollar accelerated, notwithstanding some decline in US interest rates. Against the Deutsche Mark the dollar appreciated by nearly 10 per cent., going above the DM 3 level on

Movements of bilateral exchange rates of the US dollar against selected other currencies, 1983–85.

Weekly averages, indices: end-1982 = 100.




11th September and reaching an eleven-year high point against that currency of nearly DM 3.18 on 21st September.

On 21st September the Deutsche Bundesbank sold a substantial amount of dollars in the exchange market, and other central banks also intervened on a number of occasions in late September and early October. The dollar at once fell sharply, to DM 3.02 against the Deutsche Mark, and also weakened against other currencies. After a period of nervous trading, in which it moved rather abruptly in both directions, by mid-October the dollar was moving up again, reaching nearly DM 3.15 against the Deutsche Mark and fresh peaks against the yen and sterling. From then until early November, however, the dollar weakened markedly. By that time three-month Euro-dollar rates had declined from 12 per cent. in early September to 9½ per cent., reducing the differential between three-month Euro-dollar and Euro-DM rates from over 6½ to under 4 per cent., while indications that US economic growth was slowing down considerably raised expectations of further

reductions in dollar interest rates. Altogether, between late September and early November the dollar depreciated by nearly 5 per cent. on the effective basis, by 8 per cent. against the Deutsche Mark, but by only 3 per cent. against the yen.

The dollar began to show renewed strength in early November 1984 and continued to appreciate up to late February 1985. During this period it repeatedly reached new high levels against all other major currencies, the effective exchange rate rising by over 14 per cent., while against the Deutsche Mark, sterling and the Swiss franc it appreciated by 19, 21 and 22 per cent. respectively. Against the yen and the Canadian dollar, however, it rose by only 9 and 7 per cent. respectively. The renewed appreciation of the dollar occurred despite a continued decline in US short-term interest rates, the three-month Euro-dollar interest rate declining by a further 1½ percentage points between early November 1984 and late January 1985, accompanied by two ½ percentage point cuts in the Federal Reserve's discount rate, on 21st November and 24th December respectively. Long-term US interest rates, however, fell much less than short-term rates, with market yields on prime corporate bonds declining between early September 1984 and late January 1985 by less than 1 percentage point. Since there were concurrent declines in long-term interest rates in other major countries, long-term interest rate differentials continued strongly to favour dollar investments. Moreover, the widening of differentials between long and short-term dollar interest rates opened up prospects of capital gains on investments in US long-term securities. Against this background, foreign investment in US securities expanded considerably in the fourth quarter of 1984.

In late January 1985 there was a short-lived pause in the upward movement of the dollar. While short-term interest rates continued to ease in the United States, those in a number of European countries had been rising, largely in response to exchange-market developments. Between late December and late January short-term sterling interest rates rose by 4½ percentage points. Moreover, at a meeting on 17th January the Finance Ministers and central-bank Governors of the Group of Five had reaffirmed their commitment to undertake co-ordinated exchange-market intervention as necessary, and that announcement was followed shortly afterwards by some official sales of dollars to the market.

In February the dollar resumed its upward movement. By then US interest rates had begun to move up again in response to faster domestic monetary growth, and their continued rise up to early March once more widened interest rate differentials in favour of the dollar. Market sentiment was also affected by President Reagan appearing to rule out more forceful official intervention to stem the dollar's rise. Towards the end of February the dollar euphoria took on new dimensions and against the Deutsche Mark a rate of DM 3.47 was reached. At that point the dollar's cumulative appreciation against the Deutsche Mark since early March 1984 came to 37 per cent., while against sterling, the Swiss franc and the yen it amounted to 41, 39 and 18 per cent. respectively.

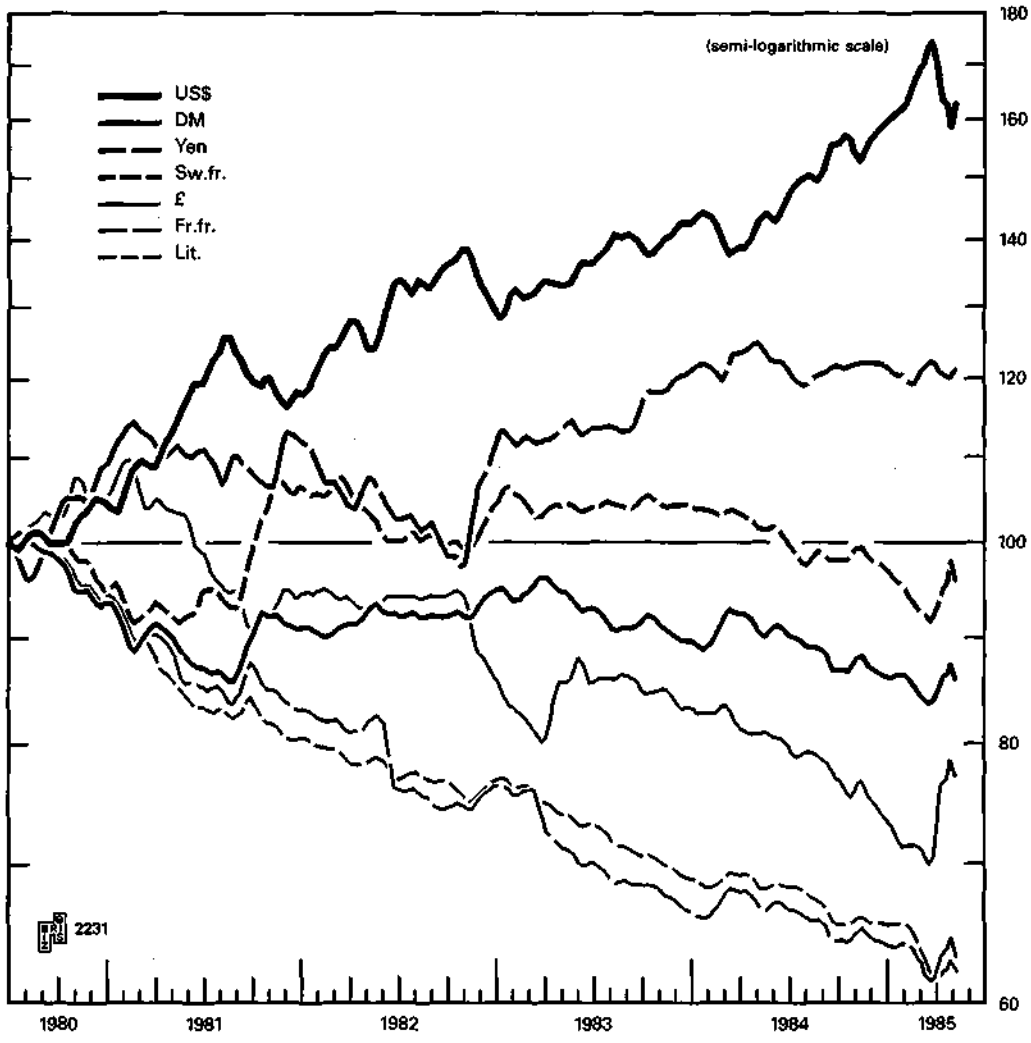
Against this background, and following comments by the Federal Reserve Chairman that the deficits on the US Federal budget and current external account could eventually produce a weakening of the dollar and that forceful official intervention in the exchange market could at times have a useful rôle to play,

co-ordinated official intervention was undertaken on a substantial scale, this time with the US monetary authorities participating more actively than before. On 27th February the dollar dropped by over 5 per cent. against the Deutsche Mark, to DM 3.27. Although the dollar rebounded somewhat in the course of the following days, it soon became apparent that a two-way market had been re-established. Exchange rates moved erratically in nervous markets, and towards mid-March the dollar began to fall sharply. By mid-April its effective exchange rate had declined by 10½ per cent. from the late-February peak, while over the same period the dollar depreciated by 14 per cent. against the Deutsche Mark, going below the DM 3 level on 19th April, but by only 6 per cent. against the yen. The dollar's decline was greatest, at 20 per cent., against sterling, which benefited from continued very high short-term interest rates and a lower than expected planned budget deficit for the fiscal year 1985–86. While it was co-ordinated official intervention in the exchange market that set off the change in sentiment about the dollar, its effects were reinforced by the emergence of some regional banking problems in the United States, as well as by evidence of slow first-quarter US economic growth and its impact on interest rate expectations. During the latter part of April there was a technical reaction, with the dollar recovering some of its earlier losses, but market conditions have since then remained rather unsettled, with no clear sense of direction and unusually large daily fluctuations.

Turning to the exchange-market performance of other major floating currencies during the period under review, the pound sterling was the most volatile, with a marked weakening until early 1985 and a sharp recovery thereafter. Between end-1983 and late January 1985 it depreciated not only by 23 per cent. against the US dollar but also against other major currencies, e.g. by 11 per cent. against the Deutsche Mark and by 16 per cent. against the Japanese yen. Contributing factors included weak world oil prices and a prolonged industrial dispute, which overshadowed balance-of-payments trends in the United Kingdom. To these were added, towards the end of 1984, doubts about the stance of fiscal and monetary policy. To restore confidence and to reduce the downward exchange rate pressures the clearing banks' base lending rates were raised in successive steps from 9½ to 14 per cent. during January 1985. By the end of that month the pound sterling started to recover gradually against other European currencies, but a more decisive turn in its fortunes came only in early March after the peaking-out of the dollar. With the help of a less unsettled oil price outlook and a well received new budget, the UK currency not only continued to appreciate against other European currencies but also rebounded sharply against the dollar and the yen. These developments were reflected in sterling's effective exchange rate, which, after a nearly 16 per cent. decline between end-1983 and late January 1985, recovered by 12½ per cent. by mid-April.

At the other end of the spectrum, the Japanese yen and the Canadian dollar showed the smallest depreciations against the US dollar and fluctuated less widely than most major currencies. The relative stability of the yen is illustrated by the fact that its effective exchange rate has moved within a 6 per cent. range since end-1983, with its bilateral exchange rate movements against the dollar having been largely offset by those against other currencies. This stability was underpinned by the

Selected industrial countries: Movements in effective exchange rates, 1980–85.
Three-week averages, indices: end-June 1980 = 100.




strong domestic economic fundamentals, notably the huge Japanese current-account surplus, stable prices and accelerating economic growth, together with the perceived reluctance of the Bank of Japan, for exchange rate reasons, to lower domestic interest rates. Nevertheless, the performance of the yen since the spring of 1984 has been less impressive than in the preceding year and a half, during which time it had not only appreciated significantly against European currencies, for example by over 30 per cent. against the Deutsche Mark, but had even strengthened against the dollar. This difference in performance was mainly attributable to the much larger volume of non-bank capital outflows from Japan, particularly long-term portfolio investments, in 1984. It may be added that the comprehensive package to deregulate the Japanese financial markets, agreed between the US and Japanese authorities in May 1984, had as its principal stated aim a strengthening of the yen, particularly against the US dollar — but its effectiveness in that respect still remains to be seen.

The relative stability of the Canadian dollar's exchange rate was the result not so much of spontaneous market forces as of policy. Owing to the country's particularly close trade and financial links with the United States, the Canadian economy is much more exposed than other countries to influences emanating from a strong US dollar, such as inflationary pressure and an impact on resource allocation between its export and other industries. The Canadian authorities therefore limited the depreciation of the Canadian dollar against the US currency through a policy of keeping interest rates well above US levels, despite the high level of domestic unemployment and although this entailed a marked appreciation of the Canadian dollar against major European currencies.

*Increasing volatility of dollar exchange rates.* A salient feature of exchange-market behaviour at certain times since September 1984 has been the high degree of short-term volatility displayed by dollar exchange rates. The following table shows two measures of daily exchange rate variability: the number of days in each month since August 1984 on which exchange rate movements exceeded 1 per cent.; and the size of the standard deviation of the daily exchange rate movements from their average day-to-day movements. The day-to-day movements on which the table is based are the changes between noon rates. Since even larger movements might take place within such a 24-hour time span, the figures in the table probably understate, if anything, the degree of volatility that has occurred.

**Daily variability of selected dollar exchange rates.***

| Periods | Deutsche Mark | Japanese yen | Pound sterling |
|---|---|---|---|
| | monthly figures | | |
| 1982 (averages) | 3 (0.66) | 4½ (0.76) | 2 (0.59) |
| 1983 (averages) | 2 (0.55) | 1 (0.52) | 1½ (0.53) |
| 1984 January–July (averages) | 3 (0.66) | 1 (0.42) | 2 (0.55) |
| August | 3 (0.71) | – (0.50) | 2 (0.60) |
| September | 7 (1.41) | – (0.43) | 7 (1.19) |
| October | 4 (0.74) | 1 (0.40) | 4 (0.70) |
| November | 3 (0.84) | – (0.41) | 2 (0.83) |
| December | – (0.51) | – (0.30) | 1 (0.49) |
| 1985 January | 1 (0.48) | – (0.31) | 5 (0.71) |
| February | 3 (1.21) | 4 (0.70) | 6 (1.09) |
| March | 7 (1.07) | 2 (0.54) | 8 (1.48) |
| April | 11 (1.30) | 3 (0.67) | 14 (1.53) |
| May (1st–15th) | 6 (1.39) | – (0.45) | 1 (0.92) |

* Variability is measured by the number of days on which exchange rate changes exceed 1 per cent. Figures in brackets are the standard deviations of day-to-day percentage changes in exchange rates.

The table shows two periods when daily volatility was unusually high. The first one covered September and October 1984, while the second began at the end of February 1985 and was still continuing at the time of writing (mid-May). Both periods included spells of very rapid dollar appreciation, followed by official intervention and a turn-round of the exchange market. The second period, however, differed from the first in that after the turn-round of the exchange market daily exchange rate movements did not decrease, but became even larger and have, in the case of the dollar/Deutsche Mark and dollar/sterling rates, reached unusual

dimensions. In April 1985, for example, day-to-day movements of the dollar/Deutsche Mark rate exceeded 1 per cent. on half of the working days, and those of the dollar/sterling rate on two-thirds of the working days. Daily movements of the dollar/yen rate also became larger during February-April 1985, but not to the same extent as in the cases of the Deutsche Mark and sterling. In the first half of May the dollar/Deutsche Mark rate continued to be unusually volatile, but the size of daily movements in the dollar/yen and dollar/sterling rates decreased.

Short-term exchange rate volatility can result from two quite different types of market situation. A strong one-way bias in market sentiment, such as existed in the first three weeks of September 1984 and in February 1985, can produce large daily unidirectional exchange rate movements. The second type of situation is rather the opposite, namely pronounced uncertainty on the part of market participants about the likely future trend of exchange rates, producing unusually large daily movements in both directions. This second type of situation prevailed after the two episodes of official intervention in late September/early October 1984 and late February/early March 1985. But whereas on the first of these occasions the pause in the rise of the dollar was rather short-lived, in spring 1985 the impact was apparently more lasting. This was probably the result not only of the larger scale of the intervention and of visible US participation in it, but also of certain other events, notably the slow growth of the US economy in the first quarter of 1985. With faith in the dollar apparently less strong than before, but no other currencies having taken its place, the market has become rather directionless. By instilling a sense of caution and reluctance to enter into open positions, official intervention may thus be responsible, at least in part, for the increased exchange-market volatility witnessed recently. However, large daily exchange rate movements with little overall change may be less harmful than unidirectional movements that carry rates to levels that are unsustainable in the long run.

*The evolution of the dollar in a longer-term perspective.* The dollar's performance during 1984 and early 1985 was remarkable enough; looked at in longer-term perspective its cumulative rise has been no less than extraordinary. Between its 1978 low point and late February 1985 its nominal effective exchange rate had appreciated by 80 per cent. and its real bilateral exchange rates (estimated on the basis of movements in relative wholesale prices of finished goods) against the Deutsche Mark and the yen by 95 and 65 per cent. respectively. In a still longer perspective, at their recent peaks the dollar's real exchange rates against the Deutsche Mark and sterling stood 40 per cent. above their post-Smithsonian (December 1971) levels, while even against the Japanese yen the dollar had appreciated in real terms by about 10 per cent. over the whole of that period.

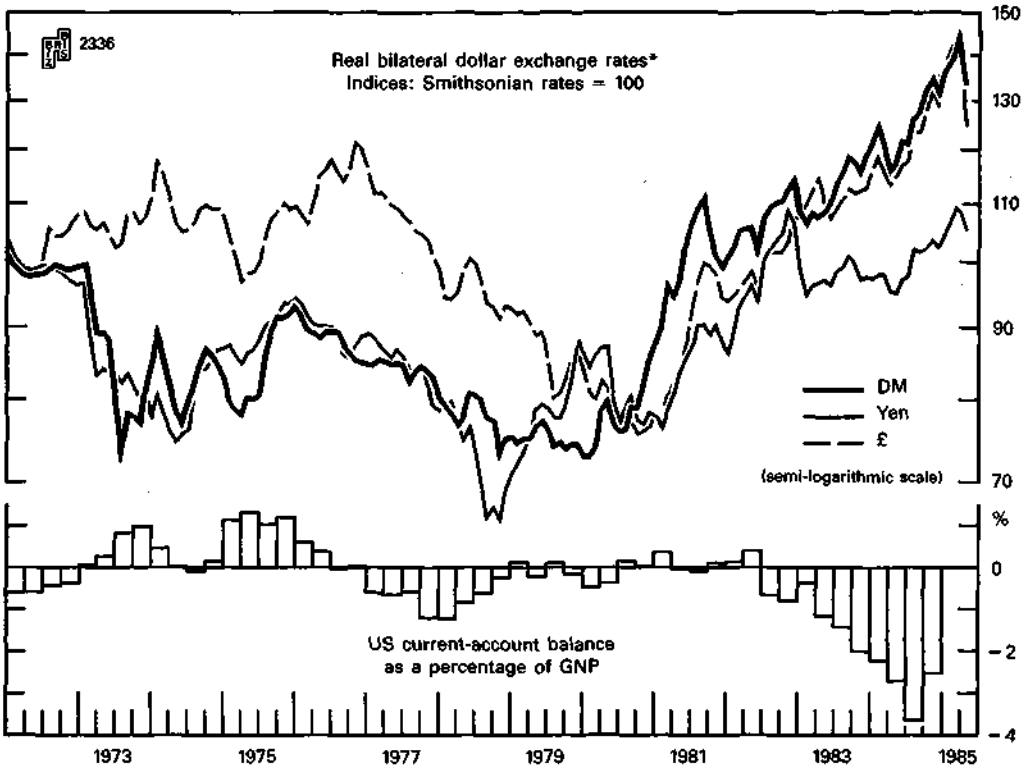
The dollar's strength in recent years is all the more remarkable, given the balance-of-payments structure which has carried it upwards for so long. At the beginning of the 1980s, when the present period of dollar strength began, the current account of the US balance of payments was only in moderate surplus, and since early 1982 it has been in steadily increasing deficit. There is no parallel for this phenomenon of an ever strengthening currency based on ever increasing capital inflows, with the current external account steadily deteriorating. In that respect the

strength of the dollar in the 1980s contrasts sharply with that of the Deutsche Mark and the yen in the 1970s, the basis for which was substantial current-account surpluses.

An evolution as unusual as that of the dollar in recent years has given rise to considerable controversy about its causes. Whatever the precise truth may be, the persistence of substantial, although varying, international interest rate differentials in favour of the dollar is surely part of the explanation; indeed, it is difficult to imagine that, in the absence of these differentials, capital inflows to the United States in recent years could have been as large as they in fact were. To say that favourable international interest rate differentials played an important part in the dollar's rise is not, however, to say that such differentials are related in stable or predictable ways to exchange rate movements. There are a number of reasons why that is not the case, all of which can be illustrated with reference to the dollar's experience.

In the first place, interest earnings are only one element of investors' total anticipated yield on assets denominated in foreign currency. Expected gains (or losses) from exchange rate movements can at times be an equally, or even more, important element. International interest rate differentials will therefore stimulate such investment only when there is confidence in the existing exchange rate structure, while their influence may become even greater if they are expected to be

Real bilateral dollar exchange rates and the US current-account balance, 1972–85.




* Adjusted on the basis of movements in relative wholesale prices of finished goods.

compounded by exchange rate gains. Favourable interest rate differentials may strengthen a currency, and that strength may itself give rise to expectations of further appreciation, thereby reinforcing the influence of these differentials. It seems likely that such effects have contributed to the cumulative strengthening of the dollar.

A second reason for lack of stability in the relationships between international interest rate differentials and exchange rate movements may be that, despite recent experience, the markets still suspect that in the longer run exchange rate movements do reflect, in a rough way, inflation differentials. This means that what tend to count, for the longer run, are real, rather than nominal, interest rate differentials. Changes in real differentials are, by their nature, very hard to identify, and they may result not only from the movements of nominal interest rates but also from changes in inflationary expectations. It seems likely that in the United States inflationary expectations diminished last year as a result of the continued low inflation rate and the moderate level of wage settlements, thus enhancing the attraction exerted by the high level of dollar interest rates on foreign investors.

A third element in investors' anticipated yield on foreign currency assets may be capital gains (or losses) resulting from interest rate movements. For example, a gradual downward movement of its long-term interest rates may for a time increase a currency's attractions for foreign investors, through the hope of capital gains, although at the same time the interest rate differential in its favour is being reduced. The further strengthening of the dollar in the final months of 1984 and early 1985 appears to have been an example of such a situation.

Whatever the influence of favourable interest rate differentials may have been, other factors too have contributed to the dollar's strength in recent years. Large-scale flight of capital to the United States was, at the time of the Latin American debt crisis in 1982, one of these factors, while the strong growth of the US economy since late 1982, which has been accompanied by a vigorous upturn in US domestic investment and improved corporate profits, and the perceived flexibility of its labour and product markets have increased the dollar's appeal in the eyes of foreign investors.

Through their exchange rate effects and their contribution to the emergence of a very large deficit on the current account of the US balance of payments, the huge capital inflows into the United States in recent years have certainly given an important stimulus to the rest of the world economy. In 1982, when the industrial world was in quite serious recession and when major external debt problems had emerged in some developing countries, it was hard to see where a resumption of world economic growth could come from other than the United States — the world's largest economy and, as its main reserve centre, the one most able to finance external deficits in its own currency. By early 1985, however, it was clear that capital inflows to the United States had pushed the dollar to levels that were substantially divorced from the underlying fundamentals, providing the most dramatic, although by no means the only, example since the introduction of floating rates in 1973 of the fact that the movement of a currency can become self-sustaining, with the markets tending to interpret all kinds of economic, financial and other

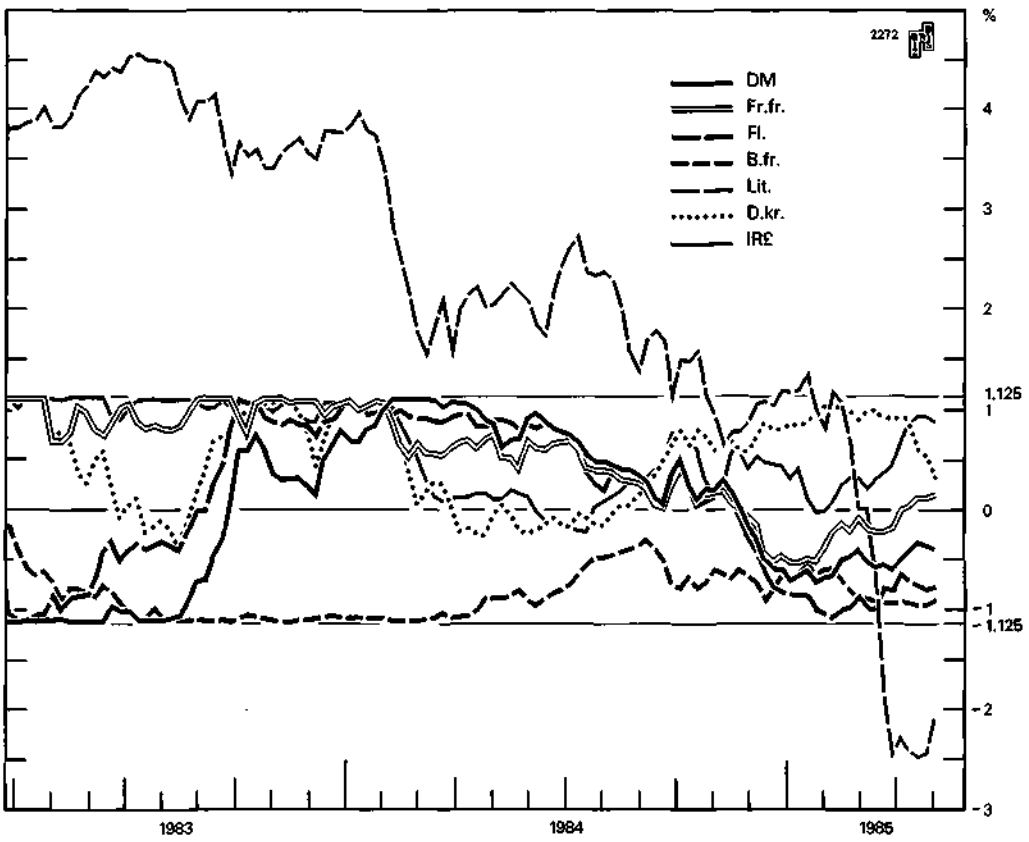
developments in its favour. Under such circumstances an exchange rate may go to unsustainable levels before the fundamentals reassert themselves. Even for the United States, however, there are limits to the current external deficits that can be run and the deterioration of the international investment position that can occur without loss of confidence in the dollar.

Moreover, it is questionable whether the world's most developed economy should, over the longer run, be a net importer of the rest of the world's savings. The conclusion must therefore be that the strong dollar has served the world well in a number of ways but that the task now is to return to a more sustainable US, and world, balance-of-payments and exchange rate structure without undoing the achievements of the past two and a half years or inflicting major damage on world economic and financial structures.

*Exchange rate developments within the EMS.* In contrast to developments on the dollar exchange market, the period under review was a relatively calm one in the EMS fixed exchange rate system. By March 1985 two years had passed since the last realignment of participating currencies' central rates, making this by far the longest period of nominal exchange rate stability within the system since its inception in March 1979.

Spot exchange rates in the EMS exchange rate system, 1983–85.

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



In early 1984, when the dollar weakened temporarily against other major currencies, there were some tensions within the system. As the Deutsche Mark strengthened against the dollar, it moved close to the upper limit of the 2¼ per cent. exchange rate band by early February 1984, while the Belgian franc continued to be close to its lower limit. However, around mid-March 1984, when the US dollar began to strengthen once more, there began a period of marked convergence in the participating currencies' exchange rates, with the result that by early September the gap between the strongest and weakest currencies within the narrow band had declined to only 0.6 per cent. The Deutsche Mark, the French franc and the Dutch guilder declined towards their central rates, while the Belgian franc detached itself from the lower limit of the band. Except for the Italian lira, which stayed in the upper part of its wider band, the Deutsche Mark remained the strongest currency in the system during most of this period. The central banks of some other participating countries took advantage of the convergence of exchange rates to recoup earlier reserve losses by acquiring Deutsche Mark through intra-marginal interventions.

In early September, when the upward movement of the dollar accelerated, the Deutsche Mark was replaced at the top of the band by the Irish pound and the Danish krone. When the dollar began to appreciate once more in early November 1984 the Deutsche Mark, the French franc and the Dutch guilder weakened against the other member currencies, subsequently dropping well below their central rates. By mid-December the Dutch guilder had replaced the Belgian franc at the bottom of the band, and in early February 1985 its spread against the Danish krone, now the strongest currency in the narrow band, gradually widened to approach the 2¼ per cent. limit. Following a ½ per cent. increase in the discount rate of the Netherlands Bank on 1st February, the guilder was able to detach itself from the lower limit of the band, and in mid-March the Belgian franc again became the weakest currency in the system. Owing to the relatively low level of nominal interest rates in Germany, the Deutsche Mark was, after the Dutch guilder and the Belgian franc, the weakest currency within the narrow band throughout the four-month period from December 1984 to March 1985. Some other member countries again took advantage of this situation to replenish their exchange reserves through intra-marginal interventions, leaving most of the proceeds in Deutsche Mark but also acquiring some non-member currencies other than the dollar.

The abrupt decline of the dollar in the course of March had little impact on the performance of the individual currencies within the EMS, and the Deutsche Mark continued in the lower half of the band. The only exception was the Italian lira, which depreciated within its wider band by over 4 percentage points between mid-February and late March, before recovering somewhat in the course of April and early May. Continuing inflation and the partly related deterioration of Italy's balance-of-payments position were probably the main reasons for this downward movement of the lira, which restored some of the international competitiveness lost earlier.

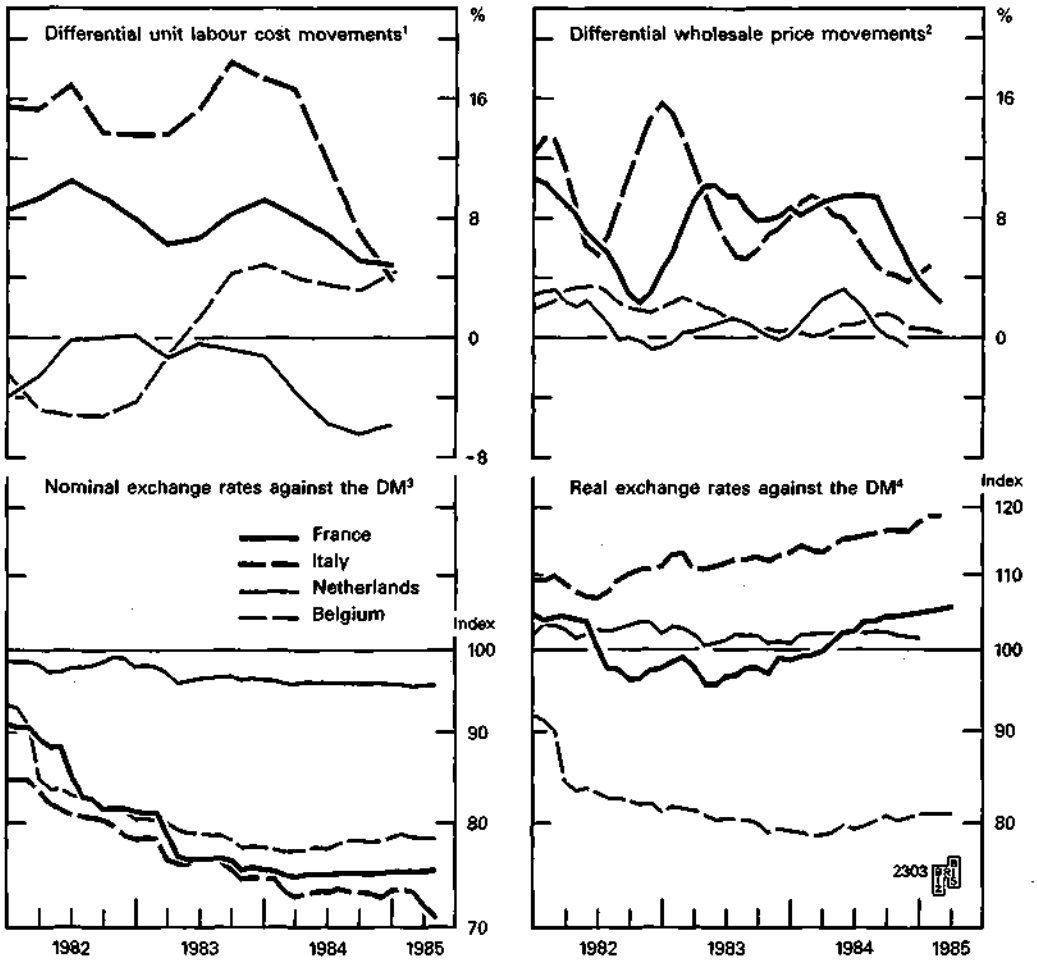
Apart from these exchange rate developments, during the period under review a change was made in the currency composition of the ECU, and a number of

measures were taken to enlarge the use, and enhance the attractiveness, of ECU reserves. On 17th September 1984, following the first five-yearly re-examination of the composition of the ECU basket, an alteration was made with a view to adjusting the component currencies' weights so as partly to offset the changes that had resulted from the various central rate realignments since the system's inception. The new weights represent a reduction from 36.9 to 32.1 per cent. for the Deutsche Mark, from 11.3 to 10.1 per cent. for the Dutch guilder and from 15.1 to 15 per cent. for the pound sterling, but an increase from 7.8 to 10 per cent. for the Italian lira, from 16.7 to 19 per cent. for the French franc and from 1 to 1.2 per cent. for the Irish pound; the weight of the Belgian franc was increased only marginally to 8.6 per cent., while that of the Danish krone remains unchanged at 2.7 per cent. At the same time, the Greek drachma was incorporated in the basket with a weight of 1.3 per cent., although it does not participate in the EMS exchange rate mechanism. These changes did not affect ECU central rates or bilateral parities within the system.

In March 1985 the central-bank Governors of the EEC member countries agreed in principle on a number of measures to expand the international rôle of the ECU. Firstly, in order to facilitate the mobilisation of official ECU holdings for exchange-market intervention purposes, EMS central banks will be allowed to exchange ECUs via the EMCF temporarily for dollars or Community currencies with other member central banks if the need arises. Secondly, non-EEC central banks and certain international monetary institutions may be permitted to hold ECUs. Thirdly, the limit for the use of ECUs by member countries to extinguish liabilities contracted under the very short-term financing facility vis-à-vis other countries with net debtor positions in ECUs is to be raised from 50 to 100 per cent. Finally, in order to increase the attractiveness of official ECU holdings, the basis for calculating the interest rate paid on them is to be raised from the weighted average of the official discount rates in member countries to the weighted average of money-market interest rates for the component currencies.

The present extended period of nominal exchange rate stability within the EMS has, of course, owed much to the rather persistent strength of the dollar against all the participating currencies, including the Deutsche Mark. There have, it is true, been some periods of dollar weakness, but these have been relatively short-lived. However, this stability has also been fostered by certain developments within the EMS area itself. Firstly, there has been a further convergence of member countries' monetary policy stances. Interest rates were, in general, kept high in higher-inflation countries, maintaining significant differentials above the corresponding rates in low-inflation countries. Where there were some downward adjustments of high interest rates, as in France, Italy and Belgium, they were cautiously executed with a view to avoiding adverse exchange rate effects. Secondly, there has been some further convergence of member countries' economic performances. Observed inflation rates continued to drop in France, Belgium, Italy, Denmark and Ireland, thereby narrowing the differentials in comparison with Germany and the Netherlands. Moreover, this lowering of inflation rates was underpinned by a significant moderation of wage increases. With respect to growth performance, too, economic recovery got under way in all member countries during 1984.

Convergence and divergence indicators within the EMS, 1982–85.




¹ Domestic minus German unit labour costs in manufacturing calculated as percentage changes over four quarters of three-quarter moving averages. ² Domestic minus German wholesale prices of finished goods calculated as annualised percentage changes over six months of three-month moving averages. ³ Indices: March 1979 = 100 (semi-logarithmic scale). ⁴ In terms of relative wholesale prices of finished goods; indices: March 1979 = 100 (semi-logarithmic scale).

In the absence of fears of an imminent realignment of central rates, nominal interest rate differentials have since the spring of 1984 played an important rôle in determining capital flows between member countries. As a result, the currencies of member countries with low inflation rates and moderate nominal interest rate levels have tended to weaken against those of countries with higher inflation and interest rates. However, this pattern of exchange rate movements, which has added to the divergence of real exchange rates and competitive positions resulting from the differences in inflation rates, is not without some possible risks for the future stability of the exchange rate system. For one thing, it may add to allocative inefficiencies and exert undesirable influences on member countries' current-account performances. Moreover, if confidence in the sustainability of the present central rate structure were to weaken, there could be a reversal of capital flows, back to the

low inflation and interest rate countries, which could generate disruptive exchange rate pressures within the system. Whether a reasonable degree of stability can be maintained in the system will therefore depend on whether the disciplinary influence exerted by the real appreciation of the currencies of those countries with higher inflation rates will lead to a further downward convergence of inflation rates, as well as on the future course of events in the dollar exchange market.

**Gold production and the gold market.**

The period under review was, on the whole, one of further weakness in the gold market; the dollar price of gold reached its lowest level for five and a half years in February 1985. The main reason for this was that the continued high level of dollar interest rates and the further appreciation of the dollar on the exchange markets gave dollar investments an appeal with which gold, whose principal attraction lies in its potential for appreciation, could not compete.

The further downward movement of the market price of gold in dollar terms encouraged an increase in the commercial use of gold and helped to contain the contraction in investors' purchases. In dollar terms the gold price dropped by nearly 26 per cent. between the end of 1983 and late February 1985, before recovering to stand about 16 per cent. below its end-1983 level in mid-May 1985. Since a substantial part of the decline in the dollar price of gold reflected the unusual strength of the dollar on the exchange markets, in terms of other major currencies, for example the Swiss franc, the market price of gold showed little change on balance over the period under review and was subject to much less pronounced fluctuations than in dollar terms. A notable feature of last year, moreover, was that in South Africa, which in 1984 accounted for 60 per cent. of world gold production, the domestic gold price rose by over 30 per cent. in the course of 1984 as a result of the weakness of the rand on the exchange market. This price increase far exceeded South Africa's inflation rate and was therefore in large measure a real one.

The upward trend of world gold production which, after the pronounced decline during the 1970s, had reasserted itself in 1981 continued last year, although at a considerably slower pace than in 1983. World gold output (excluding that of the Soviet Union, other eastern European countries, China and North Korea) may be estimated to have increased by 35 metric tons, or 3.2 per cent., in 1984 to a total of 1,145 metric tons. It thereby exceeded its 1980 low point by 20 per cent., but was still 10 per cent. below its 1970 peak level.

In contrast to the 8.7 per cent. growth recorded in 1983, the 1984 expansion in world gold production was not very evenly distributed. South African production, in particular, grew only marginally, a further increase in the amount of ore processed having been largely offset by a further shift towards mining lower-grade ores. Since 1977 the gold-mining members of the Chamber of Mines of South Africa, which account for 97 per cent. of total South African gold output, have reduced the average grade of ore mined, in response to the higher prices received, by 30 per cent.

Estimated world gold production.

| Countries | 1946 | 1953 | 1970 | 1980 | 1981 | 1982 | 1983 | 1984 |
|---|---|---|---|---|---|---|---|---|
| | in metric tons | | | | | | | |
| South Africa | 371.0 | 371.4 | 1,000.4 | 675.1 | 657.6 | 664.3 | 679.7 | 683.3 |
| Canada | 88.5 | 126.1 | 74.9 | 50.6 | 52.0 | 64.7 | 73.5 | 81.3 |
| United States | 49.0 | 60.9 | 54.2 | 30.2 | 42.9 | 45.0 | 60.9 | 71.5 |
| Brazil | 4.4 | 3.6 | 9.0 | 35.0 | 35.0 | 35.0 | 58.7 | 55.1 |
| Australia | 25.6 | 33.4 | 19.3 | 17.0 | 18.4 | 27.0 | 30.6 | 39.0 |
| Philippines | – | 14.9 | 18.7 | 22.0 | 24.9 | 31.0 | 33.3 | 34.1 |
| Colombia | 13.6 | 13.6 | 6.3 | 17.0 | 17.7 | 15.9 | 17.9 | 21.3 |
| Papua New Guinea | . | . | 0.7 | 14.3 | 17.2 | 17.8 | 18.4 | 18.3 |
| Chile | 7.2 | 4.1 | 1.6 | 6.5 | 12.2 | 18.9 | 19.0 | 18.0 |
| Zimbabwe | 16.9 | 15.6 | 15.6 | 11.4 | 11.6 | 13.4 | 14.1 | 14.5 |
| Ghana | 18.2 | 22.7 | 22.0 | 10.8 | 13.0 | 13.0 | 11.8 | 11.6 |
| Dominican Republic | . | . | – | 11.5 | 12.8 | 11.8 | 10.8 | 10.8 |
| Peru | 4.9 | 4.4 | 3.3 | 5.0 | 7.2 | 6.9 | 9.9 | 10.5 |
| Zaïre | 10.3 | 11.5 | 5.6 | 3.0 | 3.2 | 4.2 | 6.0 | 10.0 |
| Mexico | 13.1 | 15.0 | 6.2 | 5.9 | 5.0 | 5.2 | 7.4 | 6.8 |
| Total listed | 622.7 | 697.2 | 1,237.8 | 915.3 | 930.7 | 974.1 | 1,052.0 | 1,086.1 |
| Other countries | 43.3 | 56.8 | 33.2 | 38.2 | 42.8 | 46.9 | 58.0 | 58.9 |
| Estimated world total* | 666.0 | 754.0 | 1,271.0 | 953.5 | 973.5 | 1,021.0 | 1,110.0 | 1,145.0 |

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

US gold production, which had already shown a pronounced upward trend in preceding years, rose by 10.6 tons, or 17.4 per cent., last year under the impact of the wider use of more efficient methods of gold recovery from small low-grade deposits. In Australia and Canada there were increases in output of 8.4 and 7.8 tons respectively. On the other hand, there were declines in output in Brazil and Chile.

Estimated market sources and uses of gold.

| Items | 1980 | 1981 | 1982 | 1983 | 1984 |
|---|---|---|---|---|---|
| | in metric tons | | | | |
| Production | 955 | 975 | 1,020 | 1,110 | 1,145 |
| Estimated sales by communist countries (net) | 90 | 300 | 200 | 80 | 100 |
| Estimated changes in official gold stocks through market transactions[1,2] (– = increase) | – 75 | –100 | 100 | 75 | 20 |
| Total (= estimated non-monetary absorption) | 970 | 1,175 | 1,320 | 1,265 | 1,265 |

[1] As reported by the IMF. [2] Changes in South Africa's gold reserves have been excluded from the movements of official gold stocks in this 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.

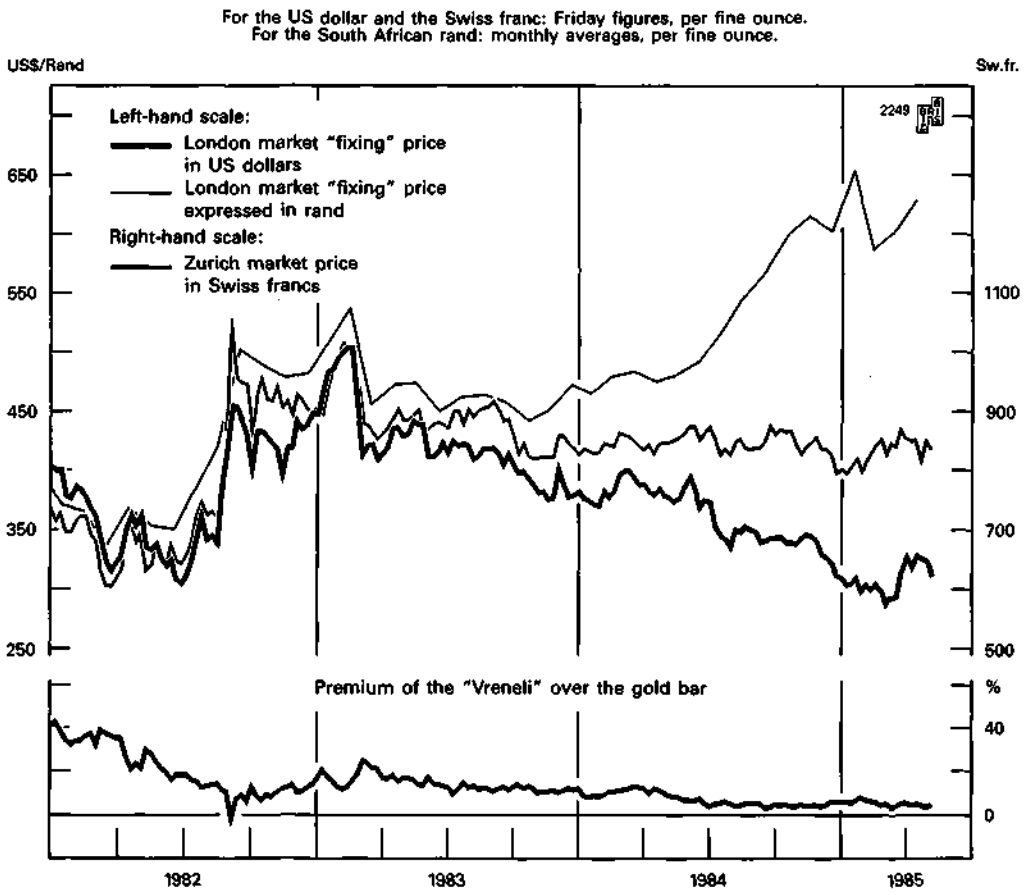
As regards other sources of new market gold supplies, communist countries' net sales of gold may be estimated to have amounted to around 100 tons last year, 20 tons more than in 1983, while official gold holdings, as reported by the International Monetary Fund, declined by 20 tons. The reduction in official gold reserves was more than accounted for by Colombia, which drew down its gold stock by 89 tons, to 43 tons as at the end of 1984. In addition, the United States reported a reduction of about 18½ tons in its official gold stock. On the other hand, the official gold stocks of Brazil, Hungary and the Philippines increased by 29, 16½ and

15½ tons respectively. Altogether, the total of gold available for non-monetary absorption in 1984 may be estimated at 1,265 tons, the same as in 1983.

The course of the market price of gold in dollar terms was dominated by exchange rate developments during the period under review. After a weak start, which brought quotations down from $381 per fine ounce at the end of 1983 to $364 in early January 1984, the gold price strengthened twice in the course of the first half of the year in connection with spells of dollar weakness: once in February and early March, when quotations reached $407 per fine ounce, the highest level recorded during the period under review; and again in late May and early June, when the price temporarily firmed to $394, after having fallen back to $370 in early May.

However, this second recovery was quickly reversed when the dollar gained new strength and dollar interest rates continued to go up quite steeply, and quotations dropped to $332.5 per fine ounce in the second week of July. During the following four months market quotations rose somewhat on balance to about $350 in mid-November. The further strengthening of the dollar on the exchange markets

Market prices of gold in US dollars, Swiss francs and South African rand, 1982–85.



then produced a sharp drop in the market price of gold, to just below $285 per fine ounce in late February 1985. The subsequent weakening of the dollar was accompanied by a recovery in the market price of gold to nearly $335 in mid-April 1985, before it eased again to around $320 in mid-May.

**Reserves and international liquidity.**

1984 was an unusual year so far as international liquidity is concerned. On the one hand, the deficit of over $100 billion on the current account of the US balance of payments was accompanied by a large further increase in the rest of the world's identified claims on the United States, much of it in liquid or marketable form, as well as by quite substantial unidentified inflows of funds to the United States. In the broadest sense, therefore, there was a considerable expansion last year of the rest of the world's dollar holdings in the United States in liquid, or potentially liquid, form. On the other hand, as most of last year's additions to the rest of the world's dollar assets were acquired by private investors, there was only a relatively modest $16 billion increase in the total official reserve assets, excluding gold, of countries other than those of eastern Europe, while in dollar terms the market value of total gold reserves, under the influence of the continued strength of the US dollar, showed a further strong decline.

In current dollar terms, the growth of countries' non-gold reserves amounted to 4 per cent. last year, but a 2 per cent. decline in the unit value of internationally traded goods suggests that the real increase was more like 6 per cent. This was less than the expansion in international trade, which amounted to 6.5 per cent. in nominal terms and 9 per cent. in volume terms. However, the underlying expansionary momentum of international liquidity was once more understated owing to the continued appreciation of the dollar, which reduced the dollar value of official reserve assets denominated in other currencies. Expressed in terms of constant end-1984 dollars, official holdings of reserve assets other than gold grew by about $35 billion, or nearly 10 per cent., last year.

The further appreciation of the dollar was also the main reason for the continued fall in the free-market price of gold last year, which accounted for virtually the whole of the $69 billion, or 19 per cent., decline in the market value of official gold holdings. This decline must be said to have offset to some extent the greater liquidity ease resulting from the accruals of other reserve assets. However, while the decline in the market price of gold affected mainly the Group of Ten countries, a number of which have comfortable overall reserve positions, much of last year's increase in non-gold reserves was in non-OPEC developing countries where it was badly needed.

By types of asset, the 1984 pattern of reserve growth was quite different from that in 1983. In 1983 the increase, at least in current dollar terms, had been essentially an "administered" one in the sense that it had consisted largely of an increase in certain countries' IMF reserve positions that resulted from the record level of IMF lending operations produced by the international debt crisis. In 1984,

Changes in global reserves, 1982–84.

| Areas and periods | Gold | | Foreign exchange | IMF reserve positions | SDRs | ECUs | Non-gold total |
|---|---|---|---|---|---|---|---|
| | in millions of ounces | in billions of US dollars at current prices[1] | | | | | |
| Group of Ten countries | | | | | | | |
| 1982 | – 0.3 | 35.4 | – 10.8 | 3.3 | 1.8 | – 8.4 | – 14.1 |
| 1983 | – 0.8 | – 49.5 | 2.7 | 7.2 | – 3.1 | 3.2 | 10.0 |
| 1984 | – 0.6 | – 53.7 | 4.2 | – 0.1 | 0.7 | – 6.9 | – 2.1 |
| *Amounts outstanding at end-1984* | *737.8* | *228.0* | *103.5* | *24.8* | *11.9* | *37.3* | *177.5* |
| Other developed countries[2] | | | | | | | |
| 1982 | – 1.7 | 3.5 | 0.8 | – 0.3 | – 0.2 | – | 0.3 |
| 1983 | – 1.3 | – 6.3 | 2.6 | 0.9 | – 0.5 | 0.4 | 3.4 |
| 1984 | – 0.3 | – 6.4 | 6.9 | – | 0.3 | – 0.4 | 6.8 |
| *Amounts outstanding at end-1984* | *86.6* | *26.8* | *44.9* | *2.2* | *1.2* | *0.4* | *48.7* |
| OPEC member countries | | | | | | | |
| 1982 | 0.3 | 2.2 | – 11.4 | 0.7 | 0.2 | | – 10.5 |
| 1983 | 0.1 | – 2.9 | – 8.2 | 4.4 | – 0.7 | | – 4.5 |
| 1984 | 0.1 | – 3.1 | – 2.8 | 0.5 | 0.1 | | – 2.2 |
| *Amounts outstanding at end-1984* | *44.0* | *13.6* | *54.1* | *12.3* | *1.7* | | *68.1* |
| Other developing countries[3] | | | | | | | |
| 1982 | – 1.8 | 2.8 | – 0.7 | – 0.4 | – 1.3 | | – 2.4 |
| 1983 | – 0.4 | – 5.0 | 7.4 | 0.3 | – 0.2 | | 7.5 |
| 1984 | – 1.0 | – 5.6 | 14.4 | – 0.6 | – 0.1 | | 13.7 |
| *Amounts outstanding at end-1984* | *71.9* | *22.2* | *97.5* | *1.4* | *1.3* | | *100.2* |
| Total of above countries | | | | | | | |
| 1982 | – 3.5 | 43.9 | – 22.1 | 3.3 | 0.5 | – 8.4 | – 26.7 |
| 1983 | – 2.4 | – 63.7 | 4.5 | 12.8 | – 4.5 | 3.6 | 16.4 |
| 1984 | – 1.8 | – 68.8 | 22.7 | – 0.2 | 1.0 | – 7.3 | 16.2 |
| *Amounts outstanding at end-1984* | *940.3* | *290.6* | *300.0* | *40.7* | *16.1* | *37.7* | *394.5* |
| Memorandum item: | | | | | | | |
| Eastern European countries[4] | | | | | | | |
| 1982 | (– 1.1)[5] | (– 0.2)[5] | 1.0 | – | – | | 1.0 |
| 1983 | ( 1.0)[5] | ( 0.1)[5] | 1.8 | – | – | | 1.8 |
| 1984 | ( 0.6)[5] | (– 0.2)[5] | 2.7 | – | – | | 2.7 |
| *Amounts outstanding at end-1984* | *( 5.8)[5]* | *( 1.8)[5]* | *22.7* | – | – | | *22.7* |

[1] Gold reserves valued at market prices. [2] Excluding eastern European countries. [3] Including (unlike Chapter V) Israel and (unlike Chapter VI) the offshore financial centres. [4] The reserve figures given for this group of countries are not all complete. For Hungary and Rumania reserve data are those reported to the International Monetary Fund, while for the other countries of the group – Albania, Bulgaria, Czechoslovakia, the German Democratic Republic, Poland and the USSR – data are those of gross deposits held with banks reporting quarterly to the BIS. [5] Hungary and Rumania only.

when the combination of the expansionary stimulus emanating from the US economy, adjustment efforts by debtor countries and some easing of international strains enabled a number of countries to improve their external payments positions, non-gold reserve growth was more than accounted for by a $22.7 billion expansion in official foreign exchange holdings, of which nearly one-quarter represented additions to Deutsche Mark reserves. By contrast, official ECU balances declined by $7.3 billion in current dollar terms, largely as a result of valuation effects and the lower official gold price used for the gold/ECU swaps between members of the European Monetary System and the European Monetary Co-operation Fund.

Member countries' reserve positions in the International Monetary Fund plus their SDR holdings, which in 1983, in the wake of the general increase in Fund quotas and record drawings, had on balance recorded an expansion of $8.3 billion, edged up only marginally last year, by $0.8 billion. At constant exchange rates, however, IMF reserve positions and SDR holdings expanded by $2.4 and 2 billion respectively last year. Gross new drawings on the Fund totalled SDR 8.1 billion, down by SDR 6 billion from their 1983 peak level. As total repurchases, at SDR 2.3 billion, increased somewhat, the net amount of new credit extended by the IMF, at SDR 5.8 billion, was less than half the 1983 figure. Nearly SDR 5 billion of last year's net new drawings was accounted for by non-OPEC developing countries, with countries in the western hemisphere alone receiving SDR 3.7 billion. Brazil and Mexico, which had already been heavy borrowers in 1983, were the largest recipients of new funds, totalling SDR 1.7 and 1.3 billion respectively. Elsewhere in the developing world, India and Korea drew SDR 0.5 and 0.4 billion respectively. In eastern Europe, Hungary obtained SDR 0.5 billion, while in the group of "Other developed countries" Portugal, with new borrowings of SDR 0.2 billion, was the only major recipient of new IMF credit.

As for the payment media used in the Fund's lending operations, 93 per cent. of net new drawings was made in SDRs (SDR 2.7 billion), US dollars (SDR 2.1 billion) and Saudi Arabian riyals (SDR 0.6 billion). Drawings were financed by the Fund through the use not only of its stock of usable currencies and SDRs but also of part of the credit facilities made available to it in April 1984 by a number of industrial member countries and Saudi Arabia.

By groups of countries, the largest increase in non-gold reserves during 1984, amounting to $13.7 billion, occurred in the non-OPEC developing countries, while in addition the non-gold reserves of developed countries outside the Group of Ten went up by $6.8 billion. Group of Ten countries' and OPEC countries' reserves, on the other hand, registered declines of $2.1 and 2.2 billion respectively in nominal terms, although in the Group of Ten the decline was more than accounted for by exchange rate effects.

The gains of the non-OPEC developing countries, which in large measure reflected the efforts of some heavily indebted countries to improve their external payments positions, were all in foreign exchange reserves, which expanded by $14.4 billion, or nearly twice the 1983 increase. These countries' IMF reserve positions declined further by $0.6 billion and, as in the two preceding years, they continued to make some use of their gold reserves. In Latin America, Brazil's non-gold reserves jumped from $4.4 to 11.5 billion and Mexico's from $3.9 to 7.3 billion, while Argentina recouped $0.6 billion of the $1.3 billion reserve loss it had suffered in 1983. Trinidad and Tobago and Colombia, on the other hand, experienced reserve losses of $0.7 and 0.5 billion respectively.

Elsewhere in the non-OPEC developing world, India and Singapore recorded reserve gains of about $1 billion each, while Lebanon's total non-gold reserves declined from $1.9 billion to barely $0.7 billion and those of Pakistan by $0.9 billion. China added $2.4 billion to its reserves in the first nine months of the year, but this movement was largely reversed during the fourth quarter.

The OPEC countries' total recorded loss in non-gold reserves, at $2.2 billion, was about half that in 1983. In particular, exchange reserves, which in 1983 had registered a decline of $8.2 billion, showed a decrease of only $2.8 billion, due largely to exchange rate effects. Within the OPEC group the largest recorded reserve losses were those of Saudi Arabia (−$2.5 billion), Libya (−$1.6 billion), Kuwait (−$0.6 billion) and Algeria (−$0.4 billion), while Indonesia and Venezuela recorded gains of $1.1 and 1.3 billion respectively.

In the developed world, the combined $6.8 billion reserve gain of countries outside the Group of Ten was twice as large as in 1983. Spain and Norway alone recorded increases of $4.6 and 2.7 billion respectively; substantial additions to non-gold reserves were also reported by Finland ($1.5 billion) and New Zealand ($1 billion). Australia and South Africa, on the other hand, experienced reserve losses of $1.4 and 0.6 billion respectively.

The decline in the Group of Ten countries' non-gold reserves was more than accounted for by the $6.9 billion fall in the current dollar value of the ECU holdings of members of the European Monetary System, to which reference has already been made. The Group of Ten countries' other non-gold reserve assets on balance showed an increase of $4.8 billion, or about $9 billion if exchange rate effects are excluded. The United States' reserves rose by $1.2 billion, and those of Japan by $1.8 billion despite the weakness of the yen against the dollar. In Canada, however, a similar weakness of the exchange rate was reflected in a decline in foreign exchange reserves from $2.7 to 1.7 billion.

Turning to the European Group of Ten countries, and excluding ECUs, substantial reserve gains were achieved by France ($3 billion) and Italy ($1.8 billion), which benefited from the stability of their currencies within the European Monetary System and their high nominal interest rate levels. The United Kingdom's exchange reserves, by contrast, declined by $1.3 billion. Germany's foreign exchange reserves showed little change over 1984 as a whole, as exchange-market intervention to moderate the rise of the dollar against the Deutsche Mark was about offset by the interest earned on dollar reserves and by other official dollar receipts.

In the first quarter of 1985 non-gold reserves of the Group of Ten countries, excluding ECUs, may be estimated to have decreased by $6 billion. Official foreign exchange holdings contracted by $6.2 billion, of which over $2 billion resulted from the unwinding of swaps between the Swiss National Bank and commercial banks in Switzerland. The large-scale official intervention in the exchange market between late January and early March, totalling almost $11 billion, was only reflected to a limited extent in movements of the Group's aggregate exchange reserves, since individual countries' reserves are affected by a variety of other factors, including official foreign borrowing and interest income on reserve assets. Exchange reserve losses for the quarter were shown by Germany (−$2.7 billion), Italy (−$2.4 billion) and the Netherlands (−$0.4 billion). In the Italian case the size of the reserve losses mainly reflected the weakness of the lira against other EMS currencies. On the other hand, France and Canada showed reserve gains for the quarter of $0.6 billion each. The US interventions were partly reflected in a $0.4 billion increase in that country's exchange reserves.

As regards the investment of exchange reserves, the outstanding feature of 1984 was that the bulk of official exchange reserve accruals was placed outside the United States. US liabilities to foreign official institutions increased by only $4.8 billion. Official Euro-dollar deposits, which, as a result of the so-called "flight to quality" and declining OPEC reserves, had shown average yearly decreases of over $10 billion in 1981–83, expanded by $9 billion during 1984. Moreover, official deposits in Euro-currencies other than the dollar, plus official deposits in national markets other than the United States, which, after declining by over 40 per cent. in 1981–82, had already begun to recover in 1983, increased in current dollar terms by a further $4.1 billion in 1984, to a total of $39.6 billion. In all, the growth of official reserve holdings with banks outside the United States amounted in 1984 to $13.1 billion in current dollar terms and to $17.5 billion in constant dollar terms.

The pattern of investment of exchange reserves, 1981–84.

| Items | Flows | | | | Amounts outstanding at end-1984 |
|---|---|---|---|---|---|
| | 1981 | 1982 | 1983 | 1984 | |
| | in billions of US dollars | | | | |
| 1. Deposits with banks in European countries,[1] Canada and Japan: | | | | | |
| (a) In national markets | − 1.4 | − 3.5 | − 1.3 | 1.0 | 12.2 |
| Deutsche Mark | − 1.6 | − 0.5 | − 0.8 | − 0.7 | 1.2 |
| Swiss francs | 1.0 | − 1.3 | − 0.4 | − 0.1 | 0.9 |
| Yen | 0.8 | − 0.4 | − 0.3 | 1.6 | 6.3 |
| Pounds sterling | − 0.8 | − 0.1 | 0.3 | 0.5 | 2.6 |
| French francs | − 0.8 | − 0.2 | − | − 0.1 | 0.5 |
| Other currencies | − | − 1.0 | − 0.1 | − 0.2 | 0.7 |
| (b) In Euro-markets | −17.9 | −24.4 | − 6.5 | 10.5 | 85.7 |
| Dollars | − 8.8 | −12.2 | − 9.0 | 7.6 | 58.9 |
| Deutsche Mark | − 5.4 | − 7.0 | 2.1 | 2.8 | 16.7 |
| Swiss francs | − 1.1 | − 2.9 | − 0.5 | − 0.1 | 3.6 |
| Yen | − | − 0.8 | 1.2 | 0.5 | 2.9 |
| Pounds sterling | − 1.1 | − 0.6 | − 0.1 | − | 0.5 |
| French francs | − 0.8 | − 1.4 | − 0.1 | 0.1 | 0.4 |
| Other currencies[2] | − 0.7 | 0.5 | − 0.1 | − 0.4 | 2.7 |
| 2. Deposits with certain offshore branches of US banks[3] | − 0.7 | − 1.7 | − | 1.6 | 4.9 |
| Total 1+2 | −20.0 | −29.6 | − 7.8 | 13.1 | 102.8 |
| *of which: in dollars* | *− 9.3* | *−13.9* | *− 8.9* | *9.0* | *63.2* |
| *in other currencies* | *−10.7* | *−15.7* | *1.1* | *4.1* | *39.6* |
| *Memorandum items:* | | | | | |
| *Reported US liabilities to foreign official institutions (excluding dollars swapped against ECUs)* | *4.8* | *2.8* | *6.5* | *4.8* | *168.4* |
| *Total OPEC[4] deposits with reporting banks[5] outside the United States* | *− 0.9* | *−27.4* | *−17.1* | *− 3.8* | *120.3* |

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. Flows for 1984 and amounts outstanding at end-1984 also include the figures for Finland, Norway and Spain. [2] Includes ECUs. [3] In the Bahamas, the Cayman Islands, Panama, Hong Kong and Singapore. [4] Flows for 1984 and amounts outstanding at end-1984 exclude the figures for Bahrain. [5] Up to end-1983, in the case of flows, comprises banks of countries listed in footnote 1 plus US banks' offshore branches in the centres listed in footnote 3. Flows for 1984 and amounts outstanding at end-1984 include, in addition, figures for Finland, Norway and Spain and data for all banks in the Bahamas, the Cayman Islands, Hong Kong, Singapore, all offshore units in Bahrain and all offshore banks operating in the Netherlands Antilles.

There were essentially three reasons for these developments. Firstly, non-OPEC developing countries, out of yield considerations, appear to have invested a major proportion of their 1984 exchange reserve gains in the Euro-market. Secondly, there was a substantial increase in Deutsche Mark reserves held by certain member countries of the European Monetary System. These increases were the product of intra-marginal interventions made by these countries in the framework of the EMS fixed exchange rate mechanism in order to moderate the strength of their currencies against the Deutsche Mark (see page 151). Thirdly, there was a sizable build-up of yen deposits, mainly with banks in Japan, which was probably related to the recent Japanese liberalisation measures.

It therefore appears that, whereas in 1981–82 and the first half of 1983 official placements of foreign exchange reserves had contributed to the recovery of the US dollar from its depressed level, since mid-1983 the build-up of official reserves with banks outside the United States, notably in currencies other than the dollar, has been a factor tending to moderate the strength of the dollar.

# VIII. ACTIVITIES OF THE BANK.

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

During the past year the Bank has continued to play its traditional rôle in fostering international monetary co-operation.

The Bank participated as an observer both in the work of the Interim Committee of the Board of Governors of the International Monetary Fund on the International Monetary System and 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.

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. It has also continued to provide the Secretariat for various groups of experts.

The Euro-currency Standing Committee 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 assembled, surveyed and distributed statistical data on international banking developments. Moreover, the coverage of these data was considerably enlarged. Nine more countries — Bahrain, the Bahamas, the Cayman Islands, Finland, Hong Kong, the Netherlands Antilles, Norway, Singapore and Spain — began to report quarterly statistics on their banks' external operations. The scope of the quarterly data on international banking was also broadened to include more detailed information than before on interbank transactions. In addition, a number of countries which report semi-annual data on the maturity profile of their banks' external assets enlarged the coverage of their data to include the business of their domestic banks on a worldwide consolidated basis.

The Committee on Banking Regulations and Supervisory Practices, in addition to its regular exchanges of information on supervisory developments in member countries, continued to pay particular attention in 1984 to the capital adequacy of international banks. This work has three principal elements: the construction of a framework of measurement designed to facilitate broad comparisons of capital adequacy standards among different international banks; the monitoring of

international efforts to strengthen banks' capital positions and their provisions against risk; and consideration of new developments and techniques in the field of off-balance-sheet business and their appropriate treatment in assessing capital adequacy.

The member central banks of the Group of Computer Experts further developed their studies in the year under review, focusing their attention on the following three main topics: telecommunication networks in the banking field, the technologies they employ and the issues they raise, in particular concerning security and reliability; the introduction of distributed data processing into all areas of the central banks' activities and the many implications of this phenomenon; and the means available to the technical services within the central banks to complete the necessary adjustments.

The central-bank representatives meeting within the Group of Experts on Payment Systems completed the revision of the book on "Payment Systems in Eleven Developed Countries". They also continued their regular exchanges of information on current developments in their respective countries and devoted a considerable proportion of their work to analysing the risks arising from the increasing speed of interbank transmissions.

Under the guidance of the Group of Experts on Monetary and Economic Data Bank Questions further progress was achieved towards establishing a fully-fledged data-bank service to meet the needs of the central banks of the Group of Ten countries and the BIS. In particular, the Group has nearly reached the goals set for the reporting of the macro-economic data blocks, via telecommunication links with the BIS Computer Centre, and continuing advances are being made in the automated transmission of international banking statistics and in their integration into internal processing systems already operational at the BIS. As a consequence of these developments, questions of particular interest to users, for instance those relating to data-access techniques, are now moving into the foreground, and the Group of Experts will give increasing attention to these questions at its future meetings.

The Committee of Governors of the Central Banks of the Member States of the European Economic Community and the Board of Governors of the European Monetary Co-operation Fund as well as their sub-committees and groups of experts continued to meet in Basle. 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 1984, the level and the significance of inflation-adjusted interest rates in EEC member countries.

In the financial year 1984–85 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. This included, in particular:

- ensuring that the arrangements governing the system were properly applied;
- strengthening the co-ordination of 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 studied a number of proposals aimed at strengthening the EMS by improving the conditions governing the use and holding of the official ECU. On 12th March 1985 agreement in principle was reached on the following measures:

- the rate of interest on positions in ECUs and on claims under the very short-term financing facility will be improved, since it will be calculated not on the basis of the official discount rates of the EEC member countries as hitherto but on the basis of their money-market rates;
- the central banks will be entitled, through the intermediary of the European Monetary Co-operation Fund, to mobilise their net creditor positions in ECUs and also part of their initial ECU allocations to meet a need for intervention currencies;
- the usability of the official ECU in intra-Community settlements will be improved;
- the circle of users of the official ECU may be enlarged to include the central banks of countries with particularly close ties with the EEC and international monetary institutions such as the Bank for International Settlements. These institutions will be entitled to hold official ECUs as "other holders".

The amendment of the legal texts necessary for the implementation of this set of measures is in progress.

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.*

These functions, on the one hand, are connected with the operation of the EMS and, on the other, relate 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.

During the period from 1st April 1984 to 31st March 1985 the volume of interventions carried out by EMS central banks in other member countries' currencies and reported to the Agent was only marginal. The volume of ECUs issued by the Fund through swap operations with each of the EEC central banks

* For a description of the structure and functions of the Fund, see the Fifty-fourth Annual Report, pages 162–164.

(except that of Greece, which does not yet participate in the EMS) amounted to ECU 52 billion at 31st March 1985; this corresponded to approximately US$ 38 billion at the rate of exchange prevailing at that date. The gross amount of transfers of ECUs between the EEC central banks' "ECU reserves" accounts and of interest paid in respect of these central banks' net positions in ECUs totalled some ECU 4 billion.

As regards the administration of Community borrowing and lending operations, during the period under review the Agent of 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. It also carried out the financial transactions connected with the repayment of the second tranche (US$ 300 million at 7.75 per cent.) of a US$ 500 million loan. With this repayment, made by Italy on 1st June 1984, the loans placed by the European Economic Community in 1976 and 1977 under the terms of Regulation (EEC) No. 397/75 for an initial total of US$1.6 billion and DM 0.5 billion were redeemed in full.

The total of outstanding loans placed by the EEC in July and August 1983 on behalf of the Republic of France under the terms of Regulation (EEC) No. 682/81 remained unchanged. On 31st March 1985 it stood at ECU 150 million and US$ 3,390 million. (For a description of these loans, see the Fifty-fourth Annual Report, pages 164–165.)

## 2. Operations of the Banking Department.

The Balance Sheet of the Bank and the Profit and Loss Account at 31st March 1985, certified by the auditors, are reproduced at the end of this Report; both are expressed in gold francs.*

| | |
|---|---|
| At the end of the financial year 1984–85, on 31st March 1985, the balance-sheet total amounted to | GF 22,851,917,382 |
| At 31st March 1984 it had stood at | GF 21,276,333,080 |
| The increase, corresponding to | GF 1,575,584,302 |

or 7 per cent., was thus greater than that recorded at the close of the previous financial year. It would have been greater still but for a gradual general depreciation in the gold franc value of currencies other than the US dollar in the course of the year, interrupted only in August 1984 and March 1985 by a slight appreciation.

The monthly fluctuations in resources were very uneven, ranging from a decline of 4 per cent. to an increase of more than 6 per cent.

At the end of July 1984 the balance-sheet total stood at just over 23 billion gold francs, which was the highest level reached in the financial year under review.

---

* 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 table shows that the growth of the Balance Sheet has been fairly constant since 1982.

**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 |
| 1981 | 19,726 | – 4,683 | – *19* |
| 1982 | 19,057 | – 669 | – *3* |
| 1983 | 20,358 | + 1,301 | + *7* |
| 1984 | 21,276 | + 918 | + *5* |
| 1985 | 22,852 | + 1,576 | + *7* |

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 1 above;

(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 1,164 million gold francs, which represented a reduction over the year of 68 million. It had stood at 1,641 million gold francs on 31st March 1983 and 1,232 million on 31st March 1984.

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 | | | |
| 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 |
| 1985 | 1,143 | 21,323 | 386 | 22,852 |

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 1984–85 GF 499,552,793

This compares with 477.6 million gold francs on 31st March 1984; the difference of 22 million represents the amount it is proposed to allocate 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 1984–85 GF 296,330,236

This compares with 263.3 million gold francs on 31st March 1984. It has been recommended that an amount of 33 million gold francs be transferred to this Fund, also from the net profit.

The total of the Bank's reserves, after allocation of the net profit for 1984–85, is thus raised to GF 847,483,397
from 792.5 million gold francs at the beginning of the financial year. The overall increase of 55 million represents the largest amount so far appropriated to the reserves at the end of a financial year.

(c) The item "Miscellaneous" stood at GF 373,006,144

against 366.2 million gold francs on 31st March 1984, showing a small rise of 6.8 million.

(d) Profit and Loss Account, *before* allocation GF 68,366,633

This figure represents the net profit for the financial year 1984–85.

Details of the proposed allocation of the net profit, in accordance with the provisions of Article 51 of the Statutes, are given in Section 3 below. A sum of 13,366,633 gold francs, compared with 16,492,877 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 1985; it appears on the liabilities side of the Balance Sheet. The amount of the dividend in Swiss francs is unchanged compared with the previous financial year.

## B. Borrowed funds.

The following tables show the *origin*, *nature* and *term* of the Bank's borrowed resources.

**BIS: Borrowed funds, by origin.**

| Origin | Financial years ended 31st March | | Movement |
|---|---|---|---|
| | 1984 | 1985 | |
| | in millions of gold francs | | |
| Deposits of central banks | 19,178 | 21,104 | + 1,926 |
| Deposits of other depositors | 627 | 219 | − 408 |
| Total | 19,805 | 21,323 | + 1,518 |

The increase in total resources was entirely attributable to the new funds received from central banks. Deposits of other depositors declined appreciably, particularly those received from various international organisations; funds borrowed on the market make up only a very small proportion of this item.

As regards the currency composition of resources, there was a substantial increase during the financial year in funds received in Deutsche Mark. Deposits in gold rose slightly.

At the end of the financial year deposits from central banks accounted for 99 per cent. of total resources, compared with 96.8 per cent. at 31st March 1984.

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

| Term | Deposits in gold | | | Deposits in currencies | | | Total | | |
|---|---|---|---|---|---|---|---|---|---|
| | Financial years ended 31st March | | Movement | Financial years ended 31st March | | Movement | Financial years ended 31st March | | Movement |
| | 1984 | 1985 | | 1984 | 1985 | | 1984 | 1985 | |
| | in millions of gold francs | | | | | | | | |
| Sight | 4,225 | 4,314 | + 89 | 346 | 312 | − 34 | 4,571 | 4,626 | + 55 |
| Not exceeding 3 months | 141 | 78 | − 63 | 13,679 | 15,238 | +1,559 | 13,820 | 15,316 | +1,496 |
| Over 3 months | − | − | − | 1,414 | 1,381 | − 33 | 1,414 | 1,381 | − 33 |
| Total | 4,366 | 4,392 | + 26 | 15,439 | 16,931 | +1,492 | 19,805 | 21,323 | +1,518 |

The slight increase in sight funds was due to the rise in deposits in gold.

The increase in longer-term deposits, in particular those with not more than three months to maturity, broadly corresponds to the expansion in total resources. Funds with a term to maturity of over three months declined slightly.

As a result of these fluctuations, the share of deposits in gold in total resources came to 20.6 per cent. and that of deposits in currencies to 79.4 per cent. At 31st March 1984 the corresponding figures were 22 and 78 per cent. respectively.

The proportion of sight deposits in the total was 21.7 per cent., compared with 23.1 per cent. a year earlier, and that of time deposits 78.3 per cent., against 76.9 per cent.

(a) Deposits in gold GF 4,391,845,185

This compares with a figure of 4,366 million gold francs at the end of the financial year 1983–84, the rise of 26 million representing a net receipt of gold.

(b) Deposits in currencies GF 16,930,512,898

This item increased by 1,492 million gold francs, or 9.7 per cent. The movement was attributable to the increase in funds with a term to maturity of not more than three months. Sight deposits and funds with a residual term to maturity of over three months declined slightly.

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 1984 | | 1985 | | Movement | |
|---|---|---|---|---|---|---|
| | in millions of gold francs | | | | | |
| Sight assets | | | | | | |
| Gold | 5,049 | | 5,021 | | − 28 | |
| Currencies | 11 | 5,060 | 5 | 5,026 | − 6 | − 34 |
| Treasury bills | | | | | | |
| Currencies | | 757 | | 453 | | − 304 |
| Time deposits and advances | | | | | | |
| Gold | 19 | | 77 | | + 58 | |
| Currencies | 13,513 | 13,532 | 14,594 | 14,671 | + 1,081 | + 1,139 |
| Securities at term | | | | | | |
| Currencies | | 1,909 | | 2,685 | | + 776 |
| Total | | | | | | |
| Gold | 5,068 | | 5,098 | | + 30 | |
| Currencies | 16,190 | 21,258 | 17,737 | 22,835 | + 1,547 | + 1,577 |

(a) Gold GF 5,021,369,537

This compares with a figure of 5,049 million gold francs at 31st March 1984.

The decline of 28 million was due to an increase in investments made on the market, the gold utilised having been only partly offset by net new deposits from central banks.

(b) Cash on hand and on sight account with banks GF 5,197,514

On 31st March 1984 this item had shown a balance of 10.9 million gold francs.

(c) Treasury bills GF 452,493,140

This portfolio had amounted to 757 million gold francs at the end of the previous financial year. The decline reflects a net reduction in the total of Treasury bills purchased on various markets, above all in the United States.

(d) Time deposits and advances GF 14,671,193,327

This compares with a figure of 13,532 million gold francs at the end of the previous financial year, giving an increase of 1,139 million.

The increase was in line with that in resources. It comprised, in particular, a sharp rise in investments in Deutsche Mark on the market.

Also included are the amounts drawn by the International Monetary Fund on a facility of SDR 2,505 million granted to it by the Bank in 1984, as mentioned in last year's Annual Report.

(e) Securities at term GF 2,685,157,948

This represents a rise of 776 million gold francs over the figure of 1,909 million recorded at 31st March 1984.

These holdings were gradually built up during the first six months of the financial year, stabilising subsequently at a record level.

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 | | Movement |
|---|---|---|---|
| | 1984 | 1985 | |
| | in millions of gold francs | | |
| Not exceeding 3 months | 12,521 | 14,077 | +1,556 |
| Over 3 months | 2,920 | 3,279 | + 359 |
| Total | 15,441 | 17,356 | +1,915 |

During the financial year under review the rise in the total of investments with a term to maturity not exceeding three months matched that in resources received with the same term to maturity.

Investments with a longer term to maturity increased, whereas at the end of the preceding two financial years a reduction had been recorded in this item.

Operations at not more than three months represented 81.1 per cent. of total investments at the end of the financial year, and those at longer term 18.9 per cent. These percentages are identical with those recorded at the end of the previous financial year.

(f) Miscellaneous GF 16,505,915

This compares with 17.8 million gold francs on 31st March 1984.

Forward gold operations.

These operations, which are mentioned in Note 2 to the Balance Sheet, resulted in a negative balance of GF 44,328,840 compared with a negative balance of 40.3 million at the end of the previous financial year.

The amount of gold payable forward increased slightly as a result of the adjustment of weights of gold connected with outstanding swaps of gold (received spot) against currencies.

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

The accounts for the fifty-fifth financial year ended 31st March 1985 show a net operating surplus of 71,206,434 gold francs, compared with 67,934,268 gold francs for the preceding financial year. The principal factor underlying the improved financial result for the year under review was the increased volume of the Bank's funds available for investment against a background of interest rate levels broadly comparable to those obtaining in 1983–84.

The net operating surplus is shown after deduction of 14,140,343 gold francs in respect of costs of administration, the decrease from the previous year's figure of 15,354,329 gold francs reflecting the continued 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.

The Board of Directors has decided to transfer 2,839,801 gold francs to the Provision for Exceptional Costs of Administration. As a result of this transfer the net profit amounts to 68,366,633 gold francs, against 67,492,877 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 68,366,633 gold francs be applied by the General Meeting in the following manner:

(i) an amount of 13,366,633 gold francs in payment of a dividend of 145 Swiss francs per share;

(ii) an amount of 22,000,000 gold francs to be transferred to the General Reserve Fund; and

(iii) an amount of 33,000,000 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 1985 to the shareholders whose names are contained in the Bank's share register on 20th June 1985.

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 1985 and of its profit for the year ended on that date. Messrs. Price Waterhouse & Co.'s report is appended at the foot of the Balance Sheet.

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

During the financial year 1984–85 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 1985 to 823,000 gold francs — came to the equivalent of about 66,000 gold francs in respect of redemption and interest; by the end of the financial year the principal amount due had thus been reduced to the equivalent of approximately 62,000 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 the Fiftieth Annual Report, pages 168–169.

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

At the meeting of the Board held on 18th June 1984 the Chairman, Dr. Fritz Leutwiler, announced that following his decision to resign from his office as Chairman of the Governing Board of the Swiss National Bank at the end of December 1984 he was tendering his resignation as Chairman of the Board of Directors and President of the Bank for International Settlements as from the same date. Dr. Leutwiler had held these two positions since 1st January 1982.

At the next meeting of the Board, held on 10th July 1984, Prof. Paolo Baffi, as the most senior member, expressed the Board's most sincere gratitude for the outstanding services that Dr. Leutwiler had rendered to the Bank. The Board then elected, under Article 38 of the Statutes, M. Jean Godeaux, Governor of the National Bank of Belgium, as Chairman of the Board of Directors and President of the BIS for a period of three years as from 1st January 1985.

At the same meeting the Chairman announced that M. Gabriel Lefort would shortly relinquish his appointment as Alternate to M. Renaud de la Genière. The Chairman expressed the Bank's appreciation of M. Lefort's valuable services.

At the meeting of the Board held on 11th September 1984 Prof. Baffi, whose mandate as a member of the Board was due to expire on 7th November 1984, was re-appointed under Article 27(2) of the Statutes by Dr. Carlo Azeglio Ciampi, Governor of the Bank of Italy, for a further period of three years ending on 7th November 1987.

Also at that meeting the Chairman informed the Board that M. de la Genière had appointed M. Francis Cappanera to act as his Alternate in the absence of M. Jacques Waitzenegger, the successor to M. Lefort.

In November 1984 M. Michel Camdessus succeeded M. de la Genière as Governor of the Bank of France and became an ex officio member of the Board in his place. At the meeting of the Board held on 11th December 1984 the Chairman expressed the Board's appreciation of M. de la Genière's outstanding services during his term of office of five years.

It was also at the December meeting that M. Pierre Languetin, who had been appointed to succeed Dr. Leutwiler as Chairman of the Governing Board of the Swiss National Bank, was elected under Article 27(3) of the Statutes to be a member of the Board for the unexpired period of Dr. Leutwiler's term of office, namely until 31st March 1986.

In addition, Dr. Johann Schöllhorn, whose mandate as a member of the Board was due to expire on 31st December 1984, was re-appointed under Article 27(2) of the Statutes by Herr Karl-Otto Pöhl, President of the Deutsche Bundesbank, for a further period of three years ending on 31st December 1987.

Finally, the Chairman also informed the Board that Dr. Ciampi had appointed Dr. Rainer Masera, in place of Dr. Giovanni Magnifico, to act as his Alternate in the absence of Dr. Lamberto Dini. The Chairman expressed the Bank's appreciation of Dr. Magnifico's valuable services.

In February 1985 Baron de Strycker, whose mandate as a member of the Board was due to expire on 28th February, was re-appointed under Article 27(2) of the Statutes by M. Godeaux for a further period of three years ending on 29th February 1988.

Dr. W.F. Duisenberg, whose mandate as a member of the Board was due to expire on 31st March 1985, was re-elected under Article 27(3) of the Statutes at the meeting of the Board held on 12th March 1985 for a further period of three years ending on 31st March 1988.

Dr. Günther Schleiminger, who had been General Manager of the Bank since 1st March 1981, retired on 30th April 1985. At the meeting of the Board held on 15th April 1985 the Chairman expressed to Dr. Schleiminger the profound gratitude of all members of the Board for the way in which he had discharged all his responsibilities and their sincere appreciation of the eminent qualities that he had shown in carrying out his duties.

In accordance with the formal appointment made by the Board at its meeting held on 13th November 1984, Dr. Schleiminger was succeeded as General Manager on 1st May 1985 by M. Alexandre Lamfalussy, who had been the Bank's Assistant General Manager since 1st March 1981. Likewise, and also as from 1st May 1985, Mr. R.T.P. Hall, who had been Head of the Banking Department since 1st January 1974, took over as Assistant General Manager, M. Rémi Gros, who had been a Manager since 1st April 1981, became Head of the Banking Department, and Dr. Horst Bockelmann was appointed Economic Adviser and Head of the Monetary and Economic Department.

* * *

The Bank learned with deep regret of the death of Dr. Donato Menichella on 23rd July 1984, of Mr. M.J. Babington Smith on 26th October 1984, and of M. Olivier Wormser on 16th April 1985. Dr. Menichella had been a member of the Board from August 1948 until December 1974. For the first twelve years, as Governor of the Bank of Italy, he had been a Director ex officio; for the last fourteen he had been a Director under Article 27(2) of the Statutes. Mr. Babington Smith had been a member of the Board under Article 27(2) of the Statutes from April 1965 until February 1974. M. Wormser, as Governor of the Bank of France, had been a Director ex officio from April 1969 until June 1974.

# CONCLUSION.

The major policy objective for the western industrial countries as a group is clear enough: to keep up the momentum of their recovery. This is the prerequisite for solving almost all other problems, both within their own economies and in the world economy at large. The principal qualifications to be attached to this objective are perhaps not very controversial either. In current circumstances, achieving sustainable growth means carefully watching two problem areas. On the one hand, no policies should be embarked upon which could rekindle inflation; or, to put it more positively, policies should aim at a further improvement in inflation performance. On the other hand, it must be recognised that sustainable growth cannot be based on an unsustainable pattern of external payments and exchange rates; or, again to put it more positively, measures will have to be taken to secure a smooth unwinding of the US external imbalance. These two preconditions for sustainable growth are not easy to meet. No wonder, then, that disagreement arises as soon as it comes to making specific proposals as to which countries should embark on what policy courses in order to realise the commonly agreed primary policy goal.

One such major point of disagreement concerns the contribution that the United States itself could make to the orderly adjustment of its external position, in particular by policy measures that would steer the dollar gradually downwards to a more appropriate level. Setting aside the possible rôle of exchange-market intervention, which is discussed below, the controversy centres on two analytical issues. Do the interest rate differentials in favour of the dollar bear a major responsibility for the appreciation and the high level of the US currency? Is the level of US interest rates to be linked to the US policy mix, i.e. the combination of a rising "structural" budget deficit and a non-accommodating monetary policy?

This Report answers both questions in the affirmative. At the same time, it recognises that the value of the dollar may well have been influenced by much improved confidence in the future of the US economy, by doubts about economic or political prospects in other parts of the world and by portfolio adjustments in the wake of capital-market liberalisation in countries like Japan. Nor does it exclude the possibility that in addition to the budgetary influence other domestic factors — such as large-scale tax deductibility of interest costs, higher prospective profit rates, and perhaps persistent inflationary expectations — may also have played a rôle in underpinning the US interest rate level. Allowing for these possibilities should not, however, be taken to be incompatible with the main argument. It is a question of emphasis, not of mutually exclusive explanations.

There are two main reasons for assigning great weight to the interest rate differential in explaining the strength of the dollar. One is the a priori acceptance of an evident economic proposition, namely that the return on an asset has an influence on the demand for it — in particular when market participants consider the quality

of the asset as good as, or even better than, that of alternative investments. The other reason is the statistical evidence. US balance-of-payments statistics reveal the predominant share of banking and other highly interest-sensitive financial flows in US capital imports. They lend little support to the view that capital has been moving to the United States primarily because it was attracted by the higher rate of corporate profitability: identified net direct or equity investment has not played a large rôle in capital inflows into the United States. Nor do statistics on corporate earnings suggest that profit rates in the United States have in general increased much faster, or have become much higher, than in some other major industrial countries.

This, of course, does not mean that one should expect to find a close and invariable correlation between the level of, or the rate of change in, the value of the dollar on the one hand and the level of, or the change in, interest rate differentials on the other. There may be times when expectations of future exchange rate developments become a self-propelling force, detached from underlying realities — even from interest rate levels or changes. This is most likely to happen after a long period of exchange rate appreciation or depreciation. History is full of examples of asset prices assuming a life of their own, that is, moving up or down to levels unwarranted by fundamentals, usually after a sustained rise or decline in response to a fully justified revision of prospective yield assessments. Such a speculative "bubble" appears to have developed during the winter months of 1984–85, when the dollar continued its upward course even though there was a narrowing of (in particular) the short-term interest rate differential against the Deutsche Mark. However, despite this narrowing, the differential *has* remained significant — and even quite large at the long end of the market — as a result of which the dollar exchange rate has continued to enjoy strong support from this source.

There are also several reasons for attaching great weight to the rôle of US fiscal policy in keeping long-term US interest rates high. One is that while the monetary component of the US policy mix has — for good reason — sought to be non-accommodating towards overall credit demand, and with it the public sector's borrowing requirement, it can hardly be considered in practice to have been markedly restrictive. The trend rates of growth of the various monetary aggregates have not been so very low; and (nominal) short-term interest rates have now declined to where they were in the summer of 1978. On the other hand, the non-cyclical or "structural" element of the US fiscal deficit has been growing over the last three years at a very fast pace, so much so that its expansion has more than offset the large natural decline of the cyclical element. And this has happened at a time when credit demand from the private sector has strengthened without a corresponding increase in the rate of business and household saving, with the result that the growth in the fiscal deficit has been almost identical to the increase in the external current-account deficit, i.e. in net capital inflows. Moreover — and this is perhaps the most decisive argument — unless there are radical changes in either the spending programme or taxation, or both, the "structural" component of the US fiscal deficit is not only there to stay but is bound to increase during the years ahead. And, as net US interest payments abroad inexorably rise, the spectre of a structural balance-of-payments deficit raises its head. These expectational elements in

themselves may well explain why long-term interest rates remain so obstinately high, despite the impressive current inflation performance.

It is this line of argument that leads to the conclusion that the smooth unwinding of the US external imbalance requires first and foremost a major shift in US fiscal policy, namely a set of measures to secure the gradual return of the US budget to structural balance. An immediate, drastic cut in the deficit is obviously not feasible. Nor is it desirable, since it could well push the US economy towards a premature slowdown. What is needed is an immediate, credible agreement between the Administration and Congress on incisive deficit-cutting measures which should contain a significant first instalment, but whose effects would be spread out over time. With financial markets more and more dominated by expectations, particularly in the United States, it is not unreasonable to hope that the interest-rate-lowering effects of announcing such an agreement, especially at the long end of the market, would in the short run outweigh the potentially dampening impact of deficit cuts on business activity. One could also hope, for the longer run, that the likelihood of a soft-landing scenario would materially increase. Such a scenario would imply a moderate slowdown in US growth, a significant further decline in US interest rates and in the external value of the dollar, and a substitution of foreign demand for domestic expenditure.

But what about the contribution of the rest of the industrial world to sustainable growth? This is a second area in which opinions are far from unanimous, although some convergence of ideas can perhaps be noted.

To begin with, there is not much disagreement about the analytical starting-point. For the global growth performance of the industrial countries to remain around a durable 3 to 3½ per cent. (compared with the exceptional and unsustainable pace of 5 per cent. achieved in 1984), a soft landing of the US economy would require as a counterpart some acceleration in the rate of growth of domestic spending of other industrial countries as a group. Without such an acceleration, a declining US current-account deficit — let alone a return to equilibrium — would necessarily be accompanied by a weakening not only of US growth but also of growth in other industrial nations. To turn the potential expansion of US exports into an actual expansion, there must somewhere in the world be increased demand for US exports.

To help achieve this, there seems to be general agreement on the need to contain, perhaps even to roll back, trade protectionism throughout the industrial world. This is a worthwhile policy objective in any circumstances, but its attainment could become vital in the present situation in which sustainable growth has also come to depend on bringing about major changes in the pattern of international trade. How could such changes take place if the shifts in international trade flows that should result from helpful exchange rate movements were in fact hindered by administrative or de facto obstacles to imports? Or to put it more bluntly: how could the US current account move towards reasonable balance without putting a fatal brake on world trade if, as a prime example, the Japanese current-account surplus cannot be brought down through substantially increased imports into Japan? And could this be achieved simply by the depreciation of the dollar against the yen?

Finally, a fair degree of convergence of views can also be observed on the need for western Europe to remove, or to continue to remove, the fiscal disincentives, legal obstacles and government and administrative interference of all kinds that hamper a full resurgence of investment activity, even in an environment which in terms of profit rates has become much more propitious to capital formation.

There is, however, serious disagreement as to whether three large countries — Japan, Germany and the United Kingdom — whose "structural" public-sector deficit has reached low or possibly even zero figures should embark upon a policy of fiscal stimulus. The suggestion has been made that, given these countries' success in bringing both the public-sector deficit and the inflation rate (the latter especially in Germany and Japan) under control, an early tax reduction would be quite compatible with internal balance and would also be desirable in directly stimulating domestic spending and import demand. The governments of all three countries have so far refused to follow such a policy course. The arguments supporting their refusal can be summarised under four headings.

Firstly, doubts are voiced about the concept of cyclical unemployment when the authorities are convinced that unemployment is to a large extent a structural matter, stemming from swollen public sectors, high real wages and market rigidities. What meaning can one attach, in these circumstances, to full-employment fiscal balance? Secondly, the point is made that once a deficit is re-created or increased — even exclusively through tax cuts — the chances of bringing it back under control, should this later appear necessary, are remote. The political process is such that the speed and ease with which budgetary policy is conducted are necessarily asymmetrical. Reducing a deficit is always a slower and more painful, and therefore a more dubious, undertaking than increasing it. Those policy practitioners who insist on this point cite almost universal historical experience, including the most recent confirmation of their fears: the difficulties encountered by the United States itself in trying to cut the deficit. Thirdly, it is said that market participants are very much aware of this asymmetry. Therefore, they will be inclined to believe that any deliberate deficit-creating policy will ultimately have inflationary consequences, mainly because sooner or later it will have to be financed through an accommodating monetary policy.

The fourth argument takes up the external constraint, and is supported by the historical experience of a number of countries, more recently that of France in 1981–82 and that of Germany in 1979–80. A deliberate fiscal move towards accelerating domestic expansion leads to a deterioration in the current account and is quite likely to put the country's currency under pressure. It is, of course, recognised that the shift in the current account is one of the objectives to be pursued. The argument invoking the external constraint, however, goes beyond this. It considers that it is highly improbable that countervailing, spontaneous capital flows will offset the pressure exerted on the exchange rate by the deteriorating current account — hence the fear concerning currency depreciation. By the same token, the absence, or the weakness, of spontaneous inflows may also mean that the upward pressure on domestic interest rates resulting from the increased fiscal deficit will not be tempered by foreign financing. The incentive for an expansion of business investment will therefore be weakened. In other words, the current US

experience is simply not "exportable"; no government outside the United States could safely base a stimulatory fiscal policy on the assumption that it will attract spontaneous external financing on a durable basis. This is another example, geographical this time, of a major policy asymmetry.

These are weighty arguments indeed, demonstrating the difficulties inherent in all attempts at worldwide policy co-ordination. But their acceptance need not lead to unqualified gloom about the prospects for the world economy. International fine-tuning is as risky, and therefore as liable to become counter-productive, as domestic fine-tuning. The time path and the intensity of the reaction of the US economy to the sort of deficit-cutting policy advocated in this Report cannot be predicted with any precision. While the logic of the argument in favour of consistent international policies is irrefutable, to propose expansionist fiscal policies in some large countries with a view to their becoming effective in the short run, as a counterpart to a drawn-out and as yet uncertain process of budgetary consolidation in the United States, could lead to dangerous results.

This is not to say that the international dimension of domestic policies should not be taken into account, or should not even in some cases receive priority attention. These cautionary words about fine-tuning are simply intended to make the point that, just as the best time horizon for successful domestic policies is the medium or longer run — except in cases of an impending financial crisis — international policy co-ordination should also be conceived within that time horizon. In this framework, measures to reduce the structural US budget deficit over time remain a priority objective, both for domestic reasons and in the interests of a better balance of the world economy. At the same time, the best contribution by European countries to improving their growth prospects and therefore helping the world economy is to speed up, perhaps even to radicalise, their efforts towards removing structural rigidities. This process will have to entail further reductions in the weight of public-sector spending. The tax burden should be alleviated pari passu with progress in this direction, not long in advance of it.

What could be done in the monetary field or, more generally, by the monetary authorities to lend support to such medium-term policies?

First and foremost, they should continue to pursue domestic monetary policies aimed at a further deceleration of inflation rates. For those countries with floating exchange rates this means the setting of monetary targets sufficient to accommodate a sustainable pace of real growth on the assumption of a gradually declining rate of price increases. For the others, in particular for smaller members of the European Monetary System, the direct target, or at least the disciplining element, could be the exchange rate.

However, these propositions, which have by now become (almost) conventional wisdom, call for two qualifications. The first is motivated by the spreading of financial innovation and the blurring of demarcation lines between instruments and institutions. This does not make targeting easier, in terms of either definition or attainment. Trying to aim rigidly at the weekly, monthly or even quarterly attainment of a monetary target defined once and for all has become an even more unrealistic exercise than it has been in the past. It would, however, be a

mistake to throw out the baby with the bath-water. Targeting in a somewhat longer perspective, accompanied by discretionary changes in the target whenever these are made necessary by the shifting institutional or economic environment, remains a worthwhile objective. Full discretion does not — to put it mildly — help to combat uncertainty, nor can it help to defuse inflationary expectations. Rules, whether in the form of a money stock or an exchange rate target, are needed to provide some anchor for the wildly fluctuating expectations of market participants, to make monetary policy-makers accountable for their actions, including their decisions to deviate from predetermined targets, and to give them leverage in their dealings with governments and parliaments.

The further qualification relates to the hopes that can be placed in the anti-inflationary effectiveness of monetary policy. Over the last few years the Annual Report has consistently supported the view that, while monetary policy of the kind suggested here is an essential condition for achieving success in the fight against inflation, it cannot be regarded as a sufficient one. In order to minimise the risk that the decelerating rate of monetary expansion will exert pressure on real growth rather than on prices, price and wage formation must be made symmetrically more flexible and adaptable. One approach could be remuneration arrangements dependent in part, at least, on the changing profitability of the individual firm, somewhat along the lines of the bonus and overtime provisions applying in Japan, where fluctuations in labour income have gone hand in hand with relative job security. These arrangements have perhaps had something to do with the fact that Japan has been more successful than other industrial nations in securing both a high degree of employment and virtual price stability. Only such a major departure from current practice could make it possible for labour to be priced into the market and for unemployment to be gradually swept away. The relatively good news on the inflation front should not distract attention from the great need for far-reaching changes in the way prices and wages are set.

A second responsibility of the monetary authorities, which in some countries would have to be exercised in co-operation with other government agencies, is the preservation of the stability of their financial systems. Monetary targeting, if applied with pragmatism, can in itself go some way towards bringing this objective closer, precisely by adding a measure of stability to the macro-economic framework and by combating inflationary imbalances, which are one of the main sources of financial instability. Monetary authorities would also be expected to provide the markets with liquidity support, as they have always done in the past, in periods of financial stress. But current circumstances call for some further action, too. Firstly, the complex process of innovation, despecialisation and deregulation must be kept firmly under control, so as to ensure that it proceeds in an orderly and balanced way without suddenly exposing whole categories of financial intermediary to disruptive pressure. A second requirement is to maintain, or to re-establish, the transparency of markets and of the operations of individual institutions by improving the information available to all those concerned on the changing pattern of, and the new risks associated with, financial intermediation. The third is to adjust the supervisory framework to this highly innovative and more competitive environment. And the fourth is to co-ordinate all these efforts internationally, given the high degree of

worldwide financial integration now reached. Progress is being made in all these directions, but the task ahead should not be underestimated.

A third area in which monetary authorities can give some support to medium-term stabilisation policies is exchange-market intervention — the emphasis, however, being equally on *some* and *support*. Exchange-market intervention in itself, even when carried out on a large scale, is unlikely to have any lasting influence on the trend or the level of exchange rates. But it can be useful in two circumstances. Firstly, when it is carried out as a complement to a shift in the stance of domestic policies, in which case its announcement effect may well underpin or accelerate the exchange rate movement induced by such a shift. This is the well-known argument of the authorities "putting their money where their mouth is". Secondly, intervention can play a most salutary rôle whenever the exchange market enters a manifestly one-way speculative phase in which counter-speculation has simply ceased to function. Large-scale exchange-market intervention, if well co-ordinated internationally and, in particular, well timed, can in these exceptional circumstances forcibly remind market participants that exchange rate movements may well go in both directions. This can lead to a better balance in the operation of the market and cut off speculative peaks that otherwise could have lasted weeks and months — though probably at the cost of increasing for a time the daily volatility of exchange rates.

That being said, it has to be recognised that the ideas put forward in this Report about how to handle current problems in the exchange market, while they may appear to some to be overly optimistic in terms of their expected effectiveness, are in fact quite modest. They ultimately do no more than suggest that better balanced domestic policies could in due course steer the dollar towards a more sustainable level, while exchange-market intervention could temper some of the speculative excesses of exchange rate fluctuations. However, even if success could be achieved in these directions, this would still leave some fundamental questions unanswered. Do we have to go on living with excessive medium-term movements of real exchange rates, of which the four-year appreciation of the dollar has been but one example? Should we continue to tolerate short-term exchange rate volatility, which indeed has reached unprecedented proportions over the last few months? Are these phenomena unavoidable by-products of a financially integrated world in which exchange-market transactions have come to be dominated by expectations responding to the quick succession of new information? If not, what can be done about them? These are serious questions, on which different views exist, and to which this Report has not attempted to give an answer. It has refrained from doing so quite deliberately, on the grounds that as long as such major imbalances in the pattern of external payments and exchange rates subsist within the western industrial world, it is hard to say how much of the two phenomena mentioned above should be attributed simply to these imbalances and the policy mismatch that lies behind them, and how much is to be explained by more "systemic" causes. But events may, sooner or later, call for further consideration of these issues.

A. LAMFALUSSY
General Manager

# BALANCE SHEET AND PROFIT AND LOSS ACCOUNT

## AT 31st MARCH 1985

# BALANCE SHEET

ASSETS (Before and after

| | | | Gold francs |
|---|---|---|---|
| **Gold** | | | 5,021,369,537 |
| **Cash on hand and on sight account with banks** | | | 5,197,514 |
| **Treasury bills** | | | 452,493,140 |
| **Time deposits and advances** | | | |
| Gold | | | |
| Not exceeding 3 months | 76,952,092 | | |
| Currencies | | | |
| Not exceeding 3 months | 12,492,512,127 | | |
| Over 3 months | 2,101,729,108 | | |
| | | 14,671,193,327 | |
| **Securities at term** | | | |
| Not exceeding 3 months | 1,507,820,330 | | |
| Over 3 months | 1,177,337,618 | | |
| | | 2,685,157,948 | |
| **Miscellaneous** | | | 16,505,915 |
| **Land, buildings and equipment** | | | 1 |
| | | | 22,851,917,382 |

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 1985, gold payable against currencies on forward contracts amounted to 44,328,840 gold francs.

# AT 31st MARCH 1985

allocation of the year's Net Profit)

LIABILITIES

| | | Before allocation<br>Gold francs | After allocation<br>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 | 477,552,793 | | *499,552,793* |
| Special Dividend Reserve Fund | 21,530,055 | | *21,530,055* |
| Free Reserve Fund | 263,330,236 | | *296,330,236* |
| | | 792,483,397 | *847,483,397* |
| **Deposits** (gold) | | | |
| Central banks | | | |
| Sight | 4,287,183,741 | | |
| Not exceeding 3 months | 78,054,164 | | |
| Other depositors | | | |
| Sight | 26,607,280 | | |
| | | 4,391,845,185 | *4,391,845,185* |
| **Deposits** (currencies) | | | |
| Central banks | | | |
| Sight | 300,041,221 | | |
| Not exceeding 3 months | 15,064,953,975 | | |
| Over 3 months | 1,373,455,406 | | |
| Other depositors | | | |
| Sight | 11,325,356 | | |
| Not exceeding 3 months | 172,983,884 | | |
| Over 3 months | 7,753,056 | | |
| | | 16,930,512,898 | *16,930,512,898* |
| **Miscellaneous** | | 373,006,144 | *373,006,144* |
| **Profit and Loss Account** | | 68,366,633 | — |
| *Dividend payable on 1st July 1985* | | — | *13,366,633* |
| | | 22,851,917,382 | *22,851,917,382* |

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 1985 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, 7th May 1985

PRICE WATERHOUSE & CO.

# PROFIT AND LOSS ACCOUNT
## for the financial year ended 31st March 1985

| | | Gold francs |
|---|---|---|
| Net interest and other income | | 85,346,777 |
| Less: Costs of administration: | | |
| Board of Directors | 209,096 | |
| Management and Staff | 10,336,054 | |
| Office and other expenses | 3,595,193 | 14,140,343 |
| Net operating surplus | | 71,206,434 |
| Less: Amount transferred to Provision for Exceptional Costs of Administration | | 2,839,801 |
| Net Profit for the financial year ended 31st March 1985 | | 68,366,633 |

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 | | 13,366,633 |
| | | 55,000,000 |
| Transfer to General Reserve Fund | | 22,000,000 |
| | | 33,000,000 |
| Transfer to Free Reserve Fund | | 33,000,000 |
| | | — |

# MOVEMENTS IN THE BANK'S RESERVES
## during the financial year ended 31st March 1985

in gold francs

**I. Development of the Reserve Funds resulting from allocations for the financial year 1984–85**

| | Legal Reserve Fund | General Reserve Fund | Special Dividend Reserve Fund | Free Reserve Fund |
|---|---|---|---|---|
| Balances at 1st April 1984, after allocation of Net Profit for the financial year 1983–84 ... ... | 30,070,313 | 477,552,793 | 21,530,055 | 263,330,236 |
| Add: Allocations for the financial year 1984–85 ... | — | 22,000,000 | — | 33,000,000 |
| Balances at 31st March 1985 as per Balance Sheet | 30,070,313 | 499,552,793 | 21,530,055 | 296,330,236 |

**II. Paid-up Capital and Reserve Funds at 31st March 1985 (after allocation) were represented by:**

| | Paid-up Capital | Reserves | Total |
|---|---|---|---|
| Net assets in | | | |
| Gold ... ... ... ... .. ... ... ... ... ... ... ... ... | 295,703,125 | 366,444,479 | 662,147,604 |
| Currencies ... ... ... ... ... ... ... ... ... ... ... ... | — | 481,038,918 | 481,038,918 |
| | 295,703,125 | 847,483,397 | 1,143,186,522 |

## BOARD OF DIRECTORS

| | |
|---|---|
| Jean Godeaux, Brussels | Chairman of the Board of Directors, President of the Bank |
| Bernard Clappier, Paris | Vice-Chairman |

Prof. Paolo Baffi, Rome
Michel Camdessus, Paris
Dr. Carlo Azeglio Ciampi, Rome
Bengt Dennis, Stockholm
Dr. W.F. Duisenberg, Amsterdam
Pierre Languetin, Zurich
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. Rainer Masera, Rome
Dr. Leonhard Gleske, Frankfurt a/M.
Georges Janson, Brussels
A.D. Loehnis, London, or
M.J. Balfour, London
Jacques Waitzenegger, Paris, or
Francis Cappanera, Paris

## MANAGEMENT

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