BANK FOR INTERNATIONAL SETTLEMENTS

FIFTY-SIXTH ANNUAL REPORT

1st APRIL 1985 – 31st MARCH 1986

BASLE

9th June 1986

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FIFTY-SIXTH ANNUAL REPORT

submitted to the

ANNUAL GENERAL MEETING

of the

BANK FOR INTERNATIONAL SETTLEMENTS

held in

Basle on 9th June 1986

Ladies and Gentlemen,

I have the honour to submit herewith the fifty-sixth Annual Report of the Bank for International Settlements for the financial year which began on 1st April 1985 and ended on 31st March 1986.

The net profit for the year amounted to 80,171,806 gold francs, after transfer of 1,547,159 gold francs to the Provision for Exceptional Costs of Administration. This compares with a net profit for the preceding year of 68,366,633 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 19,171,806 gold francs in payment of a dividend of 155 Swiss francs per share.

The Board further recommends that 24,400,000 gold francs be transferred to the General Reserve Fund and the remainder of 36,600,000 gold francs to the Free Reserve Fund.

If these proposals are approved, the Bank's dividend for the financial year 1985–86 will be payable to shareholders on 1st July 1986.

I. A FAVOURABLE BALANCE.

The world economy now looks healthier on balance than it did a year ago, or indeed than it has done at any time during the last five or six years. There are, however, negative as well as positive elements in the present situation, and striking a balance between them is not just a matter of arithmetic. While there may be a broad consensus as to what belongs in either category, it is much more difficult to agree on the relative importance to be attached to what has been achieved and to the problems that still loom large. It may nonetheless be useful to begin this review of economic developments of the past year by listing the positive and negative elements, commenting on a few only. They will be dealt with at greater length in the main body of the Report.

The list of achievements, or rather — not to over-emphasise the contribution of policy — the list of *favourable developments*, is a long one:

- inflation has eased in a large number of industrial countries, in some cases to below the level traditionally considered to be indistinguishable from zero given the problems of statistical measurement (see pages 13–18);
- although output figures for 1985 compare unfavourably with those for 1984 (owing to the slowdown in the United States since the middle of 1984), a positive feature is that aggregate demand in most economies has not fallen off as traditional cyclical patterns would have suggested. Most economies seem to be in a position to continue on the — admittedly moderate — growth path they have been following for well over three years now, thus coming closer to the old ideal of prolonging upswings by avoiding overheating (pages 9–13);
- the structure of exchange rates is now clearly more in line with the needs of the various economies than it was a year ago (see especially page 151);
- the ability and the determination of the larger industrial countries to co-operate seem to have increased (pages 29–33);
- pressure in the United States for a reduction of the government deficit — for many observers the root of a number of evils besetting the world economy — has now assumed proportions which make it likely that appropriate action will somehow be taken (pages 25–26);
- the oil price has fallen in US dollar terms to less than half the level at which it had stood for a number of years, though this is still some five or six times the pre-1973 price. The sizable reduction in the cost of energy will exert a favourable influence on many — though obviously not all — economies (pages 12–13);

– nominal interest rates have come down across the board. Admittedly the fall has not in all cases exceeded that in the inflation rate, but it is significant in itself, particularly for debtor countries and with regard to government debt burdens (pages 70–73).

On the list of *non-achievements*, the problems whose severity has diminished little, if at all, are:

– the unemployment situation in most European countries (see pages 18–25);

– the debt crisis affecting a large number of developing countries (pages 108–115);

– the strains on the financial system caused by international and domestic developments (pages 81–84); and

– large current-account imbalances (pages 39–49).

This is not to say that nothing has been accomplished on any of these fronts. In most industrial countries with high *unemployment* the rising tide has been stemmed. Some countries have even achieved their first significant increase in employment for several years, although demographic factors and increases in participation rates have prevented this from being reflected in a corresponding fall in the jobless figures. There are hopes of further advances along this road. But what are the chances of unemployment being reduced to levels which have traditionally been regarded as tolerable?

Two aspects of this question are discussed at some length in this Report. The macro-economic question is whether by means of a suitable combination of policy measures, if necessary co-ordinated internationally, economic growth could be stimulated sufficiently to reduce unemployment. Put differently, are there any policy constraints or other factors which rule this out? The micro-economic question is why many labour markets are so rigid that even over a fairly long period the play of market forces fails to produce the required adjustments.

The *debt problem* has taken several new turns since the spring of 1985. The most important was the Baker initiative launched in Seoul at the beginning of October of that year. This shift in US policy was welcomed by virtually all countries. The new emphasis on "adjustment via growth" rather than on "belt-tightening" clearly holds out greater promise in the search for solutions and is more realistic as regards the true time dimension of the debt problem. A number of those debtor countries whose problems the Baker initiative addresses are already negotiating with the World Bank for structural adjustment loans, as well as implementing, or negotiating, IMF-sponsored adjustment programmes. Admittedly, no debtor country has yet formally embarked on a course of action along all the lines envisaged by the US Treasury Secretary, but delays were to be expected from the outset. For one thing, the sharp decline in oil prices necessitated a complete reappraisal of strategies in almost all debtor countries, as it led to a sudden increase or decrease in their need for funds. (Mexico is the most obvious case in point.) In addition, the new approach itself implies that certain policy changes in the debtor countries will not only form part of the conditionality which has always been an element of IMF programmes but will have to go well beyond expressions of intent. If these countries are expected to have something tangible to show in order to become eligible under the programme, it will take time even in the best of circumstances. There are already quite a number of developing countries which have shown great determination to tackle their own problems in a bolder, more fundamental way.

While the outlook has improved, the fundamentals of the debt problem have not changed much over the past year. There has been virtually no redemption of debt; whatever fell due was rescheduled, on the whole on more favourable terms. Repayment periods have been extended, interest rates have come down in line with the declining trend and spreads have been reduced in recognition of the strong adjustment efforts made by certain debtor countries. The debtor countries seem, for the most part, to have recognised the limits to which the commercial banks (and the governments in the Paris Club) might be prepared to go. The case-by-case approach has been maintained; it still appears to be in the interest of both sides, "grand solutions" being neither available nor required. The significant improvements registered in the economic situation of many debtor countries in 1984, however, were not repeated in 1985, though Brazil and Venezuela were able to maintain a large trade surplus in the face of much slower world trade growth. There was little net new lending to problem debtor countries, they were not able to re-establish their creditworthiness, and their debt ratios remained around the 1982 levels.

The *threat to the international banking system* represented by the danger of simultaneous default on a large number of international banking loans seems less acute today than it did some years ago. This is not only because of the efforts which have been made to render such default less likely, but also because the banks have been able to strengthen their capital base in relation to their lending to problem countries. In certain countries, however, some banks — particularly those with a heavy concentration on agricultural loans and on lending to finance oil exploration — have recently been facing serious problems in their domestic business. While this may cast banks in a bad light and induce investors to look for other outlets in financial markets, the problems are contained within narrow bounds and do not pose the same kind of "systemic" threat that the 1982 debt crisis did. However, a certain degree of uneasiness about developments in financial markets and in the banking industry has arisen in the wake of the recent wave of financial innovations, which originated in the United States and the United Kingdom and has lately been spreading to Japan and continental Europe. One reason for some of these innovations has been the attempt to circumvent stringent new capital requirements; to this extent the above-mentioned strengthening of the banks' capital base may be more apparent than real. Concern about this upsurge of inventiveness, however, goes beyond this and centres on the question of whether the institutions involved are themselves fully aware of the risks they are incurring and are taking them properly into account. Central banks and supervisory authorities in the major countries have made considerable efforts over the past year to come to grips with the new phenomena in order not to be found wanting should anything emerge to threaten the international financial system — from quite another quarter than country risks.

The final point listed above on the negative side — the *large current-account imbalances* — has wide implications. Imbalances in the international exchange of goods and services of the magnitude encountered in recent years are not to be taken lightly. It may appear at first that nobody suffers. The surplus countries forgo real spending by accumulating external assets, but they may welcome the stimulative effect on their economies. The deficit countries may be happy with the higher level of spending as long as they have no difficulty in financing their deficits. But this is — on both sides — a very short-sighted view. The deficit countries eventually wake up to the fact that something has to be done. Depending on the circumstances this may be something desperate, which could severely depress the level of world demand. The surplus countries may see little reason to compensate for this with stimulative action, given the time lags and uncertainties to which all these effects are subject. One of the major causes of the present current-account imbalances, the gross misalignment of exchange rates, may to a considerable extent have been corrected, but it will probably take longer to reduce the imbalances than policy-makers are willing to wait. There will be lengthy delays not only because of the notorious J-curve effects, but also because of the large savings being made by both Japan and Germany in their oil import bill. This is certainly the area on the negative side of our list where concern about mistaken policy responses is greatest.

The favourable balance which was struck in the opening paragraphs has, moreover, to be qualified in one important respect. This is not a time for taking stock of what has been safely achieved; the process which has produced this progress is still under way and there is always the danger of things getting out of control. The new structure of exchange rates has not yet brought the desired degree of exchange rate stability, and the movement in oil prices has not yet led to a new equilibrium. This qualification even applies to the improved co-operation between industrial countries, where agreement on one step by no means implies that agreement on the next will be forthcoming and irritation surfaces only too easily.

Views on matters of fiscal policy diverge widely. All countries seem to have a very firm idea about the right course for themselves, but to have sharply conflicting views as to what would be the right policy for others. The further question of what the right collective stance might be is very often not even kept conceptually separate. Countries generally base their policies on the simple maxim that "what is good for the national economy is good for the world economy", since no mechanism exists for even approximately weighing costs and benefits within a multi-dimensional policy framework. This aspect of economic co-operation is likely to be addressed in greater depth in future meetings and studies of international organisations.

It is probable, too, that the determination and the ability of major countries to co-operate will be put to the test over the question of the development of the international monetary system. The Plaza Agreement has brought about a transformation of the exchange rate structure. It did so not so much through the exchange market intervention it initiated as by convincing the markets that the authorities of all the countries concerned were quite serious in their desire for exchange rate adjustment and would not hesitate to employ all the instruments at their disposal to bring it about in a concerted manner. It has been observed that a commitment by the US authorities in this respect carries the greater weight also because their supply of dollars is unlimited whereas that of other central banks, though extensive, is nonetheless finite. This is not another form of asymmetry; all central banks can (disregarding for the moment the internal effects on bank reserves) buy foreign currencies against their own currencies without any technical constraint, the supply of their own currencies being in principle unlimited. But as it was the US dollar which was to be brought down, it was the unlimited supply of dollars which mattered in this case.

There can be no doubt that the international monetary system after the Plaza meeting and the exchange rate adjustment which it brought about is in one important respect different from the system which had existed since 1973. Whether the new situation should somehow be formalised will inevitably remain on the agenda as the major industrial countries continue their discussions on economic co-operation. It is questionable whether formal agreements (which, by their very nature, require protracted negotiations and the taking of positions on frequently trivial matters) are really what should be sought. Where co-operation is successful, it tends to develop its own momentum, and it may be best to explore further areas where opportunities for successful co-operation exist.

One such area which presents itself is that of monetary policy, where encouraging instances of concerted action can be found and where there is not the same divergence of principles as in the field of fiscal policy. The problem of co-operation in this area may be exactly the opposite. Because it is so easy to act in parallel, this might become a guiding principle for monetary policy generally to the detriment not only of overriding necessities on the domestic front but also of the adjustment of internationally incompatible policies in other fields. It hardly needs to be said that co-ordination for co-ordination's sake would be in nobody's interest; the multi-dimensional policy framework requires that monetary policy should never lose sight of its primary responsibility, which is to prevent any resurgence of inflation. At the moment, inflation fortunately seems to have been tamed in the major countries, but it cannot be discounted as a prime concern of economic policy.

The topics discussed in this Report have been arranged in a somewhat different order from that of previous Reports. Basically, three subjects will be taken up in succession: the "real" economy, the financial markets and monetary policy. Each of these subjects will be dealt with in two successive chapters, one looking at national economies, the other concentrating on the international links between them. In the conclusion an attempt will then be made to summarise the main findings of the Report using a broader brush.

II. ECONOMIC RECOVERY AND THE CHANGING POLICY MIX.

Highlights.

By and large, economic recovery continued last year in the Group of Ten countries. This development was noteworthy in view of the fact that the stimulative role of the United States had declined markedly since the middle of 1984.

Another encouraging feature was that, after several years of adjustment, profits and profitability had improved substantially by last year. This may in part explain why in several countries business investment played an important and welcome role in the growth of aggregate demand.

At the same time, inflation performance continued to improve, often in countries where inflation had proved particularly stubborn. Outside North America, currency appreciation reinforced the effect of general commodity price weakness. More recently, the steep fall in oil prices has led to further quite dramatic improvements in price performance. In many countries the rate of increase of consumer prices is now well below the trend rise in domestic costs; these gains will therefore be short-lived unless domestic costs, and wage costs in particular, respond quickly.

The oil price decline will also strengthen real demand in most oil-importing countries, thus improving not only the inflation outlook but also the prospects for a continuation of the economic recovery.

Even so, unemployment, particularly in Europe, is likely to remain high by traditional standards. It is true that some progress has been made in creating new jobs and in reducing labour market rigidities. But it is evident that this will not be enough. The root of the problem may well be that the need for restrictive policy reaction to earlier cost and price inflation, together with employers' reaction to earlier real wage excesses, have combined to leave Europe with an inadequate capital stock, a development which can only be corrected over a relatively long time span. Of itself, this latter fact already places a severe constraint on the scope for macro-economic policy to bring about a sizable reduction in European unemployment.

On the fiscal side, moreover, not only are there additional constraints imposed by the need to gain control over rising public debt burdens and to reduce excessively large government expenditures; there is also a lack of confidence in deficit spending as a macro-economic tool against the background of experience since the early 1970s. Policy-makers in some countries may also feel that, were they to attempt fiscal stimulation on their own, exchange rate weakness would be the inevitable result, in contrast to experience in the United States.

Changes in the fiscal/monetary policy configuration as between the United States and the rest of the world have moved to the centre of policy discussion in connection with the urgent need to correct the external current-account imbalances now existing in the world economy. To date, concrete efforts to rectify these imbalances in an orderly manner have been largely confined to co-ordinated exchange market intervention and some cautious easing of monetary policy.

More has to be done on the fiscal front. Few now deny that the US budget deficit must be reduced significantly and soon. It is also important that the medium-term growth strategies adopted elsewhere — strategies which emphasise structural adjustment — become more visibly effective.

Output and demand.

Following a rate of about 4¾ per cent. in 1984, output growth in the Group of Ten as a whole fell back last year to about 2¾ per cent., roughly the same as the rate recorded in 1983.

The decline in the overall growth rate was very heavily concentrated on the United States. Indeed, US growth had already slowed in the middle of 1984 and has been running on average at slightly less than 2½ per cent. per annum since then. Consequently, the year-on-year growth rate dropped sharply to some 2¼ per cent., a rate which was not only much less than that in 1984 but also more than a full percentage point below that of 1983, the first year of the upswing.

This deceleration of growth occurred despite the fact that the contribution of net exports was much less negative than it was in 1984 (see the table on page 11). Instead, the stockbuilding cycle moved into its downward phase, the total inventory swing between 1984 and 1985 amounting to some 3¾ per cent. of GNP. Private business investment growth also began to slow down.

On the other hand, public spending accelerated as the defence build-up continued. In addition, consumer spending was supported by a decline of some 2 percentage points in the personal saving ratio. New car sales in particular rose sharply in the third quarter, influenced by the introduction of temporary buying incentives. The other side of this coin, however, was a further marked rise in consumer indebtedness — something which may have been in part a reflection of "wealth effects" associated with the stock market boom.

In official quarters, and in the private sector, too, there seems to be growing optimism about US economic prospects. The budget problem is at last being tackled, and long-term interest rates are well down, as are both the dollar and the price of oil. Thus, despite the sharp slowdown in GNP growth last year, many see the United States as having moved to a mature stage of the recovery process without the usual inflationary accompaniment.

Elsewhere, and taking the year as a whole, the economic "change of gear" was not as abrupt as it was in the United States. In Japan, for example, GNP rose by more than 4½ per cent., compared with 5 per cent. in 1984. And in Europe, although there was some deceleration as compared with 1984, output growth — at 2¼ per cent. on average — was at least still above that recorded in 1983.

On the face of it this was surprisingly good news. The US upturn of 1983–84 had drawn in an enormous increase in imports from the rest of the world. This increase had, of course, also been fuelled by the loss of US competitiveness resulting from the dollar's prolonged rise. But last year the rise in US imports virtually ceased: indeed, in the first half of the year they actually declined. It is true, however, that US exports began to fall again last year, possibly as a lagged result of declining competitiveness. This may have created some opportunity for other countries to benefit from any weakening of US export market shares. Nevertheless, the real US foreign balance worsened by much less than it had done during the previous two years, suggesting a much reduced stimulus to world demand from the so-called "US locomotive".

The counterparts of these developments are to be seen most clearly in the export performances of Japan and Canada, whose trade links with the United States are particularly strong. In Japan export growth fell from around 17½ per cent. in 1984 to 6 per cent. last year, with the rate of growth still falling in the second half of the year. In Canada the deceleration was even more spectacular, from nearly 20 per cent. to 4½ per cent. last year.

So far as the demand for domestic output is concerned, it should be noted that in both Japan and Canada import growth also fell sharply, thus mitigating some of the effect of the slowdown in exports. In addition, however, domestic demand growth was an important supportive factor. In Japan private consumption continued to grow moderately, while total investment accelerated slightly owing to an upturn in residential investment following several years of decline. Private non-residential investment again grew at a fairly high underlying rate. Private investment growth in Canada — both non-residential and residential — led to an acceleration in domestic demand in 1985 that helped to offset, in part, the large turn-round in the growth contribution of net exports, which was equivalent to some 2 per cent. of GNP.

Developments in the European economies last year were less clear-cut. This is partly because the direct effects of the slowdown in the United States were, predictably, smaller and more difficult to identify in countries with weaker trade links with that economy. In addition, some special factors were at work. A fairly general one was the severe winter weather early in the year. This tended to depress output at the time, but the loss may, to some extent, have been made up later.

Another factor which worked in the same direction in the case of the largest European economy, Germany, was the behaviour of consumers. Because of uncertainties over the introduction of pollution control measures, potential car customers apparently postponed their purchases until later in the year. The fastest-growing component of domestic demand was private non-residential investment, in line with the policy intentions of the German authorities. German export performance continued to be relatively strong during the first three quarters of the year despite the US slowdown and the falling dollar. For the year as a whole the net foreign balance was a positive influence on demand growth. However, in the fourth

Changes in real GNP and contributions of its components.[1]

Countries	Years	Real GNP	Consumption		Gross fixed investment			Exports	Imports	Change in stock-building
					private					
			private	public	non-resi-dential	resi-dential	public			
		in percentages and percentage points								
United States . . .	1982	− 2.5	0.8	0.4[2]	− 0.9	− 0.7		− 0.9	0.2	− 1.5
	1983	3.4	3.0	0.2[2]	− 0.2	1.4		− 0.4	− 1.1	0.6
	1984	6.6	2.9	0.9[2]	2.1	0.6		0.7	− 2.6	2.1
	1985	2.2	2.1	1.2[2]	1.2	0.1		− 0.3	− 0.4	− 1.6
	1985 Q4	2.1	1.9	1.5[2]	0.8	0.3		− 0.5	− 0.6	− 1.2
Japan	1982	3.1	2.4	0.2	0.4	0.0	− 0.1	0.6	− 0.3	− 0.1
	1983	3.3	1.9	0.3	0.4	− 0.3	− 0.1	0.7	0.8	− 0.4
	1984	5.0	1.6	0.2	1.7	− 0.1	− 0.3	3.0	− 1.6	0.5
	1985	4.6	1.5	0.2	2.1	0.2	− 0.6	1.1	− 0.1	0.1
	1985 Q4	4.4	1.6	0.2	2.4	0.2	− 0.4	− 0.2	0.5	0.2
Germany	1982	− 1.0	− 0.8	− 0.2	− 0.5	− 0.3	− 0.3	1.0	0.0	0.1
	1983	1.5	0.7	0.1	0.5	0.3	− 0.2	− 0.1	− 0.3	0.5
	1984	3.0	0.4	0.5	0.1	0.1	− 0.0	2.6	− 1.5	0.8
	1985	2.4	0.9	0.4	0.6	− 0.7	− 0.0	2.4	− 1.4	0.1
	1985 Q4	2.4	1.4	0.4		0.0[3]		0.7	− 1.2	1.0
France	1982	1.8	2.2	0.3	0.1	− 0.2	0.2	− 0.6	− 1.6	1.4
	1983	0.7	0.6	0.2	− 0.4	0.0	− 0.1	1.0	0.2	− 0.8
	1984	1.6	0.5	0.0	− 0.2	− 0.2	0.0	1.6	− 0.6	0.5
	1985	1.2	1.3	0.0	0.0	− 0.1	0.0	0.7	− 1.2	0.4
	1985 Q4	1.8	2.0	0.1	0.1	− 0.1	0.0	0.3	− 1.0	0.4
United Kingdom .	1982	1.3	0.5	0.2	0.8	0.3	− 0.1	0.3	− 1.2	0.6
	1983	3.6	2.3	0.4	− 0.1	0.2	0.8	0.7	− 1.5	0.8
	1984	1.9	1.1	0.3	1.3	0.1	0.0	2.0	− 2.5	− 0.3
	1985	3.3	1.7	0.1	1.0	0.0	− 0.7	1.7	− 0.8	0.4
	1985 Q4	3.3	2.0	0.0	0.4	0.2	− 0.7	0.6	0.2	0.5
Italy	1982	− 0.5	0.3	0.4		− 0.9[3]		0.1	− 0.3	0.0
	1983	− 0.2	− 0.3	0.4		− 0.6[3]		0.8	0.1	− 0.7
	1984	2.8	1.2	0.4		1.0[3]		1.6	− 1.9	0.6
	1985	2.3	1.2	0.4		0.7[3]		2.1	− 2.1	0.0
	1985 Q4	2.3	1.5	0.4		− 0.4[3]		2.3	− 1.5	0.1
Canada	1982	− 4.4	− 1.2	0.1	− 1.5	− 0.9	0.1	− 0.4	3.1	− 3.3
	1983	3.3	2.0	0.1	− 2.1	0.9	− 0.1	1.6	− 2.1	2.6
	1984	5.0	2.3	0.5	0.1	− 0.2	0.3	5.1	− 3.8	0.6
	1985	4.5	3.2	0.4	0.7	0.7	0.0	1.3	− 1.9	0.4
	1985 Q4	4.9	3.9	0.3	0.9	1.3	− 0.1	0.7	− 2.6	0.9
Group of Ten countries[4] .	1982	− 0.6	0.9	0.3		− 0.8[3]		− 0.2	− 0.1	− 0.7
	1983	2.7	2.0	0.2		0.4[3]		0.3	− 0.6	0.3
	1984	4.8	1.9	0.5		1.7[3]		1.7	− 2.2	1.2
	1985	2.7	1.8	0.7		1.0[3]		0.7	− 0.8	− 0.6
	1985 Q4[5]	2.7	1.9	0.9		1.0[3]		− 0.1	− 0.6	− 0.4

[1] Figures for 1985 are still preliminary; those for 1985 Q4 refer to changes over four quarters. Components may not add to GNP growth owing to rounding and statistical discrepancies in the national accounts. [2] Including public investment. [3] Total fixed investment. [4] GNP weights and exchange rates of the previous year. [5] Seven largest countries only.

quarter there came a sudden check to exports, which fell by almost 2 per cent. compared with the third quarter. Whether this is only a temporary setback or a reflection of the appreciation of the Deutsche Mark remains to be seen.

In France and, more particularly, Italy economic policy makers were still constrained by the need to bring inflation down further, to protect the balance of payments and, in Italy, to regain control over the budget. By the end of the year, though, it was clear that France had made considerable progress in coping with its policy constraints, most notably that of inflation. Even so, in both countries output growth slowed somewhat and was propelled by the domestic rather than the external sector.

The UK economy continued its moderate but long-standing recovery last year. The figures were, however, influenced by the effects of the miners' strike in 1984, which tended to lower output somewhat in that year but which also made for some rebound when the strike ended in March 1985. On the other hand, private business investment has proved to be quite buoyant. The announcement of the gradual phasing-out of capital allowances has probably had the effect of bringing forward some planned future investments to take full advantage of the existing system before it is abolished.

Among the smaller countries, the Netherlands experienced a slight acceleration of growth last year, led particularly by business investment and private consumption. Private residential construction and public investment both fell, however, while the rate of growth of exports declined. In Belgium, where correction of the budget situation is the highest priority, the growth of domestic demand slowed down. However, with export growth slowing down by slightly less than import growth, the foreign balance provided a small positive contribution to GNP. Nevertheless, output growth in total declined from 1½ per cent. in 1984 to less than 1 per cent. last year.

The Swedish authorities were obliged in May last year to try to curb an acceleration of domestic demand growth which was resulting in a sharp surge in imports. Their efforts were concentrated on the consumer sector, for example with stricter hire-purchase terms for car sales. Even so, for the year as a whole domestic demand grew by some 4¼ per cent., including a sharp rise in stockbuilding, while the real foreign balance deteriorated by 2½ per cent. of GNP and the external current account as a whole moved into deficit.

A novel kind of oil shock. The world is currently experiencing the effects of a novel kind of oil shock, namely a sharp fall in oil prices. This fall is the more remarkable in that it has occurred at a time when the dollar itself has also been declining. For oil-importing countries other than the United States the oil price fall is even greater when expressed in terms of their own currencies.

The effects of this development — assuming that it proves to be more than temporary — will not necessarily be exactly the reverse of those of the two previous oil price shocks, however. Then, it will be recalled, the price change was carried right through to the domestic price level, thus exacerbating inflation and reducing the real purchasing power of domestic incomes. At the same time, the oil-exporting countries tended — at least temporarily — to save much of the rise in their oil revenues. The overall effect was likened by many to an increase in indirect taxation. In addition, especially during the second oil shock, governments in the industrial oil-importing countries felt that the inflationary consequences of the oil price increase had to be countered by a non-accommodating stance of macro-economic policy. The overall result was, on both occasions, recession — something which did not, however, prevent some upsurge in inflation.

This time there will clearly be a tendency towards both a further decline in inflation and a rise in real incomes. The likely reaction of policy-makers in consumer countries is, however, hard to judge. Obviously, there is no incentive to try to offset an incipient further fall in inflation per se. On the other hand, some governments might feel that there is here a relatively painless opportunity to take further their attempts to reduce fiscal imbalances over the medium term. In other words, there could be an incentive to increase taxes on oil and oil products without any aggravation of either unemployment or inflation.

Perhaps more important will be the reaction of the oil exporters. Many of the major OPEC producers still possess large portfolios of foreign assets accumulated from the current-account surpluses of the 1970s and early 1980s. But, with the prospect of moving further in the direction of external deficit as a result of the oil price fall, it is quite conceivable that many would choose to cut down their imports. That is, they might choose not to "dissave". If so, the industrial countries would find some or all of their domestic demand stimulus offset by reduced exports to the oil producers. The analogy with the initial effects of the two previous sharp oil price changes would then not hold.

In such a case, however, a favourable domestic price effect would still be likely to remain for the importing countries. Then, as long as nominal objectives — for money and/or GNP — were adhered to, some offset to any decline in exports to oil-producing countries would be implied.

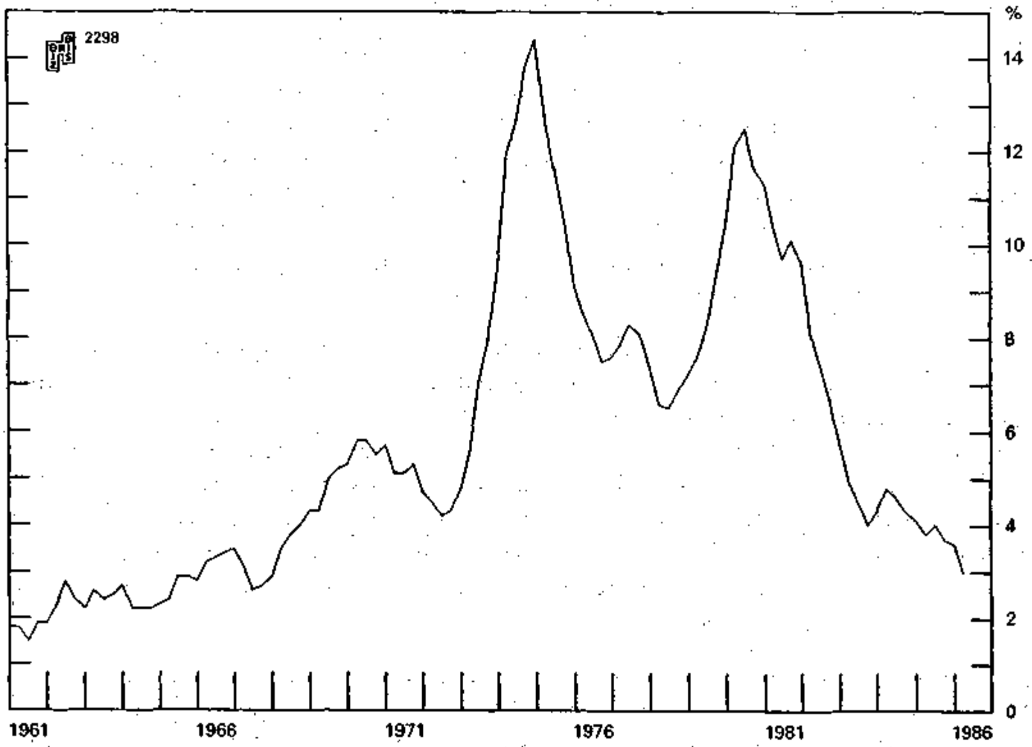
A similar point applies, for countries other than the United States and Canada, to the favourable price effects of currency appreciation. For many countries, too, the combination of declining interest rates, low inflation and buoyant equity markets should help to support business fixed investment spending.

Inflation.

Over the twelve months to the end of 1985 consumer prices rose on average by about 3¾ per cent. in the Group of Ten countries. This represented a further improvement as compared with the previous year. By March of this year consumer price inflation had fallen again to about 2¼ per cent. Thus, on average, inflation is now lower than at any time since the mid-1960s. Indeed, in the case of some countries it is possible, for the time being at least, to speak of the restoration of price stability. The disinflationary policies pursued since the second oil price shock must be given much of the credit for this achievement — especially when it is recalled that, before last year, many countries made progress in bringing down inflation in the face of exchange rate weakness.

Last year, and more especially during the early months of 1986, external factors also had a favourable effect on price developments in most countries. At the same time, however, there was a tendency for nominal wage gains either to

Inflation in the Group of Ten countries, 1961–86.*



* Average percentage change in consumer prices over four quarters. Consumer expenditure weights and exchange rates of the preceding year.

Changes in consumer prices.

Countries	1980	1981	1982	1983	1984	1985	March 1986[1]
	Changes over twelve months ending December						
	in percentages						
United States	12.4	8.9	3.9	3.8	4.0	3.8	2.3
Japan	7.5	4.3	1.8	1.8	2.6	1.8	1.1
Germany	5.5	6.8	4.6	2.6	2.0	1.8	0.1
France	13.7	13.9	9.7	9.3	6.7	4.7	3.0
United Kingdom	15.1	12.0	5.4	5.3	4.6	5.7	4.2
Italy	21.2	17.8	16.3	12.7	8.8	8.6	7.2
Canada	11.2	12.1	9.3	4.5	3.8	4.4	4.1
Belgium	7.6	8.1	8.1	7.2	5.3	4.0	1.5
Netherlands	6.7	7.2	4.3	3.0	2.8	1.7	0.7
Sweden	14.1	9.2	9.6	9.2	8.2	5.6	4.3
Switzerland	4.4	6.6	5.5	2.1	2.9	3.2	0.9
Group of Ten countries[2]	11.2	9.3	5.2	4.5	4.1	3.7	2.3

[1] Changes from March 1985. [2] Consumer expenditure weights and exchange rates of the preceding year.

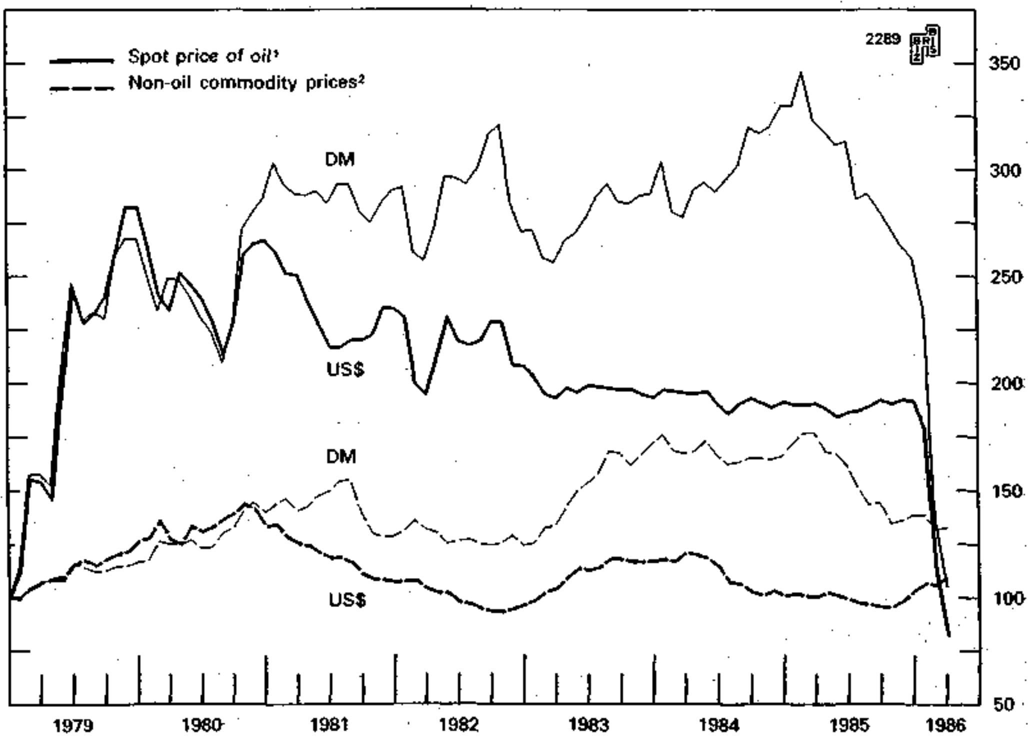
accelerate slightly or, more often, not to reflect the decline in productivity growth observed since 1983. Consequently, unit labour cost performance deteriorated in many countries last year, suggesting that the domestic component of inflation was by no means entirely dormant.

Commodity prices and import prices. Non-oil commodity prices tended to weaken during most of last year despite the fall in the value of their numeraire, the dollar. This meant that, in terms of other currencies, which were strengthening, the fall in commodity prices was quite appreciable. For example, in Deutsche Mark terms non-oil commodity prices fell by about 20 per cent. from their peak early in 1985 to March this year.

Slower growth last year was no doubt one factor behind the weakness of prices. But others were probably also at work, including continued high real interest rates, which both raise the cost of holding stocks of commodities and at the same time increase incentives for investors to shift away from real to financial assets. Furthermore, heavily indebted commodity-producing countries may have been led to engage in some "distress selling" and increased production in order to try to ensure the continued servicing of their debts. Also on the supply side, there have

World market commodity prices: Oil and non-oil, 1979–86.

December 1978 = 100.



[1] Saudi Arabian light crude in Rotterdam. Data for 1986 have been estimated on the basis of "netback" sales prices.
[2] The "Economist" US dollar-based index.

been good harvests of several staple crops and new sources of cereal exports have emerged in Asia, a fact which has tended to reduce food prices on world markets.

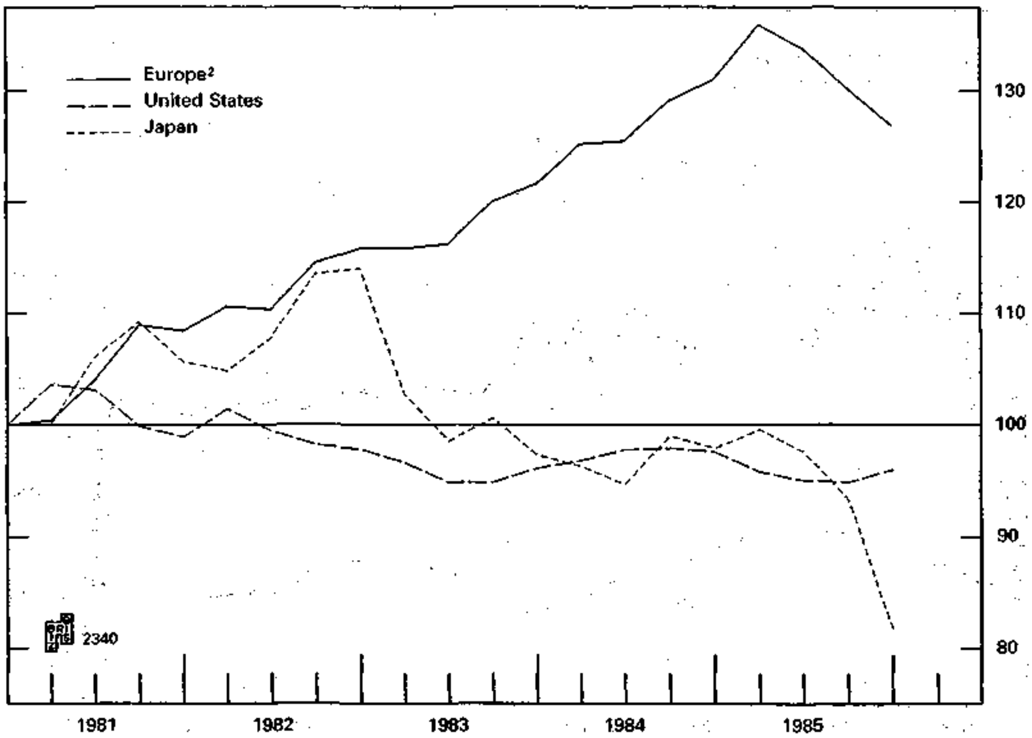
The combined result of these underlying commodity price developments and the fall in the dollar was to bring some relief from external price pressures to most countries last year. This was especially true of Europe, where, as the graph shows, import prices began decisively to reverse their previous upward trend for the first time since the second oil shock. In Japan, too, a sharp fall was recorded last year.

Interestingly, the counterpart of these developments outside the United States has not yet been seen clearly in that country itself. As the graph shows, US import prices did not begin to rise until the fourth quarter, and then did so only moderately. Exporters to the United States may have been content to allow their export profit margins to fall from the exceptional levels which they reached during the period of strong dollar appreciation.

Wages and unit labour costs. In the Group of Ten countries as a whole last year nominal wage increases were little changed. Put differently, there was little tendency for wage increases to decelerate further in spite of the high levels of unemployment prevailing in many countries and the tendency towards lower consumer price inflation already noted.

Import prices, 1981–85.[1]

Fourth quarter 1980 = 100.



[1] Unit values. [2] Comprises Belgium, France, Germany, Italy, the Netherlands, Sweden, Switzerland and the United Kingdom.

The nominal wage problem remains particularly intransigent in parts of Europe. In the United Kingdom, for example, wage increases seem to have become immune to any labour market influences and remain at a level which is likely to be incompatible with a satisfactory price performance in the longer run. In Germany a reduction in working hours led to an acceleration in average hourly earnings, though this may well prove to be only a temporary setback. Even so, it has occurred against a background of high unemployment.

In France further progress was made in reducing wage increases. A "wage norm" was promulgated by the Government, based not on the *past* rate of inflation,

Industrial wage costs[1] and wholesale prices.

Countries	Years	Nominal wages[2]	Productivity[3]	Unit labour costs[4]	Wholesale prices[5]
		percentage changes, fourth quarter to fourth quarter			
United States	1983	3.7	3.3	0.3	0.8
	1984	3.7	0.8	3.0	1.6
	1985	3.7	− 0.6	4.3	1.4
Japan	1983	3.4	9.8	− 5.8	− 3.3
	1984	4.2	8.3	− 3.8	0.5
	1985	3.8	1.3	2.5	− 3.7
Germany	1983	4.0	7.6	− 3.4	0.8
	1984	4.8	4.8	− 0.1	1.3
	1985	5.5	3.2	2.3	− 1.1
France	1983	10.7	2.9	7.4	10.1
	1984	6.4	3.6	2.8	7.4
	1985	6.0	2.6	3.3	2.2
United Kingdom	1983	9.7	9.6	0.1	5.6
	1984	8.4	2.9	5.4	6.1
	1985	8.4	3.8	4.5	5.2
Italy	1983	15.2	4.7	10.1	9.1
	1984	10.8	6.1	4.4	8.9
	1985	10.8[6]	1.0[6]	9.6[6]	5.9
Canada	1983	4.8	12.9	− 7.2	3.6
	1984	5.0	7.3	− 2.1	4.2
	1985	4.4	3.3	1.0	2.4
Belgium	1983	8.3	6.1	2.0	9.0
	1984	8.5	2.1	6.2	3.1
	1985	6.7[6]	3.3[6]	3.3[6]	− 2.2
Netherlands	1983	2.7	9.8	− 6.4	2.0
	1984	2.9	4.9	− 2.0	3.9
	1985	1.6	− 1.3	3.0	0.1
Sweden	1983	9.2	9.1	0.1	9.9
	1984	12.3	5.9	6.1	7.8
	1985	7.6	3.4	4.0	3.9
Switzerland	1983	3.1	4.9	− 1.7	0.9
	1984	1.7	2.4	− 0.7	3.3
	1985	3.2	2.3	0.8	0.9
Group of Ten countries[7]	1983	5.4	5.9	− 0.5	2.0
	1984	4.9	3.5	1.5	2.7
	1985	4.7	0.9	3.8	0.8

[1] For the United States and France, non-agricultural business sector; for other countries, total industry or manufacturing. [2] For the United States, Italy, Belgium and Sweden, total labour costs; for other countries, wages and salaries or earnings. [3] For Japan, the United Kingdom, Italy, Canada, the Netherlands and Switzerland, output per person; for other countries, output per hour. [4] Calculated from nominal wages and productivity. [5] For the United States, France, the United Kingdom, the Netherlands and Sweden, producer prices; for other countries, general index of wholesale prices. [6] Third quarter. [7] GDP weights and exchange rates of the preceding year.

but on the target *future* rate. At a time of falling inflation this can be seen as a means of encouraging inflation to fall more rapidly, but without obvious adverse consequences for real incomes.

In Italy, too, the outlook for wage inflation was improved when the electorate voted in a referendum in June not to restore four index points held back earlier under the "scala mobile" indexation system. Furthermore, an agreement was reached on a modified indexation system towards the end of last year. Even so, nominal wage inflation remains high relative to the requirements of price stability.

It also remains high in Sweden, where strenuous attempts were made by the Government early in the year to bring together employers' and employees' organisations with the aim of bringing wage settlements down to 5 per cent., and overall inflation to 3 per cent.

In Belgium the Government's attempt to impose strict wage restraint at last appeared to yield some positive results in 1985 and further measures were introduced early this year.

If European wage performance is still not wholly satisfactory, more encouraging signs appear to be coming from across the Atlantic, in particular from the United States. Wages there increased no faster last year than they had in 1983. This latter performance has to be seen against the background of a long-standing recovery — a period when inflation has usually tended to accelerate.

There are clear indications of a greater degree of flexibility in wage behaviour in the United States than in other countries. There have, for example, been cases in which outright cuts in wages have been accepted in the interests of safeguarding employment. Even so, with US productivity declining last year (see the table on page 17), unit labour costs have been rising moderately again. Indeed, as the table shows, most countries' productivity performance has been such that, when combined with nominal wage behaviour, unit labour costs have tended to accelerate.

So far as overall inflation is concerned, of course, the recent drop in oil prices is likely to mean some further deceleration in the early part of this year. Nevertheless, the recent behaviour of wages and unit costs — against a background of high unemployment — is not entirely reassuring for the longer-term outlook. With labour costs constituting by far the greatest part of total costs, it underlines the need for continuing, and in many cases intensified, moderation in nominal wage settlements. For many countries, favourable external price developments provide an unusually helpful background for initiatives in this area. But the time to take advantage of these opportunities is now.

Labour markets in the current recovery.

Europe versus North America and Japan. A major feature of labour market developments in the current recovery has been the contrast between Europe, on the one hand, and North America and Japan on the other. As can be seen from the following table, rapid employment growth in the United States reduced the rate of unemployment to 7.2 per cent. in 1985, the lowest rate for five years. Moreover, the proportion of the population of working age in employment has reached an all-time high, which in part reflects the coming-of-age of the "baby boom generation". In Europe, by contrast, unemployment continued to increase in 1985 as employment growth fell short of the rise in the labour force. The proportion of the population of working age in employment is now some 7 percentage points below that of the late 1960s and early 1970s. Moreover, a falling participation rate probably reflects demographic factors as well as a "discouraged worker effect" due to the unfavourable employment opportunities. The experience of Japan falls somewhere between those of Europe and North America. Employment growth has been positive since 1975, though at a rate which has been low compared with earlier trends and with that of North America. Nonetheless, the rate of unemployment, while still very low by international comparisons, reached a historically high level (2.9 per cent.) by the end of 1985, before falling again early this year.

Changes in the composition of employment. Another contrast in recent labour market trends, cutting across national borders, has been that between industry and services. Most countries have experienced low or negative employment growth in industry, while the services sector has shown a strong rise. Although the sluggish trend in industry has also affected the demand for services and tight fiscal policies have curbed public sector employment, the services sector has continued to expand, and by 1985 its share of total employment in most countries was almost 6 percentage points higher than ten years earlier. Financial and business services have grown particularly rapidly and in several countries now account for close to 10 per cent. of total employment. Most of this expansion can be ascribed to the growth in

Labour market indicators: United States, Japan and Europe.[1]

Countries and periods	Unemployment rate	Participation rate	Employment relative to population of working age	Compensation per employee	Real labour costs[2]	Output per person employed	Employment
	in percentages			average annual percentage change			
United States							
1965–73	4.5	66.5	63.6	6.3	1.3	1.2	2.3
1974–79	6.8	69.9	65.3	7.8	− 0.2	0.0	2.5
1980–85	8.1	72.8	67.0	6.5	0.4	0.5	1.4
1984	7.5	73.4	67.9	4.7	0.6	2.4	4.1
1985	7.2	73.9	68.7	3.7	0.3	0.2	2.1
Japan							
1965–73	1.2	71.9	71.0	14.7	7.6	7.9	1.3
1974–79	1.9	71.0	69.6	12.5	4.1	2.9	0.7
1980–85	2.4	72.4	70.6	4.5	2.4	3.1	1.0
1984	2.7	72.7	70.7	3.9	2.6	4.4	0.6
1985	2.6	72.5	70.6	3.8	2.1	3.8	0.7
OECD Europe							
1965–73	3.2	67.6	65.3	10.0	4.4	4.2	0.3
1974–79	5.4	66.9	63.3	12.5	2.3	2.1	0.3
1980–85	9.5	65.8	59.6	9.7	0.3	1.5	− 0.2
1984	11.0	65.2	58.0	7.7	− 0.3	2.1	0.1
1985	11.2	65.3	57.9	6.7	− 0.4	2.0	0.3

[1] Figures for 1985 are still preliminary. [2] Compensation per employee deflated by the GDP deflator.
Sources: OECD Labour Force Statistics and OECD National Accounts.

business services, which, in part, reflects a transfer of activities from industrial firms to service subsidiaries or independent enterprises. In the financial sector, on the other hand, employment has increased at a slower pace during the last five years as banks have introduced new labour-saving equipment.

Given the very heterogeneous nature of the services sector, it is difficult to find a general characterisation of the job creation process. Moreover, for several reasons its macro-economic implications can only be stated tentatively. In the first place, industry is more sensitive to business cycle fluctuations than services, so that during a recession the industrial employment share will tend to fall. Secondly, because of the low capital intensity of service jobs and the high and rising share of part-time workers, labour productivity is lower than in industry. Consequently, the employment shift in favour of services has tended to reduce aggregate productivity growth and thereby the scope for a non-inflationary rise in real wages. Thirdly, the extent to which developed countries appear to be going through a process of "de-industrialisation" is much less pronounced when output trends or shares of value added are considered than when employment is used as an indicator.

These cyclical and structural features are evident when recent output and employment changes are compared. For instance, only 20 per cent. of the 11 million non-agricultural jobs created in the United States since the end of 1982 are found in industry. Moreover, employment in manufacturing, which has been most exposed to the appreciation of the dollar, declined up to late last year, and by the end of 1985 was still some 8 per cent. below its 1979 peak. However, output in US manufacturing has held up surprisingly well, both in comparison with GDP and in relation to past trends. In Japan, too, manufacturing output growth has been more buoyant than the employment figures would suggest. In Germany, by contrast, and particularly in the United Kingdom, indicators of both output and employment point to a weakening of the manufacturing sectors. Adverse cyclical factors were partly responsible for this outcome. However, seen against the real appreciation of the US dollar and the related improvement in the international competitiveness of European firms, the slow growth of manufacturing output and employment suggests a more fundamental weakness.

Rigidities, real wages and capacity. Most analyses of the recent trends in labour markets have naturally focused on the reasons for the weak performance in Europe. In addition to slow growth of real demand and output, three main explanations have been suggested: inflexible labour and product markets impeding the adjustment of wage structures and employment; rising real labour costs relative to labour productivity and an accompanying fall in profit shares and profitability; and changes in the size and composition of the capital stock.

Labour market rigidities. A precise evaluation of labour market inflexibilities and their effect on employment growth in Europe is difficult to make, as very few quantitative measures exist. Moreover, the need for labour market flexibility depends on the extent to which other markets, especially product markets, are subject to wide swings in production levels and relative prices. The most frequently cited sources of rigidity are measures or institutional arrangements which prevent real wages and wage structures from adjusting to changes in demand and supply

Employment characteristics of the services sector: Selected indicators.

Countries	All services: Employment: Percentage change 1975–79	1980–85	Percentage of total employment 1985	Real value added per employee: Percentage change 1975–79	1980–83	Relative to manufacturing[1] 1983
United States	3.5	2.3	68.8	1.6	0.2	74.4
Japan	2.4	1.7	56.3	2.3	2.1	69.6
Germany	1.4	0.8	53.4	3.7	1.0[2]	80.5[3]
France	2.2	1.2	59.3	2.5	0.7	72.6
United Kingdom	1.2	1.1	65.1	2.0	1.5	70.1
Italy	2.7	2.8	55.2	1.2	– 0.6	72.8
Canada	3.2	2.4	69.3	1.6	– 0.6	62.1
Belgium	2.1	0.5[4]	66.1[5]	1.1	0.8	60.1
Netherlands	2.1	2.5[4]	67.2[5]	2.6[6]	– 1.9	81.4
Sweden	2.7	1.4	65.3	– 1.1	– 0.4	51.5
Switzerland	0.7	1.0	55.8	.	.	.
Group of Ten countries[7]	2.7	1.9	63.6	2.0	0.6	72.5

Countries	Financial and business services: Employment: Percentage change 1975–79	1980–83	Percentage of total employment 1983	General government: Employment: Percentage change 1975–79	1980–83	Percentage of total employment 1983
United States	6.1	4.5	9.7	1.2	0.4	16.5
Japan	.	4.2	6.4	1.4	0.9	6.5
Germany	1.9	2.4	6.4	1.8	1.0	15.9
France	.	2.5[8]	7.4[3]	1.2	1.6	19.2
United Kingdom	2.4	3.5	8.7	0.8	– 0.6	22.1
Italy	.	7.2[8]	3.1[3]	2.6	1.1	15.6
Canada	5.7	2.8	9.7	1.0	2.3[2]	.
Belgium	2.7	1.8	7.4	3.9	1.0[2]	19.5[3]
Netherlands	4.9	2.4	9.4	2.8	0.9	16.1
Sweden	5.7	3.2	7.2	4.6	2.1	32.3
Switzerland	1.0	3.2	9.0	1.6	1.3[2]	.
Group of Ten countries[7]	4.9	4.0	8.3	1.4	0.7	16.9

[1] Value added (in 1983 prices) per employee in the services sector as a percentage of value added per employee in manufacturing; for Italy, total industry. [2] 1980–82. [3] 1982. [4] 1980–83. [5] 1983. [6] 1977–79. [7] 1982 service employment weights. [8] 1976–82.

Sources: OECD *National Accounts*, Vol. II, OECD Labour Force Statistics and OECD Employment Outlook.

(minimum wages, indexation and high unemployment benefits), raise total labour costs in relation to earnings (social security contributions, training costs and redundancy payments) and tend to segment labour markets and to suppress the working of competitive forces. Several countries, however, have taken steps towards making labour markets more flexible. For instance, wage indexation has been adjusted (Italy, Belgium and France) or abolished (Denmark), temporary work arrangements have been facilitated (France and Germany), unemployment benefits reduced in relation to average earnings (Denmark and the United Kingdom), social security contributions lowered either generally or for particular employee groups (France, Denmark, Belgium and the United Kingdom) and part-time work and early retirement promoted (the Netherlands, Belgium and Germany). Moreover, measures have been introduced to reduce the wage-bargaining power of trade unions (the United Kingdom).

Another development pointing to more flexible labour markets has been the very rapid increase in the number of part-time workers. The increase has been especially fast in Belgium and the Netherlands, reflecting counter-cyclical measures favouring a shorter working week but also the influence of demand and supply developments. In several European countries (Norway, Sweden and the Netherlands) part-time workers now account for 25 per cent. or more of the employed labour force, with above-average proportions being recorded for women and in the services sector. At the same time, the number of part-time workers has remained relatively low in Germany and France (despite policy measures) and has increased only moderately in countries with rapid overall employment growth (Japan and North America).

Real wages and employment. Turning to the relationship between real wages and employment, the graph on page 23 suggests that, after the first oil shock, excessive real wage growth and a subsequent increase in the labour share in income contributed to the rise in European unemployment. Since then, however, weakening labour market conditions have been accompanied by real wage moderation and a remarkable recovery in the gross profit share. Consequently, the persistence of European unemployment can hardly be ascribed to rigid real wages alone. Weak real output growth compared with earlier cycles and capacity constraints to be discussed below also appear to have played a role.

Employment, unemployment and real wages in selected European countries.

Countries	1965–73			1974–79			1980–85[1]			1984			1985[1]		
	EM	U	RW	EM	U	RW	EM	U	RW	EM	U	RW	EM	U	RW
Germany	0.0	1.2	4.6	−0.6	4.1	2.6	−0.3	7.5	1.0	0.1	9.1	1.5	0.7	9.3	0.9
France	0.8	1.3	4.3	0.4	4.4	3.8	−0.5	8.7	1.2	−1.0	9.9	0.7	−0.4	10.3	0.2
United Kingdom	0.0	2.3	3.2	0.2	4.4	1.2	−0.8	10.6	1.8	1.5	12.4	0.9	0.8	12.9	1.9
Italy	−0.2	5.7	5.7	1.0	6.6	2.0	0.4	9.3	1.1	0.4	10.4	1.0	0.5	10.6	0.8
Belgium	0.7	2.4	4.8	0.0	6.3	3.7	−0.7	12.3	1.5	0.0	14.1	1.0	0.3	13.3	0.1
Denmark	1.1	1.1	2.3	0.4	5.3	1.6	0.3	9.0	0.0	2.4	9.8	−0.6	2.4	9.1	−0.3
Netherlands	0.5	1.7	5.1	0.5	4.9	2.5	−0.9	13.7	−0.7	−0.5	17.2	−2.0	0.8	15.6	−0.8
Spain	0.9	1.8	5.8[2]	−1.2	5.8	3.5	−1.9	17.4	1.2	−3.9	21.2	−0.9	0.4	21.5	−0.3
Sweden	0.6	2.0	2.3	1.2	2.0	2.1	0.4	2.8	−0.7	0.7	3.1	0.5	1.0	2.8	−0.3
Switzerland	0.8	0.0	3.7	−1.3	0.4	2.0	0.3	0.6	1.7	−0.2	1.2	1.3	0.9	1.0	2.3
EEC	0.2	2.2	4.4	0.2	4.6	2.5	−0.3	9.2	1.2	0.3	10.9	1.0	0.4	11.2	0.8

Note: EM = total employment, average annual rate of change; U = percentage unemployment rate, national definitions; RW = compensation per employee deflated by the GDP deflator, average annual rate of change.

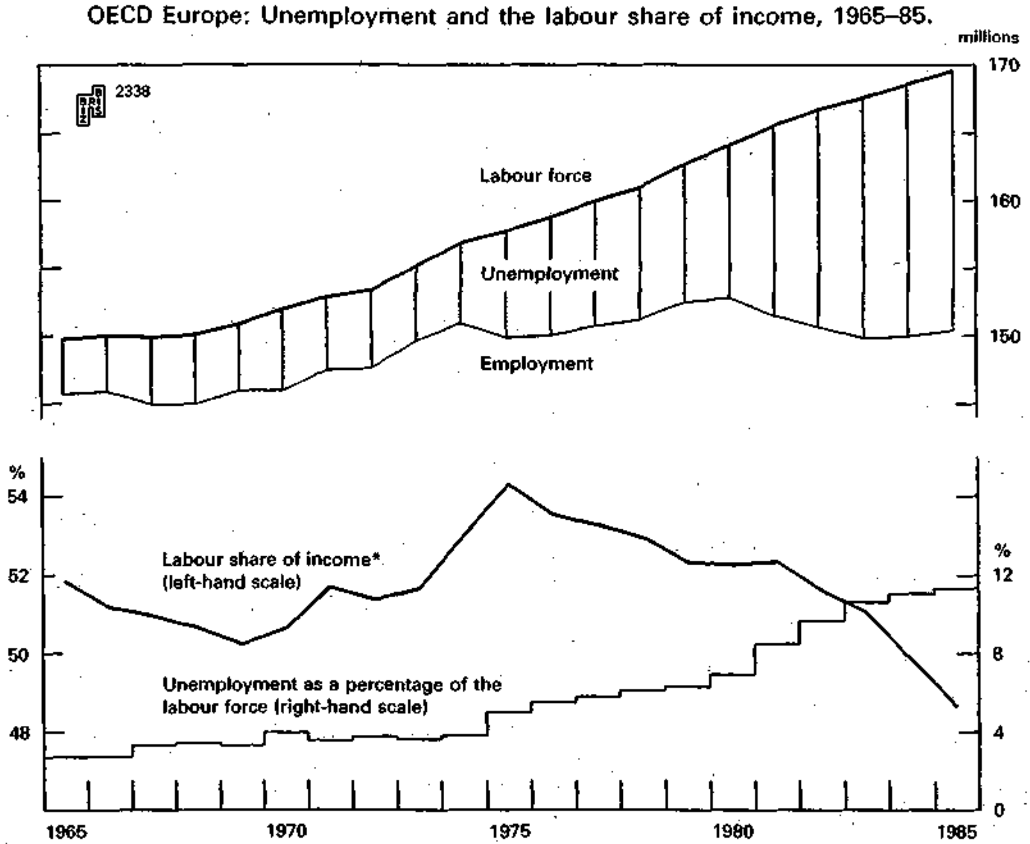
[1] Preliminary. [2] 1970–73.

Sources: OECD National Accounts, OECD Labour Force Statistics and EEC European Economy.

Real wage moderation in Europe has generally taken place in conditions of decelerating nominal wage and price increases, but the degree of moderation has varied widely from one country to another. As can be seen from the table on page 22, the Netherlands and Sweden have experienced the sharpest real wage decline among the European countries over the period since 1980, and in Denmark real wages have stagnated. In Germany the adjusted labour share in income is now lower than in the early 1960s; the same applies to France, though in this case even lower rates were recorded in the early 1970s. By contrast, in the United Kingdom the rate of increase in real and nominal wages has, as mentioned earlier, been largely insensitive to the record level of unemployment. In Italy, too, nominal wage increases have remained relatively high and until recently real wage growth exceeded that of productivity. In Japan current real wage increases are well below earlier levels, but, unlike in Europe, the labour share in income has remained high. Finally, in the United States real wages adjusted flexibly to the two oil price shocks, and the recent improvement in labour market conditions does not appear to have initiated a reversal of earlier nominal and real wage concessions.

Capacity and unemployment. Despite the shift in aggregate demand and employment towards less capital-intensive sectors, there is growing concern —

OECD Europe: Unemployment and the labour share of income, 1965–85.



* *Adjusted for changes in the number of employees in relation to total employment.*
Sources: OECD Labour Force Statistics and OECD National Accounts.

especially in Europe — that lack of productive capacity has reduced the scope for a sustainable reduction in unemployment. As can be seen from the table below the share of gross fixed investment in GDP has tended to decline and an even sharper fall can be observed for net investment. The nature and causes of the rising share of reinvestment (i.e. the difference between gross and net investment) are not well understood. To some extent it may be due to changes in the statistical procedures used in calculating depreciation. In the United States there appears to have been a shift in the composition of investment in favour of machinery and equipment, which tends to reduce the average age of the capital stock and to raise the share of depreciation and reinvestment. In Europe rationalisation investments are often cited as a cause, as firms attempt to reduce labour costs by adopting more capital-intensive methods of production. The indicators for profitability may be interpreted as supporting this view. In conditions of rising capital/labour ratios the return on investment and the productivity of additions to the capital stock can be expected to decline or rise less quickly. Whatever the causes of the low growth of the capital stock, the figures on capacity utilisation shown in the last column of the table give cause for concern: despite the relatively slow pace of the recovery in Europe, there is a risk that capacity limits will be reached long before labour market slack has been absorbed.

At the same time, developments in other indicators and the experience of certain countries militate against taking too pessimistic a view of the capacity problem. In the first place, when inefficient firms are being closed down and labour is combined with more capital the average rate of labour productivity growth could be expected to rise. Because of cyclical influences and the shift towards services and more part-time work, productivity changes must be interpreted cautiously. It is nonetheless striking that except in the United Kingdom productivity growth in

Indicators of capacity.

Countries	Fixed investment as a percentage of GDP						Rates of return in manufacturing, in percentages[1]			Rates of capacity utilisation; fourth quarter 1985 as a percentage of 1973-75 peak
	Gross investment			Net investment						
	1960	1973	1984	1960	1973	1984	1965-69	1975	1985[2]	
United States	17.9	19.1	18.0	7.1	8.5	5.0	23.6	15.4	17.6	91.7
Japan	29.5	36.4	28.0	18.6	22.8	14.0	36.7	18.5	24.0	91.9
Germany	24.3	23.9	20.2	16.5	13.6	7.6	19.3	13.7	16.0	97.5
France	20.1	23.8	18.9	10.1	14.2	6.8	16.3	13.1	13.0	95.0
United Kingdom	16.4	20.1	17.3	8.0	10.1	5.3	11.3	5.5	7.8	95.6
Italy	22.6	20.8	17.9	14.4	12.4	7.8	17.8	11.8	15.6	93.7
Canada	21.9	22.4	18.1	9.7	11.7	6.2	14.5	13.1	10.2	88.4
Belgium	19.3	21.4	16.1	9.2	12.2	6.5	17.1[3]	9.5	15.5	94.1
Netherlands	24.1	23.1	18.4	15.1	14.8	7.9	11.6[4]	8.7	9.3[5]	97.7
Sweden	22.7	21.9	18.3	12.4	12.2	6.6	11.4	9.7	9.4	99.1[6]
Switzerland	24.8	29.4	23.3	14.2	17.7	13.2	.	.	.	95.7
EEC	21.8	23.0	18.7	13.3	13.3	7.2	10.8[4]	7.3	6.6[5]	95.1[7]

[1] Gross operating surplus as a percentage of gross capital stock. For the Netherlands and the EEC the figures refer to the enterprise sector excluding housing. [2] Preliminary. [3] 1970. [4] 1960–73. [5] 1984. [6] Series starts only in 1980. [7] Belgium, France, Germany, Italy, the Netherlands and the United Kingdom.

Sources: OECD Economic Outlook, OECD National Accounts, EEC Annual Economic Review and national data.

Europe has tended to decline and in the current upturn has attained only half the rate observed in previous cycles. Secondly, high real interest rates combined with real and nominal wage moderation have changed relative factor prices in favour of labour. This encourages more labour-intensive methods of production and some "stretching" of existing capacities. Finally, the experience of one industrial country (Denmark) suggests that under the right conditions employment can expand rapidly despite earlier fears of capacity shortages. Induced by a sharp fall in interest rates, a marked decline in real and nominal wage increases and improved confidence in the business sector, gross fixed investment expanded by almost 40 per cent. between 1981 and 1985, thereby raising the share of fixed investment in GDP from an all-time low of 15½ per cent. to 19½ per cent. Although the level of fixed investment is still below that of 1979, the proportion of industrial firms reporting capacity constraints was only 8 per cent. by the end of last year. Moreover, helped by the more moderate wage behaviour, total employment increased by more than 2 per cent. in both 1984 and 1985, entirely as a result of growth in the private sector.

Summary. The general slowdown in wage inflation and the shift in the distribution of factor income in favour of profits in Europe are hopeful signs for employment. The latter development is particularly encouraging, as in several countries it runs counter to earlier patterns of pro-cyclical behaviour of profit shares. Nevertheless, several questions remain open in any assessment of future labour market prospects. In the first place, it is uncertain whether the slowdown in wage inflation reflects a change in underlying behaviour or will be reversed once employment starts to grow again. Secondly, while the improvement in profit shares has removed one serious obstacle to faster employment growth, it remains to be seen whether existing capacities in Europe can support a major increase in employment. Thirdly, the current trend rates of output and productivity growth cannot be precisely evaluated, which also implies that the scope for non-inflationary increases in real wages is uncertain. It seems, however, that these trend growth rates are lower than in the past. Moreover, if the labour intensity of production rises in response to recent changes in relative factor prices, the growth of labour productivity can be expected to fall further.

Fiscal policy and fiscal issues.

Probably one of the most significant features of fiscal policy in the past year was the major change in official attitudes in the United States towards the budget deficit. Early in the year it was becoming clear that, without major changes in the instruments of fiscal policy, continuing large Federal deficits were in prospect, at least until the end of the decade.

A new proposal was therefore put forward for reforming the entire budget-making process. An important point about this new procedure — the Gramm-Rudman-Hollings plan — was that it set statutory deficit ceilings year by year up to fiscal 1991, by which time the deficit would be eliminated. Of equal importance was the fact that these ceilings were to be backed up by automatic procedures for cutting certain categories of expenditure, including defence, if projections by the

Office of Management and Budget and the Congressional Budget Office pointed to an above-target deficit in the coming year. Only in the event of a recession or of war could this procedure be overridden.

Despite some doubts about the constitutionality of parts of what became the Gramm-Rudman-Hollings Act, the President's latest budget proposals for fiscal 1987 adhere strictly to its mandatory deficit ceilings. However, in eschewing any tax increases, reducing defence expenditure only slightly and thus concentrating expenditure cuts on a relatively small area of public spending, the President's latest budget proposals are meeting resistance in Congress.

Outside the United States the pursuit of more balance in the public finances has, of course, been under way for some time, especially in the two larger economies, Japan and Germany. Nevertheless, in October of last year — following the Group of Five meeting the previous month — and again early this year a temporary increase in public spending was sanctioned in Japan to give a short-term boost to spending on public works and to encourage private housebuilding. Even so, as the table shows, the general government deficit in Japan is estimated to have fallen again last year to about 1¼ per cent. of GNP. And in the draft budget for 1986-87 published in December a further decline is implied for this year.

In Germany, too, further progress has been made in cutting back the budget deficit. The medium-term aim of policy is to reduce the Federal deficit a little further to 1 per cent. of GNP by 1989. In the meantime, despite continuing expenditure restraint, the tax cut introduced early this year implies no further reduction in the Federal deficit in 1986.

In France and the United Kingdom a secular reduction in the general government sector's borrowing is less apparent. In France the new Government has announced a set of measures including cuts in public expenditure, tax reductions for

General government budget balances.[1]

Countries	1973	1980–81	1982–83	1984	1985[2]
	as a percentage of nominal GNP				
United States	0.6	– 1.0	– 3.8	– 2.9	– 3.6
Japan	0.7	– 4.1	– 3.7	– 2.2	– 1.3
Germany	1.2	– 3.3	– 2.9	– 1.9	– 1.1
France	0.9	– 0.8	– 2.9	– 2.8	– 2.5
United Kingdom	– 2.6	– 3.1	– 3.0	– 3.9	– 3.6
Italy	– 7.0	–10.0	–12.5	–13.5	–13.7
Canada	1.0	– 2.1	– 5.6	– 6.4	– 6.3
Belgium	– 5.5	–14.0	–14.9	–12.6	–13.0
Denmark	5.2	– 5.2	– 8.3	– 4.3	– 1.0
Netherlands	1.8	– 4.8	– 6.5	– 6.0	– 5.6
Sweden	4.1	– 4.3	– 5.5	– 2.3	– 2.5
Switzerland	– 1.1	– 0.1	– 0.5	– 0.3	– 1.1

[1] Including the social security sector but excluding capital transactions of a financial nature. [2] Preliminary.
Sources: OECD Economic Outlook and national data.

companies and subsidies to companies taking unemployed young people into employment. The net effect of the measures is estimated to be a small cut in the budget deficit as compared with the plans of the previous administration.

In the United Kingdom the picture is complicated by the unwinding of the effects of the miners' strike, which inflated the borrowing figures for 1984, and by large sales of public sector assets. Asset sales are not included in the financial deficit of the general government sector (which is shown in the table). They are, however, counted as deductions from expenditure for the purposes of calculating the public sector borrowing requirement, which is the target of UK fiscal policy, and for which a figure of 2 per cent. of GNP was set for 1985-86. For the current year a decline in expected oil revenues served to rule out much of the reduction in direct taxation originally planned, as the PSBR target was reduced to 1¾ per cent. of GNP in line with the medium-term orientation of policy.

Elsewhere, the aim in almost all countries was still to bring down budget deficits. The degree of success varied, however. For example, in Italy the original budget targets were overrun, despite some emergency measures following the devaluation of the lira in mid-year. The Canadian authorities also found budgetary control a problem, in part because of the continuing rapid growth in debt servicing costs. But, for both of these countries, exchange rate difficulties added an extra dimension of urgency to the task of budgetary retrenchment.

The growth of public debt. One of the most noteworthy fiscal developments over the past decade or so has been the virtually universal rise in the stock of public debt outstanding, even when expressed as a proportion of GNP. As the following table shows, this trend continued in 1985.

General government debt and interest payments.

Countries	Gross debt				Gross interest payments			
	1973	1983	1984	1985	1973	1983	1984	1985
	as a percentage of GNP				as a percentage of government expenditure			
United States	41.9	45.0	45.8	48.3	7.2	12.2	13.6	13.8
Japan	17.1	68.2	69.3	69.4	4.1	13.2	14.2	14.9
Germany	18.3	40.1	40.8	40.6	2.8	6.4	6.5	6.7
France	25.1	29.8	31.8	34.0	2.4	5.2	5.5	5.5
United Kingdom	69.3	53.9	55.9	56.5	9.5	10.6	10.8	11.4
Italy	60.6	84.2	91.4	99.4	6.9	16.3	17.2	16.7
Canada	46.7	58.7	63.4	69.2	11.2	16.0	17.1	18.1
Belgium	69.5	107.6	115.7	121.7	8.0	16.0	17.3	18.8
Denmark	7.9	62.7	67.6	68.6	3.1	13.4	16.2	17.0
Netherlands	43.2	62.3	66.9	70.3	6.3	9.6	10.4	11.0
Sweden	30.1	66.0	69.4	71.4	4.3	11.5	12.5	13.4
Switzerland	36.4	38.3	39.5	.	5.6	5.3	5.0	4.7

Sources: OECD Economic Outlook and national data.

Rising public sector debt ratios are viewed with concern for several reasons. In particular they place additional strains on the budget in the form of rising debt servicing costs at a time when most countries are attempting to reduce the overall total of public expenditure in relation to the size of the economy. In addition, high public debt ratios are likely to reduce the room for manoeuvre in fiscal policy.

The proximate cause of the public debt problem lies, of course, in the fact that countries have tended to run large budget deficits since the mid-1970s. What began as a partly cyclical response to the recession which followed the first oil shock turned into a secular deterioration in the public finances as most countries failed to experience a full recovery from the recession and high unemployment became a heavy drain on the public purse.

The second oil shock brought with it further recessionary forces. This time, however, there was less willingness to allow additional automatic budgetary responses to come into play. There was also, though, less willingness to accommodate the inflationary effects of the second oil price rise per se. Partly for this reason, and partly because of the emerging change in the policy mix in the United States, interest rates rose to high levels in real terms in the early 1980s. Given that outstanding public debt had already begun to grow, this implied a fairly sharp increase in debt servicing outlays.

With public debt ratios still rising in spite of strong efforts in many countries to reduce public deficits, there has been an increasing feeling of "fiscal policy pessimism" in much of the industrial world. That is, there seems now to be a widely felt reluctance for any single country to employ fiscal policy for macro-economic demand management.

In this respect, a reduction in interest rates would, however, appear helpful. It would tend to reduce debt servicing costs which add to the numerator of the debt/income ratio, while simultaneously encouraging the denominator — GNP — to rise.

However, there is some doubt whether continuing recovery outside the United States would be sufficiently supported by this means alone, especially in the face of ongoing fiscal correction. The old question therefore recurs as to what scope there might be for temporary fiscal measures aimed at taking up some slack and putting the rest of the world economy onto a higher, but sustainable, medium-term growth path.

Fiscal policy effectiveness. The academic debate about the demand management role of fiscal policy has been intense in recent years. At the same time, in the world of policy-making itself, such a role has, by and large, been shunned (the United States being a notable but perhaps unintended exception). The reasons for this have been various. In addition to the problem of public debt just discussed, short-term manipulation of the budget has been viewed as being counter-productive so far as the control of public spending and of inflation is concerned. In addition, longer-term considerations involving the need to reduce the size of the public sector, and with it the overall burden of taxation, have tended to take precedence in policy-makers' lists of priorities.

Nevertheless, the United States has for some time been urging both Germany and Japan to use budgetary policy to accelerate domestic growth. This, it has been argued, is likely to be needed to keep the recovery going (or, in some countries, speed it up) as US demand growth — especially that part which is diverted abroad — slows down. Simultaneously, it is asserted, fiscal stimulus outside the United States will assist in a more orderly unwinding of the large balance-of-payments disequilibria which have been allowed to build up in recent years.

On the face of it, it might seem that the experience of the United States since 1982 is fairly powerful evidence that fiscal policy remains effective in these traditional terms. Output has risen sharply and inflation has remained remarkably low in the circumstances. Those circumstances, however, have included not only weak commodity prices but also a sharp rise in the exchange rate — something which other countries could hardly count on.

It is no doubt true that the mix of policies pursued in the United States raised the interest rate incentive for financial investment in that country. Expectations of improved long-run profitability may also have been induced. But it is also true that external current-account deficits cannot be ignored indefinitely — and in the past have usually not been ignored — by international investors. The cumulative deterioration in net interest flows, as well as the trade deficit itself, have always to be corrected sooner or later, and the obvious instrument is usually a decline rather than an appreciation of the exchange rate.

In other respects, too, the example of the United States does not necessarily imply that fiscal policy still has strong short-term effects on demand and output everywhere. The dominant strategy pursued in recent years in Europe has started from the proposition that underlying structural problems have to be put right before sustainable medium-term growth can occur. Firm control over inflation has been one priority in this context. The reduction of public expenditure with a view to lowering tax burdens has been seen as another prerequisite of a healthy recovery. The table on page 30 shows that in some, but by no means all, countries, the rise in public expenditure as a proportion of GNP has been checked. Even so, nowhere has this share returned to the levels prevailing as late as 1973. In many cases the burden of taxation is thought to have become so high as to inhibit the supply responsiveness of the economy but tax cuts on their own would only increase deficits. This situation is also exacerbated by various other structural rigidities, of which those in labour markets have already been discussed. Finally, with profitability having declined to very low levels in the late 1970s and early 1980s, there has been a clear need for a major reversal of this trend, particularly given the recent inadequate growth of capacity (see pages 23–25).

Hence, the argument runs, if a demand stimulus is to be effective, new capacity will have to be provided first. Otherwise fiscal stimulus may only be inflationary. In any case, in the period immediately ahead the recent fall in oil prices and the appreciation of exchange rates should be factors boosting aggregate demand.

Policy co-ordination. For countries other than the United States, external constraints would probably play a much greater and earlier role than they did there, General government expenditure.

Countries	1962	1973	1982	1983	1984	1985
	as a percentage of nominal GNP					
United States	28.1	30.3	35.1	35.0	33.9	35.1
Japan	18.2[1]	21.0	31.8	32.3	31.5	30.9
Germany	33.6	40.0	47.6	46.6	46.1	45.4
France	34.0	35.6	47.9	49.1	49.7	49.3
United Kingdom	33.0	37.3	44.3	44.1	45.0	44.2
Italy	30.5	36.9	53.2	55.4	55.8	56.4
Canada	28.8	34.5	45.0	45.4	46.2	46.1
Belgium	30.3	41.1	59.5	59.3	58.6	58.5
Denmark	29.3[1]	41.0	59.0	59.5	58.8	57.6
Netherlands	33.3	45.6	58.4	59.7	58.5	57.4
Sweden	31.1	43.8	66.6	64.9	63.3	63.3
Switzerland	21.0[2]	29.7[2]	33.4	33.7	33.8	33.5

[1] 1965. [2] Estimated.

Sources: OECD Economic Outlook and national data.

especially for any one country attempting to act on its own. Unilateral fiscal reflation would seem likely to founder fairly quickly on the rock of an exchange rate crisis. Proponents of expansion point out that, if many countries were acting together, and if the United States were also playing its part by curbing its budget deficit, then the risk of external difficulties would be much reduced. At the moment, however, countries feel either that their strategy is already paying off or that more remains to be done to correct fundamental conditions in their economies. Hence, agreement on co-ordinated fiscal expansion outside the United States would seem very unlikely.

The fiscal/monetary policy mix.

The growing policy imbalance both within the United States itself and between that country and the rest of the world has been a matter of great concern for some years. Internationally, the interest rate consequences of this policy differentiation would seem to have been one important cause of the dollar's prolonged rise. Together with the cyclical disparity between the United States and other countries, this rise in the dollar also helped to account for much of the increase in external imbalance among industrial countries recorded in recent years.

1985: a turning point? Against this background, 1985 may prove to have been a significant year. In particular, there would seem to have been a growing recognition, on the part of both policy-makers and economic agents, that decisive action was required. In the United States monetary policy became more accommodating and efforts to tackle the medium-term budgetary situation were pursued more intensively. The background to this situation has been building up for some time. On the US side it began, in 1981, with the introduction of new budgetary policies aimed at reducing taxes and thus, it was hoped, stimulating the supply side of the economy. Contrary to original intentions, however, large US public sector deficits emerged and, more importantly, their structural, as opposed to their cyclical, component grew and interest rates rose to very high levels in real terms.

Thus, as the financial community had feared, the US policy mix turned out in the end to be a combination of loose fiscal policy and relatively tight monetary policy. True, there were nonetheless still supply-side features, including especially the effective incentives given to investment spending.

Even so, US policy stood in sharp contrast to that generally adopted in the rest of the world. Here, as already described, the dominant strategy was also intended to have similar — if less spectacular — supply-side effects. The difference lay in the order in which measures were to be taken. Cuts in the tax burden had, as it were, to be paid for in advance by public expenditure reductions and lower budget deficits. The latter were also intended to keep interest rates low and boost recovery from the investment side. Major reductions in the budget deficit in Japan were also thought to be necessary to prevent the public debt from rising too steeply.

The result was that, on the fiscal side, policy in the United States moved in precisely the opposite direction from that in the two other largest economies.

On the monetary policy side the differences were less pronounced. But, partly because of the real interest rate differentials which accompanied the US policy mix (see the graph overleaf), the dollar strengthened more or less continuously for four years. Even more remarkable was the fact that this appreciation was, to a large extent, recorded in real as well as nominal terms. The counterpart was, of course, exchange rate weakness elsewhere with its corresponding inflationary potential, which was, however, generally well contained.

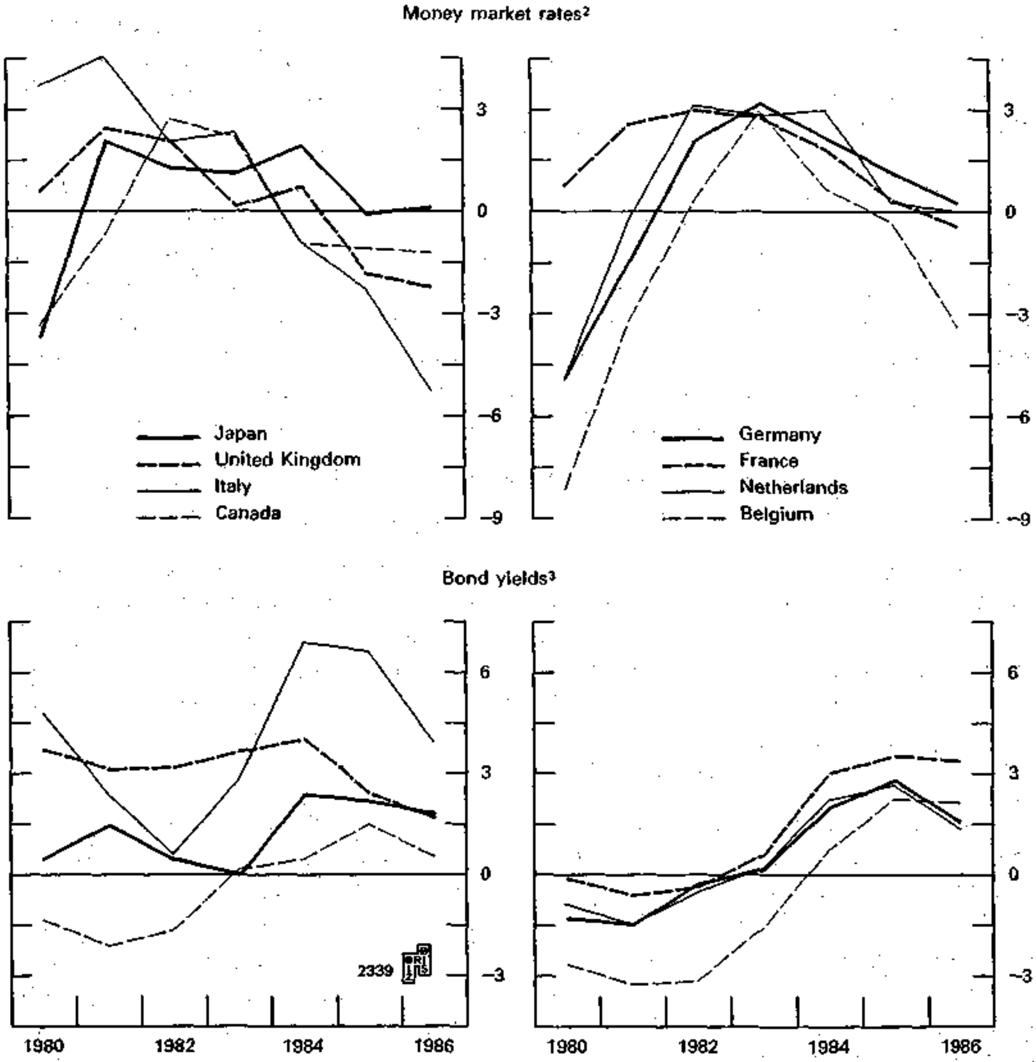
With the reduction of inflation being given a very high policy priority, policy-makers outside the United States found themselves in an awkward position. To aim at low interest rates in order to support investment might weaken the exchange rate further and be inflationary. To try to counter exchange rate weakness more forcefully might require damagingly high real interest rates. In the event, something of a middle course was adopted, especially in Europe. Interest rates were probably higher than might otherwise have been desirable. On the other hand, increased competitiveness vis-à-vis the United States, together with the sharp upturn in demand in that country, served to give a stimulus to other countries' exports. This also, incidentally, helped fiscal consolidation to be pursued without visible detriment to short-term growth performance.

In 1985 the actual structural fiscal imbalance between the three major countries increased further. Nevertheless, after reaching a peak in February, the dollar fell almost continuously thereafter. Thus, although on the surface the international policy mix situation did not seem to change in a major way, the perception no doubt grew that the authorities were increasingly dissatisfied with the course of events — most notably with the build-up of large current-account imbalances.

One early manifestation of official concern was the response of some authorities to the sharp surge in the dollar early in the year. This took the form of

US short and long-term real interest rate differentials vis-à-vis selected countries, 1980–86.[1]

Annual averages, in percentage points.



[1] Based on monthly data (1986 figures are end-March values). [2] Representative rates minus percentage changes over twelve months in consumer prices. [3] Representative rates minus annualised changes in consumer prices over the previous five years.

co-ordinated intervention in the exchange markets, though without any clear signal that policy mixes were going to be altered significantly.

Nevertheless, the dollar began to fall. Later, with M_1 growth seriously overshooting its target range in the United States, and with no significant response from the authorities (see Chapter VI), it became clear that US monetary policy was being eased somewhat. A little later still, in March, the discount rate was cut. Behind this relaxation lay several elements of concern. Firstly, the economy was slowing down. Secondly, an important reason for this slowdown was the leakage of demand through the deteriorating foreign balance. Thirdly, with the tradable goods sectors of the economy hard hit by the rise of the dollar, protectionist sentiment in the country was growing very strongly. Even in the context of a continuing large budget deficit, the authorities thus felt obliged to mount some mild attack on the US policy imbalance from the monetary side. The extent of this accommodatory shift should not, however, be exaggerated, accompanied as it was by some increase in the Federal funds rate after June. The aim was both to support demand and to help bring down the dollar in an orderly fashion as a means of heading off protectionist sentiment.

It was clear, however, that this action was unlikely to be adequate to the task on its own. Hence, there followed in September the significant meeting in New York of the Finance Ministers and central bank Governors of the five largest industrial economies. This meeting was probably most important in terms of the changes it revealed in attitudes towards the performance of the floating exchange rate system. So far as the fiscal/monetary policy mix is concerned, the outcome was less clear. The United States certainly committed itself to a marked reduction in the Federal budget deficit — something which the financial markets began to take more seriously as Congress began its discussion of the Gramm-Rudman-Hollings budget plan. The Japanese also spoke of efforts to stimulate domestic demand via measures to "enlarge consumer and mortgage credit markets" and later even introduced a modest, temporary, relaxation of fiscal stance. The European countries present felt their best course was to press ahead with the reduction of structural rigidities in their economies.

On the face of it, this result of the Group of Five meeting did not seem to go very far in resolving the international policy imbalance. Nevertheless, followed up as it was by further exchange market intervention and a growing belief that the US fiscal problem would be dealt with after all, the dollar continued to decline.

After an initial sharp appreciation of the yen, the Japanese authorities felt it necessary to aid its further rise with a temporary increase in short-term interest rates towards the end of the year. Fearing the threat of protectionism abroad, but fearing also to ease the stance of fiscal policy more than temporarily, the Japanese authorities could only implement their strong desire to raise the yen's value in this manner — at least in the short run. Fortunately, it was not long before interest rates could be reduced again, thus avoiding the risk of a deflationary effect on domestic demand.

Similarly, on the US side, any marked easing of monetary policy might have risked re-igniting inflationary expectations and destabilising the foreign exchange markets. In the event, however, the dollar continued its decline unaided by the implementation of any major policy change. Indeed, by late February there was some concern that an overshooting by the dollar in the opposite direction was becoming a danger.

For the rest of the industrial world appreciating currencies will tend over time to weaken demand via declining real external balances, though, correspondingly, the scope for lower interest rates has apparently already increased, as witnessed by the co-ordinated reductions in official rates earlier this year.

It would seem important, however, that these moves now be validated by turning expectations of a solution of the US fiscal problem into hard fact. For without such a solution there is a risk of insufficient progress being made towards a reduction of the present international imbalance. Put differently, the risks of a disorderly, and possibly deflationary, resolution of the situation would be heightened by any failure to bring down the US budget deficit.

III. INTERNATIONAL TRADE AND PAYMENTS.

Highlights.

Developments in international trade and payments last year compare unfavourably with those in 1984. World trade growth slowed down considerably, the current-account imbalances in the developed world increased further and the improvement in the developing countries' current-account position came to a halt.

After having rebounded strongly in 1984, the growth in the volume of world trade slackened to about 3 per cent. last year. The expansion was concentrated on the developed countries, while the volume of trade of the developing countries ceased to grow. This uneven and rather unusual trade pattern must be ascribed mainly to the emergence of supply and demand conditions in the oil and non-oil primary commodity markets which worked to the disadvantage of the developing countries. In particular, prices of non-oil primary commodities declined on a scale which had previously been experienced only in times of widespread economic recession, so that many developing countries suffered sizable terms-of-trade losses.

The process of adjustment of major external payments imbalances did not continue in 1985. Among the developed countries, there were substantial increases in the current-account surpluses of Japan and Germany and a further rise in the US current-account deficit.

In many developing countries no further progress was made in external adjustment and the current-account deficit for the group as a whole widened slightly in 1985. This has, moreover, to be seen in the light of a renewed tightening of policies of import restraint and a concomitant slowdown in the growth of domestic output in many countries, without which the deterioration in the aggregate current account would certainly have been larger. However, some countries, on the basis of domestic stabilisation programmes, succeeded in reducing internal and external imbalances despite the generally unfavourable international economic environment.

International capital movements in 1985 were dominated by two features. Firstly, the United States continued to attract huge amounts of non-resident capital, a large part of which was, as in the previous year, provided by Japanese investors. Secondly, cross-border securities transactions replaced international bank lending as the principal vehicle for international capital flows (see Chapter V).

The aggregate financing requirements of the developing countries decreased substantially last year as the modest rise in the current-account deficit was more than offset by a decline in capital outflows. New lending by official creditors was reduced significantly and, while bank lending increased slightly in comparison with the previous year, there were no signs of a resumption of spontaneous private sector lending to problem debtor countries.

The outlook for the world pattern of current-account payments balances has been affected by two major developments since late 1985. On the one hand, the depreciation of the dollar against other major currencies should in due course help to reduce existing imbalances in the developed world. The effects of the dollar's depreciation will, however, take time to make themselves felt and should be reinforced by measures aimed at attaining a better balance between domestic savings and investment in the principal surplus and deficit countries. On the other hand, the very large fall in oil prices is already aggravating imbalances between oil-exporting and oil-importing countries and will, in the short run, further augment the Japanese and German surpluses substantially. However, lower oil prices should also facilitate interest rate reductions and higher demand growth in the developed world, with a longer-term beneficial effect on the developing countries' external positions.

World trade.

The growth in the volume of world trade slowed down to 3 per cent. last year, compared with almost 9 per cent. in 1984. Owing to a rapid fall in commodity prices, the average dollar prices of traded goods declined by almost 2 per cent., so that the current dollar value of world trade remained close to its 1984 level of just below $2,000 billion.

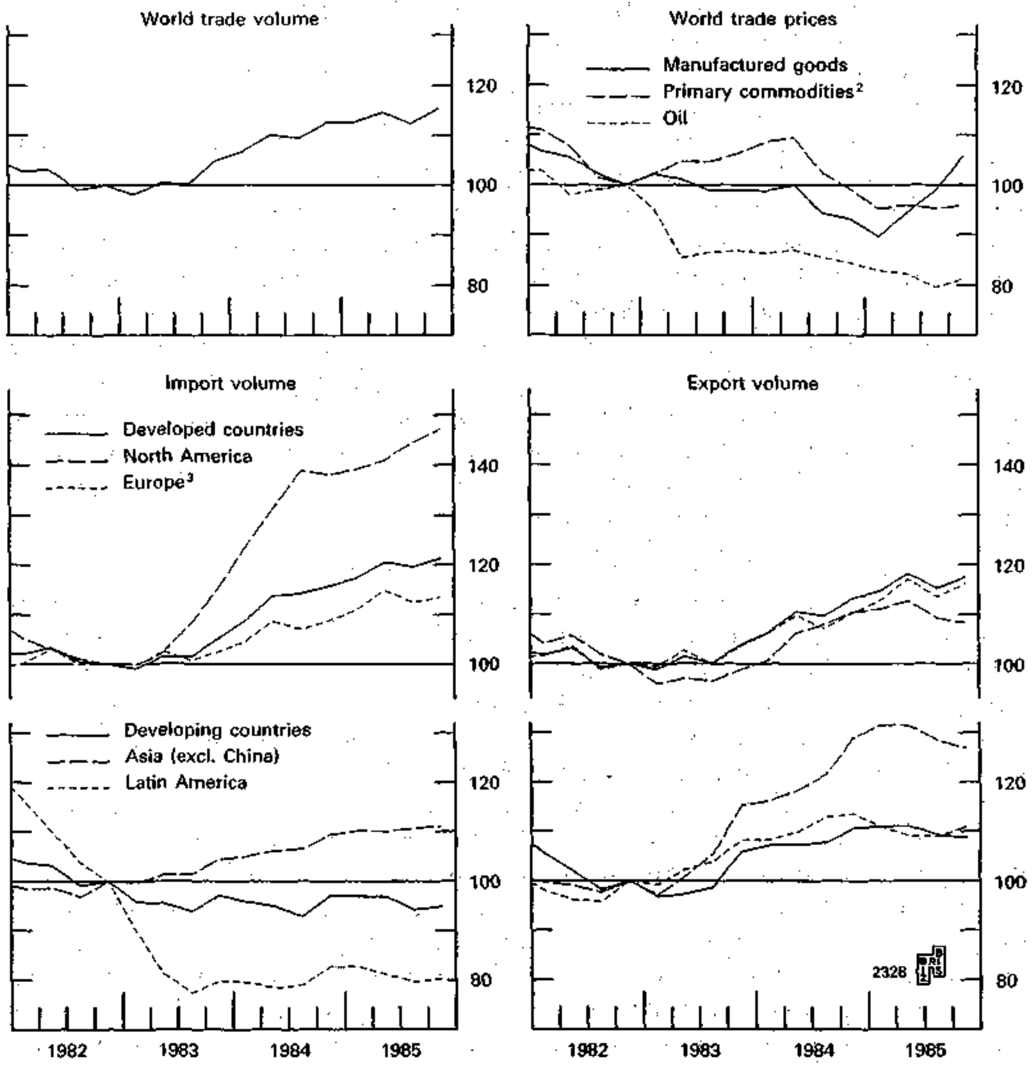
While the slowdown in world trade growth in 1985 was to some extent a normal response to the moderation of world economic activity, it was unusually pronounced in the light of the rather mild deceleration in world output growth from 4½ per cent. in 1984 to 3 per cent. last year. The trade of the developing world virtually stopped expanding in 1985, while trade among the developed countries themselves continued to rise but at a slower pace than in the previous year.

Indeed, as can be seen from the following graph, the increase in world trade in real terms in 1985 can be ascribed entirely to the growth of trade volumes in the developed countries. Their total real imports rose by about 5 per cent. and, in contrast to 1984, the rate of import growth in North America and Europe was fairly similar. However, real imports into Japan, which had risen steeply in 1984, stagnated in 1985. Real exports of the developed countries also continued to expand last year, by about 4 per cent. on average, but this was predominantly accounted for by a 5 per cent. growth in exports from Europe and Japan, whereas in North America the rate of growth slackened from 12 per cent. in 1984 to about 2½ per cent. in 1985.

The trade performance of the developing countries deteriorated last year, both in volume and, owing to the weakness of primary commodity prices, even more in value terms. In volume terms the developing countries' total exports decreased in 1985 by 1 per cent., compared with a rise of 6½ per cent. in the previous year. The weakness of demand for oil meant that the decline in export volume, of 7½ per cent., was particularly large in the oil-exporting countries in the Middle East. In addition, real exports from Latin America declined by 1 per cent. in 1985, after a 7½ per cent. increase the year before. Total exports of Asian countries continued to grow, but by only 2½ per cent., as against 14 per cent. in 1984.

World trade, 1982–85.[1]

Fourth quarter 1982 = 100.



[1] Volume data: uncentred three-quarter moving averages. [2] Excluding oil. [3] Belgium, France, Germany, Italy, the Netherlands, Sweden, Switzerland and the United Kingdom.

On the imports side, the volume change was much less pronounced between 1984 and 1985, from a very small increase to a decrease of 1 per cent. A number of developing countries again cut back real imports in 1985. In particular, imports of oil-exporting countries in the Middle East fell by 15½ per cent. in volume last year. In Latin America the decline was only 1½ per cent., while in Asian developing countries total imports went up by 6½ per cent., or at about the same rate as in 1984. Most of the Asian countries' real import growth last year, however, was accounted for by China, while elsewhere import growth was much slower than before.

On top of the unfavourable volume developments, the average dollar prices of primary commodities declined significantly in 1985 — a development which contrasted sharply with the 1 per cent. increase in the dollar prices of internationally traded manufactured goods. Last year's decline of 12 per cent. in non-oil commodity prices was on a scale previously seen only in conditions of worldwide recession. The average level of oil prices declined more moderately, 4½ per cent., but throughout the year the international oil market was in a state of precarious balance. With world oil consumption decreasing by ½ mb/d, inventories being drawn down slightly and non-OPEC producers expanding their output by 1 mb/d, the maintenance of stability in the oil market rested solely on production cuts by Saudi Arabia. Acting as the OPEC countries' swing producer, Saudi Arabia had lowered its output to less than 2½ mb/d by August 1985, only one-quarter of its annual average output in 1980–81. In September, however, Saudi Arabia abandoned this role and adopted the more market-related pricing policies of other oil-producing countries. Total OPEC production rose in the final quarter of 1985 by almost 3 mb/d and, while the seasonal increase in demand helped to sustain oil prices until the end of the year, the impact of excess supply and the scrambling for oil market shares led to a crash in oil prices in 1986.

The unfavourable developments in the volume and value of developing countries' exports in 1985 may be attributed to three main factors. As regards volume, there was, first and foremost, the fact that these countries' exports to the major developed countries, which account for two-thirds of their total exports, are strongly concentrated on the United States and Japan. This proved particularly disadvantageous in 1985, when the growth in the volume of US imports fell sharply, from 25½ to 4 per cent., while in Japan there was no growth in real imports. The effects were most keenly felt by developing countries in Asia and Latin America, which are particularly dependent on the US and Japanese markets. Secondly, developing countries' exports to developed countries appear to have been increasingly affected by non-tariff barriers. Studies undertaken by the OECD and the World Bank point to an alarming development. The proportion of manufactured products subject to non-tariff restrictions in the industrial world is estimated to have risen from 20 per cent. in 1980 to 30 per cent. in 1983 and there can be little doubt that this trend has continued in recent years. As pressures for protection arise primarily in relatively labour-intensive industries, in which developing countries with low wage levels enjoy a comparative advantage, these countries are likely to be more affected than the industrial countries. Restrictions limiting the developing countries' exports of agricultural products are even more widespread, and whereas perhaps around one-tenth of imports within the group of industrial countries is subject to trade barriers, the percentage may be twice as high for industrial countries' imports from the developing countries. While it is practically impossible to quantify the impact of protectionism on the developing countries' trade, it is noteworthy that last year's slowdown in exports was particularly pronounced in the case of those countries which have recently become major exporters of manufactured products.

Finally, the unfavourable influences on export volumes were exacerbated by factors that depressed the prices of primary commodities, and in particular non-oil commodities. In recent years the combination of relatively slow economic growth and structural changes in the developed countries, entailing shifts of activity from heavy to light industry and reduced raw material input per unit of output, have contributed to the weakness of commodity prices. Moreover, the effects on prices of these demand factors have been reinforced by an unprecedented increase in supplies of non-oil primary products of 7½ per cent. over the two-year period 1984–85. These influences exerted such downward pressure on commodity prices that the favourable price impact that would normally have been expected to result from the depreciation of the dollar did not materialise in 1985.

Widening external imbalances in the three largest industrial countries.

The current-account positions of the United States, Japan and, to a lesser extent, Germany, became more unbalanced in 1985. While these imbalances are not spectacularly large in relation to GNP, they are very substantial in absolute terms and constitute an element of instability in the world economy with potentially adverse consequences for international trade, exchange rates and the level of global economic activity. International current-account balances of individual countries and groups of countries are shown in the table on page 50.

In the *United States* the current-account deficit widened last year by $10.3 billion to $117.7 billion. While the deterioration was much less pronounced than in 1984, when the deficit more than doubled, two factors suggest that the underlying weakening of the US external position was greater than is indicated by the recorded annual current-account figures. Firstly, the seasonally adjusted quarterly trade deficit increased steadily throughout the year and in the final quarter it exceeded the first-quarter deficit, in both current and constant dollars, by more than 50 per cent. Secondly, last year's surplus on invisibles transactions, at $6.6 billion, was practically the same as in 1984. However, if valuation effects on the stock of US direct investment abroad produced by the movement in the dollar's exchange rate (in contrast to other countries the US balance of payments includes such valuation effects in the investment income and outward direct investment figures) were excluded, the invisibles surplus would have shrunk from $15 billion in 1984 to $1.2 billion in 1985, owing to higher net payments for travel and transport, reduced net investment income and increased transfer payments.

United States: Estimated components of changes in the trade balance.

Years	Changes in the trade balance	Reflecting changes in: oil imports	non-oil terms of trade	export volume: total	export volume: *due to export market growth*	non-oil import volume: total	non-oil import volume: *due to domestic demand*
	in billions of US dollars						
1984	−47	− 2½	4½	16	*16½*	−65	*−33*
1985	−10	7	− ½	1	*6½*	−17½	*−14*

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

Last year's increase in the deficit occurred despite a \$7 billion reduction in oil imports. The decline in oil payments reflected a 5 per cent. fall in the unit value of imports and a 7½ per cent. cut in their volume as domestic oil stocks were drawn down by 7 per cent. in the face of stagnant consumption.

The non-oil trade balance worsened by \$17.3 billion in 1985, which was considerably less than the \$44.4 billion recorded in the previous year. The slower pace of the deterioration was mainly attributable to the fact that the adverse influence of relative demand pressures, which had been particularly significant in 1984, subsided last year as the growth of US domestic demand converged with average demand growth in other industrial countries. At the same time, however, the US international competitive position remained weak. The annual average of the dollar's real effective exchange rate was 2 per cent. higher in 1985 than in the preceding year, even though the decline in the exchange rate vis-à-vis the yen and major European currencies after February helped to strengthen US producers' competitiveness by 14½ per cent. between the first and the last quarter of 1985. Moreover, trade volumes normally respond only with a lag of several months to changes in competitiveness, so that the full impact of the dollar's decline should be felt only in the course of 1986.

Virtually the whole of the increase in the non-oil trade deficit in 1985 was the result of volume factors. Movements in relative trade prices — export and import unit values declined by 3 and 2½ per cent. respectively — contributed about \$½ billion to the increase in the deficit. The United States is both a large exporter and a large importer of agricultural products and raw materials and, therefore, unlike most other industrial countries, did not benefit from the sharp decline in non-oil commodity prices in 1985.

Exports in volume terms scarcely expanded over the year as a whole despite a 3 per cent. growth in US export markets. Real exports declined during the first three quarters, but recovered moderately, by 2 per cent., in the final quarter of the year. This pattern was strongly influenced by movements in the volume of agricultural exports. The strength of the dollar and growing world supplies resulted in strong competition from other exporters as well as from domestic producers in the traditional export markets of the United States, and between the final quarter of 1984 and the third quarter of 1985 real agricultural exports fell by 28 per cent., before rebounding by 17 per cent. in the last three months of the year. Non-agricultural exports fared somewhat better, rising at constant prices by about 3½ per cent. in 1985, compared with 10 per cent. in the previous year. However, the overall expansion was essentially attributable to increased exports of aircraft and intra-firm exports of motor vehicle parts to US production sites located in Canada. The volume of other capital goods exports virtually stagnated, while exports of consumer goods decreased by 6 per cent.

The volume of non-oil imports expanded by about 6½ per cent. in 1985, or by \$17½ billion in dollar terms. This considerable slowdown in real non-oil import growth from 30½ per cent. in 1984 was mainly due to the deceleration in domestic demand growth from 8½ per cent. in 1984 to 2½ per cent. in 1985. Moreover, whereas only one-half of the surge in real imports in 1984 could be ascribed to domestic demand factors, in 1985 import volume growth was, for the year as a whole, much more in line with the expansion in real domestic demand, which would seem to indicate that import penetration slowed down considerably in 1985. However, following a modest rise in the first half of the year real import growth accelerated quite markedly in the second half, in spite of the fact that import costs had begun to rise in response to the depreciation of the dollar. This suggests that US importers brought forward purchases abroad in anticipation of further upward adjustments in import prices. The increase in non-oil imports was spread across all major groups of commodities with the exception of industrial supplies and materials, and was most pronounced in manufactured products, with imports being particularly boosted by a continuing strong demand for motor vehicles.

United States: Trade balances vis-à-vis groups of countries.

Years	Total trade balance	Industrial countries*	*Western Europe*	*Japan*	*Canada*	Developing countries	*Latin America*	*Asia*
	in billions of US dollars							
1984	−114.1	− 63.6	− *15.2*	− *37.0*	− *16.1*	− 50.5	− *18.6*	− *25.4*
1985	−124.3	− 78.7	− *21.2*	− *43.4*	− *17.1*	− 45.6	− *15.6*	− *25.7*

* Includes eastern Europe and international organisations.

Last year's decline in the value of US exports, of $5.9 billion to a total of $214 billion, was primarily attributable to reduced sales to western Europe, Japan and the oil-exporting countries in the developing world. By contrast, exports to Canada and Latin America increased moderately, but a significant share of this increase is likely to reflect expanding intra-firm exports of US companies to their production sites in these areas. These exports represent to a certain extent the shipment of components and parts used for the assembling and manufacturing of products destined for re-export to the US market. The value of US imports rose by $4.3 billion to $338.3 billion in 1985. While purchases from other industrial countries increased by $12.4 billion, imports from the developing countries declined by $7.8 billion, mainly on account of reduced oil purchases. These changes in the pattern of trade implied that the counterpart to the US trade deficit shifted further to the industrial countries in 1985. Whereas in 1983 more than one-half of the US trade deficit had been vis-à-vis the developing countries, in 1985 this share declined to about one-third.

Last year's increase in the current-account deficit did not pose any financing problems. Despite the very large decline in the dollar's exchange rate the deficit continued to be entirely financed by spontaneous private capital inflows. There were, however, some important changes in the pattern of these inflows. Net purchases of US securities by non-residents increased very sharply, accounting for half of all net capital inflows, while the balance of other non-bank capital transactions, which had been strongly positive in 1984, showed a small net outflow. On the rest of the capital account there continued to be net inflows through the banking system, on an even larger scale than in 1984. Unidentified inflows of funds, as recorded in the statistical discrepancy of the balance of payments, remained at about the same high level as the year before.

United States: Summary of capital-account transactions.[1]

Items	1984	1985				
		year	first quarter	second quarter	third quarter	fourth quarter
	in billions of US dollars					
Capital-account balance	107.6	123.6	35.1	20.1	26.9	41.5
Identified capital flows	77.1	90.8	23.1	15.9	19.6	32.2
US Government capital[2]	− 5.0	− 2.5	− 1.4	− 0.3	− 0.5	− 0.3
Private sector capital	82.1	93.3	24.5	16.2	20.1	32.5
Securities transactions[3]	33.5	61.0	9.9	9.2	16.2	25.8
of which:						
US Treasury securities	*22.4*	*20.9*	*2.6*	*5.1*	*7.5*	*5.7*
other US securities	*13.0*	*50.7*	*9.5*	*7.1*	*11.7*	*22.4*
Other non-bank capital[4]	25.3	− 2.4	1.1	2.7	− 1.0	− 5.2
of which:						
direct investment[3,4]	*4.2*	*− 8.6*	*1.5*	*− 3.8*	*− 2.3*	*− 4.0*
Banking flows (net)	23.2	34.7	13.5	4.3	5.0	11.9
Errors and omissions	30.5	32.8	12.0	4.2	7.3	9.3
Changes in net official monetary position (− = improvement)	− 0.2	− 5.9	− 10.9	7.5	2.4	− 4.9
Memorandum item:						
Current-account balance	*−107.4*	*−117.7*	*− 24.2*	*− 27.6*	*− 29.3*	*− 36.6*

Note: A minus sign indicates an outflow of capital.

[1] The capital-account figures are not seasonally adjusted. [2] Excluding transactions in US Government securities. [3] Net capital flows between US corporations and their finance affiliates in the Netherlands Antilles are included in total securities transactions and excluded from direct investment. [4] Inter-company flows are included in other non-bank capital and excluded from direct investment.

The record net inflow of portfolio capital can be traced entirely to an almost fourfold increase, from \$13 billion in 1984 to \$50.7 billion in 1985, in net sales of US non-Treasury securities to non-residents. More than 70 per cent. of the increase reflected sales of newly issued US corporate bonds, raising their share in total US corporate bond issues to nearly one-third. This surge in foreign purchases of US bonds can be ascribed primarily to two factors. Firstly, yields on US bonds exceeded those on bonds in some of the other major currencies and, particularly after mid-1985, there were expectations of capital gains from a decline in interest rates. Secondly, US corporations funded a substantial part of their financing needs through borrowing in the Euro-bond market. This shift in borrowing behaviour was induced by the abolition in July 1984 of the US withholding tax on interest payable to non-residents on US securities newly issued abroad and by rapid financial innovation, which offered growing possibilities to tailor new issues to the needs of particular groups of foreign investors and thus enabled US borrowers to raise funds at times more cheaply in overseas markets than at home. In particular, the introduction of new hedging devices such as partly-paid bonds and warrants to purchase additional bonds in the same or a different currency provided protection against volatile exchange rates and, especially towards the end of the year, allowed investors to benefit from a decline in US interest rates while limiting their exposure to an exchange rate loss.

Other securities transactions resulted in net inflows of \$10.3 billion, or half the amount recorded in 1984. The decline was mainly attributable to a \$6 billion reversal in securities-related flows, reflecting the balance on transactions between US corporations and their finance affiliates in the Netherlands Antilles. Indeed, with the tax advantages of borrowing in the Euro-bond market via such finance affiliates being effectively eliminated after the abolition of the US withholding tax, new bond issues via the Netherlands Antilles, which had still amounted to $9.9 billion in 1984, practically ceased in 1985. There was also a small reduction of $1.5 billion in net new sales abroad of US Treasury securities, although at $20.9 billion the demand for these securities remained very buoyant.

United States: Banking flows.

Items	1984	1985				
		year	first quarter	second quarter	third quarter	fourth quarter
	in billions of US dollars					
Banking flows (net)	23.2	34.7	13.5	4.3	5.0	11.9
Changes in claims	– 8.5	– 5.9	0.1	4.1	– 1.5	– 8.6
Changes in liabilities	31.7	40.6	13.4	0.2	6.5	20.5
Transactions for own account in dollars (net)	20.6	27.5	13.6	– 0.1	7.3	6.7
with own foreign offices	– 4.6	1.6	2.4	– 4.2	5.3	– 1.7
with other banks	14.7	13.6	7.7	0.4	1.2	4.1
with non-banks	10.5	12.3	3.6	3.7	0.8	4.3
Other transactions (net)*	2.6	7.2	– 0.1	4.4	– 2.3	5.2

Note: A minus sign indicates an outflow of capital.
* Includes transactions in foreign currencies, banks' domestic customers' external claims and banks' custody liabilities.

Net international capital inflows through the US banking sector rose in 1985 by $11.5 billion to a record total of $34.7 billion. The increase was mainly attributable to a resumption of US banks' net borrowing in dollars from their foreign offices and a turn-round in their foreign currency business from net lending of $2.2 billion in 1984 to net borrowing of $2.8 billion in 1985. The bulk of last year's banking inflows, however, continued to result from reductions, of $13.6 billion and $12.3 billion respectively, in the net foreign asset position of banks in the United States vis-à-vis unaffiliated foreign banks and non-banks. Most of these inflows resulted from a cutback in claims, which reflected two factors: banks continued to reduce their exposure to developing countries; and borrowers in the industrial countries made increasing use of international bonds and short-term Euro-notes and Euro-commercial paper as substitutes for bank credit.

The turn-round in non-bank flows other than portfolio capital, from inflows of $25.3 billion in 1984 to outflows of $2.4 billion in 1985, can be associated with two developments discussed earlier. Firstly, as the US corporate sector shifted its financing activities to the Euro-bond market, net inflows through inter-company accounts and from other forms of US corporate borrowing abroad declined by $15.1 billion to only $6.2 billion in 1985. Secondly, the balance on net direct investment swung to net outflows of $8.6 billion, with a substantial part of the $10.3 billion increase in outward direct investment representing valuation effects arising from the decline in the dollar.

In 1985 identified net flows from western Europe, Japan and other countries (virtually all of which are in the developing world) contributed in roughly equal

United States: Regional distribution of identified private sector capital flows.

Items	Total		Western Europe		Japan[1]		Other industrial countries[1,2]		Other countries	
	1984	1985	1984	1985	1984	1985	1984	1985	1984	1985
	in billions of US dollars									
US private sector assets ...	−11.8	−31.7	−13.8	−35.0	0.7	− 6.3	− 1.3	2.1	2.6	7.5
US private sector liabilities .	93.9	125.0	46.5	64.2	14.1	35.0	6.0	0.2	27.3	25.6
US private sector (net)	82.1	93.3	32.7	29.2	14.8	28.7	4.7	2.3	29.9	33.1

Note: A minus sign indicates an outflow of capital.
[1] Partly estimated. [2] Australia, Canada, New Zealand and South Africa.

proportions to the total recorded net inflows of $93.3 billion into the United States (see the table above). However, these data are compiled on the basis of residence and, with a large volume of transactions being channelled via foreign rather than domestic financial centres, the recorded regional flows cannot provide an accurate picture of the nationality of the ultimate investors and borrowers. Nonetheless, two noteworthy features emerge from the table. Firstly, net inflows from Japan soared to nearly $29 billion in 1985, with claims of Japanese residents more than doubling to $35 billion. Most of this increase appears to reflect direct purchases of US Treasury securities and depositing with banks in the United States, which together may have expanded from $9 billion in 1984 to over $26 billion in 1985. In addition, other US securities sold directly to Japanese residents are reported to have risen from $1.3 billion in 1984 to $5.7 billion in 1985, although Japanese capital-account figures suggest that the total amount of investment in US corporate securities was much more significant. Secondly, gross flows between residents in the United States and in western Europe expanded substantially last year. While the increase in gross US outflows to that area was mainly attributable to valuation effects on the large US direct investment holdings in western Europe, the rise in gross inflows from that region was entirely accounted for by a $33 billion rise in sales of US securities other than Treasury securities. This enormous increase was undoubtedly a reflection of western Europe's role as the main centre for international bond issues; indeed, about 80 per cent., or $26 billion, of the increase resulted from net sales in the London market, although a substantial portion of the purchases is likely to have been made by investors outside the United Kingdom.

The persistent and growing external disequilibrium of the United States was to some extent mirrored in the widening current-account surpluses of Japan and Germany.

In *Japan* the current account continued to strengthen in 1985 despite a marked slowdown in the growth of Japan's export markets. The surplus on current account rose by $14.3 billion, or virtually the same amount as in each of the two preceding years, reaching a record level of $49.3 billion. The bulk of the increase stemmed from a $11.7 billion rise in the trade surplus. In addition, the traditional invisibles deficit declined by $2.6 billion, mainly owing to higher income from Japan's growing net foreign investment.

Japan: Estimated contribution of changes in the volume and terms of trade to changes in the trade balance.[1]

Items	1984	1985[2] year	first quarter	second quarter	third quarter	fourth quarter
	in billions of US dollars					
Changes in the trade balance	13.1	12.5	1.5	2.7	3.9	4.4
due to volume changes	8.9	7.3	2.4	2.9	2.5	− 0.5
export volume	23.0	6.2	3.0	2.4	0.9	− 0.1
import volume[3]	−14.1	1.1	− 0.6	0.5	1.5	− 0.4
due to terms-of-trade changes	4.2	5.2	− 0.9	− 0.3	1.4	5.0

[1] On the basis of customs data. [2] Quarterly changes are measured against the corresponding quarter of 1984. [3] A minus sign indicates a rise in import volume.

The increase in the trade surplus in 1985 was, as in the previous year, the result of favourable volume and terms-of-trade developments. However, while the change in the real trade balance was broadly of the same magnitude as in the preceding year, the underlying volume changes were strikingly different. Exports at constant dollar prices had leaped in 1984 by $23 billion but rose comparatively moderately by $6.2 billion last year. In the face of practically unchanged international competitiveness, the deceleration in export volume growth — from 13 per cent. in 1984 to 4 per cent. in 1985 — must be ascribed essentially to the slowdown in the growth of Japan's export markets from about 9 per cent. in 1984 to 3½ per cent. in 1985. The fact that the trade balance continued to improve substantially despite the slower real export growth was largely attributable to last year's developments in the volume of imports. Having risen in 1984 by 11 per cent., equivalent to $14.1 billion, the level of real imports remained virtually the same last year. While this may be attributed partly to the weaker expansion of real domestic demand and industrial production in 1985, two additional factors appear to have held back imports. Firstly, inventories of raw materials and oil were apparently drawn down, possibly in anticipation of further declines in commodity prices. Secondly, the reduction in the growth of the volume of imported manufactured products, from over 20 per cent. in 1984 to just 2 per cent. in 1985, may have been related to a certain extent to the weakening export performance, as many components and parts used in the production of export goods are imported from production sites abroad.

Volume movements were the dominant influence on the trade balance during the first three quarters of 1985. In the final quarter, however, when the real trade balance ceased to strengthen, a very large terms-of-trade gain boosted the surplus by as much as $5 billion. This exceptionally large improvement in the terms of trade reflected both adjustments in dollar export prices in the wake of the yen's appreciation and the beneficial impact of declining commodity prices on import unit values.

In value terms, Japan's exports rose by $5.6 billion to $173.9 billion in 1985. Sales expanded substantially only in two markets: exports to the United States increased by $5.4 billion and sales to China, where an ambitious domestic reform programme prompted exceptionally large imports, rose by a similar amount. By contrast, exports to other developing countries, in particular to the oil-exporting countries, generally declined. The value of Japan's imports fell last year by $6.1 billion to $117.9 billion. The reduction was spread widely across different countries. Apart from cuts in oil imports from countries in the Middle East, the most significant reductions occurred in purchases from South-East Asian countries.

The current-account surplus was more than matched by net capital outflows, which, including errors and omissions, reached a record of $50.7 billion, and the net official monetary position deteriorated by $1.4 billion. Interest rate factors and portfolio adjustment triggered by the liberalisation and deregulation of financial markets again influenced the placement abroad of Japan's domestic savings surplus. The long-term interest rate differential in favour of dollar-denominated assets remained substantial in 1985, although it narrowed from over 5 percentage points at the beginning to just under 4 percentage points at the end of the year. Moreover, prospects of capital gains, associated with an expected decline in interest rates, may have provided an additional incentive to capital outflows in the second half of 1985.

Japan: Capital-account transactions.

Items	1984	1985				
		year	first quarter	second quarter	third quarter	fourth quarter
	in billions of US dollars					
Capital-account balance	−36.4	−54.6	− 8.4	−14.1	−13.5	−18.6
Long-term capital (net)	−49.7	−64.8	−10.3	−17.2	−18.3	−19.0
Resident capital	−56.8	−81.8	−14.6	−19.6	−22.7	−24.9
of which:						
direct investment abroad	*− 6.0*	*− 6.5*	*− 1.3*	*− 1.7*	*− 1.7*	*− 1.8*
trade credits	*− 4.9*	*− 3.0*	*− 1.5*	*− 0.4*	*− 0.4*	*− 0.7*
loans	*−11.9*	*−10.4*	*− 3.3*	*− 1.0*	*− 2.6*	*− 3.5*
securities	*−30.8*	*−59.8*	*− 8.4*	*−15.9*	*−17.1*	*−18.4*
Non-resident capital	7.1	17.3	4.2	2.5	4.4	6.2
of which:						
external bonds	*7.4*	*12.9*	*3.5*	*2.4*	*3.7*	*3.3*
other securities	*− 0.2*	*3.9*	*0.7*	*− 0.1*	*0.7*	*2.6*
Short-term capital (net)	13.3	10.2	1.9	3.1	4.8	0.4
of which:						
banking flows	*17.6*	*10.8*	*2.5*	*3.0*	*3.8*	*1.5*
Errors and omissions	3.7	3.9	1.7	1.8	− 0.4	0.8
Changes in net official monetary position (− = improvement)	− 2.3	1.4	− 0.1	− 1.1	0.9	1.7

Note: A minus sign indicates an outflow of capital.

The massive net capital outflows from Japan continued to be dominated by exports of long-term resident capital, which increased from $56.8 billion in 1984 to $81.8 billion in 1985 (see the table above). Even more strikingly, purchases of foreign securities doubled last year to $59.8 billion, equivalent to more than 70 per cent. of total outflows of long-term resident capital. To an important extent this development reflected the continuing portfolio diversification on the part of institutional investors. For example, stock figures from balance sheets indicate that foreign securities held by insurance companies and in trust fund accounts of banks, which had expanded by $10.2 billion in 1984, rose by a further $16.6 billion in 1985. At the same time, banks and the corporate sector added twice as much to their stock of foreign securities in 1985 as they had done in the previous year. As in 1984, the bulk of the newly acquired securities consisted of foreign currency bonds, which, at $53.5 billion, accounted for almost 90 per cent. of residents' purchases of foreign securities in 1985. Other outflows of long-term resident funds, by contrast, declined by $4 billion to $22 billion, mainly because the levels of new trade credits and yen lending by Japanese banks were somewhat lower than in 1984.

The investment of long-term non-resident funds in Japan, traditionally almost entirely in the form of portfolio investment, also rose considerably, by $10.2 billion to a total of $17.3 billion in 1985. The major part of the increase stemmed from sales of external bonds by Japanese corporations, which have been stepped up noticeably since the guidelines on the issuance of foreign-currency-denominated bonds with swap arrangements into yen were relaxed in April 1984. Moreover, the withholding tax on interest income from Euro-yen bonds held by non-residents was abolished in April 1985. So far, however, Japanese borrowers have found it more advantageous to issue foreign currency bonds with swaps. Euro-yen issues accounted only for a small fraction of total external bond sales in 1985.

As in 1984, short-term capital movements offset to some extent the net outflows of long-term capital. Net short-term outflows through the banks declined by $6.8 billion, but at $10.8 billion the level was still considerably higher than before restrictions on the banks' conversions of foreign currency into yen were removed in 1984. One factor behind the lower level of short-term banking inflows may have been banks' borrowing of US dollars in order to finance purchases of long-term dollar-denominated assets, including floating rate notes. Net outflows from other transactions — encompassing short-term non-bank trade credits and short-term securities transactions — practically ceased last year.

Germany's surplus on current account doubled to $13.9 billion, primarily on the strength of the trade performance. The increase of $6.9 billion in the trade surplus to $28.1 billion — the highest ever recorded in current dollar terms — can be traced to favourable volume movements which were reinforced by a 1½ per cent. improvement in the terms of trade. However, the relative contribution of volume and price factors to changes in the trade balance varied considerably in the course of 1985. During the first half of the year the buoyancy of export markets, in combination with a particularly strong German competitive position, resulted in significant gains in export volume, and the trade surplus rose appreciably in real terms. When these positive influences began to fade after mid-year — export volume growth decelerated markedly during the second half of 1985 — the trade balance began to benefit from sharply improving relative trade prices.

Over the year as a whole the volume of exports expanded by 6 per cent., or considerably more than the 4 per cent. growth in export markets. The corresponding gain in market shares must be ascribed mainly to Germany's international competitiveness, which, in spite of the Deutsche Mark's appreciation

Germany: Estimated contribution of changes in the volume and terms of trade to changes in the trade balance.[1]

Items	1984	1985[2] year	first quarter	second quarter	third quarter	fourth quarter
	in billions of US dollars					
Changes in the trade balance	2.2	6.7	− 0.1	2.8	2.0	2.0
due to volume changes	7.4	3.9	1.3	3.2	0.4	− 1.0
export volume	15.6	10.1	2.4	4.1	2.8	0.8
import volume[3]	− 8.2	− 6.2	− 1.1	− 0.9	− 2.4	− 1.8
due to terms-of-trade changes	− 5.2	2.9	− 1.4	− 0.3	1.6	3.0

[1] On the basis of customs data. [2] Quarterly changes are measured against the corresponding quarter of 1984. [3] A minus sign indicates a rise in import volume.

after February, remained on average broadly unchanged in 1985. The rise in the volume of exports of manufactured goods, which account for 90 per cent. of German exports, was particularly pronounced, the largest increases in sales being achieved in the United States (16.1 per cent.), the United Kingdom (10.4 per cent.) and Italy (7.6 per cent.). However, sales in Germany's most important export market, France, advanced by only 1.2 per cent. as that country pursued policies of demand restraint until mid-1985. The volume of German imports grew by over 4 per cent., which, in the light of a rather modest expansion of real domestic demand, suggests the persistence of a rather high income elasticity of import demand. Indeed, the increase in import volume was, with the exception of fuels, spread rather evenly across all major groups of commodities. Changes in the regional pattern of trade indicate that EEC countries were the main beneficiaries of higher German import demand.

Germany: Identified capital-account transactions.

Items	1984	1985 year	first quarter	second quarter	third quarter	fourth quarter
	in billions of US dollars					
Total identified capital (net)	−10.7	−16.2	− 4.8	− 3.1	− 0.2	− 8.1
Long-term capital (net)	− 5.3	− 2.1	− 0.9	0.0	− 0.7	− 0.5
Securities transactions	0.6	3.7	0.9	1.3	0.9	0.6
Foreign securities	− 5.4	−10.9	− 1.7	− 1.9	− 3.3	− 4.0
Domestic securities*	6.0	14.6	2.6	3.2	4.2	4.6
Other long-term capital (net)	− 5.9	− 5.8	− 1.8	− 1.3	− 1.6	− 1.1
Direct investment	− 2.1	− 2.8	− 0.3	− 0.4	− 0.7	− 1.4
Banking flows (net)	− 1.8	− 0.6	− 1.1	0.3	0.0	0.2
Other (net)	− 2.0	− 2.4	− 0.4	− 1.2	− 0.9	0.1
Short-term capital	− 5.4	−14.1	− 3.9	− 3.1	0.5	− 7.6
Banking flows (net)	0.3	−10.0	− 2.0	− 1.4	0.2	− 6.8
Other	− 5.7	− 4.1	− 1.9	− 1.7	0.3	− 0.8

Note: A minus sign indicates an outflow of capital.

* Including borrowers' notes of domestic public authorities.

The rise in the current-account surplus was broadly matched by a corresponding increase in net outflows of capital from Germany, as the net official monetary position, excluding valuation adjustments, improved only moderately, by $1.2 billion. As can be seen from the table on the preceding page, the pattern of identified capital-account transactions changed markedly between the last two years. In 1984 total net outflows of $10.7 billion were roughly evenly divided between exports of short-term and long-term capital. In 1985, by contrast, the lion's share consisted of short-term capital outflows, whereas the volume of net long-term capital exports declined by $3.2 billion to $2.1 billion.

The most remarkable development in the long-term capital account was, however, the very substantial increase in both inward and outward portfolio flows. Purchases of foreign securities by German residents doubled to $10.9 billion, of which almost two-thirds was in the form of foreign currency bonds. Relatively high-yielding securities continued to attract German investors' interest, despite the apparent tendency of the Deutsche Mark to appreciate. At the same time, favourable expectations about the future course of the Deutsche Mark and tax and regulatory changes, including the abolition of the coupon tax in the autumn of 1984 and the authorisation of new financing instruments such as zero coupon bonds and floating rate notes, provided strong incentives to non-residents' demand for German securities, with purchases rising from $6 billion in 1984 to a new record level of $14.6 billion in 1985. The marked expansion in outflows and inflows in respect of securities transactions went hand in hand with major shifts in their regional distribution. German residents' demand shifted after the spring to investment in currencies other than the US dollar and portfolio investment in European countries, both inside and outside the EEC, rose particularly strongly. The increased demand for German securities originated almost entirely from European countries.

Mainly owing to capital exports by the banking sector, net short-term capital outflows more than doubled to $14.1 billion in 1985. While the banks' foreign liabilities were built up by $2.7 billion, their foreign claims increased by $12.7 billion. This strong rise in assets, the overwhelming part of which reflected increased interbank claims, may to some extent have been related to switching operations. The acquisition of long-term Deutsche Mark assets by non-residents was apparently financed in part by withdrawals of short-term balances held with foreign banks which in turn restored their liabilities through compensatory short-term borrowing from the German banking sector.

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

In the other countries in the Group of Ten the balance on current account in 1985 changed much less than in the three largest economies in this group. In general, the growth in trade volumes slowed down considerably and almost all countries benefited to varying degrees from favourable terms-of-trade developments.

The largest improvement was recorded in the *United Kingdom*, where the trade deficit was more than halved to $2.5 billion and the current payments surplus

International current-account balances.

Countries and areas	Trade balance (f.o.b.)			Invisibles balance			Current-account balance		
	1983	1984	1985	1983	1984	1985	1983	1984	1985
	in billions of US dollars								
BLEU[1]	−1.9	−1.2	−0.3	1.4	1.2	0.9	−0.5	0.0	0.6
Canada	14.9	16.5	13.3	−13.5	−14.6	−15.2	1.4	1.9	−1.9
France	−8.7	−4.7	−4.5	3.5	3.8	5.1	−5.2	−0.9	0.6
Germany	20.7	21.2	28.1	−16.4	−14.5	−14.2	4.3	6.7	13.9
Italy	−3.2	−6.1	−7.0	3.8	3.2	2.8	0.6	−2.9	−4.2
Japan	31.5	44.3	56.0	−10.7	−9.3	−6.7	20.8	35.0	49.3
Netherlands	4.3	5.5	5.6	0.0	−0.3	−0.1	4.3	5.2	5.5
Sweden	2.0	3.5	2.5	−3.0	−3.1	−3.5	−1.0	0.4	−1.0
Switzerland	−2.8	−2.9	−2.4	6.6	6.7	6.9	3.8	3.8	4.5
United Kingdom	−1.3	−5.7	−2.5	6.1	6.9	6.6	4.8	1.2	4.1
United States	−67.2	−114.1	−124.3	21.2	6.7	6.6	−46.0	−107.4	−117.7
Group of Ten countries	*−11.7*	*−43.7*	*−35.5*	*−1.0*	*−13.3*	*−10.8*	*−12.7*	*−57.0*	*−46.3*
Australia	0.0	−0.8	−1.6	−5.9	−7.5	−7.0	−5.9	−8.3	−8.6
Austria	−3.4	−3.5	−3.1	3.6	2.9	3.0	0.2	−0.6	−0.1
Denmark	0.2	−0.2	−1.0	−1.4	−1.4	−1.6	−1.2	−1.6	−2.6
Finland	0.2	1.5	1.0	−1.1	−1.5	−1.6	−0.9	0.0	−0.6
Greece	−4.3	−4.2	−5.0	2.4	2.1	1.7	−1.9	−2.1	−3.3
Iceland	0.0	0.0	0.0	−0.1	−0.1	−0.1	−0.1	−0.1	−0.1
Ireland	−0.2	0.2	0.5	−1.0	−1.1	−1.1	−1.2	−0.9	−0.6
New Zealand	0.2	−0.1	0.1	−1.3	−1.3	−1.3	−1.1	−1.4	−1.2
Norway	4.2	5.1	4.5	−2.2	−1.9	−1.5	2.0	3.2	3.0
Portugal	−2.4	−2.1	−1.5	1.4	1.6	1.8	−1.0	−0.5	0.3
South Africa	4.1	2.1	6.0	−3.7	−3.2	−2.9	0.4	−1.1	3.1
Spain	−7.4	−4.1	−3.9	4.9	6.4	6.9	−2.5	2.3	3.0
Turkey	−3.0	−2.9	−2.7	1.1	1.5	1.9	−1.9	−1.4	−0.8
Yugoslavia	−1.2	−1.7	−1.6	1.5	2.2	2.4	0.3	0.5	0.8
Other developed countries	*−13.0*	*−10.7*	*−8.3*	*−1.8*	*−1.3*	*0.6*	*−14.8*	*−12.0*	*−7.7*
Total developed countries	*−25*	*−54*	*−44*	*−3*	*−15*	*−10*	*−28*	*−69*	*−54*
Middle Eastern oil-exporting countries[2]	33	34	33	−45	−47	−40	−12	−13	−7
Other developing countries	−10	21	10	−33	−40	−38	−43	−19	−28
Latin America	29	37	34	−39	−40	−38	−10	−3	−4
Asia	−18	−4	−14	4	−1	−1	−14	−5	−15
Other	−21	−12	−10	2	1	1	−19	−11	−9
Total developing countries	*23*	*55*	*43*	*−78*	*−87*	*−78*	*−55*	*−32*	*−35*
Eastern European countries[3]	8	10	3	−3	−3	−2	5	7	1
Total	6	11	2	−84	−105	−90	−78	−94	−88

[1] Belgium-Luxembourg Economic Union. [2] Iran, Iraq, Kuwait, Libya, Oman, Qatar, Saudi Arabia and the United Arab Emirates. [3] Bulgaria, Czechoslovakia, German Democratic Republic, Hungary, Poland, Romania and the USSR.

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

increased by $2.9 billion to $4.1 billion in 1985. The reduction in the trade deficit reflected a $1.4 billion rise in the surplus on oil trade and a $1.8 billion decline in the non-oil trade deficit. Both these developments were due in large part to the ending of the miners' strike, which had worsened the 1984 trade result by perhaps as much as $2 billion. In addition, however, the UK economy showed signs of responding to the lagged effects of the decline in the pound sterling's real effective exchange rate in 1984. Non-oil export volume expanded in 1985 by over 5 per cent., or considerably more than UK export market growth, whereas non-oil import volume growth fell from 10 per cent. in 1984 to 3½ per cent., despite broadly unchanged domestic demand conditions in the two years. The traditional surplus on invisibles transactions declined slightly in 1985, as higher net services receipts were more than offset by a fall in net investment earnings and increased transfer payments to the EEC.

In *France* the current-account balance strengthened by $1.5 billion to a surplus of $0.6 billion, almost entirely as a result of an improvement in the invisibles balance arising from increased net exports of services. The trade deficit declined marginally to $4.5 billion, as the deterioration in the real trade balance was more than offset by the influence of favourable terms-of-trade movements. The diverging price and volume effects became particularly pronounced during the second half of the year, when the adverse influence of a weak international competitive position was reinforced by a recovery of domestic demand, so that the trade balance in constant prices worsened in comparison with the corresponding half of 1984 by more than $3 billion. Import volume growth accelerated to over 6 per cent. in the second half, whereas real exports expanded by only 1 per cent. At the same time, the effective appreciation of the French franc, in combination with declining commodity prices, produced a very large terms-of-trade gain in the second half of the year. In *Belgium*, as in France, a strengthening of the invisibles balance, together with a terms-of-trade gain, caused the current-account position to shift from balance in 1984 to a $0.6 billion surplus in 1985.

The current payments position also improved further in the two Group of Ten countries with the highest surpluses in relation to GNP. In *Switzerland* strong export volume growth of 8 per cent. was the principal factor behind the $0.7 billion rise in the current-account surplus, which, at $4.5 billion, reached 4½ per cent. of GNP in 1985. In the *Netherlands* the current payments surplus increased moderately to $5.5 billion in 1985, equivalent to 4 per cent. of GNP — compared with 2 per cent. in Germany and over 3½ per cent. in Japan.

Three countries experienced a weakening of their external position in 1985. The largest deterioration was recorded in *Canada*, where the balance on current account worsened by $3.8 billion to a deficit of $1.9 billion in 1985. This change essentially reflected a $3.2 billion decline in the trade surplus, a significant part of which must be ascribed to the buoyancy of domestic demand. The volume of imports expanded by 8 per cent., whereas export volume growth, hampered by the slowdown of economic activity in the United States, amounted to only 4 per cent. In addition, there was a small terms-of-trade loss. Similar factors also accounted for the re-emergence of a deficit, of $1 billion, in the current account of *Sweden*. In particular, domestic demand pressures caused real imports to rise by 9 per cent., which more than offset the favourable effects of a 3 per cent. expansion in the volume of exports and a 1 per cent. terms-of-trade gain.

In *Italy* the current-account deficit widened in 1985 by $1.3 billion to $4.2 billion, mainly as a result of an increase in the trade deficit. However, the bulk of the trade deficit was incurred in the first six months of the year. In the second half of last year a slowdown in domestic demand growth, together with a reversal of exchange rate expectations following the realignment of the lira in the EMS exchange rate mechanism in July, caused the growth in import volume to slacken and export volume to rise steeply. As a result, the current-account balance turned around from a deficit of $5.4 billion in the first half of 1985 to a surplus of $1.2 billion in the second half.

Net inflows of capital into the Group of Ten countries declined substantially from $65.2 billion in 1984 to $48.2 billion in 1985 (see the table below). However, this was mainly attributable to increased net capital outflows from Japan and Germany which more than offset the rise in net inflows of capital into the United States. These capital movements were discussed in detail in the preceding section.

Looking briefly at the pattern of capital flows in the other Group of Ten countries, the table distinguishes between two groups. The "surplus countries" comprise the Netherlands, Switzerland and the United Kingdom, all of which have had surpluses on current account in the past two years. In the "other countries", viz. Belgium, Canada, France, Italy and Sweden, the current account has been in deficit or in virtual balance during this period.

Group of Ten countries: The pattern of capital flows.

Countries and items	1984	1985
	in billions of US dollars	
Total capital (net)	65.2	48.2
United States[1]	107.6	123.6
Japan and Germany[1]	−40.3	−63.5
Other Group of Ten countries	− 2.1	−11.9
Long-term capital (net)	−28.6	−31.1
Surplus countries[2]	−31.1	−35.6
Other countries[3]	2.5	4.5
Short-term capital (net)[4]	26.5	19.2
Surplus countries[2]	19.9	22.0
Other countries[3]	6.6	− 2.8

Note: A minus sign indicates an outflow of capital.

[1] Total capital, including the balancing item. [2] The Netherlands, Switzerland and the United Kingdom. [3] Belgium, Canada, France, Italy and Sweden. [4] Including the balancing item.

In each of the last two years the three countries in a relatively strong current-account position were sizable exporters of long-term capital. In the *United Kingdom* net long-term capital outflows increased slightly in 1985, by $1.8 billion to $17.9 billion. A decline of $1.5 billion in net outflows in respect of direct investment was more than offset by a $4 billion increase in net exports in the form of portfolio capital. Non-residents stepped up their acquisitions of UK securities by $4 billion to a total of $5.5 billion, but at the same time UK banks and institutional investors markedly increased their purchases of foreign securities, by $8 billion, to a new record level of $19.8 billion. In *Switzerland* net purchases of foreign securities, the only form of identified long-term capital transactions, rose in 1985 by $2 billion to $14 billion. By contrast, in the *Netherlands* net flows in respect of portfolio transactions remained negligible, and the rise in total net long-term capital outflows, of $0.7 billion to $3.7 billion in 1985, resulted from increased net outward direct investment. In those countries which were in a less strong current-account position during the past two years the sum of balances on long-term capital movements changed relatively little between 1984 and 1985.

The substantial inflow of short-term funds (including the balancing item) into "other Group of Ten countries" in 1984 and 1985 chiefly reflected the persistently large inflow of unidentified capital into Switzerland and capital imports by banks and, in 1985, also by non-banks into the United Kingdom. The greatest change in short-term capital movements in 1985, however, was recorded in Italy, where net inflows of $5.6 billion in 1984 are estimated to have given way to net outflows of $5.5 billion. These outflows occurred primarily in the second half of the year, partly because banks reduced their net external liabilities in line with limits established one year earlier and partly because of periodical pressures on the lira. In order to counter such pressures the authorities intervened heavily in the exchange markets, so that Italy's net official monetary position worsened by $7.2 billion — the only large-scale deterioration recorded in any Group of Ten country in 1985.

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

In the *developed countries outside the Group of Ten* the aggregate current-account deficit was nearly halved in 1985 to $7.7 billion, its lowest level since the first oil price shock. In general, countries in this group were able to sustain export volume growth, which, at an average of about 5 per cent., was almost twice the rate of world trade growth. Import volume expanded on average by considerably less, perhaps not much more than 2½ per cent., but this was largely the result of a sharp cutback in South Africa's real imports, whereas in most other countries real imports expanded at roughly the same rate as real exports.

Indeed, the strengthening of these countries' combined current-account position in 1985 was predominantly a reflection of a $4.2 billion turn-round in South Africa's current-account balance, to a surplus of $3.1 billion. The bulk of this change represented an improvement in the trade balance, as a very large reduction in imports, of $4.3 billion, more than offset a $0.4 billion decline in export earnings due primarily to lower receipts from gold sales. Tight domestic demand management policies and a 50 per cent. depreciation of the rand in the face of debt servicing difficulties were the main factors behind this development.

Within the group the largest deterioration on current account in 1985 occurred in Greece, where the deficit widened by $1.2 billion to $3.3 billion, equivalent to

10 per cent. of GNP. A surge in imports triggered by a rapid expansion of public expenditure, together with declining export earnings, caused the trade deficit to rise by $0.8 billion; in addition, net invisibles receipts fell by $0.4 billion. Faced with an unsustainable external position, the Greek authorities adopted a stabilisation programme in October 1985 which included various measures to restrain demand and a 15 per cent. devaluation of the drachma.

Elsewhere in the group changes in current-account positions in 1985 were relatively modest and did not significantly affect the broad pattern of surpluses and deficits. Spain and Norway again recorded sizable current-account surpluses, of $3 billion each, and Australia's deficit on current account, of $8.6 billion, amounted to more than 5 per cent. of GNP.

The improvement in the aggregate current-account position of the "other developed countries" was accompanied by a decline in total net inflows of capital from approximately $19 billion in 1984 to $14 billion in 1985. The reduction was apparently entirely on account of non-bank capital inflows. Borrowing from the BIS reporting banks, net of changes in deposits, increased last year by $2.8 billion. By contrast, in 1984 these countries had reduced their net indebtedness, adjusted for valuation changes, vis-à-vis the BIS reporting banks by $4.9 billion. Official non-gold reserves, valued at end-of-year exchange rates, increased by $7 billion in 1985, or virtually the same amount as in the previous year.

In *eastern Europe* the combined current-account surplus is estimated to have decreased from $7 billion in 1984 to less than $1 billion. The change originated entirely in the trade balance and was mainly attributable to a sharp decline in exports to developed countries in the western world. Exports to these countries fell from $42 billion in 1984 to $34 billion in 1985, whereas imports declined comparatively little, by $1 billion to $33 billion. The biggest deterioration occurred in the USSR, where the current account moved into deficit to the extent of about $1½ billion, as the trade balance vis-à-vis both eastern and western countries worsened under the influence of reduced earnings on energy exports. Following two years in which eastern Europe had cut back its net indebtedness vis-à-vis the BIS reporting banks, in 1985 the change on current account was accompanied by a resumption of external borrowing. Last year the BIS reporting banks' net claims on eastern Europe rose by $2.7 billion, excluding valuation effects. New lending by the banks amounted to $5.4 billion, of which $3.7 billion reflected new claims on the USSR. At the same time, the USSR, as well as the other eastern European countries, continued to build up their deposits in 1985, by $0.9 billion and $1.7 billion respectively.

Balance-of-payments developments in the developing countries.

After two years of marked improvements the external position of the *developing countries* weakened again last year. The increase in the aggregate current-account deficit, of $3 billion to a total of $35 billion, was quite small, but this was chiefly because it had been contained by a deceleration in income growth. The deterioration was primarily attributable to less favourable export market conditions, which caused the combined trade surplus to fall by $12 billion to $43 billion. Real exports, which had expanded by 6½ per cent. in 1984, shrank by 1 per cent. and, owing to a steep decline in commodity prices, the terms of trade worsened by 2 per cent. The impact of sharply reduced export earnings on the current-account position was mitigated partly by a 1 per cent. cutback in the volume of merchandise imports, virtually offsetting the volume increase of the previous year, and partly by a $9 billion reduction in the deficit on services and transfers. The narrowing of the invisibles deficit reflected to a small extent the effect of lower interest rates on debt service payments but was mainly the result of a decrease in payments for services and higher net transfer receipts.

As in past years, the composition of exports, the orientation towards foreign markets and, not least, varying degrees of external financing constraint continued to produce markedly different current-account performances in individual countries in this group. Some of these diverging developments can be seen from the table below, which breaks down the changes in 1984 and 1985 in the aggregate current-account balances of different groups of developing countries into three components: the effect of changes in the purchasing power of exports (i.e. the value of exports deflated by import unit values, which thus measures the combined effects of movements in the volume of exports and in the terms of trade) and the influence of changes in import volume and in the balances on services and transfers. The countries are grouped by region, with the exception of non-oil-exporting countries in the Middle East, which, together with African countries, are included in "Other developing countries". While this grouping obviously cannot take full account of the diversity of individual economies, it reflects to some extent a number of distinct structural economic features common to the majority of countries in the different areas.

Developing countries: Estimated components of changes in current-account balances.[1]

Areas	Change in current-account balances		Contribution of changes in purchasing power of exports[2]		Contribution of changes in import volume		Contribution of changes in balance on net services and transfers	
	1984	1985	1984	1985	1984	1985	1984	1985
	in billions of US dollars							
All developing countries	23	− 3	38	−16	− 6½	4	− 8½	9
Middle Eastern oil-exporting countries	− ½	5½	− 6	−15	8	14	− 2½	6½
Latin America	6½	− 1	11	− 5	− 2½	1	− 2	3
Asia	9½	−10	27	3	−13½	−12½	− 4	− ½
Other developing countries	7½	3	6	1	1½	1½	0	½

[1] Data based on information contained in the IMF's World Economic Outlook, April 1986. [2] The value of exports deflated by import unit values.

The *oil-exporting countries in the Middle East* were the only group of developing countries which recorded a considerable current-account improvement in 1985. Faced with a substantial loss of export purchasing power for the second consecutive year, these countries further tightened policies of import restraint and succeeded in reducing their combined current-account deficit in 1985 by $5½ billion to $7½ billion. The loss of export purchasing power equivalent to $6 billion in 1984 and $15 billion in 1985 was mainly attributable to the contraction in the demand for oil, reinforced by a further loss of export market shares. Export volume decreased in these two years by 4½ and 7½ per cent. and, in addition, the terms of trade deteriorated by 4½ per cent. in 1985. In response, the volume of imports was pared drastically, by 9 per cent. in 1984 and 15½ per cent. in 1985, producing a positive effect on the trade balance equivalent to about $8 billion and $14 billion respectively. Last year's cutbacks also extended to services and foreign workers' outward remittances, which helped to improve the invisibles balances by $6½ billion. The picture for the group as a whole, however, was dominated by Saudi Arabia, which, bearing the brunt of oil production cuts, is estimated to have incurred current-account deficits of $24 billion in 1984 and $20 billion in 1985. By contrast, Kuwait appears to have maintained a comfortable current-account surplus, amounting to about $5 billion in each of the last two years.

Despite some significant differences in the structure of their exports, the countries of *Latin America*, including the Caribbean area, have three features in common. Firstly, the majority of countries rely heavily on exports of non-oil primary products, although Mexico and Venezuela are also major oil exporters. Secondly, Latin American countries' trade is strongly oriented towards the North American market and, thirdly, many countries in this area have encountered debt servicing problems and financing difficulties. In consequence, the group of Latin American countries is particularly susceptible to commodity price fluctuations and changes in the level of US economic activity and has in general very limited possibilities to finance shortfalls in export earnings. These constraints became evident again last year, when the current account deteriorated by $1 billion after having improved by $6½ billion in the preceding year. In 1984 favourable commodity prices contributed to a terms-of-trade gain of 4 per cent. and the surge in US import demand boosted export volume by 7 per cent. Export purchasing power rose accordingly by almost 12 per cent., or $11 billion, which not only made possible a $6½ billion improvement in the current account but also allowed a cautious relaxation of import restraint policies, equivalent to $2½ billion. In 1985 the situation was reversed. The slowdown of US economic activity was reflected in a 1 per cent. contraction of Latin America's export volume and, mainly owing to the weakness of commodity prices, the terms of trade worsened by 3 per cent. With export purchasing power thus declining by almost 5 per cent., or $5 billion, the countries in this area had, on the whole, little choice but once again to tighten demand management policies and to reduce the volume of imports, by 1½ per cent. However, there were some noteworthy divergences from the group's average performance. Brazil experienced a consumption-led boom in 1985, with real GDP growth reaching around 8 per cent. Nonetheless, the current-account position deteriorated only slightly, owing in part to the relatively small size of Brazil's tradable goods sector and in part to the maintenance of import controls. In Mexico imports expanded rapidly, by 19 per cent., and, with export revenues declining by 10 per cent., the corresponding deterioration in the trade balance eliminated the previous year's current-account surplus of $4 billion. By contrast, the adoption of stabilisation policies in Argentina helped to reduce the current-account deficit by about $0.5 billion to $2 billion.

The principal common features of most countries in *Asia* are their strong orientation towards exports, especially of manufactured products, and their success in avoiding debt servicing problems, which left their creditworthiness largely untarnished. In consequence, countries in this area enjoy, at least in the short run, some room for manoeuvre and a less binding need to gear policies closely to external requirements. This was clearly demonstrated in the past two years, when a current-account improvement of \$9½ billion in 1984 was followed in 1985 by a deterioration of a similar magnitude. In 1984 a 14 per cent. rise in export volume and a small terms-of-trade gain had boosted export purchasing power by 15 per cent., or \$27 billion, and permitted an expansion of real imports of 7 per cent., or \$13½ billion, together with significantly larger imports of services. In 1985 the export performances weakened in line with less favourable export market growth. Although the gain from export purchasing power of \$3 billion was small, reflecting a 2½ per cent. volume rise and a 1 per cent. terms-of-trade deterioration, the growth in the volume of imports was maintained at 6½ per cent. However, as mentioned earlier, the external performance of the group as a whole was strongly influenced last year by developments in China. Not only was the extraordinary 60 per cent. surge in imports into China responsible for the major part of the rise in the region's aggregate import volume, but the turn-round in China's current account from a surplus of \$2½ billion to a deficit of over \$10 billion also accounted for more than last year's deterioration in the Asian countries' combined current-account position.

In the *other developing countries* — the non-oil economies in the Middle East and African countries — developments in 1984 had been dominated by Nigeria, where the current account improved by \$4.5 billion to a small surplus as increased sales of oil were combined with policies of import restraint. The \$3 billion improvement in the current account in 1985 was concentrated in the non-oil economies in the Middle East and, in Africa, outside the sub-Saharan area.

Developing countries: Estimated financing of the current-account deficit.[1]

Items	1983	1984	1985
	in billions of US dollars		
Current-account deficit	43	19	28
Increase in foreign assets	29	35	8
of which: exchange reserves	9	18	2
other[2]	20	17	6
Financing requirement	72	54	36
Direct investment (net)	9	9	9
Increase in other foreign liabilities	63	45	27
of which to:			
official creditors (long-term)	33	27	18
IMF credit	10	5	1
banks[3]	14	8	10
other	6	5	− 2
of which by maturity:			
long-term	87	44	39
short-term	−24	1	−12

[1] Excludes oil-exporting countries in the Middle East. [2] Includes errors and omissions in balance-of-payments accounts. [3] BIS reporting banks, excluding positions vis-à-vis offshore centres.

As shown in the table on the preceding page, the increase in the current-account deficit of the developing countries (excluding the oil-exporting countries in the Middle East) was accompanied by an even larger decline in capital outflows. The less rapid growth of foreign assets (including unidentified capital outflows) was attributable to a very marked slowdown in the accumulation of official reserves and a drop in other outflows of capital, which might suggest that measures to stem capital flight met with some success last year. As a result, the total external financing requirement declined further, from $54 billion in 1984 to $36 billion, or only half its 1983 level.

The pattern of financing continued to reflect the repercussions of the debt crisis. By category of creditor, new lending by official creditors, though about one-third less than in 1984, remained the single most important source of financing, accounting for $18 billion, or two-thirds of total new lending. It is noteworthy that for a second successive year close to 40 per cent. of the lending provided by official creditors was taken up by countries in Asia, which, although not excluded from access to private markets, seem increasingly to favour this less costly and perhaps less volatile source of financing. The remaining one-third of new lending was essentially obtained from BIS reporting banks, which increased their claims on developing countries by $2 billion more than in 1984, to $10 billion. However, one-half of this total was provided to China, while new bank lending to the rest of the developing world declined further in 1985. Outstanding debt to other private creditors is estimated to have decreased by $2 billion, with most of the reduction apparently reflecting repayments of suppliers' credits. The breakdown of new lending by maturity shows that a sizable part of the new lending of long-term funds was used to repay short-term debt and that the process of lengthening the average maturity through debt restructuring arrangements, which had stopped in 1984, was resumed last year.

As regards the financing of the aggregate current-account deficit of oil-exporting countries in the Middle East, some shift in the pattern of financing appears to have occurred last year. In 1984 about one-third of the $12½ billion deficit on current account was covered by a reduction in official reserve assets, while the remainder essentially reflected a drawdown of other foreign assets. In contrast, in 1985 official reserves were built up by $4½ billion despite a current-account deficit of $7½ billion and gross borrowing from BIS reporting banks was reduced by $2.5 billion. The financing was thus obtained by the sale of other foreign assets, an important share of which appears to have been assets held in the United States.

The total external debt of the developing countries (excluding the oil-exporting countries in the Middle East) is estimated to have increased in current dollar terms to around $780 billion in 1985, a rise of $41 billion, or slightly more than the $38 billion recorded in the previous year. However, a significant part of these changes reflected valuation effects arising from movements in the dollar's exchange rate; in terms of constant dollars the increase in debt slowed down from about $45 billion in 1984 to about $27 billion last year. Despite a considerable drop in market interest rates — for instance the annual average of LIBOR on six-month dollar deposits fell from 11.3 per cent. in 1984 to 8.6 per cent. in 1985 — reported interest payments declined only marginally, from $63 billion in 1984 to $62½ billion in 1985. The reasons for the surprisingly modest fall — with about one-half of total debt at floating interest rates the impact of lower interest rates should have been of the order of $7 billion — are not entirely clear. Part of the explanation may be that the recording of interest payments is becoming more comprehensive as debtor countries, particularly in connection with multi-year rescheduling arrangements, improve the collection of debt and debt service statistics. In addition, in 1985, for the first time since 1979, no new arrears were accumulated, which could imply that actual interest payments were larger than in 1984. With exports of goods and services declining considerably, the average ratio of interest payments to exports of goods and services rose slightly, to 13.6 per cent. in 1985. This deterioration in the debt service ratio occurred in the groups of developing countries other than Latin America. However, while Latin American countries' interest payments in relation to exports of goods and services have fallen to 29.6 per cent., or by almost 2½ percentage points since 1982, their average interest payment ratio remains nearly two and a half times higher than the average ratios of the other regional groups.

The state of the adjustment process in the developing countries. Despite some remarkable adjustment efforts by individual countries, for the group as a whole progress towards greater internal and external economic balance fell short of expectations last year. While there were a number of positive developments in 1985 — the aggregate current-account deficit widened only slightly, a modest build-up of official reserves continued, private capital outflows declined considerably and, for the first time in many years, on average no new debt payment arrears were accumulated — the overall performance was characterised by a slowdown in domestic output growth, rising inflation and deteriorating debt service indicators. These developments were attributable to a significant extent to weaker export market conditions and terms-of-trade losses which exacerbated external constraints and allowed little room for domestic expansion.

At the same time, efforts to reduce domestic imbalances and to tackle structural rigidities appear to have slackened last year. On average, no further headway was made in raising domestic savings, not least because public sector deficits were not cut back further and because adequate incentives to stimulate private savings were lacking. Gross capital formation as a percentage of GDP stagnated in 1985 and remained 4½ percentage points below the pre-debt-crisis average. Admittedly, there are wide divergences among individual countries and regions within the developing world, and some countries have been able to cope comparatively well in a less favourable international environment. Nonetheless, the scope for manoeuvre remains generally very limited in the face of heavy external debt burdens and relatively modest export market growth. More efforts are needed in the form of realistic pricing policies, structural reforms and greater reliance on market mechanisms if the foundations for sustainable external positions are to be laid.

The fall in oil prices will generate terms-of-trade gains for oil-importing countries and support their adjustment efforts. However, the bulk of the real income effect of lower oil prices will accrue to the industrial countries, and, with a few notable exceptions, the direct relief provided by reduced oil bills will be rather modest in the developing world. Nonetheless, the beneficial indirect effects — oil-price-induced acceleration of growth in the industrial world and lower interest rates — might prove to be substantial in the longer run. On the other hand, the situation will deteriorate severely in those developing countries whose export earnings depend heavily on oil sales. In particular, in countries with very high debt burdens, the huge loss of export purchasing power will force them to cut imports substantially if no additional external financing can be obtained.

IV. FINANCIAL MARKET TRENDS.

Highlights.

For financial markets in major industrial countries 1985 was an eventful year. The continuing decline in inflation rates at last brought long-term market interest rates down on a broad front. The fall in interest rates and the increase in profits caused a strong rise in equity prices. The decline in interest rates continued into 1986, spurred on by reductions in oil prices and increased market confidence in the longer-run outlook for inflation. The long-awaited depreciation of the dollar commenced in February 1985 and accelerated after the Group of Five meeting in September.

While the interest rate declines and exchange rate adjustments are certainly welcome, they cannot be expected quickly to resolve the significant financial imbalances facing some of the major economies. The large external deficit of the United States, reflecting a sizable public sector deficit and stagnant private saving, continues, as does the large current-account surplus of Japan. Sectoral financial problems also persist, owing to major changes in exchange rates, interest rates and commodity prices over the past few years. The United States has, for the first time in the post-war period, become a net debtor nation. It is difficult to say how long the rest of the world will wish to continue accumulating US financial assets and what the consequences would be for interest rates and exchange rates were international asset preferences to change markedly. This uncertainty clouds prospects regarding the contributions to aggregate demand likely to stem in the future from lower interest rates and from the very appreciable gains experienced on the world's major stock exchanges.

Changes in the world's financial markets led to a considerable expansion of securities and securities-like transactions last year. This expansion was partly attributable to falling market interest rates, which led to the refinancing of corporate borrowing. Secular trends in banking and finance, however, also played a major role. These included the continued growth of currency and interest rate swaps, the increasing importance of securities issues as a source of funding for banks and the rise in securities activities by banks as a source of fee income. The long-term expansion of institutional investment also reinforced trends towards reliance on the issuance of negotiable securities by a wide range of borrowers.

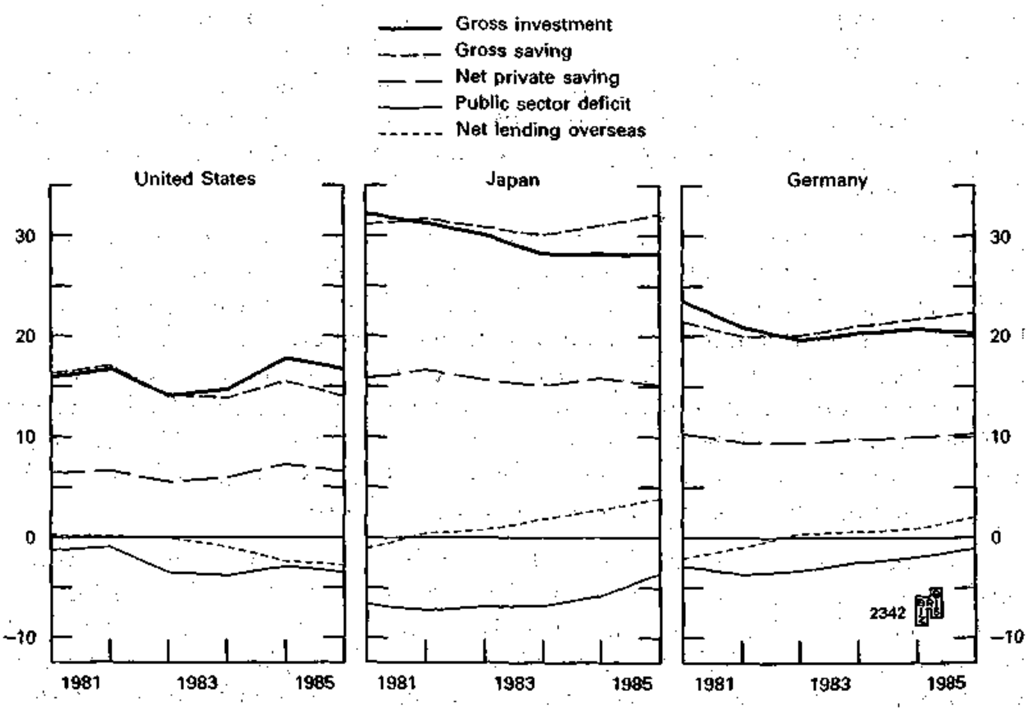
Despite a year of increased profitability for banks in many countries, tensions persisted in the financial system, particularly in North America. The underlying causes included continuing declines in inflation rates relative to expectations and major changes in the prices of commodities. These and the general developments in securities and banking markets have helped to focus attention on the need to review current systems of regulation and supervision and to create market structures that promote financial stability. They may also point to a need for enhanced international consultation on these matters.

Private and public saving behaviour in the major economies.

Saving/investment imbalances. Since the first oil crisis the world economy has witnessed large net international capital flows, resulting from increased imbalances within countries between saving and investment. These in turn have had major effects on real interest rates and exchange rates. However, the global pattern of structural saving/investment surpluses and deficits has changed significantly since the mid-1970s, when the disequilibria reflected primarily excess saving by oil-exporting countries and borrowing by less developed countries. The decline in real interest rates following the first oil price shock was partly attributable to large excess saving by the oil-exporting countries, and relatively weak investment demand in industrial economies. The large saving surplus of oil-exporting countries was eliminated after the second oil price rise, which, together with more restrictive monetary policies, contributed to the rise in real interest rates internationally. The more recent imbalances have been mainly between industrial countries, notably between the United States, with its large budget and current-account deficits, and other OECD countries, particularly Japan, where domestic saving greatly exceeds investment.

Gross investment and saving in the United States, Japan and Germany, 1980–85.*

As a percentage of GNP.



* Data for 1985 have been estimated.

Gross investment, saving and its components.[1]

Countries	Years	Gross domestic investment[2]	Gross domestic saving[2]	Net private saving[3]	Public sector deficit[4]	Net external lending[5]
		as a percentage of GNP				
United States	1971–79	16.8	17.0	8.1	– 0.8	0.2
	1980	16.0	16.3	6.4	– 1.3	0.3
	1981	16.9	17.1	6.6	– 1.0	0.2
	1982	14.1	14.1	5.5	– 3.5	0.0
	1983	14.8	13.8	5.9	– 3.9	– 1.0
	1984	17.9	15.5	7.3	– 2.9	– 2.4
	1985	16.8	14.0	6.5	– 3.6	– 2.8
Japan	1971–79	33.5	34.2	20.3	– 6.3	0.7
	1980	32.2	31.1	15.8	– 6.7	– 1.1
	1981	31.3	31.7	16.6	– 7.3	0.4
	1982	30.1	30.8	15.6	– 6.9	0.7
	1983	28.3	30.1	15.1	– 6.8	1.8
	1984	28.2	31.0	15.8	– 5.8	2.8
	1985	28.2	32.1	15.1	– 3.6	3.9
Germany	1971–79	23.0	23.8	11.6	– 1.9	0.8
	1980	23.5	21.5	10.3	– 2.9	– 2.1
	1981	21.0	20.0	9.5	– 3.7	– 1.0
	1982	19.7	20.1	9.4	– 3.3	0.4
	1983	20.4	21.0	9.8	– 2.5	0.5
	1984	20.8	21.7	10.0	– 1.9	0.8
	1985	20.3	22.3	10.3	– 1.1	2.0
France	1971–79	24.0	23.6	10.6	– 0.6	– 0.4
	1980	23.6	22.2	8.2	0.2	– 1.4
	1981	21.2	19.7	7.5	– 1.8	– 1.5
	1982	21.7	18.6	6.7	– 2.6	– 3.1
	1983	19.8	18.1	6.7	– 3.2	– 1.7
	1984	19.3	18.6	7.5	– 2.8	– 0.7
	1985	18.9	18.2	7.6	– 2.5	– 0.7
United Kingdom	1971–79	23.8	23.1	14.5	– 4.8	– 0.6
	1980	19.8	21.2	11.8	– 4.7	1.4
	1981	17.6	19.8	10.0	– 3.3	2.2
	1982	17.5	19.8	9.5	– 2.7	2.3
	1983	18.1	19.7	9.9	– 3.7	1.6
	1984	18.7	20.7	11.5	– 4.2	2.0
	1985	18.9	19.7	11.0	– 3.5	0.8
Italy	1971–79	21.8	21.6	15.7	– 8.6	– 0.2
	1980	25.0	22.0	16.0	– 8.0	– 3.0
	1981	21.5	19.5	15.5	–11.9	– 2.0
	1982	20.2	17.9	15.1	–12.5	– 2.2
	1983	17.8	18.0	13.7	–12.5	0.2
	1984	19.0	17.8	14.1	–13.5	– 1.2
	1985	20.4	18.5	14.6	–13.7	– 1.9
Canada	1971–79	23.7	21.9	10.2	– 1.3	– 1.9
	1980	23.2	23.3	12.8	– 2.4	0.1
	1981	24.8	23.1	11.5	– 1.6	– 1.7
	1982	19.6	19.5	10.7	– 5.1	– 0.1
	1983	19.3	19.7	12.7	– 6.2	0.4
	1984	19.0	19.9	13.0	– 6.4	0.9
	1985	19.8	18.9	12.0	– 6.3	– 0.9

[1] Data for 1985 have been estimated. [2] For the United States, gross private investment, and gross private saving less government deficit, respectively. [3] Gross saving less government saving and an estimate of depreciation. [4] For Japan and the United Kingdom public sector deficits differ from general government deficits shown in the table on page 26. [5] Including the statistical discrepancy in the National Accounts.

Sources: National data and definitions.

Attention has recently been focused primarily on the United States, where the budget deficit increased sharply after 1981. This was partly for cyclical but also for structural reasons, as attested by the fact that it has remained in the range of 3 to

4 per cent. of GNP despite a prolonged and substantial economic recovery since 1982. Although not large as a percentage of GNP, the absolute size of the deficit dwarfs those of other countries and helps to explain both the rise in US real interest rates and the appreciation of the US dollar. The cyclical insensitivity and size of the deficit are of particular concern because private saving in the United States as a proportion of GNP has been relatively flat since 1981 and actually declined in 1985, falling short of the level needed to finance both private investment and the Federal Government deficit. As a consequence the United States has recently had to rely increasingly on large quantities of funds from abroad.

Until early 1985 capital inflows were accompanied by currency appreciation. The increase in net demand for credit in a large country pursuing a non-accommodating monetary policy raised real interest rates domestically and led to an influx of foreign capital and an appreciation of the currency. Capital inflows were also stimulated by high expected returns on fixed investment. The large US current-account deficit, totalling $118 billion in 1985, reflected this major imbalance between national saving and private domestic investment. This process also raised world real interest rates by significantly increasing total demand in the now highly integrated world credit markets.

International concern regarding the large domestic financial imbalance in the United States stems from the need for other countries to accumulate dollar claims and from the possible interest rate and exchange rate consequences of a change in foreign preferences for US financial assets. The continuing large spread between US and foreign long-term interest rates, in particular German and Japanese rates, can be seen as reflecting, in part, expectations of a long-term depreciation of the US dollar. Justified as it is by underlying conditions, the authorities are concerned that such a change in the exchange value of the dollar, which began in February 1985 and gathered momentum after the Group of Five meeting in September, should occur at a rate that will neither cause major external and internal adjustment problems for the world economy, nor lead to a new overshooting.

In contrast to the United States, with its large external financing requirements, Japan, Germany and the United Kingdom have been net lenders internationally. Japan's lending has been by far the largest. Part of the accumulation of foreign assets by these countries reflects their successful attempts to contain the growth of public sector deficits. Combined with the large structural excess of private saving over private investment in Japan, the Government's commitment to reduce its deficit has caused Japan to become a major holder of claims on the US private and government sectors.

The mix of fiscal and monetary policy in the large industrial countries thus contributed to changes in net international investment positions. While fiscal and monetary restraint in Germany and Japan led these countries to increase their net lending overseas, a large government deficit and an anti-inflationary monetary policy in the United States caused it to require external finance. Because the United States is a large country, it could, in these circumstances, raise real interest rates and easily finance itself with private capital inflows. This luxury does not appear to be available to smaller economies, where large government deficits are often seen to lead to currency depreciation. Canada has been a recent example of this latter phenomenon, with high domestic real interest rates proving insufficient to prevent some currency depreciation.

It should be emphasised that there is no necessary direct relationship between the fiscal deficit of a country and its external imbalance. The external position depends on the determinants of private saving and investment, as well as on the size and cyclical variability of the government's financial needs and the stance of monetary policy. In 1985 both Japan and the United Kingdom had fiscal deficits which as a percentage of GNP were comparable with that of the United States, yet both were capital exporters.

A factor helping the United States to satisfy its financial needs abroad in recent years has been that investment institutions internationally, and in Japan in particular, have been increasingly geared to the purchase of international securities. It is estimated that Japanese net purchases of US dollar-denominated securities more than doubled in 1985. Major imbalances between domestic saving and investment in some of the large industrial countries have thus contributed to the movement from bank-based to securities-market-based intermediation.

Equilibrating market mechanisms. The US current-account deficit has become so large in recent years that its financing through voluntary capital inflows is widely considered to be unsustainable in the longer run, although no one can foresee the quantitative or temporal limits to the rest of the world's willingness to add to its portfolio of claims on the United States. There exist several market mechanisms which could help to re-establish balance between the domestic demand for and supply of funds in the United States, as well as in those countries where saving is greatly in excess of investment. These include the responsiveness of private saving and investment to changes in interest rates, exchange rates and output and the reaction of private saving to changes in the outstanding volume of government debt.

Private saving in the United States has been notable since 1980 for the absence of a significant positive response to the very considerable rise in real interest rates. While net private saving as a percentage of GNP rose in 1984, it fell back to only 6.5 per cent. in 1985. In fact, in 1980–85 the average net private saving rate, at 6.4 per cent., was considerably lower than the average of 8.1 per cent. recorded during the 1970s. Nor has private saving responded significantly to the rise in government debt and associated future tax liabilities. The argument that the private sector would raise its saving in reaction to an increase in the government deficit, in anticipation of future taxes required to service the debt, has not been supported by recent US saving behaviour. Nor, in contrast to what has happened in Canada, has US private saving increased as a result of the redistribution of income to interest recipients, who normally have a higher propensity to save than the average individual. In Japan, however, there has been some decline in private saving in parallel with the decline in the fiscal deficit.

Aggregate data for the United States also suggest that business investment has not been significantly "crowded out" by higher real interest rates. Rather, the crowding-out of private expenditure by government deficits took place via exchange rate appreciation, which curtailed expenditure on domestic goods in competition with imports and reduced exports. The result of this was the development of a quite unbalanced cyclical recovery.

The contribution of an exchange rate adjustment to restoring a better balance in the external accounts of the United States will in any event take time. The dollar continued to appreciate against other currencies until early 1985, but its subsequent depreciation has now assumed major proportions, in substantial measure thanks to the recognition by the United States and other major industrial countries of the need for concerted action in the exchange markets.

In short, market mechanisms have not so far operated to reduce the US saving/investment imbalance. As a result, the large current-account deficit of the United States, and the country's dependence on capital inflows from abroad, which in 1985 amounted to 2.8 per cent. of GNP, are expected to persist in 1986 and beyond. Consequently, it is increasingly coming to be recognised that the US Federal Government deficit has been a major source of the country's structural financial imbalance and that, in addition to a downward adjustment of the dollar's exchange rate, a major effort to reduce the budget deficit is required. This recognition led, towards the end of last year, to the passing of the Gramm-Rudman-Hollings Act, which provides for a progressive mandatory elimination of the deficit over the next five years. While implementation of the Act, or similar policies, may not be easy, there is now a prospect of a turn-round in the US fiscal stance.

Portfolio behaviour and asset returns.

External assets and liabilities. As a result of the national saving/investment imbalances building up since the beginning of the recovery, the United States became a net debtor in 1985, for the first time in the post-war period. As the following table shows, the shift has been a significant one, occasioned by a slowing-down of the growth of US overseas assets and a significant acceleration of liabilities since 1982.

Germany, Japan and the United Kingdom have all built up their net external assets in recent years, forming a counterpart to the US shift into indebtedness. Japan's net lending overseas as a percentage of GNP has grown rapidly in the 1980s, amounting to an estimated 3.9 per cent. of GNP in 1985 (see the table on page 63). The aggregate data do not show the division between portfolio and direct investment, and hence the liquidity of the assets. In fact, Japanese overseas assets are by far the most portfolio-based, direct investment accounting for only 11 per cent. of gross overseas assets at the end of 1984, compared with 33 per cent. for the United Kingdom. This implies that Japanese external assets may be more easily switched between countries.

Asset accumulation, valuation and portfolio shifts. Although the analysis above is based largely on flows of saving and investment, such flows are not the only source of changes in wealth. Changes in the value of existing overseas and domestic

External assets and liabilities.*

Countries and items	1978	1979	1980	1981	1982	1983	1984	1985	1985 as a proportion of GNP
	in billions of US dollars								
United States									
Assets	448	511	607	720	839	894	915	934	0.23
Liabilities	372	416	501	579	692	788	887	999	0.25
Net external assets	76	95	106	141	147	106	28	− 64	− 0.02
	in thousands of billions of Japanese yen								
Japan									
Assets	23	33	32	46	54	63	86	90	0.28
Liabilities	16	26	30	44	48	54	67	63	0.20
Net external assets	7	7	2	2	6	9	19	27	0.08
	in billions of Deutsche Mark								
Germany									
Assets	427	450	489	546	584	627	714	820	0.45
Liabilities	330	368	432	498	531	562	628	698	0.38
Net external assets	97	82	57	48	53	65	86	122	0.07
	in billions of pounds sterling								
United Kingdom									
Assets	67	77	90	115	147	176	222	249	0.71
Liabilities	55	65	73	85	104	118	149	172	0.49
Net external assets	12	12	17	30	43	58	73	77	0.22
	in thousands of billions of lire								
Italy									
Assets	73	91	127	152	154	202	236	241	0.35
Liabilities	59	68	94	135	150	189	233	253	0.37
Net external assets	14	23	33	17	4	13	3	− 12	− 0.02
	in billions of Canadian dollars								
Canada									
Assets	67	81	105	124	134	146	165	173	0.38
Liabilities	155	181	212	257	270	293	323	336	0.74
Net external assets	− 88	−100	−107	−133	−136	−147	−158	−163	− 0.36

* The data differ conceptually from country to country. For Japan, data are converted from US dollars at year-end exchange rates; for the United States, the United Kingdom and Canada 1985 data are estimated and do not allow for valuation changes in the existing stock of assets resulting from exchange rate or other asset price movements during the year.

Sources: National data and definitions.

assets are also important, and, particularly in the case of domestic assets, such valuation changes were extremely large in 1985.

As regards overseas asset positions, valuation changes may occur as a result of exchange rate changes. The importance of these effects depends on the currency composition of assets and liabilities, on which precise data are not always available. Another important determinant is the size of net external assets, both in absolute terms and in relation to wealth, which is generally rather small. Taking these factors into account, estimates suggest that, compared with the contribution to domestic wealth of rising equity prices, the wealth effects of exchange rate changes for individual industrial countries during 1985 were relatively small. The appreciation of the yen and the Deutsche Mark over the year are nonetheless likely to have caused some reduction in the domestic currency value of net foreign assets held by investors in Japan and Germany.

Real asset returns.*

Countries and items	1980	1981	1982	1983	1984	1985
	in percentages					
United States						
Equities	15	− 9	13	18	1	25
Housing	− 1	− 3	− 2	0	− 1	2
Bonds	−13	− 5	27	0	10	25
Memorandum item: agricultural real estate	*2*	*− 1*	*− 6*	*− 9*	*− 5*	*−15*
Japan						
Equities	2	13	3	20	24	15
Housing	5	6	6	3	1	1
Bonds	− 3	10	9	9	9	7
Germany						
Equities	1	− 2	11	36	10	63
Housing	5	0	− 2	− 1	0	− 1
Bonds	− 4	− 2	16	3	13	9
France						
Equities	4	−20	0	56	14	27
Housing	− 2	− 3	− 2	− 2	− 2	− 2
Bonds	−10	− 8	9	10	11	13
United Kingdom						
Equities	16	0	21	21	23	15
Housing	− 2	− 8	0	6	5	2
Bonds	4	− 9	42	7	4	6
Italy						
Equities	45	−12	−17	13	10	103
Housing	11	− 3	13	− 7	− 2	− 9
Bonds	− 4	3	3	4	5	5
Canada						
Equities	16	−19	− 5	28	− 6	19
Housing	0	− 4	−12	− 4	− 4	− 1
Bonds	− 7	−13	29	6	11	20

* The returns for equities incorporate the change during the year in the nominal asset price (respective stock market indices) plus the dividend yield, deflated by the change in consumer prices. For bonds (government or public sector long-term bonds) the yield shown is the total rate of return (percentage price change plus coupon interest) deflated by the change in consumer prices, except for Italy, where the effective yield to maturity replaces the total return. For housing (prices for dwellings sold in the United States, the United Kingdom and Italy, the cost of a new residence in Germany, France and Canada, and the urban land price index for Japan) and agricultural real estate, the figures shown are nominal price or value changes deflated by consumer prices.

Sources: National data and definitions, OECD Financial Statistics and Salomon Brothers International Bond Market Performance Indices.

The large and volatile magnitude of valuation effects on domestic assets can be gauged from the table above, which shows the real returns on equities, housing and long-term government bonds. The evidence suggests that equity investment has offered a sizable real rate of return in recent years, generally exceeding the return on real assets (housing) and the real return on bonds. The gains on equities have to be seen in the context of the size and distribution of private sector portfolios in the major economies. As can be seen from the following table, the share of equity holdings in the private sector's portfolio is greater in the United States, the United Kingdom and Canada than in Germany and Japan, if account is taken of shares held indirectly via institutions. For these reasons the impact of a given change in equity values on wealth is likely to be greater in the former countries. Valuation changes in equities in 1985 are estimated as having been equivalent to no less than 5 to 10 per cent. of GNP in most of the large countries.

Portfolio distribution of the non-financial private sector.[1]

Countries and items	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985
	as a percentage of gross financial assets									
United States										
Deposits	33	34	35	33	32	33	33	32	34	32
Bonds[2]	10	10	10	10	9	9	9	9	10	11
Equities	20	18	17	18	20	18	18	18	16	17
Institutional investment[3]	20	20	20	20	21	21	22	23	24	25
Japan										
Deposits	51	53	53	52	51	51	52	51	49	49[4]
Bonds[2]	4	5	5	5	5	6	6	6	7	6[4]
Equities	9	8	9	8	8	8	8	9	10	12[4]
Institutional investment[3]	7	7	8	8	8	8	9	10	11	11[4]
Germany										
Deposits	57	57	58	57	57	55	54	53	51	48
Bonds[2]	9	9	9	10	10	11	11	11	13	13
Equities	12	12	12	10	10	10	10	11	11	15
Institutional investment[3]	9	9	9	10	11	12	12	12	12	12
United Kingdom										
Deposits	33	32	32	32	32	33	31	30	29	29[5]
Bonds[2]	6	6	5	5	5	4	5	4	4	4[5]
Equities	12	14	13	12	12	11	11	12	13	12[5]
Institutional investment[3]	19	21	23	23	25	25	28	29	30	30[5]
Canada										
Deposits	31	32	32	32	32	31	31	29	29	29[4]
Bonds[2]	8	8	8	7	6	6	7	8	8	9[4]
Equities	17	17	18	17	18	17	17	17	16	16[4]
Institutional investment[3]	15	16	15	15	15	16	16	17	18	18[4]

[1] Based on non-consolidated balance sheets for personal and company sectors; for the United States excluding non-corporate firms and agricultural business. The sub-totals do not add up to 100, as such items as trade credit and external direct investment are not included. [2] Excluding mortgages held directly. [3] Mutual funds, pension funds, trust and insurance company funds of a non-depository nature. [4] Estimated. [5] Third quarter.

Sources: National balance-sheet data.

The above table summarises the portfolio distribution of major instruments for the non-financial private sector. The portfolio distributions reveal in most countries some movement by the private sector towards institutional investment and equities in recent years, while the share of deposits has been stagnant or declining. This shift can be explained largely in terms of relative returns, though tax concessions and the ageing of the population have also given a stimulus to institutional investment. The share of bonds in the portfolios of persons and companies has been rising in Germany and Japan, but falling in the United Kingdom. While generally slow compared with changes in the flow of funds, these portfolio shifts indicate significant changes in the disposition of wealth within financial markets, from deposits to market instruments and from holding market instruments directly to holding them via investing institutions (life assurance companies, pension funds, investment trusts).

A large rise in equity prices such as occurred during 1985 is likely to have a stimulative effect on expenditure, especially if it is perceived as permanent and does not merely compensate for inflation. This will operate both via wealth effects on consumption and via the effects on fixed investment of changes in the "valuation ratio" between firms' market value and the replacement cost of the capital stock. Other things being equal, wealth effects might also tend to reduce saving, if increases in the value of wealth are considered as substitutes for the accumulation of further assets. If this is the case, these domestic wealth effects may have weakened the expected equilibrating mechanism between saving and investment in the United States, since they reduce saving out of current income and increase investment. Elsewhere, however, they may have reinforced the equilibrating mechanism.

Debt/equity ratios of the non-financial corporate sector.[1]

Countries	1966–73	1974–79	1980	1981	1982	1983	1984	1985
United States	0.54	0.96	0.77	0.92	0.87	0.78	0.90	0.83
Japan	3.08	3.31	3.14	2.91	2.92	2.68	2.11	1.82[2]
Germany[3]	2.38	3.36	3.85	4.13	4.11	3.48	3.42	2.39
France	1.17[4]	1.33	1.23	1.40	1.55	1.56	..	..
United Kingdom	0.67	1.38	1.13	1.23	1.03	0.87	0.74	0.70[2]
Canada	0.99	1.22	1.14	1.27	1.34	1.14	1.12	1.08[2]

[1] Gross liabilities excluding equity and trade credit as a proportion of equity at market prices, except for France and Canada where equity is at book values. [2] Estimated. [3] All enterprises excluding housing. [4] 1970–73.

Sources: National balance-sheet data and OECD Financial Statistics.

Rising equity prices also influence the debt/equity ratios of firms. In general, a lower debt/equity ratio is regarded as indicating that a firm's financial situation is more stable. There are, however, pronounced differences between countries in what are regarded as "acceptable" levels of gearing, stemming from the nature of the financial system, the tax system and expectations of growth. As equity markets have been buoyant in recent years, a strengthening of firms' balance sheets has come about in most countries (see the table above). In Germany, Japan and the United Kingdom the measure of gearing shown has fallen by over a third since 1981. Combined with falling interest rates, this has also led to a lower burden of income gearing (i.e. the proportion of income required for net interest payments). In the United States, by contrast, the retirement of equity and a high rate of debt issue has prevented a significant reduction in the debt/equity ratio in recent years.

The decline in the debt/equity ratio outside the United States and the rapid rise of shareholders' rate of return on equity reflect the general improvement in corporate finances that has been observed in many countries in recent years. As is shown in Chapter II, there has been an increase in the share of gross profits in GNP in Europe, and all the major countries have seen some recovery in real rates of return on capital since the early 1980s, both in absolute terms and in comparison with real interest rates. Taken together, such developments suggest that a significant strengthening of firms' financial positions and investment incentives has come about in recent years, particularly in Europe.

Financial markets in 1985.

Interest rates. Short-term interest rates in the United States declined in the first and second quarters of 1985 but rose again slightly in the second half of the year. The initial reduction was largely associated with an easing of monetary policy, in response to subdued real growth. Short rates were again reduced in early 1986, partly in co-ordination with declines in the other major industrial economies. Long-term interest rates continued to decline throughout the year, which resulted in a significant flattening of the yield curve. Domestically, expectations of a reduction in the US budget deficit as a result of the Gramm-Rudman-Hollings proposal, together with the short-run accommodative stance of US monetary policy, played some part in reducing interest rates, while the lowering of inflationary expectations both in the United States and elsewhere contributed to a worldwide reduction in nominal interest rates. Given the stability of inflation in the United States in 1985, real interest rates also eased somewhat.

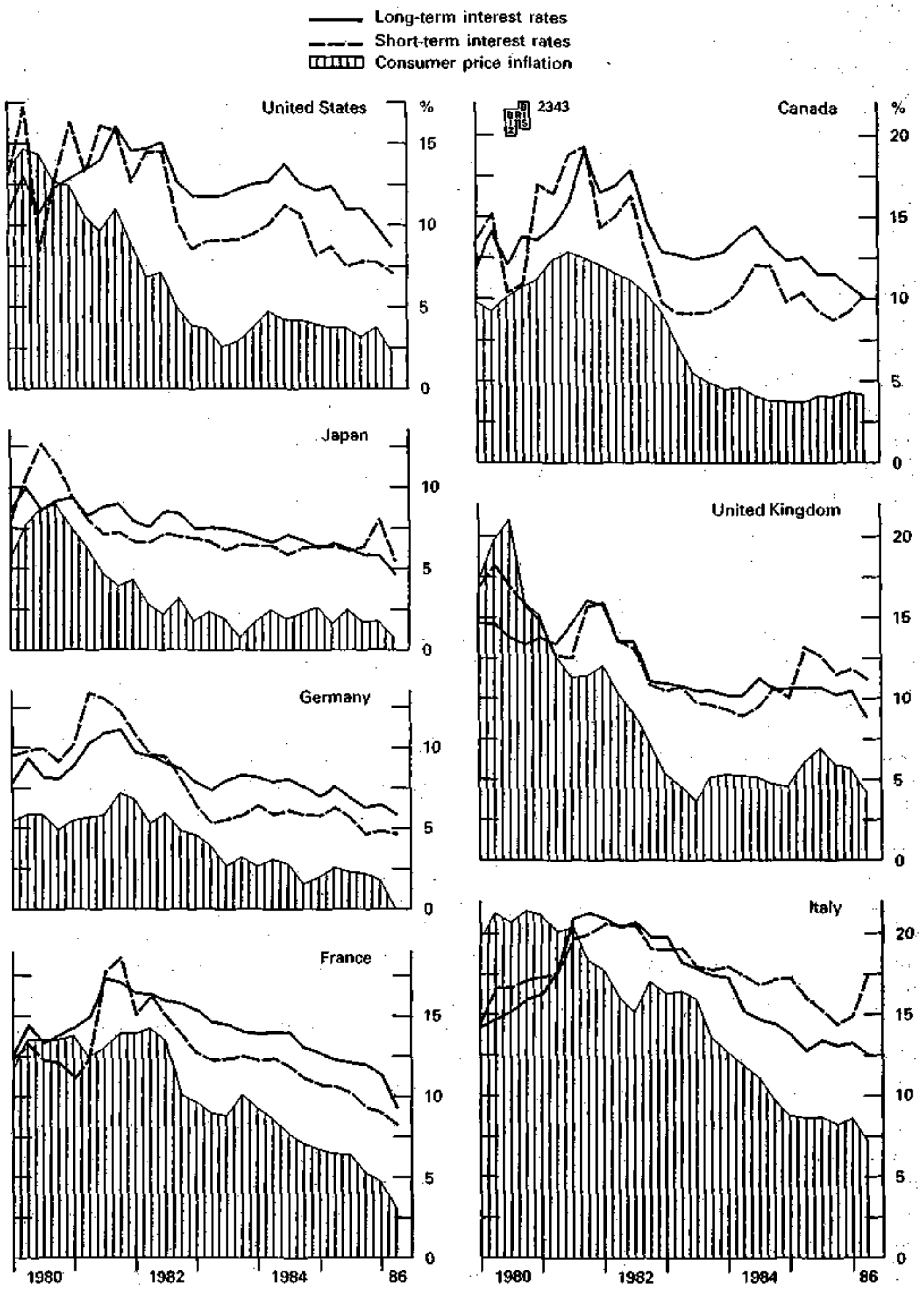
Long-term rates in Japan also fell moderately in both nominal and real terms. The differential vis-à-vis the real long-term government bond rate in the United States nonetheless remained sizable. There were thus continuing interest rate incentives for Japanese investors to lend to the United States. The Japanese short-term rate behaved very differently from the long-term rate. Following the Group of Five agreement and as a result of a desire to increase the value of the yen, the Japanese authorities induced an increase in short-term interest rates in the fourth quarter, thus interrupting the downward movement observed since 1982. Due to these changes, the yield curve was significantly inverted, and fears arose that the tightening would lead to a weakening of domestic demand. Therefore, after some appreciation had occurred, the monetary stance was relaxed, and short-term rates started to fall at the beginning of 1986.

Short-term interest rates in the United Kingdom and Italy were also influenced by exchange rate considerations. Speculation against sterling in early 1985 had led to a sharp increase in banks' base lending rates, which were slowly brought down until early 1986, when sterling once more came under pressure. In this case, however, the cause of depreciation, lower oil prices, was evidently fundamental. Base rates were raised by only one percentage point, while a substantial depreciation took place and the increase in short-term rates was subsequently reversed. Long-term rates in the United Kingdom meanwhile fell slightly, which implied a further inversion of the yield curve. The decline in long-term rates may have been encouraged by a reduction in public sector demand for long-term funds following the abandonment of the policy of "overfunding" in the gilt-edged market. In Italy short-term rates declined until November, when outflows of funds necessitated a monetary tightening to prevent a shift of the exchange rate beyond the EMS band. The long-term rate in Italy declined slightly, and remained significantly below the short-term rate, as it has since 1982.

In Germany short-term interest rates fell for most of the year, after an initial increase in the first quarter, while long-term rates came down somewhat less. As there was at first little change in the inflation rate, there was also a fall in the real cost of borrowing. To some extent these changes were conditioned by the decline in interest rates in the United States. In France interest rates, especially short-term rates, also declined during 1985. These falls, too, can be associated with international trends, particularly those in Germany, France's major partner in the EMS. However, unlike those in other countries shown, they may also be linked with a significant drop in inflation over the year.

Nominal interest rates and inflation, 1980–86.*

End-quarter figures.



* Based on monthly data. Representative long-term bond yields and money market rates; inflation as measured by percentage changes in consumer prices over twelve months.

Some common factors underlying falling interest rates can be discerned. *Foremost, the continuation of low inflation rates in many of the major economies* contributed to the decline of market interest rates. In particular, the longer-run stance of monetary policy in many countries has helped to subdue expectations of a resurgence of inflation. The decline in commodity prices and, in particular, the weakness of the OPEC cartel no doubt also led to some scaling down of inflationary expectations, although this may be only temporary. In the United States neither the reduced emphasis on the M_1 monetary aggregate nor the currency depreciation to date appear to have had much impact on inflationary expectations in the short term, while the relaxation of monetary policy reduced interest rates directly.

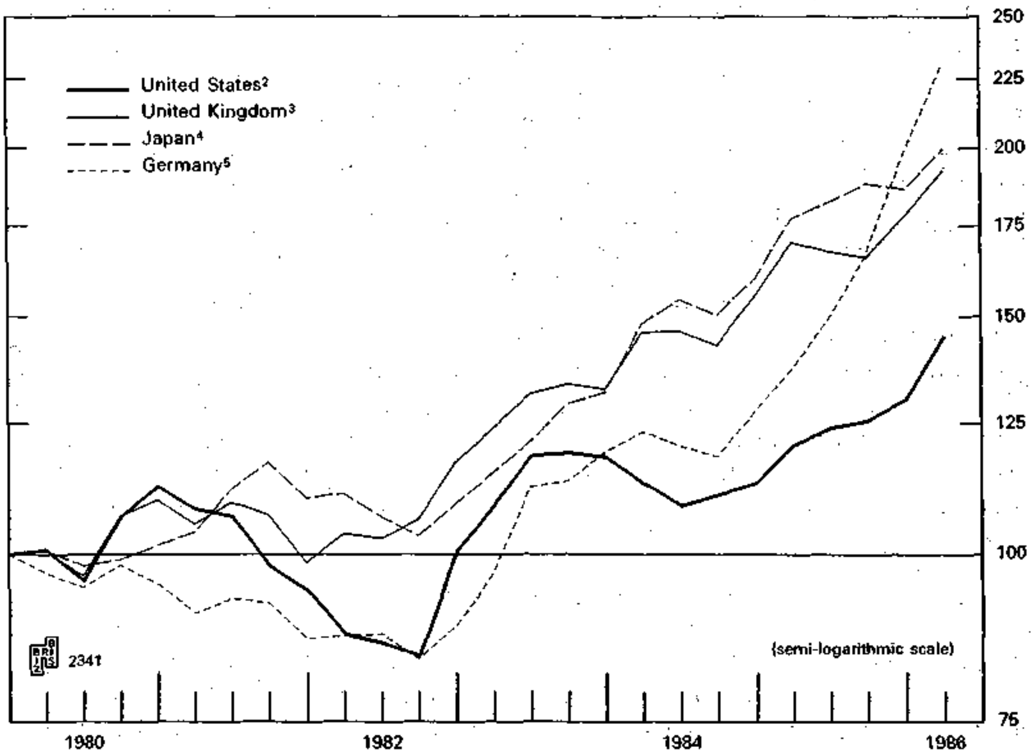
Despite the decline over the past year, real interest rates are still rather high compared with the 1960s and 1970s. While real interest rates were depressed during the latter decade by accelerating inflation and economic stagnation, the current higher level compared with the 1960s is perhaps more surprising. Inflation was running at similar levels in both periods, and the pressure of demand was higher, at least in Europe, during the earlier period. Perhaps the most important influence has been the greater demand for credit in recent years resulting from the shifts in saving, investment and public sector deficits discussed above.

Activity in the equity markets. Equity prices have risen sharply in real terms on many of the major stock exchanges. As is shown in the table on page 68 and in the graph on page 74, these boom conditions were present on the stock exchanges of New York, Tokyo, London, Frankfurt, Toronto, Paris and Milan as well as elsewhere. Equity price changes are difficult to trace back to causal factors, because they depend on expected future profits as well as on issuing activity and a range of shorter-run speculative factors. Nevertheless, the decline in interest rates observed during 1985 undoubtedly stimulated demand for equities. Secondly, the fall in commodity prices has improved expectations of future profitability for manufacturers, in a mirror image of the decline in real equity prices observed in the mid-1970s. Thirdly, the growing readiness of investors to trade in foreign securities has led to a greater foreign demand for equities in previously relatively thin markets, for example in many European countries. The recent growth of the domestic institutional sector has also led to a significant increase in transactions in some of these markets, for example in Italy. In addition, in a number of European countries stamp duty and transaction taxes have been reduced in the past few years.

Equity prices may also have been boosted by take-over activity. This was particularly marked during 1985 in the United States and the United Kingdom but was likewise evident in Italy and Germany. Management buy-outs were also a strong feature of activity in the United Kingdom and the United States. Take-overs and buy-outs are similar in that each involves the purchase of a firm's equity by individuals who feel that the market valuation of the firm is low in relation to its potential profitability.

The history of take-over activity shows a pattern of "waves", particularly in the late 1960s and early 1970s. Each was associated with increasing real share prices and revealed a strong cyclical element. It is also true that the availability of finance is a necessary precondition. The recent spate of take-overs has been financed partly

Real share prices on major stock markets, 1980–86.[1]
Fourth quarter 1979 = 100.



[1] Adjusted on the basis of movements in consumer prices. [2] Standard and Poor's corporate share index. [3] Financial Times ordinary share index. [4] Tokyo general index. [5] Frankfurter Allgemeine Zeitung general index.

by debt issues, in the form of bonds in the United States and bank lending elsewhere, as well as by firms' own resources. Earlier waves were financed to a greater extent by equity issues. In the United States a feature of the current wave was the use of low-rated "junk bonds" pledged by small predator firms on the assets of the target firm. In this way extremely large purchases became possible from a small asset base. This form of finance was not widely available in earlier periods. Further important determinants of the current take-over wave are the liquidity that firms have accumulated and pension fund assets which have grown large in relation to obligations. In many cases these offer particularly easily realisable assets and thus a bait for hostile take-over activity.

In general, the consequences of rising equity prices are improvements in the financial positions of incorporated firms and in the wealth of the equity holders. To the extent that the increases are maintained, both improvements are likely to enhance the prospects for economic expansion over the next few years. Growth should also be stimulated directly by recent declines in interest rates, except to the extent that they lead to lower net interest incomes of the household sector, and hence moderate the growth of consumption.

Fund-raising activity in the financial markets. Total credit outstanding in the United States grew by 14 per cent. during 1985, compared with a 5.7 per cent. growth of nominal GNP. Thus, the sharp rise in the ratio of debt to GNP continued unabated, prompting concern on the part of the authorities regarding the consequences for financial stability.

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

Countries	Years	Fund-raising sector[2]							Total
		Business sector				Household sector		Public sector	
		Equities	Bonds	Loans[3]	Total	Housing credit	Other		
		as a percentage of GNP/GDP							
United States	1982	0.4	1.1	2.7	4.2	1.6	1.2	5.9	12.9
	1983	0.8	0.8	3.1	4.7	3.2	2.3	6.6	16.8
	1984	– 2.0	1.7	5.8	5.5	3.4	2.9	6.5	18.3
	1985	– 2.0	2.3	3.5	3.8	3.8	3.7	8.8	20.1
Japan	1982	0.8	0.6	7.6	9.0	1.7	1.9	8.2	20.9
	1983	0.5	0.6	7.4	8.5	1.3	2.3	9.4	21.5
	1984	0.6	0.8	7.3	8.7	1.1	2.0	7.1	18.9
	1985[4]	0.5	0.9	8.5	9.9	0.9	1.2	6.3	18.3
Germany	1982	0.3	0.2	4.2	4.7	2.8	0.6	4.3	12.4
	1983	0.3	0.0	4.3	4.6	3.5	0.7	3.4	12.3
	1984	0.3	0.1	4.3	4.7	3.1	0.6	2.7	11.1
	1985	0.4	0.3	4.0	4.7	1.9	0.7	2.4	9.7
France	1982	1.2	0.9	6.7	8.9	4.2		7.2	20.3
	1983	1.7	0.8	5.9	8.4	3.9		4.7	17.0
	1984	1.8	0.7	4.0	6.5	3.1		5.0	14.6
	1985	2.2	0.8	3.8	6.8	4.0		4.5	15.3
United Kingdom ...	1982	0.3	0.0	3.1	3.4	5.1	1.6	3.4	13.5
	1983	0.6	0.1	1.7	2.4	4.8	1.8	3.7	12.7
	1984	0.3	0.1	2.7	3.1	5.3	1.3	4.2	13.9
	1985[4]	0.9	0.2	1.9	3.0	5.1	2.0	2.9	13.0
Italy	1982	1.5	1.0	5.0	7.5	1.0		16.3	24.8
	1983	2.3	0.4	6.8	9.5	0.8		17.0	27.3
	1984	1.9	0.3	7.5	9.7	1.0		16.7	27.4
	1985[4]	2.3	0.3	6.5	9.1	0.9		16.6	26.6
Canada	1982	1.1	0.8	1.9	3.8	0.9	– 2.9	10.1	11.9
	1983	1.6	0.8	– 1.3	1.1	3.0	0.9	9.4	14.4
	1984	2.1	0.4	0.9	3.4	2.0	1.7	9.3	16.4
	1985	2.2	0.3	2.4	4.9	3.1	1.7	9.3	19.0

[1] The data differ conceptually from country to country. [2] For Japan, the United Kingdom and Canada, borrowing by public enterprises is included in public sector borrowing, and in Germany borrowing by the housing sector is included in household borrowing. [3] Includes money market paper and foreign borrowing. [4] Preliminary or estimated.

Sources: National flow-of-funds data.

Funds raised by the public sector in the United States rose sharply as a proportion of GNP between 1984 and 1985. Over the same period households borrowed heavily to maintain spending in the face of slower income growth, while US businesses continued to retire outstanding equity in sizable amounts. Despite lower corporate borrowing, some questions have been raised about creditworthiness, in particular in connection with the increased significance of the low-rated "junk bonds" noted above, which accounted for 30 per cent. of bond issues by US firms last year. Reflecting concern about the markets, the Federal

Reserve imposed margin requirements on stock purchases financed by debt secured principally by the equity being acquired.

It is notable that firms in the United States raised more of their funds in the bond market and less by bank borrowing compared with 1984. Bond issuing activity also shifted towards the Euro-markets, 30 per cent. of issues being made there. To some degree, this move towards bond issues was a normal consequence of falling long-term rates, as they induce consolidation of short-term into long-term debt. There were also, however, underlying trends encouraging the issue of marketable securities; these are discussed further below.

Canadian financial markets witnessed some of the same patterns as the United States, notably continuing heavy government borrowing, together with burgeoning household borrowing to finance housing and consumer durables. However, the company sector behaved rather differently than in the United States. In 1985 it sharply increased its borrowing, reflecting both inventory accumulation and capital formation. There was also considerable equity issuance, in contrast to developments in the United States.

In Japan fund-raising activity in the financial markets mainly reflected the continuing cyclical expansion by the business sector. The growth in fund-raising was largely in the form of loans, though issues of bonds also rose. In most European countries the increase in profitability enabled investment to be financed without a sharp growth in corporate fund-raising. In the United Kingdom a significant proportion of company sector borrowing was for the financing of take-over bids. The UK authorities issued a statement of policy to banks, requiring them to limit their exposure in these cases. Borrowing by households in the United Kingdom was also extremely buoyant, with housing credit alone exceeding total funds raised by the business sector. There are indications that a large proportion of housing credit was actually used for other purposes. By contrast, household borrowing remained at a relatively low level in Japan, Germany and France. In line with the policy of fiscal consolidation, public sector borrowing continued to decline, particularly in Japan, Germany and the United Kingdom, though in the latter case the reduction was helped by the sale of public sector assets. In Europe and Japan restraint by the public sector meant that the growth in private sector demand for credit could be accommodated without exceptional increases in net financial market activity. Contrasts may thus be drawn between these countries and the United States in terms of the relative buoyancy of public sector and business borrowing, while only in the United Kingdom has there been a comparable growth of household sector borrowing.

To summarise, 1985 and early 1986 witnessed a considerable decline in market interest rates and strong gains in equity prices. In some countries, notably the United States and Canada, domestic non-financial borrowers increased their fund-raising activity as a percentage of GNP. While this activity can generally be related to the economic cycle; the saving/investment imbalances discussed earlier also manifested themselves in the high level of fund-raising by the US and Canadian Governments, and equally in the rather high level of household borrowing.

The growth of securities transactions and the role of institutional investors.

Last year witnessed a considerable expansion of securities business in national and international markets. In the United States, Japan, Germany and France gross new issues of traditional bonds and related paper were larger in 1985 than in recent years (see the table below). In net terms, too, the growth of securities issues has been quite pronounced in recent years (see the table on page 75). In the Euro-markets bonds and other forms of negotiable instrument have been supplanting syndicated bank loans since 1982. More recently, outstanding amounts of Euro-notes have grown rapidly, although the total is still relatively small. The increase in activity has not been confined to issuing; the volume of transactions in secondary markets has also expanded sharply. In addition, in a number of countries administrative changes were made that opened the way for the future growth of securities operations. New negotiable instruments were authorised in Japan, Germany, France and the Netherlands. The relaxation of restrictions on competition in underwriting and dealing in securities was announced or implemented in the United Kingdom, the Netherlands and France, and futures markets were created in Japan and France.

Gross bond issues.

Countries and items	1980	1981	1982	1983	1984	1985
	as a percentage of GNP					
United States						
Government	5.4	5.4	6.7	7.9	8.7	9.4
Non-financial companies	2.8	2.2	2.9	3.2	4.2	7.0
Financial institutions	1.7	1.8	2.2	1.7	1.9	2.4[1]
Rest of the world	0.2	0.0	0.0	0.0	0.1	0.1
Total	10.0	9.5	11.9	12.8	14.9	18.9
Japan						
Government	6.8	7.0	6.8	8.7	7.3	7.5
Non-financial companies	2.1	2.4	2.6	2.8	3.2	3.5[1]
Financial institutions	6.2	5.9	6.7	7.2	7.1	7.9
Rest of the world	0.2	0.2	0.3	0.3	0.4	0.5
Total	15.3	15.6	16.3	19.0	18.0	19.4
Germany						
Government	1.5	1.7	2.6	2.6	2.6	3.1
Non-financial companies	0.4	0.4	0.4	0.3	0.3	0.4
Financial institutions[2]	9.5	11.8	12.5	13.8	12.9	14.7[1]
Rest of the world	0.4	0.1	0.2	0.2	0.3	0.3
Total	11.8	13.9	15.7	16.9	16.2	18.4
France						
Government	1.6	0.9	1.3	1.6	2.3	2.5
Non-financial companies	0.5	0.4	0.8	0.8	0.7	0.7
Financial institutions	1.9	2.1	2.2	2.5	2.6	3.3
Rest of the world	0.0	0.0	0.0	0.0	0.0	0.1
Total	4.0	3.4	4.3	4.9	5.6	6.6
United Kingdom						
Government	6.9	5.3	4.1	5.2	4.6	4.4
Non-financial companies	0.1	0.1	0.1	0.2	0.1	0.3
Financial institutions	0.0	0.0	0.1	0.1	0.0	0.0
Rest of the world	0.0	0.1	0.2	0.2	0.3	0.2
Total	7.0	5.6	4.5	5.6	5.0	4.9

[1] Estimated. [2] Includes debt certificates.
Source: OECD Financial Statistics Monthly.

Part of the increase in activity in securities markets over the past year is cyclical, but a significant proportion may be explained by secular changes in the working of the financial system. For a wide range of borrowers, financial innovation is making the issue of negotiable paper an attractive alternative to borrowing from a bank. Some borrowers enjoying a good reputation in the market have been able to obtain funds at rates below the average paid by banks in the wholesale market. This is particularly evident in the Euro-markets, where prime Euro-notes have increasingly been issued at rates below LIBOR and without an underwriting commitment.

The unbundling of the financial package and the tendency for banks to charge explicitly for payments and financial services have facilitated the growth of securities issues. Prime issuers find it easier to obtain payments and other non-credit financial services from their preferred suppliers and to raise funds in their own names without guarantees. Second-tier borrowers also increasingly tap securities markets, but in this case a bank guarantee or line of credit is often useful and sometimes indispensable. The provision of back-up facilities allows banks to charge directly for the information they collect in their credit assessment and customer evaluation activities.

Swaps are another form of off-balance-sheet business that has spurred the growth of the securities market. They enable an issuer who enjoys a relative advantage in a particular sub-market to exchange the interest payments or the currency denomination of a given debt contract with a counterparty enjoying a relative advantage in another segment of the market. The swap technique means that the issue of paper is not limited by an issuer's need for funds of a particular type. Evidence from market participants suggests that a significant proportion of the recent surge in straight bond issues can be attributed to swaps, though declining interest rates have also played an important role.

Banks have also contributed directly to the growth of securities and securities-like instruments by issuing liabilities – debt certificates, notes, bonds or negotiable certificates of deposit – that resemble marketable securities more closely than traditional time deposits. It is noteworthy that this has occurred even in countries, such as Germany and Japan, where the pace of change in bank balance sheets has been more measured than elsewhere and where some banks have long funded their activities by issuing bonds.

Funding by banks in securities markets.*

Countries	1966–72	1973–79	1980	1981	1982	1983	1984	1985
	as a percentage of total liabilities							
United States	12.3	23.6	28.6	30.6	29.9	25.1	24.1	23.6
Japan	8.3	11.7	11.3	10.6	11.7	12.3	13.2	14.3
Germany	15.2	18.4	18.8	20.2	22.8	23.0	24.4	24.5
United Kingdom	.	8.1	8.8	11.1	12.2	12.7	12.0	10.1

* Funding by banks in securities markets includes repurchase agreements, Federal funds and large term deposits of non-banks in the case of the United States, certificates of deposit and bank bonds in the case of Japan, bonds valued at market prices in the case of Germany and certificates of deposit in all currencies in the case of the United Kingdom. Data for the latter country are available only from 1975.

Sources: National data and definitions.

In a number of cases the new instruments owe their existence or growth to the nature and relative restrictiveness of the regulations in force. The volume of large-denomination negotiable certificates of deposit expanded in Japan because they were free from interest rate controls and because restrictions on issuing and trading in them were relaxed. Issues of bank bonds and notes increased in some countries because of the ability of banks to treat subordinated debt, which in many respects resembles money market paper, as part of their required capital. The removal of legal obstacles to the domestic operation of investment trusts in Italy opened the way for their rapid expansion in 1985 and 1986 and stimulated the securities markets.

The changing roles of different financial institutions.

Despite the substantial growth of new issues of securities and securities-like instruments, direct holdings of financial claims (bonds and equities) have not increased in importance. The share of traditional deposits in the asset holdings of the household and corporate sectors has fallen in a number of the major countries. But this decline has been offset by the rise in claims of the household sector on pension funds, life assurance companies, investment trusts and other types of intermediary, commonly referred to as institutional investors, which hold a significant proportion of their assets in the form of securities (see the table on page 69).

The changing relative importance of depository institutions and institutional investors denotes a shift in the locus of financial intermediation and in the amount and type of risk borne by these two classes of institution. Institutional investors are carrying out some of the risk pooling and financial transformation previously performed by banks. Bank assets and liabilities increasingly resemble securities, in that a growing proportion are marketable. In addition, banks have more scope for managing interest rate, foreign exchange and cash-flow exposures, thanks to new financial instruments such as swaps, futures and options. Credit risk is less amenable to direct management by such methods. Indirectly, however, they may be of help. Banks can, for example, brace themselves for greater credit risk by reducing their interest rate, currency or maturity mismatches.

Buoyant demand for securities, in large measure attributable to the growing importance of institutional investors, together with more explicit charging for payments services, enables banks to increase their fee and commission income and to diversify their sources of revenue. At the same time, stagnant demand for bank loans from prime customers and keen competition for deposits have moderated the growth of interest earnings. In recent years the ratio of bank fees and commissions to net bank interest earnings has thus tended to rise in the United States, Germany, the United Kingdom and Italy.

Accompanying these changes in the nature of banking has been an increase in competition as the types of business and the functions in the market of depository institutions and institutional investors have converged. In countries in which deposit business and securities business have been separated by law (the United States and Japan) or custom (the United Kingdom), competition and convergence have occurred in issuing, trading or trust-related business. In international markets the distinction between banks and securities houses has been eroded even more quickly than in national markets. Both types of institution now play an important role in the Euro-markets, irrespective of limitations that may apply at home.

In reaction to the convergence of the business conducted by different institutions, restrictions on their activities have been relaxed. For example, controls on interest rates and limits on credit expansion have been loosened or abolished on a broad front. France and Japan are the only major industrial countries where interest rate controls continue to be applied to a range of deposit accounts, and even in these countries some rates have been liberalised either by relaxing existing restrictions or by allowing the introduction of new, unregulated financial instruments. Similarly, there has been a shift away from reliance on controls on bank lending or credit expansion in the implementation of monetary policy, though there are conditions in which some countries still find them useful (see Chapter VI).

In contrast, the question of the types of financial claims that can be created and types of business that banks and other institutions are allowed to conduct has come to the fore. Last year major changes were made in the authorisation to issue financial claims in a number of countries. In June 1985 a yen-denominated bankers' acceptance market was inaugurated in Japan. In December 1985 the Deutsche Bundesbank decided to relax its opposition to the issue of negotiable DM certificates of deposit by banks domiciled in Germany and to make them subject to reserve requirements from May 1986, as long as the maturity of the liability is less than two years. German banks were also allowed to lead manage DM issues of zero coupon, floating rate and other paper commonly used in international finance. Changes of a similar nature were made in the Netherlands and in that country and the United Kingdom the issue of commercial paper was authorised.

In terms of the range of new products, the greatest regulatory reforms last year occurred in France. In March 1985 banks were permitted to issue certificates of deposit which may now range in maturity from six months to seven years. Companies were empowered to issue commercial paper from the beginning of 1986 on condition that a standby commitment has been obtained from a financial institution. In December 1985 companies and private individuals were allowed to purchase government bills, which previously could be bought only by banks or specified investors. However, remaining restrictions put a brake on the growth of the actual volume of new products. The most notable are maturity restrictions and minimum denomination limits of Fr.fr. 5 million on all these instruments.

As far as limitations on bank activities are concerned, the two most topical questions are securities business and geographical restrictions, though it is only in the United States that the latter issue is important at the domestic level. In effect, statutory restrictions on interstate banking in that country have been weakened by the expansion of "limited service" or "non-bank" banks, which either accept deposits or make commercial loans, and by decisions of individual states to allow the entry of out-of-state banks, often initially on a regional basis. Geographical expansion may bring advantages both to individual institutions and to the financial system as a whole. Such expansion generally facilitates portfolio diversification and may allow an institution to acquire a larger base of stable retail deposits. Conducting a greater range of business over a larger area does, however, place demands on systems of control and management within an institution.

Banks have a growing interest in securities business, because brokerage and underwriting activities, when permitted, generate non-interest income. Securities business enables banks to diversify their sources of revenue and places less pressure on capital than increased lending. Once administrative barriers to securities business within and between countries are lowered, taxes on securities operations come to constitute a larger proportion of transactions costs. Tax treatment then becomes a more important determinant of the volume of transactions in different markets. In the recent past financial institutions have become more vociferous in their calls for the reduction or abolition of such taxes.

Recent problems of financial stability.

Against the background of continuing change in the structure of financial markets, 1985 was a year of contrasting developments in the banking industry. Many international banks continued the process of consolidating their positions that had been made necessary by the 1982 debt crisis, while some banks and other financial institutions, particularly in North America, with heavy exposures to certain sectors of their own economies faced asset quality problems.

Looking first at the asset quality problems that some banks experienced last year, these stemmed from a combination of interrelated factors, including the adjustments associated with disinflation, large exchange rate movements and major changes in the relative prices of internationally traded commodities. In the United States weaknesses in the agricultural and energy sectors were reflected in the performance of some institutions which are involved in financing those parts of the economy. In the US agricultural sector 1985 was another year of stagnating income. These conditions caused continuing problems for the service of a sizable fraction of US agricultural debt; it is estimated that one-third of the full-time producers on commercial-sized farms experienced financial difficulties last year. US commercial banks as a group hold roughly 20 per cent. of total outstanding agricultural debt. The weakened financial position of some US farmers caused the failure of a number of agricultural banks, whose problems were exacerbated by the further erosion of the value of collateral supporting agricultural loans that resulted from the continued fall in agricultural land values.

The recent weakness of oil prices has contributed to a deterioration of economic conditions in segments of the US energy sector and in the south-western region of the country. The value of investments in oil exploration and drilling, as well as in the provision of oil services, declined further last year. Moreover, vacancy rates for commercial office buildings in several western and south-western US cities are currently as high as 25 per cent. These developments have posed problems for a number of banks in these areas of the United States that hold regionally concentrated loan portfolios.

The economy of western Canada, too, is heavily dependent on energy. The slowdown of economic activity in the western Canadian provinces after 1982 was aggravated by the decline in oil prices, with unfavourable effects on the loan portfolios of some regional banks in those areas. Two small banks that experienced such strains had to be closed last year, bringing the first commercial bank failures in Canada since the 1920s. Some other small banks in sound financial condition experienced temporary funding difficulties when large depositors transferred deposits to the major banks. However, these problems posed no threat to the overall stability of the Canadian financial system.

The recent major decline in longer-term US interest rates will no doubt alleviate some of the debt-servicing burden of the agricultural and energy sectors. Additionally, the lower exchange value of the US dollar should improve the export outlook for US agriculture. Nonetheless, these sectors are experiencing problems which are not simply cyclical but are related to changed long-term economic prospects for agriculture and energy-based industries both in North America and elsewhere.

Economic difficulties in commodity markets have caused problems for some commercial banks outside North America. The cessation of tin trading on the London Metal Exchange, as a result of underlying weakness in the demand for tin, created potential losses for banks which had financed a price stabilisation scheme operated by the International Tin Council, as well as for other market participants. Reduced levels of international shipping have led to stress in shipping and shipbuilding industries and to some problems for banks, particularly in Asia, which financed these industries.

Some institutions outside North America have also experienced problems with real estate loan portfolios. Beginning with the recession in the early 1980s, for example, the construction industry in the Netherlands experienced a sizable fall in activity. Commercial building development was particularly hard hit and has not yet recovered. This has led to difficulties at certain mortgage banking institutions in that country.

While sectoral problems are likely to persist for banks in some countries – the full effects of the recent sharp fall in oil prices have still to be felt – in 1985 the international banking system as a whole demonstrated its resilience by making considerable further progress in strengthening its resources. Banks in most developed countries recorded substantial increases in earnings, due in part to falling interest rates but also to other factors, in particular unusually high levels of fee income. These higher profits permitted substantial additions to banks' capital and reserves, as well as a strengthening of provisions to cover potential loan losses. The boom in stock markets, by raising the market value of bank equity capital, prompted announcements by several major European banks of new share issues. Moreover, large banks in countries such as the United Kingdom and the United States, which permit subordinated debt to be counted as capital for regulatory purposes, continued to reinforce their positions through issuing perpetual or other forms of debt capital. These improvements in banks' profitability, in their capital structures and in their loan loss provisions are particularly welcome at a time when the nature and structure of banking are rapidly changing.

Financial change and stability – the challenge for prudential supervision.

Since the beginning of the 1980s those responsible for the supervision of financial institutions and the regulation of markets have faced two principal challenges: the first, which dates back to the early 1980s, was associated with disinflationary policies on which industrial countries embarked after the second oil shock; the second, which is more recent, is the challenge that financial innovation – both the proliferation of new financial instruments and changes in the structure of financial markets – presents to the operation and the design of prudential control over banks and other financial institutions. In an increasingly integrated financial world both challenges have international, as well as national, aspects.

The first challenge reached its peak with the outbreak of the international debt crisis in 1982, and the supervisory response to it centred around measures to strengthen banks' ability to sustain losses. Last year's widespread increases, both in bank capital and in provisions against doubtful international loans, were a further step in a process which began in the early 1980s and in which supervisors have played an important part. The measures taken by banks, often on the instruction or recommendation of their supervisory authorities, have varied from country to country. In some countries the emphasis has been on strengthening capital resources, in others on building up provisions. By these various means much has been achieved to reinforce the balance sheets of leading international banks. In many cases, however, these efforts will need to be sustained in the light of the uncertain outlook for some sectors of domestic activity and the position of certain debtor countries.

The challenge posed by financial innovations relates in part to the very rapid growth of banks' off-balance-sheet activities, some of which were discussed earlier in this chapter. In principle, the risks associated with the use of these new financial instruments are no different from those related to traditional banking business; indeed, to some extent the mushrooming of new sorts of off-balance-sheet business has been a response by banks to the tightening in recent years of capital requirements with respect to banks' balance-sheet assets.

The task of bank supervisors with respect to these new sorts of off-balance-sheet activity can be summarised under four headings: to see that banks' own internal control systems adequately cover these activities; to adapt banks' published accounts so as to include them; to adapt banks' prudential reporting so as to capture them; and to include off-balance-sheet business, in an appropriate way, in prudential control systems. On this last point, the authorities in a number of major developed countries – including Germany, Japan, the Netherlands, the United Kingdom and the United States – have extended, or are proposing to extend, capital adequacy requirements to note issuance facilities (NIFs) and other irrevocable back-up commitments as well as, in some instances, to other new off-balance-sheet techniques developed by banks.

The other main issues for supervisors arising out of recent financial innovation are those related to the dismantling of barriers which in many countries hitherto separated banking from securities business and other types of financial activity.

What, for instance, are the implications for banking supervisors of some banks being part of larger financial conglomerates? And where different parts of such conglomerates are supervised by different authorities how are the various supervisors to co-ordinate their activities? The convergence of the activities of providers of different financial services needs to be complemented by a less segmented approach to prudential supervision.

The international aspects of these challenges are hardly less important than the national ones. With national financial systems more closely linked than ever before, unco-ordinated national supervisory policies create incentives for banking and other financial business to move from more regulated to less regulated centres, with a consequent increase in risk-taking that could, in the longer run, harm both the efficiency and the stability of the financial system. At the same time, large differences in national banking and supervisory traditions continue to exist together, in some instances with differences in legal restrictions on the activities of financial institutions. Supervisors will therefore need to co-ordinate their activities internationally by attempting to achieve similar objectives within these different national frameworks.

The strengthening of banks' capital positions over recent years has to some extent taken place in a co-ordinated way. The Group of Ten countries agreed, in the early 1980s, on the need to halt and, if possible, reverse the erosion of banks' capital positions that had taken place in the late 1970s. More recently, they have made some progress in co-ordinating the way in which capital adequacy is measured nationally. However, standards of capital adequacy, and the actual strength of banks' capital positions, continue to differ quite markedly between these countries. This is something of an anomaly in today's increasingly integrated financial world.

Prudential supervision of banks' new off-balance-sheet activities is still at an early stage of development. For that reason, international co-ordination of prudential controls should, in theory, pose fewer problems in that area than it does where long-established differences in national practices exist. As regards the international aspects of the supervision of new financial conglomerates, one obvious issue concerns the supervision of different parts of such institutions which are located in different countries.

The challenges that face supervisors today should not obscure the fact that the primary responsibility for the soundness of financial institutions rests with the managements of those institutions. Indeed, the greater freedom to compete nationally and internationally in a wide variety of financial markets, and with fewer restrictions on the types of activities they may pursue and instruments they may use, has increased the responsibilities of financial managements. The job of the supervisors is to establish a framework, appropriate to today's integrated financial world, for the exercise of those responsibilities.

V. INTERNATIONAL FINANCIAL MARKETS.

Highlights.

Buoyed by the downward trend of interest rates, large international savings imbalances, significant deregulation and financial innovation, activity in the international financial markets grew rapidly in 1985. The total volume of new facilities arranged in the short and long-term international issues markets soared by over two-thirds. Even the gross international banking aggregates, after two years of slow growth, expanded markedly. While the volume of syndicated Euro-bank loans declined further, owing to the banks' continued reluctance to increase their exposure vis-à-vis a considerable number of heavily indebted countries and the switch by prime borrowers to the securities markets, the banks maintained their share in international credit flows by dramatically stepping up their presence in the issues markets, not only as intermediaries but also as borrowers and investors.

The gross figures for the individual market sectors, however, significantly overstate the actual volume of new credit channelled through the international financial markets last year, owing to the very large volume of refinancing operations and the banks' greatly increased importance as purchasers and issuers of securities. Net of refinancing, overlaps and double-counting, international credit growth in 1985 may be estimated at around 10 per cent., which is more or less in line with domestic rates of credit expansion.

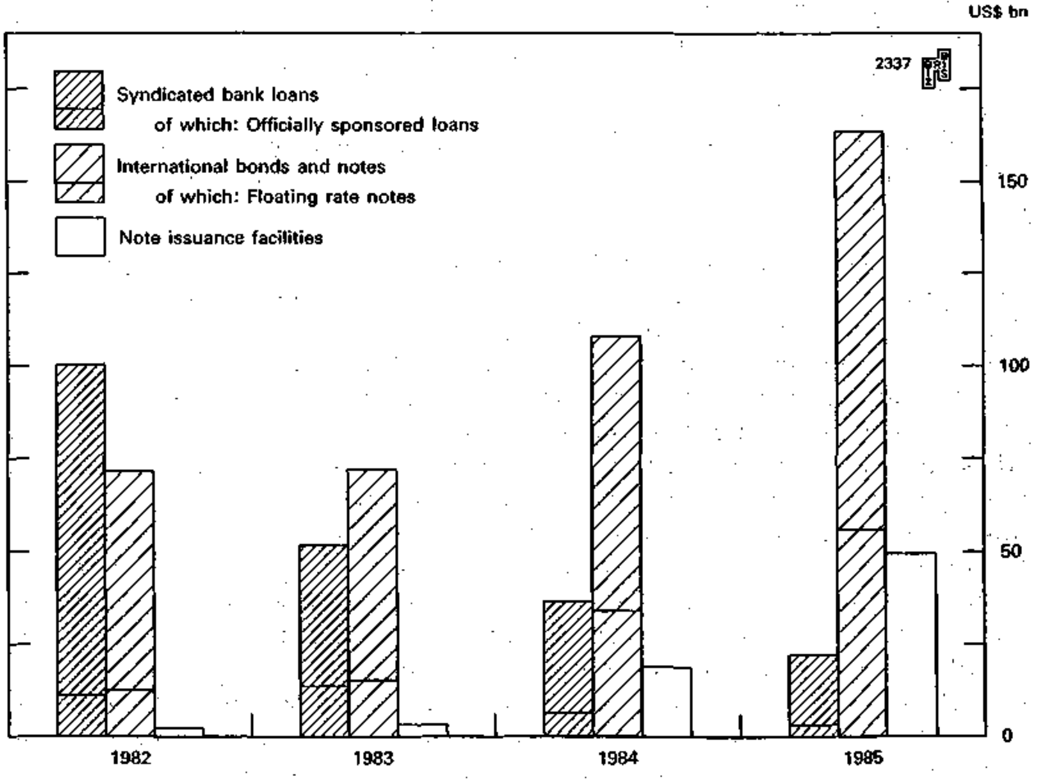
From the point of view of the international debt situation, developments in 1985 were not entirely satisfactory. The heavily indebted countries in Latin America and some other parts of the world did not, on the whole, make sufficient progress towards re-establishing their credit-standing to benefit from the favourable climate in the international financial markets and were therefore still confronted with the necessity of achieving large trade surpluses to finance their interest service payments. Although the decline in interest rates brought considerable relief, the renewed deterioration in the international trade climate — shrinking export growth, declining raw material prices and the collapse of the oil price — entailed an economic setback for a number of these countries. It was against this background that the new debt strategy outlined by the Secretary of the US Treasury, aimed at gradually defusing the international debt crisis through structural reform and a resumption of economic growth in the debtor countries, brought a new ray of hope. The success of this strategy will, however, depend not only on the full co-operation of the debtor countries and the commercial banks and increased financial assistance from the international development institutions, but also on adequate economic growth and an openness to developing countries' exports in the industrial countries themselves.

The overall picture.

1985 was a year of brisk activity and rapid structural change in the international financial markets. International bond issues expanded by over one-half, while the volume of newly arranged medium-term facilities for the issue of short-term Euro-paper (NIFs) was more than two and a half times its 1984 level. As a result, the combined amount of announced new facilities in the international short and long-term securities markets rose from $127 billion in 1984 to $213 billion last year, or nearly three times the level of two years earlier. International banking activity, after two years of slow growth, also picked up speed despite the continued contraction of the syndicated loan sector, and at the end of 1985 the reporting banks' cross-border assets, in constant dollar terms, exceeded their year-earlier level by $222 billion, or nearly 10 per cent.

These gross figures for the individual market sectors, however, overstate the true expansion of international credit flows last year. For one thing, the downward trend of interest rates, the continued paring of spreads charged to prime customers and the development of new instruments better suited to the needs of individual groups of borrowers led to a spate of refinancing operations. In the international bond markets, for example, the amount of repurchases and redemptions may be

Trends in international financial markets, 1982–85.*



* Figures based on Bank of England data, recorded according to announcement date.

estimated to have increased from around $25 billion in 1984 to $39 billion, or nearly three times their 1982 level. Moreover, a very large proportion of the $125 billion of net new issues, particularly those at floating interest rates, served to replace outstanding bank credits or other facilities. This was also true of a significant proportion of new NIFs and syndicated bank loans.

Estimated net lending in international markets: Changes in external claims of BIS reporting banks and international securities issues.

	Exchange rate adjusted flows[1]						Stocks at end-1985
	1980	1981	1982	1983	1984	1985	
	in billions of US dollars						
Total international lending of reporting banks[2] ..	241.1	264.8	180.5	103.7	122.7	221.5	2,512.7
minus: double-counting due to redepositing among the reporting banks	81.1	99.8	85.5	18.7	32.7	121.5	1,032.7
A = Net international bank lending[3]	160.0	165.0	95.0	85.0	90.0	100.0	1,480.0
Euro-bond and foreign bond issues	39.4	44.0	71.7	72.1	108.1	163.6	. .
minus: redemptions and repurchases	11.4	12.0	13.2	14.1	25.1	38.6	.
B = Net international bond financing	28.0	32.0	58.5	58.0	83.0	125.0	550.0
C (A+B) = Total bank and bond financing	188.0	197.0	153.5	143.0	173.0	225.0	2,030.0
minus: double-counting[4]	8.0	7.0	8.5	13.0	28.0	55.0	130.0
D = Total net bank and bond financing	180.0	190.0	145.0	130.0	145.0	170.0	1,900.0

[1] Non-dollar bank credits are converted into dollars at constant end-of-quarter exchange rates, non-dollar bonds at rates ruling on announcement dates. [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: firstly, 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; secondly, 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; thirdly, 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.

Secondly, it appears that only a limited amount — about 20 per cent. — of the roughly $75 billion of NIFs arranged by the end of 1985 has so far been drawn upon, while a substantial proportion merely serves as a back-up for other types of credit facility. Thirdly, much of the acceleration in the growth of the international banking aggregates last year was due to the rapid expansion of the interbank market within the reporting area. Net of the double-counting that results from such interbank operations, the estimated volume of new final lending was only moderately higher than in 1984. Fourthly, there has been an increasing amount of overlapping between the banking sector and the securities markets since the banks themselves became large borrowers and heavy investors in those markets. The double-counting resulting from this overlapping last year may be very roughly estimated at around $55 billion, as against $28 billion in 1984 and $8.5 billion in 1982.

Excluding both refinancing operations and these various elements of double-counting, it may be estimated that new credit intermediated by the international financial markets amounted to around $170 billion last year. This was only $25 billion more than the 1984 figure, despite the sharp acceleration in the expansion of the gross aggregates, and still somewhat below the $190 billion peak level reached in 1981. Although these figures do not include paper issued under NIFs and held by non-banks, on which little information is available at present, it appears that less than 50 per cent. of the outstanding amount of such paper has been taken up by non-banks; it is therefore unlikely, despite the rapid growth of this market sector, that this omission understates the 1985 figure for the amount of new credit channelled through the international financial markets by more than $5 to 7 billion.

Moreover, in view of the increasing globalisation of financial markets, it is clear that the international markets have been taking away some business from the domestic markets and that the total volume of new credit in the international markets does not therefore represent a corresponding net addition to total world credit flows. For example, Japanese corporations were important borrowers in the international bond markets, with a large proportion of the bonds issued by them being absorbed into the portfolios of banks and other investors in Japan.

The factors that shaped the growth, structure and sectoral distribution of international credit flows in 1985 were basically the same as in preceding years, though with some new nuances and shifts in relative importance.

In the international banking sector the dominant influence was the persistence of a "split" lending market. For many heavily indebted countries, notably those in the developing world, access to international bank credit remained very difficult. Excluding new credits extended under officially sponsored credit packages, the reporting banks' claims on these countries actually declined last year, although the figures may have been influenced by write-offs and loan sales at a discount. At the same time, the banks suffered from a dearth of prime customers from industrial countries, with competition for such borrowers leading to a further squeezing of lending margins. The international debt problems and, in some cases, domestic loan losses, however, undermined the perceived advantage of banks in offering safety to investors. As a result, large prime borrowers were able to raise funds in the securities markets at a lower cost than via the banking sector, despite the thinness of the banks' lending margins.

In addition, the banks' own preference for tradable assets, together with their need for more stable sources of funds, also gave a powerful boost to the growth of the securities markets. It may be estimated that about one-third of net new international securities issued last year was absorbed into the banks' own portfolios (excluding banks in the United States). Similarly, on the sources side of their balance sheets, banks accounted for nearly 60 per cent. of floating rate note (FRN) issues. In a number of countries, notably the United States and the United Kingdom, the funds raised through such issues may, on certain conditions, be counted as primary capital for supervisory purposes.

Moreover, the banks' quest for alternative sources of income that would not entail an expansion in their balance sheets and a reduction in their capital ratios was a significant factor in the rapid development of the Euro-note and Euro-commercial-paper market, where the banks could play an important role as guarantors, arrangers and dealers. For the same reason, in addition to their greatly enhanced importance as borrowers and investors, the banks continued to expand their activities as intermediaries in the long-term issues markets, often through the acquisition of a controlling interest in other financial institutions involved in trading and marketing securities. Similarly, the commercial banks played an increasing role as dealers and market-makers for new types of instrument such as swaps, options and forward rate agreements, thereby strongly expanding their off-balance-sheet activities and exposures. The resultant increase in service income, though possibly conjuring up the danger of new and not fully appreciated risk concentrations, has helped the banks to strengthen their own funds, to improve their gearing ratios and to build up resilience against the negative influences emanating from the international debt crisis and domestic loan problems.

Apart from the voluntary and involuntary support provided by the commercial banks to the growth of the securities markets, international issuing activity benefited in 1985 from a number of additional stimuli: the continued downward trend of long-term interest rates and the related opportunities for capital gains and lower-cost refinancing; the large savings imbalances amongst industrial countries; the increasing role of institutional investors with widening international horizons; national deregulation measures freeing the channels for international capital flows; and the innovativeness and flexibility of the securities markets themselves.

Looking at the developments during the period under review from a somewhat longer-term perspective, a striking feature has been the growing integration of different markets and market sectors. This has been partly associated with the evolution of a variety of instruments with similar characteristics, such as transferable syndicated loans, FRNs and NIFs. These facilities increasingly serve as direct substitutes for each other, with their use and advantages depending on factors such as market liquidity, investors' interest, flexibility of issue, possible arbitrage opportunities and, ultimately, relative costs. Consequently, although the general trend towards marketable instruments appears to be firmly established, the precise vehicles used are likely to change over the short term depending on the financial and macro-economic environment at any particular time.

This increased substitutability of different types of instrument, the greatly enhanced role of the commercial banks as investors and borrowers in the securities markets and the development of new facilities such as the NIFs combining a number of heterogeneous features have increasingly blurred the borderlines between different market sectors. This is true in particular of the distinctions between the short and long-term markets and between bank credit and the capital markets. Moreover, the increasing osmosis between different market sectors has resulted in a breakdown of the segmentation between domestic and international markets. Deregulation has played an important role in this respect, particularly in the non-dollar sectors during 1985. But the remaining regulatory barriers were also of some consequence, giving rise to specific types of arbitrage techniques and financial flows.

The progressive global integration of financial markets has been particularly striking in the case of the United States. The abolition of the withholding tax in mid-1984 has brought about a narrowing of yield differentials between domestic and Euro-issues as well as tighter price formulae. In addition, yields on new issues in the international securities markets are being quoted less and less against benchmark interest rates charged by banks in the Euro-market, and tend rather to be related to yields on US Government paper. The development of NIFs and related facilities has increased the interlinkages between the US commercial paper market and the international market for short-term securities. And, finally, a salient feature of the period under review has been the spreading to other currency sectors of instruments, such as FRNs, zero coupon bonds and certificates of deposit, which had previously been in use mainly in the United States and in the Euro-dollar market.

The international banking sector.

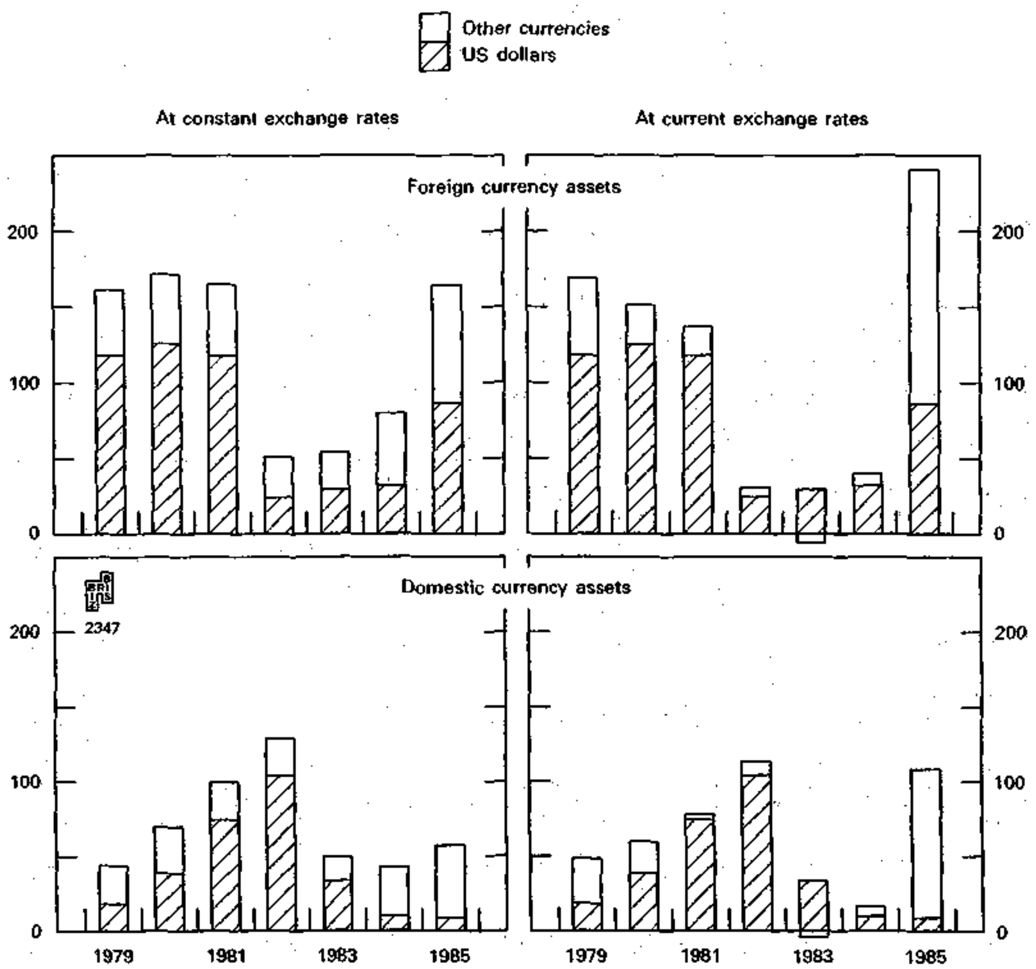
The development of the overall aggregates. Expressed in terms of current dollars, the growth in international banking activity accelerated dramatically last year, namely, on the assets side of the banks' balance sheets, from $57 billion in 1984 to $349 billion. However, this development was due in large measure to valuation effects resulting from exchange rate movements. Whereas in 1984 the dollar's appreciation had reduced the dollar value of the banks' positions denominated in currencies such as the Deutsche Mark, the Swiss franc and the yen, in 1985 its sharp decline had the opposite effect. But, even excluding these valuation changes, the acceleration in the growth of reporting banks' external assets, from $123 billion in 1984 to $222 billion last year, was quite remarkable. A similarly strong acceleration, from $27.6 billion to $62.7 billion, was, moreover, recorded in banks' domestic claims in foreign currency.

The stronger growth in international banking activity last year was due primarily to a sharp expansion in interbank operations within the reporting area itself (see the table on page 92). The very large $232 billion increase in these interbank assets (both cross-border positions and domestic positions in foreign currency) in 1985 seems to have been due to a number of influences: the growing role of the banks both as intermediaries and as principals in the international securities markets; hedging and arbitrage operations related to exchange market developments and shifts in expectations; a very strong expansion in the international activities of Japanese banks, partly in response to the various official deregulatory moves; and the importance of the US domestic banking sector as a borrower in the international banking market.

Sources and uses of international banking funds. Because of the predominance of interbank operations, the more rapid growth of the international banking aggregates last year did not imply a much larger increase in the final amount of international bank credit outstanding. Excluding the double-counting resulting from the redepositing of funds between banks within the reporting area, the total amount of new credit channelled through the international banking system may be estimated at around $100 billion, which was only $10 billion more than in 1984.

Changes in external assets of BIS reporting banks at constant and current exchange rates, 1979–85.

Annual figures, in billions of US dollars.



As regards the uses of international banking funds, credit to countries outside the reporting area continued to expand at a relatively sluggish pace, namely by $19 billion. This was $5 billion more than in 1984, but amounted to less than 30 per cent. of the exuberant growth recorded before 1982 during the heyday of international bank lending. Identified new international credit to non-bank entities within the reporting area totalled $30 billion, about the same as in 1984. However, since a very substantial part of this increase was probably in the form of securities purchases, new outright lending is likely to have declined quite sharply. In addition, there was $4 billion of new lending, representing for the most part claims on international institutions, that cannot be allocated geographically. These various inside-area uses add up to $53 billion. Apart from a sizable amount of unidentified lending to non-banks, the balance of $47 billion represented the reporting banks' own use of international funds for domestic lending or other investments not

BIS reporting banks: Selected features of international activity.

Items	Assets					Liabilities				
	Exchange rate adjusted flows				Stocks at end-	Exchange rate adjusted flows				Stocks at end-
	1981	1983	1984	1985	1985	1981	1983	1984	1985	1985
	in billions of US dollars									
Cross-border positions vis-à-vis:										
1. countries outside the reporting area	65.7	27.9	14.2	18.7	620.0	16.6	1.2	29.6	16.1	399.3
2. banks within the reporting area	160.8	65.4	92.1	179.7	1,504.9	159.3	81.1	105.7	191.9	1,667.9
3. non-banks within the reporting area	31.6	6.0	16.4	19.2	336.4	50.6	23.1	13.6	21.3	350.7
4. unallocated	6.7	4.4	–	3.9	51.4	11.2	3.7	– 1.4	1.3	58.5
Total cross-border positions	264.8	103.7	122.7	221.5	2,512.7	237.7	109.1	147.5	230.6	2,476.4
of which: in foreign currency and ECUs ..	*165.0*	*54.1*	*80.0*	*164.3*	*1,817.2*	*189.1*	*55.3*	*89.3*	*161.9*	*1,917.9*
Domestic positions in foreign currency:										
5. interbank[1]	51.2	11.1	14.5	51.8	406.5	48.4	15.3	15.0	63.8	407.8
6. vis-à-vis non-banks[2] ...	19.4	10.1	13.1	10.9	150.1	5.3	2.1	5.7	8.1	68.8
Total domestic positions .	70.6	21.2	27.6	62.7	556.6	53.7	17.4	20.7	71.9	476.6
Total foreign currency positions	235.6	75.3	107.6	227.0	2,373.8	242.8	72.7	110.0	233.8	2,394.5

Note: As from end-1983 the reporting area was 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.

[1] For banks in Europe, Canada and Japan only. [2] For banks in Europe and Canada only.

reflected in their external asset figures. Banks in the United States alone took up $27 billion of external funds for domestic purposes, mostly in dollars.

Turning to the sources side of the international banking market, the inflow of new funds from outside the reporting area slowed down quite sharply last year, from nearly $30 billion in 1984 to $16 billion. By contrast, new identified deposits received by the banks from non-bank entities within the reporting area amounted to about $29 billion, which was $10 billion more than in 1984. In addition, about $10 billion of new funds were channelled into the markets via trustee accounts of banks in Switzerland and $5 billion of new deposits were received from official monetary institutions. The balance of $40 billion included a certain amount of unidentified non-bank deposits but largely represented the new international funds provided by the reporting banks themselves, either by lending abroad in domestic currency or by switching domestic currency funds into foreign currency. Banks in Germany and Japan, the countries with high current-account surpluses, were by far the largest exporters of new funds last year and between them would seem to have accounted for the bulk of this $40 billion.

Returning to the reporting banks' direct business with non-bank entities within their own area, the largest increases in credits occurred vis-à-vis residents of the United States (+$12.6 billion) and the United Kingdom (+$10.4 billion). The bulk of the latter increase resulted from domestic lending in foreign currency by banks in the United Kingdom, with a substantial proportion of these new credits probably going to foreign-owned securities houses and other foreign firms in the United Kingdom. Other major borrowers were residents of Sweden ($2.7 billion), Canada ($2.5 billion), Switzerland ($2 billion) and a number of the smaller European countries. No figures are available on the local foreign currency lending of banks in Japan, which, however, seems to have been substantial. Sizable cross-border credits were, moreover, extended to non-bank entities registered in the Cayman Islands ($3.6 billion) and to residents of Hong Kong ($0.9 billion). On the other hand, two traditional groups of borrowers, Italian and Spanish non-bank entities, sharply reduced their debts to the international banking sector last year, by $5.2 and 4.7 billion respectively.

Estimated sources and uses of international banking funds.

	Exchange rate adjusted flows						Stocks at end-1985
	1980	1981	1982	1983	1984	1985	
	in billions of US dollars						
Uses							
Reporting area	88	93	42	53	76	77	809
Outside area	68	66	39	28	14	19	620
Unallocated	4	6	14	4	–	4	51
Total	160	165	95	85	90	100	1,480
Sources							
Reporting area	104	137	93	80	62	83	1,022
Outside area	52	17	−12	1	29	16	399
Unallocated	4	11	14	4	− 1	1	59
Total	160	165	95	85	90	100	1,480
Net							
Reporting area	−16	−44	−51	−27	14	− 6	−213
Outside area	16	49	51	27	−15	3	221
Unallocated	–	− 5	–	–	1	3	− 8

On the sources side of the banks' balance sheets, the inflow of new deposits from non-bank entities within the reporting area was more evenly distributed. The largest amount of new deposits, nearly $7 billion, was received from UK residents. US residents, having drawn down their deposits with banks abroad by $5.3 billion in 1984, built them up by $6 billion last year. Other large depositors of new funds were non-bank entities in Germany ($2.6 billion) and Belgium-Luxembourg ($2.5 billion), but sizable deposits were also received from residents of most other reporting industrial countries. Here again, no figures are available on the foreign currency deposits of Japanese residents with banks at home. Only Canadian and Swiss non-bank entities drew down their deposits last year, by $1 and 0.9 billion respectively. Elsewhere in the reporting area, substantial new deposits were received from non-bank entities in Hong Kong ($1.9 billion) and the Netherlands Antilles ($1.3 billion).

Lending to countries outside the reporting area. The 1985 pick-up in lending to the outside area was almost entirely in respect of eastern Europe. Owing to their successful earlier adjustment efforts, most of the countries in this area regained the favour of the banks and were able to obtain rather attractive loan terms. They borrowed $5.4 billion last year, while at the same time cutting back the flow of new deposits. As a result, they again became net takers of new funds, to the extent of $2.7 billion, whereas over the preceding three years they had reduced their net indebtedness to the reporting banks by a total of nearly $15 billion.

The overall picture for eastern Europe last year was as usual heavily influenced by the Soviet Union. This country, which experienced a slump in its earnings from energy exports, obtained $3.7 billion in new credit while adding $0.9 billion to its deposits. The second-largest borrower in this region was the German Democratic

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

Positions of reporting banks vis-à-vis:	Flows at constant end-of-quarter exchange rates							Stocks at end-1985
	1979	1980	1981	1982	1983	1984	1985	
	in billions of US dollars							
OPEC countries[2]								
Claims	7.2	7.0	4.2	8.2	9.8	− 1.8	− 1.1	110.2
Liabilities	37.4	41.9	3.2	−18.2	−13.1	2.3	6.9	159.9
Net[3]	−30.2	−34.9	1.0	26.4	22.9	− 4.1	− 8.0	−49.7
Memorandum items:								
Foreign exchange reserves[4]	*15.0*	*14.6*	*− 8.8*	*− 7.5*	*− 8.3*	*− 3.4*	*6.4*	*61.1*
Current-account balances	*58.5*	*106.5*	*49.0*	*−17.0*	*−17.0*	*− 9.5*	*− 5.5*	.
Non-OPEC developing countries								
Claims	35.3	38.9	39.9	19.8	12.2	10.4	8.5	349.6
Liabilities	12.3	4.0	9.5	4.6	10.3	19.8	3.1	177.3
Net[3]	23.0	34.9	30.4	15.2	1.9	− 9.4	5.4	172.3
Memorandum items:								
Foreign exchange reserves[4]	*8.6*	*− 1.8*	*−*	*− 2.5*	*8.5*	*17.3*	*3.9*	*88.8*
Current-account balances	*−42.5*	*−64.5*	*−79.0*	*−61.0*	*−34.5*	*−30.0*	*−26.5*	.
Other developed countries								
Claims	7.5	15.4	16.8	16.0	7.1	5.7	5.9	99.9
Liabilities	7.0	5.7	3.8	− 0.1	1.3	3.2	3.4	35.1
Net[3]	0.5	9.7	13.0	16.1	5.8	2.5	2.5	64.8
Memorandum items:								
Foreign exchange reserves[4]	*3.1*	*1.2*	*− 1.7*	*1.8*	*2.4*	*− 0.9*	*− 1.1*	*13.2*
Current-account balances	*− 7.5*	*−16.5*	*−25.0*	*−24.0*	*−13.0*	*−14.5*	*−11.5*	.
Eastern Europe								
Claims	7.2	6.8	4.8	− 4.6	− 1.2	− 0.1	5.4	60.3
Liabilities	4.7	0.9	0.1	2.0	2.7	4.3	2.7	27.0
Net[3]	2.5	5.9	4.7	− 6.6	− 3.9	− 4.4	2.7	33.3

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 III 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.

Republic, with new takings of $1 billion, though at the same time it built up its deposits by $1.4 billion. Other major customers were Bulgaria and Hungary, which obtained $0.9 billion and $0.8 billion respectively in new credit and also made major additions to their deposits. On the other hand, the reporting banks' claims on Romania and Poland decreased by $0.5 and 0.4 billion respectively, in the case of Poland largely as a result of transfers of claims to export insurance agencies.

Banks' lending to non-OPEC developing countries continued to decline last year, with new claims amounting to no more than $8.5 billion, $2 billion less than in 1984 and only between 20 and 25 per cent. of the levels recorded in the years before the outbreak of the international debt crisis. However, the renewed deterioration in the debtor countries' financial situations and the resultant slowdown in their reserve accumulation entailed a sharp decline in their new deposits with the reporting banks, from nearly $20 billion in 1984 to only $3.1 billion last year. As a result, after acting as net suppliers of new funds to the reporting banks in 1984, to the extent of $9.4 billion, these countries again became net borrowers last year, to the extent of $5.4 billion.

The reporting banks' business with individual groups of non-OPEC developing countries.

	Estimated flows at constant end-of-quarter exchange rates								Stocks at end-1985
	1978	1979	1980	1981	1982	1983	1984*	1985	
	in billions of US dollars								
Assets									
Latin America	14.4	23.2	27.4	30.5	12.1	7.8	5.7	1.3	217.9
Middle East	1.2	1.2	2.1	2.3	1.7	0.3	– 0.3	– 0.4	15.9
Africa	3.1	2.7	2.0	2.0	1.7	0.6	0.1	0.4	21.1
Asia	3.9	8.2	7.4	5.1	4.3	3.5	4.9	7.2	94.7
Total	22.6	35.3	38.9	39.9	19.8	12.2	10.4	8.5	349.6
Liabilities									
Latin America	8.0	4.9	– 0.9	4.7	– 1.9	5.8	10.3	– 1.1	67.9
Middle East	3.3	1.7	2.7	1.5	1.8	– 0.9	– 1.5	1.0	22.0
Africa	0.6	1.8	0.7	0.5	– 0.8	0.2	1.1	1.2	12.1
Asia	2.6	3.9	1.5	2.8	5.5	5.2	9.9	2.0	75.3
Total	14.5	12.3	4.0	9.5	4.6	10.3	19.8	3.1	177.3

* As from 1984 the coverage of the figures has been enlarged to include changes in the positions 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.

With a continuing split market, new lending to non-OPEC developing countries was very unevenly distributed. Lending to Asian countries accelerated from $4.9 billion in 1984 to $7.2 billion, whereas new credits to Latin America declined sharply from $5.7 to 1.3 billion, essentially as a result of a slowdown from $10 to 3 billion in disbursements under officially arranged new credit packages.

In Asia, by far the largest borrower was China, which, faced with a massive deterioration in its trade balance, obtained $4.8 billion in new credit and at the same time sharply reduced its deposits, thereby drawing a net amount of $10.3 billion from the reporting banks. Despite these heavy calls, China remained a net creditor vis-à-vis the international banking sector, with its end-1985 deposits of $11.7 billion still exceeding its debts by $2.3 billion. Other large borrowers of new funds were South Korea and India, which received $2.3 and 1.6 billion in new credit, while at the same time drawing down their deposits by $0.4 and 0.6 billion respectively. Taiwan, on the other hand, a country with huge balance-of-payments surpluses and correspondingly large reserve accruals, repaid $0.6 billion in debts while adding $6.7 billion to its deposits. With its claims on the banks exceeding its debts by $18.6 billion, this country is now, after Saudi Arabia, the largest net creditor outside the reporting area vis-à-vis the international banking sector. Another country that improved its net position vis-à-vis the international banking sector last year — though for quite different reasons — was the Philippines; it repaid $0.7 billion of debts and added $0.3 billion to its deposits.

In Latin America the only major borrower of new funds was Argentina, which, benefiting from an officially sponsored new credit package of $4.2 billion, drew $2.2 billion of new funds while adding $1.3 billion to its deposits. Chile borrowed $0.4 billion and withdrew $0.2 billion of deposits. Brazil, by contrast, drew funds from the international banking sector by reducing its deposits by $2 billion, while repaying $1.3 billion in debts; Peru did likewise, with $0.2 billion of debt repayments but $0.8 billion of deposit withdrawals. Mexico, too, which received only a marginal amount of new credits from the reporting banks, trimmed its deposits by $0.5 billion. On the other hand, owing to strong export performance Colombia was able to reduce its banking debts by $0.7 billion while drawing only marginally on its deposits.

OPEC countries, which, with the help of drastic import cuts, achieved a considerable improvement in their overall balance-of-payments position last year, added $6.9 billion to their deposits while repaying $1.1 billion of debt. As a result, for the first time since 1980 they were large net suppliers of new funds to the reporting banks. The major depositors of new funds were Venezuela ($2.8 billion), Libya ($2.3 billion), Algeria ($1.2 billion), Saudi Arabia ($0.9 billion) and Iran ($0.7 billion). Sizable debt repayments were made by the United Arab Emirates ($1.3 billion), Kuwait ($0.6 billion) and Saudi Arabia ($0.5 billion). Iraq, on the other hand, added $1.2 billion to its banking debts, while Algeria borrowed $0.7 billion.

Finally, developed countries located outside the reporting area conducted roughly the same volume of new business with the reporting banks as in 1984; they borrowed $5.9 billion while building up their deposits by $3.4 billion. The largest amounts of new credit were received by Australia ($2.5 billion) and Turkey ($1.4 billion). However, whereas Australia added $1.4 billion to its deposits, Turkey withdrew $0.8 billion, to become the largest net taker of new funds within that group of countries, financing more than the whole of its current-account deficit in the international banking sector last year. Other major borrowers were Greece ($1.1 billion) and New Zealand ($1 billion). Vis-à-vis South Africa, by contrast, which in early 1985 was confronted with the banks' refusal to renew expiring credit lines and had to introduce a partial debt moratorium, the reporting banks showed a $1.1 billion reduction in claims (probably partly as a result of shifts of claims to export insurance agencies); at the same time deposits received from South Africa increased by $0.7 billion. Another country to record a relatively large increase, of $0.8 billion, in its deposits with the reporting banks was Portugal, which achieved a strong improvement in its international reserve position last year.

The role of individual market centres. Looking at individual reporting countries, last year's growth in external activities was particularly pronounced in the case of banks in Japan, which continued to strengthen their presence in the international markets and made large additions to their international securities holdings. They expanded their external assets by $53.4 billion, or 38 per cent. Following the various financial liberalisation measures adopted in Japan in the course of 1984–85, external lending in yen showed an especially high rate of increase of 43 per cent. Since liabilities expanded somewhat less strongly, the external net creditor position of Japan's commercial banking sector widened sharply from $3.2 billion at the end of 1984 to $15.3 billion.

The development of the external position of banks in the United States was to some extent a mirror image of that of the Japanese banks. The external claims of banks in the domestic banking sector showed hardly any increase last year, and even the external assets of the US international banking facilities grew relatively slowly, by $11.1 billion or less than 6 per cent. It appears that there was a large amount of new lending to affiliated offices abroad, but this was offset to a considerable extent by an absolute reduction in claims on other banks and on foreign non-bank entities. At the same time, owing to the very liquid state of the Euro-dollar market and the role of the US banking sector as a kind of residual supplier or borrower of funds in this market, banks in the United States recorded a strong increase of $38 billion in their external liabilities. As a result, the external net creditor position of banks in the United States, which at its peak in March 1983 had amounted to $131 billion, declined by a further $27 billion to less than $59 billion last year.

After three years of relatively slow growth, the external activities of banks in the reporting European countries also picked up in 1985, although, at around 10 per cent., the rate of expansion was still much slower than in the years before 1982. In absolute figures, external assets expanded by $118.5 billion to a total of $1,292 billion. Banks in the United Kingdom, whose share in total outstanding positions of European market centres at the end of 1984 had exceeded 46 per cent., accounted for barely one-quarter of this increase. One reason for the comparatively modest growth of about 5.5 per cent. registered in the largest international banking centre seems to be that the figures for the United Kingdom, unlike those for most other reporting countries, do not yet include the banks' holdings of long-term securities. In fact, UK banks' external liabilities showed much stronger growth than their assets, with their external net debtor position widening by $16.6 billion to $58.5 billion last year. A substantial part of this increase seems to have reflected the banks' use of external funds for expanding their securities holdings. External asset growth was also relatively slow in France (4.5 per cent.), the largest European banking centre after the United Kingdom.

Developments in individual banking centres.

External positions of banks in:	Flows at constant end-of-quarter exchange rates								Stocks at end-1985	
	Assets				Liabilities				Assets	Liabil-ities
	1981	1983	1984	1985	1981	1983	1984	1985		
	in billions of US dollars									
United Kingdom	79.5	27.9	23.4	29.2	78.7	33.1	35.8	45.8	552.0	610.5
France	9.1	1.2	8.1	7.4	14.9	1.8	6.7	4.7	163.5	155.2
Luxembourg	6.2	1.4	7.3	9.6	4.1	0.3	5.8	9.4	108.6	99.4
Germany	7.4	–	7.5	19.3	1.5	– 2.0	5.6	6.3	97.4	74.2
Belgium	8.8	3.8	11.0	16.1	9.8	6.5	12.5	16.8	92.3	106.7
Netherlands	7.4	– 0.4	3.9	5.2	4.6	– 3.5	1.8	4.2	71.4	64.6
Switzerland	5.1	0.2	2.3	9.0	2.8	– 1.8	1.0	8.0	70.8	45.3
Italy	6.4	2.0	3.0	8.8	4.4	3.9	6.7	5.7	49.5	63.9
Austria	2.4	2.5	2.0	5.2	1.8	1.7	3.9	5.5	34.2	36.9
Spain	.	.	1.3	1.7	.	.	0.6	– 1.3	19.9	18.2
Denmark	0.7	1.3	1.2	4.1	0.6	1.3	1.4	4.8	11.4	11.7
Sweden	0.1	0.6	0.1	1.5	1.9	1.2	– 0.3	3.1	8.9	17.4
Other European reporting countries¹	0.8	– 0.1	1.8	1.4	0.9	0.3	3.5	4.9	12.5	27.5
Total European reporting countries	133.9	40.4	72.9	118.5	126.0	42.8	85.0	117.9	1,292.4	1,331.5
US IBFs	63.4	28.1	17.9	11.1	48.3	31.6	19.8	14.9	201.7	191.8
Other banks in the United States	12.3	5.4	– 1.7	0.1	–10.0	17.1	12.3	23.3	222.7	173.7
Total banks in the United States	75.7	33.5	16.2	11.2	38.3	48.7	32.1	38.2	424.4	365.5
Japan	20.7	18.6	22.0	53.4	21.8	7.5	23.8	41.3	194.6	179.3
Canada	2.7	3.5	2.1	2.1	18.0	3.9	1.6	2.1	46.1	65.7
Other reporting countries²	31.8	7.7	9.5	36.3	33.6	6.2	5.0	31.1	555.2	534.4
Total	264.8	103.7	122.7	221.5	237.7	109.1	147.5	230.6	2,512.7	2,476.4

¹ Includes, up to 1983, Ireland and, as from 1984, also Finland and Norway. 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.

An unusually strong growth in external assets, of $19.3 billion, or nearly 25 per cent., was, by contrast, recorded by banks in Germany. Most of this expansion occurred in the fourth quarter and represented lending to banks (including own offices) in the Euro-Deutsche Mark market, where there was a shortage of funds because of the use of Euro-DM funds for DM securities purchases and the withdrawal of official deposits for exchange market intervention purposes. The external liabilities of banks in Germany showed a much smaller increase, so that their external net creditor position widened sharply, by $13 billion, which corresponded roughly to the country's current-account surplus. Strong growth in external assets was, moreover, reported by banks in Belgium (21 per cent.), Italy (21.5 per cent.), Austria (18 per cent.) and Denmark (56 per cent.).

Banks in Italy reduced their external net debtor position by $3.1 billion to $14.4 billion last year. Spain was the only reporting European country whose banks cut back their external liabilities in absolute amounts, namely by $1.3 billion. Since banks in Spain at the same time continued to add to their foreign assets, they shifted from an external net debtor position of $1.3 billion to a net creditor position of $1.7 billion, a turn-round which was rendered possible by the country's underlying current-account surplus.

Currency composition of international banking activity and growth of the ECU market. As in 1984, the cross-border positions of banks in industrial reporting countries in dollars expanded much less than those in other currencies, not only in terms of growth rates but also in absolute amounts, namely by $60.4 billion as against $124.8 billion (including ECUs). In percentage terms, cross-border positions in dollars grew by 5 per cent. but those in other currencies rose by 21 per cent., or by 54 per cent. if valuation effects are not excluded. In fact, in current dollar terms the share of the dollar in the reporting banks' external positions shrank from nearly three-quarters at the end of 1984 to just under two-thirds. This would seem to indicate that the markets became somewhat cautious about the dollar, although there were also other influences, such as financial deregulation, which helped to boost non-dollar business.

The currency composition of reporting banks' cross-border positions.[1]

Currencies		Exchange rate adjusted flows								Stocks at end-1985	
		Assets				Liabilities					
		1981	1983	1984	1985	1981	1983	1984	1985	Assets	Liabilities
		in billions of US dollars									
US dollars	A	88.0	24.1	22.3	51.6	116.5	21.0	40.5	40.9	830.7	937.1
	B	74.4	33.7	10.1	8.8	38.4	48.0	28.0	32.9	408.2	350.2
Other foreign	A	45.2	22.3	35.2	64.4	39.0	28.1	33.1	78.1	397.4	414.0
	B	25.4	15.9	32.4	46.8	10.2	5.8	30.3	35.1	283.2	206.4
of which:[2]											
Deutsche Mark	A	15.8	9.5	10.7	13.4	10.2	9.0	16.5	15.8	162.1	161.6
	B	4.8	0.9	4.2	15.4	0.2	− 0.4	2.8	2.9	69.9	46.7
Swiss francs	A	11.2	2.7	3.0	15.2	15.8	4.7	2.8	18.8	80.9	90.3
	B	2.6	0.8	1.6	2.7	2.4	− 1.7	0.9	2.4	35.1	11.2
Japanese yen	A	6.6	1.3	6.4	21.0	5.8	4.0	1.8	19.3	50.4	47.5
	B	5.2	5.1	11.9	22.1	1.7	− 0.2	11.3	17.9	73.8	49.5
Pounds sterling	A	3.7	0.5	5.2	4.7	0.3	− 0.6	4.9	7.0	23.5	27.6
	B	5.0	3.3	6.7	2.4	4.8	6.1	8.4	5.8	36.6	49.9
ECUs		.	.	13.2	13.6	.	.	10.6	12.5	38.0	34.3

Note: A=Euro-currency positions; B=external positions in domestic currency.

[1] Positions of banks in industrial reporting countries only. [2] Excluding positions of banks in the United States.

The strongest growth was recorded in the yen sector, which benefited not only from the various liberalisation measures in Japan, but also from the very dynamic role of the Japanese banks in international finance; Euro-yen assets, in particular, expanded by as much as 71 per cent. The second-highest growth rates were registered in the ECU sector, with the reporting banks' cross-border assets in that unit of account expanding by 56 per cent. Substantial increases, particularly in absolute amounts, were also recorded in the international Swiss franc and Deutsche Mark sectors (18 per cent. and 14 per cent. respectively), although in the case of the

Deutsche Mark most of this expansion was in the form of external lending in domestic currency by banks in Germany.

The structure of the ECU banking market.

	Assets				Liabilities			
	End-year stocks			Flows	End-year stocks			Flows
	1983	1984	1985	1985*	1983	1984	1985	1985*
	in billions of US dollars							
Positions vis-à-vis non-banks:								
domestic	2.7	4.8	5.4	– 0.6	0.5	0.9	3.2	1.7
cross-border within the EEC	0.7	1.7	3.5	1.2	0.3	0.6	1.8	0.9
cross-border with non-EEC residents	0.2	0.8	2.0	1.0	0.1	0.4	1.2	0.5
unallocated	0.3	0.6	1.4	0.5	0.2	0.1	0.2	0.2
Total positions vis-à-vis non-banks	3.9	7.9	12.3	2.1	1.1	2.0	6.4	3.3
Positions vis-à-vis banks:								
domestic	2.3	5.4	10.8	3.5	2.5	5.3	10.7	3.5
cross-border within the EEC	5.0	12.7	24.3	7.4	5.6	13.1	25.0	7.6
cross-border with non-EEC residents	0.4	1.3	4.2	2.3	0.6	1.5	5.0	2.9
unallocated	0.3	0.9	2.6	1.2	0.2	0.4	1.0	0.4
Total interbank positions	8.0	20.3	41.9	14.4	8.9	20.3	41.7	14.4
Total	11.9	28.2	54.2	16.5	10.0	22.3	48.1	17.7

* At constant end-of-quarter exchange rates.

The strong growth of the ECU banking aggregates in 1985 was accompanied by a broadening of the scope of this market sector, particularly as regards non-bank participation, the geographical spread of business and the role of individual market centres. Whereas at the end of 1984 the non-bank deposit base of the ECU banking sector had still been rather narrow, in 1985 it grew by $3.3 billion, or over 100 per cent. Moreover, this large increase was very broadly distributed, encompassing not only domestic entities and other EEC residents, but also non-banks outside the EEC countries. ECU credits to non-banks, by contrast, showed a much smaller expansion of $2.1 billion, or 20.5 per cent. More than the whole of this increase was in cross-border lending, which expanded by two-thirds, whereas claims on domestic non-bank entities, which at the end of 1984 had accounted for over 60 per cent. of total non-bank credits, actually recorded a decline. Interbank claims and liabilities rose by over 50 per cent. last year. Business with banks located outside the EEC showed particularly high rates of growth of around 130 per cent., suggesting a widening of the geographical base of the market beyond the original circle of EEC member countries.

A breakdown by market centres reveals some decline in the relative weight of France and Italy in the ECU market in 1985. The increase in non-bank deposits was largely concentrated on the Benelux countries and the United Kingdom. In the Netherlands the banks' ECU liabilities to non-banks increased by over 250 per cent.

to $1.8 billion. Even stronger growth in ECU liabilities to non-banks, but starting from a lower base, was recorded by the banks in the United Kingdom. Banks in that country also recorded the largest expansion in interbank liabilities, of $4.1 billion, and now rank second in the ECU interbank market after banks in France. On the assets side of the banks' balance sheets, the decline in ECU lending to domestic non-bank entities was more than accounted for by a $1.6 billion reduction in such claims by banks in Italy, whereas in the other reporting countries ECU lending to residents continued to expand. Cross-border lending to non-bank entities increased strongly in virtually all reporting countries except Italy.

The syndicated loan market. As a result of the further shift of prime borrowers to the securities markets and the banks' continuing reluctance to increase their exposure vis-à-vis certain debtor countries, newly announced syndicated Euro-credit facilities declined further last year, from $36.6 billion in 1984 to $21.2 billion (see the table on the following page), their lowest level since 1972. The decline was fairly broadly distributed and encompassed all groups of countries except eastern European countries, which, in view of their limited access to the securities markets, stepped up their recourse to syndicated loan facilities from $2.5 billion in 1984 to $3.7 billion. On the other hand, new credits obtained by developing countries (including OPEC members) registered a particularly sharp decline, from over $17 billion to barely $8 billion, including $2.3 billion of non-spontaneous loans announced in the framework of officially sponsored new credit packages.

One notable feature of the syndicated loan market last year was that an increasing number of new credits carried provisions for the transferability of loans, which endow syndicated credits with many of the attributes of securities. The first transferable loan was arranged in 1984. In 1985 this technique was employed in facilities amounting to $3.9 billion, or 18 per cent. of new credits.

The international securities markets.

The short-term sector. The most striking development in 1985 was the speed with which the market for NIFs, which allow borrowers to raise funds over a medium-term period by issuing a stream of short-term notes, expanded and evolved. In 1985 the volume of new facilities arranged rose to $49.5 billion and by the end of the year a net amount of about $70 billion of such facilities was outstanding. This rapid growth was associated with profound changes in the structure and character of the market. The most important development was the emergence of non-underwritten Euro-note facilities which in structure resemble commercial paper programmes in the United States. While the original types of NIFs were underwritten facilities with three to six-month maturities, had tender panel or sole placement distribution arrangements and were priced against benchmark interest rates such as LIBOR, the Euro-commercial-paper programmes are not tied to any specific back-up lines, are issued for flexible maturities and distributed via dealerships and have interest rates set on an absolute basis. Although Euro-commercial-paper programmes amounted only to about one-third of the new facilities arranged in 1985, during the latter half of the year they accounted for an increasing proportion of the market. By the fourth quarter of 1985 more than 50 per cent. of new facilities took this form, with the expansionary trend continuing throughout the early months of 1986.

International financial market activity, by market sectors and borrowers.

Types of instrument \ Borrowers	United States	Other industrial reporting countries[1]	Other developed countries	Eastern Europe	Developing countries (incl. OPEC)	Other[2]	Total
	in billions of US dollars						
International bond issues							
1981	7.2	24.1	1.6	–	3.2	7.9	44.0
1982	15.3	37.7	4.0	–	3.1	11.6	71.7
1983	7.9	43.7	3.7	–	1.9	14.9	72.1
1984	24.9	60.8	6.1	0.1	2.8	13.4	108.1
1985	40.5	87.1	9.3	0.5	6.2	20.0	163.6
1986 Q1	12.5	31.2	4.1	0.4	1.5	6.1	55.8
Note issuance facilities[3]							
1981	–	–	0.5	–	0.5	–	1.0
1982	0.4	0.8	0.4	–	0.5	0.2	2.3
1983	0.4	1.6	1.0	0.1	0.2	–	3.3
1984	3.1	9.6	4.8	0.1	0.6	0.7	18.9
1985	17.6	19.7	9.8	0.1	1.1	1.2	49.5
1986 Q1	2.1	8.3	3.1	–	0.6	–	14.1
Total securities markets							
1981	7.2	24.1	2.1	–	3.7	7.9	45.0
1982	15.7	38.5	4.4	–	3.6	11.8	74.0
1983	8.3	45.3	4.7	0.1	2.1	14.9	75.4
1984	28.0	70.4	10.9	0.2	3.4	14.1	127.0
1985	58.1	106.8	19.1	0.6	7.3	21.2	213.1
1986 Q1	14.6	39.5	7.2	0.4	2.1	6.1	69.9
Syndicated bank loans[4]							
1981	8.3[5]	30.8	6.0	1.1	48.0	2.3	96.5[5]
1982	8.1	23.0	12.5	0.8	53.5	2.6	100.5[6]
1983	3.4	13.7	5.6	0.7	26.7	1.7	51.8[6]
1984	3.6	8.6	4.2	2.5	17.1	0.6	36.6[6]
1985	2.1	5.0	2.3	3.7	7.9	0.2	21.2[6]
1986 Q1	0.4	2.4	0.5	0.4	2.4	0.6	6.7

[1] Countries contributing to the BIS international banking statistics. [2] Offshore centres, international institutions plus unallocated items. [3] Covers all Euro-note facilities including underwritten facilities (NIFs, RUFs and multi-component facilities with a note issuance option) and non-underwritten or uncommitted facilities/Euro-commercial-paper (ECP) programmes. [4] Excludes existing loans newly negotiated where only spreads are changed. [5] Excludes $35 billion of US takeover-related standbys. [6] Includes the following amounts of non-spontaneous bank lending: $11.2 billion in 1982, $13.7 billion in 1983, $6.5 billion in 1984 and $2.3 billion in 1985.

Source: Bank of England.

Another notable feature, particularly in the first half of 1985, was the growth of multi-component facilities which allow borrowers to draw funds in a variety of ways (short-term advances, bankers' acceptances, swingline credits, etc.). In addition to the fact that they provide access to the cheapest possible source of funds at any given moment, one of the main attractions of these facilities last year was that they enabled drawings to be made in currencies in which Euro-notes and Euro-commercial paper could not then be issued, such as the Deutsche Mark, the pound sterling and the yen.

Although only a small proportion of the facilities have been drawn down, there is evidence of a growing interest in purchases of Euro-notes and Euro-commercial paper by non-bank investors who have come to view these notes as high-yield substitutes for other short-term and highly liquid instruments, such as US Treasury bills and domestic commercial paper. The introduction of credit ratings and the possibility for investors to submit unsolicited bids have enhanced the attractiveness of this financing vehicle. For borrowers, the flexibility and relative low cost of Euro-notes are no doubt among the factors that have contributed to the decline of syndicated lending and, more recently, to the slowdown in new issues of floating rate notes. In addition, these facilities have been used as substitutes for interbank lines and as back-ups for the issuance of commercial paper in the United States.

During the period under review the market for note issuance facilities was affected by regulatory changes. The first of these, announced in April 1985 by the Bank of England, concerned banks' underwriting commitments under NIFs, which were made subject to a 50 per cent. weighting in the computation of the risk asset ratio. Following this announcement, analogous changes were introduced or proposed in several other countries, including France, Germany, Japan and the United States. Secondly, domestic commercial paper markets were opened in France as from 18th December 1985, in the Netherlands as from January 1986 and in the United Kingdom as from May 1986. Thirdly, a judicial decision in the United States in early 1986 ruled that, under the Glass-Steagall Act, banks could not deal in commercial paper. It is possible that, if this decision is not overruled, some US banks may expand their Euro-commercial-paper business in order to compete for US customers.

More than 95 per cent. of the note issuance facilities announced in 1985 were for borrowers from developed countries. US corporations, in particular, stepped up their recourse to the market, with their share of new facilities expanding from $3.1 billion or about 16 per cent. in 1984 to $17.6 billion or 36 per cent. last year. Other major users of these facilities were from Australia ($7.9 billion), Sweden ($4.8 billion), the United Kingdom ($3.8 billion) and France ($3 billion). In 1985 non-bank corporations for the first time became the largest group of customers, their share in new facilities rising to over 60 per cent.

In the first quarter of 1986 newly announced Euro-note facilities amounted to $14.1 billion. Although this volume was roughly equal to the quarterly average recorded in the previous year, it represented a slowdown from the rapid expansion which took place in the fourth quarter of 1985. In keeping with the trend noted for the latter half of 1985, an increasing number of new facilities, more than 75 per cent., were non-underwritten or uncommitted. Two salient features during the first quarter were the shift in the composition of borrowers from industrial to financial companies and a sudden increase, to $3.3 billion, in facilities arranged for Japanese borrowers, notably banks, which had previously been virtually absent from the market.

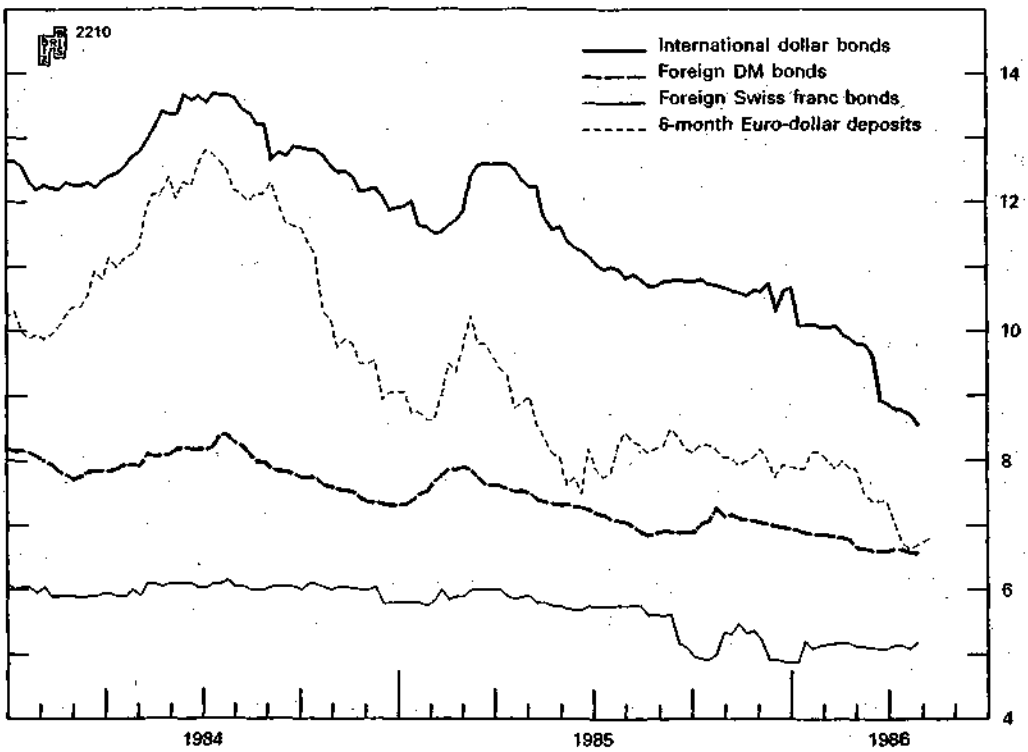
The long-term sector. Following strong growth during 1984, the volume of new international bond issues soared by a further $55.5 billion last year, to a total of $164 billion, or to 227 per cent. of its level of two years earlier. Although overall activity during 1985 was evenly divided between the first and second halves of the year, these two periods were characterised by different features. In the first part of the year confidence in the dollar and uncertainty about the future course of interest rates stimulated above all the Euro-dollar and, in particular, the floating rate note sectors, the issues in which expanded by 86 and 106 per cent. respectively in comparison with the first half of 1984. On the other hand, in the second half of the year the issue volume in these two market sectors declined by around 20 per cent. as the dollar depreciated and longer-term interest rates, after an upward reaction during the first quarter, continued on their downward trend. At the same time the market share of fixed rate bonds expanded from 56 to 67 per cent. and that of non-dollar issues from 33 to 46 per cent.

While the general influences accounting for the strongly expansionary trend of the international securities markets have been outlined in the opening section of this chapter, two factors which had a particularly important influence on the developments and structural features in the period under review deserve special attention.

One of these is the increasing use of the swap technique. A very large, though statistically unquantifiable, part of new issues in 1985 was swapped against securities

Yields of selected international bonds and Euro-dollar deposit rates, 1984–86.

Wednesday figures, in percentages.



denominated in other currencies or against other types of debt instrument, or both. Swaps have provided an important impetus to new issuing activity because they have detached the exposures taken by both borrowers and lenders from the markets for particular securities and currencies and have made it possible to take advantage of arbitrage opportunities created by regulatory barriers. As a result, interest rate and exchange rate features of a specific issue have become less important. Longer-term currency swaps have, moreover, contributed to the growth of new market sectors, particularly that for the ECU, where new issues amounted to $7.2 billion, and those for minor currencies such as the Australian dollar ($3.3 billion) and New Zealand dollar ($1.1 billion).

Structural features of the international bond markets.

Items	1982	1983	1984	1985					1986
				year	first quarter	second quarter	third quarter	fourth quarter	first quarter
	in billions of US dollars								
Total issues	71.7	72.1	108.1	163.6	38.1	42.5	37.6	45.4	55.8
of which:									
Fixed rate straight issues	56.4	50.0	65.5	100.4	22.0	23.1	26.2	29.1	46.2
Floating rate notes	12.6	15.3	34.1	55.9	14.1	17.2	9.7	14.9	8.3
Convertible bonds[1]	2.7	6.8	8.5	7.3	2.0	2.2	1.7	1.4	1.3
of which:									
US dollar Euro	40.9	35.7	67.2	95.3	24.6	27.9	19.0	23.8	26.0
foreign[2]	3.2	3.4	1.2	3.3	0.8	0.4	0.8	1.3	2.2
Swiss franc	11.6	14.0	13.2	15.1	3.4	2.9	3.2	5.6	6.4
Deutsche Mark	5.5	6.3	6.8	11.3	1.8	2.8	1.9	4.8	4.3
ECU	0.9	1.7	2.8	7.2	1.5	2.0	2.2	1.5	1.7
Yen Euro	0.4	0.3	1.2	6.8	1.2	0.6	2.7	2.3	5.5
foreign	3.5	3.7	4.7	5.6	1.2	1.7	1.4	1.3	2.2
Sterling Euro	0.8	2.0	4.1	5.7	1.4	1.0	1.6	1.7	3.2
foreign	1.2	0.9	1.4	0.9	–	0.2	0.4	0.3	0.2
Other	3.7	4.1	5.5	12.4	2.2	3.0	4.4	2.8	4.1

[1] Excludes bonds with equity warrants. [2] Excludes issues by Canadian borrowers in New York.
Source: Bank of England.

Secondly, the growth of the securities markets in 1985 was closely related to regulatory changes concerning both the permitted types of issue and the financial intermediaries authorised to arrange these issues. The most extensive deregulation took place in Japan and affected several aspects of issuing activity. Firstly, the circle of foreign borrowers allowed to issue yen bonds in the Euro-market or in Japan was gradually widened. Moreover, in October it was announced that the overseas subsidiaries of Japanese corporations were to be permitted, subject to certain conditions, to issue Euro-yen bonds. Secondly, foreign institutions were authorised to act as lead managers of Euro-yen bond issues. Thirdly, the withholding tax on non-residents' holdings of Euro-yen bonds was abolished. Finally, in June non-resident borrowers were authorised to issue FRNs, zero coupon bonds and dual currency securities on the Euro-yen market. As a result, new issues of yen-denominated international bonds more than doubled in 1985. The volume of new Euro-yen bonds in particular soared from $1.2 to 6.8 billion.

Important regulatory changes affecting international capital market activity also took place in Germany. As from May 1985 previously banned issues of FRNs, zero coupon bonds, swap-related bonds and dual currency bonds were permitted. Moreover, foreign-owned banks in Germany were allowed to lead manage foreign Deutsche Mark bond issues and the formal calendar for foreign issues was replaced by a more flexible system. With the help of these changes international Deutsche Mark bond issues expanded by 66 per cent. last year to $11.3 billion, of which nearly one-third was in the form of FRNs and zero coupon bonds.

In France the French franc Euro-bond market was reopened in April 1985, except for FRN issues, and in September the Italian authorities permitted Euro-bond issues in Italian lire by non-residents.

As in previous years, numerous international bond issues continued to be equipped with special features designed to exploit certain expectations concerning interest rate and exchange rate movements. Most of these features were attached to dollar bonds but, partly as a result of deregulation, some of the techniques began to spread to other currency sectors. As regards exchange rate related techniques, features such as partly paid bonds and warrants to purchase additional bonds allowed non-dollar-based investors to benefit from a future decline in US interest rates while limiting exposure to a depreciation of the dollar. A variety of features were also attached to FRNs. The most important were capping provisions, whereby coupon payments are allowed to vary according to an interest index up to a predetermined maximum rate, and interest rate mismatches in which interest yields are readjusted at shorter time intervals than those applying to coupon payments.

As usual, the bulk of new issues was arranged for borrowers from industrial countries. US entities, chiefly corporations, stepped up their recourse to the market by 63 per cent. to $40.5 billion, thereby accounting for nearly one-quarter of issuing activity. Japanese entities, the second-largest group of borrowers, raised $20 billion, which was 27 per cent. more than in 1984. One of the highest growth rates was recorded for UK borrowers, which expanded their calls on the market more than threefold, from $4.5 to 14.6 billion. $8 billion of this amount consisted of funds raised by banks in the form of FRNs. A further $2.5 billion was obtained through a single issue — the largest such transaction ever — by the British Government to strengthen the country's international reserve position. Elsewhere in the developed world the largest borrowing countries were France ($11.9 billion), Canada ($8.7 billion), Sweden ($5.9 billion), Australia ($5.7 billion) and Italy ($5.5 billion). Developing countries, including OPEC members, more than doubled their issuing activity, but at $6.2 billion their market share remained well below 5 per cent. However, these countries benefited in part from the funds raised by international institutions, which expanded by 41 per cent. to $18.6 billion last year.

The first quarter of 1986 was characterised by several major developments. Firstly, fixed rate bond issues soared to a record level of $47.5 billion following the

Groups of borrowers in the international bond markets.

Borrowing countries or areas	Years	Total	of which US dollars	Swiss francs	Japanese yen	Deutsche Mark	ECUs	Other
		in billions of US dollars						
United States	1982	15.3	12.8	1.5	0.2	0.6	–	0.2
	1983	7.9	6.1	1.3	–	0.3	–	0.2
	1984	24.9	21.4	1.2	0.7	0.7	0.1	0.8
	1985	40.5	30.6	2.5	3.3	1.1	0.9	2.1
	1986 Q1	12.5	7.9	1.7	1.9	0.2	0.3	0.5
Japan	1982	5.9	1.8	3.8	0.1	0.2	–	–
	1983	11.3	4.0	6.5	–	0.6	0.1	0.1
	1984	15.8	9.1	5.7	0.1	0.5	0.1	0.3
	1985	20.0	11.2	5.7	0.9	0.8	0.6	0.8
	1986 Q1	5.8	3.1	1.7	0.7	0.3	–	–
Other developed countries	1982	35.8	22.2	4.4	2.2	2.6	0.7	3.7
	1983	36.1	21.0	4.3	2.0	3.3	0.9	4.6
	1984	51.1	32.6	4.3	2.4	3.3	1.5	7.0
	1985	76.4	44.0	4.8	4.3	6.1	4.4	12.8
	1986 Q1	29.5	14.2	2.2	3.3	2.6	0.9	6.3
Developing countries (including OPEC)	1982	3.1	2.2	0.3	0.3	0.2	–	0.1
	1983	1.9	1.3	0.1	0.3	–	–	0.2
	1984	2.8	1.6	0.2	0.7	–	–	0.3
	1985	6.2	4.0	0.1	1.2	0.7	–	0.2
	1986 Q1	1.5	0.6	–	0.8	0.1	–	–
Others (including eastern Europe)	1982	0.2	0.2	–	–	–	–	–
	1983	0.2	0.1	0.1	–	–	–	–
	1984	0.3	0.2	–	0.1	–	–	–
	1985	1.9	1.4	0.1	0.1	0.1	0.1	0.1
	1986 Q1	0.5	0.4	0.1	–	–	–	–
International institutions	1982	11.4	4.9	1.6	1.1	1.9	0.2	1.7
	1983	14.7	6.6	1.7	1.7	2.1	0.7	1.9
	1984	13.2	3.5	1.8	1.9	2.3	1.1	2.6
	1985	18.6	7.4	1.9	2.6	2.5	1.2	3.0
	1986 Q1	6.0	2.0	0.7	1.0	1.1	0.5	0.7
Total	1982	71.7	44.1	11.6	3.9	5.5	0.9	5.7
	1983	72.1	39.1	14.0	4.0	6.3	1.7	7.0
	1984	108.1	68.4	13.2	5.9	6.8	2.8	11.0
	1985	163.6	98.6	15.1	12.4	11.3	7.2	19.0
	1986 Q1	56.8	28.2	6.4	7.7	4.3	1.7	7.5

Source: *Bank of England.*

sharp decline in interest rates, particularly on US dollar bonds. Secondly, new issues of FRNs declined to $8.3 billion, or 41 per cent. below the quarterly average for 1985. This slowdown can be attributed to several factors. Numerous issuers — particularly sovereign borrowers — found it easier to raise funds in the fixed rate sectors and to arrange swaps at a cost lower than LIBOR. The perceived downward trend of long-term interest rates stimulated investors' demand for fixed rate bonds. Financial institutions, which had issued a large volume of FRNs in 1985 in order to strengthen their balance sheets, were largely absent from the market. And finally, the yield curve remained flat and there was no incentive to hold FRNs financed with short-term funds. The third salient feature of this quarter was a pronounced pick-up of activity in the syndicated loan market, from $3.3 billion in the last three months of 1985 to $6.7 billion.

The international debt situation and the Baker initiative.

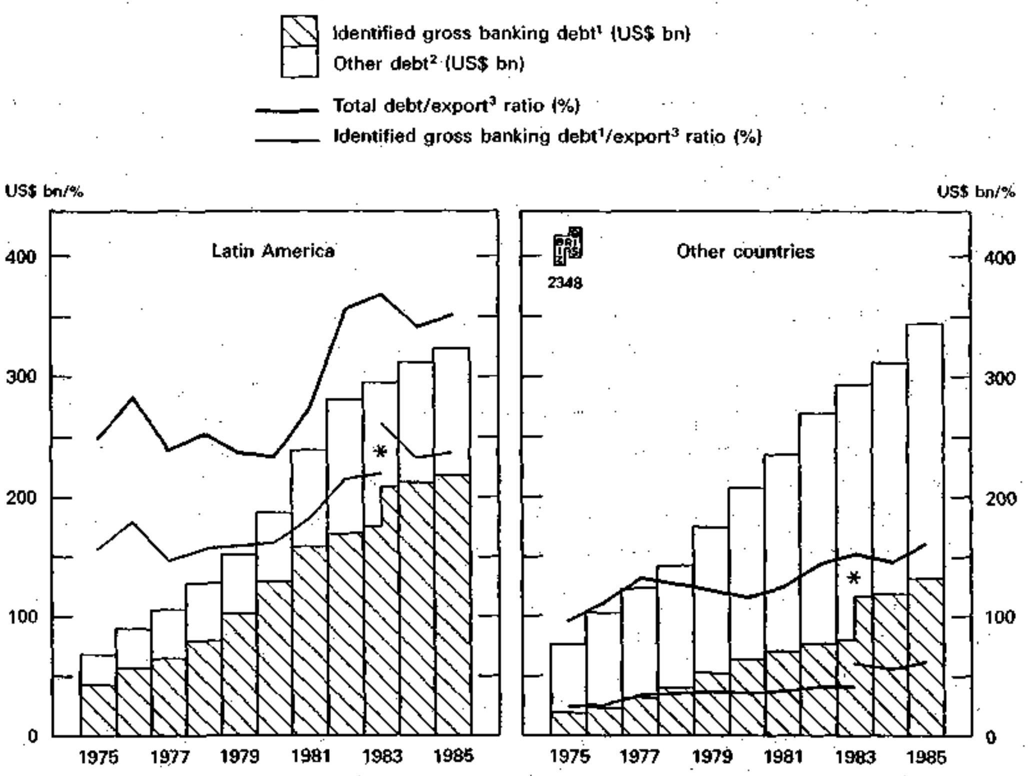
1985 was a rather mixed year from the point of view of the international debt situation. After the improvement that had occurred during 1984, some of the clouds on the financial horizon began to darken again. This was first and foremost the result of a renewed deterioration in the external trade performance of problem debtor countries. As a result of the slowdown in economic growth in the United States, the expansion of developing countries' exports, which had picked up strongly in 1984, ground to a halt, while export prices began to slide again. The resultant decline in export proceeds forced debtor countries to make further cuts in imports. The negative impact of this development on their domestic economies was in many cases compounded by the continuing depressive effects of the earlier adjustment measures, which had mainly taken the form of curbs on aggregate demand without adequate focus on supply-side measures and structural reform.

Against this sombre background of flagging export proceeds and continuing domestic economic problems, there was — not too surprisingly — no sign of a pick-up in spontaneous bank lending to the debtor countries. On the contrary, despite substantial officially sponsored new lending packages the flow of new bank credit to many debtor countries almost came to a standstill or was even reversed in 1985.

Fortunately, developments during 1985 were not all negative. Interest rates, particularly on dollar funds, continued to come down and were on average 2.5 percentage points lower than in 1984, with their decline persisting into 1986. Similarly, for countries whose debt is predominantly in dollars but which export in large measure to countries not linked to the dollar area, the fall of the dollar in the exchange markets meant a reduction in the real weight of their external debt. Moreover, as developing countries' currencies are tied in most cases to the US dollar, the depreciation of the dollar has helped to restore more realistic exchange rate relationships vis-à-vis the currencies of other industrial countries. Finally, despite growing frustration and political pressures in the heavily indebted countries, the constructive co-operation with creditor banks and international institutions has in most cases continued. With few exceptions, the debtor countries have remained current on their interest payments and some have more recently adopted fundamental adjustment programmes. The banks, in the framework of rescheduling operations, have in most cases been willing to concede more favourable spreads, thereby compounding the effects of lower interest rates.

One outstanding feature was the marked differences in the situation of individual countries. In Latin America, for example, economic growth — together with inflation — picked up strongly in Brazil, whereas in most other countries it slowed down markedly or continued to stagnate. Moreover, these differences in economic performance are being accentuated further by the recent oil price collapse and its differential impact on individual debtor countries.

Evolution of international indebtedness in non-OPEC developing countries, 1975–85.



* 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] Estimates based on IMF sources. [3] Exports of goods and services.

Given the closeness of their economic ties with their large northern neighbour, the Latin American countries were particularly strongly affected last year by the economic slowdown in the United States. Their exports of goods and services, which in dollar terms had grown by 14 per cent. in 1984, showed hardly any further increase last year. At the same time, their access to foreign capital narrowed further. Their response was to hold down their imports and terminate or reverse their earlier reserve build-up. Although, in current dollar terms, the growth of their external debt slowed down from $17 billion in 1984 to $12 billion, the weak export performance meant that, after a substantial decline in 1984, the debt/export ratio rose once more to over 350 per cent. In addition, the ratio of interest service to exports showed hardly any further improvement despite the lower level of interest rates. At the same time investment and economic growth, affected by the need for budgetary tightness and foreign exchange economies, continued to stagnate in most countries in the region, while unemployment went on increasing and per capita income showed no improvement or declined even further.

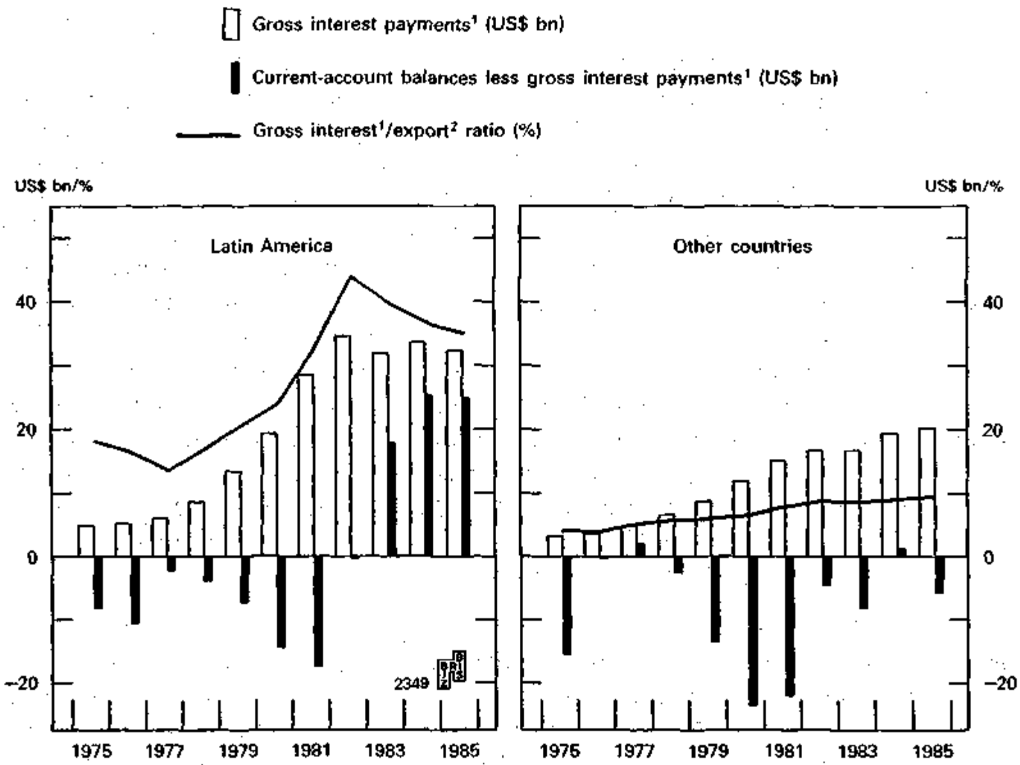
Mexico recorded a particularly marked deterioration in its external payments situation last year. Its current-account surplus, which had amounted to $4 billion in

1984, was virtually eliminated as the negative impact of the weaker oil market — although not yet fully reflected in the 1985 trade figures — was compounded by a sharp expansion in domestic demand. In Brazil the turn-round in the current-account balance was more modest. Owing to a realistic exchange rate policy, the deterioration was only from near balance in 1984 to a $0.7 billion deficit, despite the resumption of strong economic growth. Given the absence of major structural imbalances, the comprehensive anti-inflationary economic reform package adopted in March 1986 is expected to bring inflation down from around 250 per cent. to single digit figures this year. A resumption of export growth — export proceeds declined by about 5 per cent. in 1985 — would, against the background of lower oil prices and interest rates, go a long way towards solving the country's external payments problems. In Argentina the austerity programme introduced last June led to a decrease in the country's current-account deficit from $2.5 billion to $2 billion and brought inflation down from a monthly rate of 30 to just over 3 per cent. at the end of 1985, but it paid a price in terms of lower economic activity, with domestic output declining by approximately 4 per cent. and real per capita GNP falling to more than 15 per cent. below its level at the beginning of the decade. Nevertheless, only by persevering on the present policy path can the country hope to secure a lasting improvement in its economic performance.

The stagnation of exports and declining confidence, together with persistently heavy debt service burdens, meant that the external financial position of most debtor countries remained very difficult. As explained on page 95, excluding valuation effects gross new lending by commercial banks to Latin America almost ground to a halt last year, despite a substantial amount of new credits received in the framework of officially sponsored rescheduling packages. Net new IMF credit to Latin American countries also decreased, from $3.9 billion in 1984 to $1.5 billion, not only as a result of the completion of existing programmes, but also as a consequence of the suspension of disbursements because of non-fulfilment of performance criteria or outright refusal to accept Fund conditionality. At the same time, direct access for problem debtor countries to the international capital markets remained virtually closed and, as a result of the poor state of their domestic economies, direct investment inflows showed little sign of revival. One offsetting development was that Latin American countries' deposits with the reporting banks, after a $10 billion rise in 1984, declined by $1 billion last year, but this primarily reflected the fact that these countries were no longer able to add to their official reserve positions.

Outside Latin America, the financing situation remained very difficult in a broad group of small low-income countries, notably in sub-Saharan Africa, with virtually no further access to the international financial markets. In view of their poor credit-standing, these countries, even in the most euphoric days of international lending, had not been able to borrow much in the international banking sector and the bulk of their very substantial external debt is to official creditors. Given the unfavourable international trade environment, these countries, too, were not in a position to improve their balances of payments last year and, according to IMF sources, their debt and interest service to export ratios deteriorated markedly, from 345 to 383 per cent. and from 9.3 to 12.5 per cent.

Factors influencing the borrowing needs of non-OPEC developing countries, 1975–85.



[1] Estimates based on IMF sources. [2] Exports of goods and services.

respectively. Moreover, a number of these countries are in arrears with debt repayments to the IMF and some of them are barred from new borrowing because of their failure to repay such arrears. It is, however, clear that in the case of these countries the solution to the debt problems will have to lie outside the private financial markets.

The situation was quite different in the case of developing countries in East Asia. The export performance of these countries also was strongly affected by the slowdown in US economic growth, but owing to their lower level of indebtedness and/or the greater dynamism of their economies, most continued to have access to international bank credit on relatively favourable conditions. Nevertheless, except for China, which is still a net creditor vis-à-vis the international banking sector, they made only moderate use of their borrowing potential, and even where there was some increase in debt ratios, these remained far below those of Latin American countries.

To return to Latin America, in the absence of spontaneous capital flows the avoidance of outright default continued to depend on the rescheduling of maturing loans. While some kind of temporary agreement could be concluded in the case of nearly all countries, the working-out of multi-year rescheduling packages permitting the restoration of more normal credit relationships proved to be a difficult and time-consuming process. Nevertheless, by the spring of 1986 five major Latin American countries, Argentina, Chile, Ecuador, Mexico and Venezuela, had signed definitive multi-year restructuring agreements with their banks, following many months of negotiations. A number of other Latin American countries are still in active negotiation, tentative agreements with banks' steering committees having been signed, for example, in the case of Brazil and Uruguay. Altogether, by early spring 1986 the amount of Latin American debt covered by rescheduling agreements came to around \$90 billion, roughly 40 per cent. of the total banking debt of that area. In virtually all instances sizable reductions in the margins charged by the banks were incorporated in the packages, although terms of repayment and grace periods differed considerably from country to country. Two Latin American countries, Colombia and Paraguay, continued to service their debts according to the original terms of the contract, whereas at the other end of the spectrum Bolivia and Peru unilaterally suspended or reduced their debt service payments. Outside Latin America new multi-year rescheduling agreements were, for example, reached with Yugoslavia and the Philippines and negotiations with Nigeria are under way. In Poland, the first country which had reached a multi-year rescheduling agreement with the banks, ad hoc reschedulings of loans coming to maturity partly under the earlier packages are an ongoing process.

While the period under review did not bring a reduction in overall exposure vis-à-vis problem countries, or a discernible overall improvement in the quality of such assets, the creditor banks have in most cases continued to strengthen their balance-sheet structures. They have further built up their provisions for doubtful loans, while at the same time adding to their risk capital. Non-dollar-based banks have been assisted in this respect by the sharp decline of the dollar on the exchange markets, which has materially reduced the domestic currency value of their international dollar books. On the other hand, problems on the domestic front, particularly in the energy, real estate and agricultural sectors, have in some cases added to the vulnerability of the banks in their home markets (see Chapter IV). At the same time, fierce competition in the international securities markets, the shortage of first-class borrowers and the threat of disintermediation have exerted downward pressure on banks' earnings margins in their international business.

Their continuing domestic economic plight — in most Latin American countries per capita GNP still remains well below the level reached at the beginning of the decade — the more difficult international economic environment and protectionist trends in the industrial countries have tended to harden the attitude of debtor countries. At their December 1985 meeting in Uruguay the so-called Cartagena group of eleven Latin American debtor countries came up with a request to the international financial community for a reduction in interest charges, the maintenance of existing credit lines and the granting of additional loans. Moreover, they gave their advance endorsement to any decision by individual countries to take unilateral measures to reduce their debt service burden. Since then no further Latin American country has resorted to such action. Nevertheless, there can be little doubt about the damaging psychological impact of sustained austerity programmes imposed on newly elected democratic governments in these countries by external debt service considerations without much prospect of improvement in the foreseeable future.

The realisation that several years of restraint and privation had failed to alleviate the debt ratios and that therefore a new strategy for dealing with the international debt problem was needed was also among the principal reasons behind the new initiative launched by the US Treasury Secretary in October 1985 on the occasion of the Annual Meeting of the Bretton Woods institutions in Seoul and called by its author "a programme for sustained growth".

As its title suggests, the outstanding feature of this new debt strategy is its emphasis on the resumption of sound economic growth in the debtor countries as a necessary condition for a long-term solution of the international debt problem. Instead of short-run balance-of-payments adjustments, at whatever cost to economic activity, the emphasis of this new strategy is on structural reforms that would put the debtor countries onto a higher economic growth path, thereby gradually reducing the relative weight of their external debt. In order to meet the larger external financing requirements entailed by such a long-term policy design the Baker initiative foresees a 50 per cent. increase (amounting to \$3 billion on an annual basis) in new lending by the World Bank and its affiliated institutions to the principal problem debtor countries and a total \$20 billion of additional new lending by the commercial banks over the next three years.

Access to these sources of new finance will, however, be strictly contingent on the adoption of growth-oriented structural adjustment programmes to be worked out by the debtor countries in close co-operation with the IMF and the World Bank. As to the main focus of this structural adjustment, Mr. Baker mentioned specifically three areas: increased reliance on the private sector and less reliance on governments to help increase employment, production and efficiency; supply-side action to mobilise domestic savings and facilitate efficient investment, such as tax and labour market reforms and the development of financial markets; and market-opening measures to encourage foreign direct investment and capital inflows, including trade liberalisation.

The IMF and the World Bank are to lend their full support to this reorientation of development strategy even if this entails some change in present practices and procedures. This will require for one thing the establishment of an intimate working relationship and close policy co-ordination between the two institutions. While the IMF is to remain the principal overall international debt co-ordinator and guardian of sound policies, the World Bank, by its very nature, will have a large role to play in the elaboration and financing of longer-term growth strategies. In this connection, the World Bank and its affiliated institutions are to step up the share of fast-disbursing sectoral and structural adjustment loans and to expand their co-financing operations with the commercial banks. The International Finance Corporation and the recently founded Multilateral Investment Guarantee Agency are to assist the developing countries in attracting non-debt-creating equity as well as the concomitant technological and managerial know-how.

The commercial banks, in turn, are invited to pledge the \$20 billion of new funds for lending to countries that have worked out such a growth-oriented adjustment programme. This new money could be used both for short-term financing and for longer-term investment.

The overall thrust of the Baker initiative has generally received a favourable, if cautious, welcome. Firstly, it showed a new sense of commitment on the part of the present US Administration with regard to the international debt problem. Secondly, the underlying idea of a longer-term solution to this problem via revitalisation of the economies of debtor countries which, in most cases, have not yet recovered from the very serious setbacks suffered as a result of the debt crisis, is certainly a very valid concept. Even from the point of view of the commercial banks, the commitment of new funds need not be interpreted as charity, but can be considered sound business policy to the extent that the new lending would serve to improve the quality of outstanding loans. Moreover, as far as the debtor countries are concerned, sound growth-oriented economic policies, a prospering private sector, realistic price structures — particularly in the field of interest rates and exchange rates — and the absence of ubiquitous regulatory arbitrariness would certainly go a long way towards solving one of their most serious problems, namely the large outflows, both legal and illegal, of private capital.

Criticism of the Baker initiative was not therefore directed at its basic concept, but concerned rather its quantitative adequacy, its structure and its balance.

One criticism, voiced in particular by the debtor countries themselves, was that the new funds provided under the Baker Plan would amount to only a fraction of their interest service payments. The continuing drain on resources would therefore not permit the adoption of the kind of growth-oriented policies envisaged by the Plan, as many of these long-term policies would begin to bear fruit only with a considerable lag. Accordingly, the Baker strategy would only be likely to succeed if it were accompanied by a direct reduction of debt service burdens. A related argument was that a 2 per cent. reduction in interest rates would provide the debtor countries with the same amount of new funds as the Baker Plan, without giving rise to a further increase in their indebtedness. Such an interest rate reduction, it is true, has in the meantime been brought about by market forces, although, in the case of the oil-exporting countries, this has been more than offset by a further deterioration in their terms of trade. Reservations were, moreover, voiced by debtor countries concerning questions of national autonomy and the neglect of historical and political constraints, particularly as regards the forced shrinkage of the public sector and the encouragement of direct investment inflows.

Another set of criticisms, which came not only from debtor countries, referred to a perceived lack of balance in this new strategy. Whereas it demands far-reaching new commitments from both the potential borrowing countries and lending commercial banks, no corresponding undertaking is asked of the governments of the creditor countries. For example, it was pointed out that there is no mention of an expansion of official trade credits, financial guarantees or bilateral development aid. Nor is there a suggestion that the additional lending asked from the banks should receive encouragement from their national supervisory and fiscal authorities. Moreover, whereas for the debtor countries conditionality would include freer trade policies, no pledge is demanded from the industrial countries to keep their markets open to the exports of developing countries and to do away with export subsidies on products competing with developing countries' exports. Nor is there to be any commitment by the industrial countries to support the growth of debtor countries' exports through macro-economic policies and policy mixes that would reconcile high rates of economic growth with reasonably low interest rate levels.

Against this criticism it can be said that such policy intentions have been repeatedly expressed by the industrial countries, for example at the September 1985 Group of Five meeting in New York and in early May 1986 at the summit meeting of the major seven industrial countries in Tokyo, although admittedly these statements of intent can hardly be considered as a binding commitment. There can be little doubt that, without a policy of open doors and sustained economic growth in the industrial countries and without lower real interest rates, the Baker strategy would remain seriously incomplete.

So far no country has explicitly availed itself of the additional financing facilities potentially available under the Baker Plan — partly because, given the hardening attitudes among debtor countries, no country wanted to be the first — but negotiations with a number of countries are under way, while the World Bank has begun to make loan disbursements for structural projects of the type envisaged by the Baker initiative.

It may be added that, in line with the strategy outlined by the Baker initiative, a new Structural Adjustment Facility (SAF) has been established at the IMF, which will use the SDR 2.7 billion of funds becoming available during 1985–91 from repayment of Trust Fund loans for lending to low-income countries suffering from protracted external payments problems. In order not to crowd out the smaller countries, China and India have declared that they will not make use of this source of credit. Countries applying for assistance under this facility will have to present a medium-term economic and structural adjustment programme intended to overcome their balance-of-payments difficulties and to foster economic growth. This policy framework will be developed jointly with the staffs of the IMF and the World Bank.

VI. MONETARY POLICY: INTERMEDIATE TARGETS AND OPERATING PROCEDURES.

Highlights.

For some years monetary policies in the industrial countries gave priority to moderating inflation. In the larger countries these policies were based mainly on controlling the monetary aggregates. Last year, with the goal of price stability closer in sight, the aim of fostering a non-inflationary recovery received increased attention. With problems in interpreting the monetary aggregates becoming more severe, monetary policy in some countries became more "judgemental".

In the United States and the United Kingdom, where monetary developments were distorted by special influences, the authorities made adjustments in their monetary objectives and attached less importance to particular aggregates. The unexpected behaviour of the income velocity of key monetary aggregates, reflecting lower interest rates, financial innovation and continued disinflation, caused monetary policy in these and some other countries to be guided more by developments in the economy and in interest rates and exchange rates.

In Germany, Japan, Switzerland and France, on the other hand, the authorities were essentially successful in meeting their objectives for monetary expansion and saw no reason to make major changes in their monetary aggregate strategies. In many European countries monetary policy continues to be geared primarily to maintaining stable exchange rate relationships, particularly with countries with a good inflation performance.

At the same time, it has become increasingly clear that the effects on the economy of developments in exchange rates can be so great, even in the largest countries, that the authorities have to take them into account in formulating and implementing monetary policies. Partly for these reasons, central banks have had to find ways of giving more adaptable interest rate guidance to the financial markets and have adopted flexible procedures for influencing short-term interest rates.

In the long run, monetary policy influences mainly the overall rate of inflation. To lose sight of this relationship could jeopardise the hard-won gains in the fight against inflation. That danger is perhaps greatest when the immediate prospects for overall price developments are as favourable as they are at the moment as a result of a decline in energy prices and, in most countries other than the United States, appreciating exchange rates. Control over the monetary aggregates in the largest countries still seems to be the best safeguard against a revival of domestic inflation. Goals for nominal income or for interest rates alone clearly would not serve this purpose.

There are, however, many constraints on what monetary policy can achieve. In some countries, for various reasons, fiscal policy is no longer seen as a useful tool for managing aggregate demand in the economy. As a consequence there is a risk that too much reliance may be placed on monetary policy, particularly when aiming at short-term goals. Monetary policy is most useful when it is focused on the long run, on providing a stable monetary climate for economic growth.

Developments in money stock policies.

The monetary aggregates: objectives and developments. At the beginning of last year monetary policy in most of the larger industrial countries was still framed in terms of norms for monetary aggregates. Published norms for monetary expansion were lowered for 1985 in Germany and France against a background of declining rates of inflation. In line with the authorities' medium-term objectives, the targets were also lowered in the United Kingdom. In the United States the upper limit of the target range for the growth of M_1 was initially lowered, but the target range for M_2 remained unchanged and the upper margin of that for M_3 was raised slightly. The monitoring range for the increase in total domestic debt was also raised, following a steep rise in this aggregate in 1984.

In relation to the targets, monetary developments in the course of last year differed markedly from country to country. In Germany, Japan and Switzerland

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		
		1984[3]	1985[3]	1986[3]	1984	1985	1984	1985	1986
		in percentages[5]							
United States	M_1	4–8	3–8	3–8	5.4	13.2	9.1	6.5	11.3
	M_2	6–9	6–9	6–9	8.0	8.6	8.7	9.2	6.7
	M_3	6–9	6–9½	6–9	10.4	7.7	9.5	10.6	6.9
	TDND	8–11	9–12	8–11	14.3	13.9	12.2	14.4	14.7
Japan	M_2+CDs	8	8	8–9	7.9	9.0	7.9	7.9	9.0
Germany	CBM	4–6	3–5	3½–5½	4.6	4.5	5.4	4.9	5.1
France	M_2R	5½–6½	4–6	–	7.6	6.9	8.9	8.1	7.3[6]
	M_3	–	–	3–5	–	–	9.9	9.4	5.2
United Kingdom ...	M0	4–8	3–7	2–6	5.6	2.4[7]	5.8	5.4	3.9
	£M_3	6–10	5–9	11–15	12.3	15.2[7]	10.2	10.0	15.1
Italy	CPS	–	12	9[8]	17.6	11.5	15.5	16.1	9.1
	M_2	–	10	9	–	10.8	12.7	14.1	9.5
Switzerland	CBMA	3	3	2	2.5	2.2	1.1	2.4	1.4
Netherlands	DM_2	–	–	5½–6	–	–	6.5	5.7	9.6[6]

[1] TDND = total domestic debt of non-financial sectors; CBM = central bank money; M_2R = M_2 holdings of residents; M0 = wide monetary base; CPS = credit to non-state sector; CBMA = adjusted monetary base; DM_2 = M_2 creation from domestic banking sources. [2] For Japan, projection only. [3] Periods running from the fourth quarter to the fourth quarter for the United States (except for M_1 in 1985), Japan (1984–85), Germany and France (1986), and from December to December for Italy and the Netherlands. Periods based on November–January averages for France (1984–85) and, since 1985, changes over the last twelve months for the United Kingdom. Annual averages for Switzerland. For the United States the target shown for M_1 in 1985 is that established in July 1985 for a period running from the second quarter to the fourth quarter. (The target for 1985 published in January was 4 to 7 per cent.) In the United Kingdom the 1985 target for sterling M_3 was suspended in October. For Japan, for 1986 the second quarter to second quarter projection is shown. In France and Italy the definition of the aggregates was changed at the beginning of 1986. [4] Calculated on the same basis as the objective. [5] At annual rates. [6] 1985 fourth quarter. [7] Twelve months to December. [8] Before adjustment for unusual developments in late 1985.

Sources: National data and definitions.

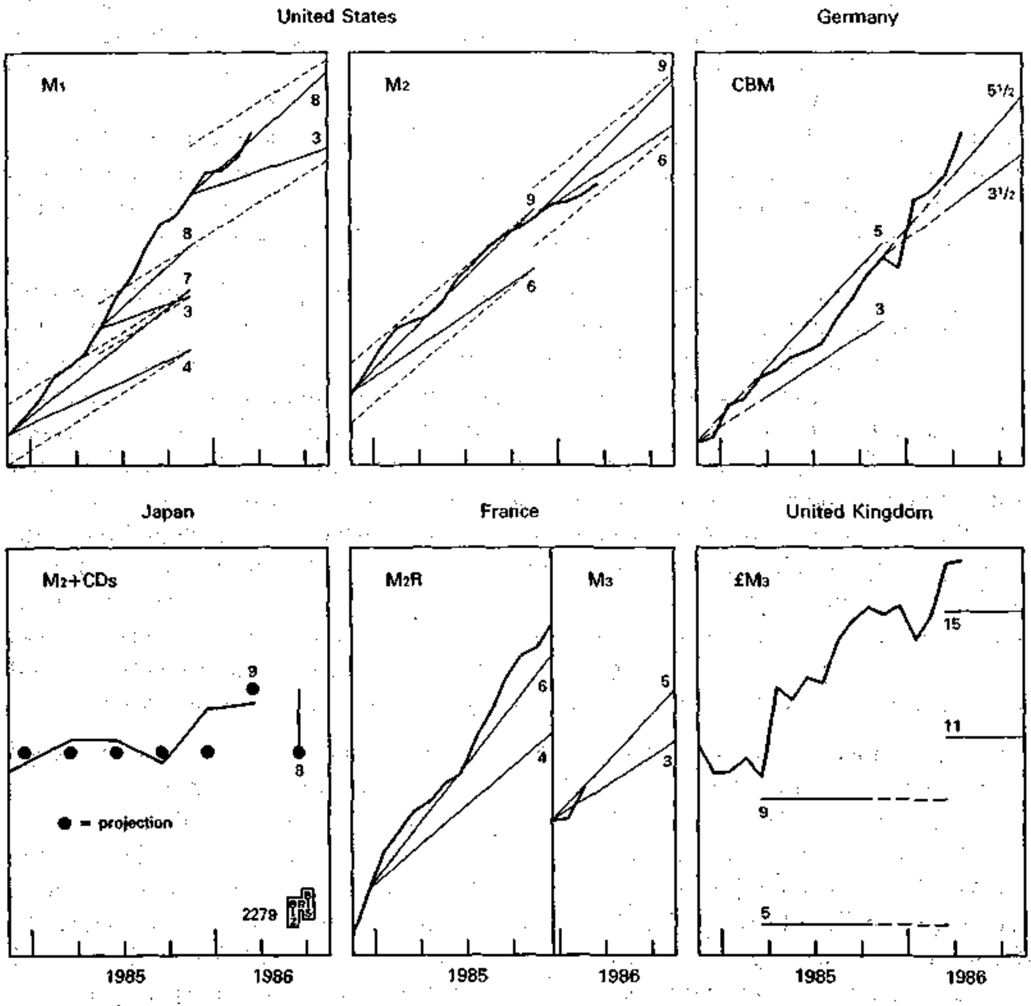
monetary expansion was closely in line with the official objectives or projections, though the authorities took advantage of elements of flexibility under the targeting arrangements. In Germany, under the influence of a decline in interest rates in the summer, the year's growth rate for central bank money (fourth quarter to fourth quarter) was in the upper half of the target range, as the Bundesbank intended. In Switzerland, where short-term interest rates also moved down, the annual average rate of increase in adjusted central bank money in 1985 was less than the published target for the year. In Japan the rate of growth of M_2 + CDs, measured over four quarters, moved above the Bank of Japan's projection at the end of 1985, partly because expectations of a rise in interest rates led enterprises to bring forward the taking-up of longer-term credits.

In the United States and the United Kingdom rates of expansion of the principal monetary aggregates last year far exceeded the original official targets. The M_1 measure of transactions balances, which has normally been regarded by the Federal Reserve as the most important monetary measure, rose at an annual rate of almost 11 per cent. between the fourth quarter of 1984 and the second quarter of 1985. In July, after weighing various factors, including an unexpected decline in income velocity, the impact of the rise in the dollar on the near-term outlook for inflation and the risk that the recovery might falter, the Federal Reserve decided to rebase and widen the target range for M_1. With the Federal Reserve clearly placing less emphasis on M_1 and more on the management of the Federal funds rate, M_1 continued to rise rapidly until late in the year, moving well beyond the upper limit of the new target range, although the year's increase in M_2 and M_3 was within the designated ranges. It may be noted that, boosted by large government borrowing and by special factors, including borrowing in conjunction with company mergers, the rise in total debt of domestic non-financial sectors again exceeded the upper limit of the monitoring range.

In the United Kingdom the growth of sterling M_3, hitherto viewed by the authorities as the principal broad monetary indicator, quickened in the spring of 1985 and, measured over twelve-month periods, subsequently remained well above the upper limit of the target range. Control of this aggregate, which reflects developments in the banks' main domestic assets and liabilities, had for some time depended less on interest rate policy than on "overfunding", i.e. on countering the impact on sterling M_3 of a fast rate of expansion of bank credit to the private sector by ensuring that net official sales of government debt to the non-bank private sector exceeded the Government's borrowing requirement. This practice had ceased by October, when the target for M_3 was suspended. The official objective for M0 (which consists chiefly of notes and coin) remained in place, and the authorities continued to use a broad liquidity aggregate, for which no norm had been published, as a policy guide. The intention, however, was to base monetary policy more on other financial and economic indicators, particularly the exchange rate.

In France and Italy developments in the monetary aggregates have to be seen in the context of the use made of administrative controls and of the importance attached to stabilising exchange rates within the EMS, which to some extent pre-empts interest rate policy. In France, where M_2R expanded rapidly in late 1984, its

Monetary aggregates: Objectives and development, 1985–86.*



* For the United States, Germany and France, levels (semi-logarithmic scale); for Japan and the United Kingdom, percentage changes over four quarters and twelve months respectively, based on end-month figures. Aggregates and objectives as defined in the table on page 117.

rise slowed down last year under the influence of a reduction in July of the official norm for credit granted by the banking system on the basis of monetary resources. In addition, exchange controls were tightened with a view to checking inflows of funds from abroad. Reserve requirements against deposits were raised in several stages, in late 1985 and early 1986, partly with a view to moderating the impact on the cost of bank credit of declines in money market interest rates. In Italy the growth of M_2 slowed down sharply at the end of last year in the context of outflows of funds associated with currency speculation, while bank lending in lire expanded at an adjusted annual rate of about 40 per cent. in November and December. In January 1986 exchange controls were temporarily tightened, short-term interest rates were raised, and a ceiling on bank credit was reimposed for the first half of this year.

Countries' revised objectives for monetary expansion published at the end of 1985 or in early 1986 partly reflected their experience in 1985. In Germany the objective for the growth of central bank money was raised slightly in the light of an expected quickening in the growth of the economy's productive potential. In Japan the growth of M_2 + CDs was expected to continue at the slightly faster rate recorded in late 1985, one influence being the decline in bond yields in relation to controlled interest rates on deposits. In Switzerland the new target for the growth of central bank money was set at 2 per cent., the rate that the National Bank considers to be consistent with avoiding inflation in the medium term.

In the United States the mid-point of the tentative range for M_1 growth in 1986 announced in July 1985 was confirmed. This was in line with a view that the unusually marked slowdown in the velocity of M_1 in 1985 was unlikely to continue. As this was uncertain, however, the range was widened slightly and movements in M_1 were to be interpreted more in the light of developments in the other aggregates. The norms for M_2 and M_3 remained largely unchanged, but in the case of M_2 and total domestic debt previous developments implied that growth in 1986 would be calculated from a relatively high base. In the United Kingdom the revised medium-term strategy announced in March 1986 included a lower target range for M0 and a higher and wider range of 11 to 15 per cent. for sterling M_3, set in the light of the rapid fall in the income velocity of this aggregate observed in recent years. It was stated that policy would be directed at maintaining monetary conditions that would bring about a gradual decline in money GDP growth over the medium term.

In France regulatory changes, such as the authorisation of new financial instruments, are beginning to quicken the pace of financial innovation. As a consequence, the monetary target for 1986 applies to a newly defined aggregate M_3 which includes, in particular, the liabilities of savings banks as well as those of the banks. Two conceptually new aggregates, M_2 (a measure of transactions balances) and L (broad liquidity) will be monitored and could be targeted in future years. In Italy the monetary aggregates have also been redefined; a new M_2A includes M_1 and savings deposits but excludes certificates of deposit, which form part of M_2. M_2 continues to be regarded as the main money stock measure, but the principal intermediate objective of monetary policy is credit to the non-state sector.

In the Netherlands an exchange rate commitment continues to underpin domestic monetary stability. However, over the last few years the authorities have become concerned that the rate of monetary expansion, which has exceeded the growth of nominal income, could eventually threaten domestic price stability. In February 1986 the banks were asked to observe a growth guideline of 5½ to 6 per cent. for lending to the private sector and long-term lending to the public sector, net of the growth of banks' long-term resources. In combination with an undertaking by the Government to refrain from recourse to monetary financing, the lending guideline is designed to bring down the domestic contribution to money creation to a figure in line with the trend growth of nominal GNP.

Official targets for broad monetary or credit aggregates continued to be used last year in Spain and Greece. In both countries strong expansion of credit to the public sector — by far the largest component of domestic credit expansion — called for measures to restrain bank liquidity and the growth of credit to the private sector. In both cases the authorities' 1986 growth targets for the principal intermediate objective — 9.5 to 12.5 per cent. for ALP (broad liquidity) in Spain and 15 per cent. for credit to the private sector in Greece — are substantially lower than the targets and actual outcomes for 1985.

Difficulties encountered in targeting the aggregates. Problems in interpreting and controlling monetary aggregates have been experienced at times in most countries that have employed targeting strategies. However, the authorities have been more fortunate in finding reliable monetary measures in some countries than in others.

Various considerations have entered into the choice of target aggregates, which differ considerably in concept from country to country. One major consideration is that there should be a fairly stable relationship between the aggregate and nominal income, i.e. that the income velocity of the aggregate should be reasonably stable, or at least predictable. In view of the variable lags which may be involved in this relationship it is sometimes difficult to discern the causes of changes in velocity and to establish clearly what they portend.

The breakdown in recent years of the previously stable trend relationship between M_1 and nominal GNP in the United States has been extensively discussed. All the US aggregates have been influenced at times by financial innovation, but it would appear that last year's fall in the velocity of M_1, which was on a scale comparable with the previous large decline in 1982, can be attributed in part to the simultaneous and lagged effects of the decline in interest rates in late 1984 and early 1985. In particular, a pronounced narrowing of the differential between the interest rates on the time deposit element of M_2 and the more rigid interest rates on liquid NOW accounts seems to have led to a large rise in the interest-bearing component of M_1. A strong rise last year in the non-interest-bearing demand deposit component of M_1, however, is puzzling, considering that highly liquid interest-bearing instruments were available. While this may have reflected precautionary demand sentiment, there is no certainty as to whether the trend rise will continue or be reversed.

To the extent that unusually large rises in M_1 reflected an increase in the demand for money associated with lasting declines in interest and inflation rates, they could safely be accommodated by raising the targets. Moreover, some interest sensitivity of an aggregate normally helps to make it amenable to control from the demand side via central bank influence over money market interest rates. If this sensitivity becomes very high, however, it may be difficult to gauge that influence with sufficient precision. In any case, earlier concern that deregulation of interest rates would reduce the interest elasticity of M_1 in the United States to such an extent as to make a control mechanism of this type unusable has proved to be unfounded. In fact, the problems now seem to lie rather in the opposite direction; the response of this aggregate to changes in interest rates has evidently become greater than anticipated.

In many other countries more attention has usually been paid to developments in broader banking-system aggregates, which are typically less interest-elastic but

Changes in money stock measures, GNP and income velocity.*

Countries	Aggregates	1985			1976–85			
		Money stock	GNP/GDP	Velocity	Average money stock	Average GNP/GDP	Average velocity	Minimum velocity
		in percentages						
United States	M_1	11.9	5.4	– 5.9	8.1	9.2	1.0	– 5.9
	M_2	8.6		– 3.0	9.3		– 0.0	– 5.5
	M_3	7.7		– 2.1	10.5		– 1.2	– 6.2
Japan	M_2+CDs	8.7	6.2	– 2.3	9.2	7.3	– 1.7	– 4.4
Germany	CBM	4.5	4.9	0.4	6.1	5.6	– 0.5	– 3.8
	M_3	5.6		– 0.7	6.8		– 1.2	– 4.7
France	M_2R	7.3	8.3	0.9	10.7	11.6	0.9	– 1.8
United Kingdom	M0	3.1	9.9	6.6	7.2	11.5	4.0	– 1.0
	£M_3	15.0		– 4.4	13.7		– 1.8	–10.6
Italy	M_2	12.5	12.3	– 0.2	15.6	17.0	1.2	– 4.7

* Based on changes over four quarters ending in the fourth quarter of each calendar year. Aggregates as defined in the table on page 117.

Sources: National data and definitions.

more amenable to control through administrative influence over the foreign and domestic credit counterparts in the balance sheet of the banking system. In some cases the relationship of these aggregates to GNP has been distorted in recent years by the growth of liquid placements with non-bank financial institutions. In France, for instance, structural financial change has at times exerted an upward influence on the velocity of M_2R. Counteracting forces operating last year, however, included declines in market interest rates and the inflation rate, accompanied by rapid growth of a tax-privileged contractual savings component of M_2R, constituted under plans involving the purchase of a dwelling. In the United Kingdom intensified competition between the banks and building societies contributed to the sharp fall in the velocity of sterling M_3 recorded last year. In particular, a measure in the April 1985 Budget designed to equalise the tax treatment of bank and building society deposits prevented the banks from paying interest on a gross basis. As the banks' competitive response was to offer market-related interest rates on chequing deposits, these deposits expanded at the expense of savings deposits, which are not included in sterling M_3. Another tax change provided building societies with incentives to hold their liquidity with the banking system instead of in instruments issued by the public sector. Even so, the velocity of a broader aggregate, PSL_2, which includes the liabilities of the building societies, also underwent a substantial decline last year. At the same time the velocity of M0 rose, possibly as a result of a decrease in the demand for notes and coin caused by high interest rates.

In Germany and Japan the velocity of the key aggregates has been fairly predictable over the years. Last year's fall in the velocity of M_2 + CDs in Japan may be partly attributable to reintermediation stimulated by progressive liberalisation of interest rates on bank deposits, although there is a significant trend decline in the velocity of this aggregate. In Germany the income velocity of central bank money changed little last year. It should be noted, however, that the Bundesbank's targets are based not on expected year-to-year changes in actual GNP but on the expected rise in productive potential at current prices.

Distortions in the development of banking aggregates stemming from financial innovation have led the authorities in some countries to look more to broader liquidity aggregates as monetary indicators. In some cases, however, such aggregates are not amenable to close control with the instruments available to the central bank. This is true, for instance, of M_2 and M_3 in the United States, since large components of these aggregates bear market rates of interest. It is not the case in Germany, however, where M_3 liabilities, which are reflected in central bank money through reserve requirements, embrace virtually all domestic short-term deposits. The fact that M_3 responds in a stable manner to changes in differentials between bond yields and the less flexible interest rates on deposits helps to explain the continued effectiveness of monetary targeting in Germany.

Moves towards flexibility in monetary targeting. Last year the conduct of monetary policy in the industrial countries seems to have entered a new phase. Following the worldwide upsurge of inflation in 1979, when all major industrial countries adopted medium-term stabilisation policies designed gradually to establish conditions conducive to a non-inflationary recovery of output, published targets for monetary expansion formed their centre-piece. Monetary authorities still view the control of inflation as a primary objective and those of the five largest industrial countries still consider monetary targets useful for this purpose. All of them wish to take advantage of the scope available for fostering economic recovery. Yet by last year differences could be seen in their willingness to take a long-term view and in their assessment of the need for flexibility in setting and pursuing money stock objectives.

In Germany, Japan and Switzerland experience still seemed to indicate that moderate and stable rates of monetary expansion are likely to foster non-inflationary growth in the medium term. The United States and the United Kingdom, on the other hand, moved further away from strict monetary targeting. In the United States, with a continuing relatively low and stable rate of inflation, a central policy question was whether and to what extent the target for M_1 should be exceeded in order to prolong the economic recovery, which was still showing signs of weakness, particularly in export and import-competing industries. In the United Kingdom the question was rather one of how far exchange rate objectives could serve as a satisfactory substitute for attempts to control the monetary aggregates in underpinning an anti-inflationary strategy.

It is not appropriate, however, to speak of the end of monetary targeting in any of these countries, though in some monetary policy has undoubtedly become more judgemental and eclectic. In the United States objectives for the monetary aggregates have been retained, although M_1 is now given less weight. In the United Kingdom the target for M0 was kept in place, despite doubts about the reliability of this aggregate as a monetary indicator, and in the 1986 Budget an objective for broad money (sterling M_3) was reinstated. Objectives for the monetary aggregates were suspended on earlier occasions in other countries. It may be recalled that in Switzerland the M_1 target was abolished in 1978, in a context of large-scale official exchange market intervention following a 35 per cent. rise in the real exchange rate of the Swiss franc in a twelve-month period. It is now recognised, however, that the failure quickly to unwind excessive monetary expansion accommodated inflation, even though a target for adjusted central bank money was introduced in 1980. In Canada the target for M_1 was suspended in 1982 and since then monetary policy has been guided mainly by developments in the exchange rate, but the search for an appropriate monetary aggregate continues.

Taking exchange rates into account in aggregate-oriented strategies. The breakdown of the post-war system of fixed exchange rates gave individual national authorities a better chance to control their own money stocks and inflation rates and was a major reason for the adoption of monetary targeting in many countries. It was anticipated that monetary policies directed at restoring domestic price stability in individual countries would also establish preconditions for satisfactory developments in exchange rates. However, subsequent experience disappointed expectations that, in the medium term, exchange rate movements would primarily reflect inflation differentials. In the event, floating exchange rates were found not to insulate countries from external disturbances as much as their earlier advocates had suggested. When monetary restraint in the United States between late 1979 and mid-1982 was associated with high and volatile interest rates, other countries had to opt either for large movements in domestic interest rates or for wide swings in the dollar exchange rates of their currencies. Subsequently they had to weigh the disadvantages of accepting higher real interest rates than would have been brought about by domestic influences alone against the potential costs of large real depreciations of their currencies in terms of the dollar. Although inflation differentials between countries had been reduced, conditions did not exist outside the United States which would have permitted countries to use monetary policy for stabilising exchange rates.

Exchange rate overshooting came increasingly to be recognised as a constraint on countries' ability to pursue independent monetary objectives. Complex questions about the appropriate response of monetary policy have been raised by situations in which exchange rates seemed to be responding mainly to non-monetary disturbances, such as changes in energy prices, or to current and anticipated government budget balances. To a greater extent than had previously been recognised, market expectations of future developments in policy and in the economy have had substantial effects on exchange rate behaviour.

By last year the contractionary domestic impact on the US economy of the large appreciation of the US dollar had become very conspicuous and was contributing to protectionist pressures. In the new international consensus that a correction of exchange rate misalignment was needed, official exchange market intervention was seen as the main instrument which could help to rectify the situation. The Group of Five communiqué published in September 1985 (see Chapter VII) seemed to imply that most of the largest countries would continue to follow a steady course in monetary policy consistent with fundamental economic requirements, although it was mentioned that monetary policy in Japan was to be managed flexibly, with due attention to the exchange rate.

Experience in the last few years has shown that the relationship between the growth of the money stock and changes in exchange rates is not direct or well understood. It would be difficult for national authorities to take exchange rates into account in a precise way in setting money stock objectives, though exchange rates can be useful as "information variables" in judging the combined influence of monetary and fiscal policies in major countries.

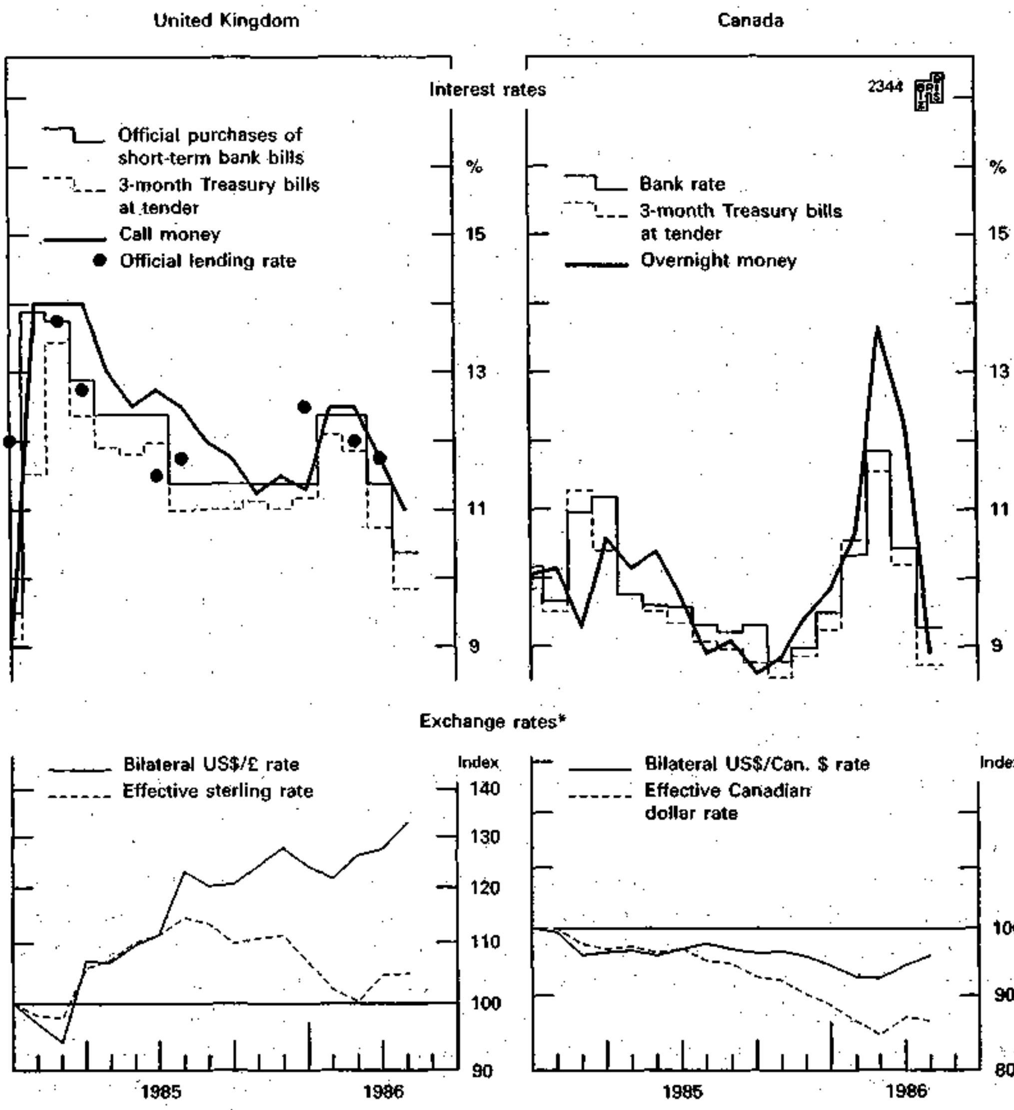
In the United States the Federal Reserve had for some time been taking into account the impact of the appreciation of the dollar both on the domestic inflation rate and on economic activity, though it certainly had no objective for the exchange rate. That the short-run effects of dollar appreciation could be viewed as similar, in some respects, to those of monetary restraint apparently influenced the decision to permit money market interest rates to decline in early 1985 and to accept a strong rise in M_1. The Plaza Agreement was evidently interpreted in the market as an indication that a tightening of monetary policy in the United States was not in prospect. Once the dollar began to weaken, however, US policy seems to have been influenced by the possibility that in time excessively rapid depreciation, while stimulating output, could push up the US inflation rate. In addition, a weakening of foreign demand for dollar investments could put upward pressures on interest rates in the United States, given the need to finance the large Federal Government budget deficit. By late 1985 interest rate policy in the United States appeared to be geared largely to preventing a precipitous decline in the dollar. While bond yields, which principally reflect market sentiment, fell sharply in late 1985 and early 1986, the Federal Reserve discount rate remained unchanged between May 1985 and the spring of 1986, when it was lowered first from 7½ to 7 per cent. in March, then to 6½ per cent. in April.

In Japan rises in interest rates geared directly to an appreciation of the yen clearly came into conflict with the desire to bring about an increase in domestic demand. Following the Plaza Agreement the Bank of Japan encouraged a rise in money market rates, which disappointed expectations of an early cut in the discount rate and was reflected also in government bond yields. By December, however, bond yields were back to their October level and, with the rise of the yen more firmly established, the Bank of Japan's discount rate was brought down from 5 to 3½ per cent. in three stages, in January, March and April 1986. In Germany, where there was less conflict between objectives for domestic and external balance, bond yields rose in October and November, though rates on the Bundesbank's own operations at the short end of the market showed little change. In March 1986 the Bundesbank led the way in a first round of discount rate cuts in major countries.

In France and Italy interest rate policy was linked to exchange market developments, but the behaviour of their currencies only partly reflected changes in the strength of the dollar. In France declines in interest rates abroad, together with an improvement in the external current account and in domestic price performance, made it easier for the authorities to implement their policy of gradually bringing interest rates down. In Italy, where external influences included inflows of funds following the downward adjustment of the central rate of the lira within the EMS in July, the underlying budgetary and external current-account imbalances left little room for manoeuvre in monetary policy.

In the United Kingdom and Canada the authorities relied more on exchange rates as policy guides last year because of difficulties experienced in interpreting

Money market interest rates and exchange rates, 1985–86.



* End-December 1984 = 100 (semi-logarithmic scale).

developments in the monetary aggregates. In early 1985 interest rate policy in the United Kingdom was geared mainly to defending the currency. By the end of the year, however, a fall in the trade-weighted exchange rate of sterling seemed to be justified by developments in world energy markets. In late 1985 and early 1986 the Canadian dollar was also subjected to strong downward pressures, which were influenced by developments in the Government's budget and which proved quite difficult to resist, even with forceful intervention in the exchange markets. The appropriate monetary policy response in situations of this kind is difficult to judge, however, and in each of these countries the absence of an explicit anchor for exchange rate expectations has at times appeared to be a disadvantage. In both the

United Kingdom and Canada short-term interest rates had to be raised. They subsequently declined, but in the spring of 1986 they still stood at levels which seemed quite high in relation both to these countries' rates of inflation and to short-term interest rates in Germany and the United States.

Alternative strategies for monetary policy.

Monetary policies with an explicit exchange rate orientation have formed the basis of counter-inflationary strategies followed in recent years by a group of European countries which includes, but extends beyond, those with exchange rate commitments within the European Monetary System. By adapting their short-term interest rates to defending regional exchange rate relationships which in most cases remained unchanged between March 1983 and April 1986, the Netherlands continued last year to enjoy a degree of monetary and price stability comparable with that in Germany, while France, Italy, Belgium, Denmark and Ireland exerted further downward pressure on relatively high domestic inflation rates.

In employing the flexible adjustment of money market interest rates as the principal means of influencing exchange rates, many continental European countries could be reasonably sure that monetary policy remained consistent with their exchange rate commitments, while the latter clearly contributed to controlling costs and to moderating inflation expectations. Such exchange rate commitments, however, beg the question as to whether monetary targets in individual countries are necessary. In principle, what is required in a system of administratively linked but adjustable exchange rates is that one large country should have a monetary target and a stable money demand relationship for the targeted aggregate. In addition, the other countries, whose currencies are linked to that of the central country, should have broadly consistent and attainable goals with respect to inflation and output. In some cases, however, norms for monetary developments may be necessary to ensure that monetary policies remain on an appropriate medium-term course. With the interest rate assigned to the exchange market objective, efforts to meet these norms would have to rely on other instruments, such as credit or exchange controls, which have often been used in EMS countries to permit both exchange rate and monetary objectives to be pursued. This is not the case in Germany, where the impact on monetary developments of capital flows associated with efforts to stabilise exchange rate relationships has usually been on a manageable scale. The relatively smooth adjustment of short-term interest rates by the authorities in Germany to cope with underlying changes in inflationary pressures has provided a fairly stable standard to which other countries could refer in determining their own money market rates. The high degree of monetary stability in Germany has therefore contributed to monetary stability in other EMS member countries.

Last year short-term interest rate policies in many European countries again had to respond to exchange market developments which reflected both domestic and foreign influences, as well as to declines in inflation rates. In France, Italy and the Netherlands money market interest rates were brought down between January and November broadly in step with short-term interest rates in Germany. In Belgium, where rates were lowered substantially in the spring of 1985, they had to be raised for a time in the summer. In Denmark and Ireland, having stood at relatively high levels in early 1985, short-term rates thereafter fell quite steeply during most of last year. Bond yields, which in some countries are subject to administrative influence, came down in most countries, with a relatively fast decline evident in Belgium, as well as in Ireland and Denmark, where inflation performance improved very markedly.

Short and long-term interest rates and changes in consumer prices:[1] Differentials vis-à-vis Germany.

Items	1979–83[2]	1984 Q1	1985 Q1	1985 Q3	1986 Q1	1979–83[2]	1984 Q1	1985 Q1	1985 Q3	1986 Q1
	in percentage points									
	France					Belgium				
Short rate	4.1	6.6	4.3	4.7	3.6	4.5	6.5	4.1	4.5	5.1
Long rate	5.6	6.1	4.7	5.7	3.4	3.6	4.3	3.9	4.1	2.5
Inflation	7.0	5.5	3.9	3.1	2.8	2.2	4.2	3.2	2.4	1.4
	Italy					Netherlands				
Short rate	8.7	11.5	9.4	9.7	12.7	0.4	0.3	0.8	1.1	0.8
Long rate	8.8	7.3	5.2	6.8	6.7	1.1	0.2	0.4	0.6	0.6
Inflation	12.6	8.8	6.1	6.1	7.2	0.3	0.9	− 0.1	0.1	0.6
	Denmark					Ireland				
Short rate	7.0	4.3	5.5	4.7	4.6	7.4	7.1	7.5	5.3	11.5
Long rate	9.4	6.1	5.4	4.8	3.6	7.1	6.2	6.0	5.6	3.5
Inflation	5.3	3.9	3.2	1.7	1.5	11.0	7.2	3.9	3.2	3.8
	United Kingdom					Sweden				
Short rate	4.7	3.1	6.9	6.8	6.6	3.3	4.1	7.1	10.3	6.6
Long rate	4.3	2.3	3.1	4.0	3.0	3.5	3.7	5.6	7.1	5.6
Inflation	6.4	2.2	3.5	3.7	4.4	5.2	5.9	5.4	4.5	4.3

[1] Short-term rates are representative rates on interbank instruments; for Italy, demand deposits; for Ireland and Sweden, day-to-day loans; for other countries, three-month instruments. Long-term rates are representative rates: for Germany, France and Italy, public sector bonds; for other countries, government bonds. Inflation rates are percentage changes in consumer prices over twelve months (for Ireland, over four quarters). [2] Averages of monthly data.

Sources: National data and definitions.

Nominal interest rates in most European countries remain higher than those in Germany, but in most cases inflation rates are also still higher. When making interest rate comparisons market participants no doubt take into account the possibility of exchange rate adjustments in the longer run. The timing of currency realignments within the EMS is, however, known to depend on political considerations. In the long period between the March 1983 and April 1986 adjustments of EMS currency values the ability of some countries to bring down relatively high rates of inflation and to improve their external balances had been clearly demonstrated. Capital flows towards countries where interest rates were relatively high in nominal terms characterised much of the period up to November 1985, to such an extent that recipient countries at times felt that an excessive easing of domestic monetary conditions was taking place. In France and Italy exchange controls were tightened in the summer of 1985 with a view to discouraging inflows of funds. In Denmark, on the other hand, the system of credit ceilings was replaced by a scheme for regulating the growth of deposits, following an earlier easing of exchange controls.

The exchange market situation changed in late 1985 and early 1986 when, in response to a weakening of their currencies against the Deutsche Mark, short-term interest rates had to be increased in Italy, Belgium and Ireland. Euro-French franc rates at some maturities also rose, but domestic rates in France could be kept on a downward path. In part because the Deutsche Mark is a major international investment currency, a strengthening of the Mark against the dollar is often associated with a weakening of other European currencies against the Mark. Even so, rises in short-term interest rates in many European countries around the turn of the year seem also to have reflected a recognition by the market that a currency realignment within the EMS was needed to take account of past inflation differentials. After the April realignment money market interest rates in the countries concerned could be brought down.

Exchange rate based approaches to monetary policy are likely to be most appropriate in relatively small open economies. In some European countries quick responses of wages to exchange rate declines also highlighted the usefulness of exchange rate stability. In a core group of countries with a relatively strong political commitment to liberalising intra-regional trade and capital movements, efforts to stabilise the exchange rates of their currencies have continued ever since the early 1970s. Perhaps more important, consistency in monetary policies among EMS countries has been facilitated in recent years by the shared conviction that countering inflation was a precondition for satisfactory economic performance generally.

Co-ordination of monetary policies in the EMS may have been easier to the extent that the large external shocks experienced by European industrial countries in the last decade, including changes in energy prices, affected many of them in similar ways. Efforts to reduce government budget imbalances and to make wage-setting procedures more flexible were not equally successful in all cases, however. While adjustments in monetary policy helped to prevent short-term volatility and medium-term swings in exchange rates, a trend depreciation of some currencies could not be avoided. That countries with relatively high inflation rates did not, over a period of years, seek corresponding exchange rate realignments implied, in effect, that in accepting the resulting real exchange rate pressures they gave priority to controlling inflation.

In Sweden an exchange rate target expressed in terms of an annually adjusted currency index, in which ECU currencies have a large weight, also helps to underpin monetary policy. In July 1985 the intervention margins were narrowed and published for the first time. However, exchange controls are still in place and, as in a number of other European countries, policies with respect to government borrowing abroad also have an influence on domestic monetary conditions. The success of adjustment efforts permitted short-term interest rates to be brought down last year from the very high levels which they had reached.

Objectives for nominal GNP and interest rates in monetary policy. The need for monetary policy in some countries to evaluate the significance of unusual and unexpected changes in income velocity has kept alive the general question of whether objectives for nominal GNP or interest rates could serve as satisfactory alternatives to targets for the monetary aggregates.

The case for nominal income targeting usually begins with the proposition that, while the rates of output growth and inflation are the ultimate concerns of policy, monetary policy can influence only nominal income in the medium term. Targets for nominal GNP would thus highlight the dependence of the "split" between real output and prices on the private sector's price and wage-setting behaviour. In fact, the short-run relationships between money, prices and output are uncertain and depend as well on fiscal policy and interest rate developments. In normal circumstances, however, it can be expected that, though monetary expansion may influence real output in the short run, it will be reflected primarily in inflation in the longer run. Where the long-run relationship between monetary expansion and inflation has become uncertain, an illustrative path for nominal income growth in future years, like the one published by the UK authorities in March 1986 in the Medium-Term Financial Strategy, may serve to underline the need to bring downward pressure to bear on the inflation rate over a period of time. However, none of the monetary authorities in the industrial countries have felt that short-run objectives for nominal income would be suitable as a replacement for monetary targets.

In general, monetary authorities do not regard developments in the money stock as indicative merely of changes in nominal income. What seems feasible in the short term with respect to output growth and inflation is normally taken into account in setting annual monetary targets. Thus, where velocity is correctly forecast, meeting the monetary target can be expected to imply satisfactory progress towards longer-term objectives for the economy. Some monetary authorities have had to adapt their monetary objectives to allow for financial innovation. Some have also sought to take into account unexpected movements in components of the money stock, as well as the influence on output and prices of exchange rate overshooting. In the United States such influences were taken into account in the evaluation of monetary expansion last year, but this does not imply that monetary policy was geared to a target for nominal income.

Monetary authorities feel that the task of trying to meet targets for nominal income would place too great a burden on them. In many cases monetary policy would not be capable of meeting targets for nominal spending without appropriate support from fiscal policy. While the long-run impact of deficit spending on output may be weak, output growth in many countries is sensitive to government spending and tax policy in the short run. These influences would need to be considered in setting objectives for nominal income. Especially in the short run, developments in output and prices are also influenced by many other factors, such as commodity supply shocks. There is also a political aspect to establishing nominal income targets. Targets for GNP are in most countries primarily the responsibility of the Government. For monetary authorities to assume responsibility for trying to meet objectives for nominal GNP could imply a dangerous focus on short-term developments in real output. It could place at risk the progress made in recent years in widening the time horizon of monetary policy, which has gone a long way towards bringing inflation under control.

The use of nominal or real interest rates as longer-term policy guides would involve similar risks. The recognition that previous reluctance to increase interest rates sufficiently to control excessive monetary growth had permitted a build-up of inflation was a major reason for focusing monetary policy on the achievement of targets for monetary aggregates. Norms for short-term interest rates are used in day-to-day monetary policy in most countries, but they serve only as operating guides and have to be adjusted in the light of developments in the money stock or in exchange rates.

Changes in monetary policy instruments and operating procedures.

New instruments and procedures. In seeking to meet their objectives for the monetary aggregates and exchange rates, the monetary authorities in many countries have in recent years relied increasingly on money market operations and less on exchange controls or credit ceilings.

Since the late 1970s administrative controls restraining bank lending have been abolished in the United Kingdom, Sweden, the Netherlands, Denmark, Ireland and Austria, and few industrial countries now make use of this instrument. In France the credit-granting regulations are no longer restrictive and now serve more as a safety net than as the principal means of meeting the monetary objectives. For 1986 the credit control arrangements were extended to cover savings banks. However, the coefficients used in calculating the reserves that have to be constituted by individual banks in respect of credit granted in excess of the official norm for the banking system were made less steeply progressive. The authorities have indicated that after a period of transition the credit restrictions may give way next year to a mainly interest rate oriented approach to controlling monetary and credit expansion. In Japan "window guidance" has evolved in recent years from a rigid control device into an expression of the central bank's views on the short-term prospects for credit expansion. By lowering the projections for credit-granting in the second quarter of 1986, however, the Bank of Japan indicated its concern about a fast rate of growth of liquid assets in the economy and sharp rises in the prices of shares and land for commercial use. In Sweden, as part of a continuing process of liberalising the financial markets, controls on interest rates on bank lending in domestic currency were removed in early 1985 and credit ceilings for banks, mortgage institutions and finance companies were abolished in November. In Denmark credit ceilings were replaced in June 1985 by arrangements for the banks to make special deposits at the National Bank when the growth of their deposit liabilities exceeds an agreed norm for the system. The National Bank can lower the interest rate payable on the special deposits so as to discourage rapid monetary expansion. In Italy the ceilings on bank lending introduced in January 1986 were intended as a temporary expedient to help check outflows of funds. In the Netherlands the guideline for liquidity creation from domestic sources, issued in February 1986, was designed mainly to restrain the trend rise in the ratio of M_2 to nominal income. As credit financed by long-term resources is exempted from the credit guideline, a shift to long-term borrowing by the banks could tend to steepen the term structure of interest rates, but the overall effectiveness of the guideline will depend on the extent to which cross-border flows of funds respond to interest rate differentials.

Most official money market operations change the balance-sheet position of the central bank in ways which have an impact on the supply of bank reserves and, given the demand for reserves, on money market interest rates. The instruments and procedures that central banks use in controlling money market conditions depend on institutional and legal circumstances, which vary from country to country. Over the years, however, operating techniques have changed in ways which display a common trend. In particular, measures have been taken in many countries to discourage recourse by banks to traditional central bank discount or secured lending facilities with fixed interest rates. At the same time, central banks have made more use of open market operations in supplying bank reserves. Minimum reserve requirements for banks, normally with provisions which permit averaging of reserve holdings over a certain period, have been retained in most industrial countries to help stabilise the demand for reserves and smooth developments in money market rates. These interest rates now play a central role as operating variables in almost all the industrial countries.

Formerly, in many countries other than the United States, the banking system used central bank credit as the main means of adjusting its reserve position. Depending on whether access to discount and secured credit was restricted, the posted official interest rates generally served either as a centre of gravity for short-term money market rates or as a lower or upper limit. More flexibility can be introduced into central bank operations by raising the charge for central bank credit in relation to market interest rates and by using market instruments for adjusting bank reserve positions. As a result of changes of this kind, central bank discount rates have normally stood above money market interest rates since 1982 in Switzerland, since late 1984 in Italy and Belgium, and for many years in Canada. In Germany the Deutsche Bundesbank's lombard lending rate has stood above money market rates since January 1985. In Belgium (since May 1985) and Canada (since 1981) the desired relationship between official and market rates has been achieved by procedures for setting the discount rate each week in relation to the Treasury bill tender rate. In Sweden, since December 1985, the central bank's penalty lending charges are no longer linked to the discount rate and have been scaled in a way which permits the cost of central bank credit at the margin — and hence day-to-day money market rates — to be varied simply through a change in the supply of reserves.

In Japan the official discount rate remains below the call-money rate but discretion is used by the Bank of Japan in granting and recalling loans, and open market operations have recently been employed to influence money market rates in a very flexible way. In the United States, where access to Federal Reserve credit is restricted, the discount rate normally remains below the Federal funds rate. The resulting relationship between these rates and bank borrowing at the Federal Reserve can be utilised to help limit interest rate volatility under the borrowed reserves targeting procedure, in use since late 1982. In the United Kingdom, where no official lending accommodation had been provided since 1982, the Bank of England had recourse to lending operations on a number of occasions in 1985 in order to make the authorities' views with respect to money market interest rates effective quickly.

Official operations influencing money market conditions.[1]

Items and periods	Japan	Germany	France	Italy	Belgium	Nether-lands	Switzer-land
	changes as percentages of central bank money stock at end of previous quarter[2]						
Central bank net foreign assets[3]							
1985 first quarter	− 0.5	− 7.9	8.4	− 4.2	2.0	− 4.9	8.0
second quarter	0.1	3.2	7.5	2.7	2.9	0.1	4.2
third quarter	− 1.1	4.1	7.1	− 2.7	− 8.2	11.1	2.5
fourth quarter	− 1.7	0.3	3.2	− 7.9	1.5	1.6	− 1.1
1986 first quarter	0.3	3.6	.	− 1.2	.	.	− 7.8
Government finance[4]							
1985 first quarter	− 0.7	0.3	7.6	10.3	− 8.9	− 2.3	−
second quarter	4.7	− 2.8	− 5.0	− 0.7	1.3	1.1	−
third quarter	−21.6	− 3.0	2.0	1.1	4.6	−10.8	−
fourth quarter	4.3	2.7	− 8.0	9.3	− 1.5	6.4	−
1986 first quarter	− 2.7	− 0.6	.	6.2	− 3.1	.	−
Central bank market operations[5]							
1985 first quarter	− 5.5	6.9	−12.3	− 1.1	−	14.0	− 7.7
second quarter	− 1.4	0.9	− 4.4	0.4	−	0.9	0.8
third quarter	9.6	0.8	0.8	2.0	−	− 2.8	− 2.0
fourth quarter	10.6	2.5	2.7	2.9	−	2.7	12.1
1986 first quarter	− 5.0	− 2.6	.	3.2	−	.	− 7.5
Central bank loans to banks[6]							
1985 first quarter	− 6.1	− 1.1	− 1.2	0.0	0.1	−11.4	− 1.0
second quarter	− 0.8	− 2.1	− 1.4	− 0.3	1.0	2.1	0.1
third quarter	5.3	− 0.1	− 2.7	1.9	− 1.5	2.0	1.1
fourth quarter	6.9	0.1	− 0.3	3.3	4.2	− 6.2	− 0.3
1986 first quarter	− 2.6	0.6	.	− 4.8	.	.	− 0.6

[1] Minus signs indicate operations decreasing bank reserves. [2] Flows net of valuation changes, partly estimated by the BIS. For Germany, France and Switzerland, based on monthly averages of daily data; for other countries, month-end data. [3] Excluding foreign exchange swaps used for the purpose of influencing bank liquidity. For Japan, operations of the Foreign Exchange Fund. [4] Excludes certain operations carried out for the purposes of money market management and, in the case of Japan, operations of the Foreign Exchange Fund. For the Netherlands, Treasury deposits at the central bank. [5] Foreign exchange swaps, bill and security repurchase agreements, outright open market purchases and sales of bills and securities, special loans at market interest rates and government deposits transferred to the market. For Italy, includes loans to Treasury bill underwriting syndicate. [6] Lombard and (except for Germany) discount credit. For France, advances at fixed interest rates minus liquidity taken back.

Sources: National data and definitions.

The instruments that central banks have recently employed more intensively to adjust bank reserves include outright purchases and sales of bills and securities, purchase and resale transactions in bills and securities, sales of bills drawn on the central bank, foreign currency swaps and the shifting of government deposits from the central bank to the market. In some countries official transactions are conducted in existing private markets; in others central banks have established special auction procedures. The new instruments permit the central bank to exercise a good deal of discretion with respect to the timing and duration of reserve supplying and withdrawing operations and the interest rate charged. In several countries the rates applied serve as signals of the central bank's intentions with respect to interest rates.

In a number of countries the structure of minimum reserve requirements has been refined or adapted to allow for the emergence of new types of bank liability. Typically the cost burden of holding required reserves has been lowered, and in a number of cases the weight has been shifted more towards transactions deposits and away from time and savings deposits. Structural modifications have been made in recent years in Italy (1982), the United States (1982 and 1984), Canada (1983) and

France (January 1985). In Germany reserve requirements were restructured in May 1986 to ensure that they covered liabilities at maturities of up to two years in the form of bearer securities. Certificates of deposit could then be issued for the first time by German banks. At the same time, the rate schedule for time and savings deposits was lowered and simplified.

The reasons for the changes. All central banks now use discretionary procedures to influence short-term interest rates, but they have employed their new instruments to make short-term interest rate determination more flexible and to permit central bank operations through the market. The desire for greater flexibility basically reflects the need to ensure that short-term interest rates are adapted expeditiously. At the same time, the aim has been to convey the central bank's interest rate intentions more exactly and to reduce the sometimes excessive publicity traditionally associated with changes in posted rates.

Flexibility has facilitated the meeting of basic domestic monetary policy objectives while permitting interest rate policy to respond to disturbances in the financial and exchange markets. With floating exchange rates reacting very sensitively to market expectations regarding the future course of policy, the newer instruments can permit gradual changes in interest rates to take place in ways that have allowed the market response to be taken into account. Traditional policy instruments, such as changes in discount rates, could then be used for giving stronger signals, where appropriate. In countries with exchange rate objectives the new techniques have also facilitated the rapid adaptation of money market interest rates which has sometimes been necessary, especially in periods of prospective currency realignments.

Greater flexibility has also been used to help counter disturbances which have complicated control over the supply of bank reserves, such as erratic short-term movements in the government accounts at the central bank. In some cases changes in procedure have been made in an attempt to prevent large deficits in the public finances and a build-up of banks' holdings of liquid short-term government securities from undermining monetary control.

Increased use by central banks of instruments such as security purchase and resale agreements has been facilitated by the growth and development of the money markets. The move away from instruments with posted interest rates has taken place against a background of greater use of adjustable interest rate instruments in bank lending.

Flexibility in money market procedures and exchange rates. The way in which the new flexibility in procedures operates was clearly seen in the complex interaction last year between monetary policy, money market interest rates and floating exchange rates.

In many countries monetary policy has most influence on day-to-day money market rates or rates at up to one month, while interest rates at longer maturities are more influenced by expectations in the market. Under the borrowed reserve targeting procedures used in the United States the Federal funds rate can move significantly in response to market expectations of changes in policy. Market reactions can at times reinforce the policy actions taken by the central bank. In early 1985, however, the rise in US money market rates largely reflected market anticipation of a response by the Federal Reserve to the rise of M_1 above its target range.

In European countries the steep further rise in the dollar at that time threatened to increase inflationary pressures and was clearly a cause for concern to the monetary authorities. In these circumstances, bond yields in nearly all countries came under upward pressure for a time, although short-term money market rates remained unchanged in many cases. In Germany, for instance, where new money market procedures were introduced in January 1985, very short-term market rates remained quite stable, close to the rates applied by the Deutsche Bundesbank in supplying bank reserves through temporary securities operations.

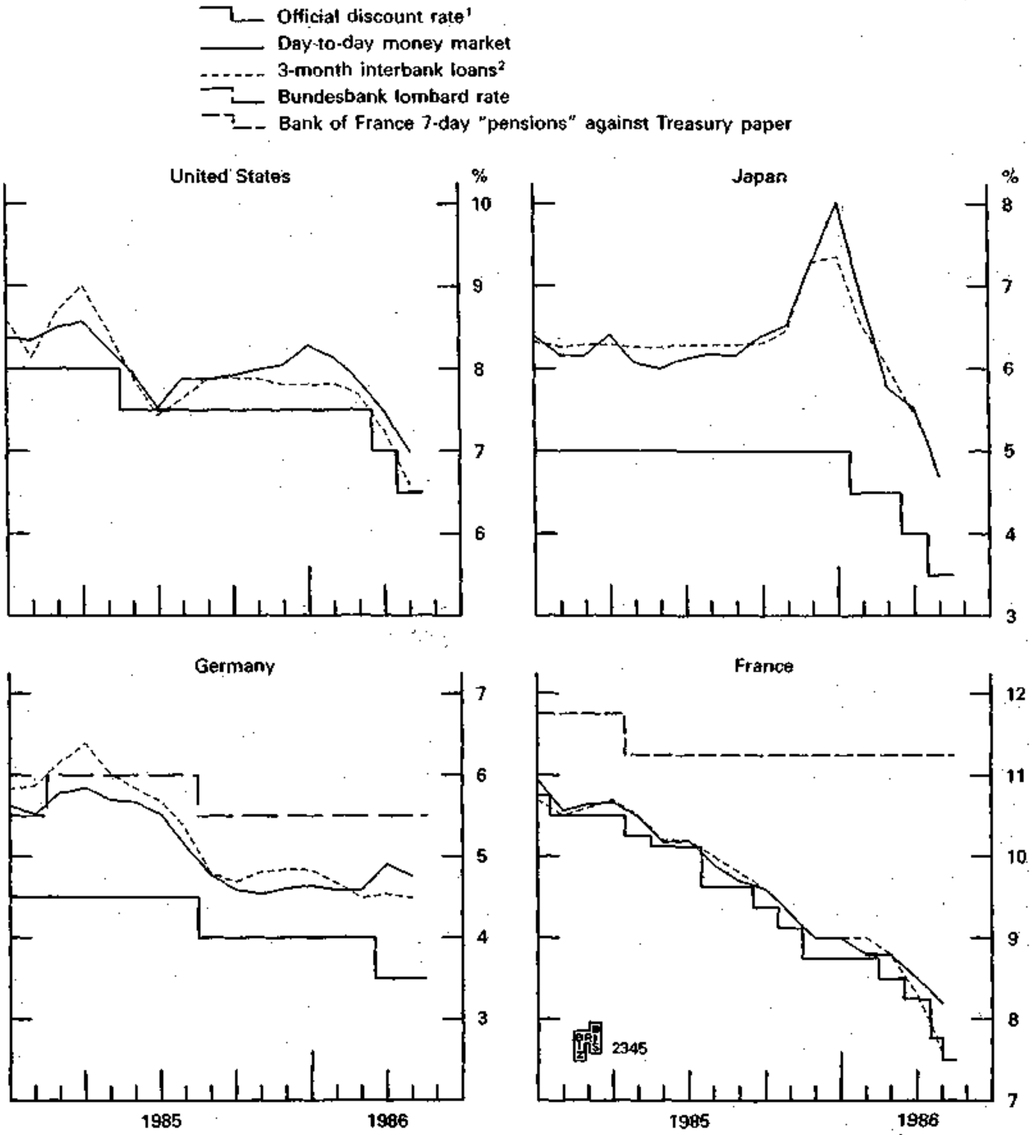
In the United States concern that the economic recovery might come to a halt increased in the spring of last year and, following the cut in official discount rates in March, the Federal funds rate moved down to the new level of the discount rate in June. Three-month interest rates on certificates of deposit fell below the discount rate, however, apparently because the market expected a further easing of monetary policy.

From June onwards, with the dollar edging down against other currencies, the Federal Reserve seems to have encouraged a progressive firming of the Federal funds rate. In Germany the Bundesbank took into account favourable domestic price developments and a firming of the Deutsche Mark to foster a decline in short-term interest rates by gradually lowering the rates applied in its purchase and resale operations. In July, when short-term rates were in the lower half of the band bordered by the official discount rate and the lombard rate, these official rates were lowered so as to leave scope for further falls in money market rates. By offering funds under temporary transactions in securities for periods of up to two months the Deutsche Bundesbank could minimise the need for fine-tuning operations — until the exchange markets again became unsettled in August and September. From January to August the Bank of Japan continued to adjust its provision of bank reserves, through the sale of bills and short-term securities as well as through lending, so as to encourage the call-money rate to respond flexibly to developments in the exchange markets.

The main change in short-term interest rate policy after the Group of Five agreement in September took place in Japan, where money market techniques were applied to encourage a steep rise in money market rates. Interest rates on credit to the domestic economy were partly insulated, however, because the discount rate remained unchanged. In Germany the Deutsche Bundesbank continued to respond to changing conditions in the exchange market by varying its tender procedures — calling for tenders at given interest rates at times when it seemed appropriate to provide the market with clear interest rate signals. Interest rate developments in Germany remained broadly consistent with meeting the domestic monetary objectives, but the timing of changes was evidently influenced by external considerations.

In France, where an improving domestic and external situation brought the French franc under upward pressure, the authorities kept it within the EMS band by

Official and interbank interest rates, 1985–86.



[1] For France, official purchases of short-term private paper. [2] For the United States, 3-month certificates of deposit.

accepting a large net increase in the official external reserves and by gradually lowering the key rate for purchases by the Bank of France of first-class private paper. The published rate for a long-standing seven-day purchase and resale facility for Treasury bills, the only remaining facility under which the banks can obtain accommodation from the Bank of France at their own initiative, remained unchanged at a level which exceeded that of money market rates by an increasing margin.

In early 1986 market interest rates at all maturities followed the call-money rate down in Japan, and bond yields also edged down in Germany. Though the cut in the Deutsche Bundesbank's discount rate in March did not imply an immediate fall of an equivalent amount in domestic money market rates, it could have an impact on the lending charges of banks and provided an important signal. It was closely followed by cuts in discount rates in Japan, the United States and the Netherlands and by a further lowering of the official money market intervention rate in France. Cuts in official rates in Italy, the United Kingdom, Sweden, Canada, Belgium, Ireland and Portugal came shortly afterwards. In Japan and France the authorities adopted new techniques for influencing interest rates more directly in the open market, particularly those on certificates of deposit, so as to help ensure that the official interest rate impulse spread quickly through the money markets. In the United States and Japan official discount rates were lowered further in late April.

Persisting problems in money market management. In some countries, where the changes in money market procedures constituted in part an effort to contain pressures on monetary creation caused by large budget deficits, more basic measures are required to reduce the deficits. Avoiding excess monetary creation in a context of large government deficits calls for arrangements which permit interest rates on government debt to respond to financing pressures. Arrangements which effectively limit the Treasury's access to central bank credit may also be necessary. In Italy the 1981 "divorce" between government financing and the operation of monetary policy helped, together with improvements in financing instruments and procedures, to establish conditions for effective monetary control in the short run. However, the limit on the Treasury's credit line at the Bank of Italy continues to rise automatically from year to year in line with the growth of government expenditure.

In Belgium the Government has been able to finance itself indirectly over the years from the National Bank via the Securities Market Stabilisation Fund, an independent public agency which could acquire special government securities by drawing on a credit line at the central bank. There are no minimum reserve requirements and the banks, having accumulated a large stock of government securities which are redeemable at short notice, now have little need for central bank accommodation. In these circumstances the National Bank retains control over short-term interest rates only by virtue of its ability to set the interest rates on short-term Treasury securities. In the United Kingdom, by contrast, overfunding of the Government's borrowing requirement in recent years drained the market of Treasury bills and made the provision of bank reserves become dependent on large-scale purchases of private bills by the Bank of England. The impact of overfunding on the term structure of interest rates may have been quite limited but it gave rise to a number of technical difficulties. The pragmatic objective since last October has been just to cover the Government's borrowing requirement over the financial year as a whole by sales of government securities outside the banking system.

In some cases arrangements intended to introduce greater flexibility into short-term interest rate determination have not operated in the way that was expected. In the United Kingdom, for instance, the objective, stated at the time of the 1981 money market reforms, of leaving the determination of interest rates more to the operation of market forces could not always be met in a context of overfunding. The revival last year of the practice of equilibrating the money market by official lending indicates that the authorities have recognised a need to give the market more guidance on occasion with respect to very short-term interest rates. On the other hand, the conventional arrangements still in place in a few countries where key central bank lending rates remain below short-term money market rates could conceivably delay flexible interest rate adjustments in a downward direction. In some countries, including Japan and the United Kingdom, constraints on the type of instrument which the central bank is prepared to purchase or to accept as security have at times hindered efforts on the part of the authorities to make their influence felt in important money markets in which they do not themselves operate.

In the United States interest rates have been much less volatile since late 1982, when the Federal Reserve abandoned strict targeting of non-borrowed bank reserves, which had implied automatic interest rate responses to deviations in M_1 from target. The borrowed reserves targeting procedures permit the Federal Reserve to exercise much more discretion in influencing short-term interest rates. However, the Federal funds rate has been free to move, even in the absence of changes in the official objectives for borrowed reserves, in response to changes in banks' willingness to borrow. A rise in the Federal funds rate in the summer of 1984, for instance, partly reflected bank responses to signs of fragility in the financial system. Last year, however, with the discount rate closely underpinning the Federal funds rate for much of the time, the scope for market expectations to be reflected in changes in the Federal funds rate was quite limited.

In some countries, including Japan, France and Sweden, where central bank procedures have been adapting to a continuing process of deregulation and financial innovation, further changes in procedures may be called for as new instruments develop and markets become more integrated. In Switzerland a proposed modification of the clearing system is likely to cause a change in the demand for adjusted central bank money — the National Bank's target aggregate — in the foreseeable future. Difficulties of this kind may, however, prove to be purely transitional.

Constraints on monetary policy.

Many of the difficulties with which monetary policy has had to cope in recent years stem from the large deficits in the public finances. In some cases the deficits have been structural, and efforts to reduce them have left little scope for using fiscal policy to stabilise the economy.

Large budget deficits may threaten the effectiveness of monetary control in both the short and the long run. In some countries where deficits are particularly large (Italy, Belgium, Spain, Greece and Ireland) difficulties in the operation of monetary policy have been caused by ineffective limits on central bank credit to the Government, or by reluctance on the part of the Treasury to offer appropriate interest returns on government securities. In other cases changing expectations about the extent to which government borrowing might influence monetary expansion have put pressure on exchange rates. Generally, however, the main problem has come from the pressures exerted on interest rates by large actual and prospective deficits in a context in which monetary policy had given priority to controlling inflation.

Developments in the exchange markets have compounded the problems of monetary policy. One of the major lessons derived from the experience with floating exchange rates in recent years has been the degree to which external factors can influence and constrain monetary policy, even in large countries. This was evident in a number of them in 1985. There are three reasons why the exchange rate consequences of monetary policies increasingly need to be considered. The first is the increase in international capital mobility brought about by the further liberalisation of national money and capital markets and the increased international substitutability of financial assets denominated in different currencies. This means that domestic financial markets are more subject to the influence of activities in foreign financial markets. Foreign monetary and fiscal policies increasingly cause changes in domestic financial conditions. As a consequence, the combination of monetary and fiscal policies in some large economies can alter substantially, via their effect on exchange rates, the set of policy choices available to other economies. Greater financial integration implies greater policy interdependence.

The second reason for paying increased attention to the external consequences of monetary policy stems from the experience of larger movements in exchange rates than seemed consistent with fundamental long-run determinants. The risk of exchange rate "overshooting" in response to policy adjustments may at times constrain or delay such adjustments. In recent years much of the movement in exchange rates of major currencies has not been associated with corresponding movements in relative prices; nominal exchange rate changes have implied large changes in real exchange rates. Even granted the basic difficulty of knowing what the "correct" or "appropriate" exchange rate might be for any currency, this experience and awareness of the substantial influence of changes in private market expectations on exchange rates place a constraint on monetary policy. This constraint certainly appeared to be in force in the United States' cautious approach to adjustment of money market rates and of its discount rate since mid-1985 and in the changes in short-term interest rates in Japan in October after the Plaza Agreement. A greater response of capital flows to interest rate differentials and to market expectations of changes in policy has increasingly made policy-makers sensitive to the consequences of even modest alterations in the stance of monetary policy.

The third reason for giving increased consideration to the external impact of economic policy generally is increased awareness of the longer-run and cumulative real economic consequences of continuing exchange rate misalignments. Large changes in real exchange rates among the major currencies have considerably altered the utilisation and allocation of real resources. The adjustment costs in these circumstances can be substantial. The reduced competitiveness of the US economy and the very large US trade deficit have resulted in severe difficulties for the internationally traded goods sector of that economy. This, in turn, has led to a heightened political sensitivity there to changes in economic policy generally and increased political debate about the stance of monetary policy. Similarly, the loss of competitiveness in Japan associated with the appreciation of the yen since the spring of 1985 and its potentially significant impact on Japanese trade have focused attention on policy changes which might have an impact on exchange rates.

It can hardly be denied that increased capital mobility associated with the further integration of international financial markets has led to a more policy-interdependent world. The environment in which monetary policy operates has changed fundamentally in recent years as a result of the dismantling of barriers to international capital movements, the continued process of financial deregulation and innovation, and financial asset diversification by many types of investor. The quite different monetary/fiscal policy mixes among the major economies have also contributed to exchange market volatility and exchange rate overshooting. With fiscal policy having lost much of its earlier flexibility, there is a risk that too much may be expected of monetary policy. Monetary policy cannot be used to achieve both internal and external balance and both short and long-term aims simultaneously. In large economies an appropriate domestic anchor for long-term inflation expectations is still required, even after the significant improvements in inflation performance in recent years. Money stock control continues to provide the necessary anchor for the long-term purchasing power of money.

VII. THE INTERNATIONAL MONETARY SYSTEM.

Highlights.

In the international monetary field the outstanding event of the period under review was that, after nearly five years of almost uninterrupted rise, the dollar peaked in February 1985 and subsequently declined sharply in the exchange markets. This turn-round was not solely the spontaneous outcome of market forces but appears to have been influenced to a considerable extent by a much more activist role of the authorities in the exchange markets. The shift to a policy of active concern, encompassing internationally co-ordinated official intervention, verbal exchange rate guidance and the attaching of greater weight to exchange rates in domestic policy formulation, amounted to an important change in official policy attitudes, notably in the United States.

Apart from describing the exchange market developments leading up to the co-ordinated intervention operations initiated in late February and September 1985 as well as the impact that these policies in turn had on the exchange markets, this chapter considers some broader questions concerning the role and effectiveness of official intervention and the functioning of the present floating rate system.

Another remarkable development was the progress made last year by the European Monetary System (EMS) towards the achievement of "a zone of monetary stability in Europe". Inflation rates among member countries displayed a pronounced trend towards downward convergence, which made it easier for the EMS exchange rate mechanism to weather the sharp turn-round of the dollar in the exchange markets without being subject to unduly disruptive forces.

As regards developments in the field of international liquidity, the gold market was hardly affected by the weaker dollar or by political unrest in South Africa. While in terms of dollars the gold price showed some recovery, it declined markedly in terms of most other major currencies.

Owing to large private capital inflows into the United States, the massive and widening US current-account deficit did not act as an engine of reserve growth in 1985. The fact that official reserve assets, measured in terms of US dollars, nonetheless showed a fairly strong expansion last year was due mainly to the sharp appreciation of the dollar value of reserve assets held in other currencies and to reserve accumulation by the United States. Reserve holdings in the United States, by contrast, declined and the share of the dollar in official exchange reserves recorded a sizable decrease.

General exchange rate developments.

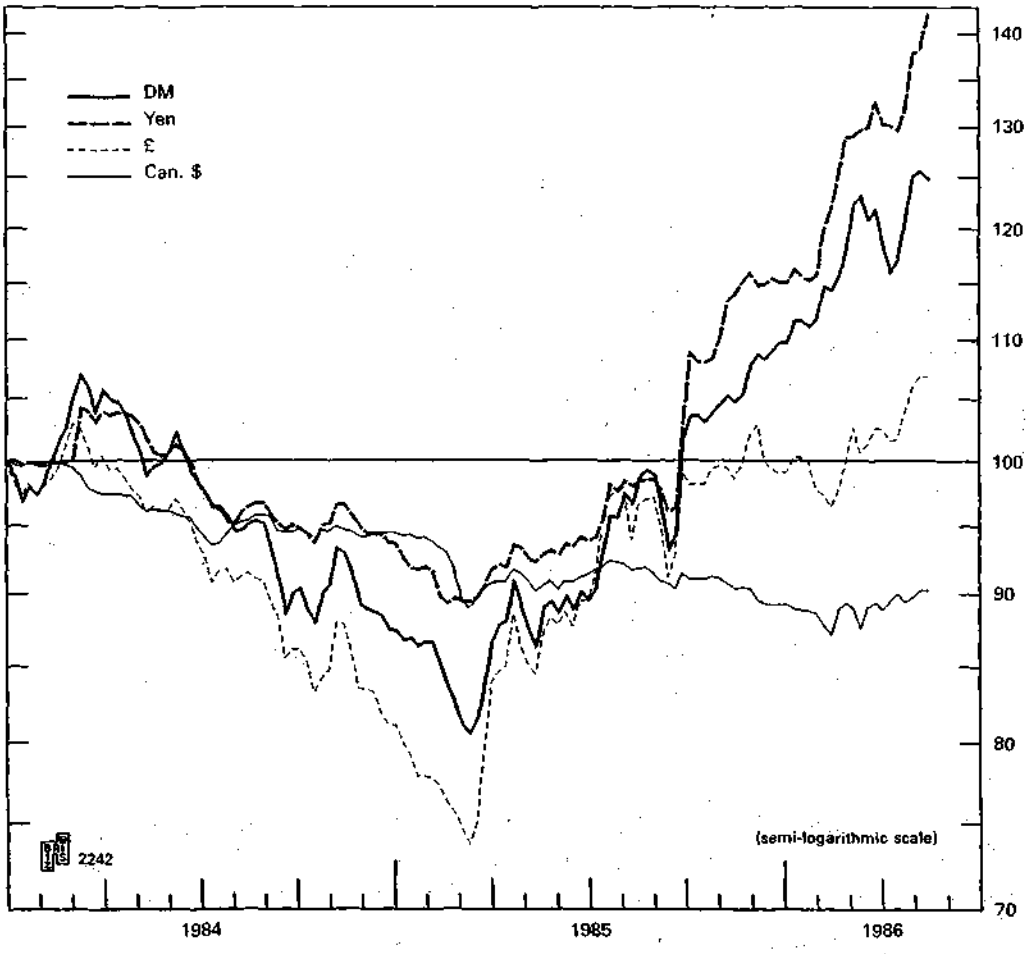
The floating currencies. In the exchange markets there were three outstanding features of the period under review: firstly, a much more activist approach on the part of the authorities to exchange rate management; secondly, the substantial depreciation of the dollar against other major currencies which the shift in official policy attitudes helped to produce; and, thirdly, the fact that this adjustment of exchange rate relationships took place in an orderly fashion, as is evidenced by the continued decline in dollar interest rates up to the spring of 1986. After a five-year-long appreciation, the US dollar eased by 30 per cent. in effective terms between late February 1985 and mid-May 1986, while against some major currencies its depreciation amounted to almost 40 per cent. This turn-round and subsequent decline of the dollar were supported by a number of fundamental developments in the US economy: large and growing current-account deficits since 1983, a weakening of economic growth since mid-1984, a more accommodating monetary policy and the downward trend in US interest rates. However, these developments were rather slow to make themselves felt in the exchange markets. It was only after the monetary authorities of the United States and other leading industrial countries had publicly stated that a depreciation of the dollar was needed and had backed that up by co-ordinated exchange market intervention that towards the end of 1985 these fundamentals began to be reflected in spontaneous exchange rate trends.

On 17th January 1985 the Finance Ministers and central bank Governors of the Group of Five countries reaffirmed their commitment to undertaking co-ordinated intervention as necessary. This announcement was followed shortly afterwards by some official sales of dollars, but as there was little evidence of a broad, co-ordinated intervention effort the markets remained unconvinced of official resolve to curb the extraordinary strength of the dollar. Buoyed by widening interest rate differentials in its favour, the dollar rose steeply once more in February. At that point, with market sentiment towards the dollar becoming more and more euphoric, its exchange rates had risen to clearly unsustainable levels, which, by aggravating existing disequilibria, was bound to lead to even greater instability later on. A large-scale, co-ordinated official intervention effort was therefore mounted under the leadership of the Deutsche Bundesbank, but this time with some support from the US monetary authorities. Between the January meeting of the Group of Five and 1st March dollar sales by the Group of Ten countries totalled approximately \$10 billion. While the bulk of the sales were made by European central banks, US intervention amounted to \$0.7 billion. These actions succeeded in restoring a two-way market. They were, moreover, underpinned by growing evidence of an economic slowdown in the United States and by some accidents in its domestic financial markets which were perceived as precluding any tightening of US monetary policy. Between 26th February, just before official intervention started, and 19th April the effective exchange rate of the dollar fell by 10 per cent. On a bilateral basis, the decline was most pronounced against sterling and the Deutsche Mark, amounting to 18 and 14 per cent. respectively; against the yen, which had previously shown less weakness than some of the European currencies, the depreciation amounted to only 6 per cent.

During the following two and a half months the dollar fluctuated widely, with fairly large day-to-day movements but no clear trend. While US interest rates were obviously moving down, with a ½ percentage point cut in the Federal Reserve's discount rate on 20th May, a rapid expansion of the US monetary aggregates raised

Movements of bilateral exchange rates of selected currencies against the US dollar, 1984–86.

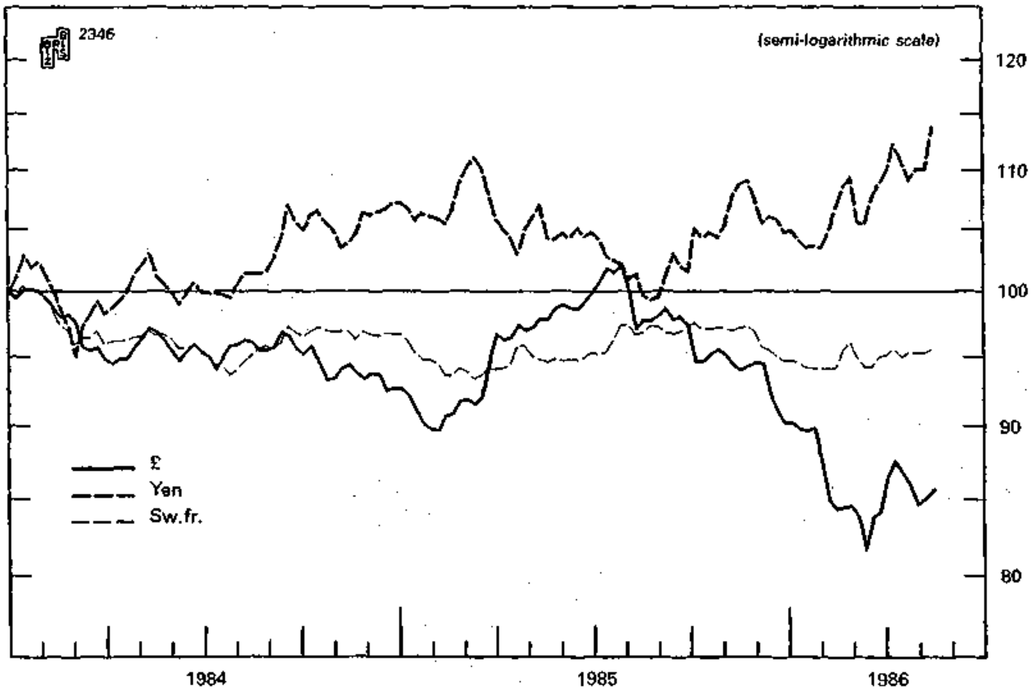
Weekly averages, end-1983 = 100.



doubts about the likelihood of any further easing. At the same time, interest rates in other countries were also declining, albeit to a lesser extent.

In July the dollar began to weaken again. Although in that month dollar interest rates temporarily firmed, the upward adjustment on 17th July of the base for the Federal Reserve's monetary targets in conjunction with the setting of a wider target range appeared to confirm expectations of a continuing accommodating US monetary policy stance. Moreover, the growing trade and current-account deficits, their depressive influence on the domestic economy and the related strengthening of protectionist pressures suggested that the US authorities might welcome a further easing of the dollar. Against this background, the dollar's effective rate fell by 6½ per cent. between early July and late August, to 15 per cent. below its late February/ early March peak. Several European central banks took advantage of the weaker standing of the dollar to replenish their exchange reserves and to lower interest rates.

Movements of bilateral exchange rates of selected currencies against the Deutsche Mark, 1984–86.
Weekly averages, end-1983 = 100.



On 16th August the Deutsche Bundesbank cut both its discount and lombard rates by ½ percentage point, and in the United Kingdom the clearing banks' base lending rates were lowered twice by ½ percentage point, on 15th and 29th July.

In late August, however, more encouraging US economic indicators, somewhat better trade figures and a temporary widening of interest rate differentials in favour of the United States led to a sharp recovery of the dollar, with quotations against the Deutsche Mark, for example, rising by about 8 per cent. within the space of three weeks. Although the dollar subsequently eased somewhat around mid-September, its underlying stance remained firm. Meanwhile, protectionist demands were increasingly gaining support in the US Congress. In this situation the Ministers of Finance and central bank Governors of the Group of Five countries met on the initiative of the United States on 22nd September in New York to reassess their policies.

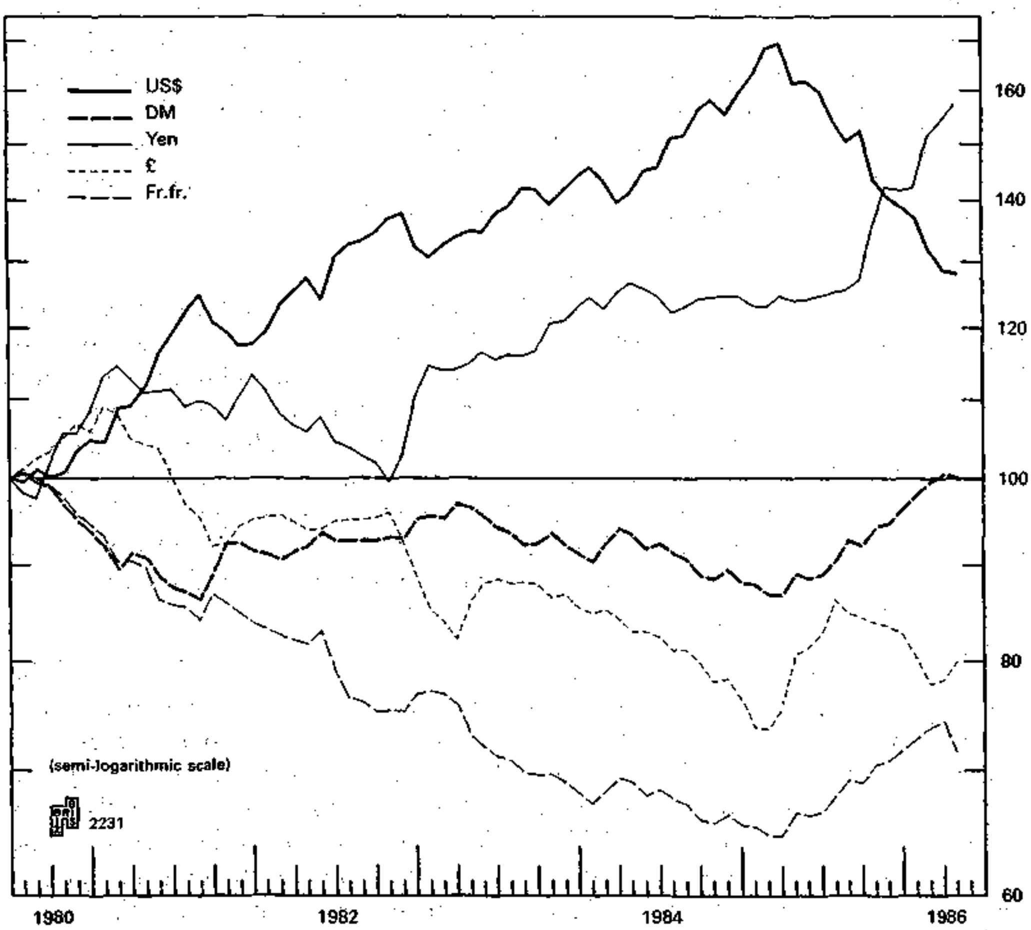
The understandings and agreements reached at that meeting went well beyond earlier efforts to co-ordinate action with respect to exchange rates and, in particular, heralded a major change in US policy attitudes. Firstly, external imbalances, especially the large and still growing US current-account deficit, were, at long last, publicly identified by the authorities as posing potential problems for the world economy. Secondly, it was agreed not only that exchange rates should play a role in adjusting external imbalances, but also that, in order to do this, they needed to reflect fundamental economic conditions better than had so far been the case. Thirdly, as a logical consequence of these shared views, it was agreed that some further orderly appreciation of the other main currencies against the dollar was desirable. Finally, the five countries underlined their readiness to co-operate more closely in order to encourage such an adjustment. Although the specific form of this co-operation was not spelled out, exchange market intervention was evidently part of it. On the following day the US authorities were reported as saying that they might be ready to intervene on occasions other than when the markets were disorderly.

This demonstrative show of official unanimity and resolve took the exchange markets by surprise. Immediately after European markets opened on 23rd September, and before co-ordinated central bank intervention had begun, the dollar registered its largest fall — nearly 6 per cent. against most other major currencies — in a single day since March 1973. This depreciation was confirmed the following day, when the Tokyo market opened after a bank holiday and the Bank of Japan began the most aggressive intervention operations in recent years. These and subsequent intervention sales pushed the dollar down by 12, 10 and 6 per cent. against the yen, the Deutsche Mark and sterling respectively within the space of two weeks.

Not surprisingly, it took time for the markets to grasp the full extent of the change in official attitudes. Consequently, in the course of October the central banks' commitment to their joint cause was tested on several occasions, but renewed upward pressures on the dollar were resisted by continued intervention. Between the September Group of Five meeting and early November total concerted dollar sales by central banks amounted to $13 billion. What was crucial to the success of the operation was that in these interventions the United States for the first time played a leading role, with sales totalling $3 billion, some in markets in the Far East. Sales of dollars by the Bank of Japan were largely reflected in the decline of that country's foreign exchange reserves by more than $2 billion in the two months up to the end of October. Moreover, in late October the Bank of Japan underlined its commitment to a stronger yen by inducing an upward adjustment of Japanese interest rates, although such a move was hardly desirable on domestic grounds. This show of official determination finally impressed the exchange markets, and in November the dollar resumed its decline without the need for further large official dollar sales.

By early December the dollar had depreciated to DM 2.50 and Yen 200, and to $1.50 against sterling. While US long-term interest rates continued on their downward path, Japanese interest rates started to decline across the board in mid-December as the result of a cautious reversal of the earlier interest rate policy. The markets appear to have then gained the impression that the monetary authorities of the Group of Five countries were content for the moment with the exchange rate correction that had occurred. While tensions began to re-emerge within the EMS exchange rate mechanism, the decline of the dollar was halted until mid-January 1986.

Movements in effective exchange rates of selected currencies, 1980–86.
Monthly averages, June 1980 = 100.



However, in the wake of the Group of Five meeting on 18th–19th January 1986 in London, US and Japanese official statements that a further decline of the dollar would not be unacceptable or might even be welcome induced a renewed shift in market sentiment. A factor contributing to this renewed decline of the dollar was the collapse of oil prices, which was perceived by the markets as being more beneficial to the German and Japanese than to the US balance of payments. Moreover, the improved inflationary outlook in the United States as a result of the lower oil prices boosted expectations of lower dollar interest rates. Against this background, in late January the dollar once more began to ease markedly against the yen, the Deutsche Mark and the Swiss franc and, under the influence of poor US trade figures and declining US capital market yields, its fall continued until late February. In view of the renewed weakness of the dollar, the Bank of Japan felt able to lower its discount rate — which had been left untouched for more than two years owing to exchange rate considerations — by ½ percentage point on 30th January. During this period from late January to early March the dollar fell by 12 per cent.

against the yen and 11 per cent. each against the Deutsche Mark and the Swiss franc, but showed little change against oil producers' currencies, viz. sterling and the Canadian dollar.

In early March the counter-inflationary leeway gained as a result of the lower oil prices, and evidence of economic slowdown in Japan as exports began to feel the impact of the higher yen, prompted a co-ordinated round of official interest rate reductions by the Deutsche Bundesbank, the Bank of Japan, the Federal Reserve and a number of other central banks. The dollar responded favourably at first, and over the following four weeks recovered particularly against the continental European currencies, whereas its undertone remained fairly weak against the yen. However, in early April expectations of a further easing of US interest rates contributed to a renewed downturn of the dollar. In fact, following the IMF Interim Committee meeting in Washington, a second round of co-ordinated cuts in official interest rates was implemented by the US, Japanese and major European central banks except the Deutsche Bundesbank between 14th and 25th April. In addition, US and European official remarks favouring further yen appreciation spurred bearish sentiment about the dollar despite repeated intervention purchases by the Bank of Japan. And in early May the economic summit meeting in Tokyo did not produce evidence of general official readiness to support the dollar at this stage. In these circumstances the dollar depreciated by 12 per cent. against the yen and by 10 per cent. against the Deutsche Mark and the Swiss franc between early April and mid-May.

During the fifteen-month period of dollar depreciation up to mid-May 1986 the yen, the Swiss franc and the Deutsche Mark appreciated by over 60 per cent. against the dollar, which was certainly one of the largest movements yet recorded within such a relatively short period since the transition to floating. In effective terms the appreciation of the Deutsche Mark and the Swiss franc amounted to 19 per cent. each, while, owing to Japan's closer trade ties with the United States, the yen advanced by as much as 35 per cent.

A salient feature of the yen's appreciation is that it was concentrated on the period after the Group of Five meeting in September. The yen had weakened against the dollar much less than European currencies over the preceding years; correspondingly, until late September 1985, its recovery was more modest. In fact, as it declined against the European currencies, the yen's effective exchange rate remained virtually unchanged from late February to late September 1985. Consequently, after the September Group of Five agreement, which, in view of the huge and widening Japanese current-account surplus, focused especially on the dollar/yen exchange rate relationship, the appreciation of the yen was much more pronounced than that of the European currencies.

The pound sterling performed quite differently. Initially, in reaction to its earlier weakness and as a result of its relatively high interest rate level, it benefited most from the decline of the dollar. Between late February and late July 1985 it appreciated not only by 36 per cent. against the US dollar but also by 11 per cent. against the Deutsche Mark. However, in mid-summer signs of slower economic growth and consequent expectations of an easing of UK monetary policy brought this upward movement to a halt. During the two months following the September

Group of Five announcement sterling recovered much less against the dollar than most other currencies on account of uncertainty over oil prices and rumours that the United Kingdom might join the EMS exchange rate mechanism at a lower exchange rate level. In early December, when oil prices started to decline, sterling began to depreciate even against the US dollar. Although in early January 1986 its weakness led to an upward adjustment in the UK clearing banks' base lending rate by a full percentage point, the decline continued until early March before a reappraisal of the impact of the lower oil prices on the British economy and a favourably received new budget contributed to a substantial recovery.

During the period under review the Canadian dollar was the only major currency that continued to show weakness against the US dollar, although Canadian monetary policy was aimed at keeping the movements against the US currency within fairly narrow bounds. After a sharp drop in the earlier part of 1985 the Canadian dollar recovered moderately in the course of spring and early summer, but came under heavy pressure once more in the last two months of the year as the weakening current-account balance and growing concern about the budget situation contributed to a pronounced deterioration in market sentiment. As a further decline against the US dollar was considered undesirable and a large downward adjustment against other major currencies had already occurred, the Bank of Canada began to raise interest rates and to intervene heavily in the exchange markets. Nevertheless, in the course of January the steep fall in oil prices and the general weakness of commodity markets intensified the downward pressures. Despite sustained intervention financed in part by official drawings on credit lines with commercial banks, and notwithstanding the further upward adjustment of domestic short-term interest rates to over 4 percentage points above their US counterparts, the Canadian currency touched a new low of $0.692 in early February 1986, before recovering somewhat in the course of the following three months.

Effectiveness of official exchange market management. The success of the authorities in bringing to a halt, and subsequently reversing, the upward movement of the dollar, and the fact that this was achieved without causing problems for the financing of the US current-account deficit, undoubtedly surprised many market observers. It is noteworthy that, in more than one instance, official statements of intent with regard to desirable exchange rate changes seem by themselves to have set such changes in motion. However, while previous Annual Reports argued that exchange market intervention had a role to play in support of medium-term stabilisation policies, it now seems necessary to caution against drawing too sweeping a conclusion from last year's experience. The success achieved was due to the simultaneous fulfilment of several important conditions.

First of all, there was the timing of the action taken. After its vigorous rise over the preceding years the dollar was ripe for a fall. The fundamentals had been moving clearly against it for some time, even if this was not acknowledged by the markets. The loss of international competitiveness and the rapidly widening current-account deficit were sapping the dynamism and strength of the US economy. The problems of broad sectors of the economy which were suffering from the distorted exchange rate relationships had given a powerful boost to protectionist pressures, posing a potential threat to the relatively free international trading system and the prosperity of the world economy.

Moreover, the very large capital flows to the United States and the vast and growing current-account deficit to which their exchange rate consequences had contributed were rapidly eroding the US international financial position. Private portfolio balances were changing in ways that, in conjunction with the current-account deficit itself, were bound sooner or later to undermine confidence in the dollar. Interest rate differentials, it is true, though narrowing, were still clearly in favour of the United States. However, the gains to be derived from these differentials were likely to be dwarfed in the medium term by the exchange losses ultimately incurred by the unavoidable exchange rate correction.

Furthermore, intervention against a currency is most likely to be successful if, as in the case of the dollar, it is supported by a large parallel current-account deficit. In such a situation, given the amount of private position-taking still needed to finance this deficit, it is not necessary to turn round market sentiment completely; all that is required in order to induce a downward adjustment is to lessen somewhat the strength of market sentiment in favour of that currency. In fact, the main difficulty in such a situation may well lie in finding the right dosage to induce a downward correction of the currency's exchange rate without giving rise to a collapse of confidence and cumulative depreciation.

Another important reason for the success of official exchange rate management was that at their September 1985 meeting the Group of Five countries gave a convincing demonstration of unanimity and common policy resolve, and that the subsequent intervention operations were fully co-ordinated and had the whole-hearted support of nearly all the major industrial countries concerned. From the point of view of credibility it was of crucial importance that, for the first time, the US authorities, whose capacity to sell dollars is in principle unlimited, were seen to recognise the need for a further downward adjustment of the dollar. Very important, too, was the impressive scale of intervention — around $10 billion in late February/March and $13 billion in autumn 1985.

In short, while the experience of last year by no means proves that official intervention and exchange market guidance can always be relied on, it has shown that they can have a major impact when certain conditions are met. Thus, it is certainly essential that the timing and the fundamentals are "right", that the intervention is supported by the underlying balance-of-payments developments and that it is implemented vigorously and in a co-ordinated way with the co-operation of all the major countries concerned. By contrast, unilateral action, accompanied as on some earlier occasions by comments from other official circles that intervention is not likely to make much difference, can hardly be expected to impress the markets. Of course, to exert a long-term influence on exchange rate developments, official intervention will have to be underpinned by suitably tailored macro-economic policies.

Moreover, last year's experience has demonstrated that the fashionable view that "the markets know best" requires qualification as far as the exchange markets are concerned. For one thing, one very important set of parameters shaping the markets' exchange rate views and expectations is the policy stance of the national authorities. To suggest that the authorities know less about their own policy intentions than the market is hardly a serious proposition, though it is necessary that these intentions be made clear to the market. In addition, "the" equilibrium level of exchange rates is certainly not the predominant concern of market-makers. The professionals can make money from exchange rate movements both towards and away from the equilibrium level. Their concern centres on the direction of the movement over the next few days and the size of their turnover. The latter, and the width of buying/selling margins, tend to be negatively correlated with exchange rate stability.

Problems can, however, arise from official exchange market intervention and guidance. For example, when, because of an excessively large and persistent current-account imbalance, a currency is already in an over-exposed position there may be a danger that official intervention will cause an unduly strong turn-round in market sentiment, bringing about overshooting in the opposite direction. However, this problem could arise even in the absence of intervention, though probably somewhat later. In fact, by capping the exchange rate peak and thereby also the extent of the disequilibrium, intervention will, if anything, take some of the force out of the inevitable backward swing of the pendulum. Moreover, official intervention may also have to play an important role in moderating the size of this backward movement.

A second difficulty could be that, with continuing large interest rate differentials, once the overshooting has been corrected market participants might feel that the higher interest yields are unlikely to be offset by further depreciation and therefore resume their investment in the country, thereby setting in motion a renewed appreciation cycle. Here again, the problem is not due to intervention, but to the fact that excessively large international real interest rate differentials are inconsistent with a reasonable degree of exchange rate stability.

Finally, when it is the aim of official intervention to put an end to a one-way market and to bring home the lesson that the exchange rate can move in either direction, the resultant greater uncertainty about the direction of future exchange rate movements may entail larger short-run exchange rate fluctuations. This was clearly the case in the spring of 1985, when, in the aftermath of the late February/early March intervention and the exchange rate turn-round to which it gave rise, quotations were extremely unstable for some weeks, showing large daily movements without much overall sense of direction. However, while such day-to-day instability may be a nuisance to some market participants, it is undoubtedly less harmful than the very large misalignments of rates which intervention seeks to correct. It is, moreover, notable that in the wake of the September/October 1985 intervention day-to-day exchange rate instability was less pronounced than in the spring. This tends to confirm that market participants were this time more convinced that the authorities would prevail. In fact, the table suggests that confidence in the appropriateness of the exchange rate correction that had occurred became more strongly embedded in market psychology in the course of the autumn; in December, in particular, there were markedly fewer days with large exchange rate movements.

Daily variability of selected dollar exchange rates.*

Periods		Deutsche Mark		Japanese yen		Pound sterling	
1983	(average)	2	(0.55)	1	(0.52)	1½	(0.53)
1984	(average)	3	(0.74)	½	(0.42)	2	(0.64)
1984	November	3	(0.84)	0	(0.41)	2	(0.83)
	December	0	(0.51)	0	(0.30)	1	(0.49)
1985	January	1	(0.48)	0	(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	9	(1.13)	0	(0.40)	5	(0.99)
	June	6	(0.83)	0	(0.30)	5	(0.94)
	July	7	(0.87)	2	(0.57)	8	(0.99)
	August	3	(0.70)	0	(0.28)	9	(1.28)
	September	9	(1.64)	3	(1.43)	9	(1.79)
	October	4	(0.63)	2	(0.74)	2	(0.50)
	November	1	(0.53)	2	(0.81)	2	(0.60)
	December	2	(0.53)	0	(0.35)	3	(0.64)
1986	January	3	(0.68)	2	(0.61)	6	(0.86)
	February	5	(0.76)	8	(1.07)	9	(1.06)
	March	6	(0.88)	4	(0.69)	6	(1.04)
	April	6	(1.09)	5	(0.92)	5	(0.74)

* Variability is measured by the number of days within a month 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.

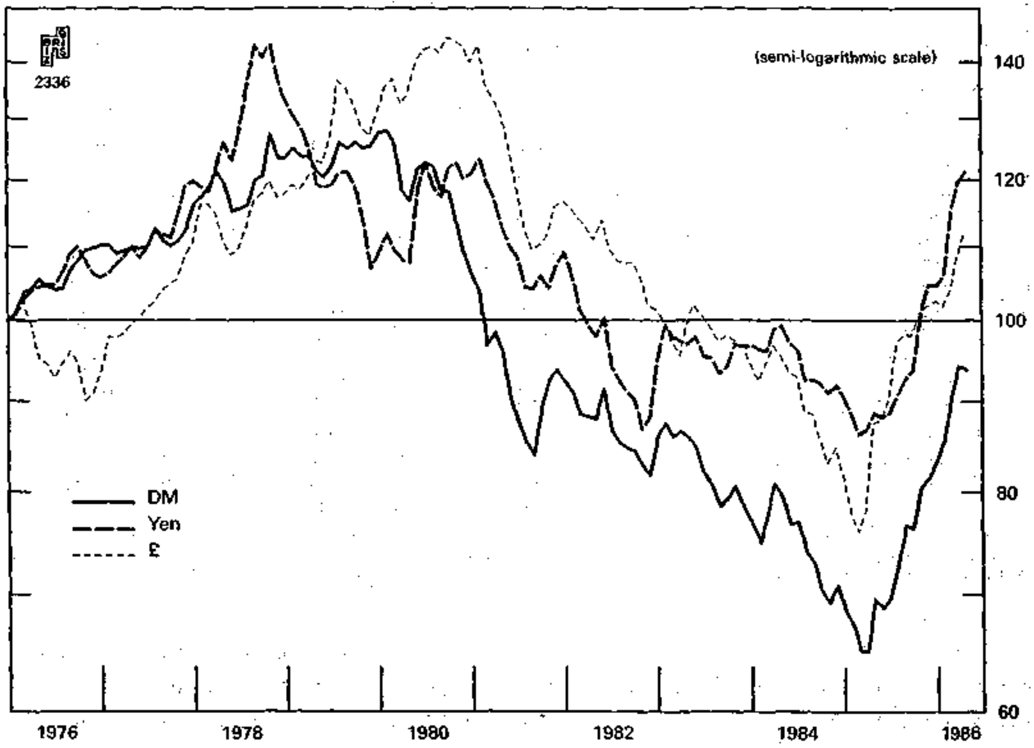
Longer-term perspectives and calls for reform. Despite the moderating influence exerted at times by official interventions, exchange rate fluctuations over the past ten years or so have been much larger than could be reasonably explained by changes in underlying conditions. The Deutsche Mark, on a real bilateral basis, depreciated against the dollar by almost 50 per cent. between its early 1980 peak and its early 1985 low and has since recovered half of this loss. The Japanese yen declined by 40 per cent. against the dollar between late 1978 and February last year and has since moved back to 10 per cent. below its earlier peak (see the graph on the following page).

It should be noted that any comparisons with a base period are necessarily somewhat arbitrary. Moreover, these bilateral exchange rates provide only a partial picture, since they cannot tell anything about the development of competitive positions vis-à-vis third countries. And, of course, capital flow patterns also have an important role to play. Nevertheless, in view of the underlying current-account imbalances, the present exchange rate structure is clearly more realistic than that of early 1985 and, given the size of the adjustment, should go a long way towards removing the existing disequilibria.

But whatever the equilibrium path of exchange rates may have been over the past decade, there can be little doubt that the fluctuations around it were excessively large. Although rigorous statistical evidence is difficult to come by, it is clear that such large exchange rate fluctuations entail very real costs. For one thing, greatly overvalued exchange rates give a powerful boost to protectionist tendencies, and the resultant measures are not necessarily withdrawn when the exchange rate subsequently returns to more realistic levels. Secondly, hugely distorted exchange rates give wrong signals for resource allocation; this will tend to be especially serious

Real bilateral exchange rates of selected currencies against the US dollar, 1976–86.*

Monthly averages, December 1975 = 100.



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

in the area of longer-term investments. Thirdly, increased medium-term exchange rate volatility and the threat of protectionism will exacerbate the uncertainties connected with investment, in particular in the internationally traded goods producing sector. This means that the level of expected profits necessary to induce such investment will have to be considerably higher. Fourthly, the price, real income and trade effects connected with large exchange rate fluctuations will tend to complicate domestic macro-economic management.

In view of these problems, it may not be too surprising that in recent years the pronounced instability of exchange rates has increasingly occupied the attention of policy-makers. In particular, two official studies of the international monetary system were conducted in which the functioning of floating exchange rates was a central issue. One of these studies was an outcome of the 1983 Williamsburg summit, the Finance Ministers and central bank Governors of the Group of Ten countries having instructed their Deputies "to identify areas in which progressive improvements [in regard to the international monetary system] may be sought". The Deputies' report was completed and officially adopted in June 1985. A second study dealing in part with the same issue, but from a very different angle, was conducted by a group set up in May 1985 by the Group of Twenty-Four countries. The report of this group, which was based on an earlier document, "The revised program of action towards reform of the international monetary and financial system", was prepared for consideration by the Interim Committee of the International Monetary Fund at its October 1985 meeting.

Although both reports ruled out any return to a fixed exchange rate system, they are quite different in overall tenor. The Group of Ten report, while acknowledging some drawbacks, emphasised the virtues of the present exchange rate system. It rejected fundamental reform of the international monetary system, but suggested improvements to be made within the present framework, largely in the form of sounder national policies and their better international co-ordination with the help of strengthened IMF surveillance. Only a minority of the Deputies advocated the introduction of target zones for exchange rates.

The Group of Twenty-Four report saw much greater shortcomings in the present system and accorded a higher priority to maintaining a reasonable degree of exchange rate stability. Like the Group of Ten report it argued for better international policy co-ordination and a strengthening of the surveillance role of the IMF; but in addition it called for trigger mechanisms which, in the event of excessive instability or serious misalignment, would automatically give rise to consultation procedures. The Group of Twenty-Four report also saw a somewhat greater role for official exchange market intervention than the Group of Ten report and advocated in particular a system of target zones for exchange rates.

Experience since the completion of the Group of Ten report has brought about a considerable change in official thinking about exchange rates in some major industrial countries. There have been repeated calls from US official circles, and indeed from the President himself, for an examination of whether an international monetary conference to discuss the reform of the system should be convened. The question of such a reform, as well as the merits of some of the envisaged proposals, are considered in the concluding part of this Report.

Developments within the EMS.

Notwithstanding the downward adjustment of the Italian lira in July 1985 and the more general realignment in April 1986, the period under review was, by and large, one of relative stability in the EMS exchange rate system. This was the result of a further downward convergence of participating countries' inflation rates and the pursuit of exchange rate oriented monetary policies. In particular, it is a testimony to the maturity of the system that the turn-round and subsequent decline of the dollar in the exchange markets did not give rise to strong centrifugal tendencies. In fact, until late November 1985, when for the first time the markets seemed to become really bearish about the US dollar, events in the dollar exchange market hardly affected the behaviour of the member currencies within the EMS parity grid. The devaluation of the French franc in early April of this year was designed not only to restore to French industry part of the competitiveness lost since the March 1983 realignment, but also to provide the new Government with more leeway in the domestic field. Thus the devaluation was accompanied by the announcement by the

French Government of a new, comprehensive economic policy package pledging, among other things, a far-reaching dismantling of domestic price controls and foreign exchange restrictions.

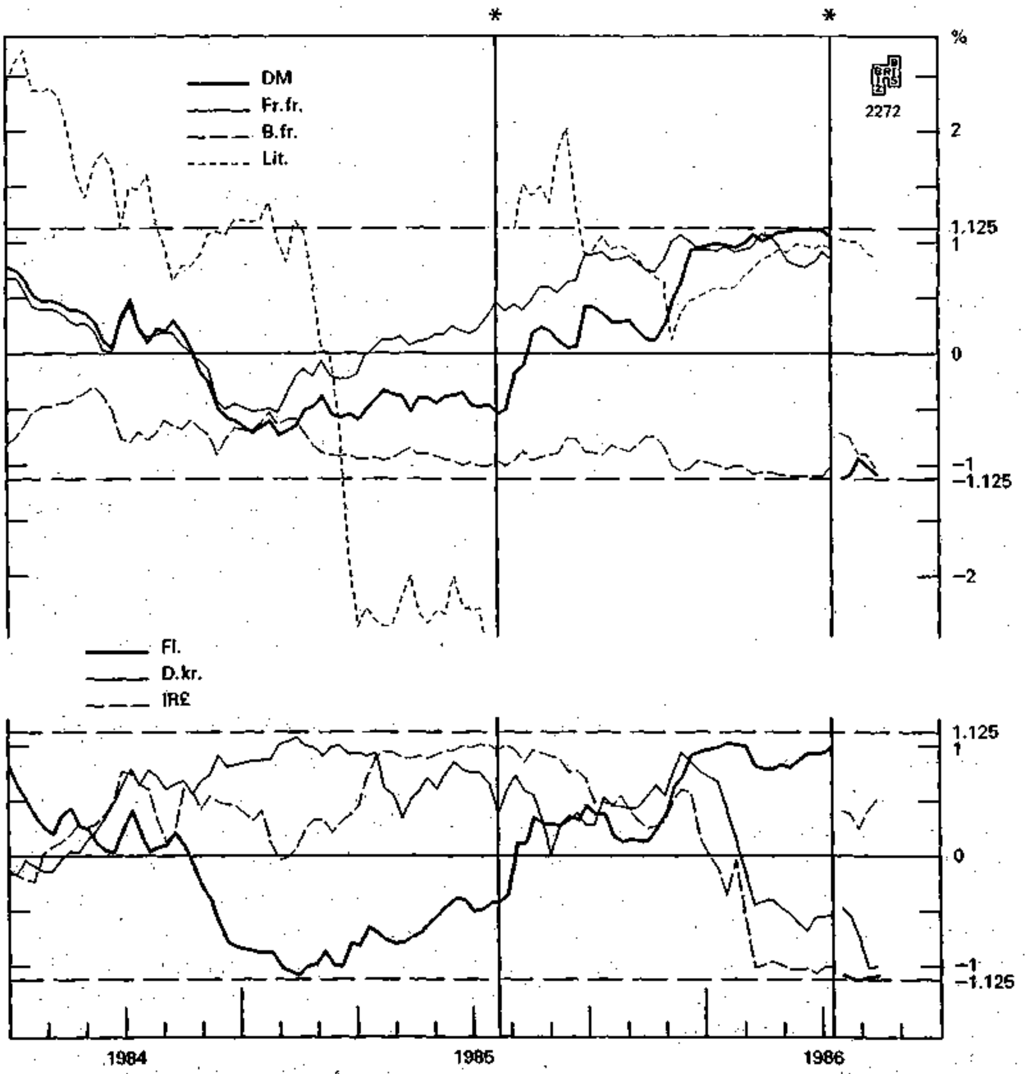
A more important factor in the behaviour of participating currencies during the period under review than the decline of the dollar was the wide differentials in nominal interest rates between EMS member countries, which, in the absence of expectations of realignment, at times exerted a dominant influence on capital movements between member countries. As a result, the Deutsche Mark and the Dutch guilder, the currencies of the two member countries with the lowest inflation rates and also the lowest nominal and real interest rate levels, were relatively weak during the first half of 1985. Until the devaluation of the Italian lira in late July they were quoted well within the lower half of the EMS exchange rate band, and even afterwards they strengthened only to slightly above the centre of the band, despite a substantial amount of intra-marginal intervention purchases of Deutsche Mark by some other member countries, which took advantage of the situation to strengthen their reserve positions. Conversely, the French franc, the Danish krone and the Irish pound, which were the beneficiaries of these capital flows, were the strongest currencies within the band until late November.

In Belgium and Italy, however, the higher nominal and real interest rates were not always successful in attracting a sufficient amount of capital inflows. From mid-March 1985 onwards the Belgian franc was persistently quoted near the bottom of the narrower band. The Italian lira had already started to weaken before the turn-round of the dollar. With market participants becoming increasingly concerned about the widening current-account deficit and the country's ability to narrow further its still very considerable inflation differential vis-à-vis other member countries, it declined by 4 percentage points between mid-February and late March 1985 to about half-way towards the bottom of its wider exchange rate band. It stabilised temporarily at that level but suffered a renewed bout of weakness around mid-July. On Friday, 19th July the Italian exchange markets were closed after the fixing and the lira dropped below the lower limit of the band. On the following day the members of the system agreed on a devaluation of the lira by 6 per cent. and a revaluation of the other member currencies by 2 per cent. each against their previous central rates with effect from 22nd July. To support the effectiveness of this realignment the Italian authorities announced emergency measures to cut the budget deficit. The lira responded favourably by rising above the ceiling of the narrower band over the following two months, before easing somewhat in the course of the autumn.

The relatively quiet conditions within the system began to change when, in the course of November, spontaneous market forces began to turn against the US dollar. At that point the market became conscious again of the stronger basic situations of the Deutsche Mark and the Dutch guilder, while expectations began to grow that a realignment of member currencies might follow the French parliamentary elections in March 1986. The downward pressures affected not only the French franc but also some other currencies and particularly the Italian lira, although the Italian current-account deficit had in the meantime narrowed. The

Spot exchange rates in the EMS exchange rate system, 1984–86.

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



* Realignments of central rates with effect from 22nd July 1985 (the average levels of the lira in the two weeks before this realignment, − 2.86 and − 3.96 per cent., are not shown) and 7th April 1986.

authorities responded with heavy intra-marginal interventions involving mainly sales of Deutsche Mark and US dollars. In addition, the Bank of Italy, the National Bank of Belgium and the Central Bank of Ireland raised their domestic short-term interest rates. In Italy these measures were supplemented on 16th January by the reintroduction of a ceiling on domestic credit expansion and a tightening of foreign exchange controls. In view of the firm response of the authorities and the prospective balance-of-payments and price benefits of the oil price slump the pressures eased somewhat from mid-February 1986 onwards.

Owing to the substantial volume of intra-marginal intervention these developments were not fully reflected in the movements of the member currencies within the EMS parity grid. Although the Deutsche Mark and the Dutch guilder moved close to their upper limit in the EMS band in the course of December, the French franc and the lira, too, remained well above the middle of the band. A sharp downward movement was, however, recorded by the Irish pound and the Danish krone.

In late March the tensions within the EMS exchange rate mechanism revived as the new French Government did not seem to rule out the possibility of a realignment. On Thursday, 3rd April the French franc plunged in the afternoon trading in New York and on the following day, as the participating central banks suspended their intervention limits within the system, it fell through the floor of the band. After discussions at an informal meeting of Finance Ministers and central bank Governors which had already been scheduled for the following weekend, a realignment was announced according to which, with effect from 7th April, the French franc was devalued by 3 per cent. and the Deutsche Mark and the Dutch guilder were each revalued by 3 per cent. against their previous central rates; the Belgian franc and the Danish krone were revalued by 1 per cent., while the Italian lira and the Irish pound were left unchanged. Immediately after the realignment massive capital inflows pushed the French franc to the top of the EMS exchange rate band, while the Deutsche Mark and the Dutch guilder moved down to the bottom. Despite reductions in French interest rates, heavy intervention by the central banks concerned was subsequently required to prevent these currencies from moving outside the band.

Several changes were made in the functioning of the EMS during the period under review. Following the agreement reached in principle in March 1985, the central bank Governors of the EEC member countries formally adopted in June 1985 measures designed to enhance the usability of the official ECU. Firstly, with effect from 1st July, a new mechanism was introduced to enable EEC central banks with a need for intervention currencies to mobilise through the European Monetary Co-operation Fund their net ECU creditor positions as well as part of the ECUs held by them under swaps with the EMCF. Such mobilisation operations would be covered by the EEC central banks, which would provide dollars in proportion to, and up to, their outstanding ECU/dollar swaps with the EMCF, and those dollars would be exchangeable for EEC currencies with the approval of the central banks issuing the currencies concerned. Secondly, also with effect from 1st July, the 50 per cent. limit on the use of official ECUs for settling obligations arising from the use of the very short-term financing facility would be waived if, and to the extent that, the recipient central bank itself had a net ECU debtor position. Thirdly, the remuneration of net ECU positions and of ECU claims under the very short-term financing facility was improved. Fourthly, it was decided that central banks of non-member countries and international monetary institutions (such as the BIS) could be accorded the status of "other holders" by the EMCF Board. "Other holders" can obtain official ECUs from EEC central banks by means of sale and repurchase agreements or reversible swap transactions, with entitlement to the same ECU remuneration as EEC central banks. This measure was completed in November, when a necessary Regulation of the Council of the European Communities came into effect.

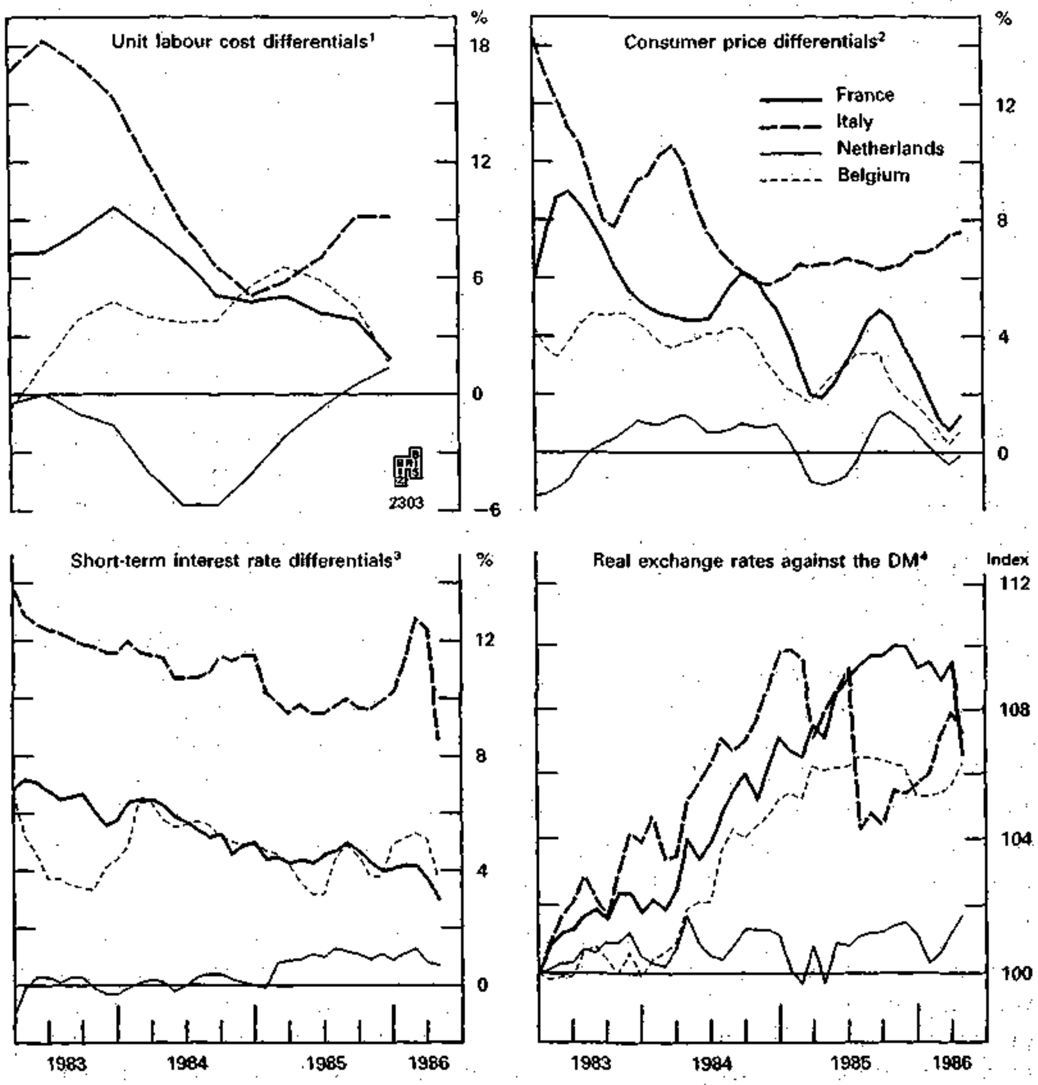
Italy was the first country to make use of the new ECU mobilisation mechanism to obtain foreign exchange for intervention purposes when the lira came under heavy pressure in late 1985. Moreover, in the course of 1985 some EMS member countries occasionally used private ECUs for intervention purposes, buying or selling these currency baskets against their national currency. Another development, described in detail in Chapter VIII of this Report, was the formal agreement entered into by the BIS to act as clearing agent for transactions in private ECUs. The continued rapid growth of the private ECU market during 1985 is discussed in Chapter V.

Just as important as these institutional innovations and developments was the progress achieved last year in moving towards "a zone of monetary stability in Europe". The outstanding feature of the period under review was a pronounced downward convergence of inflation rates among member countries which helped the EMS exchange rate mechanism to withstand the sharp turn-round of the dollar, without having unwanted realignments forced upon it. Despite the further slowdown of price increases in the two low-inflation countries, Germany and the Netherlands, inflation differentials during 1985 were much smaller than in the preceding years, and in early 1986 they ranged only between 1/2 and 1 1/2 percentage points (six-month changes at an annual rate) in the case of the four largest countries participating in the narrower exchange rate band. Progress was particularly marked in France, where, with the help of a relatively tight monetary policy, consumer price increases slowed down to 2.5 per cent. in the second half of 1985, the lowest rate recorded since 1967. In Italy the rate of inflation, thanks to the modification of the "scala mobile" and a fairly restrictive monetary policy, was the lowest since 1972. In view of the weakness of the oil and other raw materials markets, it may be hoped that this progress of the EMS member countries towards convergence in the field of price stability can be maintained in 1986.

As a combined result of the narrowing of inflation differentials and the two realignments, the divergence of real exchange rates between EMS member countries was temporarily halted and partly reversed in the period under review (see the graph on the next page). The picture is even more favourable than shown in the graph if instead of consumer prices the index of wholesale prices of finished goods is used as a deflator. On this basis the lira's loss of competitiveness since March 1983 was almost fully restored by the two recent realignments. Given the imperfections of the data and various conceptual shortcomings, measures of international competitiveness of this kind have, of course, to be approached with extreme caution; the results they give are indicative rather than conclusive.

Despite the convergence of national price developments during the period under review, there are still major differences in economic performance among EMS member countries. Germany and the Netherlands enjoy much stronger current-account balances than the other member countries, while some currencies are still protected by exchange controls. Moreover, as long as there are sizable inflation differentials between member countries, periodical realignments of exchange rates will be needed. Nevertheless, if the progress towards convergence that has now been achieved can be maintained, such realignments will become smaller and less frequent

Development of relative costs and prices within the EMS, 1983–86.



[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 consumer prices, calculated as annualised percentage changes over six months. [3] Domestic minus German representative money market rates. [4] In terms of relative consumer prices: end-March 1983 = 100 (semi-logarithmic scale).

and the system of stable, but adjustable, exchange rates will be characterised by stability rather than adjustment.

Gold production and the gold market.

Despite the weakening of the dollar on the exchange markets and social unrest in the principal gold-producing country, the gold market remained fairly depressed during most of the period under review. Abating fears about inflation, booming equity markets and the prospective capital gains to be derived from the downward trend of long-term interest rates kept private investors' demand for precious metals at a low level. On the other hand, there was a further increase in industrial uses of gold, and sizable official gold purchases were made by non-communist countries.

The dollar price of gold fell in late February 1985 to its lowest level since the late 1970s. As its subsequent recovery was too limited to compensate for the depreciation of the dollar, quotations in terms of most other major currencies eased markedly in the course of 1985 and early 1986. The main exceptions to this trend were the two largest non-communist gold-producing countries, South Africa and Canada, whose currencies continued to decline against the US dollar. As a result, in terms of rand the price of gold soared by 36 per cent., while in Canadian dollar terms it increased by 12 per cent. in the course of 1985. The greater part of the world gold-mining industry was therefore not fully affected by the weak market performance of gold. In South Africa, in particular, gold-mining profits in terms of domestic currency showed further increases.

Benefiting from the previous increase of prospecting and development activities, world gold output (excluding that of eastern Europe, China and North Korea) continued to expand last year — by 64 metric tons to 1,213 tons. This was 27 per cent. more than the 1980 production low, but still 5 per cent. less than the previous peak attained in 1970. The largest output increases in 1985 were reported for Australia (18 tons), Papua New Guinea (14 tons) and the United States (10 tons).

In South Africa, too, where activity was affected at times by strikes, gold-mining activity continued to expand, but here the increase in the rand price of gold induced a further shift towards mining lower-grade ores. As a result the somewhat larger volume of ores milled was more than offset by a decrease in their average gold

Estimated world gold production.

Countries	1953	1970	1980	1981	1982	1983	1984	1985
	in metric tons							
South Africa	371	1,000	675	658	664	680	683	673
Canada	126	75	51	52	65	73	83	86
United States	61	54	30	43	45	61	69	79
Brazil	4	9	35	35	35	59	55	63
Australia	33	20	17	18	27	31	39	57
Philippines	15	19	22	25	31	33	34	38
Papua New Guinea	.	1	14	17	18	18	19	33
Colombia	14	7	17	18	16	18	21	26
Chile	4	2	7	12	19	19	18	18
Zimbabwe	16	15	11	12	13	14	14	15
Ghana	23	22	11	13	13	12	12	12
Dominican Republic	.	–	12	13	12	11	11	10
Peru	4	3	5	7	7	10	11	10
Zaïre	11	6	3	3	4	6	10	8
Mexico	15	6	6	5	5	7	7	8
Total listed	697	1,239	916	931	974	1,052	1,086	1,136
Other countries	57	35	38	45	51	60	63	77
Estimated world total*	754	1,274	954	976	1,025	1,112	1,149	1,213

* Excluding the USSR, other eastern European countries, China and North Korea.
Source: Consolidated Gold Fields PLC (London).

content, and, in the absence of the opening-up of new mines, total gold output declined by 10 tons to 673 tons last year. This meant that the share of South Africa in the western world's total gold output shrank further to 55 per cent., compared with nearly 80 per cent. at the time of the 1970 output peak.

As regards other sources of new gold offered on the market, sales by communist countries may be estimated to have expanded by around 100 tons to a total of 250 tons last year. This increase was essentially accounted for by the Soviet Union, which, particularly in the latter part of 1985, stepped up its sales in order to compensate for export revenue shortfalls resulting from the weak trend of oil prices.

Estimated market sources and uses of gold.

Items	1981	1982	1983	1984	1985
	in metric tons				
Production	975	1,025	1,110	1,150	1,215
Estimated net sales by communist countries[1]	300	200	100	150	250
Estimated changes in official gold stocks through market transactions[2,3] (– = increase)	–100	100	70	20	–165
Total (= estimated non-monetary absorption)	*1,175*	*1,325*	*1,280*	*1,320*	*1,300*

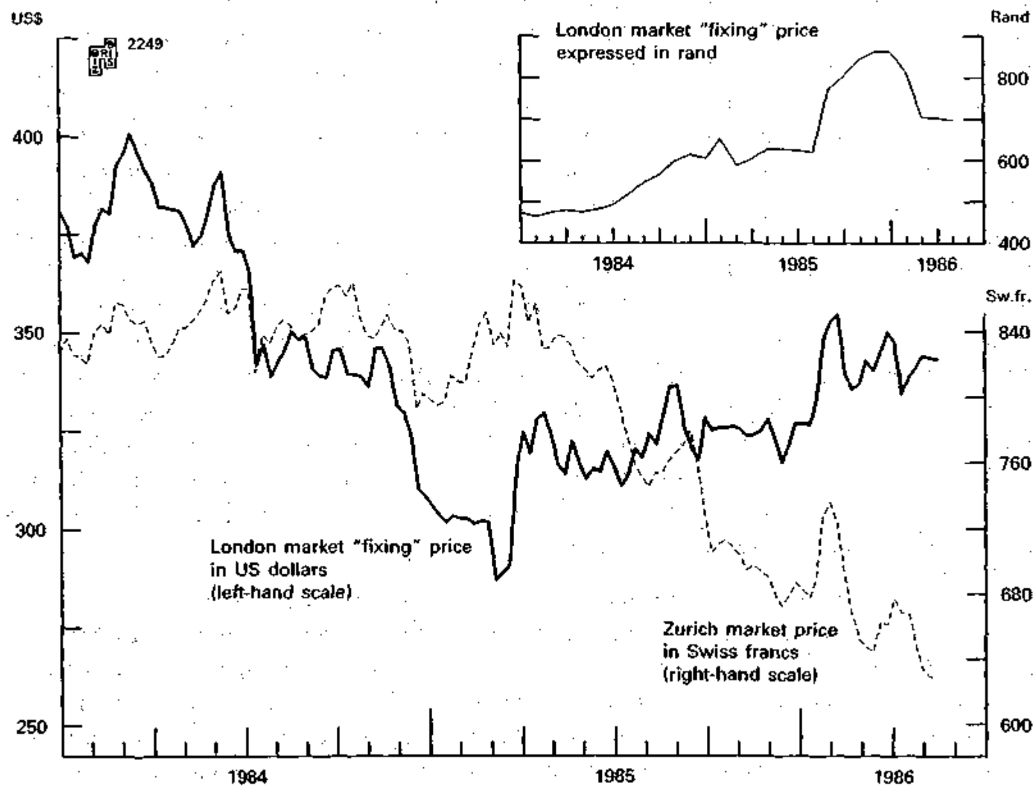
[1] Excluding IMF members. [2] As reported by the IMF. [3] Changes in South Africa's gold reserves have been excluded from the movements of official gold stocks in this table, since they are believed to have largely reflected the execution or unwinding of gold swaps between the South African Reserve Bank and commercial banks in other countries.

On the demand side of the gold market, official gold reserves (excluding those of South Africa), which had been reduced by 20 tons in 1984, are estimated to have shown on balance an increase of 165 tons last year. This turn-round was due in large part to Colombia, whose gold reserves, after having declined by 89 tons in 1984, increased by 14.8 tons in 1985. Other developing countries adding to their official gold holdings last year were Brazil (50.7 tons), which absorbed the bulk of domestic production into its reserves, the Philippines (21.5 tons), India (20.5 tons) and Peru and Taiwan (17 tons each). In the industrial world, Finland acquired 20 tons, whereas the two main gold producers in this group, the United States and Canada, reduced their holdings by 4.4 and 0.9 tons respectively.

The total private absorption of new gold last year may be estimated at 1,300 tons, slightly less than in 1984. Since the use of gold for jewellery and other industrial purposes continued to expand quite strongly, this would suggest that the amount of gold absorbed by investment demand, including purchases of coins and medals, declined markedly.

As far as market price developments are concerned, the dollar price of gold, after falling to a low of $284.25 per fine ounce in late February 1985, recovered to about $334 in mid-April. It subsequently eased again and fluctuated around a level of about $320 during the rest of the year without being much influenced by the further decline of the dollar or the social tensions in South Africa. Only on two days in the second half of August did quotations temporarily move above $340. However, in the second half of December 1985 the changed outlook for the dollar

Market prices of gold, 1984–86.*



* Per fine ounce. The prices in US dollars and Swiss francs are weekly averages, those expressed in South African rand monthly averages.

in the exchange market and sizable official purchases initiated a significant recovery. Quotations rose from a low of $315.50 per fine ounce on 11th December to a peak of $363 on 16th January 1986, before fluctuating around a level of $345 during the following four months.

In contrast to its recovery in dollar terms, the price of gold in terms of Swiss francs and other major currencies has shown a fairly pronounced downward trend since March 1985. In mid-May 1986 it was quoted at around Sw.fr. 620 per fine ounce, down by over 30 per cent. from its level of fourteen months earlier.

Reserves and international liquidity.

Expressed in current dollar terms, countries' official reserve holdings other than gold showed a fairly strong increase of about $42.5 billion, or 11 per cent., last year. However, the bulk of this expansion resulted from valuation effects connected with exchange rate movements. The sharp recovery of most major currencies against the dollar in the course of 1985 meant that the dollar value of official reserves held in these currencies recorded a corresponding increase. Excluding these valuation effects, countries' non-gold reserves expanded by barely $2.5 billion, or 0.5 per cent.

This very modest growth of the volume of non-gold reserves in terms of constant dollars was the net outcome of a number of broadly offsetting developments. On the one hand, the exchange market interventions of the US monetary authorities added about $4 billion to US official foreign currency holdings. In addition, there was some increase in other countries' reserve holdings in currencies other than the dollar, even if exchange rate effects are excluded. On the other hand, the traditional engine of reserve growth — the US current-account deficit — did not come into play last year, since, despite its record size of $118 billion, this deficit was more than financed through private net capital inflows. In fact, foreign countries' official holdings of dollars in the United States declined by $2.2 billion last year. Heavy official sales of dollars, as part of last year's coördinated exchange rate strategy, tended to reduce dollar reserves, but to a large extent this was offset by the taking into reserves of interest income on official dollar assets and other official dollar receipts. A second contractive influence on the volume of total reserves was a decline in the EMS countries' official holdings of ECUs (measured at constant exchange rates), which resulted mainly from the fall in the accounting price of gold used for the creation of ECUs through gold swaps and the lower exchange value of the dollar.

Because of the very large changes in exchange rates which occurred in 1985, the real significance of the $42.5 billion increase in the current dollar value of official non-gold reserves last year is not easy to evaluate. On the one hand, the relatively low rate of inflation in the United States and the decline of about 2 per cent. in the unit value of internationally traded goods would suggest that the increase was largely "real". In fact, as a result of the weakness of export prices, international trade in dollar value terms edged up by only 1 per cent., which meant that the global ratio of official reserves to merchandise imports, measured in current dollar terms, rose from about 21 per cent. to 24 per cent. last year. On the other hand, for purchases of goods and services from industrial countries other than the United States, such as Germany and Japan, the value of official dollar reserves declined markedly last year. For example, expressed in Deutsche Mark, total non-gold reserves shrank by nearly DM 170 billion, or 13 per cent.

The market value of official gold holdings in dollar terms showed an increase last year of $17.7 billion, predominantly as the result of a 5.8 per cent. rise in the free market price of gold.

As regards the asset composition of the increase in non-gold reserves, official exchange holdings expanded by $33.1 billion in current dollar terms, whereas in volume terms the growth amounted to $9 billion, the rest of the increase having represented valuation effects. EMS member countries' ECU balances rose by $3.7 billion in dollar terms; however, at constant exchange rates there would have been a decline of about $5 billion. The dollar value of SDR holdings and reserve positions in the IMF went up by $3.8 and 1.8 billion respectively.

The increase in the dollar value of official SDR holdings was mainly the result of valuation effects ($2 billion) and of the Fund's use of its own stock of SDRs for payments to member countries ($1.5 billion). The limited expansion of reserve positions in the Fund — excluding valuation effects there was actually a decline of

Changes in global reserves.

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							
1983	−0.7	−49.4	2.1	7.2	−3.0	2.1	8.4
1984	−0.6	−53.7	4.5	−0.1	0.6	−6.8	−1.8
1985	−0.2	13.2	13.4	0.8	2.9	3.3	20.4
Amounts outstanding at end-1985	*737.6*	*241.2*	*117.0*	*25.6*	*14.8*	*40.1*	*197.5*
Other developed countries[2]							
1983	−1.4	−6.4	2.5	0.9	−0.6	0.4	3.2
1984	−0.3	−6.3	6.8	−	0.4	−0.3	6.9
1985	−1.9	0.9	6.2	0.1	0.3	0.4	7.0
Amounts outstanding at end-1985	*83.8*	*27.4*	*49.6*	*2.3*	*1.6*	*0.8*	*54.3*
Developing countries							
1983	−0.1	−7.9	0.4	4.7	−0.9		4.2
1984	−0.8	−8.8	13.7	−	0.1		13.8
1985	4.3	3.6	13.5	0.9	0.6		15.0
Amounts outstanding at end-1985	*121.4*	*39.7*	*167.3*	*14.7*	*3.6*		*185.6*
of which:							
Middle Eastern oil exporters[3]							
1983	0.2	−1.5	−8.2	4.3	−0.2		−4.1
1984	0.2	−1.6	−5.0	0.7	−		−4.3
1985	−0.1	0.4	3.8	0.7	0.1		4.6
Amounts outstanding at end-1985	*23.1*	*7.6*	*41.5*	*12.0*	*1.3*		*54.8*
Other							
1983	−0.3	−6.4	8.6	0.4	−0.7		8.3
1984	−1.0	−7.2	18.7	−0.7	0.1		18.1
1985	4.4	3.2	9.7	0.2	0.5		10.4
Amounts outstanding at end-1985	*98.3*	*32.1*	*125.8*	*2.7*	*2.3*		*130.8*
Total							
1983	−2.2	−63.7	5.0	12.8	−4.5	2.5	15.8
1984	−1.7	−68.8	25.0	−0.1	1.1	−7.1	18.9
1985	2.2	17.7	33.1	1.8	3.8	3.7	42.4
Amounts outstanding at end-1985	*942.8*	*308.3*	*333.9*	*42.6*	*20.0*	*40.9*	*437.4*
Memorandum item:							
Eastern European countries[4]							
1983	(1.0)[5]	(0.1)[5]	1.8	−	−		1.8
1984	(0.6)[5]	(−0.2)[5]	2.9	−	−		2.9
1985	(0.3)[5]	(0.2)[5]	4.9	−	−		4.9
Amounts outstanding at end-1985	*(6.1)[5]*	*(2.0)[5]*	*27.7*	−	−		*27.7*

[1] Gold reserves valued at market prices. [2] Excluding eastern European countries. [3] Iran, Iraq, Kuwait, Libya, Oman, Qatar, Saudi Arabia and the United Arab Emirates. [4] The reserve figures given for this group of countries are not all complete. For Hungary and Romania 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 relate to gross deposits held with banks reporting quarterly data to the BIS. [5] Hungary and Romania only.

\$3.1 billion — reflected a further reduction in member countries' net drawings plus the use of SDRs rather than member currencies for loan disbursements.

At SDR 4 billion, gross drawings (excluding those in the reserve tranche) reached only about half their 1984 level and amounted to barely 30 per cent. of their

1983 peak. At the same time, repurchases of currencies increased from SDR 2.3 billion in 1984 to SDR 3.6 billion in 1985. As a result, net new drawings amounted to only SDR 0.4 billion, down from SDR 5 billion in 1984 and the lowest figure since 1980. The main net recipients of Fund credit were Latin American countries (SDR 1.4 billion), notably Argentina (SDR 1 billion) and Mexico (SDR 0.3 billion). Developing countries in Asia and European member countries repaid SDR 0.6 billion each. At the end of 1985 there were thirty-two standby and extended arrangements in effect, while the total undrawn amount of Fund resources committed under these facilities came to SDR 4.7 billion, down from SDR 6.6 billion twelve months earlier.

As regards the geographical distribution of the overall $42.4 billion increase in the dollar value of non-gold reserves during 1985, nearly half was accounted for by the Group of Ten countries. Reserve holdings of other developed countries recorded an expansion of $7 billion and those of developing countries one of $15 billion.

In the Group of Ten the United States recorded by far the largest reserve increase, of $8.3 billion in current dollar terms. Its exchange reserves went up by $6.2 billion, about $2 billion of which was the result of exchange rate effects, while most of the remainder represented the proceeds of official purchases of foreign currencies in the context of last year's co-ordinated exchange market intervention. The current dollar value of the reserves of other Group of Ten countries expanded by $12.1 billion, but this was fully accounted for by valuation effects, as these countries are relatively large holders of non-dollar reserves.

The largest reserve gains in current dollar terms among European Group of Ten countries were made by France ($5.6 billion), which at times experienced substantial capital inflows, and Germany ($4.2 billion), whose ECU holdings recorded a particularly strong increase of $2.7 billion, owing mainly to Italy's use of the new ECU mobilisation facility (see page 157). The United Kingdom, which in September had launched an official $2.5 billion floating rate note issue in the international market, also showed a $3.4 billion increase in the dollar value of its reserves, despite occasional large-scale exchange market operations in support of sterling. Italy's non-gold reserve holdings, by contrast, contracted by $5.3 billion as a result of lira support operations, which were particularly heavy in the last few months of the year. Outside Europe, Japan's and Canada's reserve holdings showed little change, the reserve drain resulting from official sales of US dollars on the exchange market being offset in Japan largely by the interest earnings on foreign currency reserves and in Canada by borrowing in the international financial markets.

In the first quarter of 1986 non-gold reserves (excluding ECUs) of the Group of Ten countries may be estimated to have increased by $5.5 billion. Official foreign exchange holdings rose by $4 billion, or by $5.7 billion if the unwinding of end-year swaps concluded by the Swiss National Bank with commercial banks in Switzerland is excluded. The further expansion recorded in the dollar value of Group of Ten members' reserve holdings reflected in large measure the continued depreciation of the dollar in the exchange market during the quarter. Sizable exchange reserve gains were shown notably by Germany ($2 billion), Japan ($1.2 billion), France ($1.1 billion) and the United States ($1.1 billion). Italy's exchange reserves, by contrast, declined by $2 billion as the country provided substantial exchange market support for its currency during January and March.

Among the "other developed countries", the 1985 reserve gains were largely concentrated on the Nordic countries, with the reserve holdings of Norway, Denmark and Finland expanding by $4.6, 2.1 and 1 billion respectively in current dollar terms. Elsewhere, Portugal's reserves nearly tripled, rising by $0.9 to 1.4 billion. Sizable reserve losses were recorded by Australia (–$1.7 billion) and Spain (–$0.8 billion); the latter country, however, made net repayments of $4.2 billion on its foreign debt.

The $15 billion 1985 increase in the dollar value of the reserves of developing countries was unevenly distributed. Countries in Latin America, which had recorded strong reserve gains in 1984, showed on balance a marginal loss. Venezuela and Argentina reported increases of $1.4 and 1.2 billion (October figure) respectively, but Mexico drew down its reserves by $2.4 billion, while Brazil showed a decline of $0.9 billion.

Outside Latin America, by far the largest gain among developing countries was recorded by Taiwan, whose non-gold reserves rose by $6.9 billion to a total of $22.6 billion, or more than ten times their level of five years earlier. Other Asian countries recording sizable reserve increases were Singapore ($2.4 billion), Malaysia ($1.2 billion) and India ($0.7 billion). China, by contrast, which had built up its reserves considerably in preceding years, reduced its holdings by $4.6 billion in 1985 to help finance a sharply increased volume of imports.

Middle Eastern oil-exporting countries, after having drawn down their reserves by $4.3 billion in 1984, replenished them to the extent of $4.6 billion last year. Sizable reserve additions were reported by Libya and Kuwait ($2.3 and 0.9 billion respectively). Outside the Middle East, Algeria nearly doubled its reserve holdings to $2.8 billion.

Turning to the investment of exchange reserves, the outstanding feature of 1985 was that exchange reserve growth appears to have been entirely in reserves held outside the United States, while official assets in that country showed no increase at all. In fact, reported US liabilities to foreign official holders, excluding dollars swapped against ECUs, declined by $2.2 billion. Moreover, within the total of exchange reserves invested outside the United States, the weight of dollar assets decreased quite considerably.

Official Euro-dollar deposits, which in 1984 had expanded by $8.7 billion, increased only by $1.1 billion last year. This slower expansion was more than offset by the more rapid growth in the dollar value of exchange reserves held in other currencies either in the form of Euro-currency deposits or with commercial banks in national markets outside the United States. At nearly $13 billion, the increase of such assets denominated in currencies other than the dollar was three times as large as in 1984 and boosted the total amount of non-dollar assets held with commercial banks outside the United States to $52.5 billion. However, the largest part of this growth represented valuation changes resulting from the depreciation of the dollar, whereas the volume increase amounted to only $3 billion.

The pattern of investment of exchange reserves.

Items	Flows 1982	1983	1984	1985	Amounts outstanding at end-1985
	in billions of US dollars				
1. Deposits with banks in European countries,[1] Canada and Japan:					
(a) In national markets	– 3.4	– 1.4	1.0	4.8	17.0
Deutsche Mark	– 0.5	– 0.8	– 0.7	0.6	1.8
Swiss francs	– 1.3	– 0.4	–	0.4	1.3
Yen	– 0.4	– 0.3	1.6	2.1	8.4
Pounds sterling	– 0.1	0.4	0.4	1.4	4.0
French francs	– 0.2	–	–	0.2	0.7
Other currencies	– 0.9	– 0.3	– 0.3	0.1	0.8
(b) In Euro-markets	–24.4	– 6.0	10.3	9.1	95.2
Dollars	–12.2	– 8.4	7.3	1.0	60.3
Deutsche Mark	– 6.9	2.0	2.8	3.5	20.0
Swiss francs	– 2.9	– 0.5	–	0.4	4.0
Yen	– 0.8	1.2	0.5	2.6	5.5
Pounds sterling	– 0.6	– 0.1	–	0.1	0.5
French francs	– 1.4	– 0.1	0.1	–	0.4
Other currencies[2]	0.4	– 0.1	– 0.4	1.5	4.5
2. Deposits with certain offshore branches of US banks[3]	– 1.8	0.1	1.6	0.1	5.0
Total 1+2	–29.6	– 7.3	12.9	14.0	117.2
of which: in dollars	*–13.9*	*– 8.3*	*8.7*	*1.1*	*64.7*
in other currencies	*–15.7*	*1.0*	*4.2*	*12.9*	*52.5*
Memorandum items:					
Reported US liabilities to foreign official institutions (excluding dollars swapped against ECUs)	*2.8*	*6.5*	*4.7*	*– 2.2*	*168.1*
Total OPEC[4] deposits with reporting banks[5] outside the United States	*–27.4*	*–17.1*	*– 4.7*	*11.3*	*138.4*

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. From 1984 onwards the figures also include Finland, Norway and Spain. [2] Includes ECUs. [3] In the Bahamas, the Cayman Islands, Panama, Hong Kong and Singapore. [4] Figures for 1984 onwards exclude Bahrain. [5] Up to end-1983, the figures cover the banks of the countries listed in footnote 1 plus US banks' offshore branches in the centres listed in footnote 3. From 1984 onwards the figures include, in addition, 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.

It should be noted that the total expansion of $14 billion in exchange reserves identified in the table above amounted to only 40 per cent. of the $35.3 billion growth in 1985 of exchange reserves held outside the United States. The remaining $21 billion may be traced essentially to three sources: firstly, reserves held with central banks outside the United States, which, owing largely to the additions to US official exchange reserves, appear to have gone up by over $7 billion last year; secondly, reserves held in national markets other than the US market but outside the commercial banking sector, e.g. in the form of money market paper or other securities, where the increase largely reflected valuation effects; and, thirdly, official reserves invested in the Euro-note or Euro-bond market, notably in floating rate paper with relatively short residual maturities. There is, however, very little statistical evidence available on this aspect of reserve investment policies.

In short, while the pronounced exchange market decline of the dollar last year increased the value, in current dollar terms, of exchange reserves held in currencies other than the dollar, it did not give rise to any significant movement of official funds out of dollars into other reserve currencies. Despite the very large official intervention sales of dollars, identified official dollar balances declined only by about \$1 billion. Moreover, last year's increase in US official foreign exchange holdings, in particular, may be considered as a development potentially underpinning future exchange market stability. It would permit the US authorities to continue to play an important role in co-ordinated intervention, should the exchange market conditions for the dollar become very different from those that prevailed last year.

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 role 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. During the course of the year a study group set up by the Committee and composed of officials from the central banks of the Group of Ten countries prepared for the central bank Governors of the Group of Ten countries a report on recent innovations in international banking. The report was published in April 1986. The Bank also continued to assemble, survey and distribute statistical data on developments in the international banking and capital markets.

The Committee on Banking Regulations and Supervisory Practices held four meetings in 1985. In addition to reviewing supervisory developments in individual countries, the Committee directed particular attention to international banks' capital adequacy and to the growth of their off-balance-sheet business. On capital adequacy, the Committee has developed a framework of measurement which seeks to reconcile different national accounting and supervisory practices and thereby to permit broad international comparisons of standards of banks' capital adequacy. The results obtained from applying this framework were examined in the course of the year. The growth and proliferation of new techniques for conducting banking business off the balance sheet also has implications for capital adequacy, and the Committee completed a study on off-balance-sheet instruments and their appropriate treatment for supervisory purposes. A report on this subject, "The management of banks' off-balance-sheet exposures: a supervisory perspective", was circulated to commercial banks early in 1986.

The members of the Group of Experts on Payment Systems continued to keep one another informed of developments in payment media and systems in their respective countries and to compare experience in a number of particular fields, such as cheque truncation and electronic payment at the point of sale. They also studied telecommunication networks dedicated to the transmission of financial messages and analysed the effects which current developments are certain to have on the role and the organisation of both central banks and national banking sectors.

The Group of Computer Experts updated its inventory of data processing at central banks in the course of the year on the basis of a questionnaire, itself amended to take account of the latest developments in data processing. Without losing sight of the purely technical issues (it also examined some of the problems posed by the interconnection of heterogeneous networks) the Group paid special attention to questions of a more general nature, in the knowledge that distributed data processing would inevitably lead to changes within the central banks. It explored, for example, one of the best ways of managing these changes, namely planning them, by drawing up master plans. It also carried out an analysis of the influence that developments will certainly have on the role and composition of data-processing staff and on relations between data-processing services and users.

The Group of Experts on Monetary and Economic Data Bank Questions achieved long-established goals concerning the automated exchange of macro-economic statistics and related documentation, as part of continuing efforts to develop a fully-fledged data bank service for the central banks of the Group of Ten countries and the BIS. Significant advances were also made during the year with regard to the automated reporting and accessing of international banking statistics. In meetings of the Group, increasing attention was given to questions concerning use of the data bank, especially to re-affirming arrangements for the timely availability of new and revised statistics.

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 (EMCF) as well as their sub-committees and groups of experts continued to meet in Basle and to be assisted by a Secretariat provided by the Bank. The sub-committees and groups 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 the 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 twelve 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 1985, the structural changes in the financial field and their consequences for monetary policy.

In the financial year 1985–86, as in previous financial years, 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 drew up and adopted the legal texts necessary for the implementation of a set of measures aimed at strengthening the EMS by improving the conditions governing the use and holding of the official ECU. Most of these measures, on which agreement in principle had been reached on 12th March 1985 (see the Fifty-fifth Annual Report, page 165), entered into force on 1st July 1985. As from that date, the new interest rate formula was applied to net positions in ECUs; another measure included in the July 1985 "package", viz. the mechanism for mobilising official ECUs with member central banks through the intermediary of the EMCF, was activated for the first time in December 1985. Finally, since November 1985 the EMCF has been empowered to grant central banks of non-EEC countries and international monetary institutions the status of "other holder" of official ECUs. In January 1986 the BIS became the first institution to obtain this status.

The Bank continued to perform the functions of Agent for the EMCF 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 1985 to 31st March 1986, interventions carried out by EMS central banks in other member countries' currencies did not give rise to any financing or settlement operations through the intermediary of the EMCF. However, following the monetary realignment on 7th April 1986 sizable interventions were recorded in the EMCF's books. The volume of ECUs issued by the EMCF through quarterly swap operations with each of the EEC central banks (except the Bank of Spain and the Bank of Portugal, which do not participate in the EMS, but including the Bank of Greece, which has participated in the ECU creation mechanism since January 1986) amounted to ECU 43.8 billion at 31st March 1986, or approximately US$41 billion at the rate of exchange prevailing at that date. It may be recalled that at 31st March 1985 the volume of ECUs had stood at almost ECU 52 billion; the decrease of some ECU 8 billion in one year was due to the

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

decline in the price of gold and the exchange rate of the dollar. Transfers of ECUs between the EMS central banks' "ECU reserves" accounts and of interest paid in respect of these central banks' net positions in ECUs totalled some ECU 3.3 billion.

As regards the administration of Community borrowing and lending operations, during the period under review the Agent of the EMCF received from the borrowers and distributed to the creditors vis-à-vis the Community the sums due in respect of interest, premiums, commission and expenses on loans outstanding. It also carried out the financial transactions connected with the following operations relating to the loans on behalf of France and Greece.

(1) The first tranche, amounting to US$ 650 million, of the US$ 1,240 million variable rate syndicated bank loan 1983–90, the proceeds of which had been lent to the Republic of France in 1983, was repaid in advance, while the second tranche of this loan, amounting to US$ 590 million, was converted into two separate public issues on the US market in the form of notes denominated in US dollars, viz.:

- US$ 240 million of notes 1985–88 at 9¼ per cent. per annum,
- US$ 350 million of notes 1985–90 at 9⅝ per cent. per annum.

(2) By virtue of the Decision of the Council of the European Communities of 9th December 1985 and under the terms of Regulation (EEC) No. 682/81 adjusting the Community loan mechanism designed to support the balance of payments of member states, the Community granted to the Hellenic Republic a loan in two equal tranches for a total amount of ECU 1,750 million, or its equivalent in other currencies. The first tranche was made available to Greece upon conclusion of the borrowing operations in January, February and March 1986, and involves the following four public issues:

- ECU 350 million of floating rate notes 1986–93,
- US$ 150 million of notes 1986–91 at 8⅝ per cent. per annum,
- DM 500 million of floating rate notes 1986–92,
- Sw.fr. 227 million of notes 1986–92 at 4⅞ per cent. per annum.

The second tranche will probably be made available one year after the disbursement of the first tranche, i.e. in early 1987.

The following table shows, as at 31st March 1986, the total of outstanding Community borrowing and lending operations under the terms of Council Regulations (EEC) No. 682/81 and No. 543/85.

Outstanding Community loans.

Borrowing countries	US dollars	Deutsche Mark	Swiss francs	ECUs
	in millions			
France	2,740	–	–	150
Greece	150	500	227	350
Total	2,890	500	227	500

2. Clearing system for the private ECU.

In February 1986 the Bank agreed to assume the functions of agent of the private ECU clearing and settlement system set up by the ECU Banking Association. It signed an agreement with the ECU Banking Association to this effect on 21st March 1986. The clearing system can be expected to enter into operation, once the technical details have been settled, in the course of the 1986–87 financial year.

(1) In February 1983 the Bank was approached by a working party which had been set up by a group of commercial banks and the European Investment Bank under the aegis of the Commission of the European Communities with a view to establishing a clearing system for operations in private ECUs. After discussions with the Committee of Governors of the Central Banks of the Member States of the European Economic Community, it was decided to enter into negotiations with the banks, on condition that the planned system remained exclusively within the framework of relations between the BIS and the commercial banks and did not contravene existing exchange control regulations or conflict with the monetary policy objectives of the countries concerned.

Active negotiations began in June 1984 and a clearing system was devised which was finally adopted in March 1986.

(2) The structure and operation of the clearing system are based on three institutions:

- an ECU Banking Association, set up with the broad aim of facilitating operations in private ECUs and the particular purpose of implementing an ECU clearing and settlement system; membership of this Association is open to banks which have their head office or a branch in one of the EEC countries and which demonstrate sufficient interest in the development of ECU transactions; member banks which meet certain criteria laid down by the BIS and the Association may be designated as clearing banks; however, these criteria, relating principally to the level of activity in the ECU market, allow every EEC member country to be represented by at least one of its banks;
- a netting centre, S.W.I.F.T., will be used to operate the clearing at the technical level. In practice, each clearing bank will be linked directly to a central clearing computer;
- the BIS, as agent of the clearing banks, will act as clearing and settlement bank; it will receive deposits in ECUs from the clearing banks and the final clearing balances will be settled over these accounts.

In practice, the system will function as follows:

- the BIS, as agent of the clearing banks, will open and operate clearing accounts in their names;
- each clearing bank will also open an ECU sight account in the books of the BIS;

- every working day the clearing banks will be able to send each other payment orders in ECUs through the netting centre. As it will be a closed system, i.e. total credit operations must equal total debit operations, clearing banks in a debtor position will be able to obtain ECU funds from creditor banks;
- to square the residual balances, the BIS, having established that all debtor clearing balances are covered by credit balances on the respective banks' ECU sight accounts, will carry out the settlement operations.

The limited number of clearing banks initially permitted to take part in the system will subsequently be raised in stages.

3. Operations of the Banking Department.

The Balance Sheet of the Bank and the Profit and Loss Account at 31st March 1986, certified by the auditors, are reproduced at the end of this Report; both are expressed in gold francs.*

At 31st March 1986, the balance-sheet total stood at	GF 26,558,446,075
whereas at the end of the preceding financial year,	
at 31st March 1985, it had amounted to	GF 22,851,917,382
There was thus an increase of	GF 3,706,528,693
or 16 per cent.	

This increase was considerably greater than those recorded at the end of the preceding financial years, as the following table shows. A large proportion of this rise was due to an appreciable increase in the gold franc value of the components of the balance sheet denominated in currencies other than the US dollar.

It should be noted that the appreciation of the currencies in question continued throughout the financial year, with the exception of March 1986, in line with developments on the exchange markets.

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
1982	19,057	− 669	− 3
1983	20,358	+ 1,301	+ 7
1984	21,276	+ 918	+ 5
1985	22,852	+ 1,576	+ 7
1986	26,558	+ 3,706	+ 16

* 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 monthly movements in resources in real terms were slight during the first half of the financial year; thereafter, fluctuations in both directions were much larger.

The balance-sheet total reached its highest level, of 27,873 million gold francs, at the end of February 1986, and then fell back in the last month of the financial year.

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. On 31st March 1986 this item amounted to the equivalent of 1,155 million gold francs (compared with 1,164 million and 1,232 million gold francs respectively at the end of the two previous financial years).

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			
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
1986	1,204	24,684	670	26,558

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 1985–86 GF 523,952,793

This compares with 499.6 million gold francs on 31st March 1985; the difference of 24.4 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 1985–86 GF 332,930,236

This compares with 296.3 million gold francs on 31st March 1985. It has been recommended that an amount of 36.6 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 1985–86, thus amounts to GF 908,483,397
an increase of 61 million gold francs.

(c) The item "Miscellaneous" stood at GF 651,824,211

against 373 million gold francs on 31st March 1985.

It may be pointed out that during the financial year 1984–85 this item had remained virtually unchanged, whereas last year it registered a large increase of 279 million gold francs.

As mentioned earlier, items denominated in currencies other than the US dollar were affected by the increase in the gold franc value of the currencies in question. This movement also affected the item "Miscellaneous".

(d) Profit and Loss Account, *before* allocation GF 80,171,806

This figure represents the net profit for the financial year 1985–86.

Details of the proposed allocation of the net profit, in accordance with the provisions of Article 51 of the Statutes, are given in Section 4 below. A sum of 19,171,806 gold francs, compared with 13,366,633 gold francs in the preceding financial year, is to be set aside in respect of the dividend of 155 Swiss francs per share payable on 1st July 1986; it appears on the liabilities side of the Balance Sheet. In 1985 the dividend paid per share amounted to 145 Swiss francs.

B. Borrowed funds.

The following tables show the *origin, nature* and *term* of the Bank's borrowed resources.

BIS: Borrowed funds, by origin.

Origin	Financial years ended 31st March 1985	Financial years ended 31st March 1986	Movement
	in millions of gold francs		
Deposits of central banks	21,104	23,836	+ 2,732
Deposits of other depositors	219	848	+ 629
Total	21,323	24,684	+ 3,361

The increase in the balance-sheet total was chiefly attributable to the expansion of borrowed resources. Deposits received from central banks showed a rise of 13 per cent., while the growth in deposits from other depositors, reflecting principally new deposits from international organisations, was even more marked in relative terms.

Thus, the share of deposits from central banks in total resources declined to 96.6 per cent. from 99 per cent. at the end of the preceding financial year.

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
	1985	1986		1985	1986		1985	1986	
	in millions of gold francs								
Sight	4,314	4,426	+ 112	312	924	+ 612	4,626	5,350	+ 724
Not exceeding 3 months	78	10	− 68	15,238	18,611	+3,373	15,316	18,621	+3,305
Over 3 months	–	–	–	1,381	713	− 668	1,381	713	− 668
Total	4,392	4,436	+ 44	16,931	20,248	+3,317	21,323	24,684	+3,361

All the movements recorded in this table reveal an underlying tendency towards a shortening of the term of resources received on time account. While the share of sight deposits remained unchanged at 21.7 per cent., that of deposits at not more than three months rose from 71.8 per cent. to 75.4 per cent.; resources at over three months, on the other hand, declined to only 2.9 per cent., against 6.5 per cent. on 31st March 1985.

Whereas total deposits increased, the share of resources in gold contracted to only 18 per cent. from 20.6 per cent., while that of deposits in currencies rose to 82 per cent. from 79.4 per cent.

(a) Deposits in gold GF 4,435,521,350

This compares with a figure of 4,392 million gold francs at the end of the financial year 1984–85, representing a rise of 44 million.

The increase in sight deposits entirely offset the decline in time deposits and reflected in addition net new receipts.

(b) Deposits in currencies GF 20,247,742,186

This item compares with 16,931 million at the end of the preceding financial year, a rise of 3,317 million gold francs, or 19.6 per cent. The new deposits were chiefly in US dollars.

The rise in this item was primarily due to the increase in resources received at terms not exceeding three months. Sight deposits also increased, but there was a decline in deposits at over three months.

ASSETS (EMPLOYMENT OF RESOURCES).

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

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

Nature	Financial years ended 31st March				Movement	
	1985		1986			
	in millions of gold francs					
Sight assets						
Gold	5,021		5,071		+ 50	
Currencies	5	5,026	10	5,081	+ 5	+ 55
Treasury bills						
Currencies		453		919		+ 466
Time deposits and advances						
Gold	77		81		+ 4	
Currencies	14,594	14,671	17,959	18,040	+ 3,365	+ 3,369
Securities at term						
Currencies		2,685		2,506		– 179
Total						
Gold	5,098		5,152		+ 54	
Currencies	17,737	22,835	21,394	26,546	+ 3,657	+ 3,711

(a) Gold GF 5,071,339,196

This compares with 5,021 million on 31st March 1985, representing a rise of 50 million gold francs.

This movement reflects, on the one hand, the net weight of gold received from central banks and, on the other, the net investments of gold made on the market.

(b) Cash on hand and on sight account with banks GF 10,349,300

This item had stood at 5.2 million gold francs on 31st March 1985.

(c) Treasury bills GF 919,176,628

During the financial year under review this portfolio more than doubled, having amounted to only 453 million gold francs previously.

The Treasury bills in question were purchased on various markets and were denominated for the most part in US dollars and Deutsche Mark.

(d) Time deposits and advances GF 18,039,462,503

This compares with a figure of 14,671 million gold francs at the end of the preceding financial year, giving an appreciable increase of 3,369 million, or 23 per cent.

The development of investments in currencies was the result of the increase in resources. The amount of the rise, viz. 3,365 million, also reflects the utilisation by the International Monetary Fund of the balance of the SDR 2,505 million facility granted to it by the Bank in 1984.

(e) Securities at term GF 2,506,303,807

This represents a slight decline of 179 million from the figure of 2,685 million gold francs recorded at 31st March 1985.

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 1985	1986	Movement
	in millions of gold francs		
Not exceeding 3 months	14,077	17,459	+3,382
Over 3 months	3,279	3,087	– 192
Total	17,356	20,546	+3,190

In line with the shift in the term of borrowed resources, it may be noted that there was an increase in investments at not more than three months, while the volume of operations at longer term declined.

Consequently, at the end of the financial year transactions at not more than three months represented 85 per cent., and those at longer term 15 per cent., of total investments (against 81.1 per cent. and 18.9 per cent. respectively at 31st March 1985).

(f) Miscellaneous GF 11,814,640

This compares with 16.5 million at the end of the financial year 1984–85.

Forward gold operations.

These operations, which are mentioned in Note 2 to the Balance Sheet, resulted in a negative balance of GF 54,494,512 whereas at 31st March 1985 the negative balance had amounted to 44.3 million gold francs. The rise in this balance was chiefly due to an increase in the weight of gold involved in swaps (gold received spot) against currencies.

4. Net profits and their distribution.

The accounts for the fifty-sixth financial year ended 31st March 1986 show a net operating surplus of 81,718,965 gold francs, compared with 71,206,434 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 only slightly below those obtaining in 1984–85.

The net operating surplus is shown after deduction of 17,649,171 gold francs in respect of costs of administration, the increase from the previous year's figure of 14,140,343 gold francs reflecting in part the rise 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 rose by some 11 per cent.

The Board of Directors has decided to transfer 1,547,159 gold francs to the Provision for Exceptional Costs of Administration. As a result of this transfer the net profit amounts to 80,171,806 gold francs, against 68,366,633 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 80,171,806 gold francs be applied by the General Meeting in the following manner:

(i) an amount of 19,171,806 gold francs in payment of a dividend of 155 Swiss francs per share;

(ii) an amount of 24,400,000 gold francs to be transferred to the General Reserve Fund; and

(iii) an amount of 36,600,000 gold francs, representing the remainder of the available net profit, to be transferred to the Free Reserve Fund. This Fund can be used by the Board of Directors for any purpose which is in conformity with the Statutes.

If the above proposals are accepted, the dividend will be paid on 1st July 1986 to the shareholders whose names are contained in the Bank's share register on 20th June 1986.

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 1986 and of its profit for the year ended on that date. Messrs. Price Waterhouse & Co.'s report is appended at the foot of the Balance Sheet.

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

During the financial year 1985–86 the Bank, in its capacity as Depositary under the terms of the Act of Pledge concluded with the ECSC, received the equivalent of about 85,000 gold francs for the service of the last loan outstanding under that agreement — the L.fr. 100,000,000 5¼ per cent. Secured Loan (15th Series) 1961–86. The amount received covered the interest payable up to 16th January 1986, the final redemption date, plus the principal due on that date.

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.

The Bank also acted as Trustee for the assented bonds of the Austrian Government International Loan 1930; in December 1985, in accordance with Article XXIV of the General Bond dated 30th June 1930, the Trustee repaid to the Austrian Government all amounts which remained unclaimed by holders of outstanding assented bonds and coupons.

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

At the meeting of the Board held on 10th September 1985 the Chairman announced that Mr. Michael J. Balfour would shortly retire from the Bank of England and therefore relinquish his appointment as Alternate to Mr. Leigh-Pemberton, Governor of the Bank of England. The Chairman expressed the Bank's appreciation of the very valuable services rendered by Mr. Balfour over a period of more than thirteen years.

At the next meeting of the Board, held on 12th November 1985, the Chairman informed the Board that Mr. Leigh-Pemberton had appointed Mr. J.E.W. Kirby, in place of Mr. Balfour, to act as his Alternate in the absence of Mr. Loehnis.

At the same meeting M. Bernard Clappier, whose mandate as a member of the Board was due to expire on 27th November, was re-appointed under Article 27(2) of the Statutes by M. Camdessus, Governor of the Bank of France, for a further period of three years ending on 27th November 1988.

Also at that meeting the Chairman informed the Board that M. Clappier had advised him that he did not wish to be re-elected to the post of Vice-Chairman on the expiration of his term of office on 27th November 1985. The Chairman expressed the Board's most sincere gratitude for M. Clappier's invaluable co-operation and wise counsel during his period of office. At the same meeting Lord Richardson of Duntisbourne was elected Vice-Chairman of the Board for a period of three years ending on 27th November 1988.

M. Pierre Languetin, whose mandate as a member of the Board was due to expire on 31st March 1986, was re-elected under Article 27(3) of the Statutes at the meeting of the Board held on 11th March 1986 for a further period of three years ending on 31st March 1989.

With regard to the Management of the Bank, the Board appointed Mr. Marten de Boer as a Manager of the Bank at its meeting held on 14th May 1985. The appointment took effect as from 1st September 1985.

Dr. Warren D. McClam, who had joined the BIS in February 1954 and had been a Manager in the Monetary and Economic Department since April 1981, retired from the Bank at the end of June 1985. At the meeting of the Board on 10th June 1985 the Chairman thanked Dr. McClam on behalf of all members of the Board for the valuable services he had rendered during a period of more than thirty-one years.

At the meeting of the Board held on 9th July 1985 the Chairman informed the Board of the appointment of Dr. Joseph R. Bisignano to the rank of Assistant Manager as from 1st November 1985.

M. Maurice Toussaint, who had joined the BIS as a Manager in the Banking Department in July 1971, retired from the Bank at the end of February 1986. At the meeting of the Board held on 11th February 1986 the Chairman expressed the Bank's appreciation of M. Toussaint's contribution to the work of the Bank over a period of nearly fifteen years.

On 31st March 1986 Mr. Roger G. Stevenson, Deputy Manager in the Banking Department, retired from the Bank after more than twenty-three years of loyal service. The Chairman paid tribute to him at the meeting of the Board held on 11th March 1986.

At the same meeting the Chairman announced that the Bank had decided to grant, as from 1st April 1986, the title of Deputy Head of the Monetary and Economic Department to Mr. M.G. Dealtry, Manager, in recognition of his long experience and important role in the management of that Department, and to promote Dr. G. Baer to the rank of Assistant Manager, also as from 1st April 1986.

CONCLUSION.

What stands out when one looks at recent developments, and where do we go from here? The favourable developments of last year and early 1986 certainly give cause to hope that the many remaining problems can, if not be solved, at least be reduced in magnitude. Such hope, however, is well-founded only to the extent that these favourable developments were due not merely to fortuitous circumstances, but to a renewed vitality of the economies themselves and a strengthening of market forces, and/or to good economic policy, nationally and internationally.

Looking more closely for what might have been pure strokes of luck for economic policy makers in the developed countries, there seems to be only one area where that might apply: that of commodity prices, and oil prices in particular. For the developed countries the decline in oil prices stands out as a favourable development: it brought down energy prices in general, further reduced inflation rates quite substantially and will tend to boost economic growth. The OPEC cartel had been able to keep oil prices up for much longer than many observers had expected at the end of 1973, to say nothing of the additional strong price rises between 1979 and 1981. The cartel eventually collapsed, firstly because of the steady growth of supplies from non-OPEC sources and secondly as a result of economies in fuel consumption achieved by allowing the price mechanism free play. There is no denying that this development contained some fortuitous elements as far as scale and timing were concerned. But the oil price decline was nevertheless part of the general disinflation process and thus indirectly attributable to anti-inflationary policies pursued in major oil-consuming countries. What can be said about the role of the disinflation process in the case of oil also applies broadly to other commodities, although the wide fluctuations in commodity prices reflect swings in aggregate world demand in a much amplified form because of typical supply rigidities connected with long gestation periods and because of autonomous supply variations.

Given the fortuitous nature of the scale and timing of the oil price decline, the success on the inflation front is not actually as complete as might appear from the present figures. In this respect it is something of a mixed blessing, since it distracts attention from the remaining cost-push elements still at work in virtually all economies. Monetary policy may be relaxed too far and excessive monetary growth may be tolerated in spite of overwhelming evidence pointing to the risk that in the medium term this will rekindle inflation. The oil price drop is also a mixed blessing in another respect, in that it severely aggravates the problems of heavily indebted oil-exporting countries. More generally, weak commodity prices turn the terms of trade against the developing countries, thus adding to the existing imbalances in the world economy (to which we shall revert later).

Nevertheless, to return to our earlier line of thought, the success on the inflation front stands out as an example of what can be achieved if the right policy is pursued with perseverance and with the necessary skill. Very few people would have deemed such success possible only a few years ago. Does this example give grounds for optimism with respect to the problems we still face, in particular that of unemployment? There has in fact been an employment miracle in the United States in recent years, with the rate of unemployment declining despite strong growth in the labour force. The Europeans, having studied it, have, however, seen little hope of being able to copy it. The high geographical and occupational mobility of labour and the differentiation of wage levels in the United States stand in marked contrast to ingrained patterns in Europe. There are also elements in the American employment miracle, such as low productivity growth, which, despite their beneficial effects on the labour market, are not very desirable in themselves. Growth can still be relied on to have some employment effect; in many European countries, however, unemployment is too high to be brought down substantially in this way with present growth rates. But why not go for much higher growth rates than those currently being achieved, now that inflation has seemingly been mastered? This question will presumably be at the centre of the economic policy debate at both national and international levels in the near future. It is a question that is surrounded by deep controversy over the potency of macro-economic policy, with at one extreme the conviction that policy has an all-important role to play, and at the other a purely negative view: the more policy refrains from interfering, the better for the economy. While both credos have their vocal disciples, most policy-makers and academics hold some kind of intermediate position; they agree that policy has a positive role to play, but admit that economic growth is not at the simple command of policy-makers. They are also aware that growth has not only a quantitative aspect; what they seek is growth which feeds on itself and not "growth" that merely reflects increases in public expenditure.

The existence of severe unemployment does not therefore absolve those holding such an intermediate position from asking whether higher real growth rates can actually be achieved in the short term and, if so, whether this can be done without using means which damage the prospects for growth and stability in the medium term. Policy experience since the early 1970s and the extensive discussions about the relative importance of demand-management and supply-side policies have produced ample evidence that simply "spending one's way out of unemployment" is not the solution. The BIS has often emphasised how much depends, in tackling this problem, on improving the flexibility of price and wage formation, on the promotion of labour mobility and on the removal of other rigidities affecting the working of the economy. Whatever is done in this direction can, however, change growth conditions only gradually. Inflation, with its wrong signals for the allocation of resources, and the fight against inflation as well as the drastic shifts in the international division of labour have left their mark on the capital stock in many economies. The precondition for raising the level of employment is to rebuild the depleted capital stock. Employment opportunities cannot be created by government fiat; they can only arise out of the economic process itself, when it becomes economic for firms to invest and to employ more people. The creation of a climate conducive to a revitalisation of the economy is what most policy-makers profess to aim at. They want to have fiscal and monetary conditions which help to set energies free for economic growth and to remove structural rigidities and distortions. Regrettably, all too often this concept is not adhered to in the day-to-day decisions which alone could give substance to it. The result can easily be neither demand management nor an improvement in supply conditions. International discussions just might have the beneficial effect of forcing policy-makers out of such inconsistencies between their words and their deeds.

The background to such discussions is, of course, the persistent payments imbalances among the developed countries, with high current-account surpluses in Japan, Germany and some other European countries on the one hand and a high US current-account deficit on the other. It is only natural that the United States, having long been lectured, at last with some effect, about the linkage between its fiscal deficit and its current-account position, should argue similarly for a fiscal remedy in the surplus countries. The statistical evidence presented in this Report (Chapter IV) does indeed point strongly to the existence of such a linkage if the fiscal deficit is part of a general saving/investment imbalance. To argue on the basis of national accounting and flow-of-funds identities, however, cuts right through the market processes which are behind them and risks presenting a rather mechanistic picture of a particular problem.

As far as the present imbalances are concerned, exchange rate developments had clearly taken on a life of their own and become a separate factor, quite unrelated to the underlying economic conditions. The main reason for this was the — in American eyes typical, to European eyes rather untypical — reaction of the US dollar exchange rate to the high fiscal deficit in the United States. A recognition of the role that exchange rate misalignments had played in producing the current-account imbalances led to the Plaza Agreement in September 1985 (which rivals the Baker initiative on the debt problem as the most important economic policy event of that year). If one views these exchange rate distortions as a major factor behind the present current-account imbalances, it is only logical to expect their removal to lead to a substantial reduction of these imbalances. The changes in the exchange rate structure which have occurred since September should go a long way, perhaps even the whole way, towards that goal. Unfortunately the remedy is not instantaneous; there are long lags and even perverse (so-called J-curve) effects. The fact that the major surplus countries stand to gain most on their trade account from the reduction in oil prices operates in the same direction. But that does not detract from the fact that an important, possibly the most important, move towards a better equilibrium among the developed countries has been made. The essential thing, after all, is not to avoid all deficits or surpluses, but only to eliminate those of an excessive, disruptive nature. What is necessary now is to muster the patience to wait for the effects on the current account which — in the light of the evidence from all major exchange rate changes since the early 1970s — will not fail to come through eventually.

This process can no doubt be supported by new efforts towards better international co-ordination of economic policies among the major countries.

However, while it is easy to agree on the principle that economic policies in different countries should be co-ordinated and should always take the repercussions on other countries into account, the actual process of co-ordination will continue to be difficult. This is not only because policy-makers have different constituencies to think about; more important is that these repercussions are difficult to identify, except in extreme cases. The larger a country is, the closer it comes to the model of the closed economy and the more it will be tempted to act accordingly. The smaller a country, the more it can argue that its actions are irrelevant for the rest of the world. Very few countries are constantly in a position in which they can clearly see that what they do matters as much to others as what others do matters to them. Some progress may be achieved by defining and agreeing on certain indicators which would help to put the process of policy co-ordination onto a more objective basis. However, no set of indicators will relieve the major countries of the obligation to discuss policy co-ordination not only in terms of the specific technical needs of a given situation, but also in a spirit of willingness to adjust domestic policies in the light of their international implications, which include exchange rate considerations. The success of the EMS has been due not so much to the mechanical use of indicators as to the deliberate policy decision to make exchange rate stability an objective to which other objectives should on occasion be subordinated. The good news is that the authorities of the major floating currencies have all now fully accepted greater exchange rate stability as one of their primary policy objectives.

The new pattern of exchange rates is still subject to marked short-term volatility, but it is evident that the authorities have every intention of holding on to what has been achieved. This has given encouragement to those who have long advocated a change in the exchange rate system in the direction of less volatility, and in particular to those in favour of target zones. However, the parties to the Plaza Agreement have consistently stressed that they have not agreed on target zones. When a misalignment of exchange rates has become as obvious as it was before the Plaza Agreement, it is not difficult to agree on the direction in which exchange rates should move. It is quite a different matter to agree on what could be regarded as an equilibrium pattern of exchange rates — even with wide margins. Not even the criteria to be used for such an exercise are obvious. Moreover, agreement on one occasion is no guarantee of timely agreement should changes become necessary later. Such inertia could lead to the emergence of new distortions and misalignments. Above all, however, recent experience with official intervention is not sufficient evidence that exchange rates can always be managed in this way. Its success depended on a rather special combination of circumstances.

If monetary policy alone were to be called upon to support target zones, situations could arise whose end result would be detrimental to international and domestic balance. This is not an imaginary danger. There would be a strong tendency to rely on monetary policy rather than on other policy support because it is the only form of policy which can act as quickly as responses to exchange rate movements require. One can speculate on what the outcome would have been in 1982–85 had the excessive appreciation of the US dollar been countered with an acceleration of monetary expansion in the United States and an increase in interest rates in Japan and Germany. Support for target zones from the whole of the macro-economic policy mix might avoid some of these dangers, but it would raise the very problems of economic policy co-ordination referred to above. The satisfactory functioning of a regional system like the EMS is no proof that a worldwide system of more rigidly managed exchange rates could be established, particularly within a relatively short period. The EMS links countries with for the most part similar structures and of similar size and benefits from policy co-operation in numerous fields; it does not include the world's dominant reserve currency; and its success took years to establish.

The advocates of target zones, however, consider any move towards greater policy co-ordination, as agreed upon in the Group of Ten and the Interim Committee and recently at the Tokyo summit, as a step in their direction. The various policy changes which have taken place in the period under review can in fact be viewed as adding up to a change in the way the exchange rate system works. Increasing weight has been attached by nearly all the major countries to exchange rate considerations in the conduct of their domestic policies. Much more active and co-ordinated use has been made — and so far very successfully — of official exchange market intervention, not only to maintain orderly market conditions and to "lean against the wind", but also to nudge exchange rates in a certain direction. In particular for the United States, the principal reserve currency country, all this represents a fundamental departure from previous policies, based on a recognition that floating without active surveillance of exchange rates can lead to distortions which seriously endanger the free international exchange of goods and services. To give in to protectionist pressures, never very far below the surface anywhere, would jeopardise all that has been achieved in the difficult and slow process of overcoming the problems of the past fifteen years.

To sum up these reflections on the current exchange rate situation, the task facing the authorities of the major western industrial countries is not an easy one. The need to avoid a resurgence of major real exchange rate misalignments and to moderate the market's short-term volatility is now universally acknowledged. At the same time, the US Administration's new policy, the skilful timing of the Plaza initiative and its subsequent success, and the recognition by leading authorities that the exchange markets cannot be left to their own devices have raised expectations that this twofold objective could indeed be achieved: hence the sharply increased importance attached by market participants to the real or perceived intentions of the authorities. It would be a great pity — and could have a gravely destabilising influence on the future development of the market — if these expectations were to be dashed. On the other hand, the premature implementation of even a watered-down version of target zones, at a time of major payments imbalances between the countries concerned, is also fraught with danger, since failure on the part of the authorities to live up to their explicit or implicit commitments could have an equally destabilising effect. However untidy it may seem, a gradual approach, combining verbal guidance, exchange market intervention and visible signs of co-ordinated policy action, seems for the time being to be the only realistic option, perhaps opening up possibilities of more "systemic" changes in the longer term. The success of this approach will hinge critically on the absence of discordant voices and actions, both within and among major industrial countries.

The imbalances between developed countries are one of the major problem areas. Imbalances between developed and developing countries are another, which in the longer run may have even more far-reaching consequences. Among the developing countries, those which have received particular attention in recent years are those which had incurred large debts to private banks in developed countries. Their inability to meet their obligations was therefore not just their own problem; because of the size of the indebtedness and the danger of a cumulation of defaults, it constituted a threat to financial stability in the developed countries too. When in the course of 1985 the considerable progress made in 1984 towards improving the situation of the debtor countries began to stall, it became evident that a new initiative was required. It was necessary to give the debtor countries hope that it was worth their while to continue their efforts towards re-establishing their creditworthiness. Failing this, the consequences for the creditors of a massive default — which had been kept at bay for three years — could again have constituted a threat to the financial system. Once more, the United States was prepared to modify its previous policy stance, putting forward a detailed proposal for dealing with the international debt problem.

The key idea in Secretary Baker's proposal is to strengthen the case-by-case international debt strategy pursued since 1982 through the adoption by heavily indebted countries, many of them in Latin America, of structural adjustment policies to promote sustained growth of their economies. These policies are to be supported by increased structural adjustment lending by the multilateral development banks as well as by new financing from the international banking community, while the International Monetary Fund is to continue to play a central role in the debt strategy. Secretary Baker's proposal was broadly welcomed by all parties to the debt strategy. However, the difficulties involved in its implementation should not be underestimated. Debtor countries will not find it politically easy to make structural adjustments to their economies; a major effort is required from the international development banks to gear themselves up for increased lending to countries prepared to undertake such adjustment; and the commercial banks will want to see programmes agreed between the debtors and the international institutions before they put up new money. Furthermore, the success of the initiative will depend not only on the efforts of the debtor countries, and on the provision of adequate conditional financing, but also on the availability of adequate outlets for debtor countries' exports in the markets of the industrial countries. This will require on the part of these countries the continuation of policies that promote non-inflationary growth and firm resistance to protectionist pressures.

More than six months have now passed since Secretary Baker put forward his proposals. A number of debtor countries are negotiating structural adjustment loans with the World Bank and the Inter-American Development Bank, but none of them has yet formally embarked on a programme of the kind envisaged under the Baker initiative. If the momentum of the initiative is not to be lost, it is vital that one or more debtor countries should as soon as possible put programmes in place that will command the support of all the other parties involved and set their economies on the path towards sustainable growth and renewed international creditworthiness.

One group of developing countries that will need to receive increasing attention in the near future is the group of the poorest countries. As a result of misfortune and mismanagement, many of these countries are now quite unable to extricate themselves from the often rapidly deteriorating situation in which they find themselves. Some have reached a point where they are unable even to meet their relatively minor obligations vis-à-vis the IMF and the World Bank, in spite of the dire consequences this has for them, of making them outcasts of the international monetary system. The IMF's new Structural Adjustment Facility is directed towards these poorest countries. But the question of how to deal with them is an extremely difficult one, quite apart from the problem of moral hazard, which is ever present when special efforts are directed towards a particular group.

On the one hand, it goes against firmly established humanitarian traditions to ignore those who are in great need and are patently unable to help themselves. On the other hand, to apply that same principle to sovereign states would raise a host of issues. It is hard to see how sovereignty could be preserved if a country were taken into an "intensive care unit". And it is equally hard to see who could provide such care. None of the existing international institutions is equipped to deal with such a situation. There is an institutional gap between the IMF, the World Bank and regional development banks, on the one hand, and, on the other, various humanitarian organisations which deal primarily with famine relief. Bilateral development aid, for one reason or another, seems unable to close this gap: traditional ties between individual developed and developing countries have in most cases weakened and neither side shows much inclination to strengthen them again. While this is not a matter directly pertinent to the activities of the BIS, it stands out as perhaps the darkest spot in a picture of the real side of the world economy which otherwise has clearly become brighter during the past year or so.

Against the background of the hopes and concerns expressed in this Report there are two areas of particular relevance to central bank policies — in addition to the exchange rate situation that has already been discussed at some length above.

One is the whole series of profound structural changes affecting domestic and international banking and financial markets, changes which have attracted growing attention not least as a result of research carried out jointly by central banks under the auspices of the BIS. The continued monitoring of these developments, of their impact on the effective implementation of monetary policy and of their potential implications for the smooth functioning of the financial markets will have to remain a dominant concern of the central bank community of the industrial countries.

The other area is that of monetary policy. The welcome decline in inflation rates, at a time when real interest rates still seem relatively high and the need to maintain growth is of paramount importance, could give rise to the temptation to ease monetary policy onto a more expansionary course. Authorities should weigh the pros and cons carefully before yielding to this temptation. Firstly, because — as is argued above — the recent sharp deceleration of inflation owes much to the continued weakness of commodity prices and to the collapse of the oil price; neither of these influences will (or, indeed, should) be permanent. If inflation rates were adjusted accordingly, real interest rates would appear less out of line with historical experience. Secondly, the ability of monetary policy to hold real interest rates down lastingly may be doubted; and to achieve even a short-run reduction may require quite a substantial acceleration of money creation. Thirdly, current rates of expansion of monetary aggregates in a number of major industrial countries are already quite high. Admittedly, it is not easy to interpret the behaviour of money supply figures in a period of disinflation; admittedly, too, the wave of innovations on financial markets may have reduced the significance of specific money supply figures. It is, however, important to distinguish between statistical problems and basic economic relationships. The market process by which too much money eventually leads to inflationary price increases will not be suspended because of difficulties in measuring money. In assessing the current stance of monetary policies, one may have to take into account several indicators which point to a fair degree of liquidity ease in the western industrial world: the boom of stock prices, the steep decline of long-term interest rates, the easy financing of large-scale take-overs, the general ebullience of financial markets and the borrowers' market for all creditworthy international borrowers. In considering any further discretionary relaxation of monetary policies in these circumstances the authorities would need to take into account the risk of building up an inflationary potential for the future. This would endanger the chances of sustainable growth and of a gradual but lasting further decline of interest rates. These objectives are best served by maintaining the economy on a moderate but steady growth path.

A. Lamfalussy
General Manager

BANK FOR INTERNATIONAL SETTLEMENTS

BALANCE SHEET AND PROFIT AND LOSS ACCOUNT

AT 31st MARCH 1986

BASLE

BALANCE SHEET

ASSETS

(Before and after

		Gold francs
Gold		5,071,339,196
Cash on hand and on sight account with banks		10,349,300
Treasury bills		919,176,628
Time deposits and advances		
Gold		
Not exceeding 3 months	80,815,401	
Currencies		
Not exceeding 3 months	16,036,416,497	
Over 3 months	1,922,230,605	
		18,039,462,503
Securities at term		
Not exceeding 3 months	1,341,545,063	
Over 3 months	1,164,758,744	
		2,506,303,807
Miscellaneous		11,814,640
Land, buildings and equipment		1
		26,558,446,075

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 1986, gold payable against currencies on forward contracts amounted to 54,494,512 gold francs.

AT 31st MARCH 1986

allocation of the year's Net Profit)

LIABILITIES

		Before allocation Gold francs	After allocation Gold francs
Capital			
Authorised: 600,000 shares, each of 2,500 gold francs	1,500,000,000		
Issued: 473,125 shares	1,182,812,500		
of which 25% paid up		295,703,125	*295,703,125*
Reserves			
Legal Reserve Fund	30,070,313		*30,070,313*
General Reserve Fund	499,552,793		*523,952,793*
Special Dividend Reserve Fund	21,530,055		*21,530,055*
Free Reserve Fund	296,330,236		*332,930,236*
		847,483,397	*908,483,397*
Deposits (gold)			
Central banks			
Sight	4,399,310,101		
Not exceeding 3 months	9,603,969		
Other depositors			
Sight	26,607,280		
		4,435,521,350	*4,435,521,350*
Deposits (currencies)			
Central banks			
Sight	907,301,172		
Not exceeding 3 months	17,806,532,730		
Over 3 months	712,810,764		
Other depositors			
Sight	17,107,405		
Not exceeding 3 months	803,990,115		
		20,247,742,186	*20,247,742,186*
Miscellaneous		651,824,211	*651,824,211*
Profit and Loss Account		80,171,806	—
Dividend payable on 1st July 1986		—	*19,171,806*
		26,558,446,075	*26,558,446,075*

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 1986 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, 9th May 1986

PRICE WATERHOUSE & CO.

PROFIT AND LOSS ACCOUNT
for the financial year ended 31st March 1986

		Gold francs
Net interest and other income		99,368,136
Less: Costs of administration:		
Board of Directors	227,637	
Management and Staff	13,013,979	
Office and other expenses	4,407,555	17,649,171
Net operating surplus		81,718,965
Less: Amount transferred to Provision for Exceptional Costs of Administration		1,547,159
Net Profit for the financial year ended 31st March 1986		80,171,806

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: 155 Swiss francs per share on 473,125 shares	19,171,806
	61,000,000
Transfer to General Reserve Fund	24,400,000
	36,600,000
Transfer to Free Reserve Fund	36,600,000
	—

MOVEMENTS IN THE BANK'S RESERVES
during the financial year ended 31st March 1986

in gold francs

I. Development of the Reserve Funds resulting from allocations for the financial year 1985–86

	Legal Reserve Fund	General Reserve Fund	Special Dividend Reserve Fund	Free Reserve Fund
Balances at 1st April 1985, after allocation of Net Profit for the financial year 1984–85	30,070,313	499,552,793	21,530,055	296,330,236
Add: Allocations for the financial year 1985–86 ...	—	24,400,000	—	36,600,000
Balances at 31st March 1986 as per Balance Sheet	30,070,313	523,952,793	21,530,055	332,930,236

II. Paid-up Capital and Reserve Funds at 31st March 1986 (after allocation) were represented by:

	Paid-up Capital	Reserves	Total
Net assets in			
Gold	295,703,125	366,435,610	662,138,735
Currencies	—	542,047,787	542,047,787
	295,703,125	908,483,397	1,204,186,522

BOARD OF DIRECTORS

Jean Godeaux, Brussels	Chairman of the Board of Directors, *President of the Bank*
The Rt.Hon. Lord Richardson of Duntisbourne, London	Vice-Chairman

Prof. Paolo Baffi, Rome
Michel Camdessus, Paris
Dr. Carlo Azeglio Ciampi, Rome
Bernard Clappier, Paris
Bengt Dennis, Stockholm
Dr. W.F. Duisenberg, Amsterdam
Pierre Languetin, Zurich
Robert Leigh-Pemberton, London
Karl Otto Pöhl, Frankfurt a/M.
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
J.E.W. Kirby, 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
Prof. Dr. F.-E. Klein	Legal Adviser, Manager
M.G. Dealtry	Deputy Head of the Monetary and Economic Department, Manager
Marten de Boer	Manager

Robert Chaptinel	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
Dr. Joseph R. Bisignano	Assistant Manager
Dr. Gunter Baer	Assistant Manager