OECD ECONOMIC OUTLOOK

5

JULY 1969

ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

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CONVENTIONAL SIGNS

$	US dollar	—	Irrelevant	*In charts:*	
c	US cent	.	Decimal point		
£	Pound sterling	I, II	Calendar half-years		
...	Data not available	Q1, Q4	Calendar quarters	S	Strike
0	Nil or negligible	Billion	Thousand million	B	Break in series

SUMMARY

Economic Prospects to Mid-1970

The expansion of activity has slowed down much less in the last six months than expected. In particular, demand in the United States has been stronger and more resistant to fiscal and credit action than envisaged, and although its pressure is now weakening, the full impact of cost increases on prices has begun to appear. In most other OECD countries—Germany and France are outstanding examples—the strength of demand also proved unexpectedly high. In the United Kingdom, exceptionally, demand pressures have eased much as expected in last December's issue of the OECD Economic Outlook. In total, the rise in OECD output in the first half of 1969 may have been nearly twice as fast as foreseen late last year—an annual rate of perhaps 5 per cent instead of 2½ per cent.

As a result, international trade has also continued to expand strongly. The trend has been distorted by various temporary factors—dock strikes in the United States and the immediate aftermath of the German border tax measures. Allowing for these factors, OECD exports and imports in the first half of 1969 appear to have risen at an underlying annual rate of 13-14 per cent or so, much the same rate as between 1967 and 1968, and contrasting with only 5½ per cent in the year before that.

Persistent imbalances, both internal and external, have necessitated strong policy action. The measures taken to secure a period of disinflation in the United States and one of rather restricted growth of domestic demand in the United Kingdom, together with the similar intentions of the French authorities, point to a slower expansion of total demand and output in the year ahead. So do capacity limitations in Germany. The growth of GNP for the OECD area as a whole may fall to some 3½ per cent between the first halves of 1969 and 1970, with the growth of trade following suit. The rise in the value of OECD imports may be, say, 9 per cent between the first halves of 1969 and 1970.

Summary of underlying trends[a]

Percentage changes, annual rates seasonally adjusted

	1967	1968	1969 I	1969 II	1970 I
Real output (GDP or GNP)					
United States	2½	5	3	1½	2¼
Other OECD	4½	6½	7	5¾	5
TOTAL	3½	5½	5	3½	3½
Prices (GNP deflator)					
United States	3	3¾	4¼	3¾	3¼
Other OECD	2¾	3½	3¾	3½	3¾
TOTAL	3	3¾	4	3½	3½
OECD trade					
Imports	5½	12½	13½	9½	8½
Exports	5½	12	13½	9¼	8¼

a) For various adjustments see footnotes to Tables 2 and 7.

THE PROBLEMS OF MAJOR COUNTRIES

Though many countries now face both internal inflation and external imbalance, the nature of their problems varies.

In the United States, policy is directed towards a slowing down of growth so as to bring price inflation under control and improve the current balance of payments. A stringent monetary policy is now being used to reinforce earlier fiscal measures. There seems likely to be a slowing down of expansion in the second half of this year, followed perhaps by slight acceleration in the first half of 1970 to an annual rate of growth of around 2 per cent; unemployment would thus show a gradual increase from its present relatively low level. But it is impossible to forecast turning points precisely: expansion could continue more buoyantly or there could be a more abrupt adjustment if there were, for example, a shake-out of stocks, a large cut in investment plans or a marked rise in the personal savings ratio. Since the United States accounts for half the GNP of the OECD area, its development may have important repercussions on other countries.

In the United Kingdom, the main objective of demand management is to make room for the improvement of the balance of payments; demand restraint should also help the cost/price situation. In France, the economy in recent months has shown signs of over-heating. This, together with confidence factors, has been reflected in exceptionally high imports since April. In its early statements the new Government has stressed the need for a return of confidence: the first action has been to tighten monetary policy to restrain the growth of demand.

In Italy, expansion seems likely to be quite strong ; but the external current account surplus may remain very high in relation to GNP—considerably higher than in other surplus countries. The aim of diverting the use of resources to domestic development seems unlikely to be fulfilled in the near future. Japan has recently emerged into a surplus position: though 1969 is another year of fast growth, Japan's current external surplus is now as large as Italy's. Germany is facing exceptionally high demand pressures which are producing a faster rise of prices, but the economy is now so competitive that a substantial current account surplus seems likely to remain. Domestic and external considerations thus pull in different directions. Demand management policies have been tightened somewhat in the face of inflationary pressures, but domestic disinflation, if carried far, would enlarge the current external surplus ; and if it took the form of monetary restraints, this could put a brake on capital outflows—even if interest rates in Germany remained lower than elsewhere—and thus further swell the overall external surplus.

PROSPECTS FOR PRICE MODERATION

The rise in the general price level in the OECD area as a whole was unusually large last year. In the United States, the price rise was the largest in the last decade, and in Europe increases were rather large in several countries. The policies now being pursued could lead to a considerable easing from now on of the pressures behind the unusually rapid price increases of the last eighteen months, at any rate in some countries. (A review of price developments is on pages 14 to 18). In the United States, where both cost inflation and inflationary expectations have added to the strength of investment and consumption, falling demand pressures could significantly reduce the rate of price increase by mid-1970. In Europe, the change-over to TVA—already completed in several countries but imminent in others—has meant exceptional increases in consumer prices; in the United Kingdom, heavy reliance on indirect taxation for demand management has had the same effect. Such shifts of taxation may have unintended repercussions on wage demands and on cost pressures and *may, as in the Netherlands, lead to price increases greater than justified by the tax changes. In several European countries, completion of the tax changes and lower demand pressures should lead to some easing of the course of prices. But this may not be general. In Belgium, the change-over to TVA is due at the beginning of 1970. In France, the effects on prices of last year's wage explosion and its aftermath may still be working themselves through. High demand pressures in Germany are now causing some acceleration of the price rise and in Italy the exceptionally low increases of the past year or two may not continue. In both France and Italy much may depend on the outcome of wage negotiations in the autumn.*

PROBLEMS OF PAYMENTS DISEQUILIBRIUM

Imbalances in international payments, despite earlier hopes, are still large, and are likely to remain so despite the improvement which seems probable over the next twelve months. Some of the issues this raises are discussed on pages 28 to 32.

Balances on Current Account
$ billion, annual rates seasonally adjusted

	1969 I	1970 I
United Kingdom	–0.3	0.6
United States	–0.5	1.0
Italy	3.1	2.0
Japan	2.6	2.5
Germany	1.5[a]	1.6
France[b]	–0.8	0.0
Canada	–0.8	–1.0

a) Say $ 2½ billion, underlying, after removing distortions to trade at end-1968 caused by the introduction of the border tax measures.
b) Transactions with non-franc countries.

Disinflation should improve the United States' current external balance; the deterioration of the trade balance should be halted and a surplus re-established. But the swing could well be less than hoped earlier, and a full and early recovery to the level of current account surplus prevailing in 1964-67 (an average of $ 3½ billion) seems unlikely. If the improvement proves slow it may raise difficult questions —for instance, a need to maintain, in the longer term, interest rates in the United States which are high in relation to those elsewhere. Prospects for the United Kingdom are subject to somewhat similar uncertainties. Progress towards surplus since devaluation has been disappointingly slow. The current account may have reached an approximate balance in the first half of this year (the authorities have recently stated that published figures understate export earnings); nonetheless, achievement of an external surplus of $ 720 million on current and long-term capital account—the objective for the year to March 1970—would still be small, both in relation to the earlier target of a rate of surplus of $ 1.2 billion, and to the volume of debt to be repaid.

Italy and Japan—the largest surplus countries—could have surpluses at annual rates of $ 2 and $ 2½ billion in the first half of 1970. Germany's surplus could be a little less—perhaps at rate of $ 1½ billion—but since this would be at a time of unusually high demand pressures, it would understate the underlying strength of the German position.

Italy's surplus on current account has been between $ 1½ and $ 2½ billion a year ever since 1965 ; despite the need for domestic development it does not seem likely *to be quickly reduced. The German surplus is, in part at least, a by-product of the 1967 recession : German costs improved markedly relative to those of other countries and the limited border tax measures announced last November may have offset only some of this advantage. Letting inflationary pressures in Germany take their course would hardly be a satisfactory way for it to be further reduced. The Japanese surplus may be weakened by improvements in the United States balances; but it seems likely to remain large—and Japan would gain from any move towards better balance by other surplus countries.*

Judgment of the present and prospective pattern of current balances needs to take into account that, surpluses and deficits being inter-connected, action by one country to change its position implies contrary effects on others. Disinflation in the United States may have important effects for Japan. But it is equally true that if, for example, Italy succeeded in reducing her surplus to small dimensions, it would tend to increase those of Germany and Japan as well as benefiting, perhaps, the United Kingdom and France. By the same token, reduction of the German surplus would tend, among other effects, to increase that of Italy.

Despite the development of an unsatisfactory pattern of surpluses and deficits on current account, levels of activity and of international trade have gone on rising strongly. One important reason why this has been possible has been the rapid development of new patterns of long-term capital flows, partly induced and partly spontaneous. Another important factor has been collaboration between national authorities to develop swap arrangements and other short-term assistance. Experience has shown that, for a time, an individual country may have open to it a rather wide range of current account positions which are compatible with a manageable overall position. But it becomes increasingly pressing for countries to achieve balance of payments structures which can be regarded as appropriate on national and international grounds.

7th July 1969.

GENERAL TRENDS IN OECD COUNTRIES

DEMAND MANAGEMENT

In the last six months activity—and trade—in the OECD area have continued to expand strongly, despite earlier expectations of a slowdown. Some features of the past year or so are described in the first part of this section. Slower growth is likely in the year ahead: growth of total output for the OECD area may be only 3½ per cent or so, compared with an annual rate of 5 per cent in the first half of this year. The reasons for this deceleration are reviewed next. More detailed accounts of the seven major countries, and of Finland, begin on page 60.

RETROSPECT

In the second half of last year output was expanding strongly in nearly all OECD countries. The United States economy was responding only slowly to disinflationary policies and in Europe demand was building up rapidly, with general reflation continuing in Germany and a resurgence of demand in France after the disturbances of the early summer. Demand has continued to rise strongly this year, with still only slow deceleration in the United States and high levels of demand nearly everywhere in Europe. Only in the United Kingdom has pressure eased so far this year as much as expected.

An important part of the strength of demand in the second half of last year was the widespread upsurge of industrial investment and this has continued to be an important factor this year. The general upsurge of private fixed investment (excluding residential construction), at an annual rate of increase of nearly 12 per cent, contributed nearly 1½ per cent to the rate of growth of total domestic demand in the second half of 1968 (see Chart A). This rate is likely to have been maintained in the first half of 1969: perhaps over a third of the increase in total domestic demand in the seven major countries so far this year can be ascribed to this one component of demand.

A sharp rise in stockbuilding was also important in the second half of last year (the turnaround in France after the fall in stocks in the early summer was specially marked) but, in total, this has probably not continued to be an expansionary factor this year. Fixed investment and consumer demand are now the main sources of rising demand for the area as a whole.

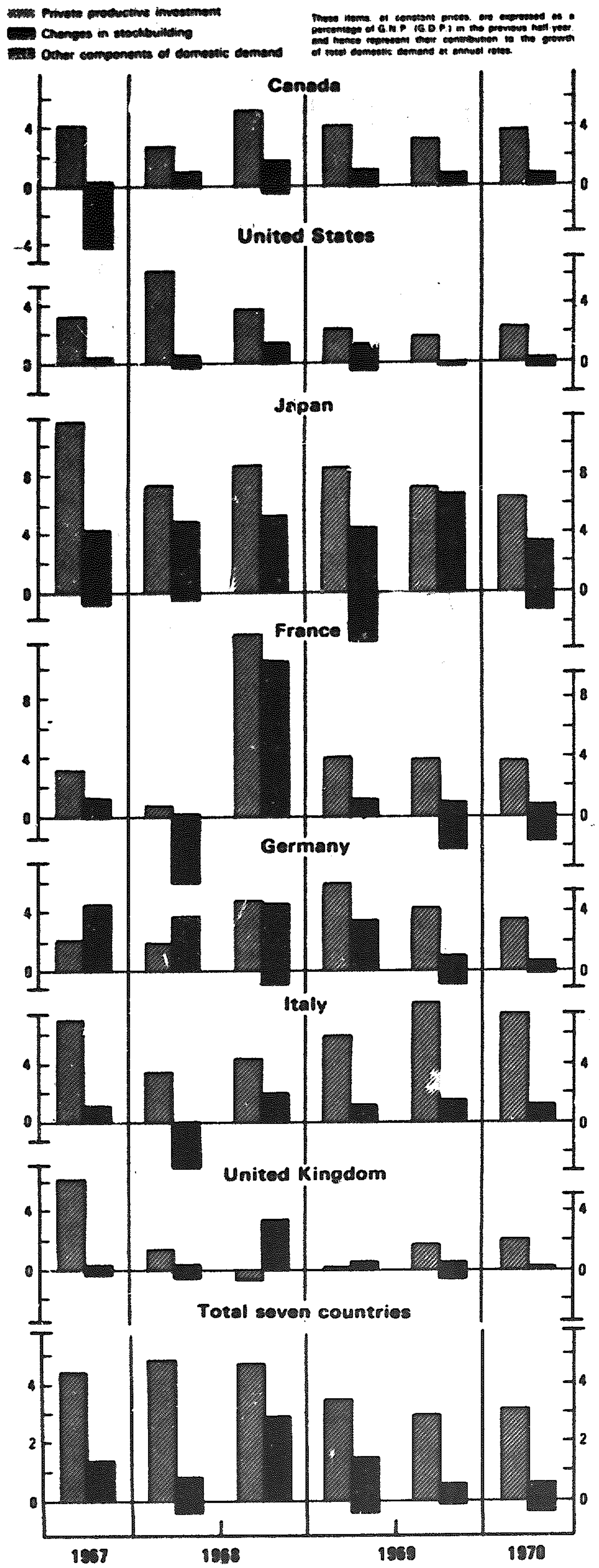
TABLE 1.
OECD industrial production 1968-1969
(1967 = 100)

	1968 Q1	1968 Q2	1968 Q3	1968 Q4	1968 Average	1969 Q1	1969 April
United States	102.5	103.9	104.5	105.9	104.2	107.6	108.7[a]
Canada	101.7	104.5	105.5	108.6	105.1	110.4	110.6
France	105.1	88.3	108.3	113.9	103.9	115.0	117.5
Germany	104.6	110.8	113.8	119.2	112.1	121.9	121.9
Italy	104.1	105.3	106.6	109.5	106.4	111.7	114.8
United Kingdom	103.3	103.8	105.6	106.8	104.9	107.3	107.1
Japan	109.4	115.1	119.8	125.2	117.4	126.5	135.8
Total OECD	103.8	104.6	107.5	110.1	106.5	111.7	113.4

a) United States : May = 109.3.

CHART A

STOCKBUILDING, PRODUCTIVE INVESTMENT AND DOMESTIC DEMAND



In the second half of last year the growth of OECD industrial production spurted to an annual rate of 10 per cent, but this owed something to temporary factors. A short pause followed early in 1969 but rapid expansion was resumed in March and April. In Japan, there was a brief interruption in the boom in the first quarter, perhaps associated with stock adjustments, but in April industrial production showed a further sharp rise. In Germany, anticipation of the export tax, announced in November, was partly responsible for the spurt in production at the end of the year and for the pause early this year. By March-April production again slightly exceeded the December peak. In France, the level of industrial output around the turn of the year—in January 1969 it was more than 12 per cent higher than a year earlier—resulted partly from a sharp upsurge of consumer demand at a time when stocks of finished goods were still seriously depleted. At the same time, export and investment demand were strong. Given spare capacity and scope for increasing productivity, industry was able to step up production to match demand but by the spring capacity utilisation was reaching a level only surpassed in the 1956 boom. In the United Kingdom, production was rising sharply last year but levelled out in the early months of this year, following tax increases in November and reflecting also disappointing exports in the early months of this year. In the United States, however, production has risen continuously—by May it was 3 per cent higher than it had been six months earlier. Production has also risen rapidly in Canada, with strong consumer and investment demand.

PROSPECTS

The need for a period of disinflation in the United States and for restricted growth of domestic demand in the United Kingdom and France, and the measures already taken to secure these objectives, point to slower growth of demand and output in the year to the middle of 1970. So do capacity limitations in Germany.

Demand pressures have weakened a little in the *United States* in recent months, but the full impact of cost increases has begun to be felt on prices. An important part of the persistent strength of demand

—in addition to consumer spending—has been the unexpected strength of business fixed investment. The recent increase in it does not seem to be justified by current levels of plant capacity utilisation and it is difficult to say how far it may have been provoked by expectations of higher investment costs or by firms taking a longer-term view of demand prospects and possible wage cost developments.

The authorities have responded to the continued buoyancy of demand with an increasingly stringent monetary policy. With the raising of the prime rate to 8½ per cent in June, interest rates generally reached record levels. Proposals have also been tabled for fiscal policy. They include the repeal of the investment tax credit and the extension of the surcharge on personal and corporate income taxes, at an unchanged rate in the rest of this year and at reduced rates in the first half of next. These policies seem likely to secure a further progressive slowdown in the second half of this year. The annual rate of growth between the second and fourth quarters of this year might be around 2 per cent or possibly less, the rate might be little more early next year. By mid-1970 a significant margin of unutilised capacity would then have appeared; unemployment might be 4¾ per cent and the rate of rise of the price level distinctly less than at present. But the range of uncertainty is clearly wide.

The slow response of the economy so far to restrictive action raises the question of whether demand might not continue to exceed forecasts with little or no reduction in inflationary pressures, for instance, because of a resilience of business investment, a substantial decline in the savings ratio (which is still rather high by historical standards) or serious slippage in the restraints on public expenditure. Equally, there could be a more abrupt adjustment than at present envisaged, with, for instance, involuntary stock accumulation followed by a sharp reversal, a rise of the savings ratio and a larger downward revision of investment plans in response to unfulfilled sales expectations.

Such developments could result in a standstill—or even some decline—in real GNP during one or two quarters. In these circumstances, there would be a faster rise in unemployment, with all its social costs,

TABLE 2

Changes in real Gross Domestic Product and total Domestic Demand

Estimates and forecasts
Percentage at annual rates
Seasonally adjusted

Country or group of countries		Weight in 1967[a]	From previous year 1967	1968	1969	From previous half-year[b] 1968 I	1968 II	1969 I	1969 II	1970 I
United States	GNP	51.0	2.4	5.0	3¼	5.8	5.0	3	1½	2¼
	DD		2.7	5.4	3	6.6	5.0	3	1½	2¼
Canada	GNP	3.7	3.1	4.7	5	5.9	6.6	4¾	4¼	3¾
	DD		2.0	3.4	5¼	3.7	6.6	5¼	4	3¾
France	GDP	7.5	4.5	4.2	8	−3.7	21.1	4½	3½	3½
	DD		4.6	4.5	8½	−3.8	22.8	5¼	2½	2¾
Germany	GNP	7.8	0.0	6.7	6½	5.4	10.2	5½	4½	3
	DD		−2.1	6.5	8	5.6	8.3	9½	4	4
Italy	GDP	4.5	6.5	5.4	7¼	4.3	6.1	7¾	7	7
	DD		7.4	4.0	7½	0.6	6.9	7	9	8½
United Kingdom	GDP	6.9	1.8	3.1	1¾	4.4	2.4	½	3¼	2¾
	DD		3.0	2.4	1	2.1	1.4	½	2	2¼
Other Europe	GDP	10.9	3.8	4.5	5½	4.5	5.1	5½	5½	5½
Japan	GNP	7.7	12.9	14.4	12½	14.7	14.3	11½	13¼	9
	DD		14.5	13.4	11½	12.5	13.7	9¼	14	8½
TOTAL OECD	GNP = DD	100.0	3.5	5.7	5	6.0	6.1	5	3½	3½
Of which:										
OECD excl. U.S.A.	GDP	49.0	4.6	6.4	6¾	6.5	7.1	7	5¾	5
OECD Europe	GDP	37.6	3.2	4.9	5¾	4.9	5.7	6½	4½	4
EEC	GDP	22.5	3.5	5.7	7	5.3	6.9	8½	4¼	4

GDP = Gross Domestic Product.
GNP = Gross National Product.
DD = Total Domestic Demand (including stock building).

a) Member countries' GDP for 1967 converted into dollars at current rates of exchange.

b) The half-yearly figures for the total OECD and the three sub-totals have been adjusted for the distortions caused by fiscal measures in Germany at the end of 1967 and 1968 and by the French strikes.

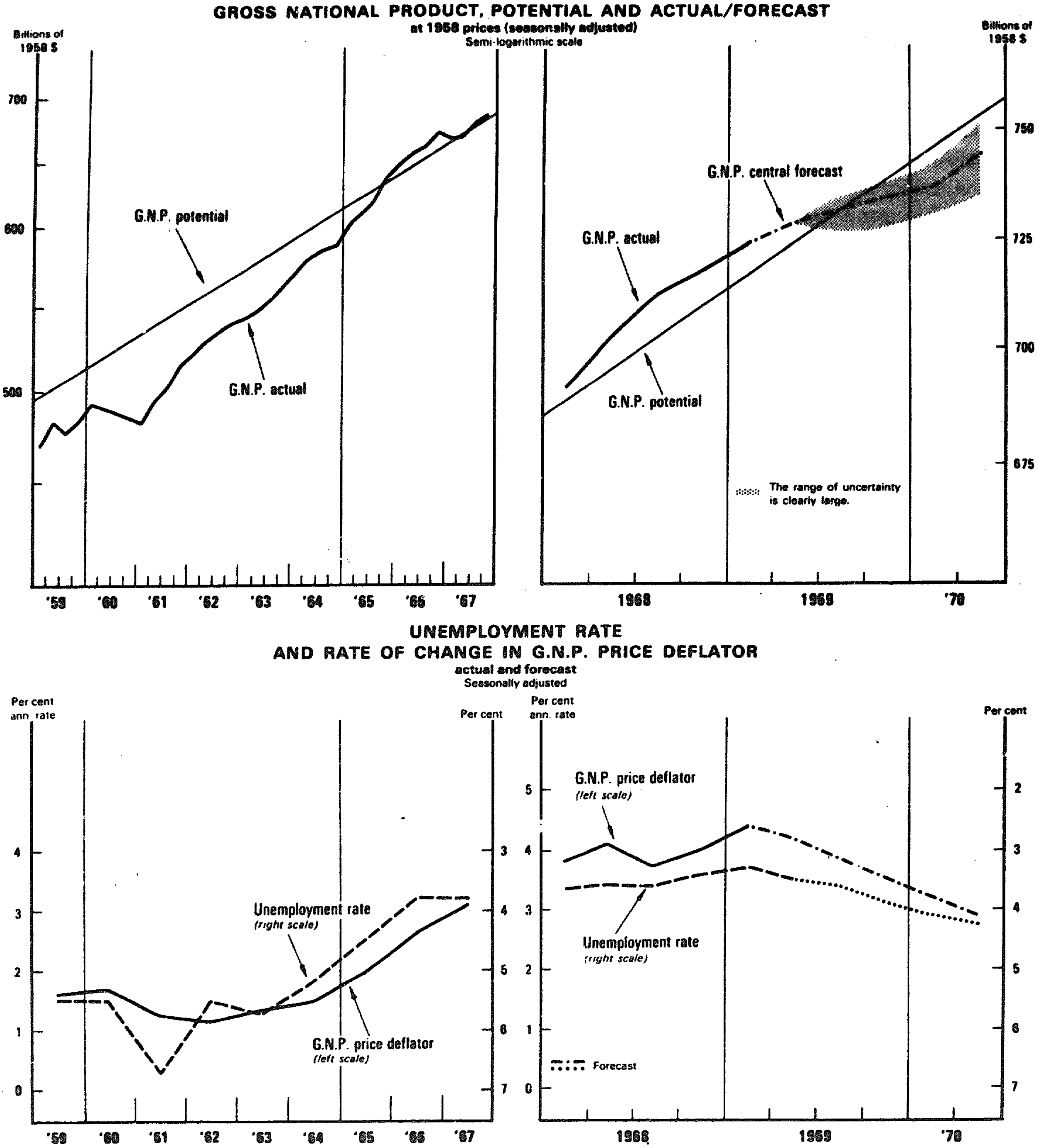
CHART B

UNITED STATES

GROSS NATIONAL PRODUCT, POTENTIAL AND ACTUAL/FORECAST

at 1958 prices (seasonally adjusted)

Semi-logarithmic scale



but, given the policy weapons at the disposal of the authorities, the strong underlying demand for housing and the backlog of social programmes, there would seem little risk of a cumulative recession developing.

In the *United Kingdom* and in *France* the objectives of demand management policies—to make room for improvement of the external current account—are clear. Developments into 1970 will depend on the determination with which appropriate policies are pursued. In both countries, a restrictive fiscal policy is being followed and both are relying heavily on monetary policy to control demand. In both countries domestic demand is potentially strong and restraint is also needed because of the cost-price situation and its possible impact on wage developments and consumers' attitudes. In 1968 each country experienced unusual cost increases—the consequences of devaluation in the United Kingdom and of the Grenelle agreements in France. In addition, fiscal measures produced substantial increases in consumers' prices. It is important to prevent the emergence of a price-wage spiral and to break inflationary expectations which might result in a decrease in savings. In France, in particular, improvement of the external current account is likely to depend heavily on the avoidance of new speculative pressures and inflationary price and wage developments.

There are, however, considerable differences between the two countries. In the United Kingdom, demand pressures eased significantly in the first quarter of 1969 under the combined impact of a fall in personal consumption—following tax increases last November—and a pause in the growth of both exports and private investment. The check to the growth of output is not likely to be prolonged. Export prospects seem quite good, and fixed investment is expected to rise—though the latest survey of business intentions suggests it will not be as powerful as expected earlier (perhaps lessening the short-run risk of overloading in the engineering industries)—and the trend of consumer demand is upward, though restrained by fiscal and monetary policies. During the coming year output could rise by a little under three per cent, with a smaller increase in domestic demand and a shift of resources to the balance of payments. But even if the authorities' present aim for the balance of payments were achieved, this would still fall short of the rate of surplus needed, given the volume of debt outstanding.

In France the savings ratio appears to have fallen further in the early months of 1969. Private investment and exports are buoyant and demand pressures have risen—as evidenced by the highest ratio of vacancies to unemployment since 1964 and extremely strong demand for imports. Though there has been a temporary lull in nation-wide negotiated wage increases, actual earnings have continued to rise rapidly in response to the tensions on the labour market. Prospects are hard to appraise, given present uncertainties (the new Government's economic policy was known only in broad terms at the time of writing). The need to restore confidence implies restrictive demand management policies. On this basis, output might be rising at a rate of, say, 3-4 per cent during the coming year, with some easing of demand pressures. Private investment and exports could be the main expansionary factors, with consumer demand rising perhaps in line with output. Some relief of pressure could come from stockbuilding: it has recently been at a high rate and could become more moderate.

TABLE 3.
Labour force in Germany
Thousands, seasonally adjusted

	1966 I	1967 I	1967 II	1968 I	1968 II	1969 April[a]
1. *Labour force* (2 + 3)						
Germans	25 960	25 805	25 660	25 630	25 650	25 700
Foreigners	1 240	1 070	960	970	1 075	1 300
TOTAL	27 200	26 875	26 620	26 600	26 725	27 000
2. *Employed*						
Independent	5 150	5 130	5 095	5 020	5 005	4 960
Salaried	21 920	21 255	21 005	21 215	21 440	21 890
TOTAL	27 070	26 385	26 100	26 235	26 445	26 850
3. Registered unemployed	130	490	520	365	280	150
4. " Labour reserve "	—	335	345	220	235	150
TOTAL EMPLOYABLE RESERVE (3 + 4)	130	825	865	585	515	300

a) Secretariat estimates.

The *German* economy had entered 1968 with a fairly sizeable margin of unused resources. Unemployment was 2 per cent, of which about half constituted hard-core unemployment, and there was a " labour reserve "[1] of slightly more than one per cent (see Table 3). In addition, the fall in the number of foreign workers from the 1966 peak was equivalent to somewhat more than one per cent of the labour force. GNP rose by nearly 8 per cent during 1968, a faster recovery than had seemed likely, so that by the spring of this year the gap was almost absorbed. Unemployment fell below one per cent, all the foreign labour lost earlier returned to Germany, and perhaps one half of the domestic " labour reserve " was re-employed. Current requests for more foreign workers are very high and

1. The « labour reserve » consists of wage earners who withdrew from the labour force during 1967 recession without registering as unemployed and who can be considered to be prepared to re-enter the labour force under favourable conditions. The exact size of this reserve is difficult to estimate. The figures shown in Table 3 for 1967 have been calculated by the Institut für Arbeitsmarkt- und Berufsforschung (see also *Economic Outlook*, No. 4, page 13). The more recent figures are Secretariat estimates.

some further increase in their numbers is likely; but neither this, nor the fractional rise in the domestic labour force expected from now onwards, can provide more than marginal alleviation of the labour bottleneck. Vacancies number nearly 800,000, an all-time record.

From now on, the growth of real output is bound to start slowing down, perhaps rather sharply, to the rate of increase of productive capacity (say 4 per cent a year). But nominal domestic demand seems likely to go on rising at a rate of 8 per cent or more, with very buoyant private demand both for investment and consumption. In these circumstances, imports will probably continue to rise fast and lengthening delivery dates may in time begin to check the growth of exports. Pressure on domestic prices is likely to increase. Despite the high pressure on resources, the external surplus (on goods and services) in the first half of 1970 could still be equivalent to about 2 per cent of GNP, well above the objective set for 1973 of a surplus equivalent to 1½ per cent of GNP at much lower demand pressures. In roughly similar cyclical circumstances in the first half of 1965, the external surplus was virtually nil. These prospects point to a dilemma for economic policy; the domestic situation calls for measures of restraint, but fiscal or monetary measures would delay the adjustment of the external balance.

Problems of demand management seem less in the other major countries. In *Italy* the recovery of domestic demand continues, supported by good export markets in Germany and France as well as in most other European countries. The measures already taken or under discussion, especially pension and pay increases, are likely to help ensure a fairly fast growth of consumption. The recovery of private productive investment would be encouraged not only by higher demand but also by better confidence; government action aimed at improving the availability of long-term capital, partly by restraints on the capital outflow, could prove important in this connection. Even on conservative assumptions about private productive investment, total domestic demand may increase by about 9 per cent between the first halves of 1969 and 1970, 2 per cent more than between the first halves of 1968 and 1969. This should reduce Italy's very large surplus on current account. But in the first half of 1970 this may still be running at an annual rate of around $2 billion.

Because of the impetus already received, the expansion of domestic demand in *Canada* is likely to decelerate less markedly than in the United States. The growth of output may be around 4 per cent or so during the coming year, with some rise in unemployment, but improvement in the cost/price situation may be slow in coming.

The signs of weakening of the *Japanese* boom early in 1969 have not been confirmed by later indicators. Fairly rapid expansion—a growth rate of 10 per cent or more—seems likely to continue, though the pace may decelerate a little since export prospects are weaker (the United States market—on present expectations—will be increasing only slowly) and the private investment boom may slow down. The external position is very strong, a contrast from previous boom periods which have been cut short by balance of payments' difficulties.

The following table summarises the conjunctural position of nine smaller OECD countries where there has recently been a significant acceleration in domestic demand following a sharp rise in exports. This has, in some countries, been superimposed upon the full impact of earlier reflationary measures.

In the *Netherlands*, the boom in the second half of 1968 reflected a rapid increase of both fixed investment and exports, together with a bunching of purchases in anticipation of the change-over to TVA. The growth of activity paused in the early months of 1969 following the introduction of the TVA, but pressure of demand remained uncomfortably high, and output is likely to rise less this year than in

Conjunctural Indicators for certain OECD countries

	Timing of upturn *(a)*	Slack at mid-1969 *(b)*	Outlook 1969 *(c)* PC	Outlook 1969 *(c)* Inv.	Present policies *(d)*
Austria	Q1-1968	+	+	+	—
Switzerland	Q3-1968	0	0	0	0
Spain	Q3-1968	+ +	0	—	+
Netherlands	Q3-1968	0	—	0	—
Belgium	Q4-1968	+	+	+	—
Sweden	Q4-1968	0	0	+	—
Finland	Q4-1968	+ +	+	+	+
Denmark	Q4-1968	+	+	+	—
Norway	Q1-1969	0	0	+	0

a) The quarter when domestic demand started accelerating significantly.

b) Rough estimate of the short-fall between actual and potential GNP : 0 negligible ; + small ; + + significant.

c) Outlook through 1969 for private consumption (PC) and productive investment (Inv.) : — below ; 0 equal to ; + above long-term rate of growth.

d) Present policies : — contractionary ; 0 neutral ; + expansionary.

either of the last two years. In *Belgium* expansion started somewhat later from a lower level of capacity utilisation and appears to be somewhat less vigorous. However, the risk of price tensions when TVA is introduced at the beginning of next year suggests caution in demand management. In *Switzerland*, the revival of domestic demand in the course of 1968 followed the resumption of export growth. Sustained expansion does not, so far, appear to have produced any serious demand pressures, though price increases have accelerated slightly. Unless the export boom persists, the development of total demand is unlikely to exceed capacity in the months ahead. In *Austria* the upturn started before mid-1968, but followed a very gradual path with some weakening in the fourth quarter and renewed growth in recent months. Unemployment has remained relatively high. Given the slightly restrictive posture of the 1969 budget, the upswing, particularly in business investment and private consumption, is unlikely to lead to excessive demand pressures.

In *Sweden*, the turnaround occurred only towards the end of 1968; current prospects seem to be quite buoyant, particularly for productive investment. The labour market has reacted rapidly and by April vacancies were above their 1965 peak. On the other hand, unused capacity still exists in some industries and the change to the TVA (at the same rates as the general purchase tax) was carried out without serious disturbances. On balance, some restraint in the growth of domestic demand may be called for, particularly if the export boom continues. In *Norway*, the acceleration of domestic demand occurred only in early 1969. By April, productive capacity was almost fully utilised and slack in the labour market had practically disappeared. But the upswing of domestic investment (excluding ships) is not expected to be very strong. The introduction of TVA in January 1970 may lead to anticipatory purchases in the autumn, but this is not expected to necessitate a change from present demand management policy. After a very moderate rise during 1968, domestic demand in *Denmark* accelerated strongly in the first months of 1969, stimulated by a continued growth of exports, easy credit and large wage increases. The margin of unused capacity and unemployment diminished rapidly. Large speculative outflows of funds, and a prospect of over-heating towards the end of the year, led the Government to adopt restrictive measures in May. In *Finland*, there was a strong increase of exports and a marked strengthening of the current balance after devaluation, but for the third consecutive year there was a rise of only 2 per cent in GNP last year. By the end of the year unemployment amounted to 4 per cent of the labour force. There was a sharp upturn in the beginning of this year. Spare capacity is expected to be taken up and some demand management problems may arise by 1970. Much will depend on the current negotiations concerning incomes policy. (A special article on Finland is on pp. 103-113.) In *Spain*, the foreign balance ceased to provide a stimulus last autumn, and slack in the economy has been reduced only slowly. Prices have remained fairly stable. So far the recovery in productive investment has been hesitant but, with a rapid expansion of private and public consumption, some signs of over-heating could appear later this year.

In general, the momentum in the smaller industrial countries seems to be such that, even if they experience a weakening of external demand, rapid expansion should continue for some time. If high demand pressures were to persist in several of the larger European countries, severe strains on capacity could develop in some of the smaller countries.

RISING PRICES

The rise in the general price level in OECD countries accelerated last year. The implied GNP deflator—the broadest measure of prices—seems to have risen by 3½-3¾ per cent, the largest rise for a decade. The year-to-year rise in 1969 may be even larger, perhaps above 4 per cent, even if in some countries (most importantly in the United States since it accounts for half total OECD output) upward pressures ease off gradually during the year.

Much of the change in price performance in recent years has been in the United States. In 1961-63 the rate of increase in the implied GNP deflator in the United States had fallen to little over one per cent a year. Since then it has accelerated sharply, exceeding 3 per cent in 1967 and reaching nearly 4 per cent last year. The preliminary estimate for the first two quarters of this year is a rise at an annual rate of 4½ per cent.

Over the last ten years or so, average rates of increase in Europe have been distinctly higher than in the United States—perhaps 3½ per cent for the countries combined. During 1967 falling demand pressures in Germany, Italy and France were accompanied by easing pressure on prices. Other countries, too, had below-average increases for various reasons and in total the year saw a rather small rise in European prices. Despite the United States acceleration, the rate of price rise for OECD as a whole dipped a little. The picture changed in 1968—for several reasons, including widespread changes in tax structures and in rates of indirect taxation, and the wage crisis in France. It was the larger increase in Europe, coinciding with the continued acceleration in the United States, which made the increase for OECD countries as a whole so large.

CONSUMER PRICES

Consumer prices normally show much the same general development as the GNP deflator at market prices, tending to rise slower and to fluctuate more than the aggregate measure. A particular feature of the last year or two has been an even faster rise in consumer prices than in prices generally. Nearly all OECD countries publish a monthly base-weighted consumer price index. This may move differently from the implied consumption deflator for an individual country, but a combined index for OECD countries generally shows a fairly close fit so the monthly indicator can be used to fill out the story. The combined index was rising about 3 per cent a year during 1967. It has accelerated fairly steadily since then and rose over 2½ per cent between the fourth quarter of 1968 and the second quarter of this year. (See Chart C.)

Part at least of the explanation lies in the changeover to TVA in many European countries, and, in the United Kingdom, in heavy reliance on indirect taxes for demand management. The changeover to

TABLE. 4.

Price changes in 1969 against longer-run trends

Price deflators of GNP at market prices

Annual percentage changes

	Average 1958-68 (10 years)	1958-68 Smallest annual rise	1958-68 Largest annual rise	1967	1968	1969 forecast
United States	2.0	1.1	3.8[a]	3.1	3.8	4¼
Canada	2.6	0.7	4.6	3.6	3.6	3¾
United Kingdom	2.8	1.0	4.7	2.7	3.3	4
Germany	2.8	0.9[b]	4.3	0.9	2.1	3
Italy	3.6	–0.5	8.7	2.7	1.5	2½
France	3.9	2.1	6.1	3.0	5.0	6
Netherlands	4.2	1.7	7.5	4.1	4.0	6½
Japan	4.3	2.5	6.0	4.5	4.1	4½
Total OECD	2.7	2.0[c]	3.6[a]	3.1	3.6	4¼

a) 1968.
b) 1967.
c) 1959.

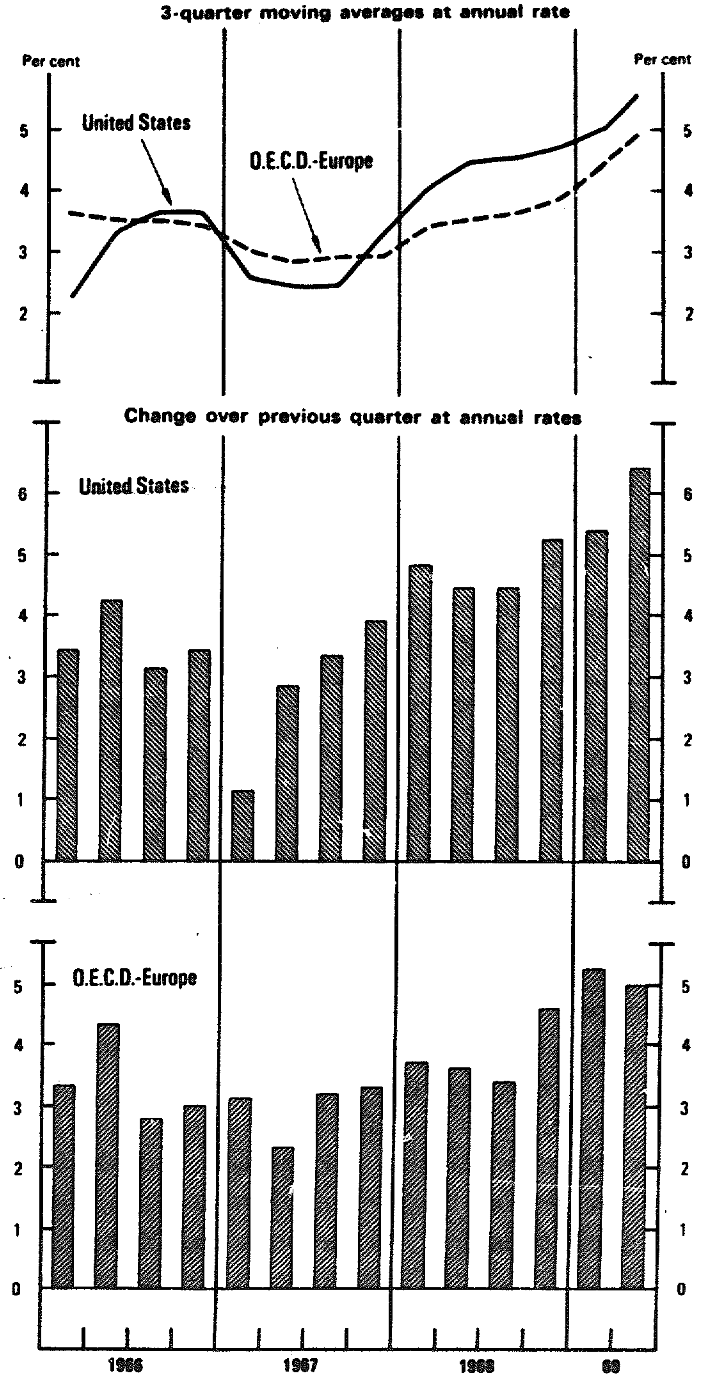
TVA has meant a shift in the incidence of taxation towards consumer goods while in the United Kingdom indirect taxes bear much more on consumer purchases than other sectors of demand. In France the extension of TVA to services and distribution at the beginning of 1968 added a good 1 per cent to the level of consumer prices, and in Germany the changeover to TVA accounted for more than half of the 2 per cent rise in consumer prices last year. At the same time the competitive position of exports improved. In these cases fears of exaggerated price increases by producers and traders did not materialise mainly because demand pressures were rather weak in both countries.

Events were different after the introduction of TVA in the Netherlands at the beginning of 1969 and the increase in rates in France. According to official calculations, the mechanical effect of the tax reform on consumer prices in the Netherlands was only 1.3 per cent. Nevertheless, the cost-of-living index jumped by 3½ per cent in January 1969 and went on rising until April, indicating a considerable widening of profit margins. The Dutch authorities have now reacted by imposing price controls. In France, the effect of the increase in the rates on prices was contained between December and February, but instead of decelerating, the rise in prices continued at a high rate at least until May. In both countries the pressure of demand and the related psychological atmosphere probably explain the unexpectedly sharp rise in prices. In Sweden, by contrast, where demand pressures were not very high, the acceleration in the rise in the cost-of-living index at the beginning of 1969 exceeded only slightly the calculated mechanical effect of the tax changes (0.3 per cent). Given the experience of other countries, the Belgian authorities have decided to adopt lower rates than originally planned. Even so, official calculations suggest a mechanical effect on prices which on rather pessimistic assumptions could approach 3 per cent.

EXPORT PRICES

For OECD countries as a whole, " export prices " have risen far less than the general internal price level. Between 1958 and 1968 the implied GNP deflator for all OECD countries combined rose by about 30 per cent while a combined index of export

CHART C
CHANGES IN O.E.C.D. CONSUMER PRICES
seasonally adjusted



ANNUAL RATES OF CHANGE IN THE IMPLIED PRICE DEFLATOR OF PRIVATE CONSUMPTION

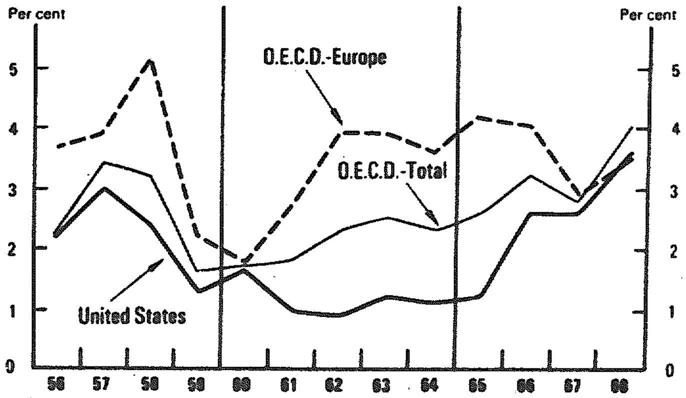
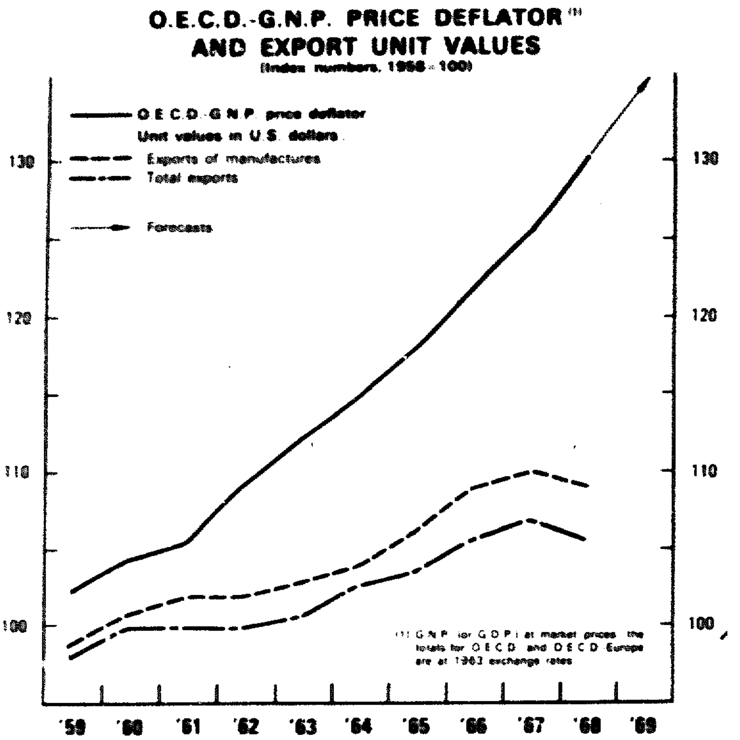
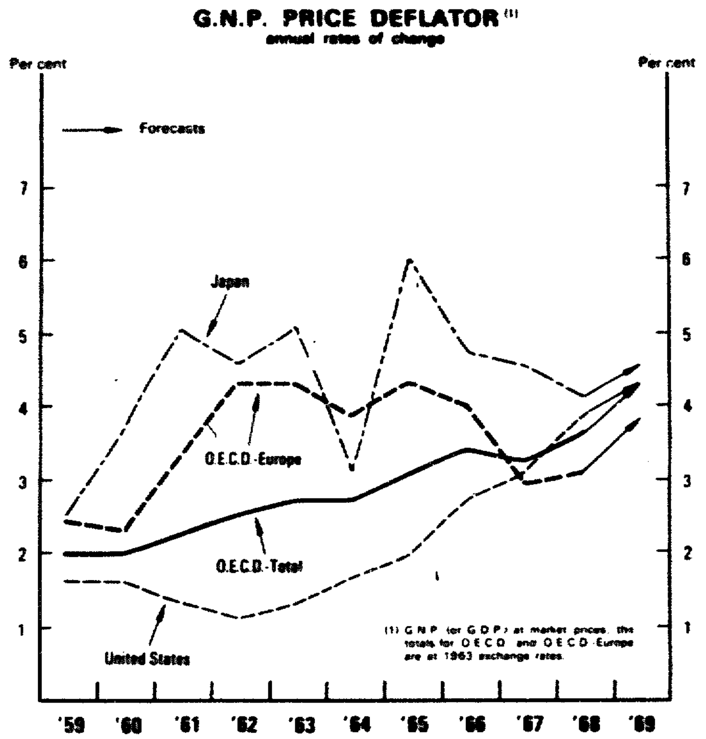


CHART D





unit values (in current US dollars) rose only 6 per cent for total exports and 9 per cent for exports of manufactures.[1] One reason is that devaluations have been more important than revaluations over this period. But there has been a wide-spread tendency for export prices, measured in national currencies, to rise less than domestic prices in general. This has been most marked for Japan and Italy, where export unit value indices have actually fallen over the period despite an above-average rise in their GNP deflators. At the other end of the range, for U.S., U.K. and Germany, export prices have risen by not much less than the deflator. Investigation is hampered by weaknesses of the data (true measures of export prices or export quotations are rare) and differences between countries both in methods of compilation and in the commodity structure of trade. Even so, some conclusions can be suggested.

1. The aggregate index refers to the unit value of manufactures exported by the seven major countries, Belgium-Luxembourg, Netherlands, Sweden and Switzerland. In 1967 these eleven countries accounted for about 95 per cent of total OECD exports of manufactures. Source : United Nations, *Monthly Bulletin of Statistics* and Secretariat estimates.

2. The United States unit value index for exports of manufactures alone rose by 2.7 per cent last year.

The large rise last year in domestic prices in OECD countries would, in the ordinary way, have led to a rise in combined export prices. The main reasons why the index fell between 1967 and 1968 seem to be the devaluation of sterling and some other currencies late in 1967 (which had some effect on international commodity prices in dollar terms, as well as reducing the dollar export prices of the devaluing countries) and the changeover to TVA in Germany at the beginning of 1968 (which meant complete exemption of exports from tax instead of the partial exemption under the old tax system). Export prices for the United Kingdom, for instance, measured in dollars, fell about 6 per cent between the two years, and export prices for other countries which devalued also fell. German export prices fell by over one per cent. The indices for some smaller countries also fell. In total, they were sufficient more than to outweigh the rise of one per cent in the index for the United States.[2]

The prospects for home prices this year—discussed below—suggest a fairly steep rise in export prices for OECD countries combined. In addition, U.K. export prices will show a fairly big rise between the two years since most exports early in 1968 were shipped at pre-devaluation prices (which meant

TABLE 5.

Prices and labour costs in selected European countries and Japan

Annual percentage changes

	GNP price deflator		Consumer price index		Labour costs per unit of real GNP		Unit labour costs in industry		Unit value of exports of manufactures a	
	1958 to 1968	1965 to 1968	1958 to 1968	1965 to 1968	1958 to 1968	1965 to 1968	1958 to 1968	1965 to 1968	1958 to 1968	1965 to 1968
United Kingdom	2.8	3.4	3.0	3.7	2.9	3.2	2.3	3.1	1.1	-0.3
Germany	2.8	2.2	2.3	2.1	3.3	2.0	2.6	0.8	1.2	0.2
Italy	3.6	2.2	3.3	2.3	4.9	2.2	3.7	1.5	-1.0	-1.3
France	3.9	3.6	3.9	3.3	5.1	4.6	4.3	4.1	0.6	1.1
Netherlands	4.1	4.5	3.4	4.3	5.3	4.5	3.0	1.0	0.5	-0.6
Japan	4.3	4.4	4.9	4.8	4.8	3.5	1.1	-1.2	-0.6	0.8

a) In U.S. $.

exceptionally low prices in dollar terms at the new exchange rate). The German border tax measures of November 1968 have been reflected in the rise of 2½-3 per cent in the German base-weighted price index for total exports in the first quarter (though the average value index rose much less). U.S. export prices also seem likely to rise since the evidence of the past is that U.S. export prices of manufactures have kept broadly in line with changes in home costs, while commodity prices are likely to be fairly strong. Altogether, a rise of two or even three points in the combined OECD export price index is possible.

NATIONAL DEVELOPMENTS [1]

In the United States the acceleration of prices has clearly been associated with the shift in the economy from slack growth to full employment. The change in the profile for labour costs is rather steeper than that for the price level.

By contrast to the United States, increases in unit labour costs in recent years have been below the longer-term average in quite a number of European countries. This has been basically a cyclical development. The relationship between labour costs and output prices has also been affected in some countries by tax changes. No short period offers a good comparative base for all countries, so the decade average is used in the table as the benchmark. It will be noticed how similar the cost rankings for the decade average are to that for the GNP deflator.

In Germany, unit labour costs in industry fell during the recession. There was a sharp dip in both employment and hours in 1967. On an annual comparison, labour costs fell further in 1968 but the trend is likely to be upwards this year. A considerable acceleration of the GNP deflator is possible. In France, labour cost increases were rather small in both 1966 and 1967, but the wage increases last summer led to a rise of about 7 per cent last year in labour costs per unit of real GNP, the largest annual rise since 1963. By January this year hourly wage rates in manufacturing industry were 16 per cent

1. Throughout this section data are based as far as possible on country sunmissions to OECD. Other sources used are OECD *Main Economic Indicators*, United Nations *Monthly Bulletin of Statistics* and national statistics, especially for 1968. Unit labour costs in industry include construction. The diversity of sources, especially for unit labour costs in industry limits the extent to which inter-country comparisons can be made.

TABLE 6.

Prices and labour costs in North America

Annual percentage changes

	United States		Canada	
	1960 to 1963	1965 to 1968	1960 to 1963	1965 to 1968
GNP deflator	1.2	3.2	1.3	3.9
Consumer price index	1.1	3.3	1.3	3.8
Labour costs per unit of real GNP	0.9	4.5	0.9	5.3
Unit labour costs in industry	0	3.9	-1.6	4.0
Export unit value of manufactures in U.S. $	0	2.8	-2.8	3.0

higher than a year earlier while production in the first quarter was 9-10 per cent higher. Abolition of the payroll tax late last year goes some way to offset the rise in wage costs. But consumer prices by May were over 6 per cent higher than a year earlier, partly because of higher TVA rates, and a fairly large year to year rise in domestic prices seems inevitable. In the United Kingdom higher indirect taxation is adding to the domestic price rise this year. In Italy, the upswing in activity may lead to rather bigger wage increases but the price level may well show another below average rise this year.

In Japan, as in Europe, labour costs have recently risen less than on average in the past. They have also fluctuated much less during the last three years than they did earlier when the growth of output changed pace much more sharply. A feature of the figures is the much more marked contrast between the industrial sector and the whole economy than is shown by the figures for other countries. The nearest parallel in Europe is Italy, and also the Netherlands. Comparative analysis cannot be pressed too far because of the limitations of the statistics, but the figures seem to demonstrate the importance of structural shifts from low wage/low productivity sectors to high wage/high productivity sectors, accompanied by rapidly rising incomes throughout the economy.

PRICE PROSPECTS

The outlook for 1969 as a whole is thus for an even larger rise in the general price level in the OECD area than there was last year but in some countries there could be a considerable easing from now on of the varied pressures that have been causing specially large increases. In the United States, the implied deflator in the first quarter was already so high that a year-to-year rise larger than in 1968 seems almost certain, even if the rate decelerates from now on: but by mid-1970 the rate of increase could be much less if pressures in the economy have subsided as now intended. In the United Kingdom and France recent developments, including tax increases, also suggest rather large year-to-year increases. But from now on the rate of increase in both countries is likely to be less provided wage increases are not excessive. In the Netherlands, the change-over to TVA at the beginning of the year led to a price explosion, which policy is now directed to combatting. Some countries, however, face the probability of accelerating increases. In Germany high demand pressures are causing prices to rise faster, and in Italy the exceptionally low increases of the last year or two may well not continue. In Belgium, the change-over to TVA is due at the beginning of next year and this may mean an exceptional price increase.

TRADE AND CURRENT PAYMENTS

Trade of OECD countries has been growing very rapidly since late in 1967, in response to the acceleration of demand and output. OECD imports rose by nearly 13 per cent last year (Table 7), adjusted for the main special factors, and a strong underlying rise has probably persisted this year, though masked by temporary disturbances[1]. For 1969 as a whole, OECD imports could rise by about 12-13 per cent but this partly reflects the high level already reached at the beginning of the year. A slowing down now seems likely and the increase between the first halves of 1969 and 1970 might be only about 9 per cent. A slower growth of United States imports as the economy cools off seems unlikely to be offset fully elsewhere.

The fast acceleration of United States demand last year worsened the trade balance of North America relative to other OECD countries. This year the pattern should begin to move the other way, but large imbalances seem likely still in 1970. Speculative elements seem to have been affecting trade in recent

1. In this section the following special factors have been allowed for :

1968 Effects of 1967 U.K. dock strike, anticipation of U.S. 1969 dock strike, acceleration of German exports prior to border tax change, and postponement of German imports.

1969 U.S. dock strike and counterpart of German trade displacements.

Table 7.

Foreign trade of the OECD area [a]

Values, per cent changes, seasonally adjusted annual rates
Estimates and forecasts

	1968 $ billion[b]	From previous year 1967	1968	1969	From previous half-year 1968 I	1968 II	1969 I	1969 II	1970 I
TOTAL[c]									
Imports	164.4	5.4	12.7	12½	13.8	14.5	13½	9½	8¼
Exports	158.7	5.7	12.2	12¾	14.9	15.8	13½	9½	8½
INTRA-OECD									
Exports	111.0	6.1	13.7	14	16.9	15.6	15½	10¾	9½
EXTRA-OECD									
Imports	48.6	3.6	10.4	9	8.6	13.0	8¾	6½	5
Exports	45.7	5.1	8.7	9½	14.1	13.8	9¼	7¼	5
Memorandum Item:									
Recorded figures[d]									
TOTAL[c]									
Imports	..	5.4	13.0	12	12.6	18.6	10½	10¼	8¼
Exports	..	5.6	12.9	12	14.7	19.5	9½	10½	8½

a) Adjusted for statistical discrepancy in the recording of intra-OECD trade, for the effects of the U.K. dock strike and of the French strikes, and for the estimated shift between 1968 and 1969 of U.S. imports and exports affected by the dock strike and German imports and exports affceted by speculation and the export tax.

b) Recorded figures.

c) Including trade with unspecified origins/destinations.

d) Adjusted for statistical discrepancy in the recording of intra-OECD trade, as in footnote (a).

months — whether in fear of parity changes or of administrative restrictions. Such speculation, if it persisted, would tend to shift trade in favour of the exports of surplus countries; no allowance for its continuance has been made in the detailed projections that follow.

The large rise in OECD imports from non-OECD countries last year was followed by a rise in OECD exports to them with less time-lag than has been typical in the past. The timing of future changes is uncertain because some non-OECD countries are probably less immediately dependent in the short run on export earnings than they used to be. Primary producers' reserves rose by some $ 2 billion between end-1963 and end-1967, and by a further $ 2 billion in 1968. Some slowdown is nonetheless expected for OECD exports to non-OECD countries, should imports from them begin to decelerate. The probability is that the rise in total OECD exports between 1968 and 1969 will be about as fast as the rise in total OECD imports and that both will be rising more slowly from now on.

Trade developments and prospects are analysed in some detail in the following paragraphs. The section ends with a discussion of prospects for current balances. Recent developments in capital flows (no forecasts are attempted) are described in a separate section.

DEVELOPMENTS IN 1968

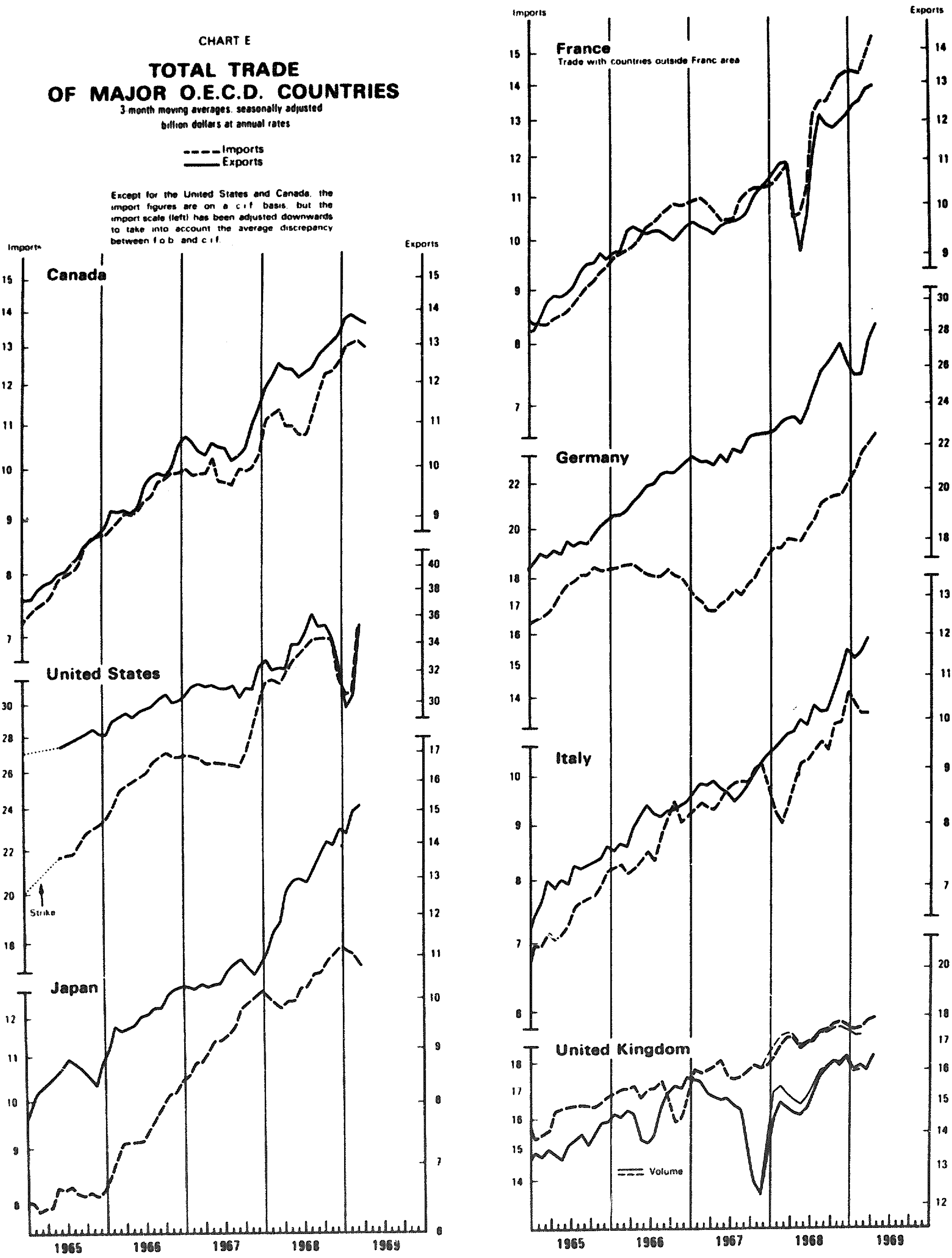
The very large rise in imports by the United States last year and also the full scale of the rise in United Kingdom imports despite devaluation, have not yet been fully explained. In addition to exceptionally high imports, the United States export performance was worse than usual. Adjusted for special factors, United States exports grew about 9 per cent in value compared with a growth of export markets of over 11 per cent, a larger than average difference. In consequence the trade surplus fell from nearly $ 3.9 billion in 1967 to $ 0.6 billion in 1968 (Table 8). The United Kingdom trade balance also worsened, though only a little. The high volume of imports and the adverse change in the terms of trade following devaluation were not quite offset by the growth in volume of exports. But for the United Kingdom, export performance was better than usual, with a growth of exports (adjusted for the effects of strikes and also for price effects of devaluation) greater than the growth of export markets instead of the shortfall that had been usual before devaluation.

The rapid rise in United States imports, which accounted for much of the deterioration in her trade accounts, had widely spread repercussions on the trade of other countries. The Canadian surplus

CHART E

TOTAL TRADE OF MAJOR O.E.C.D. COUNTRIES

3-month moving averages, seasonally adjusted
billion dollars at annual rates



almost doubled. The Japanese surplus more than doubled, but a further factor here was the rather slow growth of Japanese imports, relative to the growth of the economy. For Germany, the rise of 38 per cent in exports to the United States in 1968, accounting for a quarter of the total rise in German exports, was one of the reasons why the trade surplus rose in the face of strongly growing domestic demand. The strong Italian trade position was mainly due to sluggish imports, but it also reflected a strong growth of exports, including exports to the United States.

OUTLOOK FOR OECD IMPORTS IN 1969 AND FIRST HALF OF 1970

In the first quarter of 1969 OECD imports were probably about 7½ per cent above the average for 1968 as a whole, if allowance is made for the various disturbing factors already listed. (The recorded increase was about 6 per cent). The prospect for the rest of this year and early next year, as Table 7 indicates, seems to be for a gradual deceleration of the underlying trend[1]. By the second half of this year, or early next, the rate of increase could fall below the average of the last five or six years.

The forecast of some 12 per cent for the underlying rise in total OECD imports between 1968 and 1969 is distinctly larger than the forecast of 7½ per cent made last year[2]. Demand in the United States has been stronger and more resistant to fiscal and credit action than expected and its strength in France and Germany at the turn of the year was also underestimated.

The forecast for 1969 includes a substantial deceleration (to a rise of only about 6 per cent) in the trend of imports by the United States (Table 9). This allows for a further sharp increase in special automotive imports from Canada, and is related to the expected slowing down of the growth of output

1. The recent distortions to trade could, however, mean that in terms of half-yearly changes, the recorded figures for the second half of 1969 will not show any deceleration from the first half. There seems recently to have been speculative importing and if this continued it would also affect the total figures.

2. OECD, *Economic Outlook*, No. 4 p. 14.

TABLE 8.

Trade balances, 1967 to 1969 and longer-run trends

$ billion
Estimates and forecasts

	Average 1960-63	Average 1964-67	1967	Change 1967 to 1968	Change 1968 to 1969
United Kingdom	–0.52	–1.08	–1.67	–0.24	0.80
United States	5.07	4.89	3.86	–3.23	0.00
RESERVE CURRENCY COUNTRIES	4.56	3.81	2.19	–3.47	0.80
France[a]	0.39	0.17	0.22	–0.20	–0.40
Germany	2.09	2.98	5.25	0.47	–0.85
Italy	–0.98	0.08	–0.02	1.07	0.25
Belgium-Luxembourg	–0.03	0.04	0.14	–0.17	–0.05
Netherlands	–0.30	–0.61	0.56	0.23	0.05
TOTAL EEC	1.17	2.66	5.03	1.40	-1.00
Canada	0.43	0.71	0.84	0.80	–0.55
Japan	–0.01	1.43	1.16	1.37	1.50
Other OECD North	-1.72	-2.31	-2.22	0.40	0.20
Other OECD South	–1.14	–2.57	–2.70	–0.07	–0.60
TOTAL OECD	3.29	3.73	4.30	0.55	0.40
Adjustments[b]	–1.3	–0.9	–0.8	..	..
OECD TRADE BALANCE WITH REST OF WORLD	2.0	2.8	3.5	0.1	0.1

a) Transactions with non-franc countries.
b) For inconsistencies in recording of intra-OECD transactions.

TABLE 9.
Imports of selected OECD countries or areas
Annual percentage changes
Estimates and forecasts

	1960 to 1963	1964 to 1967	1967 to 1968	1968 to 1969
United Kingdom	1.9	3.6	7.0	3½
United States	4.5	12.8	23.5	6
EEC	10.9	6.9	12.8	18
Other OECD countries	9.3	10.7	8.6	12

with a progressive reduction of cost and price pressures. It must be uncertain, after last year's experience, how imports will change. The present forecast assumes that part of last year's rise in imports will prove irreversible but growth could fall back more sharply than allowed for as domestic demand and cost pressures ease. The range of possible outcomes is clearly wide.

Slow growth in imports is also projected for the United Kingdom. Although the April budget was only moderately restrictive, it came after a long series of fiscal measures to dampen the growth of domestic demand, and monetary policy has been tightened. Imports might be 3 or 4 per cent higher than last year. The import deposit scheme is probably exerting some restraining influence on the volume of imports, but its main effect appears to be on import finance. Devaluation seems to have had much less effect than expected on import propensities so far : if greater than expected effects were to develop as demand pressures ease, the rise in imports might be even smaller.

Imports into EEC countries and Canada are, however, likely to show large rises. For EEC countries taken together the year on year increase will probably be very substantial (perhaps 18 per cent); by the early months of this year imports had already shown a large increase and from now on growth is likely to be much less rapid, under 10 per cent between the first halves of 1969 and 1970. The trend of imports is expected to be strongest in Germany and Italy. Demand pressures are already strong in Germany and imports could rise by 20 per cent year on year, with further rapid growth through the year continuing into 1970. In Italy, with the recent acceleration in economic expansion, imports could rise by 15 to 20 per cent a year through the first half of 1970. French imports over the last year have risen rapidly so that the year on year increase might also be around 20 per cent; but if demand pressures now ease, imports would rise little from now on.

Japanese imports, after stagnating in the first half of 1968, rose fast in the second. Although they levelled off again in the first five months of this year, a renewed rise seems likely, with growth continuing in the first half of 1970. The increase between 1968 and 1969 is however unlikely to be very different from the 11 per cent recorded last year.

OECD TRADE WITH NON-OECD COUNTRIES

OECD trade with non-OECD countries has been growing strongly for nearly two years (Table 7). In late 1967 and early 1968, the growth of imports from primary producing countries briefly outstripped that of intra-OECD trade-under the impact of various abnormal factors such as a rapid stock accumulation of raw materials, the high cost of oil, including tanker freights, after the closure of the Suez Canal, and high copper prices. More recently a fairly widespread upward trend in the prices of primary products has acted to keep up the growth rate of imports from non-OECD countries.

Exports to non-OECD countries have also grown strongly, in line with the development of OECD imports from them. The OECD's trade surplus with the rest of the world, which showed some marked swings in 1967 has thus remained roughly stable, at a very high level, during 1968 and the first half of 1969.

OECD trade balance with the rest of the world
$ billion, seasonally adjusted, annual rates
Estimates and forecasts

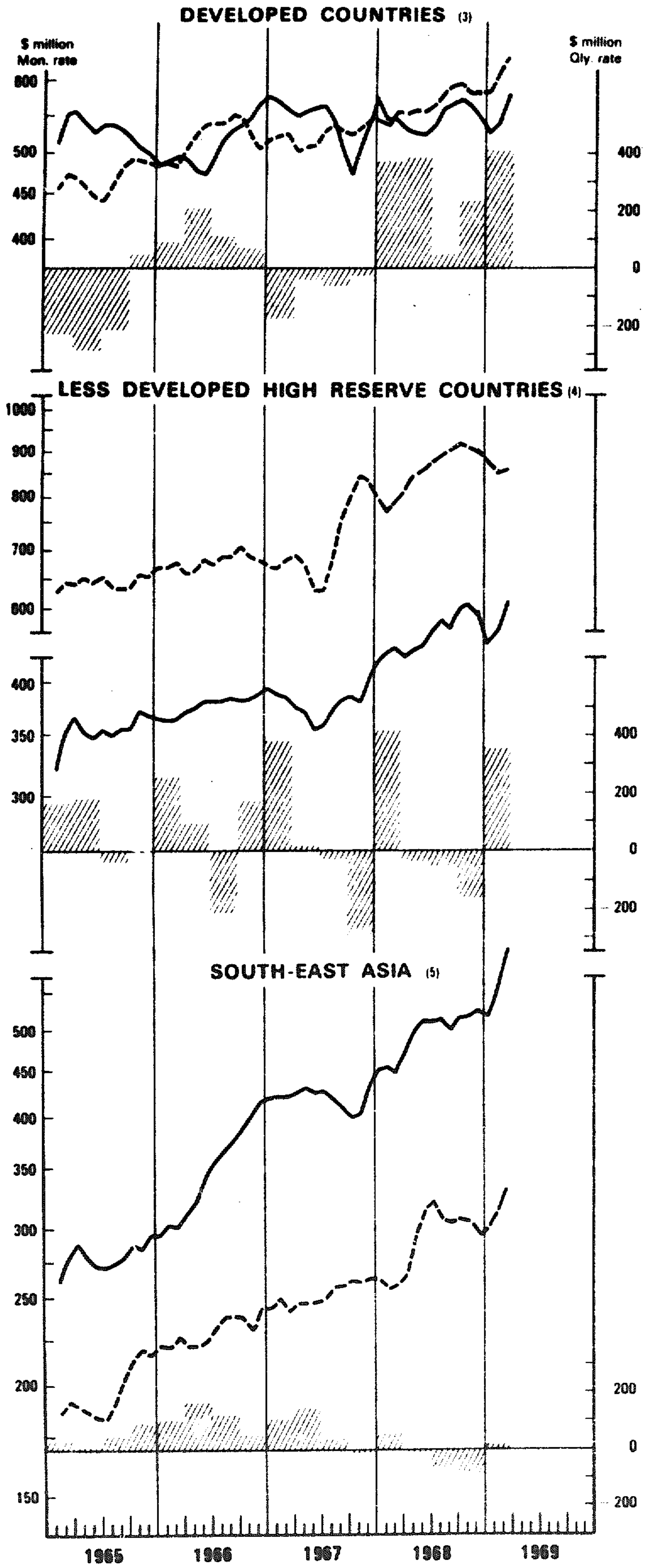
1967		1968		1969		1970
I	II	I	II	I	II	I
5.4	1.6	3.5	3.7	3½	3¾	4

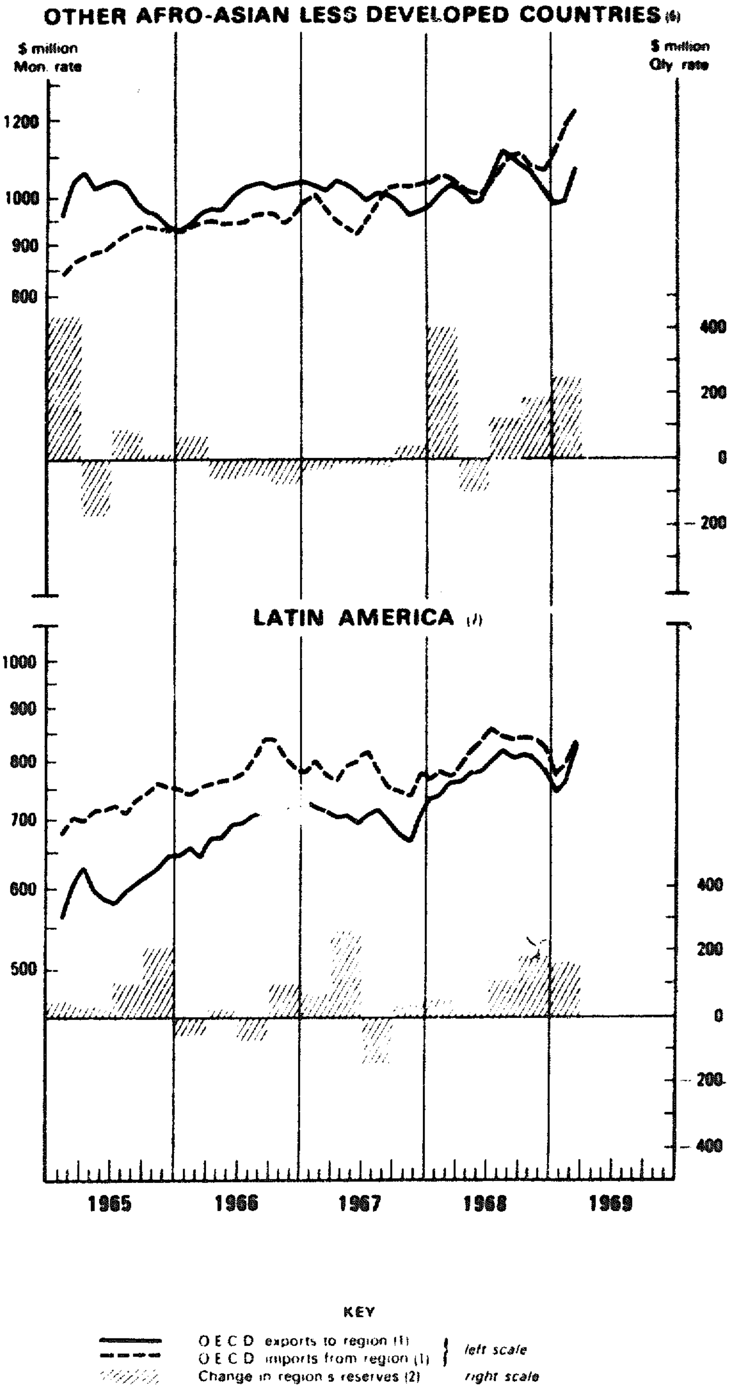
The large reserves accumulated by non-OECD countries over the last few years, especially in 1968 (Table 10) could act as a buffer for some time to come and allow a continuation of strong import growth. But other current debit items, notably debt servicing, are likely to grow rapidly in importance

CHART F

O.E.C.D. TRADE WITH PRIMARY PRODUCING COUNTRIES AND PRIMARY PRODUCERS' RESERVES

Adjusted for seasonal variations
3-month moving averages





NOTES

1. O E C D. exports and North American imports are f o b Other O E C D. imports are c i f
2. including net I M F position. Fourth quarter 1967 data are not adjusted for the change in the dollar value of sterling area countries' reserves due to the devaluation of the pound
3. Australia, New Zealand, South Africa
4. Bahrain, Iraq, Israel Kuwait Lebanon Libya, Malaysia, Saudi Arabia, Singapore, and Venezuela
5. Cambodia Formosa, Hong Kong, Laos, Philippines, South Korea, South Vietnam, and Thailand
6. Including Yugoslavia
7. Excluding Venezuela

TABLE 10.
Changes in reserves[a] of primary producers
$ billion

	Average 1960-63	Average 1964-67	1967	1968
Developed primary producers *b*	0.3	–0.1	–0.2	0.8
Less developed countries	0	0.7	0.5	1.0
High reserve countries *c*	0.3	0.2	0.1	0.2
Latin America *d*	–0.2	0.2	0.2	0.4
South East Asia *e*	0.1	0.3	0.3	–0.1
Other Afro-Asian less developed countries *f*	–0.2	–0.1	–0.1	0.6

a) Including net IMF position.
b) Australia, New Zealand and South Africa.
c) Iraq, Israel, Kuwait, Lebanon, Libya, Malaysia, Saudi Arabia and Venezuela.
d) Excluding Venezuela.
e) Cambodia, Formosa, Hong-Kong, Laos, Philippines, South Korea, South Vietnam and Thailand.
f) Including Yugoslavia.
Source : I.M.F., *International Financial Statistics.*

over time[1]. The outlook for future capital flows from the OECD area, is therefore important when trying to assess the prospects for OECD exports.

During the 1960's the capital outflow (including transfers) to the rest of the world increased substantially, with the major contribution coming from the public sector[2]. Data for 1968 are, as yet, too scanty to provide a consistent picture, but since there seems to have been a small deterioration in the rest of the world's current account and a large reserve increase, the inference is that there was a further substantial increase in its capital inflow (Table 11). Fragmentary information suggests this came from the private sector. It would appear that Australia and South Africa have benefited to a large extent from the boom in mining shares in 1968 and among the developing countries Latin America may have received an increased inflow, with several important countries in the area benefiting from large scale private or official credits.

The 1969 outlook for the capital outflow from the OECD area is not very favourable. Total OECD public aid seems unlikely to rise and may even fall. Though little is known about how far capital flows to the rest of the world are proving sensitive to the much tighter monetary climate this year, it can hardly be conducive to an increasing supply of funds to non-OECD countries.

1. OECD, *Development Assistance, 1968 Review*, Paris 1968.
2. OECD, *Economic Outlook*, No. 4, pp. 17-20.

In addition, the forecast deceleration in the reserve currency countries' imports can be expected sharply to reduce the growth rate of total OECD imporst from non-OECD countries from say the middle of 1969, for the reserve currency countries import more from outside the area than do EEC countries. The deceleration of imports is likely to continue into the first half of 1970 and could be reinforced should the slowing down in the rate of growth of trade be accompanied by a decline in prices of primary products from their present levels.

In view of these expectations the forecast of OECD exports to the rest of the world has been based on the hypothesis that non-OECD countries will adjust their import demand relatively smoothly to foreign exchange receipts so that OECD total exports are likely to be unfavourably affected, albeit only moderately, by a deceleration in sales outside the area from the middle of this year onwards. Were the primary producing countries to draw more on their reserves, the outlook for OECD exports could well be more buoyant in the near future, but at the cost of a steeper adjustment later.

OECD EXPORT PROSPECTS IN 1969 AND FIRST HALF OF 1970

Putting together the projections of non-OECD countries' imports from OECD, and the forecasts of imports by individual OECD countries, an estimate of the growth of potential export markets for each OECD country can be reached (Table 12). For 1969

TABLE 11.
OECD balance of payments with the rest of the world 1966-1969
$ billion ; estimates and forecasts

	1966	1967	1968	1969
Trade balance	2.9	3.5	(3.6)	3¾
Services, net	5.1	5.0		
Transfers, net	–4.5	–4.8		
Current balance	3.5	3.7	(3.8)	4
Total capital	–3.2	(–3.5)		
Balance on official settlements[a]	0.3	(0.2)	(–1.0)	

a) Adjusted for gold transactions with the private sector. In 1967 and 1968 the adjustment is particulary tentative because of the impact of the gold crisis and other speculative capital flows.

TABLE 12.
Relative export performance
Percentages ; estimates and forecasts

	Growth of markets and growth of exports						Total market gains or losses[e]		
	1967 to 1968*c*			1968 to 1969			Average		
	Growth of country's export markets *a b*	Growth of country's exports *a*	Growth of country's recorded exports *d*	Growth of country's export markets *a b*	Growth of country's exports *a*	Growth of country's recorded exports *d*	1959-60 to 1966-67	1967 to 1968[e]	1968 to 1969[e]
United Kingdom	11.9	13.4	6.8	12½	11	9½	–3.1	1.5	–1½
United States	11.2	8.9	9.4	11½	6½	5½	–1.5	–2.3	–5
France	11.7	11.6	..	14½	17½	..	2.1	–0.1	3¼
Germany	12.0	12.6	14.3	13½	15	12	0.5	0.6	1½
Italy	13.8	17.0	..	15	17½	..	4.7	3.2	2½
Belgium-Luxembourg	15.0	16.0	..	16½	14½	..	0	1.0	–2
Netherlands	14.0	14.5	..	16	14½	..	–0.5	0.5	–1½
Canada	25.3	19.0	..	10¾	9	..	–2.6	–6.3	–1¾
Japan	15.1	24.2	..	10	20½	..	7.2	9.1	10½
Other OECD North	11.8	10.8	9.6	12¾	13	..	–0.3	–1.0	¼
Other OECD South	13.2	17.1	6.2	12½	12	..	1.1	3.9	–½
Total OECD	13.6	13.6	12.9	12¾	12¾	12	..	..	..

a) Adjusted for the effects of the U.K. and U.S. dock strikes, and for the acceleration in German exports at end-1968.

b) The growth which would have occurred in a country's exports if it had exactly maintained its share in total OECD exports to each of 15 broad geographical areas. The figures are adjusted for certain special factors such as U.S. — Canadian trade in cars under the Ottawa Agreement.

c) For the calculation of market growth between 1967 and 1968, U.K., Danish, Irish and Spanish exports were valued at pre-devaluation prices. The figures given for the adjusted export growth of U.K., other North, other South, and total OECD are also on this basis.

d) Given only in cases where the figure differs from that in the previons column.

e) The difference between the growth rates of markets and (adjusted) exports, i.e. a measure of the extent to which countries gain (+) or lose (—) market shares in total OECD exports.

total OECD exports may rise about 12¾ per cent. Both Canada and Japan will, however, face a much slower growth of markets than this, partly because of the importance of the United States as a market to them and partly, for Japan, because of the forecast slowdown in primary producers' import demand. (The contrast with 1968 is marked : last year Canada and Japan had an especially favourable pattern of export market growth). Prospects for the United States and the United Kingdom are roughly similar to last year's developments.

The EEC countries will be providing rapidly rising export outlets to each other. They will also help to sustain the prospects of the smaller OECD countries, thereby partly offsetting the latters' dependence on the slowly growing British market.

The forecast for each country's exports [1] takes into account developments in the first four or five months of 1969 and views about possible changes in short-term competitiveness. Exports from the United Kingdom were clearly responding to devaluation in the second half of 1968 though the response was perhaps slower than had been hoped. The failure of exports so far this year to respond fully to buoyant demand conditions in Europe is puzzling. The 1½ per cent loss of share shown in Table 12 for 1969 as a whole implies a sharp rise in United Kingdom exports in the rest of this year. For the United States a rise of some 9 to 10 per cent might normally have been expected in relation to a market growth of over 11 per cent. United States exports have for some time been growing more slowly than United States export markets (possibly because of their commodity

1. Exports are shown both adjusted for the effects of U.S. and U.K. dock strikes and for the acceleration of German exports at end-1968, and without adjustment for these factors. Special allowance has not been made for the possibility of short-term disruptions caused by speculative trade developments. Any sustained acceleration of German exports, for example, might in effect add to trade (through higher stock building or the displacement of domestic output in the importing country) or displace exports of other countries — probably those against which there has been currency speculation.

composition) and recently domestic demand and cost pressures may have become more important. On top of this, performance may be affected this year by a once-and-for-all export loss incurred as a result of the dock strike early in the year. For Germany, apart from the irregular movements caused by the November 1968 border tax changes, performance is assumed to be slightly better than usual. The effect of the export tax in raising export unit values is assumed not to be entirely offset by volume losses in 1969. By 1970 some net reduction may, however, be apparent. French exports were reduced last year by the strikes and this affects the year to year rise. On an underlying basis France is assumed to record a limited gain in shares—a performance rather less good than during most of the sixties—in view of domestic pressures.

Japanese exports in the first five months of this year were already 17½ per cent above their average in 1968. Thus the forecast assumes rather little growth from now. This is heavily influenced by the pattern assumed for the United States market and also by the assumed deceleration of imports by non-OECD countries. As for the smaller OECD members, including the Benelux countries, they seem to have benefited more than proportionately so far this year from the general buoyancy of Continental European demand. Their export growth is, however, forecast to decelerate, over the rest of the year and into 1970, under the combined influence of slower market growth and strong domestic demand pressures.

TABLE 14.
Current balances, 1967 to 1970 and longer-run trends
$ billion; estimates and forecasts

	Average 1960-63	Average 1964-67	1967	1968	1969	1970 *a* I
United Kingdom	–0.03	–0.63	–1.03	–1.09	0	0.60
United States	2.70	3.75	2.18	– 0.28	0	1.00
RESERVE CURRENCY COUNTRIES	2.67	3.12	1.15	–1.38	0	1.60
France *b*	0.80	0.27	0.24	–0.30	–0.60	0
Germany	0.41	0.24	2.46	2.88	1.60	1.60
Italy	0.10	1.64	1.60	2.64	2.80	2.00
Belgium-Luxembourg	0.04	0.06	0.20	0.02	–0.10	–0.20
Netherlands	0.20	–0.10	–0.08	0.06	0.15	0.10
TOTAL EEC	1.55	2.11	4.42	5.30	3.85	3.50
Canada	–0.86	–0.75	–0.50	–0.15	–0.80	–1.00
Japan	–0.42	0.38	–0.19	1.05	2.40	2.50
Other OECD North	–0.53	–0.74	–0.52	–0.05	0.15	–0.40
Other OECD South	–0.20	–0.68	–0.58	–0.49	–0.80	–0.80
TOTAL OECD	2.22	3.44	3.78	4.30	4.80	[illegible].40
Adjustments c	0	0.2	–0.1	–0.5	–0.8	–0.9
OECD CURRENT BALANCE WITH REST OF WORLD	2.2	3.6	3.7	3.8	4.0	4.5

a) Seasonally adjusted, annual rates.
b) Transactions with non-franc countries. See also footnote *b*), Table 13.
c) For inconsistencies in recording of intra-OECD transactions.

TABLE 13.
Current invisibles, 1967 to 1969 and longer-run trends
$ billion ; estimates and forecasts

	Average 1960-63	Average 1964-67	1967	1968	1969
United Kingdom *a*	0.49	0.45	0.65	0.82	1.10
United States *a*	–2.37	–1.14	–1.68	–0.91	–0.60
RESERVE CURRENCY COUNTRIES	–1.89	–0.69	–1.04	–0.09	0.50
France *b*	0.41	0.10	0.02	(–0.30)	–0.20
Germany	–1.67	–2.74	–2.79	–2.85	–3,30
Italy	1.08	1.56	1.62	1.59	1.50
Other EEC	0.56	0.53	0.54	0.44	0.40
TOTAL EEC	0.38	–0.56	–0.61	–1.15	–1.60
Canada *a*	–1.29	–1.46	–1.35	–1.79	–1.90
Japan	–0.40	–1.05	–1.35	–1.48	–1.65
Other OECD North	1.20	1.58	1.70	1.77	1.75
Other OECD South	0.94	1.89	2.12	2.13	2.40
TOTAL OECD	–1.07	–0.30	–0.52	–0.60	–0.50

a) Data include waived debt obligations payable by the United Kingdom to the United States and Canada (1964, 1965 and 1968).
b) Transactions with non-franc countries. The figure for 1968 has been estimated by the Secretariat and may be subject to a considerable margin of error. In 1968, part of the speculative capital outflow may have taken the form of leads and lags or exports of bank notes which may result in an undervaluation of current receipts and an over valuation of current payments as measured on an exchange record basis. Secretariat estimates are calculated on a transactions basis.

OECD TRADE BALANCES AND CURRENT INVISIBLES IN 1969 AND FIRST HALF OF 1970

The predictions suggest there may be a fairly general but rather slow move by the first half of 1970 towards trade balances that are more appropriate from the point of view of general equilibrium. Balances on invisible account seem likely also to move in an equilibrating way (Table 13).

The large capital movements of recent years have been having a fairly marked effect on invisible flows. By swelling the interest payments of the major capital importers (the reserve currency countries), they have tended to offset to some extent the latters' trend towards improvement. In 1968, for instance, U.S. interest payments on overseas investments in the United States (including liquid dollar holdings) rose by over $ ½ billion. This went a long way to offset the rise in United States earnings, which reflected in part extra remittances secured under the mandatory direct investment programme introduced at the beginning of the year. The United Kingdom's invisible balance also improved last year, but net earnings of interest profits and dividends actually fell, mainly because of higher interest charges on an increasing total of external liabilities which nullified the expected savings in foreign currency terms of servicing sterling denominated debt. A further reason was that heavy costs for the oil companies of the Suez canal closure in 1967 fell into 1968.

Despite the unfavourable influence of rising interest rates, some further improvement in net invisibles earnings in 1969 is foreseen for the reserve currency countries—for the United States because favourable trends in most items are not offset by any deterioration on the military account ; and for the United Kingdom because of savings on defence expenditure and because of lower costs associated with the Suez canal closure. The counterpart is to be found in worse prospects for Canada, Japan and the EEC countries. The German balance is likely to record the largest deterioration (nearly $ ½ billion), with freight, tourism and workers' remittances all showing rising debits. France, on the other hand, may well improve on last year's estimated deficit, thanks partly to the expected sharp rise in transfers from the EEC Agricultural Fund but also to the cessation of last year's unfavourable factors on travel account. Growing imports and rising incomes may lead to a small fall in the Italian invisible surplus for the third year running. A structural change may well be taking place at present in Italy's invisibles balance : though some items are still buoyant, notably emigrants remittances and, lately, investment income, the tourist surplus has remained about the same since 1965 and the freight and miscellaneous services accounts have deteriorated rapidly.

CURRENT BALANCES

Although some progress should be made over the next twelve months towards reducing current account imbalances, the outlook for the first half of next year is far from satisfactory. Prospects for individual countries are discussed in the next paragraphs. Some of the issues raised by the continuing imbalances are discussed in the following section.

Prospects for the reserve currency countries are particularly uncertain, as regards both domestic developments and the effects of a change in domestic demand conditions on the trade balance. On the assumptions made in previous sections, the United Kingdom might show an improvement this year on current account of the order of $ 1 billion from the very disappointing 1968 results. Little improvement is expected for the United States this year, partly because the trade balance has been unfavourably affected this year to the extent of perhaps $ 300 million by an unusually long dock strike. Both countries may show current balances in approximate equilibrium for the year as a whole, and move towards surpluses in the first half of next year (Table 14).

The EEC countries' current surplus, which increased by nearly $ 1 billion to about $ 5¼ billion in 1968, may fall back to some $ 3¾ billion in 1969 and show a further decline in the first half of 1970. Most of the fall would reflect strong demand pressures in Germany. The Canadian current deficit was unusually low in 1968, largely as a result of booming demand in the United States. It is now expected to rise gradually through the first half of next year. The Japanese current surplus is expected to double in 1969 to a figure above $ 2 billion and may remain at approximately that level in the first half of 1970, despite slower growth from now on in the American and non-OECD markets and sustained high demand at home. In 1968 most of the smaller industrialised countries (and particularly Norway and Switzerland) shared in the export boom and improved their current balances. This improvement has continued into the first half of 1969. Renewed rapid expansion in Mediterranean countries may, on the other hand, lead to some deterioration in their current balance, despite the very rapid growth of exports expected for some of them.

The total current surplus of the OECD area with the rest of the world is expected to remain very high through 1969 and may rise further in the first half of next year. It is doubtful, however, whether so high a level could be sustained for long, given present trends in official aid to less-developed countries.

PROBLEMS OF BALANCE OF PAYMENTS ADJUSTMENT

In the issue of *Economic Outlook* published in July of last year it was suggested that a marked reduction in payments imbalances was in sight and that the worst of the international monetary crisis was probably over. One main reason why this has been proved premature is that action to correct inappropriate levels of domestic demand has been less effective and taken longer to produce results than expected. This was notably so for the United States and the United Kingdom on one side, and Italy on the other ; it does not apply to Germany where the recovery in domestic demand has been more rapid and sustained than foreseen a year ago. But it also seems clear that earlier optimism was based on an under-estimate of the extent to which persistent differences in cost and price pressures have led to more enduring changes in competitive positions. There may also be structural factors, not directly connected with demand pressures or costs and prices, contributing to the persistence of imbalance. Moreover, speculative factors have recently affected trade.

Although most of the changes foreseen in current balances in the coming year go in the right direction, they start from a very unsatisfactory situation. The position forecast here for twelve months hence would represent only very limited progress towards a more viable structure of international payments. This can be illustrated by comparing the forecast positions with the kind of current account aims which countries seem to be seeking to achieve. The broad lines of a set of "interim aims" were suggested a year ago. [1] The figures shown in Tables 15 and 16 are based on general statements made from time to time by national authorities about individual countries' aims or intentions. But since general statements are often not quantitative, the suggested figures for several countries cannot be regarded as precise.

In assessing the significance of the discrepancies between the forecasts and the suggested medium-term aims a judgment has to be made as to whether cyclical conditions in the first half of next year should be regarded as favourable or unfavourable to the country concerned. The biggest discrepancy in absolute terms—though not in relation to GNP—is for the United States ; this despite the fact that if the internal adjustment goes according to plan, relative demand pressures by the middle of next year should be somewhat more than normally favourable to the United States. It seems likely, however, that there will be continuing benefits to the payments position, with some further improvement in the current balance in the second half of next year—although it will probably still fall short of the suggested aim unless the check to domestic demand turns out to be sharper and more prolonged than at present envisaged. A substantial discrepancy is also forecast for the United Kingdom. Relative to conditions in the United Kingdom's major export markets, the cyclical position in the first half of next year would seem to be neither particularly favourable nor unfavourable. The further benefits still to come through from devaluation, however, are an uncertainty in the trade forecast. The target for the United Kingdom has been largely determined by the need to repay debt. It involves a relatively large surplus on goods and services expressed as a percentage of GNP—but not so high as those actually achieved by Germany and Italy.

If the trade forecasts for France are fulfilled, the current balance might not be very far from the medium-term aim in the first half of next year. This forecast is based on the assumptions that confidence is improved and that the rise in domestic demand is kept somewhat below the growth of capacity over the next twelve months. It also reflects the cyclically strong demand expected from the important French export markets in Germany and Italy and a number of other neighbouring countries.

For Japan, Germany and Italy, the forecasts all show a positive discrepancy of $ 1 billion or above, equivalent to 0.6, 0.8 and 1.6 per cent of GNP respectively. Japan has been benefiting from excess demand in the United States which should be eliminated by the middle of next year. The large current

1. Cf. *Economic Outlook*, No. 3, pages 49 and 50.

NOTES ON "MEDIUM-TERM AIMS"

United States. The authorities have not given any quantitative target but they have indicated the need for a substantial improvement in the trade and current balance. The figure of $ 3¾ billion is the level achieved on average in 1964-67, and would require a surplus on goods and services equivalent to about 0.7 per cent of GNP. The outflow of non-monetary capital averaged $ 5¼ billion in 1960-67 but fell to $ 2¼ billion in 1968.

United Kingdom. The authorities' aim announced after devaluation is for an overall surplus of £ 500 million. This would seem to require the achievement of a somewhat larger current account surplus to cover some net capital outflow. Recently, a short-term target of £ 300 million has been announced for the year ending March 1970.

France. Some time ago the authorities indicated that they regard a small surplus on current transactions with non-franc countries as normal, and in view of the need to restore confidence and rebuild reserves this would also seem appropriate in the not too distant future. A surplus of $ 500 million on current transactions with non-franc countries would imply an overall surplus on goods and services and private transfers (with franc and non-franc countries) of about 0.7 per cent of GNP.

Canada. In the longer run the Canadian authorities want to eliminate the current deficit, but it would probably not be appropriate to aim to achieve this during a period when the United States is seeking a large improvement in its trade balance. In relation to GNP the suggested interim aim represents a significantly smaller deficit than that incurred over most of the post-war period.

Germany. The official medium-term aim for 1973 is for a surplus on goods and services equivalent to 1.5 per cent of GNP, or around 0.9 per cent if private transfers are included.

Japan. The official aim was to reach a current surplus of $ 1½ billion by 1971. There is a question, however, whether even this is consistent with the desired improvement in the United States position. A $ 1 billion current surplus would give a surplus on goods and services equivalent to 0.7 per cent of GNP.

Italy. The authorities have indicated their desire to reduce the current surplus very substantially. A current account surplus of $ ½ billion would give a surplus of 0.2 per cent of GNP on goods and services, but still nearly 1 per cent if private transfers are included.

These aims imply a significant improvement in the current balance of the seven countries taken together, part of which would probably have to be obtained at the expense of other OECD countries, but which would also seem to require a rise in the combined current surplus of the OECD area as a whole—and hence also in the financial flows to non-OECD countries.

TABLE 15

Current account forecasts and " medium-term aims "

$ billion ; estimates and forecasts

	Average 1960-1967	1968	1970 I annual rate	"Medium term aims"	Discrepancy	As per cent of 1968 exports
United States	3.23	–0.28	1.0	3.7	–2.7	8
United Kingdom	–0.33	–1.09	0.6	1.5	–0.9	6
France[a]	0.53	–0.30	0	0.5	–0.5	4
Canada	–0.80	–0.15	–1.0	–0.8	–0.2	2
Japan	–0.02	1.05	2.5	1.0	1.5	12
Germany	0.33	2.88	1.6	0.5	1.1	4
Italy	0.87	2.64	2.0	0.5	1.5	15

a) Transactions with non-franc countries.

TABLE 16

Balances on goods and services

Per cent of GNP at current prices
Estimates and forecasts

	Average 1960-67	1968	1970 I annual rate	" Medium-term aims "	Discrepancy
United States	0.9	0.3	0.4	0.7	–0.3
United Kingdom	0.2	–0.5	1.1	2.0	–0.9
France[a]	0.6	–0.2	–0.1	0.3	–0.4
Canada	–1.4	–0.2	–1.2	–0.9	–0.3
Japan	0.1	0.9	1.3	0.7	+0.6
Germany[b]	1.7	3.5	2.3	1.5	+0.8
	(1.1)	(2.9)	(1.6)	(0.9)	
Italy[b]	1.1	3.1	1.8	0.2	+1.6
	(1.8)	(3.7)	(2.6)	(0.9)	

a) Transactions with non-franc countries.
b) Figures in brackets include private transfers.

surplus nevertheless forecast could mark the emergence of a longer run trend. For Germany the forecasts assume that the border tax adjustments remain in force. Demand conditions in the first half of next year seem likely to produce a below-normal current surplus, with inflationary pressures emerging at home against somewhat slacker conditions in important markets abroad. For Italy, on the other hand, conditions may still be cyclically favourable, and a continuation of sustained domestic expansion should bring the surplus down further in the second half of next year and into 1971.

CURRENT ACCOUNT AIMS AND CAPITAL MOVEMENTS

The foregoing is confined to imbalances on current account. The last few years have witnessed extremely large changes in net capital movements, which, at least until recently, have tended to offset—and, in some cases, more than offset— changes on current account. Recent developments are discussed in the next section. They reveal, inter alia, the paradox that last year and in the first quarter of this year, the United States was running a current account deficit for the first time this decade, but at the same time recorded its first significant overall surplus on official transactions in the 1960's.

It may, therefore, be open to question how much it matters if a country fails to achieve a preconceived structure of its balance of payments, particularly since both current and capital transactions are extremely difficult to forecast with any precision. The authorities' first concern may simply be to achieve a sustainable overall position on official settlements over a period of years. A country running an unexpectedly large current surplus may prefer to adapt its policies so as to stimulate a correspondingly larger capital outflow, rather than take the steps necessary to achieve its desired balance of payments structure ; and, similarly, in reverse for a country with an unexpectedly weak current account position. Such a solution will be sustainable unless and until speculative forces build up—often in a rather fickle way—because public opinion at home or abroad becomes convinced that the new configuration is inappropriate and, therefore, unlikely to last indefinitely. As they build up, speculative forces tend to slow down or reverse the equilibrating capital movements which normally take place between countries in different cyclical positions, and ultimately to distort current transactions as well.

This has been an increasing feature of events over the last two years. It should be noted, however, that by altering the policy mix there may be a fairly wide range over which the structure of the balance of payments as between the current and capital account can be varied, with both a sustainable overall position and the maintenance of the desired degree of full employment and price stability. There are, however, limits, which are not easy to identify clearly ; beyond a point, for example, a policy combining relatively easy monetary conditions to stimulate capital outflows with fiscal restraint to prevent overheating will—with fixed exchange rates—run into conflicts which prevent one or other of the objectives from being achieved.

Over a period of time questions of the *desirability* as well as the sustainability of the structure of the balance of payments become increasingly relevant. On general economic grounds individual countries may feel it appropriate to draw on foreign savings to finance domestic investment with high rates of real return ; or, conversely, to take advantage of high rates of return on investment abroad. Such considerations may be qualified, however, on more narrowly nationalistic grounds : for example, by a view that large foreign debts and/or control over domestic production facilities involve an unacceptable infringement of national sovereignty ; or, conversely, that beyond a certain point the export of domestic savings is undesirable on national welfare grounds.

At the international level, a further consideration is the accepted need to promote an adequate transfer of real resources to the developing countries as embodied in the 1968 UNCTAD resolution to devote to aid flows the equivalent of 1 per cent of GNP. While this implies a presumption that the average developed country should run a surplus on goods and services of a significant size, this cannot, for the reasons already discussed, provide a clear-cut criterion for each developed country taken individually. In practice, the size of the combined OECD surplus on goods and services with the developing countries is determined by the financial resources made available to them through official or private channels (less any "backflow"). If, therefore, any one OECD country fails to achieve its intended current surplus, the counterpart will normally be a complementary discrepancy in the case of another OECD country or countries. In 1968, neither the $ 3.2 billion deterioration in the United States trade balance nor the $ 7 billion improvement in its capital balance were reflected to any significant extent in the combined balance of payments of the OECD area as a whole. It is important to recognise, however, that imbalances within the area will—and probably have—reduced the combined current surplus to the extent that balance of payments difficulties lead to cuts in aid without corresponding increases from surplus countries ; moreover, escalation of interest rates may cut back interest-sensitive capital flows to the developing countries.

For *Canada* it is usually accepted that—despite the high level of per capita income already achieved—net capital inflows are appropriate in order to facilitate the rapid exploitation of high-yielding investment opportunities. At the same time, Canada is perhaps one of the countries which, because of its close trade and financial ties with the United States, has a rather wide range over which it can achieve a sustainable balance of payments structure by varying the policy mix. Over both the short and longer run, the capital inflow has been matched quite closely to fluctuations in the current deficit—although at times this has posed problems in the use of monetary policy for domestic demand management. The question for Canada is, therefore, less one of sustainability [1] than of desirability ; more particularly, of the appropriate trade-off between rapid exploitation of domestic investment opportunities against considerations of national sovereignty.

Italy has been a substantial net exporter of goods and services for more than ten years,[2] part of which has been used to build up official reserves, but which has been increasingly covered by large-scale capital outflows. In view of Italy's large social and economic investment requirements, this is generally considered to be inappropriate. This seems to be a case where failure fully to exploit the growth potential of the economy has tended to perpetuate an unsatisfactory structure of the balance of payments. On the one hand, it has been associated with a better than average cost and price performance which has accentuated Italy's strong competitive position. On the other hand, the continued efforts to maintain easy credit conditions and keep interest rates down in the face of monetary tightness elsewhere, while appropriate in the short run from both the internal and external point of view, seem to have led to the large capital outflow acquiring a momentum of its own. One factor has been certain institutional weaknesses in Italian money and capital markets ; another has been the emergence of economic and social unrest, itself probably partly a consequence of the failure to absorb the substantial margin of under-utilised resources. Up to a point, this situation has been sustainable ; the expansionary monetary forces—and exchange rate speculation—which might otherwise have been generated by the very large current surpluses have been counterbalanced by the developments in the capital balance. But, as time has passed, both the desire to reduce the excessive export of domestic savings—and the difficulties of doing so have increased. In this sense the situation prevailing over the last few years is not sustainable over the longer run.

Germany has also been running current surpluses well above the desired level since the 1966-67 recession. In the recovery phase it did not prove too difficult to stimulate correspondingly large capital outflows through vigorous use of monetary policy. As full employment has been reached, however, the conflict between internal and external objectives of monetary policy has increased. These difficulties have been greatly exacerbated by speculative forces which, although partly due to accidental factors, also reflected—rightly or wrongly—a feeling that the position was becoming unsustainable.

The prospects for the *United States* over the next few years raise the possibility of the opposite sort of problem. Any assessment must be subject to considerable uncertainty. But, even after the economy has been cooled off and the price rise has been brought down to an acceptable level, the trade surplus may remain below past levels. Given the favourable trend in invisible transactions and underlying forces benefiting the capital account, it might be possible to achieve a sustainable overall balance through a policy combining high interest rates with fiscal stimulus. But how far it would be feasible to go in this direction is at present extremely difficult to assess, particularly in view of the desire to ease and eventually remove the present controls on private capital movements.

These four examples may generally support the conclusion that while in the short and medium run there may be a rather wide range of current account positions which are compatible with a sustainable overall position, over the somewhat longer run it becomes increasingly desirable and necessary to achieve balance of payments structures which can be regarded as appropriate on national and international grounds.

The question arises, therefore, whether the slow progress that appears likely to be achieved in reducing imbalances over the next twelve months—despite

1. It is relevant that when the Canadian dollar came under speculative pressure early in 1968 this was because of doubts about the continuing freedom of capital flows from the United States rather than about the current balance which was, in fact, in an unusually strong position.
2. With the exception of 1962-1963. The cumulative net export of goods and services over the 11 years 1958-68 amounted to the equivalent of 16 per cent of an average year's GNP.

the improvement expected in respect of relative demand pressures—can be accepted as satisfactory. The risks involved in unduly slow adjustment are of various kinds. First, deficit countries have to adopt undesirably restrictive demand management, generating widespread deflationary tendencies. Looking at the present situation and prospects this does not seem to be a very immediate danger—perhaps the main reason being the strong political resistance that has grown up in almost all countries to the idea of deliberately running an economy significantly below its full employment potential. Given this, there is the converse risk that failure to adjust may in certain circumstances push surplus countries into undesirably inflationary situations. More generally, the uncertainties generated by the persistence of extreme imbalances have probably been contributing to inflationary expectations in quite a number of countries. Third, there is the danger of increasing recourse to direct controls on international transactions. This has already been apparent over the last two or three years.

DEVELOPMENTS IN INTERNATIONAL CAPITAL FLOWS

Very large and often sudden international capital movements have continued, reflecting speculative forces, measures in various countries to control or foster long-term capital movements as a balance of payments corrective, and the widespread consequences of increasingly tight and dear money in the United States.

The major change in capital balances last year was the sharp swing in net capital flows of the two major capital exporters—the United States and Germany—from a combined outflow of $ 7.5 billion in 1967 to an inflow of $ 0.6 billion in 1968 (Table 17). Of this reversal of $ 8.2 billion, $ 7.0 billion was accounted for by the United States which—for the first time since at least the end of the war—recorded a net capital inflow, of $ 1.7 billion. This more than offset the deterioration on current account and left the United States in official settlements surplus for the first time in the present decade. The decline of about $ 1.2 billion in the net export of capital from Germany was more than accounted for by a massive swing in short-term capital movements—from net outflows of $ 1.6 billion in 1967 to net inflows of $ 1.7 billion in 1968. Coinciding with an increase in Germany's current account surplus, this led to a rise in the German surplus on official settlements by about $ 1½ billion. Long-term capital exports from Germany—mainly of resident-owned funds—increased by just over $ 2 billion, to a quite exceptional total.

The main counterpart of the change in the combined capital account of the United States and Germany was a sharp increase in net capital outflows from the United Kingdom and the other EEC countries. The United Kingdom capital balance deteriorated by about $ 2 billion, and that of the five EEC countries other than Germany by an estimated $ 6 billion. A major factor in the latter amount was speculative outflows from France, but the capital balances of the other EEC countries also

TABLE 17

Summary balances of payments, 1967 and 1968

$ billion

	1967			1968		
	Current balance	Capital movements[a]	Balance on official settlements	Current balance	Capital movements[a]	Balance on official settlements
United Kingdom	–1.03[b]	–0.25[bc]	–1.28	–1.09	–2.09[c]	–3.18
United States	2.18	–5.21[c]	–3.03	–0.28	1.74[c]	1.46
RESERVE CURRENCY COUNTRIES	1.15	–5.46	–4.32	–1.38	–0.35	–1.72
France[d]	0.24	0.04	0.34[e]	(–0.30)	(–3.50)	(–3.70)[e]
Germany	2.46	–2.34	0.13	2.88	–1.12	1.76
Italy	1.60	–1.04	0.56	2.64	–2.71	–0.06
Other EEC	0.12	0.30	0.42	0.08	–0.46	–0.38
TOTAL EEC	4.42	–3.05	1.44	(5.30)	(–7.80)	(–2.39)
Canada	–0.50	0.51	0.01	–0.15	0.36	0.21
Japan	–0.19	0.13	–0.06	1.05	–0.19	0.86
Other OECD North	–0.52	0.63	0.11	(–0.05)	(0.74)	0.69
Other OECD South	–0.58	0.59	0.01	(–0.49)	(0.66)	0.17
TOTAL OECD	3.78	–6.64	–2.81	(4.30)	(–6.60)	(–2.20)

a) Including banking funds and unrecorded transactions.
b) Based on most recent data in dollar terms available from the Central Statistical Office: not entirely comparable with latest data published in terms of sterling.
c) Including changes in liquid liabilities to international non-monetary institutions.
d) Transactions with non-franc countries.
e) Including net settlement on behalf of the overseas franc area.

TABLE 18.
Capital movements in OECD countries 1967-1968
$ billion

	1967						1968					
	Total capital	Non-monetary capital: Total	Non-monetary capital: Long-term	Non-monetary capital: Other *a*	Banking funds *b*	Total short-term capital	Total capital	Non-monetary capital: Total	Non-monetary capital: Long-term	Non-monetary capital: Other *a*	Banking funds *b*	Total short-term capital
United States	-5.21	-6.23	-5.32	-0.92	1.02	0.11	1.74	-2.23	-1.20	-1.03	3.97	2.94
United Kingdom *c*	-0.14	0.05	-0.24	0.28	-0.18	0.10	-2.19	-1.08	-0.23	-0.85	-1.12	-1.96
TOTAL RESERVE CURRENCY COUNTRIES	-5.35	-6.19	-5.55	-0.63	0.84	0.21	-0.45	-3.30	-1.43	-1.88	2.85	0.98
France *d*	0.04	-0.33	0.12	-0.46	0.37	-0.09	(-3.50)*e*	..	..	..	..	..
Germany	-2.34	-1.13	-0.77	-0.36	-1.21	-1.57	-1.12	-1.91	-2.87	0.96	0.79	1.75
Italy	-1.04	-1.22	-1.10	-0.12	0.18	0.06	-2.71	-1.98	-1.28	-0.71	-0.72	-1.43
Belgium-Luxembourg	0.05	-0.04	0.05	-0.09	0.09	0.00	-0.30	-0.24	-0.13 *e*	-0.12 *e*	-0.06	-0.18 *e*
Netherlands	0.25	0.15	-0.17	0.31	0.11	0.42	-0.16	-0.10	-0.08	-0.02	-0.07	-0.08
TOTAL EEC	-3.05	-2.58	-1.87	-0.72	-0.46	-1.18	(-7.80)*f*	(-7.50) f	..	..	-(0.30)f	..
Austria	0.27	0.32	0.27	0.05	-0.05	0.00	0.12	0.20	0.20	0.01	-0.08	-0.07
Denmark	0.19	0.21	0.22	-0.01	-0.02	-0.03	0.15	0.22	0.15	0.07	-0.08	-0.01
Norway	0.34	0.37	0.39	-0.02	-0.03	-0.05	-0.13	-0.01	0.04	-0.05	-0.12	-0.17
Sweden	-0.05	0.12	..	..	-0.17	..	0.23	0.21	..	..	0.03	..
Switzerland	-0.07	-0.13	..	..	0.06	..	0.18	0.70	..	..	-0.53	..
Other European countries of the OECD	0.54	..	1.02	..	..	-0.48	0.85	..	..	..	..	..
Canada	0.51	0.83	1.24	-0.41	-0.32	-0.73	0.36	0.66	1.35	-0.69	-0.30	-0.99
Japan	0.13	-0.38	-0.81	0.43	0.51	0.94	-0.19	0.05	-0.25	0.30	-0.24	0.06
TOTAL OECD NON-RESERVE CURRENCY COUNTRIES	-1.18	..	..	..	..	..	(-6.20)	..	..	..	..	..
NET APPARENT CAPITAL OUTFLOW TO THE REST OF THE WORLD	-6.53	..	..	..	..	..	-6.65	..	..	..	..	..

a) Including errors and omissions and unrecorded transactions.
b) Including, for the reserve currency countries, changes in liquid liabilities to international non-monetary institutions.
c) See Note *b)* to Table 17.
d) Transactions with non-Franc countries only.
e) Secretariat estimates.
f) Including an estimate for France.

deteriorated in 1968: Italy's by $ 1.7 billion, and that of the Benelux countries, taken together, by about $ 0.8 billion, these changes mainly reflecting short-term capital movements. In the United Kingdom and France these movements, added to an already unfavourable or deteriorating current account position, led to very large official settlements deficits.

On the basis of the global data summarised in Table 18 (regional details are not yet available on the 1968 capital accounts of most OECD countries) there appears to have been little net change in the imputed net outflow of capital from the OECD area to the rest of the world. However, ancillary evidence of various kinds (see page 24) suggests that there was probably a significant increase in net private long-term capital outflows to non-OECD countries, with little net change in outflows of official long-term capital.

The main feature of 1969 to date has been the steadily increasing pressure of tight money and rising interest rates in the United States on capital and money markets throughout the OECD area. This was interrupted in late April and early May by the massive speculative inflow into Germany in anticipation of revaluation. The focus of attention switched back again to the United States with the recent raising of the prime rate to the record level of 8½ per cent, and by mid-June the 3-month Euro-dollar rate had risen to 11-12 per cent.

Partly for domestic reasons, but also partly in response to these external pressures, short-term interest rates have been raised and a variety of other measures taken to stem capital outflows in virtually all the European OECD countries since the beginning of the year. Although they may be modified by the recent proposals to inhibit capital inflows through United States banks (see page 38), these trends are unlikely to cease entirely until the credit squeeze in the United States bears fruit in terms of a slackening in the demand for funds and a reduction of inflationary pressures.

Short-term Capital Movements up to the November Crisis

International movements of short-term funds throughout 1968 were dominated by waves of speculative forces—the run on sterling and the gold crisis early in the year; the outflow from France during the May-June crisis, which continued more or less steadily through the summer; a preliminary burst of speculation on a Deutschemark revaluation at the end of August; and the massive flow of funds into Germany in November.

Alongside this turbulent flow into and out of European currencies was the pull of the U.S. financial markets, although net flows of short-term funds into the United States were large only in the second quarter, when monetary conditions were noticeably tightened, and in the third, when a general easing of dollar interest rates led to a situation where it was cheaper for U.S. banks to borrow Eurodollars through their European branches than to issue certificates of deposit in New York—though they continued to do both.

October was one of the few periods of relative calm in the exchange markets during the year. There was a pause in speculation on the Deutschemark. Moreover, the announcement of a more favourable United Kingdom trade balance, and of the central bank arrangements to offset withdrawals of sterling funds by official institutions in sterling area countries, led to a marked improvement of sterling in the forward exchange markets. As a result, foreign funds began to move back into the United Kingdom early in the month, despite the upward pressure that was beginning to emerge on Eurodollar interest rates. And in France, where the ending of exchange controls had been announced in September, there appears initially to have been a sharp decline in the capital outflow that had been more or less continuous since May.

The respite from speculation, however, was brief. From late October through the first three weeks of November there was a further capital inflow into Germany of about $ 3 billion. The Bundesbank intervened to rechannel funds into the Eurodollar market and, in the period to 15th November, is reported to have engaged in swap transactions with the German commercial banks of about $ 1 billion. Despite this rechannelling and the return flow of some of the foreign capital after the Bonn communiqué of 22nd November, the net inflow of short-term funds, German and foreign, over the month as a whole totalled $ 1.4 billion and German official reserves rose by $ 1.8 billion.

Virtually all other major currencies except the Swiss franc were affected to some extent by the intense speculative pressure. There were substantial withdrawals from the Eurodollar market for conversion into Deutschemarks, as evidenced by a sharp rise in Eurodollar interest rates—the counterpart, on this occasion, being mainly a drain on central bank dollar holdings rather than a deterioration in the United States' official settlements position. The currencies hardest hit were sterling and the French franc; both were again traded at a substantial forward discount (in the case of the franc, as wide as during the earlier political crisis), and there appear to have been large short-term capital outflows from both countries.

Short-term Capital Movements after the November Crisis

The return flow from Germany which began after the Bonn conference continued through January, by which time German reserves were below their late summer level. In the meantime both France and Britain had taken measures to deter capital outflows or encourage capital inflows, and were thus able to benefit from the reflux from Germany. Although detailed monthly figures are not available, published reserve changes indicate that both countries were able to improve greatly their balances of payments on official settlements account; an improvement which continued into the early months of 1969.

The French improvement was accomplished by various policy measures. The discount rate was raised and a ceiling placed on the growth of short-term bank credit early in November. After the Bonn meeting, and the decision not to devalue the franc, additional monetary and fiscal measures of a restrictive character were announced and exchange controls, much more stringent than those in effect earlier, were reimposed. Measures were also taken requiring French banks to reduce their net foreign assets, or to refrain from redressing a net liability position. As a result of these measures, and perhaps because of rising domestic interest rates, French commercial banks reduced their net position in foreign currencies vis-à-vis non-residents by $ 780 million in the fourth quarter as a whole—a change that was more than accounted for by increased borrowing abroad, since assets payable in foreign currencies actually increased by about $ 500 million.

The improvement in the United Kingdom's position, although erratic and interrupted during the May crisis, seems to indicate at least some restoration of confidence in sterling. This has been bolstered by the measures taken at the time of the November crisis, strengthened further by the discount rate increase in February, the April budget measures, the higher long-term interest rates permitted to appear in the gilt-edged market, and the sharp turnaround in the fiscal position.

But clearly the most important factor dominating short-term capital movements between the Deutschemark crises of November and May was the rapidly growing tightness in U.S. financial markets, with escalating interest rates and large drafts on the Eurodollar market by United States banks.

Until late last year, the pressure of demand for funds in the United States was allowed to be reflected in higher interest rates; but no major specific actions were taken to enhance the growing stringency. On 17th December, however, the authorities announced an increase in the discount rate from 5¼ to 5½ per cent and began to follow a markedly more restrictive open market policy and these measures led immediately to a further sharp jump in market interest rates in the United States. United States banks were also confronted with sharp pressures on their liquidity from another direction. Because of the Regulation Q ceiling, the rates they were able to offer on large certificates of deposit were no longer competitive; by the end of last year their liabilities in this form had declined by $ 1.5 billion from the peak reached at the beginning of December. Immediate resort to the Eurodollar market to replace funds lost by the deposit withdrawals was hindered by certain special year-end developments, including the substantial, but temporary, withdrawal of Eurodollar deposits from London by U.S. corporations to ensure compliance with the U.S. programme. The further sharp rise in Eurodollar interest rates may have partly reflected French demands on the market and the fact that only part of the funds that had entered Germany in November had left that country by the end of December. Another growing demand on the market during the latter part of the year, which seems to have been exceptionally heavy in the fourth quarter, came from U.S. corporations, who were borrowing from the Eurodollar market (in addition to issuing Euro-bonds) to finance their overseas investments.

Since the beginning of this year financial conditions in the United States have tightened steadily, as an increasingly restrictive monetary policy confronted credit demand heightened by expectations of continued inflation. Most short-term interest rates climbed steadily, although the key 90-day Treasury Bill rate fluctuated narrowly at a high rate of just over 6 per cent until early June, when it jumped suddenly to 6.5 per cent. Open market policy, a rise in the discount rate in April and an increase of about $ 650 million in required reserves all added to the pressure on the banking system. The effects of Regulation Q ceilings caused a continued drain of large certificates of deposit—by $ 5.8 billion from 1st January to 28th May. In these circumstances the banks resorted to heavy borrowing from their overseas branches, pushing interest rates in the Eurodollar market well above U.S. rates; by early June, the 30-day rate was in the 11-12 per cent per annum range.

This tremendous pull of the dollar market began to attract more and more funds from all over Europe and from the rest of the world. Some indications of the source and destination of these short-term capital flows emerge from the data on dollar assets and liabilities of British banks:

	$ billion	
Western Europe	0.88	
Germany		0.22
Belgium		0.22
Netherlands		0.20
France		0.17
Italy		0.17
Norway		0.06
Canada, Japan and United States	0.59	
Non-OECD countries	0.99	
	2.46	

Thus as 1969 has progressed, the pressures on the Eurodollar market have intensified, with a resulting escalation in interest rates. Almost all European countries have responded to this situation—and to their own domestic needs—by raising domestic short-term interest rates, and in many cases taking various kinds of action to stem capital outflows—which, in reducing the supply of funds, have added to the upward pressure on interest rates.

These actions were varied, and occurred at differing times, beginning as early as December, when three countries, Canada, Belgium and the Netherlands followed the U.S. action and raised their discount rates. So far in 1969, discount rates have been increased in twelve member countries of the OECD ; in five countries more than once. Several countries—Germany, Italy, Belgium, Denmark, Sweden—took new discrete measures to inhibit capital outflows or to stimulate capital inflows.

During April and early May, growing evidence that the German measures taken in the autumn were not seriously affecting the German current account surplus, and renewed public discussion in private and official circles regarding the desirability of revaluing the Mark, combined to provoke a new speculative crisis. According to German spokesmen, from late April to 9th May—when the decision was again taken not to change the parity—there was an inflow of speculative funds of about $ 4 billion. There seem to have been large shifts in leads and lags and again large withdrawals from the Eurodollar market. The resultant strain on official reserves was widely spread throughout Europe, being particularly severe in the case of Denmark. Although there was no significant fall in funds borrowed by U.S. banks from their foreign branches, it seems likely that some of the pressure fell on the United States balance of payments, probably pushing the official settlements position, at least temporarily, back into substantial deficit.

Faced with this flood of incoming funds, the German authorities at first intervened actively to rechannel the funds back into foreign currency markets, but suspended their operations when it became clear that the swaps were being increasingly used to finance the speculation. In the two weeks following the second decision not to revalue the Deutschemark the German authorities took a number of steps to discourage further inflows and induce a return of funds to other countries. Reserve requirements against foreign deposits were reimposed; and on 22nd May the Bundesbank began again to offer swap cover on short-term foreign investments by the German banks on very favourable terms. The reversal of the speculative flows got under way rather slowly, but appears to have accelerated in mid-June, as conditions in United States financial markets tightened further and Eurodollar rates reached new record levels. The additional funds tied up in German reserves—which are presumably invested entirely in U.S. Treasury bills—may directly or indirectly be exerting additional pressure on the Eurodollar market.

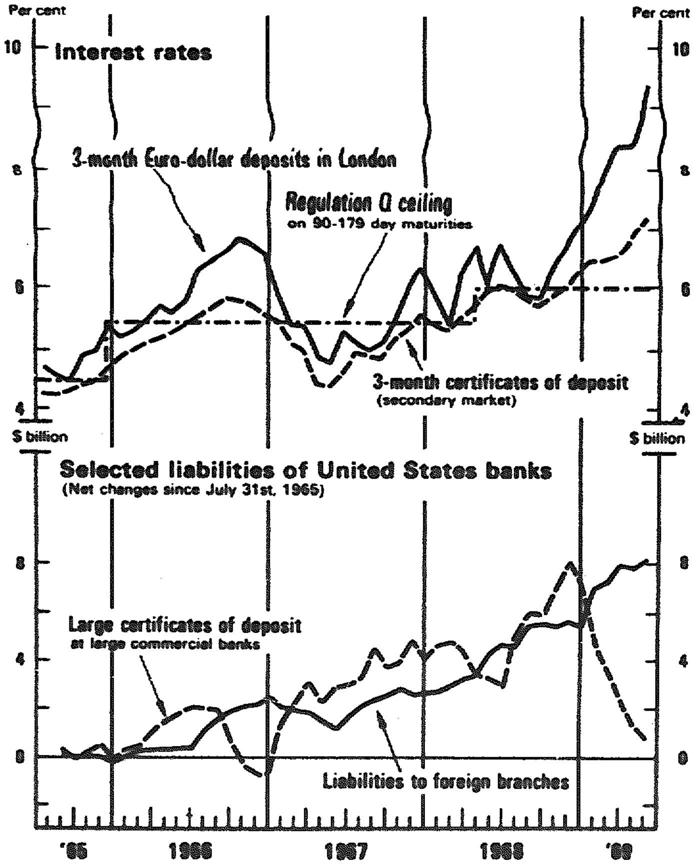
The monetary pressure coming from the United States, and the response this has elicited from other countries, has raised some important issues. Given the size of the United States economy, it was to be expected that vigorous use of monetary restraint would have considerable repercussions throughout the OECD area. In fact, the pull has been sufficient to put the United States significantly—albeit erratically—into surplus on official settlements, despite the deterioration in the current account. There has therefore been a drain on other countries' reserves—accentuated in May by the Deutschemark crisis—and several countries' official dollar holdings have fallen to unusually low levels. Moreover, in a number of them the high demand for funds in the Eurodollar market has begun to contribute to growing stringency in domestic money and credit markets.

There is obviously a danger that under these circumstances countries might be pushed into undesirably restrictive monetary policies. For the two countries in the most vulnerable external positions, France and the United Kingdom, the tensions which have prevailed so far this year in international markets are clearly not helpful. However, capital outflows from these countries appear to have owed as much to confidence factors as the attractiveness of interest rates elsewhere; and, in any case, both need to rely heavily on restrictive monetary policies for internal reasons. For a number of other European countries—notably Germany, but also several of the smaller industrialised countries—there have also been good domestic grounds for a significant tightening of monetary policy since last autumn, as domestic expansion has begun to run into capacity limitations. While, therefore, there does seem to have been some defensive element in certain of the measures taken, it is not clear that up to June the general tightening of monetary conditions in Europe had gone further than would in any case have been justified by the pace of expansion and the inflationary problems faced by several countries. It might have been, however, that some countries would soon be pushed into an unbalanced policy-mix giving undue weight to monetary restraint in relation to the requirements of their own domestic situation.

In June, the borrowing of Eurodollars by United States banks from their foreign branches accelerated sharply, increasing by more than $ 3 billion in three weeks. Against this general background, the Federal Reserve Board announced on 26th June plans to impose a 10 per cent reserve requirement against increments in such borrowing above the May average : the same requirement would also apply to " borrowings " from foreign banks [1]. In order to avoid by-passing the intended effect of slowing down the domestic use of Eurodollars, a similar requirement was imposed against direct loans by foreign branches of United States banks to residents of the United States and against assets acquired by a foreign branch from a United States office of the bank. These changes—if eventually approved by the Federal Reserve Board—should have the effect of slowing down the flow of short-term foreign funds to the United States through the banking system: indeed,

CHART G

INTEREST RATE DEVELOPMENTS
AND UNITED STATES BANKS' BORROWING
FROM FOREIGN BRANCHES



since the banks' position at end-June was apparently well above the base figure, the initial effect might well be some net outflow of these funds. However, other short-term flows—including loans by foreign banks to U.S. residents, both directly and via the United States agencies and branches of such banks—will remain unaffected by the proposed change in Federal Reserve regulations : so that, given the present degree of monetary tightness in the United States economy, some short-term capital movements across the Atlantic may continue, although probably at a much reduced pace.

Eurodollar Market

The foregoing description of recent short-term capital movements has made frequent reference to movements into and out of the Eurodollar market. This market, which consists of the depositing of short-term funds denominated in dollars at banks outside the United States and their relending (both to U.S. and non-U.S. residents), grew remarkably in 1968, according to the estimates published by the Bank for International Settlements [2]. It expanded by more than 40 per cent, from about $ 17.5 to $ 25 billion. Of this $ 7.5 billion increase, $ 1.9 billion came from the United States and Canada (Table 19) consisting almost entirely of the temporary deposit of funds borrowed abroad by U.S. corporations to finance direct investments.

On the other—or " uses "—side, the BIS data show that $ 4.4 billion—about 60 per cent—of the funds raised in 1968 were employed in the United States and Canada. This is more than twice as much as the U.S. banks reported as having borrowed through their foreign branches; the remainder (after some allowance for lack of comparability of statistics from different sources) must have represented direct lending to U.S. residents—bank and nonbank—by banks engaged in the Eurodollar market. This could include, *inter alia*, loans to domestic (U.S.) customers sold by U.S. banks to their foreign branches and correspondents; funds placed in the U.S.

1. Deposits of foreign banks with United States banks have previously been subject to reserve requirements, and would remain so under the new regulations.

2. These data comprise activities of commercial banks operating in eight European countries, which are believed to cover practically all the market. Transactions of Canadian and Japanese banks, however, are excluded, except to the extent they are counterparts to the assets and liabilities of banks in the eight reporting countries.

TABLE 19

Net Euro-dollar flows, 1966-68

$ billion

Geographic area	1965	1966	1967	1968	Balance outstanding end-1968
Sources of funds (" deposits ")					
Outside area					
United States and Canada[a]	-0.2	0.4	0.9	1.9	4.5
Other	0.5	0.8	0.9	2.0	7.3
TOTAL	0.3	1.2	1.8	3.9	11.8
Inside area					
Non-banks	0.4	0.6	1.1	1.3	5.2
Banks[b]	1.8	1.2	0.1	2.3	8.0
TOTAL	2.2	1.8	1.2	3.6	13.2
Total sources	2.5	3.0	3.0	7.5	25.0
Uses of funds (" credits ")					
Outside area					
United States and Canada[c]	0.5	2.3	0.8	4.4	10.2
Other	0.7	0.7	1.6	2.0	6.8
TOTAL	1.2	3.0	2.4	6.4	17.0
Inside area					
Non-banks	1.0	0.4	0.4	0.6	4.7
Banks[d]	0.3	-0.4	0.2	0.5	3.3
TOTAL	1.3	0.0	0.6	1.1	8.0
Total uses	2.5	3.0	3.0	7.5	25.0

a) Excludes loans and other conventional commercial transactions with United States banks.
b) Including funds deposited by commercial banks within the area (e.g. German banks' deposits in London) under special arrangements with official monetary institutions.
c) Excludes funds placed in the United States unless such funds are the counterpart of *dollar* deposits at the bank making the U.S. placement. For instance, investments of German banks in U.S. Treasury bills, financed by dollars obtained by swaps with the Bundesbank, are excluded. Also excluded, are normal correspondent balances held in the U.S.
d) Including assets payable in a non-dollar currency if obtained by "swapping" dollars obtained in the Euro-market as deposits or by borrowing. However, such transactions when carried out by Italian banks with Italian residents are reported in the "non-bank" category.

Note : The data, in principle, exclude redeposits among reporting banks.

market through the New York agencies and branches of European banks engaged in Eurodollar operations; loans to U.S. corporations and their overseas financing subsidiaries to assist the latter in financing direct investment; and other direct extensions of credit to U.S. residents.

Long-term Capital Movements

An account of long-term capital movements in 1968 and early 1969 can be limited to developments in the private sector; after adjustment for various types of special transactions, changes last year in net flows of official capital were relatively small.

Among the major countries, the main developments were a substantial increase in net outflows of resident capital from most countries of the EEC and large increases in inflows of non-resident capital, particularly into the United States, but also into Japan and Canada (Tables 20 and 21). The main force at work has been the shifts in monetary pressures already described and their effects on interest rates and capital market conditions in different countries. The United States balance of payments programme has also been a powerful force working in the same direction. The rapid growth of the international issue market and of large-scale purchases of outstanding issues may also reflect a growing willingness and desire on the part of institutional investors in many countries to build up their foreign portfolio holdings.

As noted below, the main effect of the United States balance of payments programme in 1968 was to induce American corporations to draw heavily on foreign sources of funds to finance their overseas investments, particularly by floating bonds in foreign and international markets. Together, these diverse influences combined to produce large changes in flows of portfolio capital. In addition, in the United States and Japan there were sharp increases in the use of other foreign sources of long-term finance, principally—it would appear—of long-term loans from banks: a major counterpart was a substantial increase in long-term lending by German residents, particularly German banks (in addition to purchases of foreign bonds) ; but it is also likely that a significant part was obtained in the Eurodollar market.

In the *United States* all but $ 0.3 billion of the $ 3.9 billion swing in net movements of private long-term capital last year was accounted for by a massive increase in inflows of foreign capital, from $ 1.6 billion in 1967 to $ 5.2 billion. Some $ 2.9 billion of this increase was due to a sharp rise in foreign long-term claims on and investments in the United States corporate sector. Corporate bond issues abroad rose from $ 0.4 billion to $ 2.1 billion; and other foreign purchases of United States securities rose by about $ 1¼ billion.

Net foreign purchases of U.S. corporate equities at $ 2.3 billion, three times as much as in the previous year (which had followed three years of net sales), reflected a marked change in attitudes toward investment in United States securities. This may have been, at least in part, induced by the more favourable treatment of foreign investors provided by the Foreign Investors Tax Act of 1966. The hope of short-term capital gains may also have been a stimulus, although the performance of Wall Street in 1968 was outpaced by that of most of the other principal stock exchanges of the world. Political and economic uncertainties in Europe may have been another factor. The movement induced, and was aided by, the formation of a large number of mutual funds, organised outside the United States, for the principal purpose of investing in equities, particularly of United States corporations.

There was an increase of $ 670 million (compared with a rise of only $ 90 million in the previous year) in other long-term liabilities of the United States corporate sector. Both the bond issues and the other corporate borrowing reflected the constraints of the balance of payments programme on the use of domestic funds to invest abroad. Part of the

TABLE 20
Private long-term capital movements of major OECD countries 1967 and 1968
$ billion

		Total net	Assets reported separately				Liabilities reported separately				Other assets and liabilities net
			Total	Direct investment	Portfolio	Other	Total	Direct investment	Portfolio	Other	
United States	1967	-2.81	-4.45	-3.15	-1.27	-0.03	1.64	0.26	1.29	0.09	..
	1968	1.13	-4.11	-3.03	-1.27	0.18	5.23	0.32	4.24	0.67	..
United Kingdom	1967[a]	-0.09	-1.16	-0.74	-0.08	-0.34	1.07	0.51	0.03	0.54	..
	1968	-0.15	-1.49	-0.89	-0.39	-0.21	1.34	0.60	0.20	0.54	..
France[b]	1967	0.17	-0.45	-0.20	-0.06	-0.18	0.61	0.32	0.16	0.13	..
	1968	..	..	..	..	..	..	..	..	..	..
Germany	1967	-0.42	-0.83	-0.25	-0.35	-0.24	0.41	0.70	-0.16	-0.13	..
	1968	-2.50	-2.95	-0.39	-1.41	-1.15	0.45	0.38	0.00	0.06	..
Italy	1967	-1.00	-1.31	-0.23	-0.87[c]	-0.20	0.31	0.26	0.06	-0.02	..
	1968	-1.29	-1.77	-0.23	-1.41[c]	-0.14	0.48	0.33	0.05	0.10	..
Belgium	1967	0.15	-0.16	-0.05	-0.11	0.00	0.31	0.23	0.06	0.02	0.01
	1968	-0.06[d]	-0.29	-0.03	-0.27	0.01	0.23[d]	0.23	-0.01	-0.01[d]	0.00[d]
Netherlands	1967	-0.15	-0.47	-0.21	-0.04	-0.22	0.40	0.05	0.04	0.31	-0.08
	1968	-0.05	-0.59	-0.22	-0.27	-0.11	0.56	0.13	0.30	0.13	-0.02
Canada[e]	1967	1.24	-0.47	-0.08	-0.39	0.00	1.42	0.57	0.85	..	0.29
	1968	1.35	-0.64	-0.16	-0.43	-0.05	1.93	0.54	1.39	..	0.05
Japan[e]	1967	-0.81	-0.87	-0.12	0.00	-0.75	0.06	0.05	0.06	-0.04	..
	1968	-0.24	-1.10	-0.22	0.00	-0.88	0.86	0.08	0.35	0.43	..

a) See Note b) to Table 17.
b) Transactions with non-Franc countries only.
c) Including remissions of bank-notes.
d) Partly estimated by Secretariat.
e) Including official assets and liabilities.

TABLE 21

Changes in private long-term capital balances of major OECD countries 1967 to 1968[a]

$ billion

	Total net changes	Of which, due to changes in flows of: Resident capital			Non-resident capital		
		Total	Portfolio	Other	Total	Portfolio	Other
United States	3.94	0.34	0.00	0.34	3.60	2.95	0.65
Japan[b]	0.57	–0.23	0.00	–0.23	0.80	0.29	0.50
Canada[b]	0.34	–0.16	–0.04	–0.12	0.51	0.54	–0.03
United Kingdom[c]	0.06	–0.33	–0.31	–0.02	0.27	0.18	0.09
Netherlands	0.04	–0.12	–0.22	0.11	0.16	0.26	–0.10
Germany	–2.09	–2.12	–1.06	–1.06	0.03	0.16	–0.13
Italy	–0.29	-0.47	–0.53	0.07	0.18	–0.01	0.19
Belgium	–0.21[d]	–0.13	–0.16	0.03	–0.08[d]	–0.07	–0.02[d]

Note : A positive figure indicates a reduction in outflows of resident capital or an increase in inflows of non-resident capital.

a) Data relate only to capital movements for which details of assets and liabilities are available.

b) Including official long-term capital : see Note *e*) to Table 20.

c) See Note *b*) to Table 17.

d) See Note *a*) to Table 20.

borrowing abroad, however, appears to have been used to finance domestic activity. This indicates that although the balance of payments programme was an important factor behind the swing in the United States capital balance, it was powerfully assisted by the growing monetary pressures in the United States compared to conditions in most European capital markets.

The higher net inflow of non-resident capital to *Canada* in 1968 was also due to a substantial increase in foreign purchases of Canadian securities, which rose by $ 540 million. Of this, $ 350 million reflected new bond issues by Canada in European capital markets. In contrast, United States purchases of Canadian securities increased by only $ 90 million. The diversification of Canadian borrowing abroad last year largely reflected the growing pressures in United States and domestic capital markets.

The $ 0.3 billion increase in foreign portfolio investment in *Japan* last year also partly reflected resort by Japanese borrowers to European bond markets, but mostly purchases of outstanding Japanese bonds and shares by foreign investors, attracted by high yields and booming conditions in Japanese capital markets. High bond yields in Japan probably also contributed to the substantial increase in other Japanese long-term borrowing abroad, which rose from $ 30 million to $ 480 million.

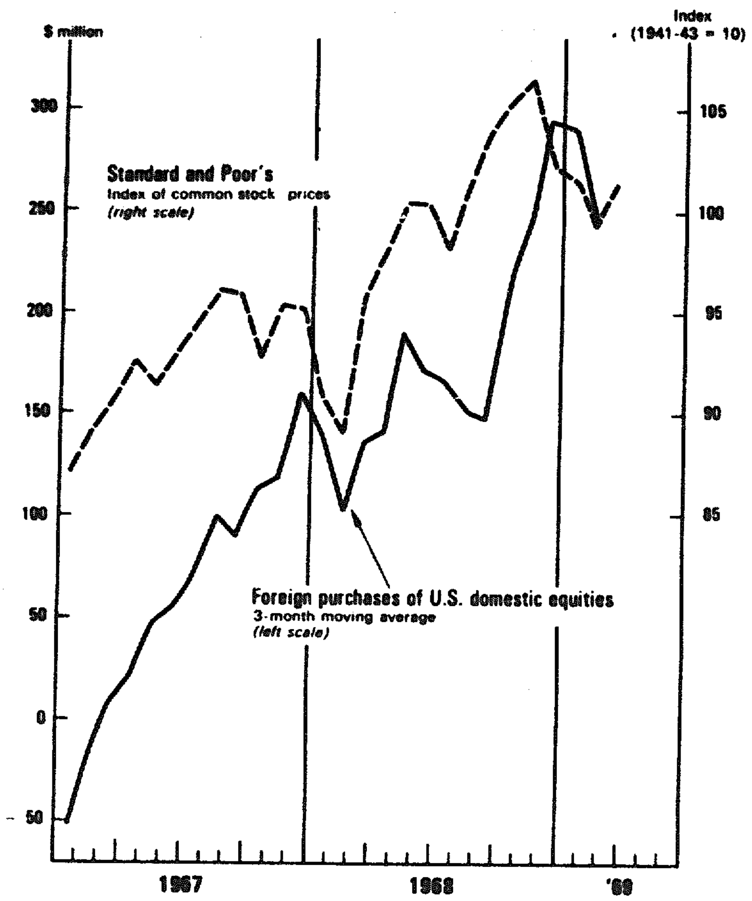
Borrowing in other European capital markets contributed to the rise in inflows of non-resident capital in both the *United Kingdom* and the *Netherlands*. The high level of activity in the Eurobond market probably also attracted some Dutch investors, contributing to the sharp increase in their acquisitions of foreign bonds and shares. The increase in resident portfolio capital outflows from the United Kingdom largely reflected purchases of Australian oil and mineral securities: exchange controls continue effectively to limit net investment in non-sterling countries. However, British companies, like American ones, are turning increasingly to overseas borrowing to finance overseas investment.

The main counterpart to the increased inflows of non-resident capital into the countries discussed above was a substantial increase in outflows of resident capital from Germany, Italy and Belgium, totalling $ 2.7 billion for the three countries together ; net inflows of non-resident capital changed little. Outflows of German funds almost quadrupled, rising from $ 830 million to $ 2,950 million, reflecting the ready availability of funds on the German capital market throughout the year. The increase was about equally divided between German purchases of foreign bonds and other securities, which rose by $ 1.01 billion, and long-term loans, mainly from German banks, which increased by $ 0.9 billion. Direct investment outflows from Germany also increased somewhat. Portfolio movements also featured largely in the higher net capital outflows from Italy (where—including an estimate for purchases financed by exporting bank notes—they accounted for more than the total increase) and from Belgium.

Few details are available of the overall picture of long-term capital movements in OECD countries in

CHART H

U.S. STOCK PRICES AND FOREIGN PURCHASES OF U.S. EQUITIES



early 1969. The most notable development was the further substantial increase in net long-term private capital outflows from Germany, which at $ 1.9 billion in the first four months, was already over three-quarters of last year's total. In the same period German purchases of foreign securities totalled $ 1,070 million. On the other hand, foreign purchases of United States equities seem to have reached their peak about the turn of the year, and have since fallen off (albeit from a very high rate of about $ 3½ billion a year), probably reflecting the downturn in United States stock prices (Chart H).

International Bond Issues

New Eurobond issues in 1968 soared to about $ 4.5 billion, almost double the volume of 1967 (Table 22). Of these about 75 per cent consisted of "international offerings" and the balance comprised foreign issues offered solely within national markets, mostly in Germany and Switzerland. In the first quarter of 1969 they amounted to an annual rate of $ 6¾ billion, but fell off sharply in April and May to an estimated annual rate of $ 3 billion, and activity has since remained rather slack. The fact that United States companies hold in liquid form some $ 1.5 billion of the proceeds of earlier issues may have lessened their need for borrowing. The market also seems to have become congested in the first quarter. Moreover, it may have paused to digest the implications of the measures taken in April by the Italian authorities to regulate capital outflows and the "queueing" requirements imposed in Germany on non-resident issues in domestic currency—though

TABLE 22
International bond issues outside the United States market[a]
$ billion

	1967	1968	1969 Q1	1969 April-May
CURRENCIES OF ISSUE				
Dollars	1.66	2.46	0.76	0.25
Deutschemarks	0.19	1.32	0.78	0.18
Swiss Francs	0.16	0.33	0.09	0.02
Other[b]	0.28	0.34	0.05	0.03
TOTAL	2.29	4.45	1.68	0.49
Of which:				
Issued in international markets	1.89	3.37	1.15	0.35
Issued in national markets	0.40	1.08	0.53	0.14
BORROWERS				
U.S. companies	0.60	2.23	0.65	0.20
Western Europe[c]	0.95	0.86	0.43	0.08
Other OECD countries[d]	0.07	0.44	0.30	0.11
Non-OECD countries	0.44	0.42	0.17	0.01
International lending institutions[e]	0.23	0.50	0.13	0.09
TOTAL	2.29	4.45	1.68	0.49
U.S. BORROWERS				
Dollars	0.49	1.88	0.51	0.17
Deutschemarks	0.06	0.21	0.09	0.01
Swiss Francs	0.05	0.14	0.03	0.01
Other	0.00	0.00	0.02	0.01
TOTAL	0.60	2.23	0.65	0.20
Of which:				
Convertible	0.23	1.65	0.40	0.09
Non-convertible	0.37	0.59	0.25	0.11

a) Data for 1967 and 1968 are based on BIS compilations ; data for 1969 are Secretariat estimates.
b) Including issues denominated in units of account and in more than one currency.
c) Excludes the United Kingdom.
d) United Kingdom, Canada, Japan.
e) Including European regional institutions.

UNITED STATES BALANCE OF PAYMENTS PROGRAMME

The net outflow of capital items affected by the United States balance of payments programme declined by roughly \$ 3½ billion in 1968. On direct investment transactions it fell by \$ 2.3 billion to \$ 1.5 billion (Table 23) ; bank credit covered by the programme swung by \$ 1 billion to an inflow of \$ 0.6 billion ; and there were substantial repatriations of short-term balances previously held abroad by United States corporations.

The effects of the controls in producing these changes cannot be distinguished from those of other forces at work. Thus, although the growth in investment expenditures by United States subsidiaries abroad slowed down in both 1967 and 1968, there is little evidence that this was due to the programme. The main effect of the latter was to stimulate an increase in the financing obtained outside the United States both by parent companies and, it appears, by subsidiaries. But this was considerably facilitated by the easy conditions in foreign money and capital markets relative to those in the United States : indeed, some of the borrowing abroad appears to have been undertaken to finance domestic expenditures rather than foreign investment. Similarly, that United States banks remained well below their target ceilings suggests that they were able to satisfy as much foreign demand for credit as they desired in the light of their liquidity position.

The programmes relating to direct investment and bank lending have been extended at least until end-1969. In both cases the leeway carried over from 1968, plus the quotas for 1969, would theoretically permit net capital outflows substantially above those of last year. Thus, it appears that United States non-financial corporations *could* make foreign direct investments (including the use of retained earnings) of about \$ 5 billion this year. In fact, survey results indicate intentions to make net exports of capital, including reinvested earnings, totalling only \$ 2.8 billion — nearly twice last year's figure, but still well below 1966 and 1967 : excluding reinvested earnings (which are not comprised by the United States balance of payments statistics) the net outflow of capital covered by the programme would, on this basis, rise from \$ 0.25 to \$ 1.12 billion. The guidelines for the banks would allow a considerable capital *outflow* this year ; but the present degree of monetary tightness in the United States may lead to some further repatriation of bank assets, although perhaps less than last year.

TABLE 23
Direct investment transactions affected by U.S. balance of payments programme
\$ billion

	1966	1967	1968[a]	1969[b]
Reinvested earnings	1.08	0.92	1.21	1.67
Capital transfers, gross	3.44	3.35	2.47	3.42
Total direct investment	4.53	4.27	3.68	5.09
Less:				
Use of funds borrowed abroad	0.65	0.56	2.22	2.30
Equals:				
Direct investment, net of foreign borrowing	3.87	3.71	1.46	2.79
Memorandum items				
Total long-term borrowing abroad :				
Programme data	...	...	3.8[c]	
Balance of payments data	0.8	0.5	2.9	
Total plant and equipment expenditures, balance of payments data, excluding Canada	6.3	7.0	7.6[a]	
Capital transfers, balance of payments data, excluding Canada	2.5	2.6	2.2	

a) Estimated.
b) Projected.
c) Cumulative total, 1965-68 : \$6.0 billion.
Note : The data for 1966-68 are based on reports from 3,300 companies ; the 1969 projections represent 469 major companies, which accounted for almost 90 per cent of investment in recent years.

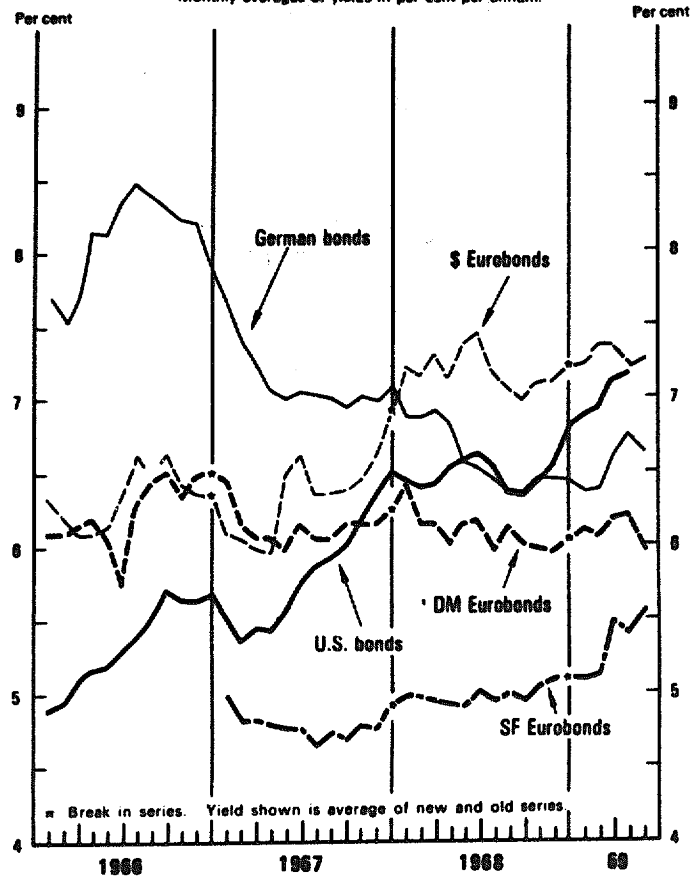
the latter requirement has created a backlog of potential borrowers which may result in further "international" issues later. It also appears that the present high interest rates are having a deterrent effect on borrowers' willingness to incur additional long-term debt.

On the demand side, the new United States balance of payments programme introduced in January 1968 was no doubt a major factor behind the rapid rise in offerings of international issues last year. But the market could not have expanded as it did had there not been a sufficient supply of funds forthcoming to keep the cost of international borrowing at levels that have been increasingly attractive in relation to alternative sources, notably in the United States. The gap between yields on dollar Eurobonds and U.S. domestic bonds has narrowed steadily since the middle of last year ; and the yield on Deutschemark Eurobonds (Chart I) at 6-6½ per cent has become increasingly attractive to borrowers from many countries. Other factors contributing to the growth of the market have been the introduction of attractive convertible features to U.S. bonds in the face of a rising U.S. stock market ; capital flight from

CHART I

YIELDS ON CORPORATE BONDS

Monthly averages of yields in per cent per annum.



German bonds: 5.5 per cent non-convertible industrial bonds.
United States bonds: Non-convertible corporate bonds, all classes.
$ Eurobonds
DM Eurobonds
SF Eurobonds United States companies' 10 to 20 year non-convertible Eurobond issues denominated respectively in dollars, deutschemarks and Swiss francs.

some European centres due to political or economic uncertainties; and the fact that interest on international bonds is not subject to withholding tax in the country of issue.

Market uncertainties over the future of monetary parities seem to have contributed to substantial relative shifts in currencies of issue and in interest yields on issues in given currencies. Thus, while the volume of dollar denominated issues increased in 1968 by 48 per cent to $ 2.5 billion, DM-denominated issues increased nearly seven-fold to $ 1.3 billion.

The growing interest of borrowers—almost entirely governments and international institutions—in floating DM issues reflected the widening spread between DM and dollar rates that began to appear in mid-1967, and which in 1968 and early 1969 was apparently wide enough to offset any reluctance to incur the exchange risk of a possible revaluation of the Deutschemark.

The fact that rates on dollar issues in European markets have risen so steeply in the past two years probably reflects in part the natural tendency for all securities denominated in a particular currency to follow generally similar trends: in the case of DM-denominated issues (rates on which have been roughly stable since mid-1967 in the face of rates on German domestic issues which were declining through most of the period) this tendency appears to have been outweighed by the rapid rise in flotations and the fact that, in the German capital market, 6 per cent is generally regarded as the floor for long-term interest rates. United States borrowers, however, have not made much use of the DM market, apparently preferring to use the convertibility feature to avoid the high interest rates on straight debt rather than to incur the exchange risk of a possible revaluation of the Deutschemark. Practically all the foreign issues placed in Germany in 1968 were those of central governments or international institutions, who could not command the lower rates applicable to convertibles in the dollar section of the market.

About 75 per cent of the increase in all international issues in 1968 was accounted for by United States companies and their special financing subsidiaries. To a significant extent, the borrowing to finance investment abroad seems to have been precautionary; of the $ 2¼ billion raised during 1968, about $ 1.5 billion remained on deposit abroad, mainly in the Eurodollar market. In view of the high interest rates prevailing in that market, the amount that can be earned on Eurodollar deposits exceeds the rates of interest paid on Eurobond issues, a factor likely to stimulate precautionary borrowing.

The rising rates on Eurodollar bond issues led American companies in 1968 to turn increasingly to issues containing an equity feature. For the year as a whole, over 70 per cent of the Eurobonds issued by American companies were convertible. These were usually marketed at an interest rate substantially below the rates available on comparable straight debt issues ; buoyant conditions in the United States stock market obviously helped to increase the attractiveness of such issues. But even with the decline in U.S. stock prices which began late in 1968, convertible issues were still being marketed heavily during the first quarter of 1969.

Borrowing by countries within the Western European area itself accounted for about 19 per cent of the total in 1968, but was very slightly lower than in the previous year. Borrowing by Canada and Japan rose from under $ 100 million to over $ 400 million. There was no change on balance in the amount of capital raised on international markets by non-OECD countries, but international lending institutions increased their takings substantially, and Canada and Japan entered the Eurobond market despite their relatively free access to the United States capital markets. This is further evidence, along with borrowing by United States companies for use in the United States, that at least some borrowers could obtain money more cheaply and readily on the Eurobond market than on the United States new issue market. This change in the cost of long-term borrowing in Europe relative to the United States was most notable in the case of flotations in Germany.

Although the recent expansion of the international issue market probably owes a good deal to essentially temporary factors, there are other considerations —often of a fiscal nature—pointing to continued growth of the market. Bonds payable in U.S. dollars, for instance, bear a higher rate of interest than comparable domestic United States securities; they are payable in the most widely used international currency ; and for foreigners interest on them is not subject to United States income tax. The yield on foreign bonds payable in Deutschemarks has up to now been below that on German bonds; but for non-German holders these issues are exempt from the 25 per cent withholding tax imposed on the interest on domestic bonds—and they are denominated in a popular currency.

As a result, part of the DM issues offered in Germany has been purchased, at the time of issue, by non-residents; it is also reported that a considerable amount of the capital inflow into Germany early in May 1969 took the form of purchases of non-German bonds payable in Deutschemarks.

DEVELOPMENTS IN INTERNATIONAL LIQUIDITY

This section examines the major factors which affected the supply and demand of official international liquidity in the ' sixties and summarises the present position of OECD countries. Though there are no precise criteria which would permit an objective definition of what "adequate" levels of official liquidity should be, this examination throws light on some of the main elements to be taken into account in an analysis of future prospects and needs for official international liquidity creation.

THE EXPERIENCE OF THE 1960's

World holdings of reserve assets, as recorded in official statistics, rose by some $ 14 billion from end-1960 to end-March 1969. This was almost fully accounted for by a rise in holdings of currency assets and reserve positions in the IMF, with holdings of monetary gold rising by only $ 1 billion over the period as a whole (Table 24). Two points, however, need to be borne in mind in interpreting these figures. First, the increase in reported holdings of currency assets includes large amounts of creditor countries' holdings of currency assets arising from support operations (mainly sterling and, to a lesser extent,

TABLE 24

Development of official international liquidity[a]

$ billion; amounts outstanding at end of period

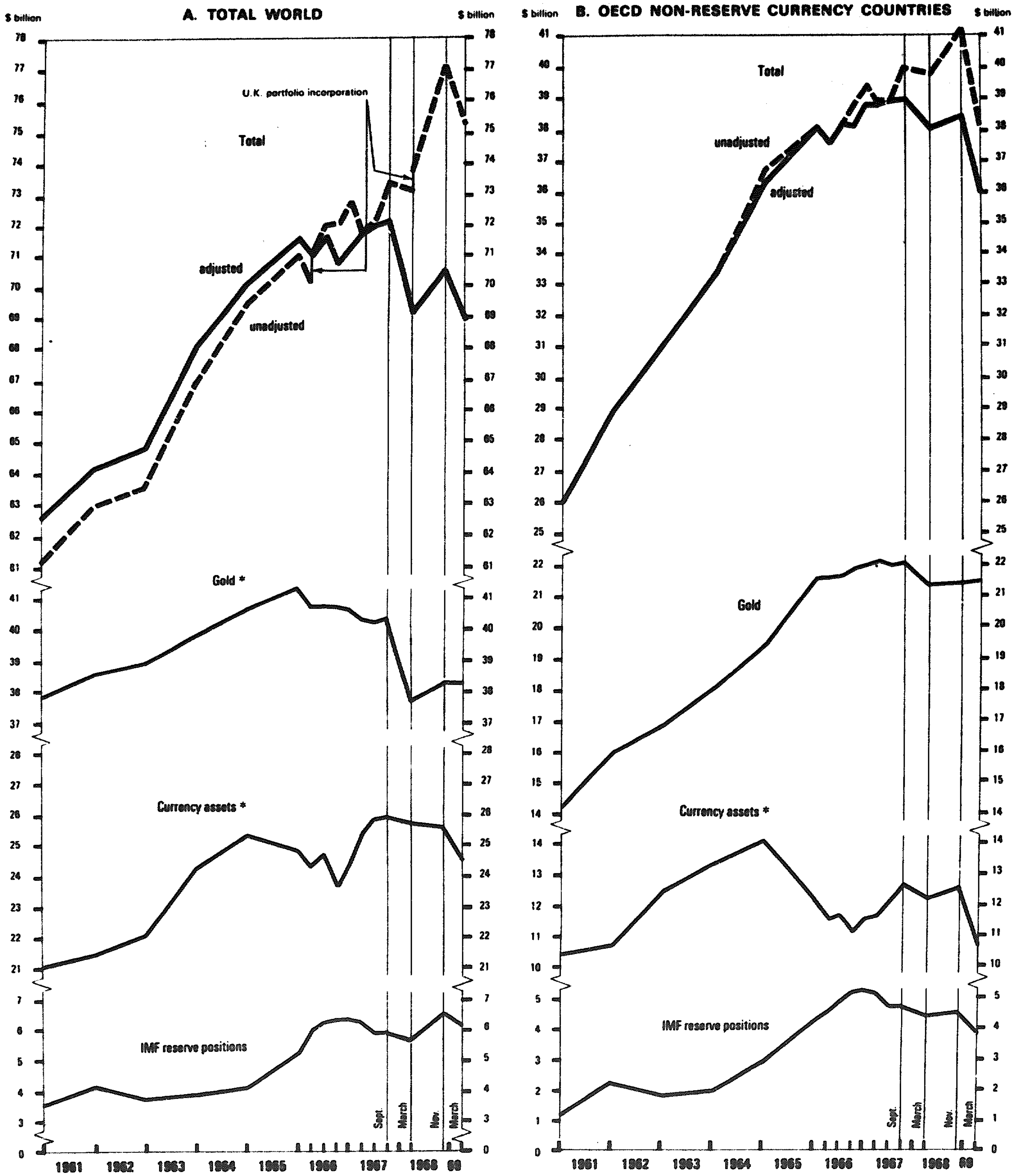
	1960	1965	1967 Sept.	1969 March
Gold				
Recorded	37.9	41.4	40.4	38.9
Adjusted	37.9	41.4	40.4	38.3
Currency assets				
Recorded	19.7	24.3	27.1	30.3
Adjusted	21.1	24.8	26.0	24.5
Reserve positions in the IMF	3.6	5.4	5.9	6.1
Total				
Recorded	61.2	71.0	73.4	75.4
Adjusted	62.5	71.6	72.2	68.9

a) Foreign reserve assets of national monetary authorities; for definitions of both recorded and adjusted reserves see inset on pp. 50-51.

CHART J

OFFICIAL RESERVE ASSETS

Amounts outstanding, end of period



* Adjusted

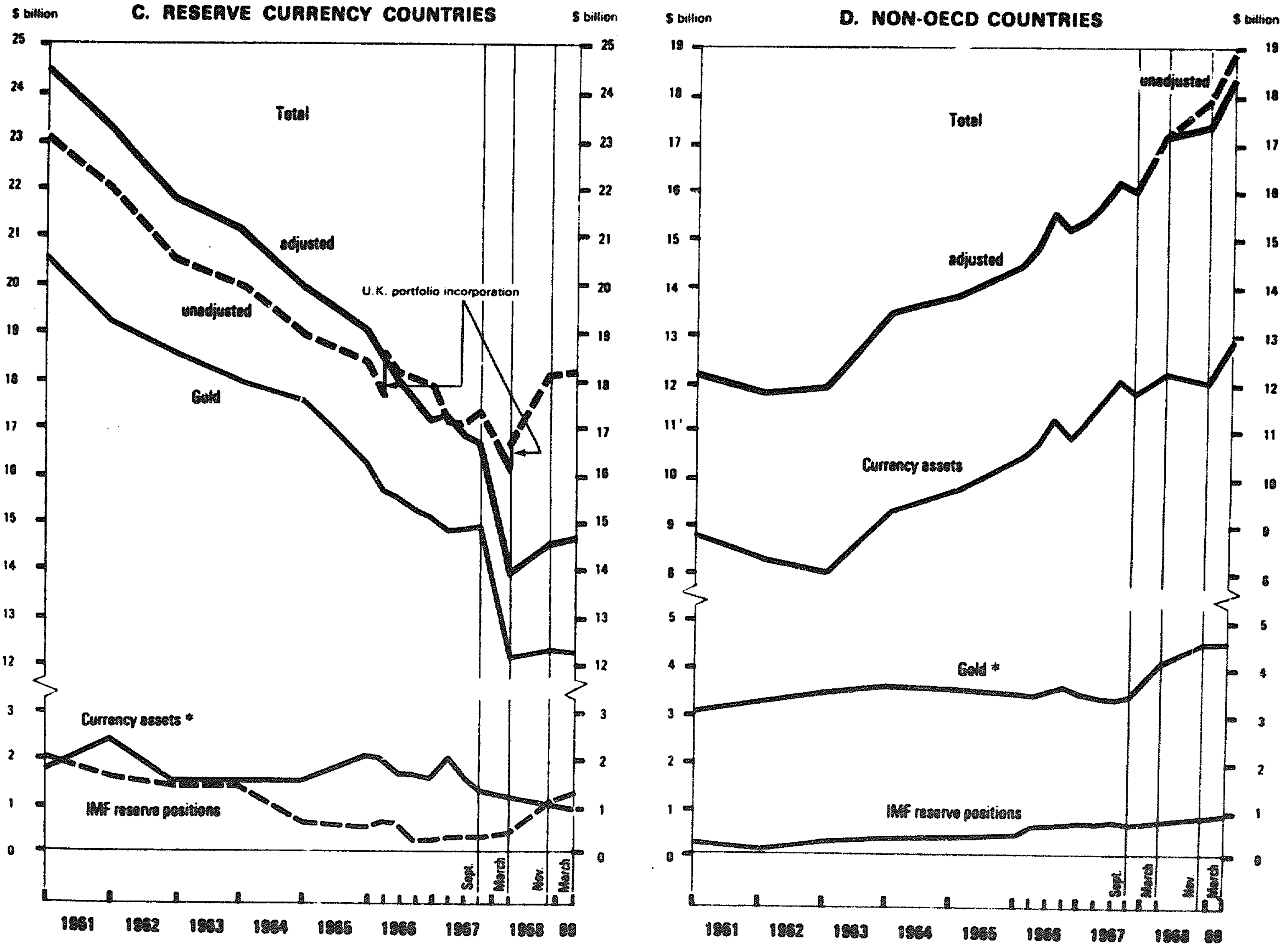
Note: For definitions of adjusted and unadjusted reserves see inset francs). It is doubtful whether countries providing support in this way regard such holdings as fully equivalent to first-line reserves : their mobilisation would require the reversal of the support operation or a shift in the burden of support to another country. Secondly, the significance to be attributed to the rise in South Africa's monetary gold holdings since adoption of the two-tier price system is at present inevitably uncertain. This rise accounted for more than half the total increase in monetary gold holdings recorded during the period as a whole. In what follows, use will normally be made of a concept of official liquidity on an adjusted basis, excluding these two items as far as possible on the basis of available data and also correcting for the discontinuity arising from the incorporation into published reserves of the United Kingdom's dollar portfolio. Any such adjustments are of necessity somewhat arbitrary and alternative methods could have been used. A brief discussion of the technical reasons behind the adjustments made here and of possible alternative lines of approach is in the inset.

On this adjusted basis, total official liquidity increased by $ 6½ billion (about 10 per cent) between end-1960 and March 1969. Development through the period was, however, not regular (Chart J.). Indeed, total official liquidity (on an adjusted basis) increased by $ 9 billion in the five years from end-1960

CHART J (continued)

OFFICIAL RESERVE ASSETS

Amounts outstanding, end of period



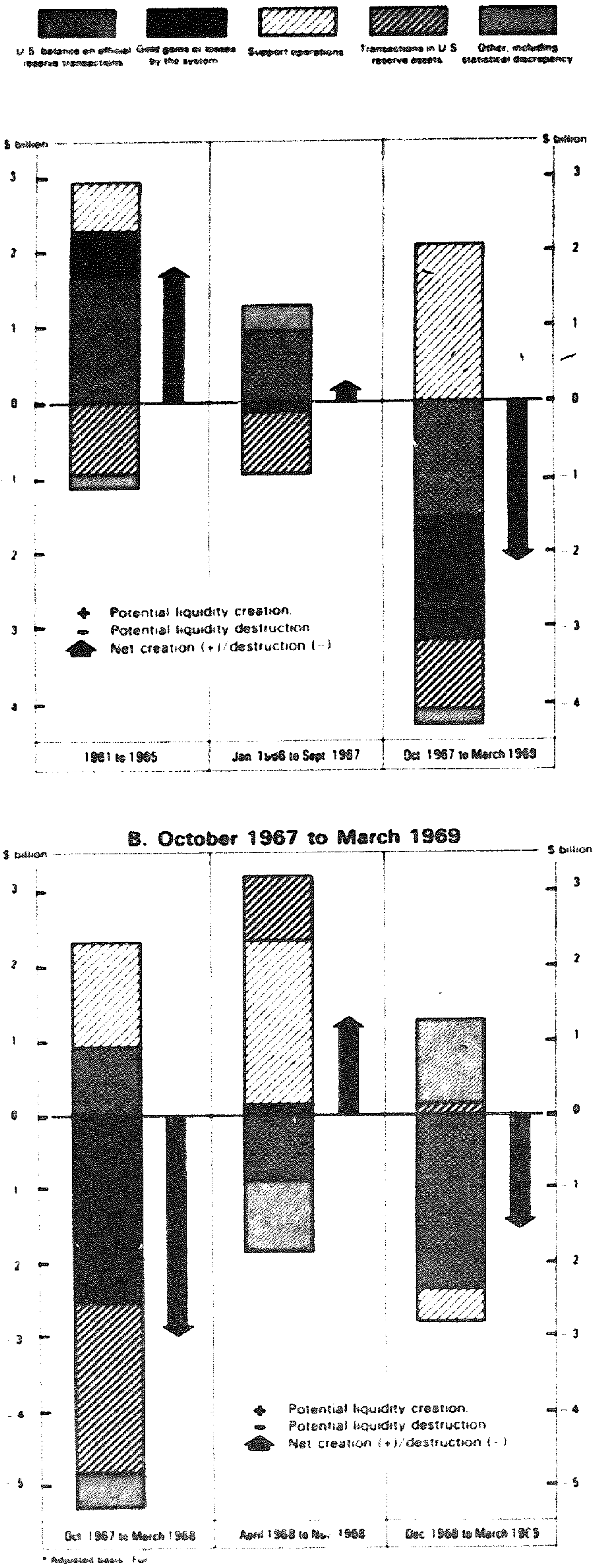
* Adjusted.

Note: For definitions of adjusted and unadjusted reserves, see inset.

CHART K

SOURCES OF OFFICIAL INTERNATIONAL LIQUIDITY*

A. 1961 to March 1969 (Annual averages)



* Adjusted basis. For definitions and explanation see insets

to end-1965 ; then increased only slightly until September 1967; and fell by over $ 3 billion in the eighteen months to March 1969.

Creation or destruction of official international liquidity in a given period may be due to a combination of factors affecting the potential supply of liquidity and the demand for it, though supply and demand factors are difficult to identify separately. Among the factors shown in Chart K,[1] two may be considered as due to supply forces—monetary gold and the United States balance on official reserve transactions. A third factor—support operations—originates basically from demand by certain countries, but becomes a supply factor for other countries as the countries receiving support lose reserves. The fourth—transactions in United States reserve assets—largely reflects demand forces.

In terms of this analysis, supply factors played a decisive role as shown in Chart K in the changing trend of official liquidity in the periods under consideration:

i) The United States had an average annual deficit on official reserve transactions of $ 1.7 billion in the period 1961-65; showed a smaller deficit ($ 1 billion per annum) in the second period; and swung into sizeable surplus in the third period. In this sense, the amount of new dollars available to foreign monetary authorities declined in the intermediate period and became negative in the most recent one.

ii) Gold transactions with the private sector (equal to newly-mined gold minus private hoarding) contributed to the rise in world official liquidity until 1965 to the tune of $ 0.6 billion per annum. In the intermediate period, some net monetary gold losses to the private sector took place, and these were extremely large in the last period until the introduction of the two-tier gold market.

The third factor became of real importance in the more recent period when the two traditional supply factors became largely negative. Liquidity creation through support to deficit countries (either directly by Central Banks or through the International Monetary Fund), amounted on average to $ 0.7 billion per annum in 1961-65. In the 21 months to

1. For the exact coverage of these items and the main reasons behind the treatment adopted here, see inset on sources and uses of international liquidity.

September 1967 there was no net creation of this type, but from end-September 1967 to end-March 1969 it amounted to $ 3.1 billion [1] (equivalent to $ 2.1 billion at an annual rate).

Finally, transactions in United States official reserve assets (gold and reserve position in the Fund) were at roughly the same rate and acted in the same direction in all three periods. In the first two periods they consisted very largely of conversions into gold of dollar assets accumulated by other countries as a result of the United States official settlements deficit. These resulted in a transfer of assets from the United States to other countries, rather than a rise in global official assets as would have occurred if official monetary authorities of these countries had decided to hold the acquired foreign assets in the form of claims on the United States. To this extent, they provided an offset to the potential liquidity-creating effect of the United States deficit. In the third period, United States gold sales were closely connected with the functioning of the Gold Pool until March 1968.

In the eighteen months to March 1969 there also were sharp short-term fluctuations in the world totals of official assets (Chart J). Within this period, three sub-periods can be distinguished (Chart K):

i) October 1967—*March* 1968: *Sterling and gold crises*

a) Main liquidity destroying factors

- Gold losses to the private sector through Gold Pool operations: their potential impact on total international liquidity was aggravated by the fact that in practice most of the total loss resulted in gold sales by the United States;
- The effects of sterling devaluation on official holdings of the overseas sterling area. [2]

b) Liquidity creating factors

- A United States' official reserve transactions deficit, fully concentrated in the fourth quarter of 1967 (when monetary conditions were only beginning to tighten);
- Large-scale support to the United Kingdom, because of both the devaluation crisis and the indirect impact of speculation in gold. [3]

Despite the gold losses, reported official reserves over this sub-period actually rose because of the sterling assets created as a counterpart of support to the United Kingdom, but on an adjusted basis total official liquidity declined by around $ 3 billion.

ii) April 1968-*November* 1968: *French disturbances and Franc/Deutschemark currency crises*

a) Main liquidity destroying factors

- A United States official reserve transactions surplus of $ 0.9 billion concentrated in the April-June period and partly due to monetary tightness in the United States and to the capital flight from France and the United Kingdom;

b) Liquidity creating factors

- Support to France and to the United Kingdom, both in the form of IMF drawings and of direct assistance from Central Banks;
- A small rise in national monetary gold holdings following the Washington announcement, even discounting the rise in the South African gold stock.
- French gold sales to the United States.

The latter factors had a much bigger impact than the former, so that over this period there was an exceptionally large increase in official liquidity on an adjusted basis.

iii) December 1968-*March* 1969: *Reversal of previous phase and considerably increased monetary stringency in the United States*

Two main factors contributed to *liquidity destruction* during this short period :

- A very substantial United States official reserve transactions surplus as monetary conditions tightened;
- Repayment of debt by the United Kingdom and France.

1. This figure represents the amount of official liquidity created through support operations (including IMF drawings) on the " adjusted " definition. The effect on recorded liquidity was as much as $ 7¼ billion.

2. United Kingdom liabilities to the Overseas Sterling Area have not been identified separately in Chart K as a source of reserves (they are part of " other "). For detailed figures and explanation of treatment given, see inset on sources and uses of international liquidity.

3. See *Economic Outlook*, No. 3, p. 35 for an analysis of the impact of the gold crisis on private capital transactions of reserve currency countries.

There was no rise in national monetary gold holdings outside South Africa and the fiduciary component of official reserve assets on an adjusted basis fell by about $ 1½ billion, resulting in a decline in official liquidity on an adjusted basis. As there was some debt repayment, the decline in recorded reserves during this sub-period was somewhat larger.

The background to these violent changes in international payments positions has been discussed in earlier sections of *Economic Outlook*. Short-term capital movements were by far the most important cause of disturbances and this is reflected in the exceptionally large rise in privately held foreign assets in 1968.

Total short-term assets and liabilities vis-à-vis non-residents of commercial banks in Group of Ten countries other than the United States increased by $ 16¾ billion and $ 14¼ billion respectively (42 per cent and 34 per cent respectively). The major part of the increase in both assets and liabilities was denominated in foreign currencies: in dollars the increases were $ 12 billion (assets) and $ 9½ billion (liabilities).[1] This was connected in large part with the further rapid expansion in the Eurodollar market. Viewed from the angle of its impact on official international liquidity, the relevant factor is that insofar as part of these funds took the form of short-term capital movements into the United States they led to a surplus on official reserve transactions, which in turn was a potential source of destruction of official liquidity. Conversely, central banks in other countries can *as a group* increase their official reserves through withdrawing funds from the Euro-dollar market, only to the extent that this leads to a deterioration in the U.S. position on official reserve transactions (i.e. a shift in U.S. liabilities from private to official holders). In other words, in the framework of the analysis used here, official liquidity can only be increased at the expense of private liquidity to the extent that private holders can be induced to relinquish, not just deposits in the Euro-dollar market, but claims on the U.S. monetary system.[2]

1. *Source:* Bank for International Settlements, *39th Annual Report*, Basle, 1969.

2. Unless central banks keep their holdings in the form of claims on the Euro-dollar market or other currency markets. These have not been separately allowed for as sources of liquidity in this analysis and are therefore part of the statistical discrepancy (see inset).

ADJUSTMENTS TO GLOBAL RESERVE FIGURES

As explained in the text, recent years have seen a contraction —and at times reversal—in the traditional sources of reserve creation. The situation has been alleviated by substantial extension of inter-central bank credits, so that—at least until recent months—published totals of world reserves continued to rise; it is estimated that the total of world reserves at end-March 1969 included over $ 9 billion arising from inter-central bank credit operations of various kinds. It is therefore necessary to make adjustments in order to obtain an impression of the underlying development of reserve assets readily usable for making settlements. The starting point, as shown in Table 25, is the recorded series of global reserves, which differs only slightly from the series given in the International Liquidity tables of the IMF *International Financial Statistics*. The changes[1] are made to bring the figures closer to standardised definitions. These basic figures then undergo adjustment to yield the series of "adjusted reserves" used throughout this section.

Most of the adjustments to currency assets relate to those created by *support operations*. Several kinds of support operation need to be distinguished, since a variety of effects on published reserves is possible, and the adjustment needed to bring the figures to a basis useful for analysis varies correspondingly.

i) *Drawings on US facilities* put dollars into the hands of —and give the US an equivalent foreign currency claim on—the drawing country. The dollar proceeds of the transaction are normally used with little delay to make payments, but the claim acquired by the US must be held if the support of the debtor's currency is to be effective. Assuming that all of the dollars accrue to official holders, such a "swap" drawing will increase published global reserves by double the amount of the drawing. Only the dollars created by the swap can be regarded as additions to usable reserves, however, and in arriving at "adjusted reserves" it is necessary to subtract US holdings of foreign currency assets arising from this kind of operation;

ii) *Drawings by the US* on swap facilities with another Central Bank normally have no effect on global reserves and therefore call for no adjustment. The proceeds of such drawings are generally used to "mop up" temporary surplus dollar holdings of the partner country, with the result that neither party to the arrangement increases its holding of currency assets: the partner country effectively obtains forward cover on its surplus dollars;

1. To include Switzerland's holdings of Roosa Bonds, to exclude Japan's holding of Eximbank certificates, and to include foreign assets of the Kuwait government (given in the Kuwait country pages of I.F.S); adjusted also for the Secretariat's estimate of gold swaps between the Swiss National Bank and the Bank for International Settlements. It should be noted that countries excluded from IFS (notably those of the Sino-Soviet Area) are also excluded here.

TABLE 25

Development of recorded and adjusted reserves

$ billion; amounts outstanding at end of period

	1960	1961	1962	1963	1964	1965	1966	1967 Sept.	1968 March	1968 Nov.	1969 March
1. Total, countries' reserves, recorded	61.2	62.9	63.6	66.9	69.6	71.0	72.8	73.4	73.8	77.2	75.4
2. ADJUSTMENTS											
2.1. To exclude creditor countries' currency assets arising from support operations	—	–0.1	–0.1	–0.2	–0.8	–0.8	–1.9	–1.7	–4.6	–6.2	–5.8
2.2. To include U.K. dollar portfolio throughout period	1.4	1.4	1.4	1.4	1.4	1.4	0.5	0.5	—	—	—
2.3. To exclude the rise in South Africa's gold holdings since March, 1968	—	—	—	—	—	—	—	—	—	–0.5	–0.6
3. Total countries' reserves, adjusted (1 + 2)	62.5	64.2	64.8	68.1	70.2	71.6	71.4	72.2	69.2	70.5	68.9

iii) *Operations in which the US does not participate* have the effect, in general, of increasing published global reserves by the amount of the assistance given. The debtor country either obtains dollars directly, or else obtains the creditor's currency, with which it purchases dollars from the creditor. As in *i*) above, the dollars are in general used speedily to make payments. The creditor country's assets are unchanged in amount, but changed in composition, as a result of the support operation : in place of the dollars given in assistance the creditor holds either the currency of the debtor (in the case of a simple swap drawing) or else claims in dollars (or possibly a third currency) that are not for the moment usable (in the case of a " dollar deposit " or a swap routed through the BIS). For some purposes the creditor country may be justified in regarding claims of these kinds as part of its reserves, on the ground that the support operation is reversible in the relatively short term or that if its balance of payments suddenly deteriorated, the claims would be transferable to another creditor. But the latter would be an exceptional course, and in any case assistance of this kind cannot be said to increase the total of freely usable reserves for the system as a whole. For these reasons, the concept of " adjusted reserves " used here excludes the creditor countries' holdings of currencies arising from such operations.

To sum up, global adjusted reserves as defined in this note should exclude in principle all creditor countries' holdings of currency assets arising from support arrangements. This implies that the dollars created by drawings on the US *are* regarded as a contribution to total adjusted reserves, but that other support operations are treated as means of temporarily shifting given amounts of usable reserves within the system without adding to the total. An alternative would have been to adjust only for the " double counting " that arises when a support operation creates reserves by twice the amount of support given (item *i*). A choice between the two methods is to some extent arbitrary, but the former—which takes account of the " quality " of reserve assets—has been preferred for the purpose of this note.

In practice, available statistics do not permit precise calculations of the adjustments ; it is, however, possible to arrive at estimates that are believed not to be seriously wide of the mark. US holdings of currency assets, which were negligible until the early 1960's, appear to have arisen almost entirely from the extension of support to others [1] : for present purposes it has been assumed that all US currency holdings arise in this way, even though very small amounts may be held as working balances, etc. Support extended to the UK by countries other than the US has been assumed to be represented by changes in UK sterling liabilities to central monetary institutions in Western Europe and by UK liabilities in non-sterling currencies to all central monetary institutions. [2] Assistance to France by countries other than the US has been estimated by the Secretariat on the basis of information in various central bank publications[3]. Other instances of support extended by countries other than the US (for example, in favour of the lira in 1964) appear to have been unwound within the calendar year, and therefore do not affect the figures presented here. [4] At end-March 1969, the sum of the items excluded from " adjusted " reserves was nearly $ 6 billion (Table 25, line 2.1).

Another adjustment to the series of currency assets consists of the inclusion of the *UK dollar portfolio* in that country's reserves from the start of the period, at its value realised on liquification. It could be argued that the liquification was a source of liquidity creation. Its recording differs, however, both in valuation and timing between the UK and US statistics, and it has been found preferable for purposes of statistical consistency—particularly in relation to the treatment of " sources and uses " that follows—to regard the proceeds as having formed part of UK reserves from the beginning of the period (Table 25, line 2.2).

The total of countries' gold holdings is adjusted to eliminate the *rise in South Africa's holdings* since March 1968, the first date after the Washington announcement for which figures are available. While the Gold Pool arrangements operated, gold sales by South Africa could be regarded as leading to an increase (or a reduced fall) in the monetary gold stock of Gold Pool countries, on the assumption that those countries would have continued—at least in the short term—to meet the same volume of private demand whether or not the Gold Pool's stocks were being replenished by South African sales. With the introduction of the two-tier gold market, the whole of the South African gold stock can no longer be regarded as a virtually certain future contribution to the total supply of gold available to other monetary authorities—part may be sold in the free market, depending on policy decisions yet to be taken and on market developments. It is therefore thought to be preferable for analytical purpose to record additions to the monetary gold stock from South African production on an ex-post basis (i.e. the amounts effectively entering the system through sales to other central banks) rather than ex-ante (the amounts accruing to the South African central bank), (Table 25, line 2.3).

1. See the regular articles by Mr. C.A. Coombs in the *Federal Reserve Bulletin* and figures appearing in that publication and the US *Treasury Bulletin*.
2. *Source* : *Bank of England Quarterly Bulletin*. The fact that non-sterling area countries' holdings of sterling other than in support of the pound would have tended to fall over recent years implies that the assumption employed here yields an under-estimate of the extent of support.
3. Banque de France : *Bilans hebdomadaires* : Deutsche Bundesbank : *Annual Report* ; Banca d'Italia : *Annual Report*.
4. The only other adjustment made on account of "support" is the exclusion of Italy's Canadian bond acquired in 1968.

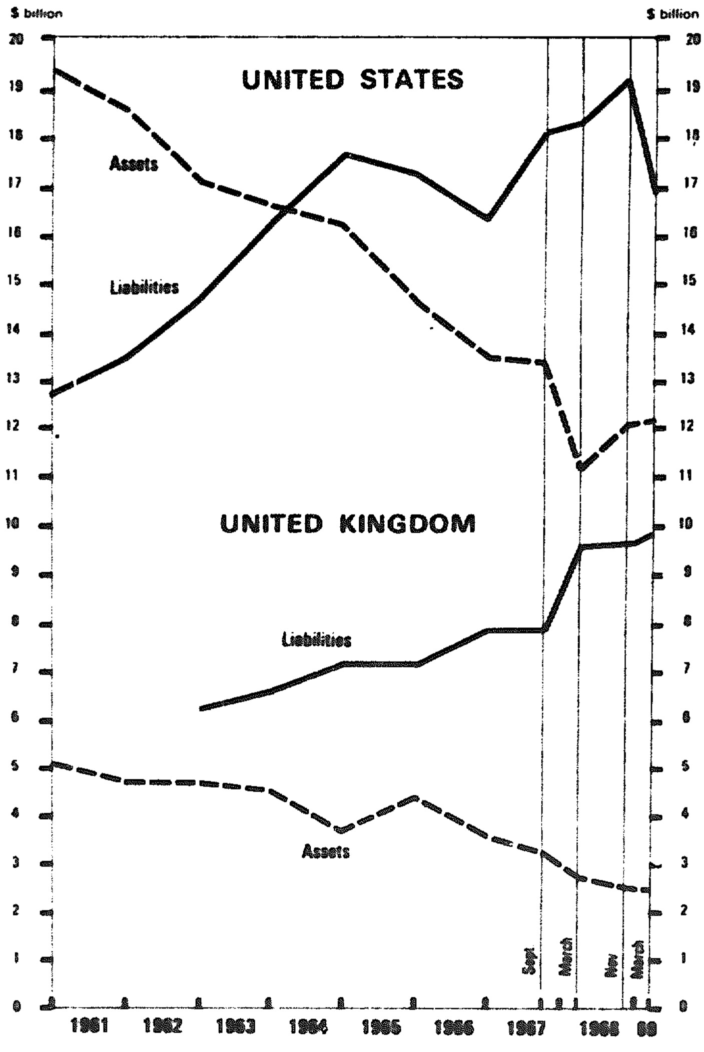
The total rise in official reserve holdings since the beginning of the decade was unevenly distributed, both as regards the total amounts of reserves accruing to the various countries and as regards the asset composition of those reserves. Without entering into the details of the country distribution, [1] the following points may be noted regarding the large areas shown in Chart J:

i) *Reserve currency countries:* These countries' reserve assets, essentially in the form of gold, have declined more or less regularly throughout the period, reflecting their weak balance of payments position. At the same time their liabilities to national monetary authorities have increased sharply (Chart L). However, the improvement in the United States' balance on official reserve transactions has been reflected in a marked change in trend on the liabilities side and, in the most recent period, in a sharp improvement in the net position, through both a rise in assets and a decline in liabilities.

CHART L

OFFICIAL ASSETS AND LIABILITIES OF RESERVE CURRENCY COUNTRIES

Amounts outstanding, end of period



• Adjusted See inset

ii) *OECD non-reserve currency countries:* Total reserves increased rapidly until late in 1966. Until end-1964 the rise took the form of both gold and currency assets, holdings of the latter reaching a peak at the end of that year. In 1965 holdings of currency assets fell sharply but the fall was more than offset by a substantial rise in gold holdings (United States gold sales were large that year) and by increasing reserve positions in the Fund. The latter also accounted for part of the further reserve rise which took place in the period up to September 1967. Total reserves of these countries then declined sharply on an adjusted basis and by end-March 1969 they were $ 3½ billion lower than at end-September 1967. All three types of assets shared in the fall but, as noted below, important changes took place in this period in the asset composition of individual countries' reserves.

iii) *Non-OECD countries:* Their reserves have increased continuously since 1962 (exclusively in the form of currency assets until the recent period), following a prolonged period of decline.

The asset composition of official reserves has also changed fairly markedly during the period. The following developments may be noted regarding the *composition* of *total world reserves:*

— The gold ratio declined fairly regularly from 1960 to September 1967, then suffered a sharp fall until March 1968—with total monetary gold holdings going down and total fiduciary assets going up (Chart M);

— The ratio declined further but more slowly in the middle sub-period, as gold remained virtually constant and fiduciary assets increased;

— In the most recent sub-period the decline in total fiduciary assets has led to a sharp rise in the gold ratio.

1. The position of major countries at end-March 1969 is discussed on pp. 54-55 below.

By March 1969, the ratio of gold to total reserves had declined to about 52 per cent, against 62 per cent at end-1960. On an adjusted basis the fall was somewhat less marked, the ratio declining from about 61 to around 56 per cent.

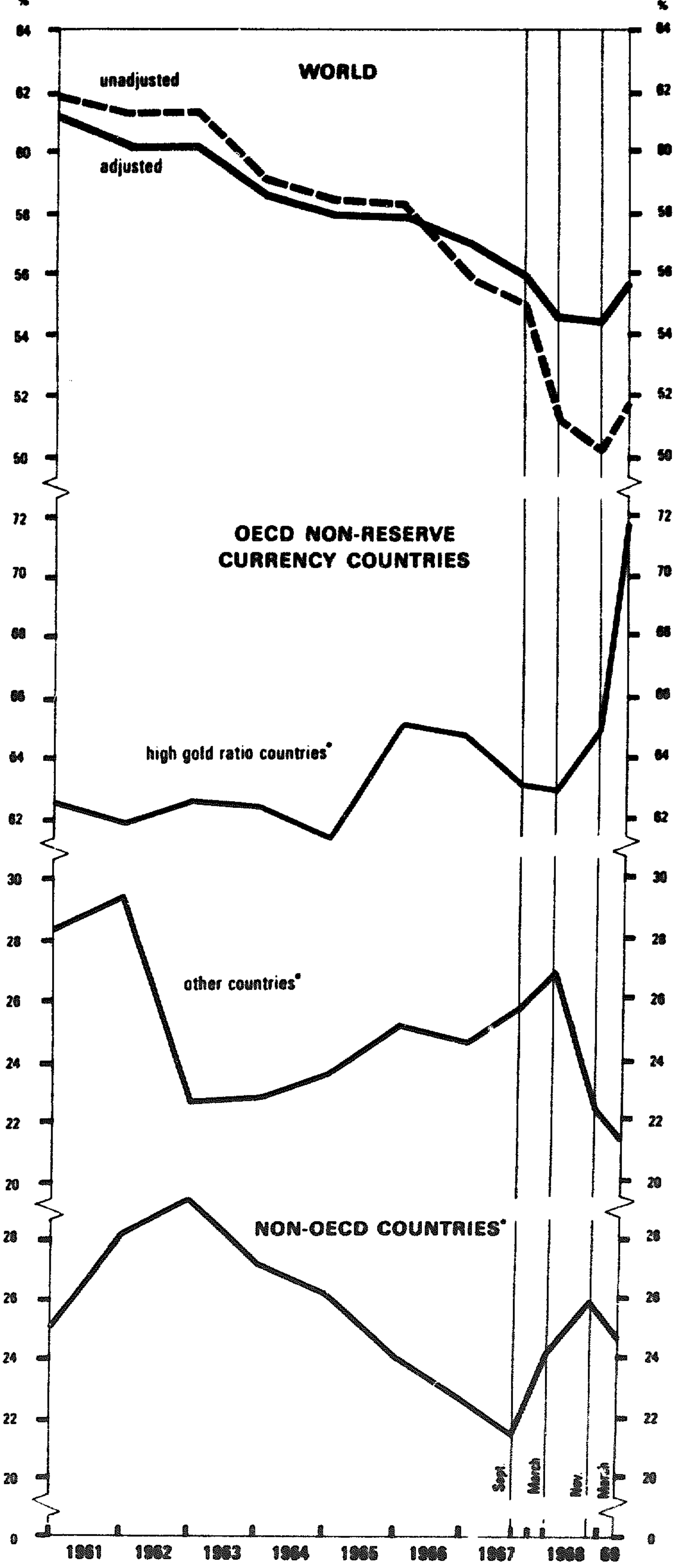
A separate analysis of development in groups of countries, notably those with traditionally high ratios [1] and the others, reveals more striking changes. Within the OECD area the dichotomy between the two groups of countries has increased considerably. On an adjusted basis, non-reserve currency countries with high gold ratios had together the same ratio in September 1967 as at the end of 1960 (63 per cent). But in the more recent period their gold ratio has risen sharply to some 72 per cent, after having fallen slightly during the gold crisis. In the recent period these countries have tended to finance deficits with fiduciary assets, with the exception of France whose gold holdings fell somewhat more than its holding of fiduciary assets. French gold sales, however, were largely to the United States and other high gold-ratio countries, and the latter also received a very high proportion of the gold sales made by the International Monetary Fund to finance United Kingdom and French drawings. As a result, this group lost \$ 2½ billion of fiduciary assets between September 1967 and March 1969 and only \$ 0.4 billion of gold (all of which occurred before March 1968). Other non-reserve OECD countries' gold holdings remained virtually stable throughout the period. Their fiduciary assets rose rather sharply between 1960 and 1965 and consequently the ratio of gold to their total reserves declined. Following an intermediate period in which fiduciary assets fell, the recent picture has been dominated by the large surpluses of Japan, and, to a lesser extent, Canada, both of which have been financed by accumulating fiduciary assets (in addition Canada made gold sales to the United States). As a result, from end-March 1968 to end-March 1969 the gold ratio of these countries as a group fell from 27 to 21 per cent.

Gold holdings of non-OECD countries have increased significantly in the last 18 months for the first time in the decade, even excluding the rise in South

CHART M

GOLD RATIOS

Percentage ratio of gold to total reserves



* Adjusted. See inset

1. Such a distinction must necessarily be somewhat arbitrary. The countries included here in the non-reserve currency high gold-ratio group are Austria, Belgium, France, Germany, Italy, Netherlands, Portugal, Spain and Switzerland. With one exception (Spain in 1960) these countries all had gold ratios in excess of 40 per cent at the dates shown in Tables 24 and 27.

Africa's stock. The increase is almost totally accounted for by certain sterling area countries and took place in the period immediately following the devaluation. Thus the gold ratio in the reserves of non-OECD countries combined, which had declined over the previous five years (pari-passu with the rise in these countries' fiduciary assets) rose during the 18 months following September 1967 to above its 1965 level and almost to the level of end-1960.

THE PRESENT POSITION

As already noted, the marked slowdown in the growth of the more durable elements of official liquidity since around the end of 1965 has mainly affected OECD countries. By end-March 1969 the effect of these movements on both the asset composition of most OECD countries' reserves and on indicators of their relative size such as the ratio to foreign trade was quite marked. For OECD non-reserve currency countries this ratio was only 29 per cent at end-March 1969, compared with 45 per cent at end-1965 and 50 per cent at end-1960. The ratio was 35 per cent for the United States and only 14 per cent for the United Kingdom at the most recent date, against 105 per cent and 43 per cent respectively at end-1960 (Table 26). Among non-reserve currency countries the ratio at end-March 1969 tended to be higher for the smaller than for the larger countries, with Portugal, Switzerland, Austria and Ireland all having ratios above 50 per

TABLE 26

Official reserve assets of individual countries

$ billion and percentages

		Reserves a March 1969	Average annual change		Ratio of reserves to foreign trade b	
			End-60 to end-65	End-65 to March 69	End-1960	March 1969
Large OECD countries, adjusted[c]						
Italy		4.5	0.31	–0.11	78	44
United States		12.2	–0.94	–0.77	105	35
Germany		7.6	0.08	0.07	65	34
France		4.0	0.81	–0.72	35	30
Japan		3.1	0.04	0.30	46	24
Canada		3.0	0.21	–0.01	33	24
United Kingdom		2.5	–0.14	–0.59	43	14
TOTAL LARGE OECD COUNTRIES, ADJUSTED		36.8	0.37	–1.84	66	30
Smaller OECD countries, recorded[c]						
Portugal		1.3	0.06	0.13	146	152
Switzerland		3.6	0.17	0.17	106	92
Austria		1.6	0.12	0.10	57	73
Ireland		0.6	0.02	0.06	61	60
Spain		1.0	0.17	–0.12	75	40
Netherlands		2.4	0.11	0	44	27
Norway		0.6	0.03	0.05	26	27
Belgium		2.1	0.17	–0.06	39	26
Sweden		0.8	0.09	–0.07	19	15
Denmark		0.3	0.06	–0.08	17	11
TOTAL SMALLER OECD COUNTRIES, RECORDED[d]		14.9	1.00	0.17	48	38
TOTAL OECD	Adjusted	50.6	1.36	–2.03	62	31
	Recorded	56.4	1.53	–0.08	60	34
Non-OECD	Adjusted	18.4	0.45	1.21	35	34
TOTAL WORLD	Adjusted	68.9	1.81	–0.81	54	32
	Recorded	74.5	1.97	1.33	53	35

a) Large countries' reserves have been adjusted as far as possible for the factors mentioned in the inset on p. 50. It has not been possible from published information, however, to allocate to particular countries the whole of the adjustment made to global reserves, much of which was derived from data on liabilities. Information was especially difficult to obtain for the smaller countries, for which recorded figures have therefore been given.

b) Ratio of recorded or adjusted reserves to the annual average of exports and imports in 1960 and in 1968, expressed as percentages.

c) Countries ranked within groups according to ratios of reserves to trade at March 1969. It should be noted that the proportion of non-trade transactions varies considerably between countries.

d) Including Greece, Iceland and Turkey.

cent,[1] while among the larger countries the highest ratio was that of Italy at 44 per cent. Japan and Canada had among the lowest ratios in the OECD area.[2] All OECD countries except Portugal, Austria, Ireland and Norway had significantly lower ratios of reserves to foreign trade at end-March 1969 than at end-1960.

The impact of these developments on changes in the asset composition of OECD countries' reserves has already been shown in terms of gold ratios for the group as a whole and for " high gold ratio " countries taken together. The absolute figures at the end of the period are perhaps even more striking. By end-March 1969 holdings of freely usable foreign exchange[3] of " high gold ratio " countries had fallen to $ 2½ billion, or about 9 per cent of their total reserves. This is an exceptionally low figure: at end-September 1967, for instance, holdings were $ 7 billion (Table 27). They could, of course, be increased again by the conversion of other official assets. Gold holdings amounted to $ 19½ billion at end-March 1969. At the same date, this group of countries was also holding various forms of non-marketable U.S. Treasury bonds (and 3-12 month certificates) to a total of $ 2.4 billion. The largest holders were Germany ($ 1.2 billion), Switzerland ($ 450 million) and Italy ($ 370 million). In the case of Germany a substantial part of these holdings was acquired under military offset arrangements and is mobilisable only in case of serious balance of payments deficit. At the same date these countries also had reserve positions in the International Monetary Fund amounting to $ 3.0 billion, of which $ 2.2 billion represented super-gold tranche positions and GAB lending. Of the latter claims, which involve no repayment obligations, $ 1.1 billion was accounted for by Germany, $ 630 million by Italy and $ 320 million by the Netherlands.

Reserves of non-OECD countries as a group have grown rather more rapidly since the end of 1965 than in the previous five-year period (Table 28). Although the growth of reserves has been unevenly distributed, a positive element to be noted is that since end-1965 reserves of less developed countries as a group (excluding high-reserve countries, largely petroleum producers) have grown proportionately more rapidly than their foreign trade. At end-March 1969, reserves of less-developed countries as a group amounted to 27 per cent of their foreign trade compared with 35 per cent for developed primary producing countries and 31 per cent for the OECD area as a whole.

1. The fact that it has not been possible to estimate reserves of the smaller OECD countries on an adjusted basis may account for part of the difference, but these countries' holdings of currencies obtained through support operations are believed to be small.
2. It is perhaps relevant in this context that Japan has for some time indicated its desire to raise the level of its reserves
3. Excluding creditor countries' holdings of currencies arising from support operations and holdings of non-marketable U S bonds.

TABLE 27
Non-reserve currency " high gold ratio " countries[a]
Reserve asset composition
$ billion; amounts outstanding at end of period

	1960	1965	1967 Sept.	1969 March
Gold	12.5	19.5	19.9	19.5
Freely usable foreign exchange[b]	6.7	5.8	6.9	2.5
Other fiduciary assets	0.8	4.7	5.2	7.2
TOTAL[c]	20.0	30.0	32.1	29.2

a) For list of countries, see footnote on p. 53.
b) Excludes creditor countries' currency assets acquired through support operations, and holdings of U.S. non-marketable Treasury securities.
c) Unadjusted.

TABLE 28
Official international liquidity position[a] of non-OECD areas
$ billion, outstanding at end of period, and percentages

	1960	1965	1969 March
Total reserve assets ($ billion)			
Total non-OECD	12.2	14.4	18.4
Developed primary producers[b]	1.6	2.5	3.2
High reserve countries[c]	3.1	4.5	5.5
Other less-developed countries	7.5	7.4	9.7
Ratio of reserves to trade[d] (per cent)			
Total non-OECD	35	32	34
Developed primary producers[b]	26	28	35
High reserve countries[c]	49	57	56
Other less-developed countries	34	26	27

a) Adjusted basis.
b) Australia, New Zealand, Finland and South Africa. Finland has been included throughout as a non-OECD country in order to maintain continuity.
c) Iraq, Israel, Kuwait, Lebanon, Libya, Malaysia, Saudi Arabia and Venezuela.
d) Average of imports and exports in the years 1960, 1965 and 1968.

At the time of writing, the effects of the sharp speculative crises witnessed in late April and early May had been partially unwound. By end-June $ 3 billion out of the $ 4 billion of funds estimated to have flowed into Germany had left that country. But the official reserves of most other OECD countries except the United States seemed to have fallen further since end-March. It seems that post-crisis flows from Germany to the United States have been rather greater than flows from the United States to Germany during the crisis and that for the first half of the year the United States has recorded a substantial official settlements surplus. If so, the main characteristics of the position at end-March had become accentuated by end-June.

FUTURE PROSPECTS

The analysis of past trends may provide a guide to some of the factors that may have to be considered in assessing future developments in the supply and demand for international liquidity and their implications for reserve creation, notably by the creation of special drawing rights with the International Monetary Fund. No arithmetical calculation is possible of the future need for reserves. But it may be useful to consider the result of various projections of past trends, as a background to the consideration of the question. Projections can of course be made on many different bases, and three alternatives are illustrated below.

First is a simple projection of the trends in reserves recorded over the whole period end-1960 to end-March 1969. It seems necessary to take the reserve currency and other countries separately; for though the former lost reserves in the past period, it may be taken as an assumption that they will not continue to do so in future. The adjusted reserve assets of non-reserve-currency countries over this period rose on average by about 3 ½ per cent a year, equivalent at current levels to about $ 2 ½ billion.

While it is probably true that countries had no positive aim to acquire such additions to their reserves, the results of payments trends was such that certain countries acquired disproportionate increases; and having once acquired even appreciable reserve increases, they were not in general disposed to regard the resulting level of their reserves as excessive. The increases that occurred might therefore be regarded

Possible projections of future reserve needs

Projection based on	Annual percentage increase in world reserves	$ billion annual rate
1. Increase in reserves of non-reserve currency countries (end-1960 to end-March 1969)	3½	2½
2. Increase in world reserves (end-1960 to end-Sept. 1967)	2½	1½
3. Increase in reserves required to keep reserve/trade ratio at March 1969 level with 8 per cent annual growth in world trade.	8	5½

as representing a *de facto* demand for reserves over this period. This is relevant for the future since payments trends are likely to continue to result in certain countries acquiring disproportionate reserve increases.

The increase in the reserves of the non-reserve currency countries in any period is, however, by definition, equal to the supply of new monetary gold plus the deficit of the reserve currency countries.[1] Though the latter deficit is affected by the actions both of the non-reserve and the reserve currency countries, it can be argued that it is to some large degree outside the control of the latter group of countries.[2] For these and other reasons it could therefore be argued that the resulting increase in reserves was not a true reflection of their needs.

This objection would not apply if the increase in total world reserves, including those of the reserve currency countries, were taken as the starting point for the projection. For this purpose it seems best to take the trend over the period end-1960 to September 1967, thus stopping short of the period of heavy loss of monetary gold preceding the institution of the two-tier gold price system. Over this period, world reserves grew at $ 1½ billion a year. A projection based on this figure would however make no allowance for the fact that the fall in U.S. reserves which occurred in this period could hardly be repeated.

1. Apart from the effect of support operations in favour of non-reserve currency countries.

2. Part of the increase in monetary gold may go to the reserve currency countries, but the result of such purchases would be to increase the supply of sterling and dollars to other countries pro tanto over and above any sterling and dollars acquired by other countries as the counterpart to the official settlements balance of the United Kingdom and United States. If such acquisitions are in excess of other countries' requirements they have the possibility of taking gold in settlement. This will reduce total world reserves, but the change of reserves of all non-reserve currency countries taken together will remain, as before, equal to the reserve currency countries' deficit plus new monetary gold.

Projections of both the above trends would result in relatively moderate increases in world reserves in future. As already noted, the rate of increase in reserves since 1960 has been less than that of world trade. A third basis of projection is to assume that in general countries will be unwilling to see their reserves continue to decline relative to their trade. The third illustrative projection is therefore based on the assumptions that there is no further decline in the ratio of reserves to international trade and that world trade continues to expand at 8 per cent a year.[1] Reserves would then have to grow by some $ 5 billion a year.

Even if these projections were held to indicate the possible range of the rate of growth of future reserve needs, many other factors would have to be taken into account in deciding the appropriate scale of deliberate reserve creation. Account would have to be taken of the possible extent both of other sources of additional reserves, and of the extinction of existing reserve assets in consequence of an official settlements surplus on the part of the reserve currency countries. It is generally agreed that an adequate growth of reserves is required for the smooth working of the international payments system. Excessive reserve creation would tend to hamper the balance of payments adjustment process by reducing the incentive to control inflationary tendencies and to adopt, in the case of deficit countries, effective corrective measures. A general shortage of reserves, on the other hand, could lead to a general intensification of direct controls on current and capital transactions or to the adoption of unduly deflationary policies as a protection against reserve losses and such policies on the part of other countries would thus impede the efforts of the deficit countries to correct their balance of payments. A judgement therefore has to be made of the adequacy of present reserve levels from the point of view of the adjustment process, and of the further effects from this point of view of reserve creation on a greater or smaller scale. A more general consideration which will also have to be taken into account is the need to maintain general confidence in the international monetary system, and the effect on such confidence of the scale on which new international liquidity is created.

1. i.e., the average growth since 1960.

SOURCES AND USES OF OFFICIAL INTERNATIONAL LIQUIDITY

Table 29 is intended to provide a simplified analysis of the ways in which official reserve assets can potentially be created, the factors which prevent the potential creation taking place, and actual reserve changes. The data are based on the " adjusted " definition of official reserves explained in the earlier inset to this section. In the analysis that follows some items are presented as *potential* sources of liquidity creation and others as offsets ; this treatment is essentially based on the values typically taken by those items in the early 1960's. Thus the US balance on official reserve transactions was, on average in 1961-1965, significantly in deficit, and was the most important source of liquidity creation. The recent surpluses have, correspondingly, been a source of liquidity destruction. A minus sign in the table indicates either a negative potential source (i.e. in effect liquidity destruction) or a negative offset (i.e. in effect liquidity creation).

1.1 *US Balance on official reserve transactions.* This item gives the potential liquidity-creating effect of a US deficit, i.e. the extent to which US liabilities to central monetary institutions would rise if no other means of financing the deficit were used. It can be thought of as the " supply " factor in the generation of additional US liabilities. In general, a US deficit on official reserve transactions has been financed in part by the reduction in US reserve assets—gold and the reserve position in the IMF—to an extent that can be regarded as a reflection of " demand " factors. The extent to which other countries are willing to hold more dollars depends partly on whether the reserve-holding preferences of central banks are changing and partly on the country distribution of the surpluses. A given United States deficit results in different amounts of official dollar liabilities being created depending on the gold or dollar-holding preferences of the surplus countries which provide the counterpart to the United States deficit. But the fact is that when other countries convert their official dollar holdings into gold or other reserve assets they offset the *potential* liquidity creating effect of an official settlements deficit of the major reserve currency country. For example, during the period 1961 to 1965 an average deficit on official reserve transactions of $ 1.7 billion was partly offset by transactions in US reserve assets (gold and the reserve position in the IMF) amounting on average to $ 0.9 billion a year. The two factors do not necessarily work in opposite directions, however : in the eighteen months to March 1969 the liquidity-destroying potential of the official reserve transactions surplus of $ 2.3 billion was reinforced by transactions in reserve assets (mainly gold losses) to the extent of $ 1.3 billion.

The figures used are those published by the US Department of Commerce, adjusted in the years 1965-67 for the estimated effect on US liabilities of the liquification of the UK dollar portfolio. (As explained in the earlier inset, the portfolio has been regarded for present purposes as forming part of U.K. reserves from the start of the period, and appropriate adjustment has been made on both the assets and liabilities sides.) It could

TABLE 29
Sources and uses of official international liquidity
Adjusted basis ; $ billion

	Annual average 1961 to 1965	Jan. 66 to Sept. 67	Oct. 67 to Mar. 69	Oct. 67 to Mar. 68	April to Nov. 68	Dec. 68 to Mar. 69
Potential sources						
1.1. U.S. deficit on official reserve transactions (deficit = +)	1.7	1.7	–2.3	0.9	–0.9	–2.4
1.2. Gold purchases from private sector	0 6	–0 2	–2.4	–2.6	0.1	0
1.3. U.S. support operations for others	0.2	0.4	2.4	1.5	0.9	–0.1
1.4. Use of IMF credit	0.5	–0.4	0.7	–0.2	1.3	–0.4
1.5. U.K. net liabilities in sterling to central monetary institutions in sterling area	0.1	–0.2	–0.7	–0.8	–0.5	0.6
1. TOTAL, POTENTIAL SOURCES	3.0	1.3	–2.3	–1.0	1.0	–2.2
Less identified offsets						
2.1. Transactions in U.S. reserve assets (+ finances deficit)	0.9	1.4	1.3	2.3	–0.8	–0.2
2.2. IMF surplus and gold deposits	0	–0.1	0.1	0	0	0
2. TOTAL, IDENTIFIED OFFSETS	1.0	1.3	1.4	2.3	–0.8	–0.1
3. NET IDENTIFIED SOURCES (1 — 2)	2.0	0	–3.7	–3.4	1.8	–2.1
Plus						
4. DISCREPANCY	–0.2	0.6	0.4	0.4	–0.5	0.5
5. TOTAL, USES (3 + 4) (CHANGES IN COUNTRIES' ADJUSTED RESERVES)	1.8	0.6	–3.3	–3.0	1.3	–1.6
5.1. Gold	0.7	–1.0	–2.1	–2.6	0.6	0
5.2. Currency assets	0.7	1.1	–1.4	–0.2	–0.1	–1.2
5.3. Reserve position in the IMF	0.4	0.5	0.2	–0.2	0.8	–0.4

be argued that a more appropriate measure of the *potential* source of liquidity is the broader " balance on official settlements " (which includes debt prepayments and other special transactions as financing items below the line). Even the balance on official settlements may to some extent be influenced by transactions which are essentially of an official financing nature (such as preferential swap rates on dollars provided by several European Central Banks to their commercial banks). The balance on official reserve transactions has been used here for the sake of simplicity and reflects the concept of *potential* creation of official dollar holdings only in a rather narrow sense.

1.2 *Gold purchases from the private sector*. This item is equal to the net change in countries' gold holdings and in IMF gold holdings, as given in International Financial Statistics, adjusted to eliminate the rise in South African holdings since March, 1968. The private sector as defined here includes, therefore, international organisations other than the IMF and countries whose holdings are not reported in IFS. The counterpart to this item on the uses side is to be found in line 5.1—changes in countries' gold holdings—and part of line 5.3—reserve positions in the IMF.

1.3 *US support operations*. The previous inset briefly described various kinds of support operation, and concluded that the only one which added to the *adjusted* total of global reserves as defined here was the support of others by the US. This item gives the extent of such support : as already explained, it has been taken for simplicity to equal changes in US holdings of foreign currency.

1.4 *Use of IMF credit*. This is defined in IFS as " drawings other than drawings against a Gold Tranche Position (i.e. drawings against the Credit Tranche Position, drawings that raise Fund holdings beyond 200 per cent of quota and Compensatory Financing drawings) ". The drawing country receives currencies of other members, which are normally converted to dollars : the countries drawn upon are credited with increases in their reserve positions in the IMF equal to their sales of dollars, so that their total reserves are unchanged, while the drawing country has at its disposal additional reserves equal to the drawing. Drawings against a Gold Tranche Position give rise, in general, to no such reserve creation, since in this case the drawing country's reserve position in the IMF falls equally with the drawing, leaving its total reserves unaltered.

A complication arises when the currency drawn is the US dollar, since the counterpart of the resulting increase in the US reserve position in the IMF is not a drop in US foreign exchange reserves but increased liabilities to foreign monetary authorities. Gross reserves are thus increased by the amount of drawings in dollars against Gold Tranche Positions, and doubly increased by drawings in dollars that are defined as use of IMF credit. A full treatment of sources and uses would therefore identify drawings on the IMF in dollars as a separate source of liquidity creation. In the present simplified approach, net drawings in dollars are included (with minus sign) in the offset line " transactions in US reserve assets ".

1.5 *UK net liabilities in sterling to central monetary institutions in the sterling area*. The role of the UK as a reserve currency country has declined during the period under review. At the end of 1962 (when the present series of figures started) UK liabilities to all central monetary institutions amounted to $ 6.2 billion, representing—even on an adjusted basis—nearly 10 per cent of world reserves, and over a quarter of currency assets. But only $ 0.6 billion of this consisted of liabilities to central monetary institutions in Western Europe and North America. By September 1968, the total had risen to $ 8.2 billion, but $ 4.2 billion of this was accounted for by liabilities to central monetary institutions in Western Europe and North America, almost all of which have been regarded as resulting from support operations and excluded from global reserves on an adjusted basis. The dollar value of the amount of sterling held as freely usable reserves had declined markedly, partly as the mechanical effect of devaluation. In September 1968 the

Basle Facility enabled the UK to offer an exchange guarantee on sterling area countries' official holdings of sterling above 10 per cent of their total reserves in return for undertakings to maintain not less than an agreed proportion of their total reserves in sterling. Since then, those countries' official sterling holdings have risen substantially. This facility permits the maintenance of a reserve currency role for sterling, at least as far as sterling area countries are concerned.

Ideally, the *potential* source of liquidity creation by the UK in its relations with the sterling area would be its total official settlements deficit with the area. Since available data do not allow the calculation of this concept, however, liabilities to central monetary authorities have been used. (For 1961 and 1962, the earlier series of official overseas sterling area sterling holdings was used).

2.1 *Transactions in US reserve assets.* This item has already been discussed in relation to the US balance on official reserve transactions. It corresponds to published figures for changes in US gold holdings and reserve position in the IMF, except that the effect on the US gold stock of IMF gold deposits and investments has been eliminated. The reason for this is that IMF gold deposits and investments have no effect on the balance on official reserve transactions, since the rise in gold holdings is offset by liabilities to the IMF ; and on the uses side (line 5.2) only dollar claims of monetary authorities of countries are counted in global reserves.

2.2 *IMF surplus and gold deposits.* This item is included in order to reconcile use of Fund credit and changes in IMF gold holdings, on the sources side, with changes in reserve positions in the IMF, on the uses side. It is taken from the international liquidity tables in IFS.

4. *Discrepancy.* The discrepancy between total net identified sources and total (adjusted) uses mainly reflects (apart from purely statistical discrepancies and divergent reporting) the lack of recording on the liabilities side of two categories of recorded currency assets :

i) Official claims on commercial banks and the BIS (particularly in the form of Eurodollars) ;

ii) Official claims (other than those obtained by creditor countries in support operations, which have been excluded from adjusted reserves) on countries other than the US (or the UK in the case of overseas sterling area countries). The most important examples are probably holdings of French francs by overseas franc area countries and holdings of Deutschemarks by other countries.

Notes to Chart K

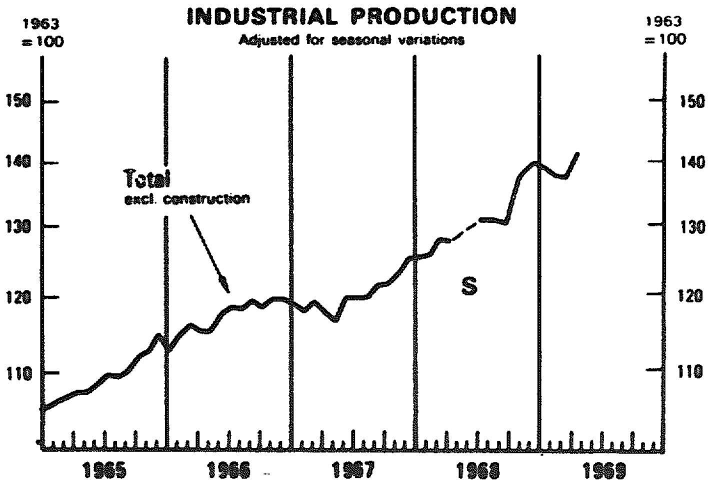
The correspondance between the items shown in Chart K and those in Table 29 is as follows :

Item in Chart K	*Corresponding items in Table 29*
US balance on official reserve transactions	1.1
Gold gains or losses by the system	1.2
Support operations	1.3 + 1.4
Transactions in US reserve assets (sign inverted)	2.1
Other, including statistical discrepancy	1.5-2.2 + 4
Net creation/destruction	5

DEVELOPMENTS IN MAJOR COUNTRIES

FRANCE

Activity remained high in the early months of 1969 despite the fiscal and monetary policy measures taken after the November crisis. The trend of domestic demand was probably much stronger than envisaged by the French authorities in their October forecasts. Even so, exports have been faring better than generally expected and the trade balance improved in the first quarter of 1969, after a strong deterioration in the preceding quarter. But it worsened in April and May, because of surging imports. New monetary measures were taken in May and June to curb the growth of domestic demand and to speed up the restoration of internal and external equilibrium. The prospects for both domestic demand and the external balance are difficult to assess. In the rest of this year and early 1970, assuming no excessive wage increases, the expansion should be much slower than during the recent recovery period, and probably less than the growth of capacity. But a strengthening of the current balance of payments is likely to depend very heavily on the avoidance of new speculative pressures and of inflationary price and wage developments.



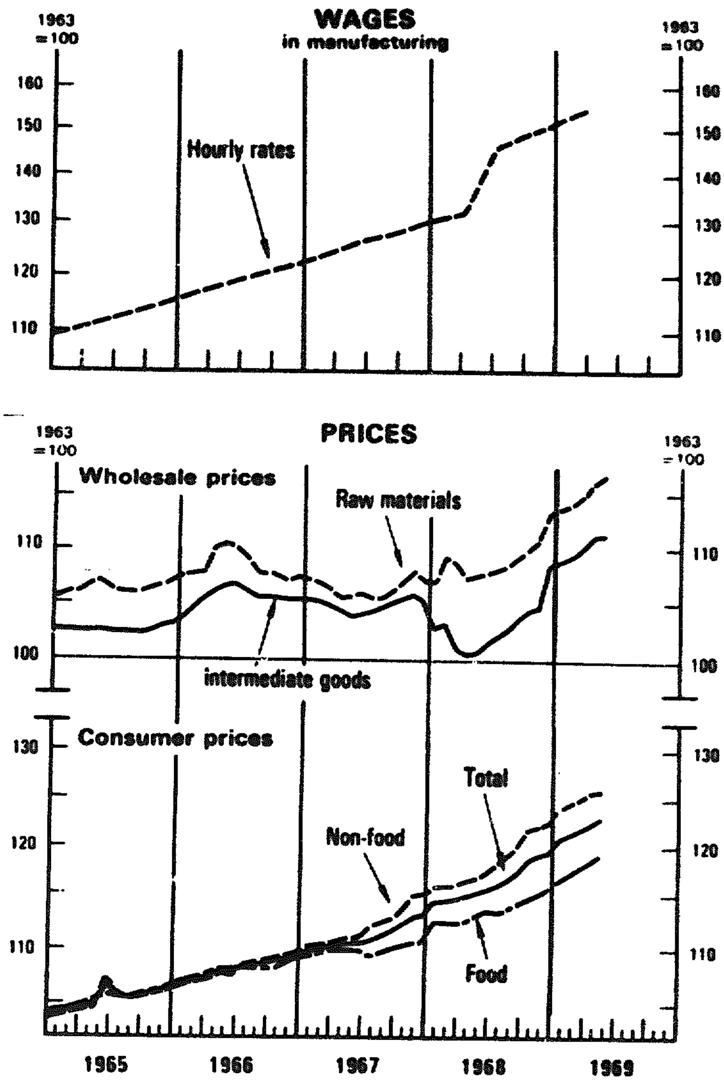
Recent Trends

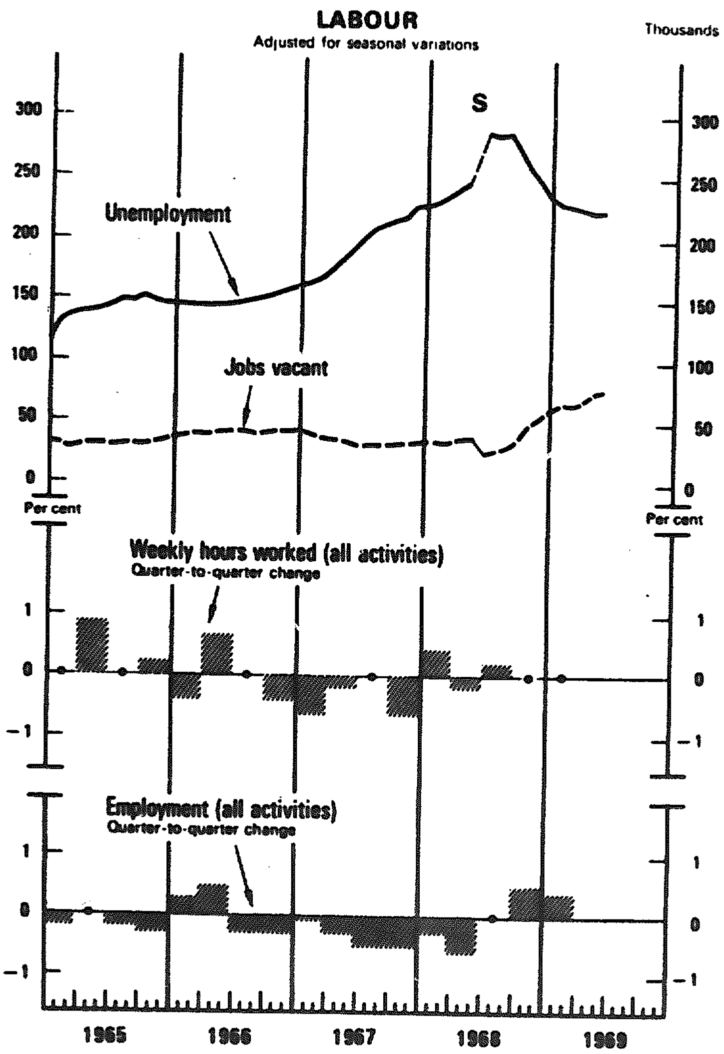
Industrial production, excluding building, recovered so sharply in the second half of 1968, that it increased by 4.2 per cent between the years 1967 and 1968, despite the strikes. In the early months of 1969, there was some apparent hesitation, but this was partly due to unusually adverse weather and to a one-day national strike ; April saw a strong upturn. In the May business survey, production prospects were judged even more buoyant than in previous surveys, with the outlook considered exceptionally good in the intermediate industries. Order books were regarded as particularly well-filled, with foreign demand remaining dynamic. Stocks continued to be regarded as abnormally low. In the June capacity survey, the proportion of firms finding it difficult to increase output with existing equipment and manpower resources was large by past standards and still increasing, suggesting that a high degree of capacity utilisation has been reached in manufacturing. The labour market has progressively tightened. At the beginning of April, employment in manufacturing (seasonally adjusted), steadily falling from the beginning of 1967 until last autumn, was 0.8 per cent higher than a year earlier and weekly hours worked were also somewhat higher. Complaints of skilled labour shortages have grown and unfilled vacancies rose markedly up to May. Registered unemployment (seasonally adjusted) decreased steadily from the peak of last summer ; at the end of April, some 360,000 could be estimated to be out of work—corresponding to about 2.4 per cent of dependent civilian employment. Hourly wage rates in manufacturing rose by 2 per cent during the first quarter of 1969.

The official aim of limiting the increase in the consumer price index between 1967 and 1968 to 4.4

per cent was roughly attained. The increase was sharp in services (10½ per cent) and moderate in food and drink (3.1 per cent). The removal of the payroll tax and the increase in TVA rates following last November's currency crisis had officially been estimated to bring about a mechanical increase of the consumer price index of about 1½ per cent ; the index rose by 1.1 per cent in January and 0.3 per cent in February, less than could have been feared, given the inevitable uncertainties as to how far the abolition of the payroll tax, particularly in the trade and services sectors, would, in fact, be passed on to consumers. But in March-May the index registered a further advance of 1½ per cent and the spring business surveys indicated that a large number of price increases were planned for the months ahead. The price rise could, therefore, turn out to have been rather steep in the first half-year.

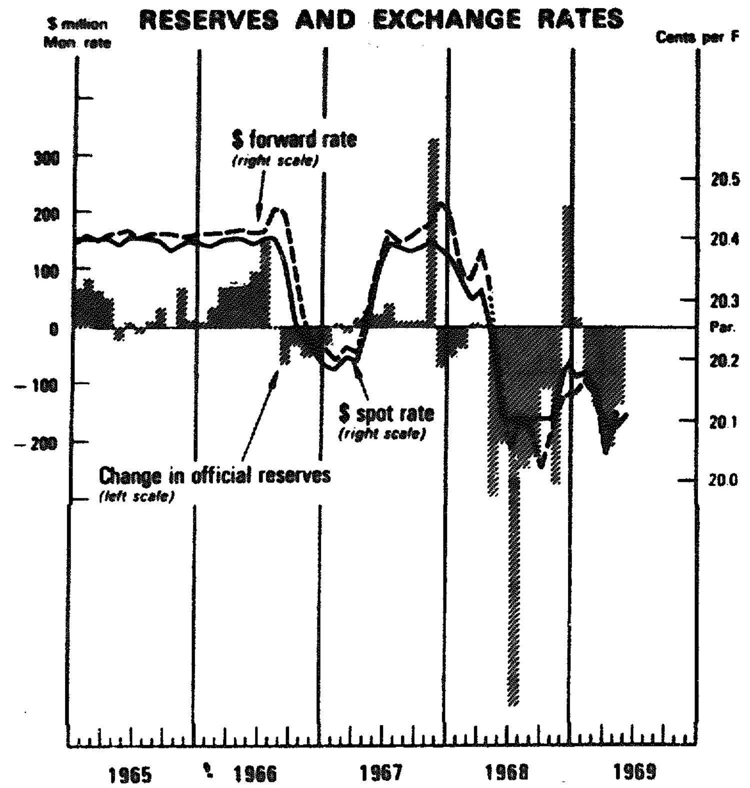
The buying spree of the later months of last year seems to have been followed by a calmer development in the early months of 1969, on the basis of the move-





ment of retail sales and the levelling-off of new passenger car registrations. Partial indicators, such as savings deposits, point, however, to some fall of the household savings ratio. And in the spring there may have been some new strengthening of real private consumption.

According to the March investment survey (covering slightly less than one-third of total gross fixed investment) productive investment by firms included in the survey could increase by about a quarter at current prices (perhaps 20 per cent in volume) between 1968 and 1969. A strong upsurge in private productive investment could be influenced by the fiscal incentives adopted by the authorities last September, the postponement of certain projects initially scheduled for 1968, and the favourable development of business profits : by the end of last year profit margins were at least back to their pre-strike level, as a result of productivity gains, tax relief, government subsidies and price increases.

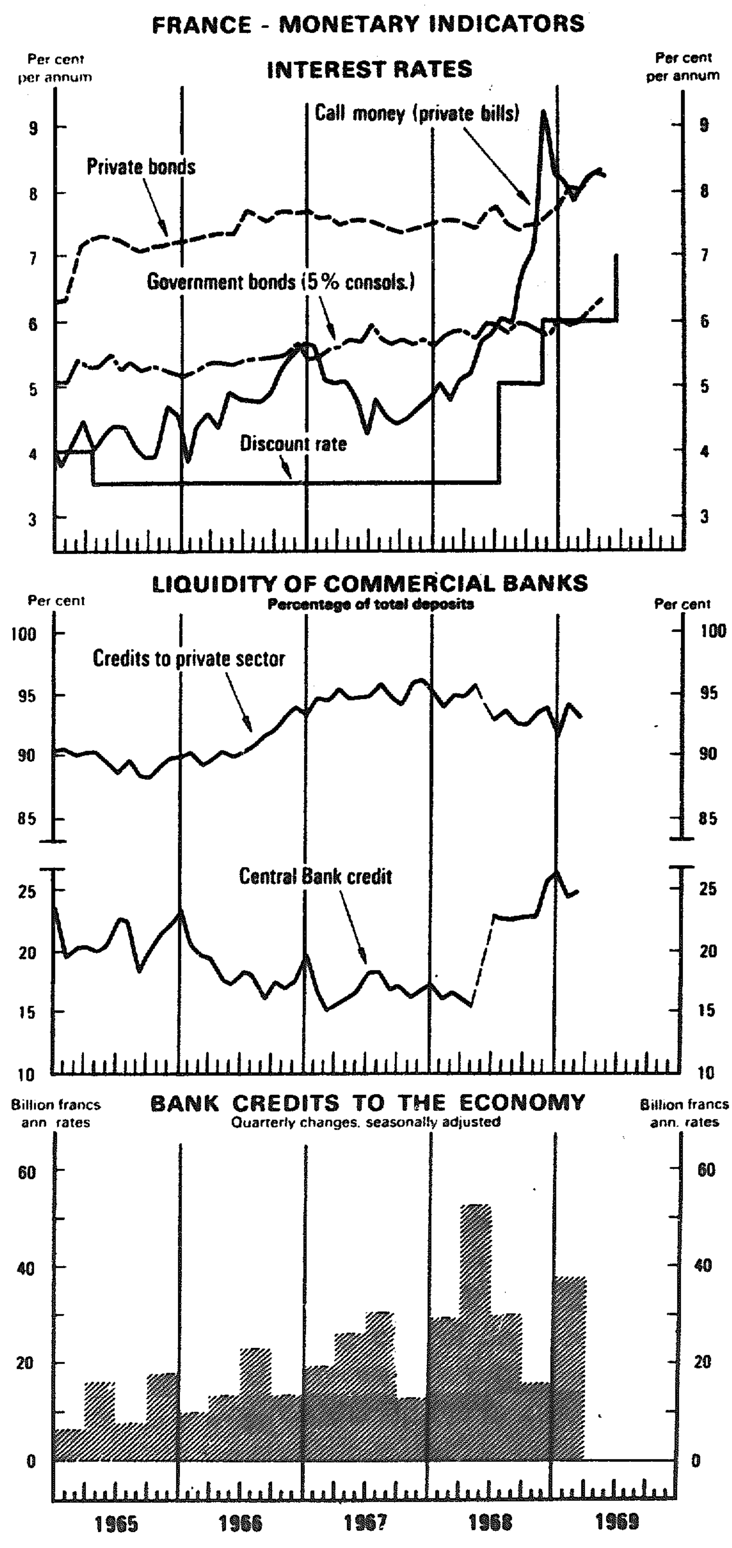


In the first quarter of 1969, imports (seasonally adjusted) were relatively stable. But April saw a marked upturn to well above the peak of last November, and imports increased again in May. Stockbuilding may have been responsible for much of this latest increase. Exports expanded at a very satisfactory rate in the first five months of 1969. French exporters have been able to take advantage of the buoyancy of world trade and there is no clear evidence of a deterioration in their competitive performance.

There was, thus, on the basis of seasonally adjusted figures on a transactions basis, a marked improvement of the trade balance in the first quarter of 1969 ; the deficit fob/fob with non-franc countries fell to an annual rate of $ 200 million from $ 600 million in the fourth quarter of 1968. The significance of the sharp worsening of the trade balance in April and May cannot yet be assessed, but it is probable that temporary factors played some role. The comparatively limited trade deficit in the early months of the year and some reflux of capital in January and February did not prevent severe intermittent attacks on the franc. The new currency crisis, with heavy reserve losses, which occurred in the spring was largely influenced by growing expectations of DM revaluation and uncertainties concerning the outcome of political events at home. During the first six months of the year, gross official reserves fell by $ 590 million to $ 3,610 million. These figures do not take account of drawings on credits extended by foreign central banks.

Policies

The new Government had, at the time of writing, only outlined its economic strategy. In the field of fiscal policy there had been no further measures



since those following the November currency crisis. The tax and expenditure changes then announced were officially forecast to reduce the deficit on transactions of a definitive nature to F 4.3 billion in 1969 (compared with F 9.3 billion in the original October budget) and to bring the total deficit (including financial transactions) down from F 11.7 to F 6.4 billion.

Further steps have been taken to tighten monetary conditions. Bank rate had been raised from 5 to 6 per cent last November, minimum reserve requirements and the ratio for banks' obligatory holdings of medium-term paper had been put up, and short- and medium-term bank lending (other than discountable medium-term credit and credit eligible for the mortgage market) had been subjected until end-June to a ceiling of 4 per cent over September 1968. It appears that the banks by and large observed the ceiling, but a surge of credit exempt from it meant that total bank lending increased substantially in the early months of 1969. This and other developments led on 8th May to new measures to stem domestic demand, including :

— Extension of the ceilings on short-term bank loans to the end of the year. This would limit the expansion of such loans to 3 per cent in the course of 1969. Certain norms were established for the expansion of medium-term discountable credits for equipment and construction ;
— Increased interest rates on savings accounts ;
— A tightening of consumers' credit ; minimum down payments were increased, maximum repayment periods reduced, and the limit on credit granted by specialised institutions was brought down.

These measures were followed on June 13th by increases of one percentage point in Bank rate to 7 per cent, and in the rate for advances by the Banque de France against securities to 8½ per cent. The rediscount rate for export credit of less than 18 months, which had been raised from 3 to 4 per cent in May, was increased to 5 per cent ; export credits exceeding 18 months could still, however, benefit from the 3 per cent rate.

Following the May and June measures, the commercial banks raised their prime rates for short-term and medium-term loans by some 1½ percentage points to 7.2 and 8.25 per cent respectively. In June, the Crédit Foncier increased its lending rates for non-subsidised construction credits (these credits account for virtually all its lending operations) by 0.7-0.8 percentage points on rates varying from 7.35 to 8.85 per cent, following smaller increases in March.

The hire purchase credit restrictions may not be very stringent, but credit restrictions for 1969 seem restrictive by past standards. The recent measures must be viewed against the probable marked increase of business profits since last summer, which suggests that business in general should still be fairly liquid.

Demand and Output
FRANCE[a]

Percentage changes, volume
Seasonally adjusted
at annual rates
Estimates and forecasts

	1967 billion francs	From previous year			From previous half-year				
		1967	1968	1969	1968 I	1968 II	1969 I	1969 II	1970 I
Private consumption	345.92	4.3	4.5	7	0.2	14.6	4½	4¾	4½
Public consumption	70.46	6.0	4.2	5	2.8	4.1	6¾	2½	1½
Fixed investment	143.90	6.0	5.6	9	0.8	16.5	6¾	6¾	5½
Final domestic demand (excluding stocks)	560.28	4.9	4.8	7¼	0.7	13.7	5½	5	4½
*plus change in stock building	10.01[b]	-0.3	-0.2	1½	-4.5	8.3	0	-2¼	-1½
*plus change in foreign balance	1.10[b]	-0.1	-0.3	-½	0.0	-1.5	-¾	¾	¾
GDP at market prices	571.39	4.5	4.2	8	-3.7	21.1	4½	3½	3½
GDP implicit price deflator	..	3.0	5.0	6	4.8	7.1	6	4¾	3½
Industrial production	..	2.6	4.2	13	-8.8	32.5	8¾	5¾	4½

* The yearly and half-yearly rates of change refer to changes in stock building and in the foreign balance expressed as a percentage of GDP in the previous period. These two figures plus the rate of change of final domestic demand broadly equal the rate of change of GDP. In practice, however, divergences are possible because the rate of change of final domestic demand is not expressed as a percentage of GDP.

a) All the figures shown in the demand and output table refer to the new series of French national accounts, converted to the SNA system.

b) Actual level of stock building and foreign balance.

But small and medium-sized firms whose rate of self-financing is generally rather low could feel the credit restrictions rather strongly.

Prospects

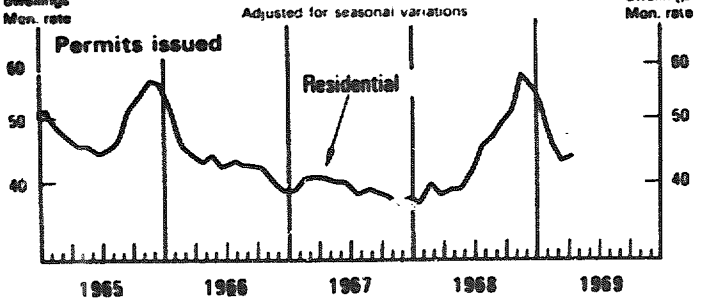
Short-term forecasting is particularly hazardous, given the difficulty of appraising the underlying strength of demand of recent months, the lack of detail about the new Government's economic policy at the time of writing and the uncertainty as to domestic reactions to future financial developments abroad. The following paragraphs only indicate the sort of trends which could ensue if government policies succeed in restoring confidence and social developments at home and financial events abroad do not occasion new major upsets.

The trend of private consumption could still remain fairly strong in the second half-year. Employment is expected to rise until the autumn and the wage rise could well amount to 7-8 per cent through the year. Although, with confidence gradually restored, the savings ratio might revert to a more normal level and the tighter conditions for consumer credit might influence the situation somewhat, real private consumption could increase by as much as 7 per cent between the calendar years 1968 and 1969, assuming some moderation of the price rise.

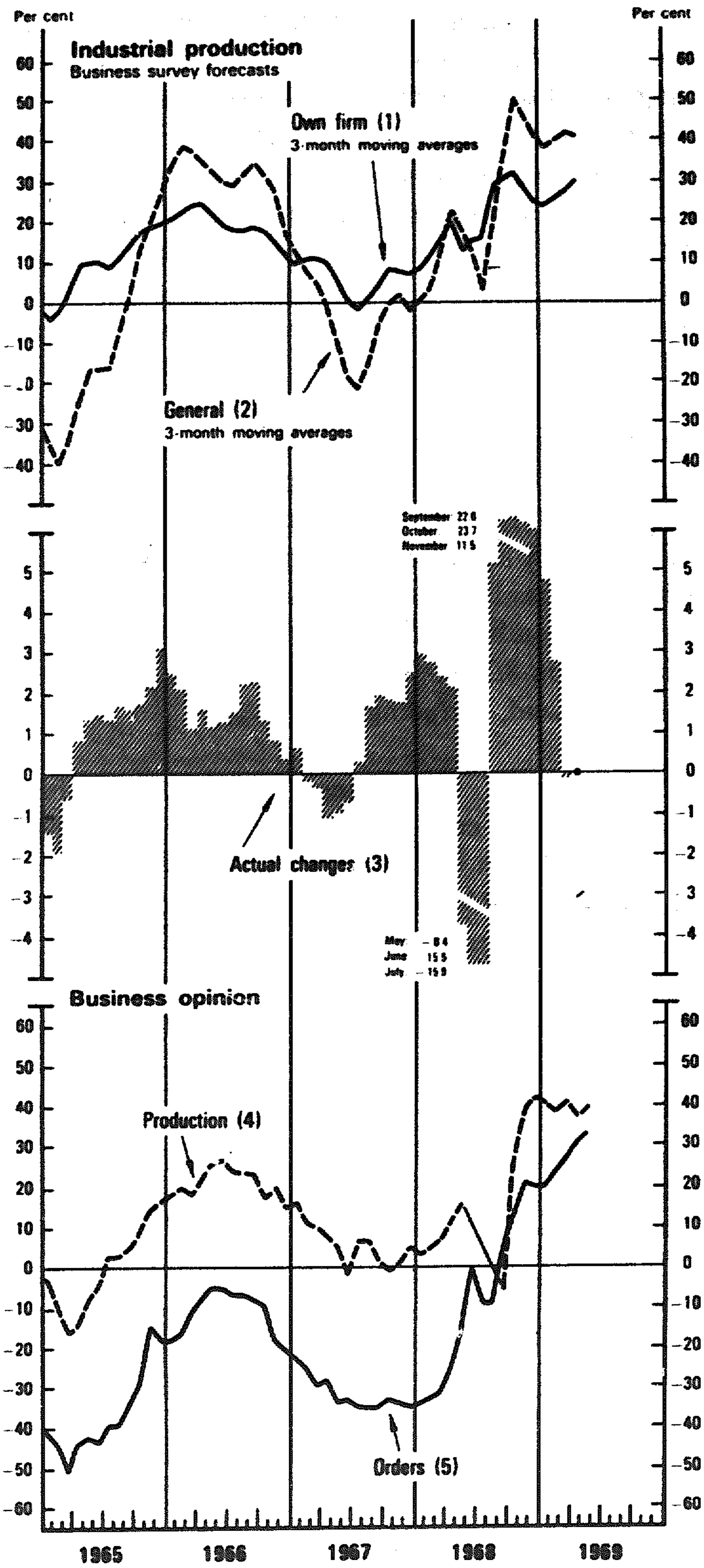
Government expenditure should feel the impact of the budgetary measures taken at the end of last year, but its deceleration may be tempered by the fact that part of the expenditure on goods and services scheduled to take place in 1968 was postponed to 1969, and that the number of civil servants is expected to increase by 4.4 per cent in 1969. Preliminary information points to a rather restrictive budget on the expenditure side in 1970.

Private productive investment seems likely to continue increasing rapidly through the year. Des-

CONSTRUCTION
3-month moving averages
Adjusted for seasonal variations



SURVEY OF BUSINESS OPINION



Source: I.N.S.E.E., Notes rapides.

Series 1, 2, 4, and 5 give the difference between the positive and negative answers to business surveys.
1. Expectation for 3 to 4 months of production of own firm.
2. Expectation for 3 to 4 months of total industrial production.
3. Rate of change of the index of industrial production (3-month moving averages over three months).
4. Judgment on current trend in production.
5. Judgment on unfilled orders.

pite the slowing down of the growth of public investment and a rather moderate expansion of dwelling construction, total gross fixed capital formation may expand by some 9 per cent between 1968 and 1969 but decelerate somewhat in the first half of 1970, when the impact of the various government incentives to business investment will be smaller and the trend of consumer demand may become less buoyant. The rate of stockbuilding could become more moderate in the second half of 1969 following the very strong first half (normal levels seem to have been restored already in retail trade). But estimates of stocks are uncertain, special influences may affect stock policies, and stocks in industry were still considered very low in the May business survey, so restocking could still be strong in the second half of the year despite the high cost of credit.

If the assumption of slower growth of final domestic demand in the second half of 1969 was borne out, the prospects for a better current foreign balance would seem reasonably good. The growth of imports could decelerate markedly in the second half, though stockbuilding and uncertainty concerning price movements could keep the import propensity rather high. The growth of exports should continue at a good rate in the course of the year. French export markets, especially Germany and Italy, are likely on present prospects to be particularly favourable and there need be no loss of France's market shares. On these assumptions, the trade balance (fob) with non-franc countries could approach equilibrium in the second half of 1969. The deficit on current invisible transactions should be somewhat smaller than last year. The tourist account could improve, reflecting the disappearance of last year's strike losses and the exchange control measures. Net receipts of investment income may decline if, as seems likely, the tendency to repatriate income were to increase in the case of non-residents and decrease in the case of residents. Since the foreign labour inflow is not expected to increase much this year, private transfers should rise less than in 1968. Net receipts on official transfers will probably increase markedly with the scheduled payments by the EEC agricultural fund.

The deficit on the current balance of payments could, thus, be relatively small in the second half of the year, with the deficit for the year as a whole held down to some $ 600 million. By early 1970, approximate equilibrium or even some surplus could have

Balance of Payments FRANCE[a]

Value, million dollars
Estimates and forecasts

	1967	1968	1969	1968 I	1968 II	1969 I	1969 II	1970 I
SEASONALLY ADJUSTED								
Exports	10 002	11 200	13 300	5 100	6 100	6 500	6 800	7 200
Percent change[b]	(4.4)	(11.6)	(17½)	(–1.4)	(45.0)	(11)	(8½)	(11½)
Imports	9 784	11 200	13 700	5 000	6 200	6 800	6 900	7 100
Percent change[b]	(4.4)	(12.7)	(21)	(–2.2)	(55.8)	(17)	(1½)	(6½)
Trade balance	218	0	–400	100	–100	–300	–100	100
Services and transfers, net	24	–300	–200	–200	–100	–100	–100	–100
Current balance	242	–300	–600	–100	–200	–400	–200	0
UNADJUSTED								
Current balance	242	–300	–600	–100	–200	–400	–200	0
Long-term capital	123			–163				
Short-term capital and unrecorded	–455			–530				
Multilateral settlements	57			–39				
Balance on non-monetary transactions	–33	–3 216		–835	–2 374			
Change in reserves	363	–1 908		–937	–971			

a) Balance with non-franc countries on a transactions basis.
b) Over previous period at annual rates, customs basis, total trade.

been restored. But the overall payments position, as in recent months, could be substantially affected by capital movements and leads and lags.

These estimates of the trend of the current balance of payments, which may be thought optimistic, are only likely to be realized if economic policy, in the months immediately ahead, is adequate for the task and if wage developments can be contained within reasonable limits. Demand management policy, as in the recent past, is faced with particularly difficult problems ; it needs not only to assure that overall demand, for the time being, expands less fast than capacity and a sufficient improvement in the foreign balance on current account is achieved, but to combat the widespread anticipations of price increases and the capital outflow, which are not directly related to the underlying trend of the main economic variables. Economic policy has, therefore, to be more restrictive than would otherwise have been required.

GERMANY

The expansion of activity was very strong in the second half of 1968 and has remained strong this year. By early 1969 the economy was working at virtually full capacity. All indicators point to continued buoyancy of domestic demand. The border tax changes have been followed by a fairly sharp rise in the export price index ; the rise in that for imports has been due mainly to rising world prices. But lasting effects on trade flows are not noticeable so far. Given domestic supply limitations, the growth of output is bound to slow down during the coming period to the rate of growth of productive capacity (4 per cent at most). The pressure of demand will in all probability rise, resulting in a faster rise in prices and some reduction of the large current external surplus. Even so, the surplus in the first half of 1970 could still be high. These prospects point to a dilemma for economic policy. The domestic situation calls for restrictive policies.

But these, whether monetary or fiscal, would delay the adjustment of the external balance. The rise in the discount rate in June followed increases in interest rates elsewhere but would seem also to reflect the increasing preoccupation of the authorities with domestic problems.

Demand and Output
GERMANY

Percentage changes, volume
Seasonally adjusted
at annual rates
Estimates and forecasts

	1967 billion DM	From previous year			From previous half-year				
		1967	1968	1969	1968 I	1968 II	1969 I	1969 II	1970 I
Private consumption	281.4	0.6	3.6	6¼	3.4	6.5	6½	5½	4½
Public consumption	80.6	3.3	–0.9	4	–3.0	2.5	5½	2½	4
Fixed investment	110.4	–7.3	8.8	14½	3.2	21.7	15½	6¼	3¼
Final domestic demand (excluding stocks)	472.4	–0.9	4.0	8	2.3	9.4	8½	5¼	4
*plus change in stock building	–3.5[a]	–1.1	2.4	0	3.2	–0.9	1	–1	0
*plus change in foreign balance	16.2[a]	2.1	0.4	–1½	–0.1	2.1	–3½	½	–1
GNP at market prices	485.1	0.0	6.7	6½	5.4	10.2	5½	4½	3
GNP implicit price deflator	..	0.9	2.1	3	2.4	2.8	3	3½	3½
Industrial production	..	–2.2	12.2	11	10.0	17.2	11	5½	5¼

* The yearly and half-yearly rates of change refer to changes in stock building and in the foreign balance expressed as a percentage of GNP in the previous period. These two figures plus the rate of change of final domestic demand broadly equal the rate of change of GNP. In practice, however, divergences are possible because the rate of change of final domestic demand is not expressed as a percentage of GNP.

a) Actual level of stock building and foreign balance.

TABLE 30.
Indicators of demand pressure

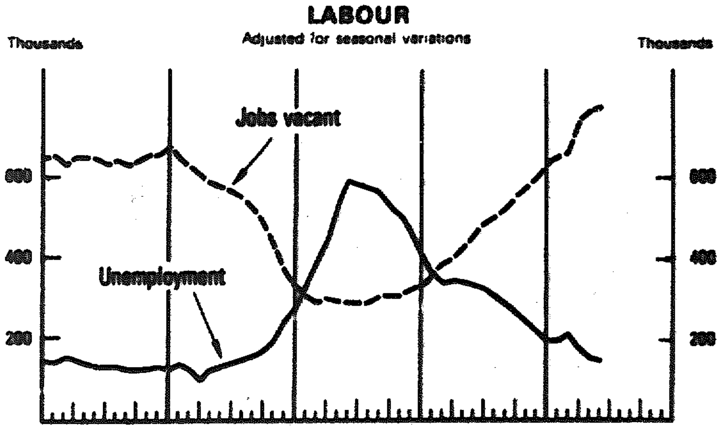
	1960 Q1	1965 Q1	1969 Q1
Capacity utilisation in industry, seasonally adjusted	94.0	89.5	92.0
Length of order books in industry (months)	3.9	3.5	3.7
Percentage balance of price expectations in manufacturing (IFO-test)a	...	11	11
Unit labour costs, seasonally adjusted, % increase on previous quarter	...	1.2	−1½
Cost of living (non food), % increase on previous quarter	0.9	1.1	1.1
Industrial producer prices for investment goods, % increase on previous quarter	0.8	0.9	1.1
Unemployment seasonally adjusted, in per cent of dependent labour force	1.4	0.7	0.9
Vacancies, seasonally adjusted (1,000)	405	646	680

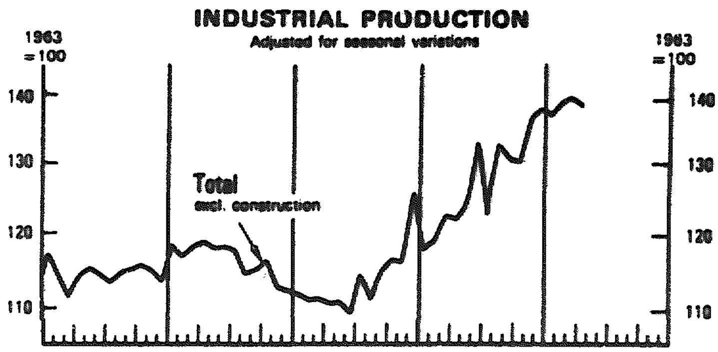
a) Percentage of industrialists expecting price increases *less* percentage expecting falling prices.

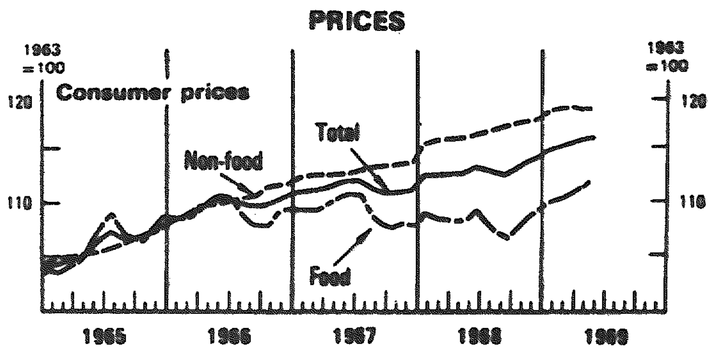
Recent Trends

The anticipatory effects of the border tax measures on the foreign balance, and the unexpected buoyancy of domestic demand, forced output up at an annual rate of some 10 per cent in the second half of 1968. The unwinding of the anticipatory effect reduced the apparent growth rate in the first half of 1969[1] to about 5½ per cent per annum. But the rise in business fixed investment, although more moderate than earlier, remained strong and private consumption rose fast, supported by a significant increase in employment (notably of foreigners) and a strong advance in hourly earnings. More stockbuilding, after the fall in the second half of 1968, may have added to the strength of domestic demand. Total domestic demand (including stocks) seems to have been expanding at an annual rate of some 9½ per cent in volume terms, about the same as in the preceding half-year. Table 30 suggests that, by the first quarter, pressure on resources was already about as strong as during the peak periods of the 1960/61 and 1964/65 booms.

There are indications of some acceleration of the rise in prices. The cost-of-living index, stable during much of 1968, continued to rise during the first quarter of 1969 at a seasonally adjusted annual rate of close to 4 per cent. Judgement as to the significance of this must be tempered by the consideration that the upward movement was to a large extent due to a reversal of the trend in food prices, which had fallen until the middle of 1968, and to rent adjustments. During the second quarter prices rose more slowly. Nonetheless, since the middle of 1968 the strong expansion has led to a moderate upward trend in industrial producer prices, notably in the field of investment goods, where prices in April 1969 were more than 2 per cent up on their mid-1968 level. And the acceleration of the wage rise, which had started at the end of 1968, continued in the first quarter of 1969, when industrial wages and salaries per man-hour rose at an annual rate of some 8 to 9 per cent. Wage settlements in the first quarter provided increases in hourly rates averaging 6 to



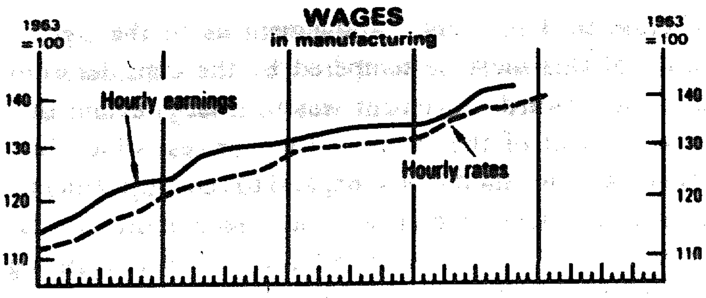


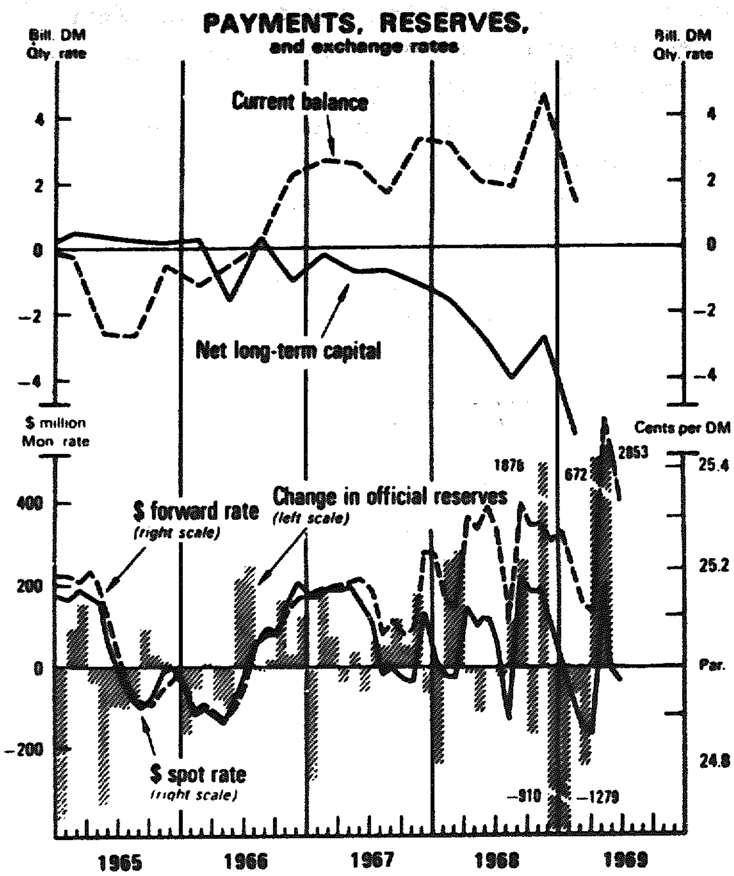


1. The adjusted "underlying" movement of GNP at seasonally adjusted annual rates may be as follows :

1967 II	1968 I	1968 II	1969 I	1969 II	1970 I
4 1/4	8 3/4	7 1/4	8	3 1/2	3

This adjustment takes account of the forward shifts of expenditure from 1968 to 1967 (mainly business fixed investment) and from 1969 to 1968 (mainly exports).

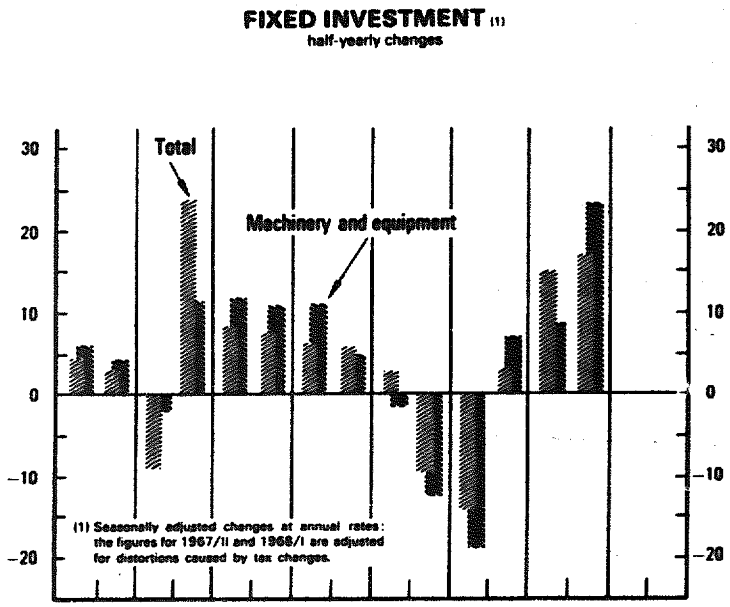


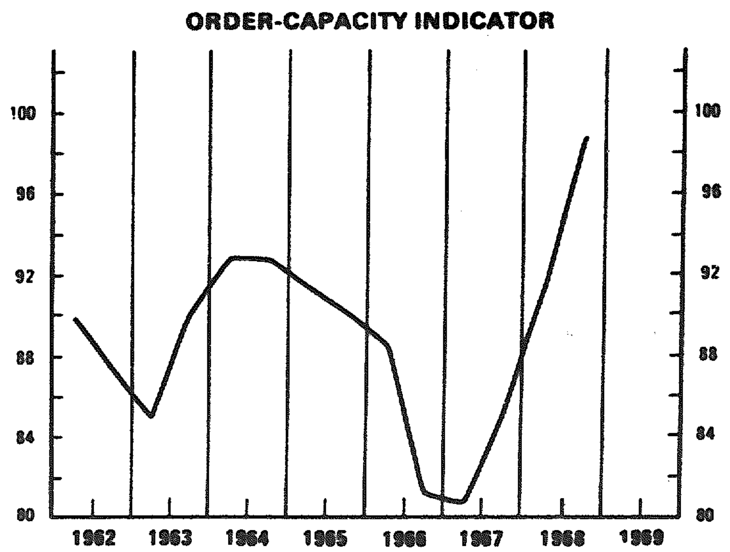


7 per cent for about 6 million workers. However, with the continuing strong rise in productivity, unit labour costs in industry seem to have fallen somewhat further on a seasonally adjusted basis.

Mainly because of the artificial disturbances to trade flows around the turn of the year, the surplus on the current account of the balance of payments (seasonally adjusted) fell to $ 0.2 billion in the first quarter from $ 1 billion in the fourth quarter of 1968. Exports showed an absolute decline and imports rose by 10 per cent, heavily influenced by the reversal of the export acceleration and import delays experienced in the preceding months. The second quarter, less affected by special factors, saw a sharp rebound of the current account, and in the first half of the year there may have been a current surplus of about $ ½ billion. If adjustment is made for the special factors operating in the fourth and first quarters, the underlying current account surplus may have declined, but only slightly, from $ 1.3 billion in the second half of 1968 to $ 1.2 billion in the first half of 1969, reflecting the sharp rise of imports associated with the strong expansion of activity.

The actual current account surplus in the first quarter was more than offset by a long-term capital outflow, most of it on private account. The volume of DM-denominated foreign bonds sold to residents, which had risen sharply in 1968, showed a further strong increase to $ 0.43 billion. There was also



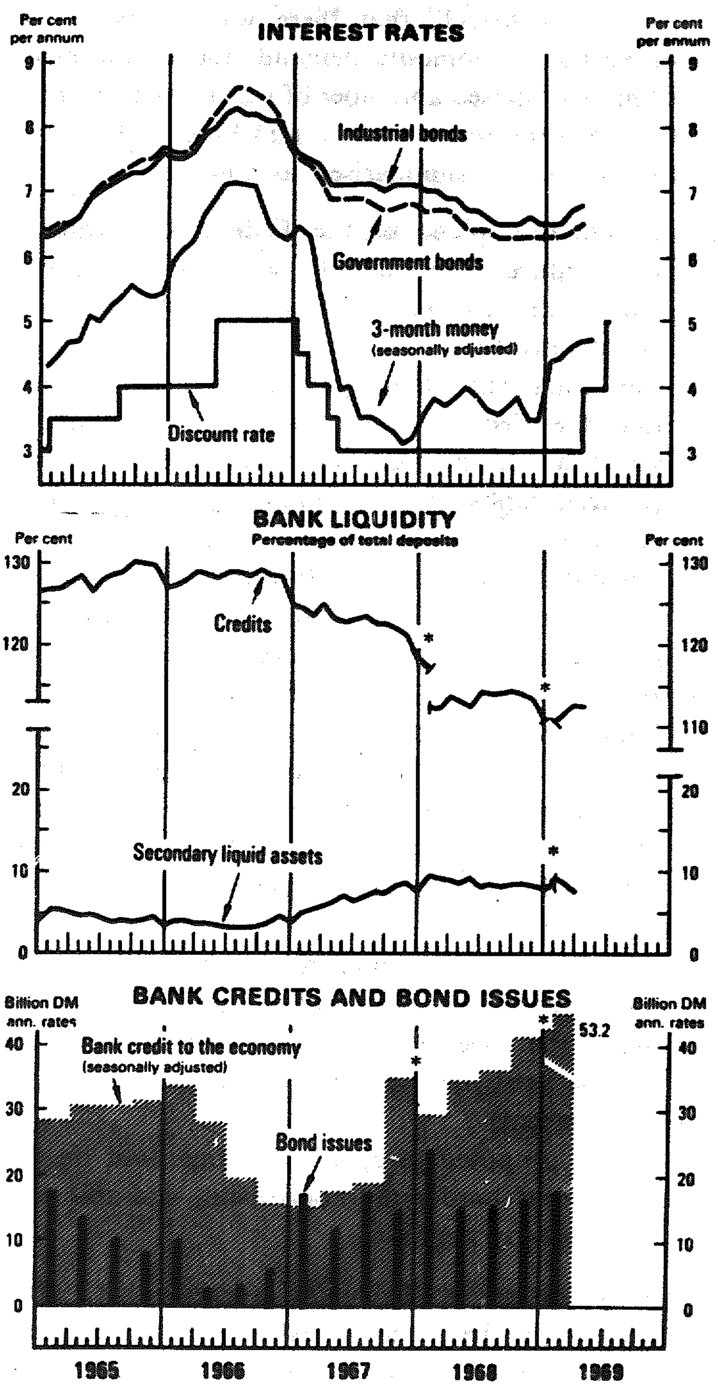


This indicator represents:

$$\text{Order-capacity} = \frac{O}{P} \times CU$$

in which O=Index of new manufacturing orders (1962=100);
P=Index of manufacturing production (1962=100);
CU=Ratio of capacity utilisation in manufacturing as calculated by the DIW.
All figures are seasonally adjusted.

GERMANY - MONETARY INDICATORS



* Break in series: see *Technical notes.*

a very large outflow of short-term funds ; by the end of March the whole of the speculative funds that had flowed in during the November crisis had left Germany again. Thus there was a deficit on official settlements of $ 1.75 billion in the first quarter, and official reserves at the end of March were about $ 0.8 billion lower than at the end of September. But there was another extremely large speculative inflow in May of more than $ 4 billion. Less than a quarter of it was reflected in the net foreign position of the banks. Most took the form of changes in the terms of payment (leads and lags), the taking up of foreign currency credits by German enterprises and the movement by foreign companies of liquid reserves into their German subsidiaries. A considerable part of the funds entering Germany seems to have been invested in securities, notably Euro-DM bonds. The reversal of the inflow was at first hesitant. By the end of June, Central Bank reserves had fallen by about $ 3 billion, though only a small part represented a net outflow on account of domestic non-bank bodies.

During the first quarter the banks felt some pressure on their liquidity position. A major influence was the external deficit on non-monetary transactions and substantial withdrawals of foreign deposits as the speculative positions taken in November were unwound. Further pressure came from the very sharp increase in bank lending during the quarter : loans to the private sector accounted for the greater part of the acceleration (with the growth of profits declining and high investment expenditure, the financial deficit of the enterprise sector has risen considerably). But compared with the years prior to 1967 the banks' liquidity position remained comfortable and was subsequently boosted by the repercussions of the renewed speculative inflow of foreign funds in April-May. The trend of long-term interest rates, flat since the middle of 1968, has become upwards. The general coupon on new bond issues had risen by one half a percentage point to 6½ per cent for domestic issues and about 7 per cent for foreign issues by late May and has risen further since. Short-term interest rates have also moved up again since the speculative fever in May. The rise in domestic short-term rates early in June may have reflected temporary factors. The banks were exporting funds on a large scale, stimulated by the high returns to be obtained in the Euro-dollar market and the swaps then offered on very favourable terms by the Bundesbank and this produced some tightening in domestic markets. But the raising of the discount rate later in the month reinforced the rising trend of money market rates and also bond rates.

Recent Policy Measures

The 1969 budget (general government) originally contained certain expansionary measures to offset the expected deflationary impact of the border tax measures adopted last November. When it became clear, by mid-March, that there was a risk of an excessive rise in domestic demand, the Government adopted or proposed a number of restrictive measures, and these were reinforced in mid-May. The most important can be summarised as follows :

a) Expenditure plans of the Federal Government were reduced provisionally by about DM 2 billion. The cuts mainly affect public consumption and investment ;

b) The Financial Planning Council recommended that the Federal Government and the Länder set up a contracyclical reserve of DM 3.6 billion (in accordance with paragraph 15 of the Growth and Stability Law). This was approved by Parliament in June. The authorities have, however, discretion to use these funds partly for increased redemption of money market paper ;

c) Any tax revenue of the Federal Government, Länder and communes resulting from a growth of GNP faster than assumed in the original budget calculations and not needed to meet the above requirements should either be used for increased redemption of money market paper or put into the contracyclical reserve ;

d) Tax payments by enterprises, which have been lagging considerably behind the accrual of income, are to be speeded up. The additional revenue will be used for the reduction of net borrowing requirements ;

e) It was proposed to cancel the time limit on the 4 per cent border tax adjustment, and this was subsequently approved.

The estimates in Table 31 suggest that, after allowance for the various restrictive measures actually taken, the General government budget is now likely to exert a deflationary impact of some 1 per cent of GNP in 1969.

Monetary policy has also been tightened. In March the Central Bank announced that it would no longer intervene at the long end of the market, and it was decided to reduce rediscount quotas of the credit institutions by some DM 3.5 billion. The discount rate was raised from 3 to 4 per cent and the Lombard rate[1] from 3½ to 5 per cent. The Central Capital Market Committee decided to subject foreign issues, which had been very high indeed in the first quarter, to voluntary regulations similar to those existing for domestic issues. With effect from 1st June, minimum reserve requirements for domestic

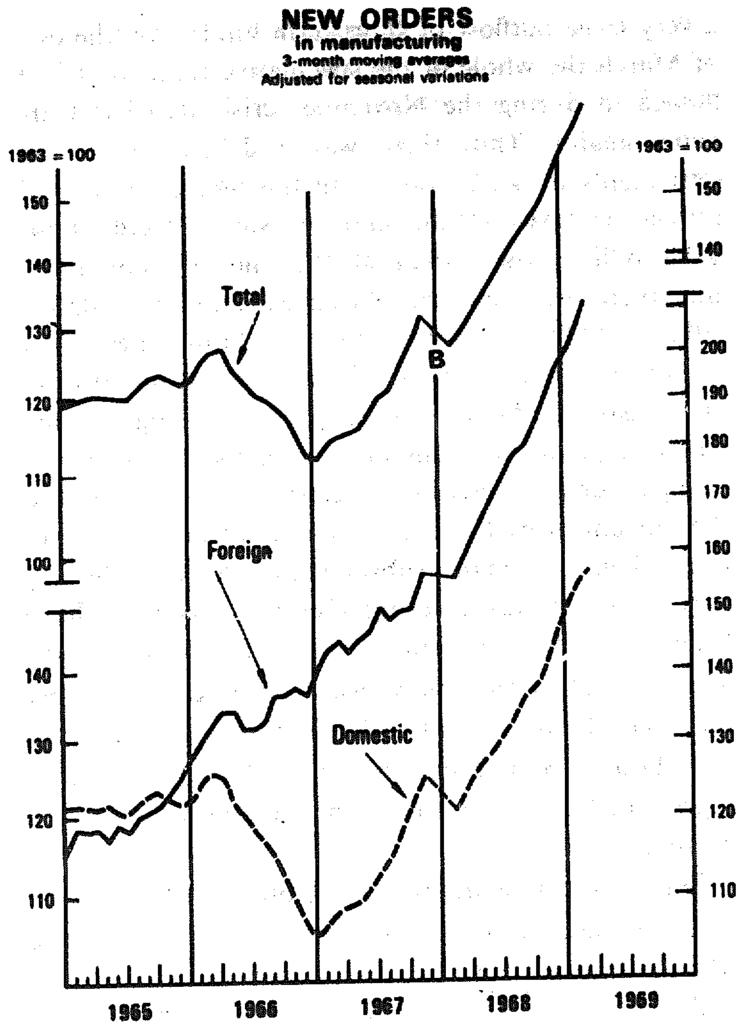


TABLE 31.
General government budget and its estimated impact on domestic demand

	DM billion 1966	Percentage changes 1967	1968	1969 Originally planned	1969 After introduction of restrictive measures in March and assuming a stronger growth of GNP *a*
Current revenue	177.3	2	8	10	14-15
Expenditure on goods and services at home	73.2	7	4	10½	9
Gross asset formation	20.3	−5½	11	10½	9
Transfers to domestic sectors	82.0	10	5½	7½	7
Estimated impact of budget changes on domestic demand (per cent of GNP)		2½	−½	½	−1

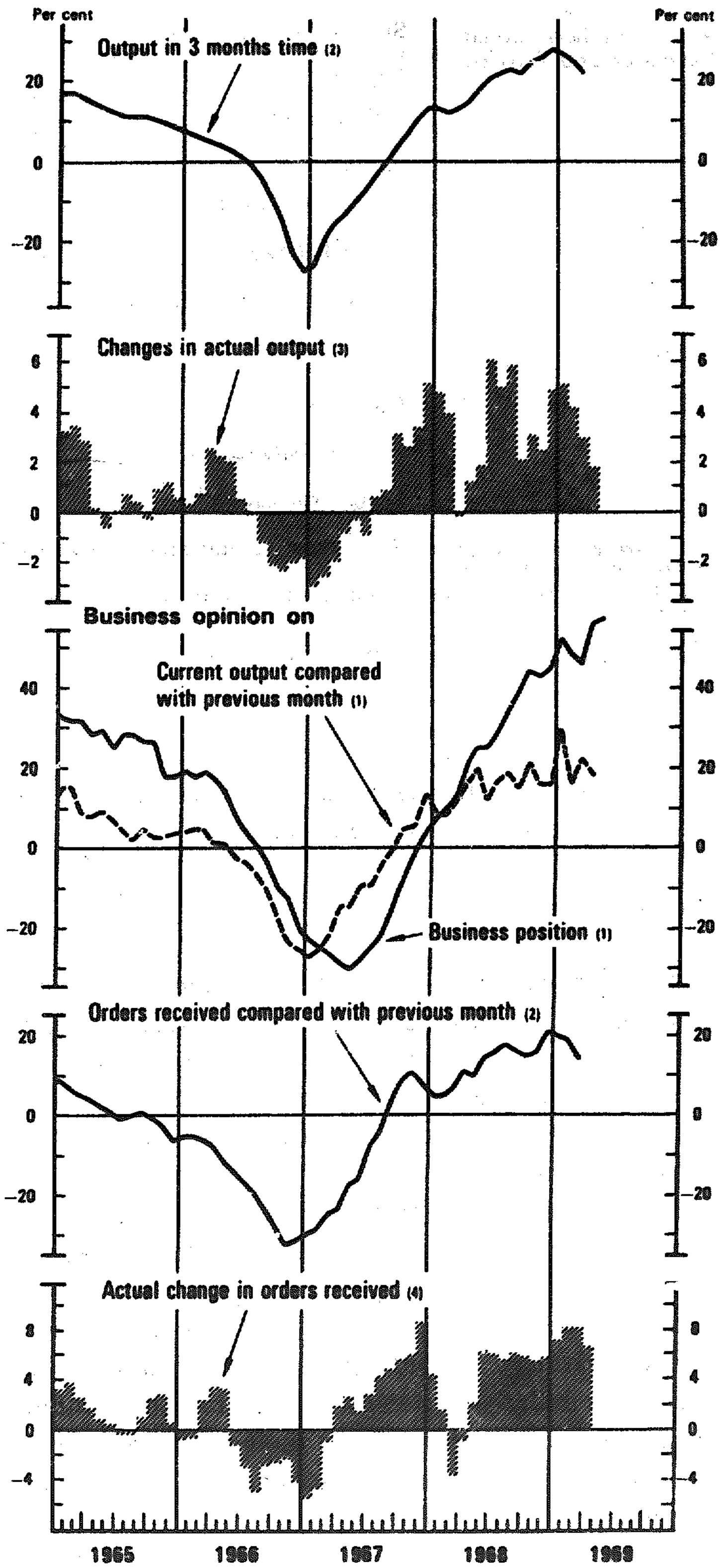
a) Secretariat estimates.

1. Rate of short-term Central bank lending against collateral.

deposits were increased by 15 per cent and those for foreign deposits by 50 per cent. The latter measures resulted in a reduction of bank liquidity by about DM 2½ billion. At present, secondary bank reserves are still relatively high, suggesting that the "braking distance" of monetary policy is rather long. However, a conflict might soon begin to emerge between the domestic aims of monetary policy and the external aim of maintaining conditions conducive to exports of long-term capital sufficient to match the current account surplus. The raising of the discount rate to 5 per cent in June—which had immediate effects on the bond market—may bring the conflict nearer.

Early in 1969, given the deficit in the basic balance of payments, the monetary authorities decided that the encouragement of short-term capital exports by the banks was no longer necessary for the maintenance of international payments equilibrium. The Bundesbank therefore gradually made the terms of swaps offered to the commercial banks less attractive, and, at the beginning of May, temporarily discontinued them. They had, however, to be reintroduced at the end of the month. To discourage short-term capital inflows the Bundesbank had announced at the beginning of May that increases in foreign deposits exceeding the level of either 15th April or 1st May were to be matched by an equivalent

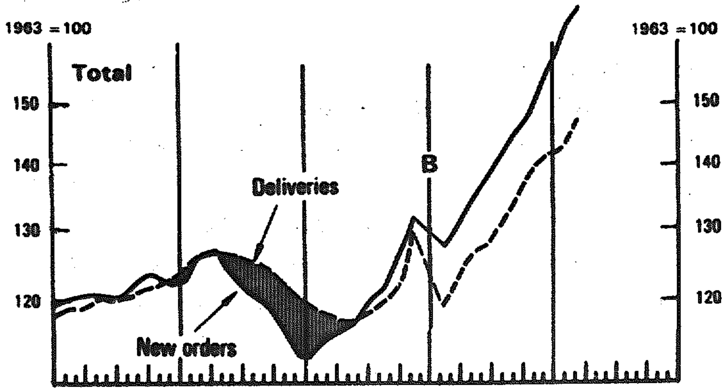
SURVEYS OF BUSINESS OPINION
Manufacturing industry



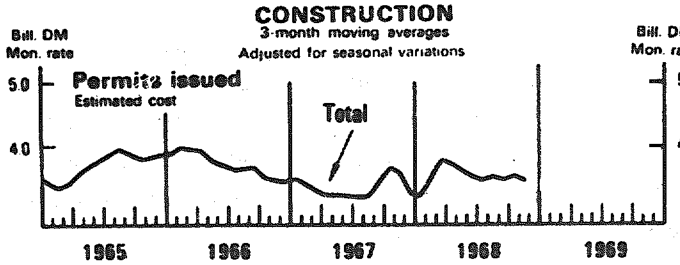
Source: I.F.O. - Institut fur Wirtschaftsforschung, Munich.

1. Answers to the survey are judgements on own firm, and the series show the difference between positive and negative replies, seasonally adjusted, for the months in which the survey was taken.
2. 3-month moving averages.
3. Percentage changes in the seasonally adjusted index of manufacturing production (3-month moving average over previous 3-month).
4. Percentage change in the index of new orders received by manufacturing industries (3-month moving averages over 3-month). Before January 1968 the index of new orders included indirect taxation; these figures have been reduced by 5 per cent to make them comparable with the 1968 figures.

DELIVERIES AND ORDERS
in manufacturing
3-month moving averages
Adjusted for seasonal variations



CONSTRUCTION
3-month moving averages
Adjusted for seasonal variations



Balance of payments GERMANY

Value, million dollars
Estimates and forecasts

	1967	1968	1969	1968 I	1968 II	1969 I	1969 II	1970 I
SEASONALLY ADJUSTED								
Exports	21 697	24 820	27 750	11 563	13 257	13 450	14 300	14 950
Percent change[a]	(8.0)	(14.3)	(12)	(8.6)	(32.2)	(3)	(14½)	(9)
Imports	16 445	19 094	22 850	9 197	9 897	11 100	11 750	12 400
Percent change[a]	(–3.7)	(16.1)	(20)	(16.0)	(21.0)	(26½)	(9)	(12½)
Trade balance	5 252	5 726	4 900	2 366	3 360	2 350	2 550	2 550
Services and transfers, net	–2 788	–2 850	–3 300	–1 284	–1 566	–1 600	–1 700	–1 750
Current balance	2 464	2 876	1 600	1 082	1 794	750	850	800
UNADJUSTED								
Current balance	2 464	2 876	1 600	1 261	1 615	900	700	950
Long-term capital[b]	–772	–2 865		–1 147	–1 718			
Short-term capital and unrecorded[c]	–360	959		667	292			
Balance on non-monetary transactions	1 332	970		781	189			
Change in reserves	329	1 332		183	1 149			

a) Over previous period at annual rates, customs basis.
b) Excluding special transactions.
c) Including advance payments for military imports.

deposit with the Bundesbank—in effect, a 100 per cent incremental reserve requirement.[1]

Prospects

If no further policy measures are taken, and monetary conditions, despite the recent measures, remain relatively easy throughout the forecast period, the rise in demand seems likely to remain strong. But the growth of output will slow down because of capacity limitations.

In the second half of 1969, the underlying rise in exports should have reasserted itself (the forecasts do not allow for possible future speculative disturbances), and fixed investment is likely to show a further advance. Residential construction may revert to its underlying downward trend as the stimulus from the second contingency budget in 1967 wears off. But business fixed investment demand is likely to remain buoyant. The IFO-test taken in the spring suggested an upward revision of investment plans and the order-capacity index (a fairly reliable indicator) points in the same direction. Nevertheless, the rise in investment may slow down in real terms because of supply bottlenecks. Inventory accumulation, probably strong in the first half of the year, may fall back. The rise in public consumption should be moderate, influenced by the recent measures. But the increase in private consumption is likely to remain strong. The acute pressures on the labour market seem bound to lead to faster increases in hourly earnings so that even though employment may increase only a little and the rise in prices accelerate (under both cost and demand pressures) real personal income should increase considerably. By June, the number of foreign workers, at 1,370,000, was 360,000 more than a year earlier, and some further—though much smaller—increase is expected during the rest of the year on the basis of current applications. Nonetheless pressure on resources is likely to increase, with consequent pressures on costs and prices.

Prospects for the first half of 1970 are necessarily uncertain. In the absence of new measures, the inflationary trend seems likely to continue. There seems little reason to expect a slowdown of the rise of demand in money terms. Given the probable pressure on capacity and the tight situation likely

1. The effect of the incremental minimum reserve requirement is not necessarily a full 100 per cent in all circumstances as the Central Bank Act includes limitations on the *average* rate of reserve requirements. The Government has therefore proposed a change in the Act enabling the Bundesbank to increase reserve requirements on foreign deposits to 100 per cent.

to prevail in the labour market, investment demand and wage incomes should remain buoyant. The increase of output, however, is unlikely to exceed the growth of capacity (estimated at around 3½-4 per cent a year, assuming very little increase in the labour force). Some further acceleration of the rise in prices therefore seems in prospect.

With continuing high pressure of demand, the current external surplus would tend to decline. The rise in exports may remain relatively fast in the short-term, given the likely trend of world trade and the strong competitive position of German industry that has developed since 1966. The inflow of export orders has continued rapidly. But imports are likely to rise much faster, and the deficit on invisibles could rise considerably, because of a sizeable increase in the remittances of foreign workers and a higher deficit on tourism. By the first half of 1970 the current account surplus could be reduced to around an annual rate of say $ 1½ billion compared with the estimated underlying annual rate of nearly $ 2½ billion in the first half of this year. But this could nevertheless imply a surplus on goods and services of somewhat more than 2 per cent of GNP in the first half of 1970, well above the official medium-term balance of payments aim of 1.5 per cent. And given the fact that, in that period, demand pressures would be exceptionally high in Germany, the surplus might be expected to grow again with the return to more normal conditions.

ITALY

The more vigorous rise in economic activity that began late in 1968 continued in the early months of this year, boosted both by a persistent rapid growth of exports and by stronger domestic demand. GDP seems likely to rise at an annual rate of 7 per cent or more through the first half of next year and non-farm employment may grow significantly. Nevertheless there may still be considerable slack at mid-1970. And the current balance of payments surplus —now running at an annual rate of over $ 2.5 billion— while expected to decrease, is likely to remain large next year. Capital outflows, including banking funds, exceeded somewhat the current surplus in 1968. The outflow has since accelerated so that despite the large current surplus and a repatriation of banking funds there was a decline of official reserves, though they

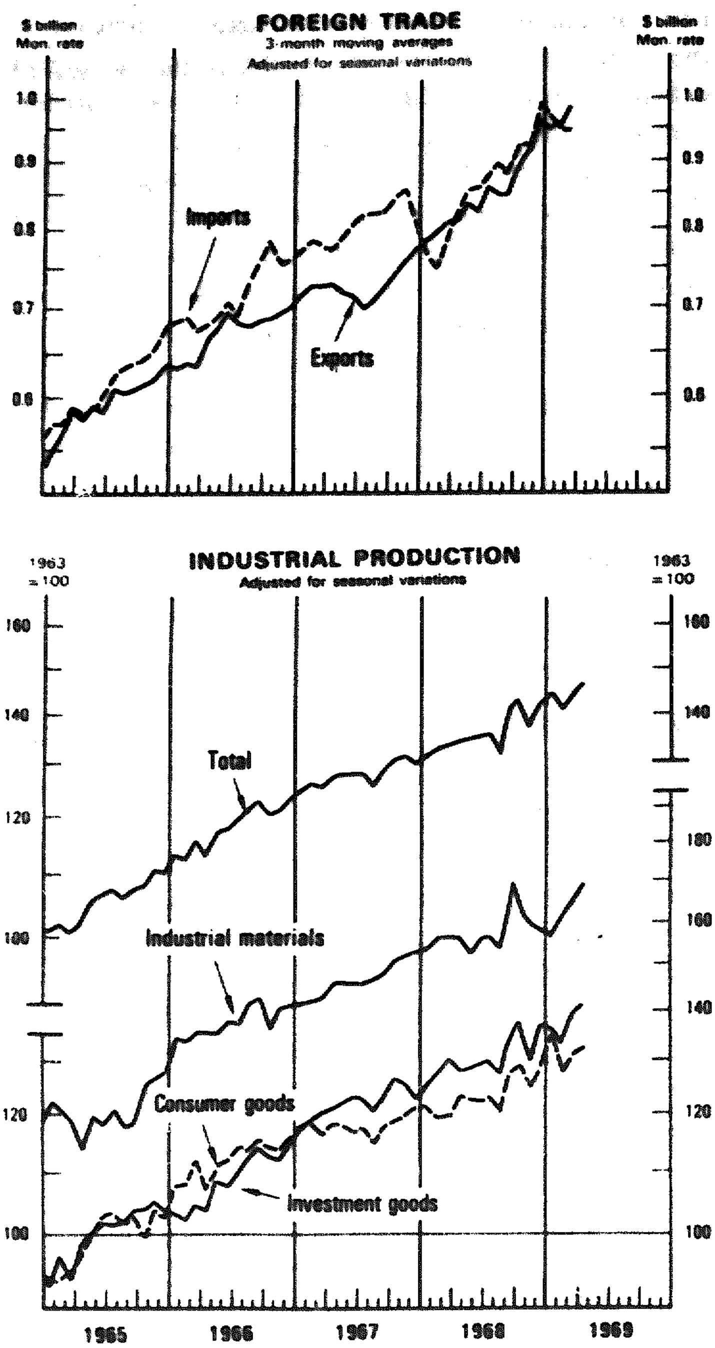
Demand and Output
ITALY

Percentage changes, volume
Seasonally adjusted
at annual rates
Estimates and forecasts

	1967 billion lire	From previous year			From previous half-year				
		1967	1968	1969	1968 I	1968 II	1969 I	1969 II	1970 II
Private consumption	28 218	7.2	4.3	6¼	2.4	4.5	6	8½	7½
Public consumption	5 780	2.8	4.2	4½	4.6	4.9	4½	4½	4½
Fixed investment	8 233	10.2	7.5	10	6.3	6.0	10½	13	13
Final domestic demand (excluding stocks)	42 231	7.1	4.9	6¾	3.5	4.8	6½	8¾	8¼
*plus change in stock building	550[a]	0.4	-0.9	¾	-2.8	2.0	¼	½	½
*plus change in foreign balance	523[a]	-0.8	1.4	-¼	3.7	-0.6	1	-2	-1½
GDP at market prices	43 304	6.5	5.4	7¼	4.3	6.1	7¾	7	7
GDP implicit price deflator	..	2.7	1.5	2½	0.8	1.2	2½	3¾	4¼
Industrial production	..	8.5	6.3	8½	6.8	6.0	9½	8½	8½

* The yearly and half-yearly rates of change refer to changes in stock building and in the foreign balance expressed as a percentage of GDP in the previous period. These two figures plus the rate of change of final domestic demand broadly equal the rate of change of GDP. In practice, however, divergences are possible because the rate of change of final domestic demand is not expressed as a percentage of GDP.

a) Actual level of stock building and foreign balance.



remain high. The measures taken in recent months to reduce the capital outflow illustrate the many difficulties posed by the combination of a large current account surplus and major domestic development needs.

Recent Trends

The acceleration of activity in late 1968 was essentially due to higher domestic demand. Exports continued to rise quite strongly, but imports increased sharply, due partly to rebuilding of stocks. In early 1969, the external surplus again provided an additional expansionary stimulus as export growth accelerated and the rise of imports became more moderate. But final domestic demand has probably continued gaining strength. After a strong upswing in late 1968, industrial production (seasonally adjusted) moved somewhat irregularly, but progressed from December to April at an annual rate of about 10 per cent. The effect on employment was fairly significant for industry and construction; the quarterly surveys of January and April show an average increase of 3.1 per cent compared with a year earlier. But total employment declined on a similar comparison, because of a continued large movement of labour away from the farms and of a fall in services—a sector where employment had risen particularly fast in the first half of 1968.

The rise of wage rates remained fairly moderate until recently. By the end of last year the combination of higher rates and wage drift had only raised average hourly earnings by 5 to 6 per cent for manufacturing workers over twelve months, and average hours worked in industry (including construction) fell fractionally in the same period. But wage rates accelerated significantly in April when 50 per cent of the regional differentials [1] in minimum rates were abolished. They then showed an increase of about 6 per cent over April 1968, compared with an earlier year-to-year increase of 3.7 per cent. Moreover, the sliding-scale adjustment of wage rates in relation to the cost-of-living resulted in a fairly significant rise for the period May-July. Consumers prices, practically stable in the year to last October, rose between November and April at an annual rate of just over 3 per cent, with food prices rising slightly faster.

When activity began to strenghten in the second half of last year, inventory formation may have accounted for nearly a third of the total increase in domestic demand. Its impact in the early part of this year seems to have been smaller; consumers' expenditure, fixed investment and exports seem to be supporting the underlying trend of total demand. Both production of investment goods and imports of machinery are showing signs of acceleration. This may partly reflect the effect of the special tax allowance introduced last autumn to encourage private

1. Italy is divided into seven zones for the purpose of establishing minimum wages, the differential in rates reaching 20 per cent. This difference was reduced by 50 per cent from April; the remaining difference will be halved in October 1970. By 1st July 1972 all regional differences are due to have been eliminated, and all minimum wage rates will then be aligned on those of Milan and Turin.

productive investment, and partly the acceleration effect of increased total demand. Residential construction is still progressing fast though probably less rapidly than last year.[1]

The rise in industrial employment coupled with increased wages has probably served to boost consumers' expenditure in recent months. The index of sales by department stores showed an increase of 6 per cent between the first four months of 1968 and 1969, with a tendency towards an acceleration. Over the same period, registrations of new private cars, which had been flat in the course of last year, rose by 4.5 per cent. The results of the latest business survey (for the end of April) seem to confirm the more buoyant trend of domestic demand. The difference between the percentage of firms which considered the level of domestic orders as "high" or "low" was + 19, as compared with — 11 a year earlier.

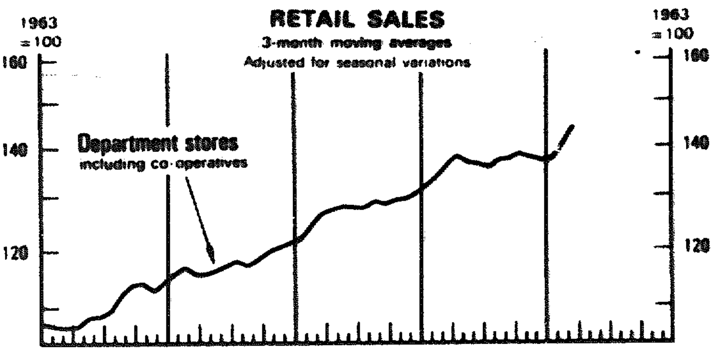
Imports, seasonally adjusted, rose very fast in the second half of 1968.[2] They have risen again this year, though more moderately, and in the first four months were about 12 per cent above last year's average. Exports, seasonally adjusted, have continued to grow fast, and were on a similar comparison 15.5 per cent higher. On a cash basis the current account surplus for January-April was practically the same as a year earlier ($ 420 million compared with $ 407 million). It was, however, more than offset by an exceptionally high capital outflow of $ 966 million as compared with $ 490 million in the same period of 1968. As a result, the balance of payments showed a deficit on non-monetary transactions of $ 558 million, substantially higher than in the first four months of 1968. The capital outflow was probably even higher on a transactions basis. The impact of the deficit on official reserves was cushioned by the repatriation of banking funds following the instructions of the monetary authorities. Between December and April net official reserves decreased by $ 307 million to $ 457 million. The banks' net foreign position started decreasing in February and over the four months showed a decline of about $ 240 million.

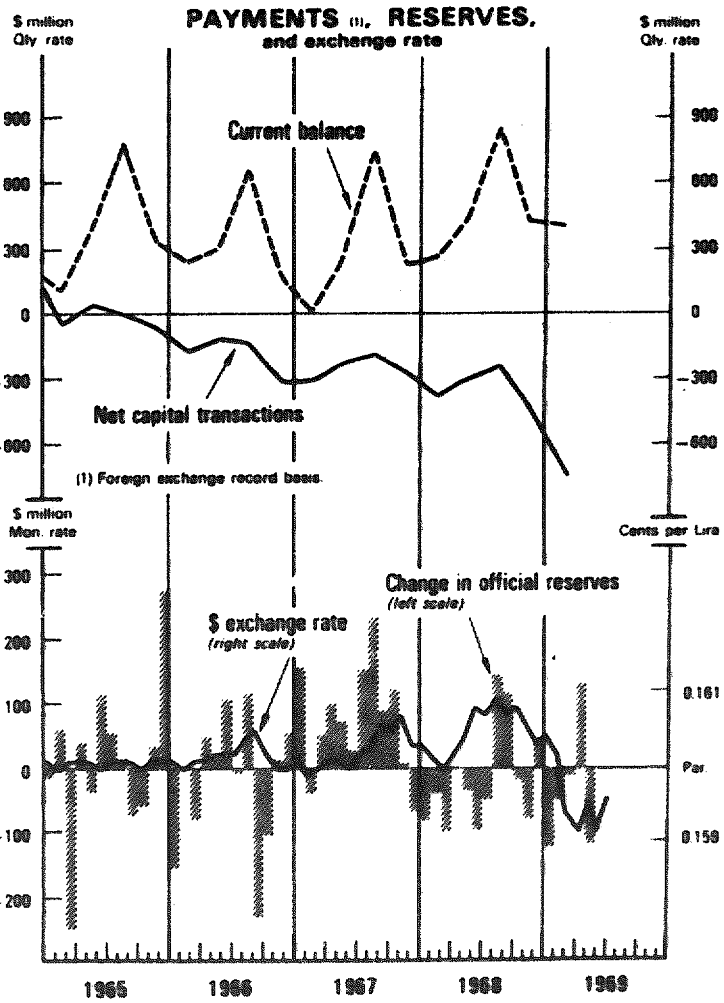
1. Construction permits issued have slowed down since October, after a fast increase early in 1968 in anticipation of restrictive urban planning measures effective from September.

2. Imports of merchandise as recorded (especially food imports) were rather erratic during 1968.

Policy measures

The public sector may have been one of the main sources of rising domestic demand by the second half of last year. The expansionary effect of the public sector last year on current account—as estimated by the reduction in the cash surplus on current account—amounted to 0.5 per cent of GNP; it probably became stronger as the year went on. The impact of the capital account seems likely to have been similar.





While budget forecasts are difficult to interpret, given the considerable difference between estimates and actual receipts and expenditures, there are some grounds for expecting the public sector to exert a stronger expansionary effect in 1969. Current expenditure is forecast to rise substantially. The increase in pensions—approved by Parliament in May—will represent an addition to purchasing power equivalent to about 1 per cent of GNP (slightly offset by an increase in the price of oil products). And the increase which has been recently approved in civil servants' salaries may raise Government expenditure by about 200 billion lire in the second half of this year. Receipts should be affected by the tax credits granted last autumn to stimulate investment and by the reduction in social security charges in the South (total tax receipts—excluding social security contributions—were rising less fast in the first four months of 1969 than a year earlier). As a result, government borrowing on the capital market is expected to be considerably larger than last year.

Throughout 1968 the authorities had allowed monetary conditions to be easy. Thus interest rates in Italy remained stable in contrast to the sharply rising trend in most other major industrial countries. Nevertheless, demand for domestic loans and investments was not very strong : the ratio of bank credit to deposits registered a modest decline and the ratio of securities to deposits remained virtually stable. Italian funds flowed increasingly abroad. Consequently, when early in 1969 the capital outflow showed signs of accelerating from the 1968 rate of $ 2.7 billion, measures were taken to dampen it :

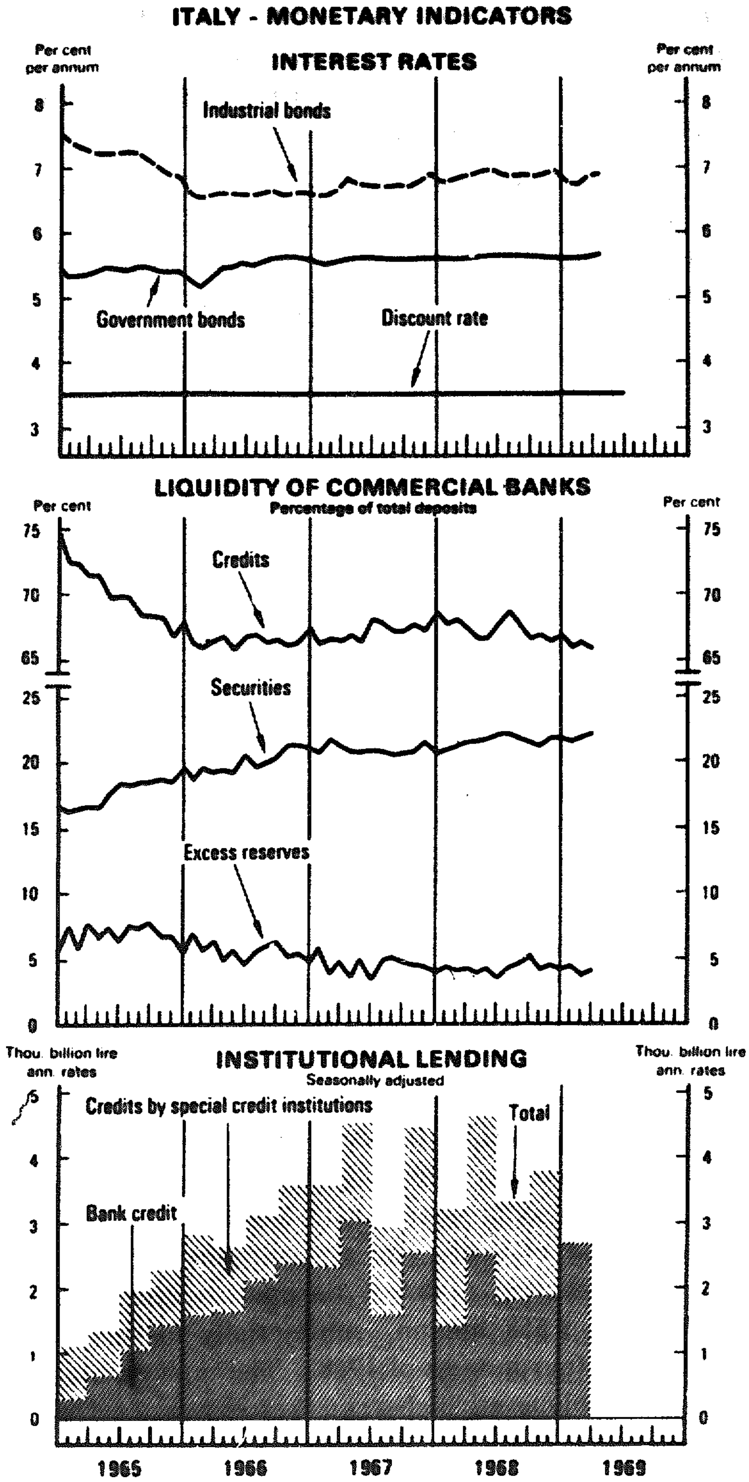
a) In February the authorities let the spot rate for the lira fall to its permissible floor ;

b) On 23rd March it was announced that the interest rate applying to special short-term advances [1] by

TABLE 32
Income and outlay account of General Government
Cash basis

	1966 billion lire	Annual change in % 1967	1968
Current account			
Income	12 436	14.8	8.7
Expenditure	12 318	8.7	11.0
Saving	118	(1.9)a	(-0.5)a
Capital account			
Gross investment	1 014	-5.0	23.2
Transfers	548	38.6	2.6
Less: Receipts	250	..	..
Net borrowing	1 312	(-1.6)a	(1.0)a

a) Absolute changes in saving and net borrowing as percentages of the previous year's GNP.



1. Advances for a period of 8 to 22 days. This method of financing was introduced in the second half of 1967 to satisfy the additional liquidity needs of commercial banks at the end of each half-year.

the Banca d'Italia (accounting for roughly 20 per cent of total advances) to Italian banks would be raised progressively from 3.5 per cent up to 5 per cent for banks demanding such advances more than once in the same six-months period ;

c) The banks were requested to reduce their net credit position abroad (amounting in December to about $ 720 million) to zero by the end of June. In the period January-April total bank advances of the Banca d'Italia to commercial banks fell (seasonally) by only Lit. 119 billion, compared with a fall of over Lit. 700 billion a year earlier, and the change was relatively more marked for special short-term advances ;

d) In April automatic authorisation for banks to participate in consortia for the underwriting or placing of foreign issues in Italy was temporarily suspended. Priority in placing foreign issues is to be given to the banks most active in placing domestic securities, and will be granted only if the issuers have interests in Italy. At the same time, banks were forbidden to purchase shares of non-authorised foreign investment funds, authorisation being reserved for funds investing at least 50 per cent of their portfolio in Italian securities. Subsequently, these funds were authorised to set up subsidiaires in Italy and the 50 per cent rule will apply to savings collected by them in Italy. These measures were reinforced by the decision taken later on to submit the purchase by residents of units of foreign investment trusts to prior authorisation by the Ministry of Foreign Trade ;

e) Transfers abroad by Italian emigrants were subjected to authorisation ;

f) A system of flexible rates for one-year Treasury bonds has been introduced. The interest rate on bonds purchased voluntarily either by the banks or the public will be changed every month according to market conditions. [1] The yield of bonds purchased by banks to invest their compulsory reserves remains unchanged at 3.75 per cent. This measure became effective for the first time on 19th May, when Lit 200 billion of freely negotiable bonds at 4.25 per cent interest rate were allotted to the banks, together with Lit 225 billion at 3.75 per cent interest for their compulsory reserves ;

g) Effective from July lst, the authorities have announced a partial increase in bank rate, which had not changed since 1958. The basic rate will still remain at 3.5 per cent, but a penalty rate of 5 per cent will be charged to banks and credit institutions whose average rediscounting activity in the previous six months has been in excess of 5 per cent of their required reserves [2] with the Bank of Italy.

The creation of Italian investment funds—now being considered by the Government—could eventually play a considerable role in shifting financial resources from foreign to domestic uses, subject to tax treatment being comparable with that in other Member countries.

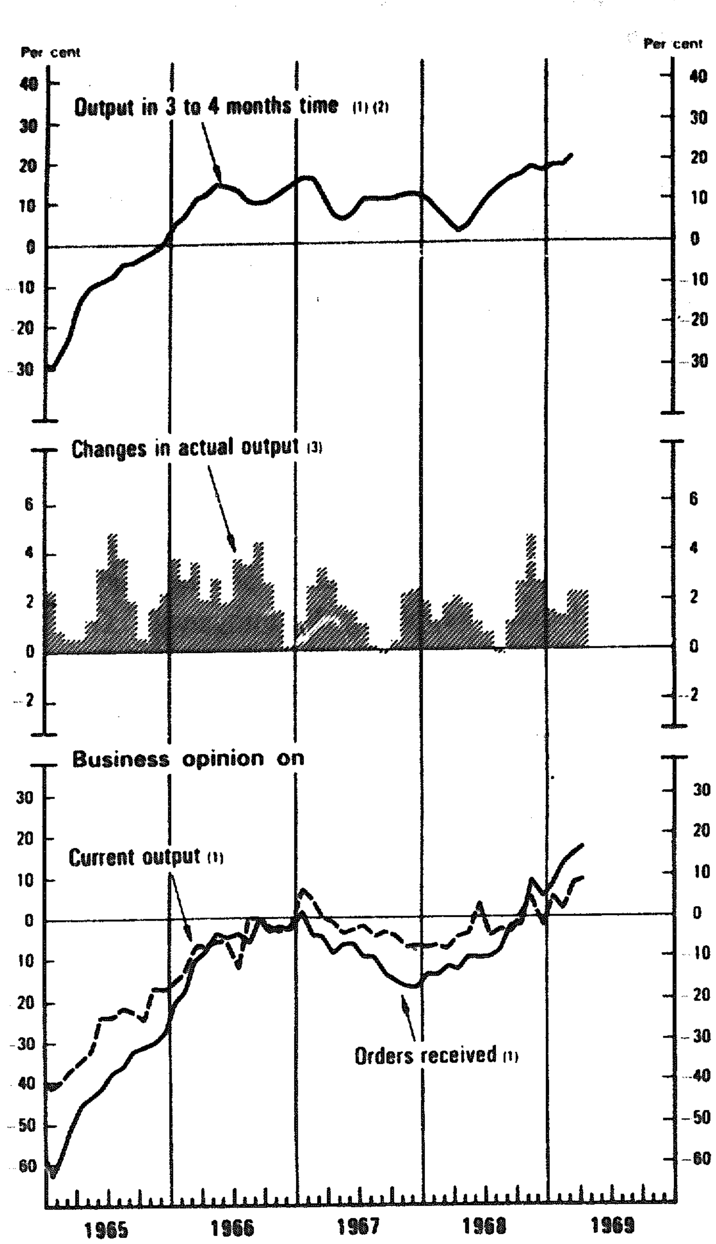
Prospects

The pace of economic activity should remain strong this year and may accelerate progressively with domestic demand supplying the buoyancy. GDP in real terms is expected to rise at a rate of slightly more than 7 per cent in the course of 1969 and in the first half of 1970. From mid-1968 to mid-1970, real output would thus have been progressing faster than the rise of capacity which is probably around 6 per cent per year. But given the slack at the beginning of the period, the economy is likely still to be running below full capacity at the end of the period covered by the forecast.

The public sector (including transfer payments) is expected to be one of the main props of domestic demand. Government consumption should accelerate this year and remain buoyant in 1970, though part of the additional expenditure will probably be reflected in higher prices of Government purchases. Government fixed investment may again rise faster than private investment. Residential construction should rise strongly though the trend may be less sharp than in 1968. Productive investment seemed to be on an upward trend in the second half of last year: it should accelerate well into the first half of 1970, as the fiscal measures taken last autumn to stimulate it produce their full effect and spare capacity is reduced. The latest business survey shows domestic orders in the capital goods industry high by the standards of recent years. Inventory formation is expected to provide some additional stimulus.

1. Out of a total of Lit. 2,000 billion of Treasury bonds in the market at the end of January 1969, only 350 billion (i.e. 16 per cent of the total) had been purchased voluntarily.
2. Up to last December rediscounts were clearly below this ceiling, but from then up to February they amounted on average to about 7 per cent of banks' required reserves.

SURVEYS OF BUSINESS OPINION
Manufacturing and extractive industries



Source: I.S.C.O. Congiuntura Italiana.

1. Answers to the survey are judgements on own firm, and the series show the difference between positive and negative replies, seasonally adjusted, for the months in which the survey was taken.
2. 3-month moving averages.
3. Percentage changes in the seasonally adjusted index of manufacturing production (3-month moving average over previous 3-month).

The rise of consumers' expenditure should strengthen because of some acceleration in wage rates, especially in the first half of 1970,[1] and in employment. This should be intensified by the progressive abolition of the regional differences in miniumm wage rates and by the increase in pensions. The savings ratio of households seems likely to rise only fractionally (it appears to have risen by as much as 1½ percentage points in 1968) partly because of the shift in income to households with a high propensity to consume.

Exports are expected to be very buoyant through 1969, rising faster than Italian markets, though as the pace of domestic demand gathers momentum this might cease to be the case. Imports are still increasing quite rapidly and the rate should accelerate into the first half of 1970 in line with the growth of total demand. With some fall in net invisible earnings, the current surplus (seasonally adjusted) is likely to fall. But in the first half of 1970 it may still be running at an annual rate of about $ 2 billion, and for the present year as a whole it may amount to $ 2¾ billion. The outlook for the capital account is very uncertain. The recent measures concerning banking funds implied a reflux of over $ 0.7 billion by end-June. On the other hand, the outflow of non-monetary capital remained substantial until recently and it is doubtful how much the restrictive measures taken so far will dampen it—at least as long as interest rate differentials with foreign markets remain high and domestic confidence factors are not particularly favourable.

Thus, during the period under review, neither the internal nor external problems facing the Italian economy seem likely fully to be solved. The growth of domestic demand should narrow the gap between potential and actual GDP—but the gap may only have shrunk from a little over 4 per cent to a little less than 2 per cent by mid-1970, while the external surplus on current account seems unlikely to fall very much by the first half of 1970. It seems generally agreed that a country with a development problem as important as that of Southern Italy should not be exporting so significant a proportion of real resources instead of absorbing them at home. This raises the question of whether the balance of payments adjustment could appropriately be speeded by an even faster rise in domestic demand than at present in prospect, or whether this might generate serious physical bottlenecks and cost pressures. The fact that the recent outflow of capital has been large enough to lead to some reserve losses is not, in itself, dangerous given the present level of Italy's reserves. Its importance lies—apart from the sheer size of outflow—in the fact that it would be appropriate for more capital funds to be employed in developing the economy at home. It must be dubious whether the recent res-

1. Some important collective wage agreements—apparently affecting 3.5 millions of workers—will be re-negotiated this autumn.

Balance of payments
ITALY

Value, million dollars
Estimates and forecasts

	1967	1968	1969	1968 I	1968 II	1969 I	1969 II	1970 I
SEASONALLY ADJUSTED								
Exports	8 605	10 095	11 900	4 816	5 279	5 850	6 050	6 300
Percent change[a]	(8.3)	(17.0)	(17½)	(22.8)	(17.7)	(23)	(9)	(8)
Imports	8 626	9 044	10 600	4 245	4 799	5 100	5 500	5 950
Percent change[a]	(14.7)	(4.3)	(18)	(–13.0)	(28.8)	(14)	(16½)	(16½)
Trade balance	–21	1 051	1 300	571	480	750	550	350
Services and transfers, net	1 620	1 593	1 500	816	777	800	700	650
Current balance	1 599	2 644	2 800	1 387	1 257	1 550	1 250	1 000
UNADJUSTED								
Current balance	1 599	2 644	2 800	1 070	1 574	1 250	1 550	700
Long-term capital[b]	–1 100	–1 278		..	..			
Short-term capital and unrecorded	–122	–705		...	..			
Balance on non-monetary transactions	376	661		22	639			
Change in reserves	595	–367		–458	91			

a) Over previous period at annual rates, customs basis.
b) Excluding special transactions.

trictions on capital exports will, by themselves, have any large durable effect. The most appropriate course would seem to be to speed up the introduction of institutional reforms of the Italian capital market, thereby diminishing the more permanent factors behind the outflow of private capital.

UNITED KINGDOM

Progress towards balance of payments surplus has been disappointingly slow since devaluation, with the current account probably only approaching balance in the first half of this year.[1] The next twelve months should offer a good opportunity for further export growth; and there should be scope for the replacement of imports by domestic output as a result of devaluation, provided there is not too rapid a growth of domestic demand. But even if the external surplus of at least £ 300 million on current and long-term capital account, recently set as the objective for the year ending March 1970, is achieved, policies will have to remain geared to balance of payments needs if the improvement is to be maintained and further progress made towards the aim of a surplus at an average annual rate of £ 500 million. To help the balance of payments, taxes were increased again in the April budget, while public expenditure is to rise little in volume this year. New weight is being given to monetary policy, in more stringent terms than at any time in the post-war period. Present prospects seem to be for the increase of domestic demand to be restrained within rather narrow limits in the immediate future. In present circumstances, the main concern of policy will have to be to ensure that these limits are not exceeded. The downward revision of industrial investment plans, which has recently been

1. Allowing for the recently announced under-recording of exports in both trade and balance of payments figures. The actual and forecast figures given here are on the old basis. It is expected that when revised figures are prepared by the authorities they will show a better current account for the past several years at the expense of the balancing item.

announced, should, in the short run, lessen the risk of domestic demand impeding the improvement of the balance of payments, however undesirable it may seem from the point of view of the long-run re-shaping of the economy.

Fiscal and Incomes Policies

Tax changes contained in the April 1969 budget are estimated to raise revenue by some £ 270 million during the current fiscal year (£ 340 million in a full year). The main heads under which they will be levied are as follows:—

TABLE 33.
Tax changes in the April 1969 budget

	Yield in £ million in 1969/70	Full year
Corporation tax: raised from 42½ to 45 per cent	75	105
Selective employment tax: contributions of employers raised from 37/6d. to 48/- for adult male workers (other rates to rise also)	123	130
Indirect taxes:		
extension of purchase tax to previously exempt commodities, higher fuel and excise duties	88½	118½
	286½	353½
Other tax changes (including income tax relief)	−14½	*a*
	272	(340)

a) Difficult to estimate.

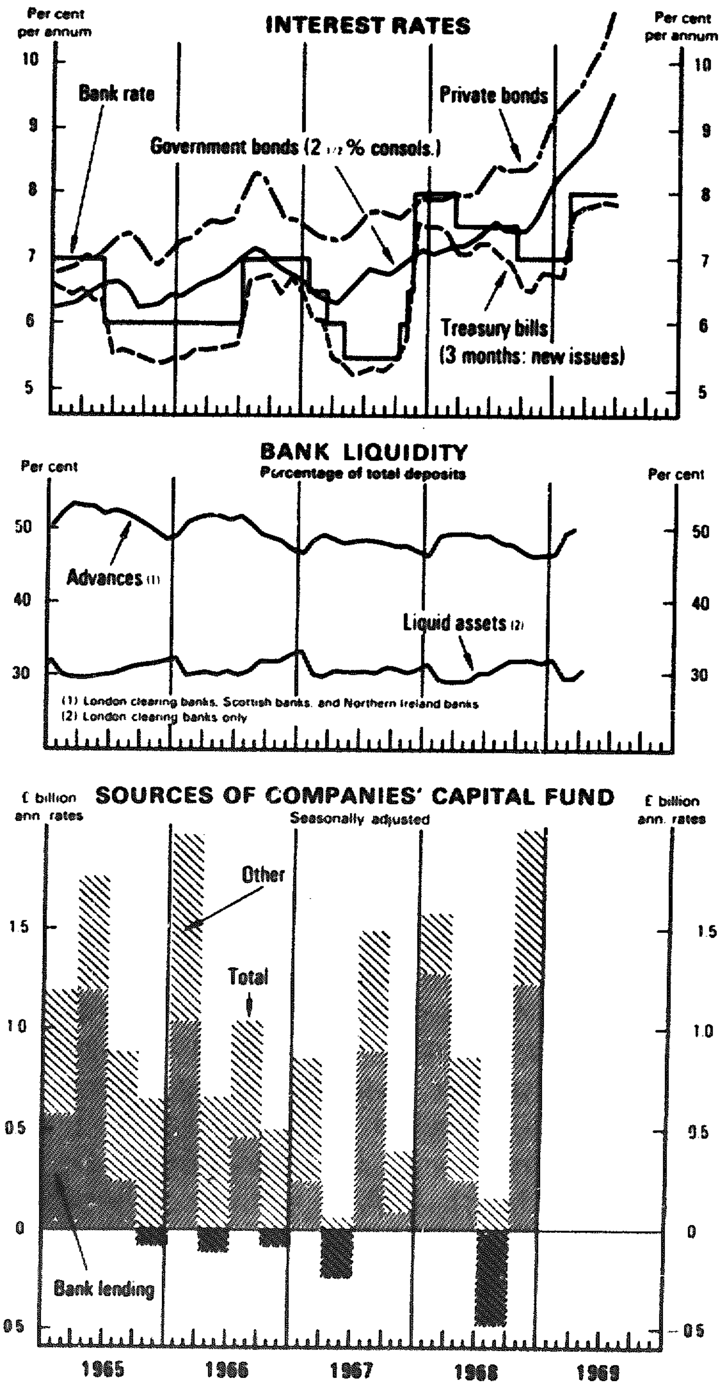
Including secondary effects, the impact on domestic demand has officially been estimated to build up to an annual rate of about £ 280 million (or 0.5 per cent of GDP) in the first half of 1970. The impact on output would be smaller insofar as the check to domestic demand sets free resources for higher exports or import replacement. The Central Government borrowing requirement (excluding receipts under the import deposits scheme) was reduced to only about £ 70 million in 1968/69. For the financial year 1969/70 the accounts are intended to be in surplus (again excluding import deposits) by at least £ 850 million, and the authorities suggest that the surplus might approach £ 1,000 million.

Statutory powers which enable the Government to delay the payment of wage increases by up to one year will not be renewed when Part I of the 1966 Prices and Incomes Act expires towards the end of 1969. But the powers under Part II of the Act, which enable the Government to delay wage increases by up to three months whilst referring them to the Prices and Incomes Board, are to be retained.

Monetary Policies

Monetary conditions in late 1968 and early 1969 tightened somewhat less than might have been expected. The Bank of England absorbed a large amount of government securities from holders outside the banking system, and bank credit expanded faster in the fourth quarter than in the third. For these reasons, the money supply increased at an annual rate, seasonally adjusted, of over 10 per cent in the fourth quarter.

UNITED KINGDOM - MONETARY INDICATORS



DOMESTIC CREDIT EXPANSION

The introduction of the concept of domestic credit expansion (DCE) as a tool of economic analysis and management in the United Kingdom reflects the desire to "supplement the money supply indicator by an indicator which measures not simply total bank credit, as reflected in the money supply, but total credit extended to the domestic economy by the banks and overseas together".[1] More precisely, DCE is defined and measured as the sum of bank lending to the private and public sectors, changes of currency in the hands of the non-bank public, and overseas lending to the public sector. This last item can take the form of reductions in gold and foreign exchange reserves, as well as of increases in credit received by the public sector from foreign official institutions and other overseas sources.

The new concept is intended to provide an appropriate indicator for assessing monetary and credit policy in relation to the attainment of both domestic and balance of payments objectives. The increase in the money supply, broadly defined to include all deposit liabilities of the banking system, is an approximate measure of the total credit extended by the banking system to the public and private sectors combined. The increase of notes and coin in the hands of the non-bank public, however, plus overseas "lending" to the public sector (as defined above) also add to the total amount of funds available to finance expenditure by the public sector, over and above the amount which it raises by borrowing from the banking system and from the domestic non-bank sector. (Borrowing from the latter is presumed to have a neutral effect on total funds available for spending or investing domestically and is therefore excluded from the concept of DCE.) The concept of domestic credit expansion has the advantage over the concept of the money supply that it adds back the negative (or positive) effect on the level of the money supply arising from a deficit (or surplus) in the balance of payments. It thus represents what the expansion in money supply (and credit created by such expansion) would have been had the balance of payments been in equilibrium. Thus it is closer to the magnitude that should bear some reasonable and reasonably stable relationship to potential capacity growth if inflation or deflation is to be avoided.

It also represents the total amount of credit made available to the economy by monetary expansion *plus*, in the event of a balance of payments deficit, the conversion into domestic currency by the public sector of owned reserves or funds borrowed abroad, which has the effect of reducing the need of the public sector to have recourse to domestic sectors of finance, at any given level of budgetary deficit. In time of balance of payments deficit, the change in the money supply alone will fall short of indicating the total amount of credit made available to the public and private sectors by the banking and overseas sectors and may thus give the impression that monetary policy is more restrictive than it really is.[2]

The following summary tabulation, taken from the article in the May 1969 issue of *Economic Trends* explaining the new concept, shows the importance of external transactions on the difference between the concept of domestic credit expansion and that of money supply. The increase in the money supply has fallen significantly short of the total amount of domestic credit expansion, especially in the two most recent fiscal years.

	1965-66	66-67	67-68	68-69
		£ million		
Domestic credit expansion	1 119	503	2 262	1 224
Adjustments:				
For net overseas transactions	+9	+29	-979	-190
For non-deposit liabilities of banks	-79	-142	-44	-98
Equals: Increase in money supply	1 049	390	1 239	936

The same table in *Economic Trends* illustrates how domestic credit expansion is built up from the borrower's side.

	1965-66	66-67	67-68	68-69
		£ million		
Public sector borrowing: *a*				
From the banking system	578	411	-26	88
Through issue of notes and coin to the non-bank private sector	241	125	106	59
From overseas (including use of reserves)	-77	29	1 441	408
Total public sector borrowing *a*	742	565	1 521	555
Bank lending to private sector etc.	377	-62	741	669
Domestic credit expansion	1 119	503	2 262	1 224

a) Excluding sales of interest-bearing debt to the non-bank private sector

Two of the stated objectives of the United Kingdom in the financial year ending March 1970 are a surplus of at least £ 300 million on current and long-term capital account of the balance of payments and a central government financial surplus of at least £ 850 million (and possibly even £ 1,000 million). The United Kingdom authorities have also adopted a specific limit on total domestic credit expansion. This limit implies that, if the DCE target is not to be exceeded, any short-fall in achieving the balance of payments objective will reduce, *pari passu*, the credit that can be extended by the banking system to the domestic economy. It also implies that any shortfall in achieving the public sector surplus, which is not offset by smaller than expected retirement of public debt from the non-bank private sector, will reduce the amount of credit which the banking system can extend to the private sector.

1. *Economic Trends*, May 1969, p. XXII.
2. Another, but less important, factor that affects the difference between money supply and total credit granted by the banking sector is the change in net non-deposit liabilities of the latter.

On 27th February, in view of the continuous expansion of bank credit to the domestic sector and in line with developments abroad, Bank rate was raised from 7 to 8 per cent. During the first quarter there was a record fiscal surplus of about £ 1.4 billion (much of the extra revenue levied in the spring 1968 budget was payable only in the last quarter of the financial year). The Bank of England progressively lowered the prices at which it was willing to absorb securities. The clearing banks were subjected to strong pressure to contain advances within the ceilings established by the authorities, but failed to do so in the time requested. In the first quarter as a whole the money supply, seasonally adjusted, continued to rise, though only a little, so the rise (on United Kingdom definitions) over the October—March period was at an annual rate of about 7 per cent.

Much the same lines of policy have been continued since the first quarter. When bank advances increased again in May, the authorities introduced an interest penalty, halving the rate payable on special deposits at the Bank of England. Advances fell back sharply and by mid-June they were only 1 per cent above the ceiling. Prices of government securities were allowed to continue to fall. By early July, after the further increases in international rates set off by the increase in the United States prime rate, yields on long-dated government securities were about 9½ per cent, compared with 7½ per cent at the beginning of December. Corporate bond issues could be floated only with coupons of about 10½ per cent. Since the rate of increase of the general price level has not been accelerating, the real rate of interest has also been rising sharply.

The greater emphasis now being placed on monetary policy is reflected in the letter of intent to the International Monetary Fund in May requesting a new standby. The objective is to restrict domestic credit expansion to the public and private sectors in the year ending 31st March 1970 to not more than £ 400 million, compared with some £ 1,225 million in 1968/69.

Recent Trends

The recovery of demand and output in the second half of last year was checked in the early months of 1969. In the first quarter personal consumption was lower than in the second half of last year, partly reflecting the tax increases of last November, and the upturn in private investment seems to have been checked, though probably only temporarily. There was, however, a large rise in stocks: work in progress went up, perhaps linked with the rise in engineering orders, but there was also an unusually large rise in stocks of finished goods. Retail sales remained fairly low in April and May: industrial production did not increase between January and April. Unemployment has been rising, reaching 2.3 per cent by

Demand and Output
UNITED KINGDOM[a]

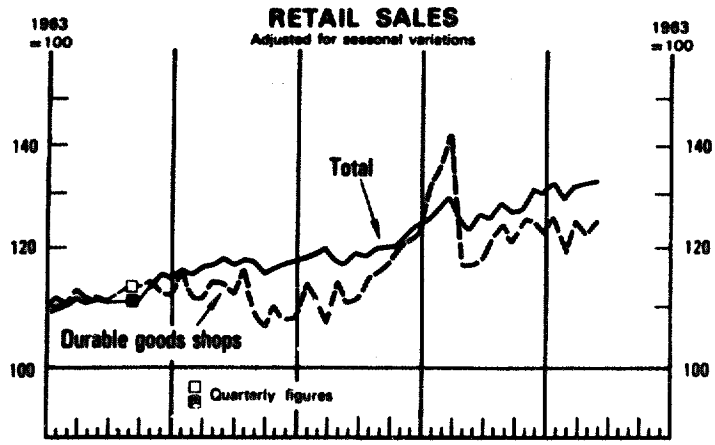
Percentage changes, volume
Seasonally adjusted
at annual rates
Estimates and forecasts

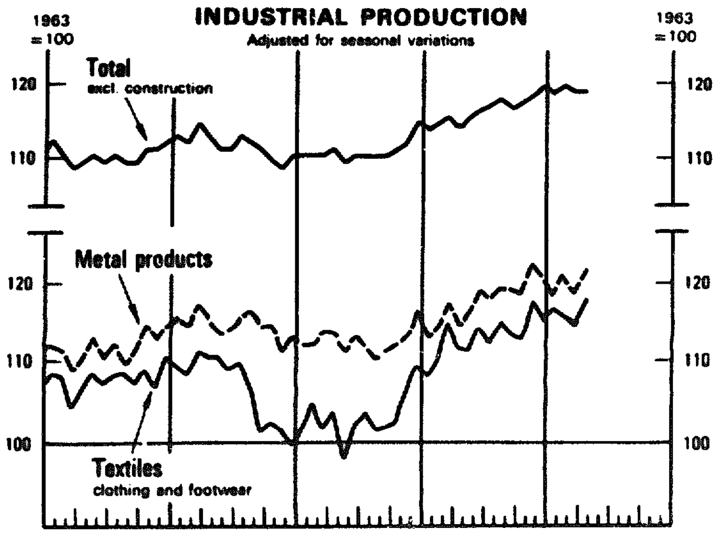
	1967 billion £	From previous year 1967	1968	1969	From previous half-year 1968 I	1968 II	1969 I	1969 II	1970 I
Private consumption	25.3	1.8	2.3	½	1.7	0.3	−¼	2	2
Public consumption	7.1	4.7	1.1	½	2.7	−2.4	1	1¾	1¼
Fixed investment	7.2	6.8	3.0	2¾	3.7	2.9	½	7	5
Final domestic demand (excluding stocks)	39.7	3.2	2.2	1	2.3	0.3	0	2¾	2½
*plus change in stock building	0.2[b]	−0.2	0.2	¼	−0.2	1.2	½	−¾	−¼
*plus change in foreign balance	−0.6[b]	−1.2	0.7	½	2.3	0.9	0	1¼	½
GDP at market prices	39.3	1.8	3.1	1¾	4.4	2.4	½	3¼	2¾
GDP implicit price deflator	. .	3.1	3.6	4	3.4	4.8	4	3½	3
Industrial production	. .	−0.6	4.9	3¼	6.1	5.3	2	3½	3

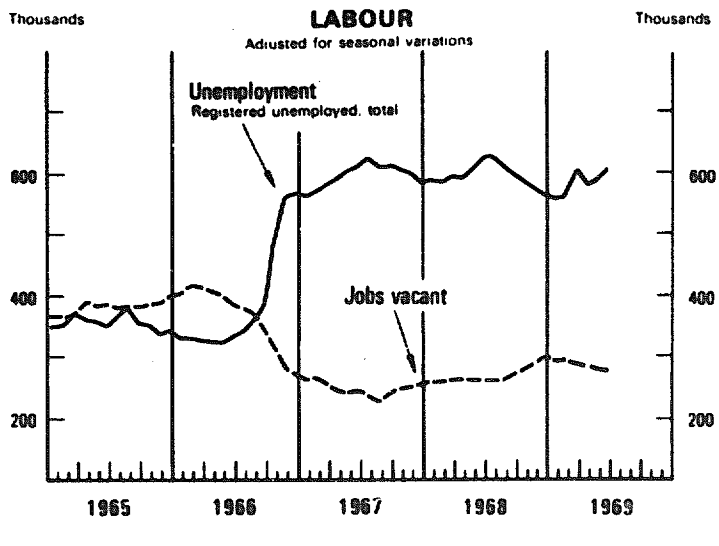
* The yearly and half-yearly rates of change refer to changes in stock building and in the foreign balance expressed as a percentage of GDP in the previous period. These two figures plus the rate of change of final domestic demand broadly equal the rate of change of GDP. In practice, divergences are possible because the rate of change of final domestic demand is not expressed as a percentage of GDP.

a) The figures shown for the past (up to 1968 II) are based on a compromise between the three estimates of GDP.

b) Actual level of stock building and foreign balance.







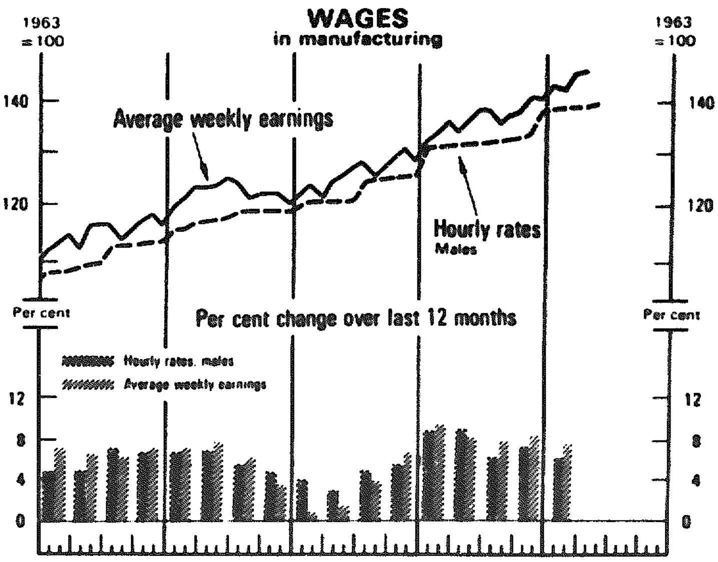
early June, but unfilled vacancies have fallen only a little, and some sectors report growing difficulties in recruiting skilled workers. The unemployment ratio may not now be fully comparable with that of earlier years, as redundancy payments and higher unemployment benefits may enable workers to take a longer time choosing a new job. Many firms—particularly in engineering—seem now to be working at full capacity.

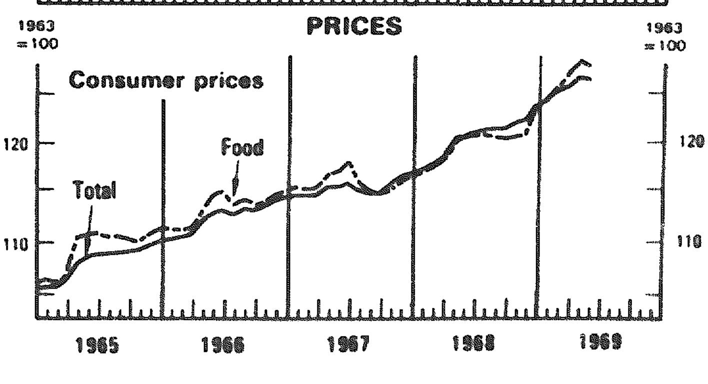
TABLE 34.
Productivity in U.K. manufacturing industry
Percentage change over a year earlier

	1960-66 average	1967	1968	1968 Q1	1968 Q2	1968 Q3	1968 Q4	1969 Q1
Output per man	2.5	1.8	6.6	5.7	6.6	7.5	6.0	4½
Output per man hour	4.0	4.2	6.9	6.6	6.8	7.8	5.9	2

The shake-out of labour in manufacturing which began during 1966 continued in 1967. Dishoarding of labour caused output per man to increase—output per man hour rising as quickly as the longer-term average—in marked contrast with previous experience during recessions. When output recovered in 1968, some slack was taken up. But employment, seasonally adjusted, remained fairly stable and productivity performance improved further (Table 34). The favourable development of productivity seems to have been arrested in the first quarter of 1969, when manufacturing output fell, and from now on the rate of increase seems likely to be nearer to the longer-term trend.

Although the rise in newly negotiated wage rates has been moderate so far during 1969, the implementation of the construction workers' and engineers'

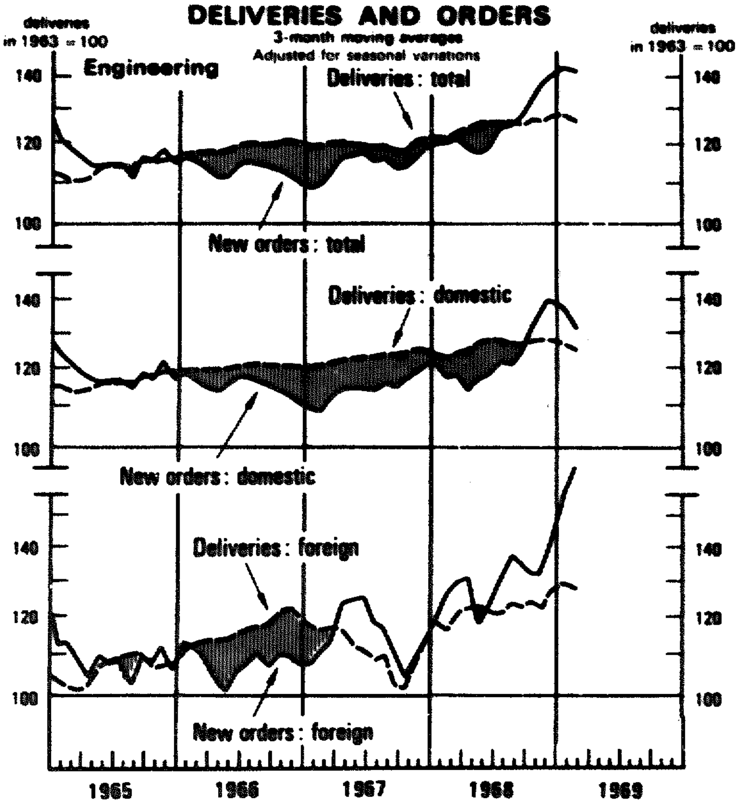




agreements in November and December 1968 pushed up the starting point. By April hourly wage rates were some 3 per cent above the average for the second half of 1968. Thus, whilst the effect of devaluation on input prices seems now to have come through in full, pressure on costs has remained considerable. Retail prices have continued to rise fairly rapidly, partly because of indirect tax increases late in November and in April, and by May the index was 4 per cent higher than the average in second half of last year.

The deficit on the current and long-term capital account of the balance of payments fell, on a seasonally adjusted basis, from $ 1.1 billion in the first half of 1968 to $ 0.2 billion in the second. Most of the change was on long-term capital account, which showed a surplus in the second half heavily influenced by large inflows associated with foreign takeovers of British firms. The current account improved, but still showed a deficit of $ 0.4 billion in the second half. Exports rose rapidly during the year, helped by the strong growth of world trade and some gain in market shares after devaluation. Imports were high all through the year but most of the increase came early on. Between the first and second halves the rise was only 3 per cent, excluding deliveries of U.S. military aircraft, most of it due to higher prices. In the first half of the year foreign exporters had reduced their prices in dollar terms to maintain as far as possible their shares of the U.K. market after devaluation; in the second half, price absorption was less important. The volume of imports changed little after the first quarter, but for the year as a whole (excluding U.S. military aircraft deliveries) was 9 per cent higher than in 1967. Two percentage points of the volume rise was due to abnormally high imports of silver bullion and diamonds. The remaining 7 per cent was about what might have been expected on the basis of the earlier relationships between the rise in imports and the growth of final expenditure. This does not necessarily mean that devaluation had no effect on imports : analysis is hampered by the various attempts in recent years to limit the growth of imports.

The initial estimates of the current account in the first quarter of this year, and the trade figures for April and May, suggest a further reduction in the current deficit for the first half of 1969. Exports increased little—a rather disappointing performance, especially for sales to Europe where demand has been rising fast. But imports were virtually flat



and there were, on preliminary estimates, exceptionally high net invisible earnings in the first quarter, especially from net investment income.

Prospects

The risk that a substantial private industrial investment boom might impede the improvement of the balance of payments this year seems less in the light of the latest investment intentions enquiry which shows a fairly sharp downward revision of plans in manufacturing. The latest private investment surveys indicate that for manufacturing a rise of 7-8 per cent is now intended rather than 10-15 per cent as indicated by the previous survey taken in November and December last year. But the rather low preliminary estimates of investment in the first quarter of this year suggest that industrial investment will have to rise fairly rapidly during the year if the intentions are to be fulfilled. Housing investment is also likely to be deterred by the scarcity and high cost of mortgage finance. For stockbuilding, the high rate early this year suggests that it may be, if anything, a depressive factor from now on, but this must be uncertain. Public consumption is not expected to rise more than marginally, and the rise in government capital spending, in accordance with cuts made in 1968, is expected to be limited to 4-5 per cent in volume.

The main risk on the domestic side is probably in the field of personal consumption. As last year, consumer demand could again be stronger than expected. It must be uncertain how strong the upward pressure on both basic wage rates and wage drift will be, given that prices have been rising more than usual for some time and that present powers under incomes policy are to be reduced. A rise of 6 per cent in the wage and salary bill between the first halves of 1969 and 1970, coupled with a rise of 3 per cent in consumer prices and some decline in the personal savings ratio from the apparently rather high level in the first part of 1969, could lead to a rise in personal consumption of about 2 per cent between the first halves of 1969 and 1970.

Exports could grow quite strongly; market prospects are relatively favourable and there has been a rapid increase in export orders. The rise in imports could be fairly small, especially if stockbuilding falls back from the recent very high rates and if greater devaluation effects develop as domestic demand pressures ease. During the next year total output could be rising at a rate of about 3 per cent, with a smaller rate of rise in domestic demand and a shift of resources to the balance of payments. At the time of the budget the authorities were reckoning on a rise of just under 3 per cent in total output, with a rise of about 2 per cent in domestic demand and a substantial shift of resources to the balance of payments. The picture differed from that suggested here because they envisaged a slower growth of private consumption and higher rates of investment, both fixed and in stocks. Clearly there is a wide margin of uncertainty attaching to any projection. The cut in manufacturing industry's investment plans may do something to ease the prospective pressure on the key engineering industry. But in a situation where the authorities are trying to secure a shift of resources to the balance of payments, to a large extent by repressing the normal growth of personal consumption, and where investment demand is rising, competing pressures are bound to be strong. The ability of the authorities to ensure that from now on domestic demand developments do not

Balance of payments
UNITED KINGDOM

Value, million dollars
Estimates and forecasts

	1967	1968	1969	1968 I	1968 II	1969 I	1969 II	1970 I
SEASONALLY ADJUSTED								
Exports	13 891	14 647	16 000	7 024	7 623	7 800	8 200	8 500
Percent change[a]	(–2.0)	(6.8)	(9½)	(18.2)	(18.2)	(5)	(10½)	(7)
Imports[b] *	15 565	16 557	17 100	8 128	8 429	8 500	8 600	8 800
Percent change[a c]	(5.5)	(5.8)	(3½)	(9.0)	(5.9)	(1½)	(5)	(4)
Trade balance	–1 674	–1 910	–1 100	–1 104	–806	–700	–400	–300
Services and transfers, net[d]	645	818	1 100	415	403	550	550	600
Current balance	–1 029	–1 092	0	–689	–403	–150	150	300
Long-term capital[d e]	–316	–230		–447	217			
Basic balance	–1 345	–1 322		–1 136	–186			
UNADJUSTED								
Basic balance	–1 345	–1 322		–1 013	–309			
Short-term capital and unrecorded[e f]	345	–845		–592	–253			
Balance on non-monetary transactions	–1 000	–2 167		–1 605	–562			
Change in reserves	–404	–274		–11	–263			
* *Of which:*								
Progress payments on military aircraft purchases from the US	267	262	200	129	132	150	50	50

a) Over previous period at annual rates, customs basis.
b) Including progress payments on military aircraft purchases from the United States.
c) Excluding United States military aircraft.
d) 1968 data include waived debt obligations payable to Canada and the United States.
e) Adjusted for special transactions under offset arrangements with Germany.
f) Including the exchange adjustment on pre-devaluation forward deals.

prejudice the balance of payments is likely to depend heavily on their success in the field of monetary trends. A fairly wide area of investment and consumption could prove sensitive to increasing stringency of monetary policy.

The objective for the balance of payments, stated late in May in the letter of intent to the IMF, is a surplus on current and long-term capital account of at least $ 720 million in the year ending March 1970 (a figure formulated before the under-recording of export earnings was announced). This would represent a substantial improvement on performance to date but would still represent only a first step towards the essential strengthening of the United Kingdom's external position, given the volume of debt which remains to be repaid.

On present definitions, the current account may still have been in deficit in the first half of this year. A prospect of rising exports and rather little increase in imports would suggest the account moving into surplus from now on. But unless the swing is much more pronounced than at present seems likely, an unusually favourable outturn on long-term capital account would seem to be required for the achievement of the declared objective.

UNITED STATES

The deceleration in the rate of expansion, which began midway in 1968, continued into the first quarter of 1969. For the second consecutive quarter the rate of growth of output was below that of potential. The deceleration has been less pronounced than anticipated earlier; heavy demand pressures, especially in labour markets, have persisted, and price increases have accelerated. The balance of current external transactions deteriorated sharply in the fourth and first quarters. Responding to these developments, the Federal Reserve system has applied an increasingly stringent monetary policy to reinforce the fiscal measures already in place.

Assuming that restrictive fiscal and monetary measures are maintained until satisfactory progress against inflation has been made, a further deceleration is probable during the remainder of 1969, and no significant revival in the rate of growth is anticipated

Demand and Output
UNITED STATES

Percentage changes, volume
Seasonally adjusted
at annual rates
Estimates and forecasts

	1967 billion $	From previous year			From previous half-year				
		1967	1968	1969	1968 I	1968 II	1969 I	1969 II	1970 I
Private consumption	492.2	3.0	4.7	3	6.2	4.2	2½	3	3¼
Public expenditure	178.4	11.2	6.0	2¾	8.9	3.8	3	1	½
Private fixed investment	108.2	–1.4	6.6	5¼	6.6	5.8	9½	–3¼	1
Final domestic demand (excluding stocks)	778.8	4.0	5.3	3¼	6.8	4.4	3½	1½	2¼
*plus change in stock building	6.1[a]	–1.2	0.2	0	–0.2	0.6	–½	0	0
*plus change in foreign balance	4.8[a]	–0.2	–0.4	0	–0.7	0.0	0	0	0
GNP at market prices	789.7	2.4	5.0	3¼	5.8	5.0	3	1½	2¼
GNP implicit price deflator	..	3.1	3.8	4¼	3.9	3.9	4½	4½	3
Industrial production	..	1.2	4.6	4¾	6.0	4.0	6¼	4	3

* The yearly and half-yearly rates of change refer to changes in stock building and in the foreign balance expressed as a percentage of GNP in the previous period. These two figures plus the rate of change of final domestic demand broadly equal the rate of change of GNP. In practice, however, divergences are possible because the rate of change of final domestic demand is not expressed as a percentage of GNP.

a) Actual level of stock building and foreign balance.

for the first half of 1970. The easing of demand pressures should bring a slowdown in price increases and an improvement in the current account of the balance of payments—though satisfactory performance on neither objective seems likely to be achieved by the first half of 1970. Moreover the capital account could become less favourable. The risks and uncertainties in the prospect underline the need to ensure that recent inflationary tendencies are overcome.

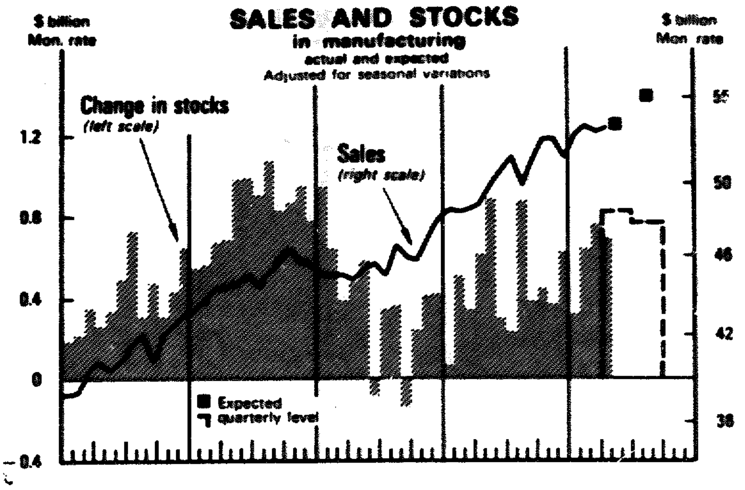
Recent Trends

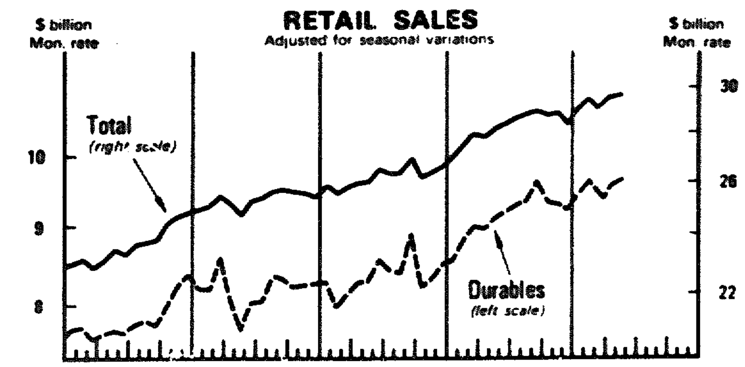
While the first quarter of 1969 saw expansion continuing to slow down, final demand was still somewhat more buoyant than expected. Consumption expenditures regained momentum after a small increase in the previous quarter. The personal saving rate fell rather sharply to its lowest level in about three years, roughly offsetting the increase in personal tax burdens resulting from higher social security tax rates and the retroactive nature of the 1968 surcharge. First estimates showed a remarkable surge in business fixed investment, to more than 5½ per cent in value terms above the previous quarter, and 10½ per cent above the level of only two quarters earlier. Residential construction rose, though more slowly than previously. Federal government purchases continued to climb slowly in value terms (a flat pattern would have been implied by the January budget estimate) ; state and local government spending accelerated. A fall in the rate of inventory accumulation, however, partly offset the strong expansion of final sales.

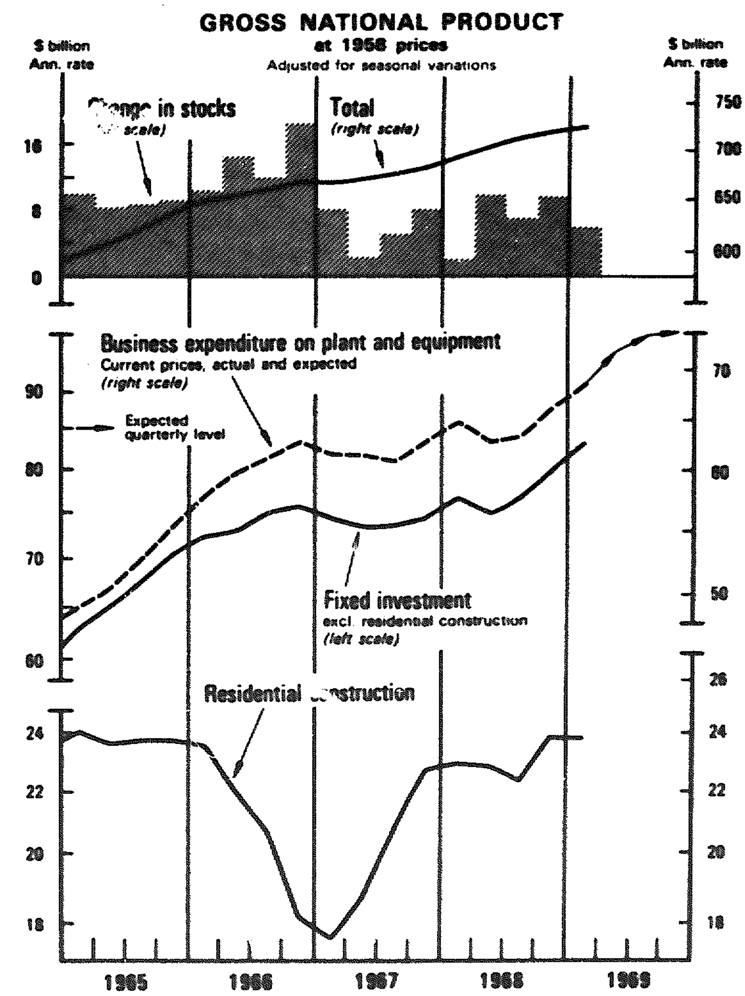
GNP — 1958 prices
Percentage increase at annual rate

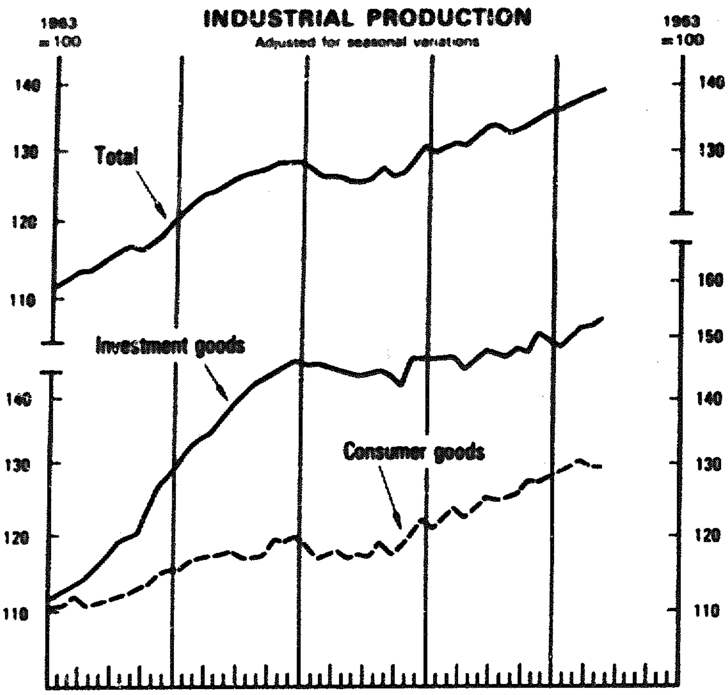
1968				1969
Q1	Q2	Q3	Q4	Q1
6.5	6.3	5.2	3.5	2.9

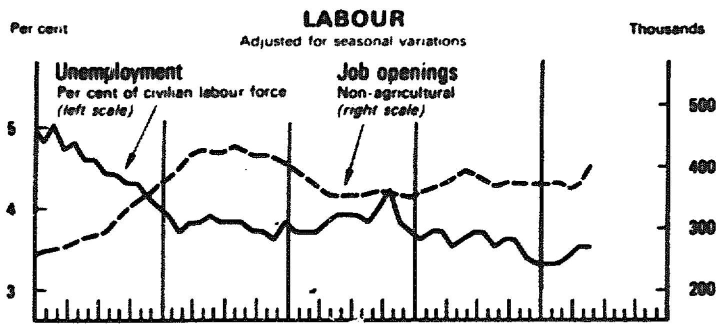
Pressures on resources have eased only slightly since their peak in the second half of 1968. In the first quarter real GNP still exceeded estimated " full employment " potential GNP by about 0.9 per cent, down only moderately from the peak of 1.3 per cent in the third quarter of 1968. Employment, typically lagging somewhat behind output, continued to

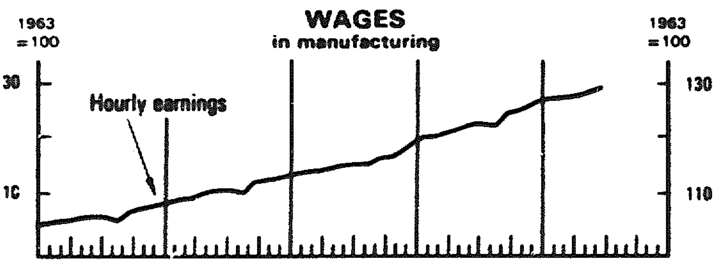


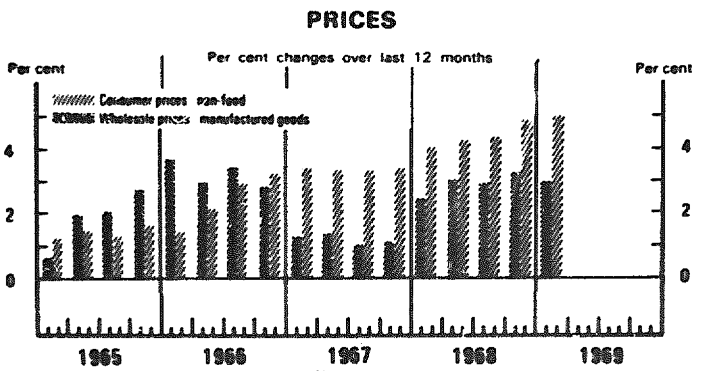












expand rapidly into the early months of 1969. The unemployment rate has only recently begun to rise from the trough of 3.3 per cent in December—February, reaching 3.5 per cent in April and May. It still remains at levels below any reached since the Korean War period. Plant capacity utilisation in manufacturing, however, as measured by the Federal Reserve index, remained moderate in 1968, easing somewhat in the second half of the year and in early 1969.

With excess demand pressure continuing—especially in labour markets—wage and price increases have continued to be unacceptably large. The industrial wholesale price index, however, levelled off sharply in the second quarter.

TABLE 35.
Wage and price trends
Annual rates of change

	Dec. 67 to June 68	June 68 to Dec. 68	Dec. 68 to March 69	Dec. 68 to May 69
Consumer price index	4.6	4.7	6.3	6.1
Wholesale price index, industrial commodities	2.6	2.6	6.7	4.4
Average hourly earnings (non-agricultural, private)	7.4	5.7	7.0	7.5
	1967 Q4 to 1968 Q2	1968 Q2 to 1968 Q4	1968 Q4 to 1969 Q1	
GNP deflator	3.9	3.8	4.4	

The balance on current external transactions continued to be weak in the first quarter of 1969. Part of this reflects the impact of the East and Gulf Coast dock strike, which apparently fell more heavily on exports than on imports. The trade balance registered a $ 100 million deficit in the first quarter compared with about $ 75 million in the fourth quarter, and a surplus of $ 626 million for 1968 as a whole. Since the first half of 1968 had been adversely affected by extraordinary imports of copper and steel, the underlying trade surplus appears to have seen a considerable deterioration since then.

The invisibles balance showed a strong improvement in the first half of 1968, but worsened in the second half. Investment income continued its strong secular increase, and the tourist balance, worsened in 1967 by Canada's Expo'67, showed a recovery. But interest payments abroad increased through the year with the rise in both interest rates and U.S. borrowing abroad; and military payments were swollen in the second half by the government pay increase.

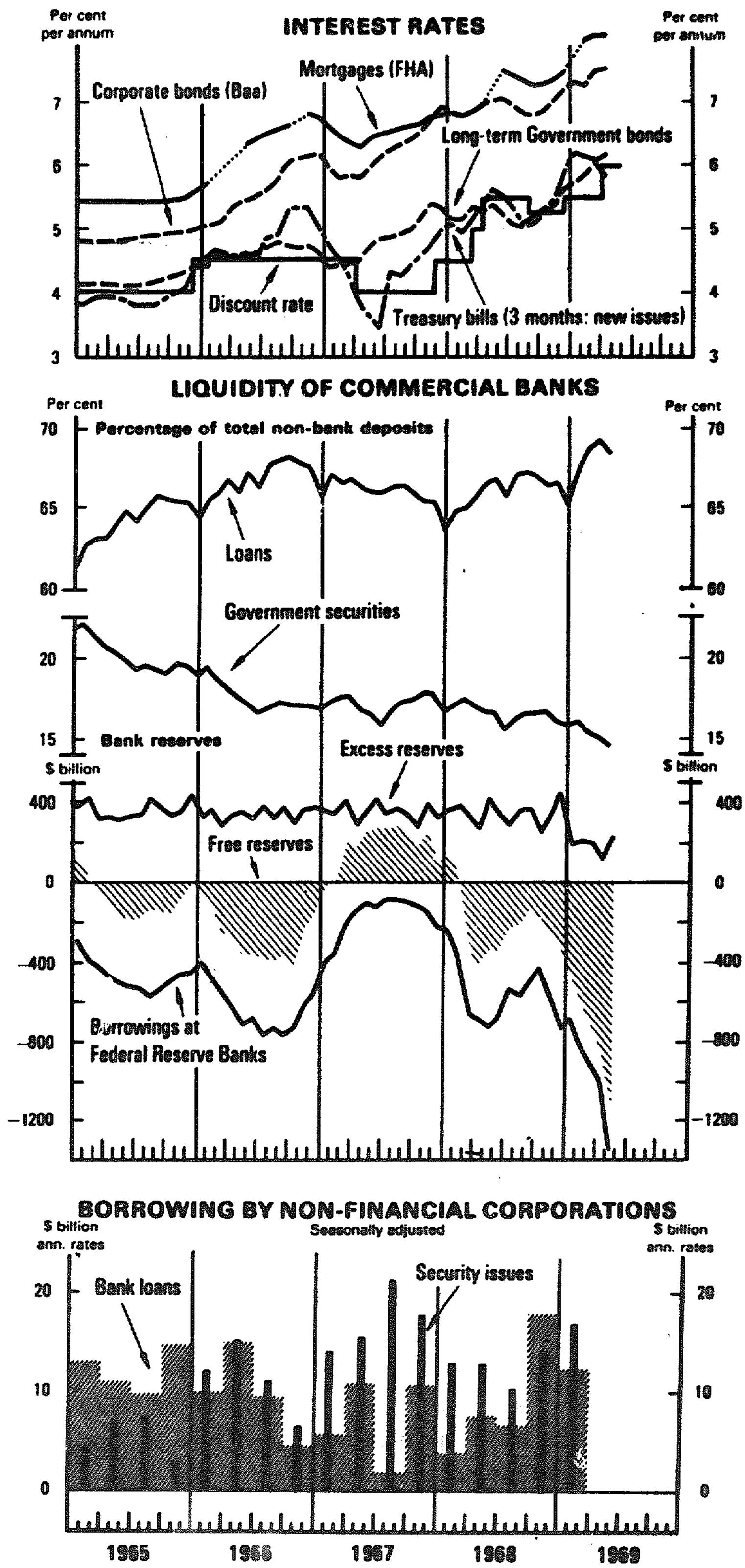
The first quarter of 1969 saw a sharp turn-around of the capital inflows that had produced the substantial surplus in the fourth quarter of 1968 and there was a liquidity deficit of $ 1.7 billion (seasonally adjusted). In large measure, this appears to have resulted from a heavy return flow of corporate liquid funds to abroad after the very large repatriation of these funds—apparently to meet requirements under the capital restraint programme—just before the end of 1968. Aside from this rather artificial swing, available data do not suggest a deterioration in the inflows that produced last year's strong capital account result. Inflows of foreign capital into United States equities during the first quarter were higher than in any quarter of last year, although the peak was reached in January and there was a continuous month-by-month decline through the quarter. Corporate flotations of Eurobonds continued at a heavy rate through the first quarter but then fell fairly sharply in April and May (see pp 42-45). United States banks made a further substantial reduction in their claims on foreigners.

The acute pressure on U.S. bank reserve positions has also led to heavy borrowing from foreign branches—amounting to about $ 3 billion. As a result, the balance on official reserve transactions was in surplus by $ 1.2 billion in the first quarter.

The Tightening of Monetary Conditions

Late in 1968, when it was clear that fiscal measures alone had not been sufficient, the Federal Reserve System moved strongly towards restraint. There was a ½ point increase in the discount rate in December ; and bank reserve positions were put under increasing pressure through open market operations. Non-borrowed and total reserves declined over the first four months of the year (both seasonally adjusted). On April 3rd, the discount rate was raised by a further half point to 6 per cent (the highest level since the 1920's) ; and reserve requirements on demand deposits were raised by half a percentage point. Lending capacity was also put under pressure by the refusal of the Federal Reserve Board to raise the ceiling on interest rates that the banks are permitted to pay on time deposits. The combination of this ceiling and rising market rates led to a decline in time deposits at banks over the early months of the year. Net borrowed reserves, a widely used index of pressure on bank reserve positions, have climbed sharply since late 1968. During May, net borrowed reserves averaged around $ 1.1 billion, compared with about

UNITED STATES - MONETARY INDICATORS



$ 250 million in November—more than a half billion dollars higher than in the peak months of the 1966 credit squeeze and in the first half of 1968.

These measures have led to a sharp decline in the rate of monetary expansion. The money supply (demand deposits plus currency holdings of the public) increased at an annual rate of less than 3 per cent during the first five months of the year (seasonally adjusted) compared with 6½ per cent during 1968. The money supply including commercial bank time deposits has actually declined since December.

Interest rates have responded to sustained inflation and tightening monetary conditions. With the raising of the " prime rate " from 7½ per cent to 8½ per cent early in June, the general structure of interest rates reached record levels. Yields on new issues of 91-day Treasury bills, which had climbed to about 6¼ per cent shortly after the beginning of the year, after easing somewhat, turned up again in May and reached 6.7 per cent in late June. Rates on bankers' acceptances and prime commercial paper also went up sharply, each to around 8 per cent by June. Long-term rates also rose sharply early in the year. Yields on high-grade corporate bonds were near 7 per cent in March. They receded somewhat later but in mid-June were near previous peaks. Partly because of the Federal Reserve ceiling on commercial bank time deposit rates, flows into savings institutions were not quickly or severely affected ; there were signs that this might be beginning in April, but the impact of monetary restraint has not yet fallen—as it did in 1966—especially heavily on residential construction.

New Fiscal Proposals

In April the Administration put forward a number of fiscal policy proposals. New estimates of Federal expenditure for fiscal years 1969 and 1970 were released. These reflected two partially offsetting factors. First, estimates of certain costs were revised upwards for both fiscal years, largely reflecting increased interest payments and farm price support payments. For fiscal year 1970 [1], however, these increases, estimated at $ 1.6 billion, were more than offset by a $ 4 billion reduction in other expenditure proposals, including $ 1.1 billion in defence, and $ 1 billion in the previously proposed increase in social insurance benefits. On a national accounts basis, expenditures are expected to be $ 1 billion higher than previously estimated in the fiscal year just ended but $ 3.2 billion less for fiscal year 1970.

Several major tax changes were also proposed :

i) Repeal of the 7 per cent tax credit for machinery and equipment, effective on all orders placed after the announcement date ;

ii) Extension of the surcharge on personal and corporate income taxes at an unchanged rate through the second half of 1969, but the rate to be halved to 5 per cent as of Ist January, 1970, and maintained at that level for the last half of the fiscal year ;

iii) An extensive set of proposals for tax reform designed to have little net fiscal impact.

The reduction in the surcharge would increase personal disposable incomes at an annual rate of about $ 4 billion, and corporate after-tax profits at an annual rate of around $ 2½-3 billion beginning mid-way in the fiscal year. The repeal of the investment tax credit would have an eventual revenue effect of something over $ 3 billion per year ; however, the impact on revenue in fiscal year 1970 will be around $ 2 billion, since the tax credit will continue to be claimed on equipment ordered before the announcement date. The impact on capital spending is more difficult to predict. Estimates of its eventual effect in reducing investment levels vary from $ 3-6 billion per year, but it will take a substantial time for the full effect to be realised.

The first two proposals were designed to have a roughly offsetting effect, comparable to the restraint

TABLE 36.
Federal expenditures, national accounts basis
Billion dollars

	FY 1968 actual	FY 1969 Jan. est.	FY 1969 Apr. est.	FY 1970 Jan. est.	FY 1970 Apr. est.
Federal govt. expenditure	172.4	187.3	188.3	199.6	196.4
Purchases of goods and services	95.6	101.5	102.0	105.6	104.2
(Defence)	(75.8)	(79.9)	(80.0)	(82.2)	(81.0)
Transfers	44.5	50.1	49.9	54.9	53.6
Interest	10.8	12.0	12.3	12.2	12.7
Other	21.5	23.7	24.1	26.9	25.9

Source: Survey of Current Business.

1. Beginning July 1st, 1969.

that would have resulted from the simple prolongation of the 10 per cent surcharge through fiscal year 1970. They appear, therefore, to reflect a rearrangement of priorities rather than a basic shift in the intended degree of restraint. The net effect of the tax proposals may be slightly stimulative in fiscal year 1970, but could well be restrictive in the longer run.

Looking at the budget as a whole, it is clear that there has been a sharp swing towards fiscal restraint in the fiscal year 1969 and that additional restraint will be applied in the period ahead. Tax revenue grew rapidly last year, and expenditure only slowly ; and in fiscal 1970 revenue should continue to grow more rapidly than expenditure. Using the revenue estimates made in January [1], the national accounts budget would show surpluses of $ 1.7 billion in fiscal 1969 and $ 5.9 billion in fiscal 1970 compared with a deficit of $ 11.3 billion in fiscal 1968.

Prospects

Assuming that the recent fiscal proposals are enacted fairly promptly and that a strongly restrictive monetary policy is maintained, a further progressive slowdown is likely through the rest of 1969, and continued slow growth, with at most a gradual acceleration, in the first half of 1970. The range of uncertainty is clearly large. Though an actual recession seems unlikely—and could be corrected if signs of it emerged—the deceleration could be quicker than depicted. Equally it could continue to be slower.

There probably will have been no further slowing down in the second quarter. Final sales, however, probably rose substantially less than in the first quarter. Business fixed capital spending was expected in the latest intentions survey to rise rather less fast in value terms. Retail sales in April and May suggested a slower rise in consumption. With housing starts dropping off sharply between February and May, residential construction probably declined in volume terms. However, net exports and inventory investment have probably increased sufficiently to keep output growing at about its first quarter pace.

In the second half, however, some further slowdown should become evident. There will be some stimulus coming from the $ 2.8 billion Federal pay increase beginning on 1st July, and from a lightening of the personal tax burden owing to the end of the retroactive tax payments. But after the third quarter Federal purchases should be declining (in value) if the current budget cuts are adhered to. Fixed investment is not likely to be buoyant. Residential construction, in particular, should feel the full effects of monetary stringency by then. The SEC/Commerce Survey published in June indicated a rather marked levelling off in business fixed capital spending in the second half of the year, with downward revisions from earlier projections. Further downward revisions seem likely with continued monetary stringency and relatively weak cash flows. The repeal of the investment tax credit could also reduce spending somewhat towards the end of the year. Apart from the Federal pay increase at mid-year, the rise in personal incomes should slow down and the savings rate is likely to be somewhat above the level of the first quarter. Inventory investment may be moderate if credit costs and an easing of inflationary expectations impel business towards a gradual reduction of stock-sales ratios. For the year as a whole, a "central" projection for real GNP may be an increase of about 3¼ per cent over 1968 ; however, this implies an annual rate of gain between the second and fourth quarters of around 2 per cent, or possibly less.

Any acceleration in first half 1970 would probably be small while present policy lines are followed. Federal purchases should continue to decline somewhat if the present expenditure estimates are achieved. Business capital spending should be dampened by the combination of falling utilisation rates, continued credit tightness and weak cash flows and the ending of the investment tax credit. There are no prospects for much revival of residential construction given the financial conditions assumed. (Underlying demand conditions are very strong, and a relaxation in monetary policy could bring about a strong revival in home building). Labour compensation should be growing more slowly with gradually rising unemployment and a dampened pace of wage increases. The halving of the tax surcharge will add about $ 4 billion (annual rate) to disposable income and provide some stimulus to consumption. But if existing policies are adhered to—particularly monetary policy and Federal spending restraint—there seems no reason to expect a very significant speed-up in growth in the first half of 1970.

1. These revenue estimates have been out-dated by more recent information and the proposed changes in tax laws. The latter might reduce revenues by roughly $ 1 billion ; however, other revisions might be at least partially offsetting.

By mid-1970, then, a significant margin of unutilised resources probably would have appeared, which might amount to between 1¼ and 1½ per cent of potential GNP. Unemployment might have risen to perhaps 4½ per cent. The improvement in price performance will be gradual, judging from past experience. The GNP deflator might be rising at an annual rate of 2½-3 per cent by mid-1970, compared with the current 4½ per cent rate.

A slowing down of the economy is necessary for internal reasons in order to bring price inflation under control. How fast the process should proceed must clearly depend on the importance assigned to opposing factors. Too fast a cooling-off would produce rapidly-mounting unemployment and unacceptable social costs. On the other hand, a long drawn-out process could fail to dispel the climate of inflationary expectations and could result in the later stages of the process being diluted. If policies were to be eased prematurely there would be need for a new cooling-off period in, perhaps, 1971, and this could entail more sacrifice of growth and employment levels in total than now envisaged. On the other hand, should a more rapid adjustment develop, it might entail, say, a period about the turn of the year when expansion was temporarily halted ; an unemployment figure of 4½ per cent would probably be reached rather earlier than mid-1970 ; and there might be some temporary further increase, until the economy could be brought back smoothly to a higher growth rate. But this might result in overcoming the more certainly, during the year ahead, the recent inflationary tendencies.

Domestic disinflation should bring some improvement in the current balance of payments. But the capital account could become less favourable. Consideration of the balance of payments prospects, and of the inevitable uncertainties, underlines the importance of carrying present lines of policy to their conclusion. The trade surplus of previous years was eroded in 1968 by the rapid growth of imports. Most current projections assume that there will be only gradual improvement from now on, as the economy cools off—i.e. that much of the damage done in 1968 will not be reversed as more normal levels of internal demand are restored. The gain in exports in 1969 will have been reduced both by anticipation of the dock strike—which probably shifted into 1968 exports that would otherwise have been shipped in 1969—and by the strike itself, which probably caused once-for-all loss of exports. The growth for the calendar year may be only about 6 per cent. The underlying growth of imports consistent with the "central" domestic prospect is estimated at 8 to 9 per cent. Adjustments for dock strike distortions, the effects of actual and threatened strikes on copper and steel imports in 1968, and the effects of the automotive trade agreement with Canada, reduce it to about

Balance of payments UNITED STATES

Value, million dollars
Estimates and forecasts

	1967	1968	1969	1968 I	1968 II	1969 I	1969 II	1970 I
SEASONALLY ADJUSTED								
Exports	30 681	33 598	35 550	16 336	17 262	16 950	18 600	19 250
Percent change[a]	(5.2)	(9.4)	(5½)	(13.0)	(12.1)	(–4)	(19½)	(7)
Imports	26 821	32 972	34 950	15 948	17 024	16 850	18 100	18 700
Percent change[a]	(5.0)	(23.5)	(6)	(38.3)	(10.5)	(0)	(16½)	(6½)
Trade balance	3 860	626	600	388	238	100	500	550
Services and transfers, net[b]	–1 681	–910	–600	–401	–503	–350	–250	–50
Current balance	2 179	–284	0	–13	–265	–250	250	500
Long-term capital[b]	–5 315	–1 195		–477	–721			
Short-term capital and unrecorded	–916	–1 033		–1 498	467			
Balance on non-monetary transactions	–4 052	–2 512		–1 988	–519			
Change in reserves[c]	–146	10		–1 250	1 260			

a) Over previous period at annual rates, customs basis.
b) 1968 data include waived debt obligations payable by the United Kingdom.
c) Not seasonally adjusted.

6 per cent. The trade balance should improve within 1969, but the year's total will probably not be much different from last year's $ 600 million surplus. With an improvement in the net balance on services and unilateral transfers (including government grants), however, the current account may revert to balance, following last year's $ 284 million deficit.

Prospects on the capital account are quite uncertain, especially given the large swings in the recent past. The net outflow of non-monetary capital, however, seems likely to widen in 1969. In part, this simply reflects the fact that some of last year's favourable flows were related to the initial impact of the 1968 capital restraint programme, and are not likely to be repeated in 1969. With the substantial leeway left under direct investment programme ceilings, and the easing of these restraints announced on 4th April, net capital outflows related to direct investments will probably increase, perhaps substantially. In addition, U.S. banks may not contract their foreign loan portfolios as much as in 1968. Foreign purchases of U.S. equity securities have been deterred by falling prices. The balance on non-monetary transactions thus seems likely to deteriorate in 1969. Inflows of monetary funds through U.S. banks will continue to be highly sensitive to the degree of pressure on U.S. bank reserve positions, as well as to conditions in the Euro-dollar market, and, moreover, will be influenced by the new reserve requirements proposed by the Federal Reserve Board (see p. 38).

In 1970 the current account should show some further strengthening. Exports can be expected to rise more than this year, while imports will be reflecting the deceleration of domestic demand. The trend of invisibles is favourable. The pace of improvement must however be uncertain. It can be argued that overheating caused the disappearance of the trade surplus in 1968, and that, with overheating removed, imports will fall quickly back on to a lower trend. But it is difficult to believe that there will not prove to have been more lasting effects from the recent poor price performance of the United States and from the establishment of new trading habits. If domestic growth accelerates only slowly next year and the price rise slows down steadily, it is possible that the trade balance could improve rapidly during the year. But on present prospects the quick return to a trade surplus as large as in 1967 seems rather improbable

CANADA

Although slowing down, expansion has been stronger than expected earlier. But in contrast to the export-led growth experienced in 1968, this year's expansion is being spurred mainly by domestic demand, notably personal consumption, residential construction, and a recovery in business fixed investment. Early indicators point to an annual rate of growth of real GNP of about 5 per cent in the first half of 1969 (seasonally adjusted), slower than earlier, but still in line with the growth of capacity. Over the next twelve months, the expansion is expected to slow down, perhaps to a rate below that of capacity growth, with some increase in unemployment. Progress towards better price/cost performance has so far been small; indeed, the rise in costs and prices has accelerated in recent months. The easing of demand pressures which seems likely over the next twelve months and the coming into operation of the Board of Review for Prices and Incomes may serve to slow down the price/cost rise, but it could take some time before a satisfactory performance is restored.

Policies

In October 1968, restrictive measures were taken to eliminate the budget deficit in the coming fiscal year to 31st March 1970, affecting both expenditures and taxation. The new budget presented on 3rd June, shows no important changes from that in October, but it forecasts a surplus on a national accounts basis of Can. $ 575 million against an estimated actual deficit of Can. $ 67 million in 1968/69. However, there seems to have been a surplus of about Can. $ ½ billion in the first quarter of 1969 (seasonally adjusted annual rate), so fiscal restraint will not be intensified from then on. Total spending is forecast

Demand and Output
CANADA
Percentage changes, volume
Seasonally adjusted at annual rates
Estimates and forecasts

	1967 million $ Can.	From previous year			From previous half-year				
		1967	1968	1969	1968 I	1968 II	1969 I	1969 II	1970 I
Private consumption	37 714	4.8	4.5	5	4.1	5.8	5	4	4
Public expenditure	12 377	4.7	1.1	3½	–0.6	5.0	3	2½	2
Private fixed investment	12 609	–1.0	–1.8	5½	4.7	1.5	8	4½	4½
Final domestic demand (excluding stocks)	62 700	3.6	2.7	5	3.4	4.8	5¼	4	3¾
*plus change in stock building	225[a]	–1.5	0.8	½	0.3	1.7	0	¼	0
*plus change in foreign balance	–667[a]	0.9	1.0	–½	2.0	–0.8	–½	0	0
GNP at market prices[b]	62 109	3.1	4.7	5	5.9	6.6	4¾	4¼	3¾
GNP implicit price deflator	..	3.6	3.6	4	4.0	3.3	4¼	4¼	4
Industrial production	..	1.9	5.0	7	4.2	8.0	8	4	4½

* The yearly and half-yearly rates of change refer to changes in stock building and in the foreign balance expressed as a percentage of GNP in the previous period. These two figures plus the rate of change of final domestic demand broadly equal the rate of change of GNP. In practice, however, divergences are possible because the rate of change of final domestic demand is not expressed as a percentage of GNP.
a) Actual level of stock building and foreign balance.
b) Including errors and omissions.

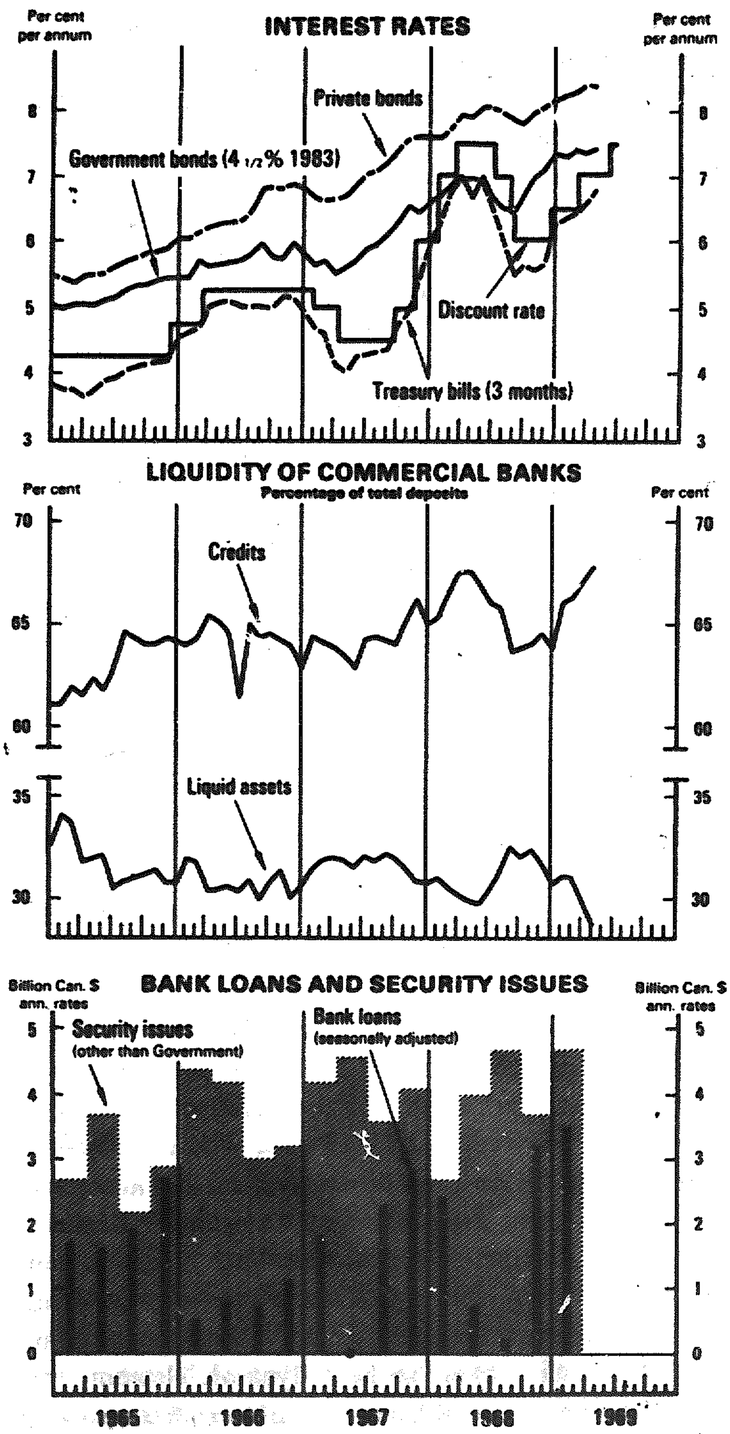
to grow by 10.3 per cent, slightly less than last year, and by 10.5 per cent for goods and services, 2 percentage points more than in fiscal year 1968/69. The extension of Medicare to provinces will exclude Quebec and probably Ontario and add less to federal outlays than expected earlier. Revenue is estimated to grow by 15.5 per cent (13.7 per cent in 1968/69). The Government plans to maintain the present structure of income taxes and to extend the 3 per cent surtax on personal and corporate incomes, introduced in February 1968, by a year, to the end of 1970. Non-budgetary expenditure (excluding foreign exchange transactions) are forecast at about Can. $ 650 million. This will be financed partly by the budget surplus ; net borrowing requirements are estimated at about Can. $ 200 million to $ 300 million, compared with Can. $ 900 million in 1968/69. The budget for the total public sector is expected to show a swing from a deficit on a national accounts basis of about Can. $ 200 million in calendar year 1968, to a surplus of the order of Can. $ 300 million in calendar year 1969, suggesting somewhat less fiscal restraint than from the central government budget alone.

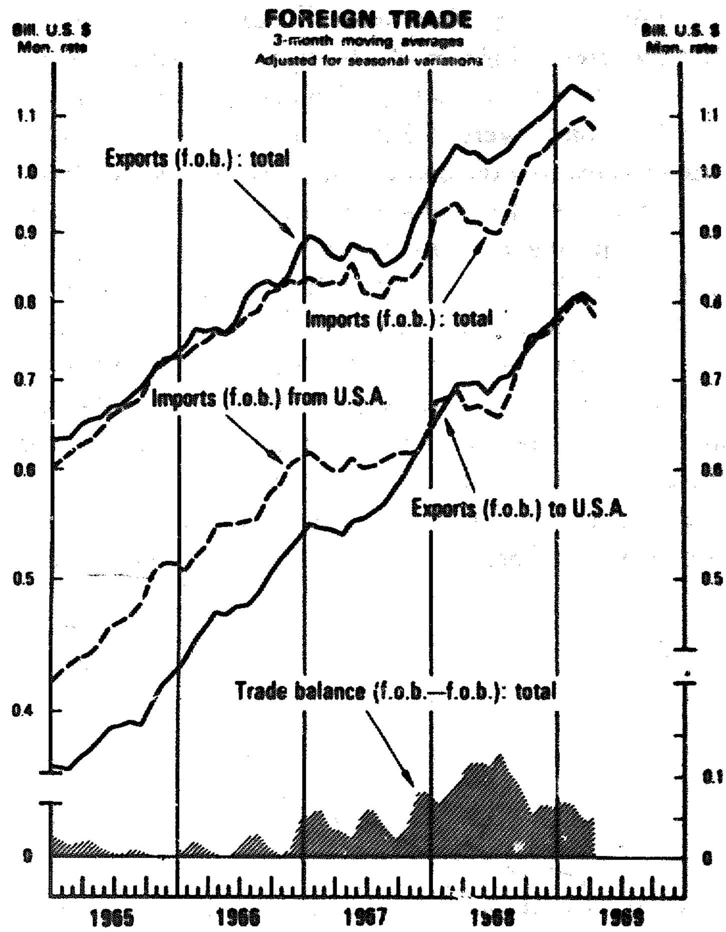
Monetary policy has become increasingly restrictive. The Bank of Canada at the end of February raised bank rate from 6½ to 7 per cent, after a half per cent rise in December 1968. The rise was motivated mainly by strong domestic demand for bank credit and represented a further step in the progressive tightening of monetary policy since last September, evidenced by the steep rise in market interest rates, since about that time. The bank rate was raised further to 7½ per cent on 10th June (in response to the increase in U.S. banks' prime rate the day before), and chartered banks followed by raising their prime rates to between 8 and 8½ per cent. In the middle of April an increase of one percentage point in the banks' secondary reserve requirements was announced, effective from June, reducing bank lending capacity by about Can. $ 260 million. The money supply (the public's holdings of currency and chartered bank deposits) grew at a seasonally adjusted rate of 2.8 per cent over the first four months of the year, equivalent to 8.5 per cent at an annual rate, and considerably more slowly than the 14.7 per cent annual rate during the previous six months. Demand for bank credit seems to be rising faster than bank deposits, and the coming into force of the higher secondary reserve requirements has added to the pressure on bank reserves. This pressure may have led to the increase in net new issues payable in currencies other than the Canadian dollar.

Recent Trends

Fixed investment demand appears to be very strong. Recent surveys point to a sharp rise in planned business capital outlay. Housing starts have continued vigorously upwards, the volume of residential construction increasing perhaps at a seasonally adjusted annual rate of 8 per cent, despite record mortgage rates. Consumer demand seems also to have been strong, especially for durables. Sales of appliances in the first quarter were 14.5 per cent higher than a year earlier: outstanding consumer credit at chartered banks rose by 5.5 per cent from December to March compared with 2.6 per cent in the same period last year. Up to 7th June vehicle production was 21 per cent higher than a year ago. In sum, the increase in final domestic demand in the first half of 1969 may

CANADA - MONETARY INDICATORS

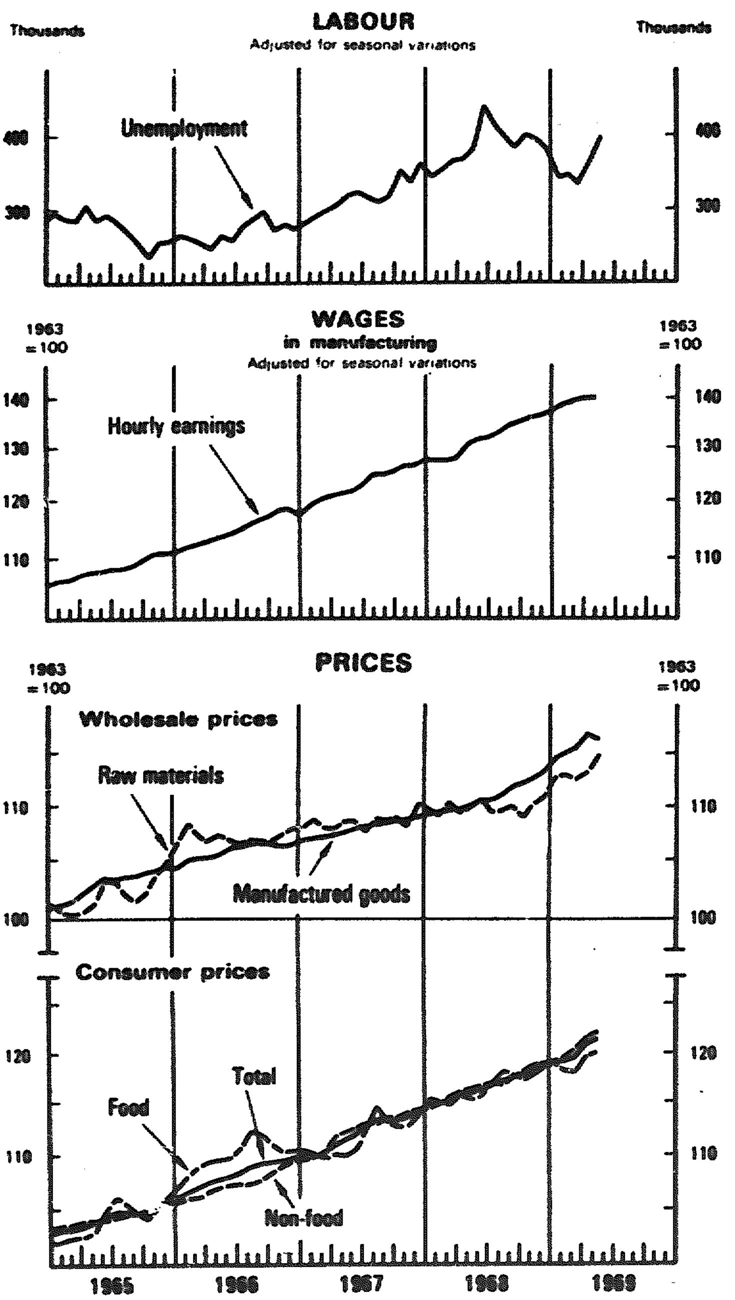




have been even stronger than in the previous half year. But the rise in stockbuilding was probably smaller than earlier, so that the growth of total domestic demand may have slowed down to an annual rate of about 5¼ per cent as against 6½ per cent in the second half of 1968.

The growth of exports (goods and services, annual rates) in the first half of 1969 seems to have accelerated to about 9 per cent in real terms from 7 per cent in the second half of 1968. However, special factors make the underlying trend difficult to assess. The U.S. dock strikes led to a substantial re-routing of goods through Canada, inflating both exports and imports. On the other hand, there were strikes on the west coast of Canada, and anticipation of strikes in the U.S. in 1968 probably deflected exports to the United States from 1969 to 1968. Imports are likely to have shown a strong increase, perhaps some 11 per cent. Some of this, however, probably resulted from the U.S. dock strikes, which added goods in transit to Canadian import needs. The current external deficit (seasonally adjusted) probably increased in the first half of 1969, perhaps to U.S. $ 400 million from $ 137 million in the second half of 1968, because of a weaker trade balance and a further deterioration in non-trade items. At end-May, official reserves, including Canada's reserve position in the Fund, were $ 3.01 billion, about the level reached towards the end of 1968. In December 1968, the target level for Canadian exchange reserves under the arrangements with the United States (then at U.S. $ 2.55 billion) was abolished, on the basic principle that it would not be Canada's intention to achieve a permanent increase in its foreign exchange reserves through borrowing in the United States, and on the understanding that this measure would increase Canada's flexibility in monetary policy.

Rising activity has been accompanied by a vigorous rise in employment, reducing the rate of unemployment from 4.8 per cent at the end of 1968 to 4.4 per cent in April. The rise in productivity seems to have been smaller than last year when the growth of industrial activity was concentrated in certain sectors (notably the base metal industries) where output could be increased significantly without much rise in employment. Industrial wage contracts signed in the second half of 1968 provided for increases in the base rate of about 8 per cent on an annual basis, about the same as in the first half but slightly lower than in 1967. Long-term contracts typically provide for disproportionately large increases in the first year of the contract period. Thus, the main part of the increases is likely to have fallen in the first half of 1969. With a weaker productivity performance than last year, unit labour costs have risen faster than earlier. Price increases have generally accelerated. Wholesale prices were rising at an annual rate of 9.2 per cent in the first four months, compared with virtually no change in the same period of 1968 ; sharp increases in prices for wood products, non-ferrous metals, and building materials in January accounted for most of the acceleration. Consumer prices went up at an annual rate of 5.2 per cent between December and May compared with the rate of about 4.4 per cent in the previous six months. The increase, although widespread, was due in part to higher taxes on tobacco and alcohol. The GNP deflator in the first half is likely to have increased at an annual rate of 4 per cent, against 3.3 per cent in the previous half-year.



Prospects

The rise in real domestic demand is expected to slow down to an annual rate of about 4 per cent in the second half of 1969, and to remain at about that rate in the first half of 1970. Both business fixed investment and residential construction are expected to grow less than earlier, given the trend towards tighter credit conditions. The volume increase in public consumption should be relatively moderate (about 3½ per cent) for 1969 as a whole, reflecting, inter alia, the upward trend in provincial and municipal spending. The expansion of consumer demand, although slowing down somewhat, may remain relatively strong, given the sharp rise in wages and a further increase in employment. But stockbuilding would not seem likely to be a dynamic element over the next twelve months and, with exports growing

Balance of payments
CANADA

Value, million dollars
Estimates and forecasts

	1967	1968	1969	1968 I	1968 II	1969 I	1969 II	1970 I
SEASONALLY ADJUSTED								
Exports	11 115	13 225	14 350	6 487	6 738	7 100	7 250	7 450
Percent change[a]	(10.5)	(19.0)	(9)	(34.3)	(8.6)	(13)	(4)	(6)
Imports	10 273	11 587	13 250	5 622	5 965	6 550	6 700	6 950
Percent change[a]	(8.0)	(13.7)	(14)	(19.2)	(12.1)	(21)	(5)	(7)
Trade balance	842	1 638	1 100	865	773	550	550	500
Services and transfers, net[b]	–1 345	–1 787	–1 900	–857	–930	–950	–950	–1 000
Current balance	–503	–149	–800	8	–157	–400	–400	–500
UNADJUSTED								
Current balance	–503	–149	–800	–233	84	–650	–150	–750
Long-term capital[b]	1 241	1 450		773	677			
Short-term capital and unrecorded	–412	–786		–700	–86			
Balance on non-monetary transactions	326	515		–160	675			
Change in reserves	29	557		306	251			

a) Over previous period at annual rates, customs basis.
b) 1968 data include waived debt obligations payable by the United Kingdom.

much less rapidly than in 1968—because of the likely trend in U.S. imports—the foreign balance (which has already deteriorated) probably will not provide any new net stimulus to demand.

Both exports and imports are likely to grow rather slowly in the second half, and the trade balance may not change much. For the year as a whole, the trade surplus would thus be less good than last year. With some further deterioration of the non-merchandise balance, the current account deficit may be of the order of U.S. $ 750 million, after last year's unusually low deficit. No improvement is expected in the first half of next year, on the basis of developments forecast in the section on the United States.

Although the growth of output is slowing down, employment may continue to increase fast, because of the likelihood of a more moderate advance in productivity than the relatively strong increase experienced last year. Nevertheless, given the rapid growth of the labour force, the unemployment ratio is likely to rise towards 5 per cent by the end of the year, and to continue to edge upwards in the first half of 1970. Even though the rise in wages may slow down somewhat, the increase in unit labour costs could remain substantial, given the modest advance in productivity. The rise in prices is therefore not expected to show any appreciable deceleration before the first half of 1970.

JAPAN

The present boom in Japan has already lasted longer than any of its post-war predecessors and seems likely to continue into the first half of 1970. Unlike any previous boom, it has not run into balance of payments difficulties ; indeed, the surplus on current external account, after 3½ years fast growth of activity, is running at record levels and seems likely to remain extremely high over the year ahead. With no signs at present of domestic overheating, and the external position strong, it would be desirable to keep the economy growing at its present rate, and this will require the maintenance of relatively easy credit conditions. The time also seems highly appropriate for accelerated progress towards the removal of the remaining import restrictions and obstacles to capital exports. The Japanese authorities are committed to

Demand and Output
JAPAN
Percentage changes, volume
Seasonally adjusted
at annual rates
Estimates and forecasts

	1967 billion yen	From previous year 1967	1968	1969	From previous half-year 1968 I	1968 II	1969 I	1969 II	1970 I
Private consumption	23 162	9.6	9.4	10	9.1	9.6	10½	9	9
Public consumption	3 734	5.5	6.9	9	7.2	6.0	11	7	9
Fixed investment	13 896	17.1	22.7	19	23.7	20.6	19½	16	12
Final domestic demand (excluding stocks)	40 792	11.6	13.7	13	13.8	13.2	13¾	11½	10¼
*plus change in stock building	2 252[a]	3.2	0.4	–1	–0.5	1.1	–3½	2½	–1¼
*plus change in foreign balance	–5[a]	–1.4	1.0	1	2.1	0.6	2	–½	½
GNP at market prices	43 039	12.9	14.4	12½	14.7	14.3	11½	13¼	9
GNP implicit price deflator	..	4.3	3.8	4½	1.8	6.2	4¼	3½	4
Industrial production	..	19.4	17.7	16½	14.8	19.1	14½	18	12

* The yearly and half-yearly rates of change refer to changes in stock building and in the foreign balance expressed as a percentage of GNP in the previous period. These two figures plus the rate of change of final domestic demand broadly equal the rate of change of GNP. In practice however, divergences are possible because the rate of change of final domestic demand is not expressed as a percentage of GNP.
a) Actual level of stock building and foreign balance.

progress in these fields and the present combination of economic circumstances is favourable to fulfilment of these commitments.

Policies

Fiscal and monetary policies appear to be fairly neutral in character at present. Central and local government budget estimates for the fiscal year to March 1970 foresee total expenditure rising at about the same rate as in the previous year though with a significantly slower advance in spending on goods and services. Total income tax cuts, including local taxes, are estimated at Yen 276 billion in a full year (3 per cent of total tax revenue), following a relatively moderate reduction of Yen 140 billion in FY 1968, when, moreover, the cuts were offset by increased indirect taxation. Despite the higher tax cuts, the central government's deficit is expected only marginally to exceed that of 1968 (Yen 460 billion) and may be smaller since the forecast growth in GNP of 14.4 per cent in current prices to which it was related seems likely to be surpassed.

Since suspending quantitative credit control ("window guidance") last October, the Bank of Japan has adopted a more flexible system of credit guidelines, taking into account the fund position of individual banks. The fund position is defined as the difference between money market lending and borrowing from domestic financial institutions (including recourse to the Bank of Japan credit facilities). According to the new directives, the main credit institutions (comprising the city banks and long-term credit banks, which account together for about 70 per cent of total outstanding credit of all banks) should not allow their fund position to deteriorate. Strict adherence to this rule would imply that recourse to the Bank of Japan credit facilities was limited to the amount of additional money market net lending or to a reduction of money market indebtedness. The temporary worsening of the banks' fund position since the end of last year suggests, however, that the liquidity guidelines have been handled in a rather flexible manner, though it is understood that the Bank is closely watching each individual bank's lending activity.

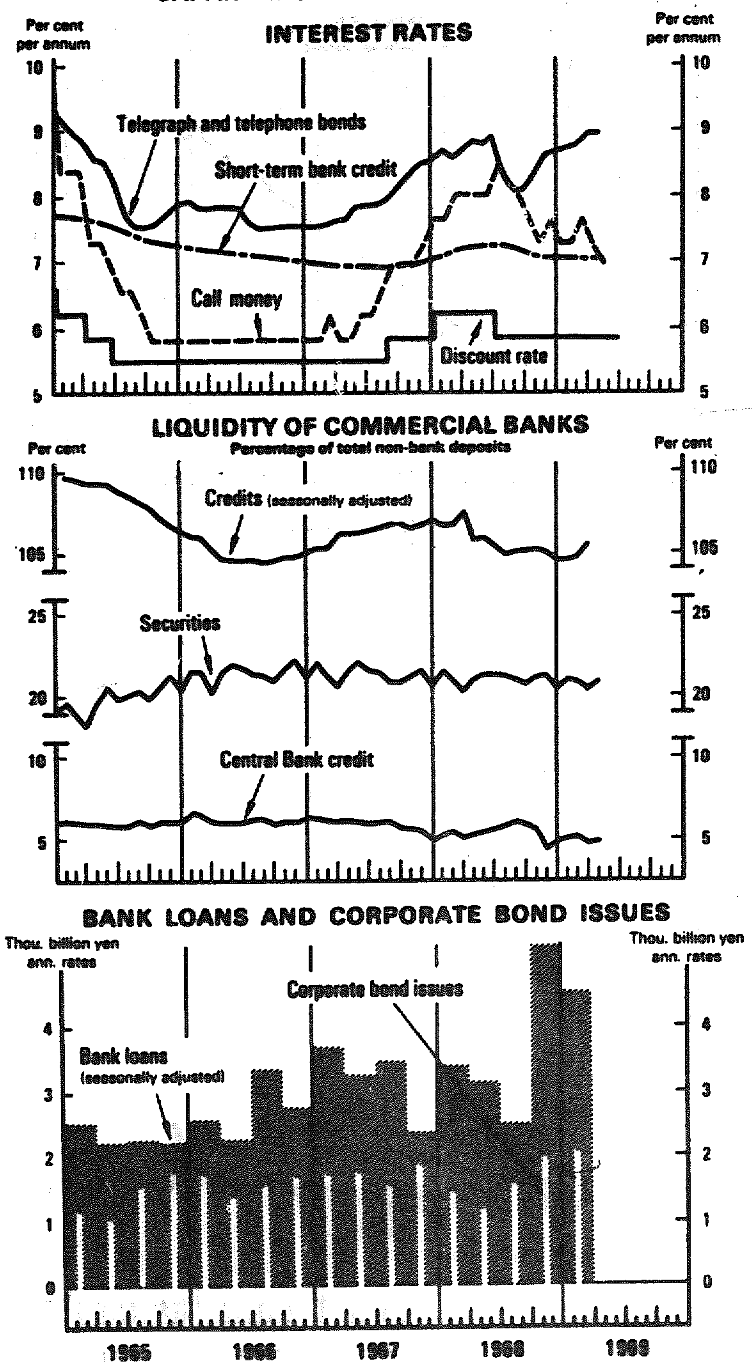
TABLE 37
Public expenditure

	1968 Billion Yen	Percentage changes over previous fiscal year: 1968 Provisional results	1969 Initial estimates
Central government			
General account expenditure	5 917	13.7	15.8
Fiscal loan and investment programme	2 769	10.0	14.0
Local government expenditure	5 605a	17.5a	18.0
Total government spending on goods and services (current prices)	9 750	14.8	12.3

a) Initial estimates.
Source : Official estimates.

After a drop in new lending by commercial banks in the third quarter of 1968, credit expansion has accelerated sharply; in the second quarter of this year, it may have been as much as 80 per cent faster than a year ago. In response to buoyant credit demand and tightening liquidity conditions, yields on outstanding long-term bonds have risen conspicuously since last September, but call money rates and yields on new issues (largely placed with banks) have so far been kept relatively stable. The Ministry of Finance has recently eased restrictions on foreign borrowing by Japanese firms; but given the interest rate ceilings fixed for such borrowing, no significant increase in capital inflows on this account seems likely in the near future. On the other hand, the Bank of Japan has facilitated a shift of import financing from foreign to domestic sources by tolerating a deterioration of the fund position of city banks. The amount of this "Yen shift" was expected to amount to about \$ 250 million for the second quarter, but exceeded \$ 300 million by the end of May.

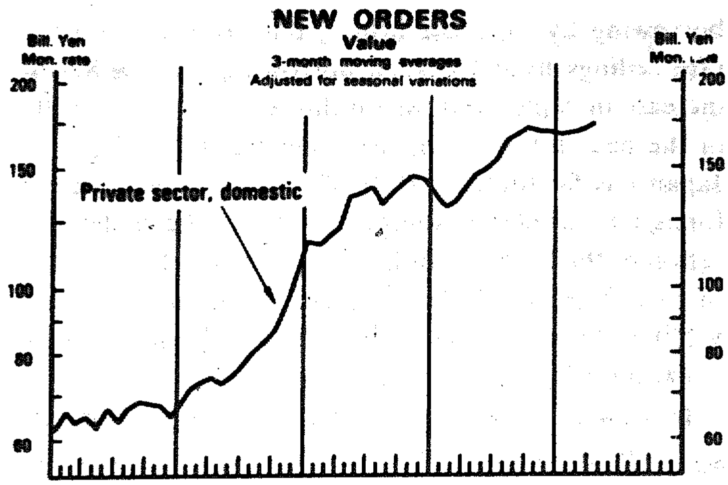
JAPAN - MONETARY INDICATORS

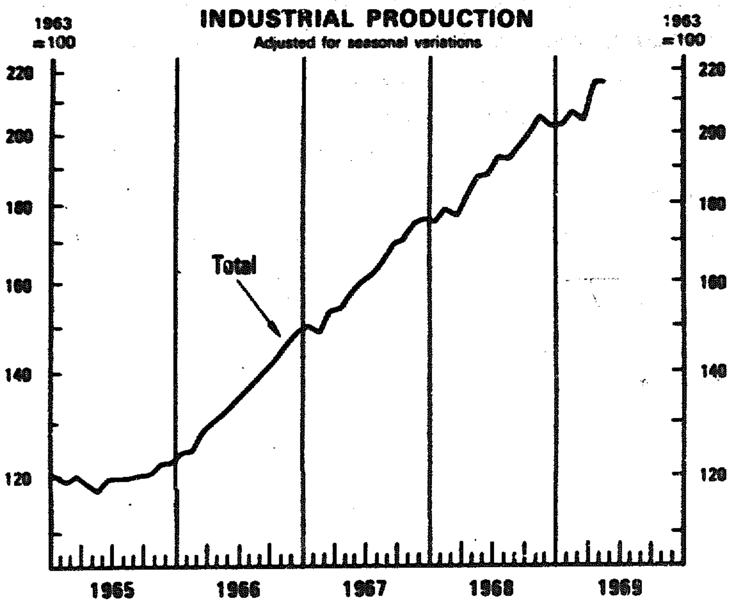


In view of the much stronger external position, the government has recently intensified its moves towards further liberalization of both invisible trade and capital flows. As from April 1969, tourist and business travel allowances have been raised, from \$500 to \$700, and from \$1,000 to \$3,000, respectively, for each trip. Plans are under consideration, both for raising substantially the ceiling for automatic approval of overseas direct investment and for abolishing restrictions on transfers of non-residents' earnings and of profits of foreign-owned enterprises. Furthermore, export credit regulations are to be eased. Controls on foreign direct investment in Japan were relaxed in March: the second round of the liberalization scheme covers a wide range of trade and industry, with maximum foreign participation ratios normally fixed at 50 per cent but in some cases 100 per cent.

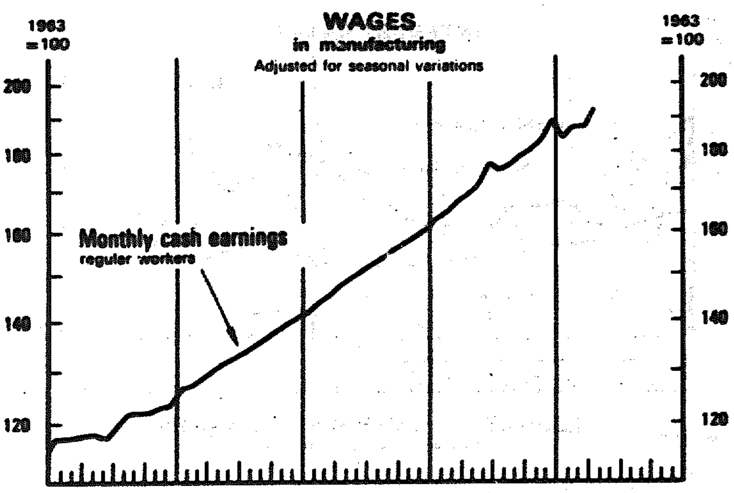
Recent trends

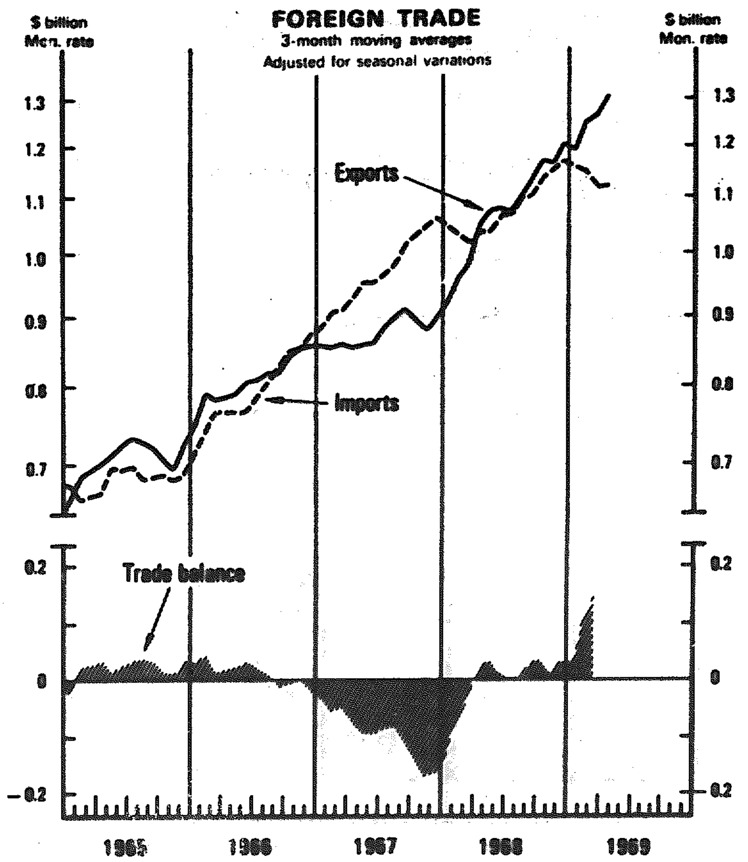
Boom conditions continued unabated up to the fourth quarter of 1968. A certain hesitation, which may have been partly statistical, seemed to appear in early 1969—the index of industrial production levelling off, imports receding slightly and new domestic orders for machinery, excluding ships, declining sharply. However, this weak trend was reversed in April. Industrial production in April and May was 5.4 per cent above the first quarter average (throwing some doubt on the seasonal adjustment) and recent estimates suggest a vigorous revival of new domestic orders for machinery in the second quarter. The growth of merchandise exports also became faster and industrial deliveries maintained their buoyant tendency, bringing to a halt the marked rise of the inventory/delivery ratio. Following some slack in the third quarter of last year, new construction orders resumed a steep upward trend. But imports were rather flat up to May.





The balance of payments surplus on current account was running at a seasonally adjusted annual rate of about \$ 2½ billion in the first five months of 1969. Merchandise exports were 10.4 per cent above the last five months of 1968, while imports (cif) showed a rise of less than 1 per cent. The growth of exports was concentrated on developing countries and the United States. The pause in imports was probably due to stock adjustments, but may also be reflecting structural changes in import needs. After a net outflow of long-term capital in the last five months of 1968 of \$ 172 million (of which about \$ 100 million was accounted for by exceptionally

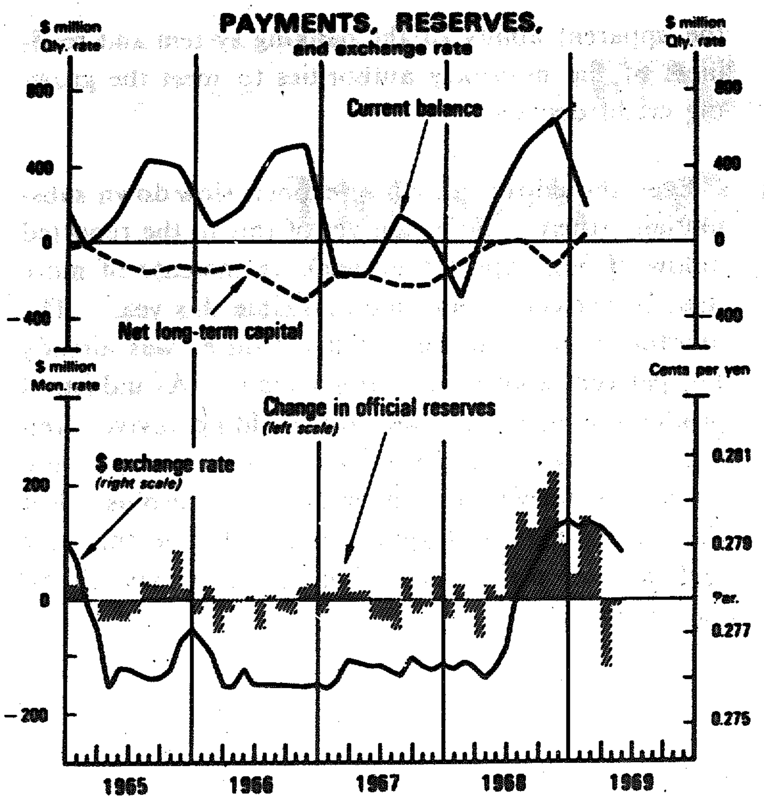




Persistent pressure of demand is reflected in the "operating index"[1] which, between November and April was running at a record level. Labour market conditions have continued to tighten. The ratio of job vacancies to job seekers has risen continuously over the past year or more. With important bonus payments at the end of last year, the rise in wages has accelerated; in December-April, average monthly earnings of regular workers in manufacturing were 15.7 per cent higher than a year earlier. The downward tendency of wholesale prices of producer goods has been reversed since last autumn, reflecting strong increases in metal prices. Consumer prices levelled out between September and February, but have risen again since; by April the index was 4.7 per cent higher than a year earlier, with the non-food component 4.1 per cent up on the year.

1. Operating index $= \dfrac{\text{Index of industrial production}}{\text{Index of production capacity}}$

(The index of industrial production is reweighted and seasonally adjusted).



high direct investment by Japanese trading firms), the balance shifted back into a surplus of $ 80 million in January-May. At the end of May, official reserves, including the reserve position in the Fund, stood at $ 3 billion, some $ 1.1 billion higher than a year earlier. Moreover, during the twelve months to April, the net foreign exchange position of commercial banks improved by $ 0.6 billion.

Prospects

Quite vigorous expansion seems likely to continue for another year, with real GNP growing about 11 per cent between the first halves of 1969 and 1970 and little, if any, decline in the rate of external current surplus. Leading economic indicators, such as the diffusion index, point to a continued boom, profits rose faster in the six months to last March and business enquiries show a picture of continuous buoyant profits and sales, and favourable investment prospects. The pace may lose some momentum in coming months, because of a slower advance of exports (especially to the United States and primary producing countries, which together take most of Japan's exports), and private productive investment. The weaker inventory accumulation of the first half of 1969 is likely to be followed by a new but moderate upturn. The trend of consumer spending may not change much. The sharp rise in wages is likely to

Balance of payments
JAPAN

Value, million dollars
Estimates and forecasts

	1967	1968	1969	1968 I	1968 II	1969 I	1969 II	1970 I
SEASONALLY ADJUSTED								
Exports	10 228	12 754	15 400	5 979	6 775	7 500	7 900	8 450
Percent change [a]	(6.8)	(24.2)	(20½)	(31.3)	(23.4)	(25½)	(11)	(14½)
Imports	9 070	10 223	11 350	4 867	5 356	5 400	5 950	6 300
Percent change [a]	(22.5)	(11.4)	(11)	(3.8)	(17.9)	(3)	(21½)	(12½)
Trade balance	1 158	2 531	4 050	1 112	1 419	2 100	1 950	2 150
Services and transfers, net	–1 350	–1 483	–1 650	–730	–753	–800	–850	–900
Current balance	–192	1 048	2 400	382	666	1 300	1 100	1 250
UNADJUSTED								
Current balance	–192	1 048	2 400	–104	1 152	800	1 600	750
Long-term capital	–812	–245		–128	–117			
Short-term capital and unrecorded	434	299		206	93			
Balance on non-monetary transactions	–570	1 102		–26	1 128			
Change in reserves	–7	726		–61	787			

a) Over previous period at annual rates, customs basis.

continue, given the tightening labour market conditions and the comfortable profit situation. The increase of farm income may, however, be less than in the preceding two years, when it was boosted by bumper harvests and substantial increases in government-controlled prices.

Given the unabated boom conditions, private productive investment should remain the main source of expansion up to the middle of next year, though even its rate of increase may slow down. Latest investment intention surveys suggest that investment of bigger corporations would grow by about 20 per cent in current prices in the year to March 1970, and that smaller enterprises might increase investment outlays even faster. Financing problems should be eased by the favourable development of profits and the apparent ability of the banking system and readiness of the monetary authorities to meet the growing credit demand.

Even should the growth of exports slow down substantially (there is little sign yet of this in the reported inflow of new export contracts), an increase of more than 20 per cent seems quite possible this year. The monthly average in the first five months was already 17½ per cent above last year's average. As industrial production increases and stockbuilding revives, imports can be expected to increase again, possibly reducing somewhat the current account surplus. But the surplus may well approach $ 2½ billion this year and the rate in the first half of next year may still be very high.

FINLAND
TRENDS AND POLICIES

GENERAL BACKGROUND

Finland became the 22nd Member of OECD at the beginning of this year. With an area of 337 000 square kilometres, her size is about the same as that of Italy. But with a population of 4.7 million, she is one of the least densely populated member countries (14 per square kilometre). Nearly a tenth of the country is covered by inland water-ways and lakes—numbering, it is supposed, 60 thousand—while forests cover 70 per cent of the land area. The forests are Finland's main natural asset; the waterways provide power and easy transportation for forestry industries. Economic progress since the war has been rapid : 48 per cent of the population now live in urban areas and income per head is about the average for OECD countries in Europe.

Finland has close historical links with her two main neighbours. An integral part of the Kingdom of Sweden for many centuries, she became after the annexation of 1809 an autonomous Grand Duchy under the Russian crown. Finland achieved independence in 1917, and adopted a republican constitution in 1919. Under the constitution, legislative power is exercised by Parliament and the President; the chief executive power, by the President. The two hundred seats in Parliament are shared by six or so main political parties, and in no election has one party yet got half the seats. Most governments have been coalition governments, though seven of the twenty-one post-war administrations have been minority governments.

With the economy based on private enterprise, and with relatively small units becoming increasingly integrated with world markets, economic planning on the part of the Central Government can be only indicative and of general guidance. State enterprises are not more widespread than in most European OECD countries and their decision-making on production, investment and marketing is fairly independent of the Government. Some big groups are found within wholesale trade and pulp and paper producers, but no single group or company is considered to be of dominating importance in the economy.

BASIC DATA

AREA AND POPULATION

Area (1 000 sq. km.)	337
of which : Cultivated land	31
Forests	240
Lakes	32
Total population (end of 1967)	4 676 000
Per sq. km. of land area	15.3
Average 1962-66 :	
Live births (per thous.)	17.5
Deaths	9.4
Net natural increase	8.1
Net increase of population	7.3

Population in major cities (end of 1966) :	
Helsinki	519 200
Tampere (Tammerfors)	147 500
Turku (Abo)	145 600
Urban population (per cent of total)	48
Man-power by industry (per cent, 1967) :	
Agriculture and forestry	27
Industry and construction	34
Commerce	14
Transport and communications	7
Services	18

PRODUCTION

Gross Domestic Product 1968	
Mk. mill.	33 721
GDP per head, US dollars at exchange rate \$ 1 = Mk. 4.20	1 710
Gross fixed asset formation 1968 per cent of GDP	22.7
Public consumption per cent of GDP	15.7

Gross Domestic Product by Industries 1968 (per cent) :	
Agriculture and forestry	15.5
Industry and construction	38.9
Commerce	9.8
Transport and communication	7.5
Services	28.4

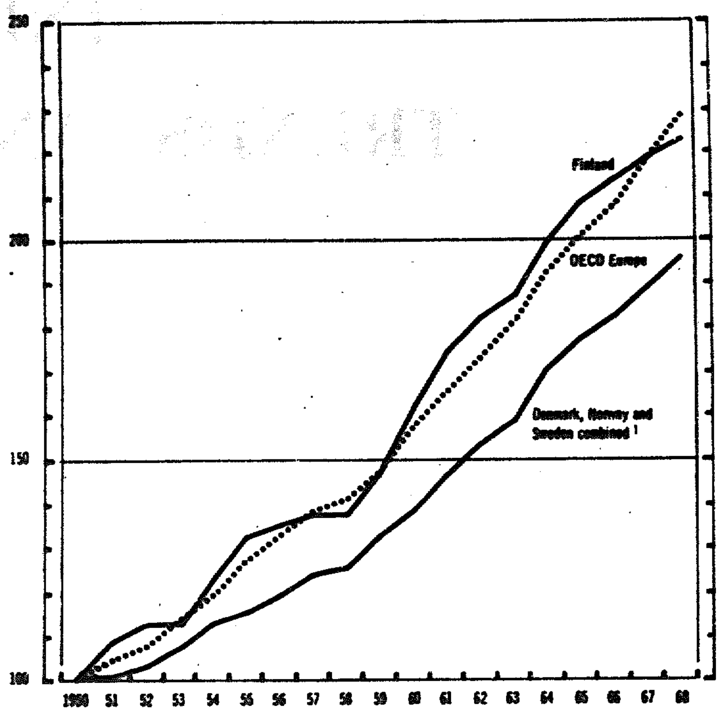
FOREIGN TRADE

Exports of goods and services, per cent of GDP, 1968	34.8
Merchandise exports 1968, per cent :	
Agricultural products	4.7
Round and hewn timber	0.8
Wood products	16.9
Pulp and paper	43.6
Metal products, etc.	22.8
Other goods	11.2
Import of goods and services, per cent of GDP, 1968	23.1
Merchandise imports 1968, per cent :	
Raw materials, etc.	44.9
Fuels and lubricants	13.1
Investment goods	22.8
Consumer goods	19.3
Currency units per \$ (from 12th October 1967)	4.20

Finland faced great problems after the Second World War. There had been heavy destruction, and the peace settlement involved not only a large cession of territory and reception of the displaced population, but also heavy war reparation payments which extended over eight years. Despite these difficulties, output per head regained its pre-war (1938) level by 1948. Exports have continued to grow rapidly—partly as a result of world demand for pulp and paper; partly because of trade agreements with Eastern Europe; and partly through the development of new exports to EFTA and other countries. During the last two decades Finland has been one of the fastest growing economies of Western Europe; and in the process the economy has been progressively industrialised and diversified.

There was serious inflation in the early post-war years and it has continued to be more rapid than in most OECD countries. The last devaluation in 1967 was the fourth since 1948. Developments since 1967 have, however, been favourable. Incomes policy has succeeded in braking the rapid rise in incomes; and last year the balance of payments improved, demand expanded and unemployed resources were absorbed.

Diagram 1 Long-term Trends in GNP
Volume indices, 1950 = 100



1 1958 exchange rates.

Sources: National Accounts of OECD Countries 1957-1966, Statistics of National Accounts 1950-1961 and national publications.

GROWTH AND STRUCTURAL CHANGE

Growth

The rapid recovery of activity in the early post-war period represented great effort and sacrifice. Finland lost 10 years of normal economic growth during the war. After the war 12 per cent of its territory and productive capacity was ceded to the Soviet Union. About 15 per cent of the population had lived in this area and had to be resettled in Finland. Unlike most other Western European countries, Finland received no economic aid; on the contrary, during the eight years ending 1952 reparation deliveries totalling $ 570 million (in 1952 prices)—about a quarter of 1948's gross national product—were made to the Soviet Union. Most of these indemnities were paid out of Finland's own production: net foreign borrowing over the eight-year period amounted to about $ 100 million. Finland, however, benefited greatly from an improvement of her terms of trade. Since 1948 GNP has increased at an average annual rate of about 5 per cent, rather faster than the average for OECD countries combined but roughly in line with the performance of OECD Europe.

Change in Industrial Structure

Expansion has been accompanied by rapid structural change. In 1948, agriculture and forestry (a vocational combination typical in Finland) accounted for about one-third of total output and employed more than 40 per cent of the labour force. By 1967, employment in agriculture and forestry had fallen by one-third—a major factor in the improvement of real income of those remaining in agriculture. The relative size of this sector remains higher than in most other industrialised countries. Output per man in agriculture is still relatively low; productivity in agriculture has, in recent years, increased roughly in line with the trend in industry; but the initial difference has remained.

The manufacturing sector has grown about in line with GNP, and accounts for about one-third of total output and one-quarter of total employment. But there have been major changes within manufacturing. The engineering industries—relatively modest before the war—have thus grown especially rapidly. The goods demanded as war reparations necessitated a major development of these industries, and after 1952 exports of engineering products to the Soviet Union continued under bilateral trade agreements. Engineering exports to Western countries have also increased as their quality and competitiveness improved. Today the metal and engineering industry is the largest industrial employer and accounts for one fourth of industrial output. Its most important products are machinery for the wood-processing industries, ships, lifting and hoisting equipment, transport equipment, electric motors, generators and cables.

The wood, pulp and paper industries maintain a dominant position, though expansion has been somewhat slower than for total industry; their share of industrial production has fallen from about 25 per cent after the war to 20 per cent today. The fact that the volume of timber felling has reached the growth of the forest stock may have served partly to limit the overall expansion of the wood-processing industry, and partly to shift production towards a higher degree of processing. As in many other industrialised countries, the relative importance of the textile, clothing and footwear industries has declined.

Growth and Structure of Foreign Trade

Exports of goods and services now account for about a quarter of GNP, with goods alone representing about one-fifth of GNP; on the import side the relationships are about the same. Both the commodity and the geographical patterns of exports have changed significantly in the post-war period (Table II).

TABLE I. **Gross Domestic Product by Industries**
Per cent

	Gross domestic product (current factor cost)		
	1948	1958	1967
Agriculture, forestry, hunting and fishing	33	21	15
Mining, manufacturing and electricity supply	30	28	30
Building and construction	8	10	10
Transport and communications	6	7	7
Trade, banking and insurance	10	12	13
Public administration and defence	4	4	4
Other services	9	18	21
Total	100	100	100

Sources: Finnish National Accounts and Economic Survey 1968.

TABLE II **Exports by Main Types of Goods**

	Per cent of value			Annual change in volume, per cent		
	1950	1958	1966	1950/58	1958/66	1950/66
Agricultural products	4.1	4.3	5.5	14.0	8.5	11.0
Forestry products	10.0	7.8	1.2	0.5	—7.0	—3.5
Wood industry products	35.1	23.3	17.9	1.0	2.5	1.5
Paper industry products	41.6	46.5	47.7	7.5	9.5	8.5
Metal and engineering industry products	4.9	13.7	18.2	23.5	10.0	14.0
Other goods	4.3	4.4	9.5	13.5	28.0	20.5
Total	100.0	100.0	100.0	6.5	7.5	7.0

Source: Bank of Finland, Monthly Bulletin.

Wood and paper products maintain a dominant position, but their share of total exports has fallen from over 85 per cent in 1950 to about 60 per cent in 1968, with a marked shift towards shipments of more highly-processed goods. The share of engineering products has increased markedly; the share of non-traditional manufactured products, though still relatively modest, has increased significantly over the last decade, reflecting increased exports of a wide range of products as a result of stronger marketing efforts and the progressive removal of barriers to international trade.

About two-thirds of Finland's foreign trade is with other European OECD countries, her main trading partners being EFTA countries. The share of the Eastern countries is about 20 per cent: trade with countries outside Europe is small. In Europe, Finland's main suppliers are Western Germany, the Soviet Union, Sweden and the United Kingdom, each accounting for a little more than one-seventh of total imports. On the export side the United Kingdom remains the biggest buyer of Finnish products (one-fifth), followed by the Soviet Union (one-seventh). In post-war years the share of Western Europe in Finland's trade has been increasing, reflecting mainly a strong expansion of trade with Sweden. The shares of the Eastern countries have declined somewhat, although the Soviet Union has maintained its relative position.

The growth and change in the structure of foreign trade has of course been decisively influenced by foreign trade policy. Up to 1957, practically all foreign trade was conducted on a bilateral basis. After the devaluation in that year quantitative restrictions on imports from Western countries were gradually abolished; licensing is now maintained on only a small percentage of total imports, mainly agricultural products and mineral fuel. Finland has been associated with EFTA from mid-1961, and has

TABLE III Foreign Trade by Areas
Per cent

	Imports		Exports	
	1955	1967	1955	1967
EFTA countries	32.9	40.6	31.3	38.5
EEC countries	22.6	27.7	22.8	23.5
Other OECD countries	7.9	6.5	9.7	9.5
Eastern countries	26.8	20.4	24.2	21.2
Other	9.8	4.8	12.0	7.3
	100	100	100	100

Source : Finnish Foreign Trade Statistics.

gradually abolished tariffs on imports of industrial goods from those countries. Tariffs on imports from Western countries outside the EFTA area will decline over the next few years as a result of the commitments made in the Kennedy Round in GATT.

MANAGEMENT OF THE ECONOMY

The rate of inflation as well as cyclical fluctuations would seem to have been more marked than in most developed Member countries. The lack of stability can to a large extent be ascribed to fluctuations in foreign demand for Finnish exports, but certain features of economic policy may also have exerted a destabilising influence.

The Rise in Prices

The development of prices has been irregular with galloping inflation from 1945 to 1951, virtual stability in 1952-1955, a steep rise 1956-1958, stability in 1959-1962 and a renewed upturn from 1963 to 1967.

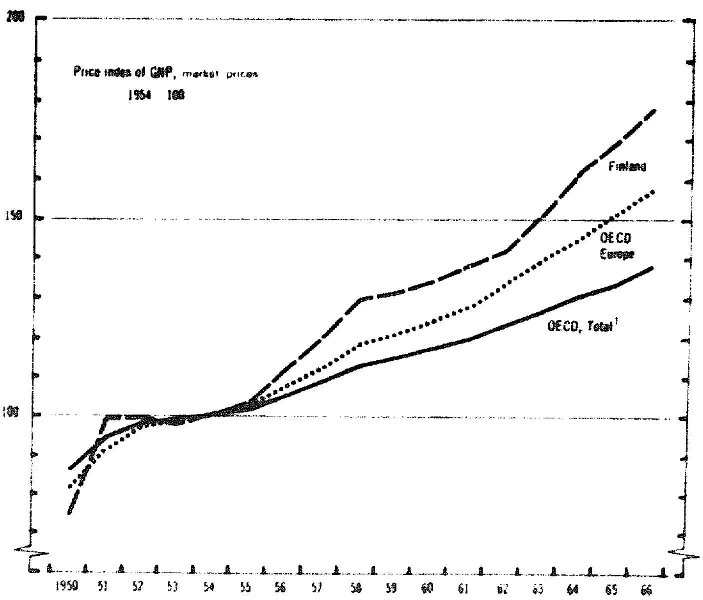
In the period from 1945 to 1949 the cost-of-living index rose by some 40 per cent a year. This reflected the pressure on resources due to reconstruction of the war-damaged productive potential and reparation payments; to an important extent, high investment expenditure and war reparation deliveries were financed by an inflationary credit expansion: the rise in prices served to limit the growth of consumer spending in real terms. The Finnmark was devalued twice in 1949—once independently and once in line with the devaluation of other European currencies. The rise in prices remained strong in 1950 and 1951, but the steep increase in exports during the Korean boom (from $ 350 million in 1950 to $ 800 million in 1951) made it easier to absorb higher domestic incomes and prices.

From 1952 to 1955 prices were practically unchanged. Demand pressures eased in 1952-1953 when the Korean boom subsided and war reparation deliveries came to an end. From 1954, moreover, the Finnish authorities pursued a policy of suppressed inflation with higher government subsidies to limit the rise in the cost-of-living index and legally-enforced ceilings on wage increases.

Regulatory powers to control prices expired at the end of 1955. The 6 per cent rise in prices in the subsequent three months sparked off a strong price-wage spiral which lasted till mid-1958. A general strike for 19 days in 1956, and the inflationary settlements which brought it to an end, reinforced the pressure on prices. The 1957 devaluation (28 per cent) led to a further immediate rise in prices; but the stabilisation measures taken in the spring, and the weakening of foreign demand in 1958 together with the liberalisation of imports served to ease demand pressures and the rise in prices levelled out. The primary source of inflation in the 1955-58 period would seem to have been cost pressures rather than excess demand conditions.

The period of price stability beginning in mid-1958 lasted for three years. Wage indexation was abolished at the beginning of 1959 and wages in 1959 probably rose only in line with productivity. But from 1960 onwards aggregate demand was allowed to rise sharply, with demand pressures becoming excessive in 1962 when unemployment fell to

Diagram 2 Trends in Prices

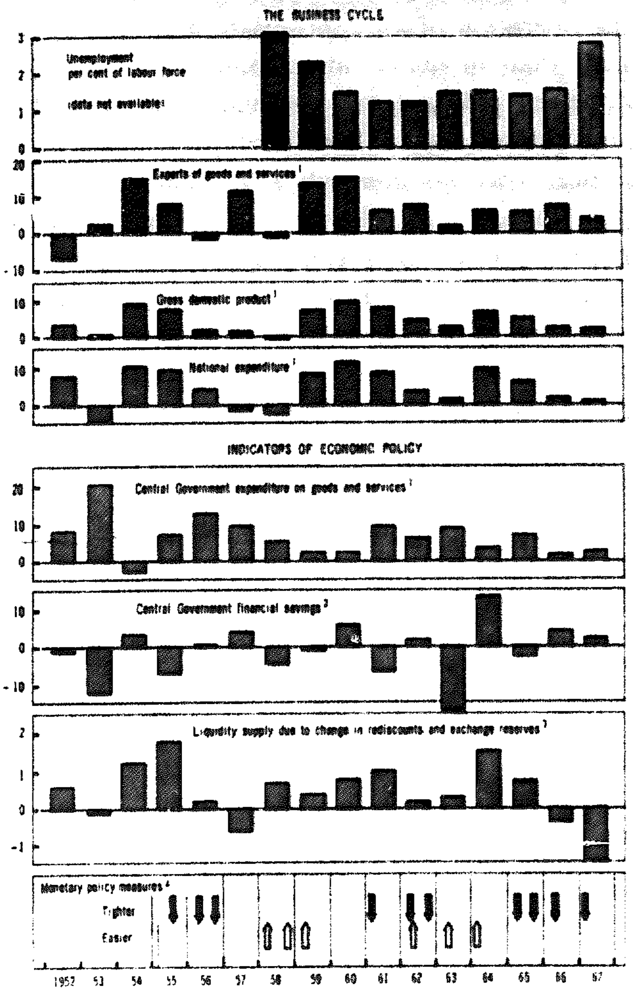


1 Until 1956 excluding Japan.

Sources National Accounts for the OECD Countries and Finnish National Accounts.

a very low level (just above 1 per cent). Between 1962 and 1967 the GNP deflator rose by more than 5 per cent per year. Labour costs per unit of production rose relatively fast; and indexation between wages, other incomes and prices again became an important factor. But excessive demand pressures may have been the principal factor behind the inflationary trend in this period. More stable conditions were not restored until the stabilisation agreement in March 1968.

Diagram 3 **The Business Cycle and Economic Policy**



1 Percentage change (volume terms) from previous year, approximate estimates.
2 Change in balance on current and fixed investment account in per cent of current revenue.
3 In per cent of GDP in current prices. Adjusted for effect of export levy deposits.
4 Black arrows indicate a tightening, white arrows an easing.
Source: OECD Secretariat.

Countercyclical Policy

Fluctuations in the annual rate of growth of real GNP have been more marked than in some other countries (Table IV). This can largely be ascribed to strong fluctuations in the growth of merchandise exports, reflecting the unstable world demand for wood, pulp and paper products which have a heavy weight in Finland's exports. But there has been little tendency for domestic demand to move in a countercyclical manner. Diagram 3 suggests that, on the whole, it has tended to vary in the same direction as the increase in exports, and the fluctuations have been relatively strong. This, though undesirable, is perhaps not surprising; an inverse variation is not easy to achieve in a country with a large foreign trade. For a rise in exports has a direct impact on domestic incomes which, in turn, influence domestic demand; and foreign demand is a major determinant of the business climate, affecting the propensity to spend of both investors and consumers.

The efforts made by the authorities to achieve a countercyclical movement of domestic demand do not, however, appear to have been very strong. The increase in real central government expenditure on goods and services has often tended to be strong when the expansion of activity and pressures of demand have been strong, and vice versa. Exceptions seem to have occurred in 1959 and 1963, when government spending exerted a stabilizing influence on demand.

Financial savings, measuring the income effect of the budget, also show no clear countercyclical movement: over much of the period considered they seem to have moved in a destabilising manner. It has been a feature of Finland's post-war developments that restrictive fiscal measures have tended to be too long delayed. As in other countries, prompt adjustment of fiscal policy to the needs of the economy involves a number of difficulties. Many items in the budget cannot easily be changed quickly. Moreover, in the early phase of an export upswing, the balance of payments tends to be strong so that there is no imperative need for action on external grounds. The political situation prevailing during the post-war

TABLE IV **Fluctuations in Growth**
Finland compared with other countries

	Merchandise exports, $ values		Gross Domestic Product (Volume)	
	Average rate of change 1951-66	Average deviation	Average rate of change 1951-66	Average deviation
Finland	8.0	5.6	4.6	2.9
Denmark	8.1	2.5	4.2	2.4
Germany	12.5	4.0	5.1	1.7
Sweden	8.6	3.1	4.0	1.4

Source: OECD Foreign Trade Statistics, Finnish Bulletin of Foreign Trade and National Accounts period, with generally weak governments, has rendered the operation of an appropriate fiscal policy more difficult than in many other countries.

Monetary policy, less constrained by political and administrative factors than fiscal policy, has by and large been used countercyclically. There is no good single indicator of changes in monetary policy. Diagram 3 shows in a general way the posture of monetary policy, as indicated by the « direction » of the measures taken (restrictive or expansionary). It suggests that, over most of the period, monetary action to dampen the cyclical swings in activity was taken at a relatively early stage of the cycle. But it is difficult to assess the strength of the measures adopted. The movement of the supply of liquidity to the economy as a result of changes in the Central Bank's foreign exchange reserves and the volume of its rediscounts has, at least in certain periods, been strongly pro-cyclical, notably in 1954-55, 1960-61 and 1964. Official foreign exchange reserves rose in these periods, rather strongly in the first and third, and offsetting action by the monetary authorities seems to have been limited.

Structural Policies

Although Finland is essentially a free market economy, government policy influences structural developments in various ways. One key factor has been agricultural policy and the land settlement for people who lost their farms at the end of the war. Through import controls on agricultural products and price and income support to farmers, the authorities have aimed at a high degree of self-sufficiency for basic food products. Finland's output of dairy products and, occasionally, that of meat and eggs exceeds domestic requirements; she is almost self-sufficient in bread grain and has a relatively big production of sugar. But partly because many small units were created under the resettlement programme, the farms are small—their average size being even less than in the 1930's. Since there is no longer scope for an expansion of total agricultural production, further improvement of farmers' incomes will depend on a marked decline in the agricultural labour force through higher productivity and, thus, on the capacity of other industries to employ the labour released from agriculture. To stimulate the development of new industrial projects the Government, on certain occasions, has granted cheap loans

NOTE ON INSTITUTIONS AND POLICY INSTRUMENTS

The Central Bank (Bank of Finland) is an autonomous public institution operating under the guarantee and supervision of the Parliament. The Government may borrow from the Central Bank only in exceptional cases and for specific purposes. The banking system further consists of six commercial banks, 350 savings banks, 470 co-operative credit societies and their central bank, six mortgage societies, and the Post Office Savings Bank; the latter only is owned by the State. Other principal financial institutions are the National Pension Fund and 62 private insurance companies.

The banks are normally in debt to the Central Bank; variations in the volume of their rediscounting is the principal monetary policy weapon used by the authorities. If the rediscount ceiling is exceeded, a progressive penalty interest rate (maximum 4 per cent) has been applied on top of the rediscount rate (now 7 per cent). The Central Bank controls directly the average lending rates of the commercial banks. The average lending rates at present are 7.5, 7.9 and 8.1 per cent respectively for commercial banks, savings banks, and credit societies. The Central Bank has at times imposed ceilings on bank advances and issued recommendations regarding the pattern of the credit expansion. Borrowing abroad by banks or others is regulated through general instructions and individual licensing. The bond market is small, so there is little scope for open-market operations; at the end of 1966 outstanding bonds accounted for only 5 per cent of domestic credit, and bonds are usually held to maturity. The Central Bank regularly informs the credit institutions about the aims of monetary policy, and seek to reach mutual understanding on its implementaton.

Taxation and central government expenditure are approved by Parliament for each fiscal year (coinciding with the calendar year). The Government has no power to change tax rates without the prior approval of Parliament; however, it may change a few charges (tobacco, spirits) and prices for services rendered by government enterprises. Appropriations for fixed investment are transferable over four years and some budget items which are exceptionally difficult to forecast may be exceeded, which allows some flexibility in government expenditure. Supplementary budget proposals are often submitted to Parliament in the course of the fiscal year. Local authorities are free to stipulate their own tax rates but they may not raise loans of more than 5 years' maturity without the approval of the Ministry of the Interior.

The Ministry of Finance prepares annual Economic Surveys covering recent developments and forecasts for the year ahead. To help plan public activity over the longer-term, work on 5-year indicative budgets has been started. The Economic Council, presided over by the minister responsible for long-term economic planning, comprises representatives of the Government, the Central Bank and labour and business organisations. Its work will be devoted mainly to long-term developments; a study for the years 1969 73 is to be published in 1969. The Bank of Finland has a research department making short-term forecasts and studies on special economic topics. A Regional Development Board was established by government resolution in 1966, comprising members from different Ministries, city administrations and local authorities.

and made direct contributions for the financing of business investment. Private enterprises have obtained loans from the World Bank against government guarantee. State-owned enterprises have been established in some sectors (iron and steel, chemicals, oil refineries, power production). In their guidelines to domestic banks and in controlling the intake of foreign long-term loans the monetary authorities give priority to the financing of exports and capital expenditure in exporting industries. Special tax allowances and interest rebates are granted to firms setting up in regions where industrial development is slow and the labour force underemployed. To facilitate the transfer of manpower from agriculture and forestry to other occupations the labour market authorities arrange for vocational retraining courses, grant removal allowances, give advice on state housing finance and make contributions to firms' housing programmes for their workers.

In the 1969 budget important changes were made concerning transfer payments to agriculture to reduce central government expenditure related to exports of surplus agricultural production and to promote structural change in agriculture and reduce the area under cultivation. Small farmers who cease to cultivate their arable land will be paid Mk 250 per year for each hectare taken out of production; only farms with arable land up to 14 hectares are eligible, so that the maximum amount a farmer can receive will be Mk 3,500 per year. It is expected that in the course of two years the cultivation of about 4 per cent of the arable land will be abandoned. Total transfer payments to agriculture are likely to fall because the decline in production will reduce subsidy payments related to the volume of output.

Moreover, on 23rd May the Government submitted to the Diet proposals for a new framework for determination of agricultural prices and incomes, with the double aim of ensuring that farmers' incomes develop in line with those of wage and salary earners and reducing the surplus of some agricultural products.

According to these proposals:

i) The agricultural prices will be adjusted automatically to compensate for rising costs of production;

ii) The stipulated income from the farmers' own work shall be determined through negotiations between the farmers' associations and the Council of State;

iii) Cost and price calculations will be based on the level of production in 1968. If this level is exceeded, the proposal provides for a certain reduction of the prices otherwise determined. In addition, a second proposal provides for the imposition of a charge, the size of which will depend on the amount by which the production of milk and wheat exceeds predetermined reduced levels.

THE 1967 DEVALUATION AND RECENT POLICY MEASURES

In 1964 and 1965 there were large current external deficits: exports rose only moderately and there were sharp increases in imports. Several factors served to reinforce the rise in imports. Domestic demand rose rapidly and strengthened demand pressures. With growing incomes, domestic demand was directed more towards imports, especially since trade barriers within EFTA had been removed. The strong rise in Finnish costs also contributed. In 1964, the current deficit was financed by capital imports. This became more difficult in 1965, when foreign capital market conditions became tighter, and Finland's external reserves fell sharply, necessitating corrective action. Monetary measures—notably a reduction of the banks' rediscount quotas with the Central Bank—were introduced at an early date, but major fiscal action was not taken until late in 1966.

As a result of more restrictive policies, the growth of domestic demand slowed down considerably in 1966 and 1967 and demand pressures eased. But the balance of payments remained difficult. After rising rather slowly in 1966 imports declined in 1967. The rise in exports, however, remained relatively modest, especially in 1967, when the expansion slowed down in many European countries. The reserves fell to little more than one month's merchandise imports by the end of 1966, and 1967 saw some further decline. With unemployment high, and little early prospect of a marked improvement of the balance of payments, more radical action was needed.

On 12th October 1967, the Finnmark was devalued by 23.8 per cent in relation to the US dollar; this implied a rise of 31.25 per cent in the US dollar rate expressed in Finnmark. But as more than a quarter of Finland's exports goes to the United Kingdom and

TABLE V Selected Indicators of Economic Developments

	1964	1965	1966	1967
	Percentage change from previous year			
Gross domestic product *(volume)*	6.6	5.1	2.4	2.6
Exports of goods and services *(volume)*	5.8	5.2	7.0	5.9
Imports of goods and services *(volume)*	19.2	9.2	4.8	—1.3
Average hourly earnings in industry	13.2	8.6	7.3	8.5
	Per cent			
Unemployment *(annual average)*	1.5	1.4	1.6	2.9
	$ million			
Balance on current external account	—175	—190	—198	—143
Change in foreign reserve holdings	56	—88	—111	—31

Sources: National Budget 1969 and Monthly Bulletin, Bank of Finland.

other countries whose currencies devalued later in 1967, the average rise in the rates of foreign currencies expressed in Finnmark was about 26 per cent. Between October and the end of 1967, Mark prices for Finnish exports and imports rose almost as much as the rise in foreign exchange rates.

Incomes policy has been a key element in recent government strategy. Given the inevitable rise of import prices resulting from the devaluation, and wide use of escalator clauses in wage and income agreements,[1] there was a clear danger that the effect of the devaluation would be whittled away by excessive increases in wages and other incomes. Negotiations with representatives of labour, management, agriculture and other groups where therefore initiated by the Government soon after the devaluation. Under the agreement reached in March 1968:

i) The trade unions agreed to forego the cost-of-living adjustment to which they expected to be entitled in December (estimated at 5 to 6 per cent), though they did not relinquish the 3.5 per cent automatic wage increase due in June 1968.

ii) Wage increases were to be limited to the rise of productivity, estimated at 3 to 4 per cent a year. For 1969 the agreement provided for an across-the-board increase of 16 pennies per hour, entailing a 3.5 per cent rise in the wage and salary rates.

iii) Farm target price adjustments were to be limited to 2 per cent in June 1968 and 2 per cent in January 1969.

A main condition for the concessions made by the trade unions and the farmers was that index linkages elsewhere in the economy—including those applying to financial contracts—should be abolished, and that the Government should be authorised to control prices, rents and wages. The Economic Special Powers Act passed in April 1968 granted such powers, to be exercised in collaboration with a Prices and Wages Council on which trade unions, employers and other groups are represented. The law expires at the end of 1969, but index clauses will not automatically be re-introduced. The Government undertook not to raise tax rates during 1968 and 1969, and to keep its long-term borrowing in 1969 below Mk. 550 million. The agreement called for more macro-economic planning and for an evaluation of long-term growth policy.

The existing stabilisation agreements expire at the end of 1969. Negotiations concerning a new agreement covering 1970 and, possibly, 1971 have been undertaken in recent weeks but, at the time of writing, no agreement had yet been reached.

The 1969 budget should serve to stimulate demand. The rise in expenditure may slow down as a result of the limitations imposed by the stabilisation agreement. But the 14 per cent export levy imposed after the devaluation (to limit the rise of incomes of the export industries and, thus, their ability to increase wages and prices on other inputs) has been gradually reduced and was abolished last April. The levy has yielded Mk 650 million ($ 155 million) the main part of which will be used to stimulate investment in 1969, entailing a sharp increase in government lending.

The improvement of the balance of payments caused a strong increase of domestic liquidity in 1968, despite the restrictive monetary impact of the

TABLE VI Money and Credit
Change in balances during the year, Mk. mill.

	1965	1966	1967	1968
NON-BANK LIQUIDITY:				
Money supply	43	129	—31	488
Time deposits	1 040	1 239	1 101	1 205
CENTRAL BANK:				
Net foreign assets	—39	—368	—105	1 011
Rediscounts	192	275	—48	—250
Net credits to the private sector	—52	76	332	—77
BANKS:				
Total loans	1 124	1 257	1 016	776
Total deposits	1 041	1 253	1 108	1 545

Source: Bank of Finland, Monthly Bulletin.

1. The three-year wage agreements concluded in 1966, covering most wage and salary earners, included escalator clauses, and farmers' incomes were subject to adjustment in accordance with the rise in prices of products purchased by farmers.

government budget. The banks' net indebtedness to the Central Bank fell by Mk 240 million (30 per cent) and the money supply (currency outside banks plus sight deposits) increased by 22 per cent after having remained practically stable in the preceding year. Monetary conditions have remained easy in the present year and bank advances have been rising faster than earlier.

TABLE VII **Balance of Payments**[1]
$ million

	1964	1965	1966	1967	1968
Export of goods	1 280	1 419	1 495	1 524	1 625
Import of goods	—1 505	—1 652	—1 732	—1 706	—1 599
TRADE BALANCE	—225	—233	—237	—182	26
Services	80	79	85	101	114
Transfers	—31	—36	—46	—62	—64
CURRENT ACCOUNT	—175	—190	—198	—143	76
Long-term capital, net	153	31	48	79	94
IMF drawings	—	—	—	63	—63
Other capital movements[2]	78	71	39	—30	35
OVERALL BALANCE	56	—88	—111	—31	142
Change in foreign exchange holdings, incl. IMF position					
Central Bank	56	—63	—100	—24	158
Other (mainly commercial banks)	..	—25	—11	—7	—16

1 At current exchange rates. The 1967 balance in national currency has been converted at the average rate $1 = 3.41 Mk.
2 Including errors and omissions.
Source : Bank of Finland, Monthly Bulletin and Economic Survey 1968.

RECENT TRENDS AND PROSPECTS

Recent Trends

The volume of exports rose by 11 per cent between 1967 and 1968, the strong upward trend continuing throughout the year. Output turned up sharply in the second half when fixed investment recovered, stimulated by the favourable trend in exports, the better competitive position and growing profits. Recent indicators suggest that the upturn of activity has remained fast in the first months of 1969, with most demand components sharing in the advance. Industrial production in the first quarter was 8.5 per cent and industrial employment in January 2.3 per cent higher than a year earlier. Available indicators point to a strong rise in both building activity and investment in machinery and equipment. A 5 per cent increase in the volume of retail sales between the first two months of 1968 and 1969 suggests that private consumption is also recovering. The margin of unused resources has been reduced, but remains considerable; the unemployment rate (seasonally adjusted) fell from 4.7 per cent in the third quarter of 1968 (the peak) to 4 per cent in the first quarter; in earlier periods of high activity, however, the ratio has been well below 2 per cent.

During the months immediately after the devaluation, consumer prices rose at an average rate of 1 per cent per month. After the introduction of the price freeze in March 1968, the rise was dampened, and since mid-1968 consumer prices have remained virtually stable. The rise in wages, relatively fast in the early months, has also been moderate since the middle of last year, influenced by the stabilisation agreement concluded in the spring of 1968.

The current account of the balance of payments showed a surplus of $ 76 million in 1968 after deficits between $ 150 million and $ 200 million during the preceding four years. The current balance has remained strong in 1969. In the first quarter merchandise exports were 22 per cent higher than a year earlier. Imports, on the same comparison, showed a 29 per cent increase, reflecting the upturn in aggregate demand. Imports of investment goods, passenger cars and raw materials have risen fastest. Seasonally adjusted, the trade balance showed a small deficit in the first quarter, but with the invisible balance normally showing an excess of receipts, the current account may have remained in surplus. In the first months of the year the capital account does not seem to have been seriously affected by the rise in interest rates in international financial markets and official reserves rose by $ 32 million during the first quarter. The speculation in May in favour of the German mark, however, touched Finland as well as other countries, entailing a fall in official reserves of $ 58 million to $ 279 million at the end of the month (the equivalent of 2 months' merchandise imports).

Prospects

Prospects for 1969 would seem to be favourable. The rise in exports is likely to remain strong, and with domestic demand recovering, activity should rise fast and lead to a decline in unemployment without endangering the balance of payments. And with the incomes agreement in force to the end of the year, the rise in costs and prices should remain moderate.

The authorities expect the rise in the volume of merchandise exports to slow down somewhat, from 11 per cent in 1968 to 10 per cent in 1969 whereas the value increase is estimated at 12 per cent. This is probably more than the likely growth of Finnish foreign markets this year. Total OECD imports may rise by 12 per cent in 1969, but import demand may be weaker than this in some of Finland's most important markets—notably the United Kingdom—so that Finnish OECD markets could grow by somewhat less. However, there are reasons to expect some further devaluation effects, given notably the fact that the export levy has been completely abolished in 1969. Moreover, a favourable development of costs during 1969 should contribute to a further improvement of the exports industries' competitive position. The volume of export orders on hand at the beginning of 1969 was relatively high; a large part of estimated exports has already been sold. An increase in the value of merchandise exports of some 12 per cent could therefore very well be attainable. Exports of wood and paper industry products are expected to rise less than this (some 8 per cent) whereas exports of engineering products are forecast to grow much more rapidly (by 25 per cent). Exports of services may increase slightly faster than that of goods; there will be important additions to the merchant fleet in 1969 and the devaluation could have a further favourable effect on tourist earnings.

The Finish authorities envisage a strong recovery of business fixed investment in the course of the year. Capacity utilisation rates are increasing, profit margins have improved considerably and prospects for stronger growth of activity are favourable. The financing of fixed investment should not be a problem. The abolition of the export levy will increase the cash flow of export industries and a large amount of export levy funds collected by the Government in 1968 will be used for investment purposes in 1969. In volume, fixed investment in machinery and equipment is expected to be some 20 per cent higher than in 1968, whereas investment in non-residential buildings could increase by around 13 per cent.

House building picked up in the latter part of 1968 and is forecast to increase by more than 10 per cent in 1969, supported by higher government and Central Bank lending and by easier credit conditions in general. Although the expected rise in residential construction may bring the number of completed dwellings up to 40,000, the house-building programme will still fall short of official long-term aims. On the above assumptions total private fixed investment should rise by 16 per cent in 1969. Given the restrictions imposed on budgetary policy by the stabilisation agreement, and given the fact that private investment is likely to recover strongly, the appropriations for central government investment have been reduced, entailing a slight fall in public investment in real terms. All in all, total fixed investment should increase by 12 per cent.

Table VIII Prospects for GDP in 1969

	Mk. mill. 1968	Percentage change in volume from previous year 1968	1969
Private consumption	18 717	0.2	4.0
Public consumption	5 500	4.1	4.4
Gross fixed asset formation	7 641	—4.4	12.0
Private	5 849	—6.0	16.0
Public	1 792	1.1	—1.0
Change in stocks (incl. statistical error)	1 280	3.8[1]	4.1[1]
Domestic demand	33 138	—1.0	6.2
Exports of goods and services	8 360	11.7	9.5
Imports of goods and services	7 777	—3.3	10.5
Gross domestic product	33 721	2.5	6.0

1 Per cent of GDP.
Source: Ministry of Finance.

Public consumption may increase at about the same rate as in 1968, 4 to 4 ½ per cent. Taking account of the fall in public investment, total public demand for goods and services should increase by only 3 per cent (as in the previous year), a stabilising feature in a year when exports and private domestic demand are rising strongly.

The collective agreements in force for 1969 point to a 5 per cent rise in negotiated hourly rates this year. With relatively slack labour market conditions, wage-drift is likely to remain moderate, perhaps of the order of 1 per cent. The paid labour force may increase by some 3 per cent, so that the total wage bill could rise by 9 per cent. Employers' contributions to social security arrangements will increase somewhat more (12 per cent) as a result of the additional benefits agreed to in an appendix to the stabilisation agreement. Non-wage income is likely to rise faster than wages and salaries. The increase in farmers' income may be only 2 per cent, in line with the rise in agricultural prices but income of private forest owners, could rise by some 25 per cent. With the rise in costs moderate, and price controls dampening the extent to which they are passed on, consumer prices may rise by less than 2 per cent in the course of the year, implying a price rise between 1968 and 1969 of 2½ per cent. With the predicted development of nominal incomes and prices and with no major changes in taxation, the real disposable income of households is likely to increase by some 6 per cent. As consumer spending may only respond to the advance in income with some lag, private consumption is expected to increase by 4 per cent in 1969.

The rise in aggregate demand is likely to be accompanied by a sharp recovery of imports. The import content of investment in machinery and equipment is high (about 50 per cent); it may be even higher in 1969 due to some bunching of deliveries of ships and aircraft. Imports of cars are also likely to rise strongly in 1969, following a sharp fall in the previous year owing to price rises resulting both from the devaluation and higher taxation. The authorities expect imports of other consumer goods to rise by 6 per cent—somewhat more than private consumption. Merchandise imports in 1969 are estimated to exceed the 1968 level by 11 per cent in volume. The rise in imports of services should be somewhat slower.

On the above assumptions the authorities expect a 6 per cent increase in real GNP from 1968 to 1969, with particularly strong increases in industry (7 per cent) the building sector (12 per cent) and forestry (10 per cent). Production in agriculture and construction is forecast to remain at the 1968 level, while output in the service sectors is assumed to increase by 5 per cent. Productivity is thought likely to increase by 5 per cent. With employment rising by over 1 per cent and little increase in the labour force, the unemployment ratio could decline to under 3 per cent by the end of 1969.

The forecasts for exports and imports of goods and services point to a current external surplus of the same order as last year, or about $ 70 million. As the capital account of the balance of payments may show a net inflow, a further strengthening of the reserve position seems likely.

The devaluation has so far been a success, and prospects for 1969 would not seem to call for any major change in existing policies. But it is not too early to consider the policy problems likely to arise next year. Continued success in maintaining stability will to a very large extent depend on incomes policy, on which negotiations are now in process. It is greatly to be hoped that the enlightened attitudes and moderation which made possible the restoration of cost and price stability in 1968 will continue to prevail.

The 1968 stabilisation agreement included provisions limiting the flexibility of fiscal and monetary policies. These may well have been appropriate in 1968 and 1969. But it would seem important that, in the future, the authorities should be free to use policy instruments to maintain a rate of growth of demand compatible with the maintenance of stable economic conditions. It seems very probable that some change of emphasis in demand management policy will be needed next year. With unemployment likely to fall towards 2 per cent, pressures on resources may tend to become excessive in the industrialised southern part of the country. The risk of an excessive rise in costs and prices will be reduced if the movement to a higher level of activity and a lower rate of unemployment is not so fast as to entail bottlenecks and shortages of labour.

TECHNICAL NOTES

The OECD *Economic Outlook* draws heavily on the statistical work of the Department of Economics and Statistics. The following notes describe briefly the statistical concepts and methods applied as well as the forecasting techniques used. Special emphasis is given to deviations from national (or other international) practices.

FORECASTING TECHNIQUES

Tables 2, 7, 8, 9, 11 to 14 as well as the tables on demand and output and the balance of payments of seven major countries are based on an internally consistent set of forecasts of national accounting aggregates for the OECD area. Relatively detailed forecasts are prepared for the major seven OECD countries (Canada, France, Germany, Italy, Japan, the United Kingdom and the United States), which account for more than 70 per cent of total OECD trade. For the smaller industrialised countries forecasts are made only of the likely development of GDP and of foreign trade; and for the developing countries the forecasts are confined to foreign trade. While account is taken of forecasts prepared in the countries concerned, both official and unofficial, the forecasts given here are entirely the responsibility of the Economics and Statistics Department. Some of the forecasting methods employed, particularly in the major countries, have been described in an OECD Report: *Techniques of Economic Forecasting*, Paris, 1965.

Forecasts are first prepared for what may be broadly called the exogenous elements of demand: public consumption, gross fixed investment and exports of goods and services. For public consumption and public investment as much use as possible is made of budgetary statements, although their availability and usefulness vary from country to country. With regard to private investment extensive use is made of the intention surveys which are carried out in most of the seven countries. Exports are initially forecast in the light of past trends, but as will be seen below, they are reconsidered as the general forecasts for each country and for all countries together take shape.

The forecast for these exogenous elements of demand, plus any information that may be obtained regarding stock changes, provides a first indication of the likely development of the pressure of demand. In order to get some indication of the possible growth of supplies, use is made of relationships describing the "capacity" rate of growth of the economy. At this stage an appropriation account for the household sector is constructed which takes into account the probable development of incomes as indicated by wage settlements and by the forecast change in the pressure of demand and provides an estimate of personal disposable income. Little is known about the short-term behaviour of the personal saving ratio and hence the forecast underlying consumers' expenditures usually assumes an unchanged ratio unless there are particular reasons to assume otherwise. The forecast for the exogenous elements of demand, together with that for personal disposable income, provides a basis for a first assessment of likely price developments. This in turn is used to forecast the likely development of personal consumption in real terms.

Thus, a first forecast of the change in final expenditure is obtained and on the basis of past cyclical relationships with imports, an estimate is also made of the likely import demand. In this respect a number of relationships have been developed linking import demand with domestic demand which have thrown some light on the cyclical variation in import propensities.

The subsequent stages of the forecasting procedure consist of reiterations, with a view to ensuring the international consistency of foreign trade forecasts of individual countries.

OECD trade forecasts are based on the projected import demand of individual countries, described above. In order to obtain this forecast, it is necessary to transpose the import figure in national accounting terms (goods and services at constant prices) into current trade statistics (customs basis, goods only, at current prices): this involves a good deal of approximation. The figures thus obtained for the seven major countries, together with direct import forecasts for the other OECD countries, provide the aggregate OECD import demand, which is broken down into:

i) demand for OECD exports;

ii) demand for imports from the rest of the world.

The forecast for OECD imports from the rest of the world is taken as the starting point for a forecast of OECD exports to the rest of the world, via an assessment of possible movements in other elements in the rest of the world's balance of payments with the OECD area, the financial position of the primary producing countries, and special factors affecting exports to the Sino Soviet countries.

Exports to the rest of the world, in combination with *i)* above, yield the projected total of OECD exports [1], which is allocated among exporting countries on the basis of the projections shown in Table 12.

These projections distinguish between :

i) Potential exports—defined for each country as the exports which would take place in any given period if the country retained its share in OECD exports to each individual export market[2];

ii) Export performance—defined as a country's gain or loss in market shares. This has been found to be affected both by longer-run factors and by cyclical changes in relative pressures on capacity.

The export forecasts thus obtained are transposed into national accounting terms and incorporated in the forecasts of the seven major countries.

The consistency check imposed by the foreign trade matrix often contributes to the country forecasts themselves, since the inter-dependency of the OECD area is such that developments in one country or in a group of countries are as a rule reflected in developments elsewhere.

All forecasts are prepared on a half-yearly basis. In a number of cases this can be done on the basis of quarterly national accounts compiled in Member countries. In others, the half-yearly national accounts aggregates covering the past periods are prepared by the Secretariat on the basis of the short term economic indicators available and can only be considered as more or less rough estimates.

NATIONAL ACCOUNTS

The figures shown in the country tables on Demand and Output follow, in general, the *OECD Standardized System*[3] definitions which need not be summarized here. There are,

1. Allowing for inconsistent recording of intra-OECD trade, as discussed on pp. 116-117.

2. For the purpose of this calculation, the following markets are distinguished: each major OECD country, other OECD countries aggregated into three groups, the primary-producing countries aggregated into four groups, and the Sino-Soviet area.

3. *OEEC A Standardized system of National Accounts*, Paris, 1958.

however, some important deviations from the *Standardized System*:

(a) *France*

In the French system the main aggregate is the "Gross Domestic Production" which has a more restrictive definition of the border of production. It excludes the services provided by the General Government, financial institutions and domestic servants.

It follows from the French definition that "government consumption" excludes salaries paid to civil servants. On the other hand, expenditure on goods and services of so-called "private administrations", which would come under private consumption in the *Standardized System*, are included with government consumption in the French System.

In 1964 the French definition of stocks was extended to include unfinished as well as new, finished, but unsold dwellings which are excluded from "fixed capital formation" and "residential construction".

Exports include net services plus freight earned on imports, the latter being given c.i.f.

Finally, the activities are recorded on a territorial basis and thus, for instance, expenditure by foreign tourists is treated as part of French personal consumption, whereas in the *Standardized System* it is classified under exports.

The figures shown in this number of the *Economic Outlook* are based on the new series of French national accounts (see *Economic Outlook*, N° 4, pp. 99-101), adjusted to the definitions of the standardised system.

There are no official French quarterly national accounts.

(b) *Germany*

Although the German official national accounts follow the *Standardized System*, the rates of change in constant prices shown in *Economic Outlook* differ significantly from those published officially (e.g. in 1968 the rate of increase of GNP is here shown at 6.7 per cent, against 7.0 per cent in German official publications.) This discrepancy results from the use of a 1954 price base in the official calculations, whereas the OECD figures are estimates expressed in terms of 1967 prices.

Official half-yearly accounts, going back to 1960, have been published by the Federal Statistical Office starting in December 1965; the seasonal adjustment used in *Economic Outlook* is made by the Department of Economics and Statistics.

(c) *Italy*

The definitions used are those of the *Standardized System*. The half-yearly aggregates shown for the past are based on quarterly figures at 1963 prices published for some categories of expenditure and output in *Relazione Generale sulla Situazione Economica del Paese*.

(d) *United Kingdom*

The quarterly national accounts for the United Kingdom are published in *Economic Trends* by the Central Statistical Office and follow the *Standardized System*.

However, since the published expenditure, output and income accounts show somewhat different quarter to quarter movements, in the Demand and Output table on page 82 a "compromise estimate" of GDP and its components, based on the movements of the three official estimates, is used for the past.

(e) *United States*

Government fixed investment expenditures (including those of government enterprises) are included in "public consumption" and no allowance is made for depreciation of government fixed capital. The investment figures therefore refer to the private sector only. Official quarterly national accounts are published in the *Survey of Current Business* of the Office of Business Economics of the U.S. Department of Commerce.

(f) *Canada*

Government expenditure on fixed assets and changes in inventories of government commodity agencies are included in "public consumption" and excluded from "fixed investment" and "changes in stocks" respectively.

The quarterly figures appear regularly in the *Canadian Statistical Review* of the Dominion Bureau of Statistics.

(g) *Japan*

"Public expenditure" includes expenditure by some public enterprises and "Gross fixed investment" includes work in progress on heavy equipment and on ships for the domestic market which are hence excluded from "changes in stocks".

The quarterly national accounts are published in the *Annual Report on National Accounts* and *National Accounts Statistics Quarterly* of the Economic Planning Agency. However, data on constant prices only become avialable after a considerable delay. Hence the half-yearly figures shown for the most recent periods are estimates based on official quarterly figures at current prices.

BALANCE OF PAYMENTS DATA

(a) *Sources*

Annual balance of payments statistics in *Economic Outlook* are derived from OECD countries' annual submissions to the Organisation, on the basis of a reporting system common to OECD and the IMF. The concepts and definitions underlying this system are, with few exceptions, those described in the IMF *Balance of Payments Manual* (third edition, July 1961).

Up-to-date information and figures for periods of less than one year are derived from national sources and adjusted by the Department of Economics and Statistics to internationally comparable definitions. Seasonally adjusted series are taken from national sources for Canada, Italy, the United Kingdom, the United States and, for some data, Japan and estimated by the Department of Economics and Statistics for other countries.

(b) *Presentation*

For analytical purposes, the *Economic Outlook* makes use of a uniform presentation of the balance of payments data of all OECD countries. The analytical groupings adopted are the following:

A) *Trade Balance*. This is defined as merchandise exports less imports f.o.b. frontier. It is recorded on a transactions basis, i.e. derived from customs records of merchandise trade, with valuation and coverage adjustments required:

i) to put the figures onto an f.o.b. frontier basis,

ii) to ensure that the data reflect as closely as possible the net transfer of ownership of goods to and from abroad by the residents of a country.

B) *Current Balance*. This is the sum of the trade balance, net services and private and official transfers.

C) *Balance on non-monetary transactions*. This covers all current and long-term capital transactions, as well as the short-term capital transactions of the non-monetary sector of the economy (including the balance of unrecorded transactions). It excludes, however, official transactions undertaken for specific balance of payments reasons: such " special transactions " relate, in particular, to the anticipation or postponement of public debt servicing, and changes in official long-term assets and liabilities, such as the extension of special credits to international lending institutions.

D) *Balance on official settlements*. This is the sum of the balance on non-monetary transactions and the net change in the external short-term position of commercial banks. It is financed by:

i) changes in official gold and currency assets;

ii) changes in the net IMF position;

iii) changes in official liabilities to foreign official monetary institutions, and in official short-term assets other than gold and currency;

iv) special transactions, as described above.

(c) *Relation to national concepts*

In a number of cases, the uniform concepts and definitions used by the Department of Economics and Statistics to ensure inter-country comparability differ from those most commonly found in national presentations of balance of payments statistics. The main deviations are listed below:

A) *Trade Balance*. While the trade balance concept appears in all national publications, its definition may differ from that adopted in *Economic Outlook*.

i) In Canada, the trade balance as usually defined excludes inland freight on both imports and exports, and gold production available for export.

ii) In France, trade as well as other components of the balance of payments are recorded on a settlements basis, i.e. based on foreign exchange rather than customs statistics. The same applies to Italy, although data on a transactions basis are also given in national publications.

iii) In Germany, the trade balance concept which appears most frequently in public discussion includes all freight on imports and excludes the coverage adjustments of customs data to a balance of payments basis.

B) *Current Balance*. Aggregates corresponding to the current balance concept appear in all national presentations, under various denominations. They are identical with the data appearing in *Economic Outlook* subject to the remarks made above about France and Italy.

C) *Overall Balance*. Most national presentations emphasize some form of overall balance which either takes the form of a balance of monetary movements (akin to the balance on non-monetary transactions) or a balance on official reserve transactions (akin to the balance on official settlements). The concepts used in major OECD countries are related to those shown in *Economic Outlook* as follows:

i) The overall balance as defined under various denominations in France, Italy, Japan and the United Kingdom, corresponds fairly closely to the balance on « non-monetary transactions », except insofar as special transactions are generally not shown below the line. Furthermore, the United Kingdom « balance of monetary movements " treats the recorded short-term capital transactions of the non-monetary sector of the economy as a financing item below the line.

ii) The United States " balance on liquidity basis " corresponds to a balance on non-monetary transactions *with the short-term claims of the banking sector moved above the line* (and without adjustment for special transactions). In addition, United States data have been adjusted by the Department of Economics and Statistics to include as financing items below the line certain obligations of the United States Government to foreign central banks in the form of special Treasury bonds, and purchases of U.S. Government Agency bonds by international institutions, as well as foreign holdings of certificates of deposit in United States commercial banks, which are included above the line in the calculation of the " liquidity balance ". In view of the complexity of these adjustments, a detailed reconciliation is shown in the table below.

iii) The overall balance as defined in Canada and Germany, and also the " balance on official reserve transactions " which appears in United States publications, approximate the concept of the " balance on official settlements ", except insofar as special transactions are included above the line. In addition, the figures appearing in German publications exclude changes in foreign holdings of German Treasury bills, as well as the greater part of the changes in Germany's net IMF position, both of which are treated as financing items in *Economic Outlook*.

(d) *Inconsistencies in balance of payments recording*

A uniform accounting framework does not by itself ensure consistent recording of each transaction by the two participating

UNITED STATES

Reconciliation between OECD " balance on non-monetary transactions " and U.S. " balance on liquidity basis "

	Balance on non-monetary transactions (OECD basis)	Source[a]
Less:	Liquification of U.K. government dollar security portfolio	Secretariat estimates
Plus:	Debt prepayments received	*SCB* Table 1, line 45, plus *SCB* Table 5, line C.2
	Long-term bank liabilities	*SCB* Table 1, line 53
	Short-term banking claims	*SCB* Table 1, line 38
	Non-convertible, non-marketable U.S. Treasury securities not associated with specific transactions	*SCB* Table 5, line C.3
	Special Treasury securities issued to foreign official agencies in connection with military contracts	*Federal Reserve Bulletin*, International statistics, Table 11
	Non guaranteed U.S. Government agency bonds held by international institutions	*SCB* Text Table A2
Equals:	Balance on liquidity basis	*SCB* Table 3, line 1

a. SCB refers to the US Department of Commerce *Survey of Current Business*, June, 1969 (Article on Balance of Payments).

countries. In fact, transactions of the same type among OECD countries do not sum to zero as theoretically they should. The sum of any particular balance for all OECD countries should therefore not be taken to be the balance of the OECD area with the rest of the world, and developments in this type of aggregate should be interpreted with due regard to the possibility that the net effect of inconsistent recording may vary over time.

The analysis done to date points to the following main sources of inconsistency in OECD countries balance of payments recording:

i) On current account, inconsistencies arise in connection with the classification, coverage and valuation of transactions. In particular, the border-line between merchandise and service transactions tends to be blurred in the case of government purchases, while the distinction between services and transfers may be interpreted differently by the two partner countries in the case of workers' remittances; a cross-classification problem also arises from official indemnification payments to private recipients. Discrepancies occur in the estimation of freight on imports (which tends to exceed the corresponding receipts) and in the recording of foreign travel (where receipts tend to exceed payments). Further discrepancies result from the inclusion in some countries' data of re-invested earnings of foreign subsidiaries, which are not covered in most countries' statistics. Some, but by no means all these inconsistencies cancel out at the current balance level.

ii) On capital account, asymmetries result in the first place from the inconsistent recording of current transactions (the net effect of which produces an offsetting entry under unrecorded transactions). Further asymmetries result from the principle of allocating changes in assets and liabilities according to the domestic sector involved, which implies that international transactions between two different sectors (e.g. banks on one side and non-banks on the other) will be reported under different headings by the two partner countries.

iii) On official settlements account, the sum of all OECD countries' balances will not reflect the change in the area's net official position vis-à-vis the rest of the world, due to:

a) changes in total official gold holdings resulting from the incorporation of newly mined gold or sales to private users;

b) the inclusion in official reserve assets of claims on commercial banks (either in the form of non-reserve currencies or of Euro-dollars) the counterpart of which is not reported as a liability to monetary authorities.

PRICE AND COST DEVELOPMENTS

The data in Tables 4-6 are based, as far as possible, on country submissions to OECD. Other sources used are OECD *Main Economic Indicators*, United Nations *Monthly Bulletin of Statistics* and national statistics especially for 1968. In Table 4 figures concerning the current year are Secretariat estimates.

The inter-country comparability of the data is rather limited because of differences in methods of compilation which in turn are influenced, inter alia, by the availability of data. Thus true measures of export prices or export quotations are rare and the percentage of merchandise exports covered by the unit value index is rather small and varies from country to country. There are also differences in methods of compilation ; certain countries use current weights in calculating export unit values, others have fixed weights or combined current and constant weights. Further, there are wide differences with regard to reference years.

Unit labour costs in insutry include construction. Here too, the diversity of sources and in certain cases the limited availability of data call for caution with regard to inter-country comparisons.

MONETARY DEVELOPMENTS

The notes on the individual countries contain a certain number of graphs illustrating monetary phenomena. The data chosen are intended to give an indication of developments in the field of interest rates, liquidity and institutional lending and security issues. To the extent that the institutional differences between countries and the very uneven quality and availability of data permits, an effort has been made to prepare the statistics in such a way as to facilitate international comparison.

The interest rates shown are mainly representative of yields to lenders rather than cost to borrowers. They give an indication of the movement, of the level and of the time structure of interest rates in a given country, but the international comparability of absolute levels is difficult because of differences in fiscal treatment, statistical coverage, etc.

The sections on *liquidity* consist of graphs of commercial bank liquidity. Commercial bank liquidity is shown as the ratio of certain assets to deposits. For some countries the ratio of borrowing from the central bank to deposits is also shown.

The graphs of *borrowing and lending* are based, whenever possible, on flow of funds statistics. They show selective types of borrowing, such as bank lending, lending by non-bank financial intermediaries and security issues.

Data have been derived from national sources ; in afew instances series have been seasonally adjusted by the Secretariat's Department of Economics and Statistics.

Discontinuities in the graphs on *Germany* reflect breaks in the basic series published by the Bundesbank (the German authorities have recently completed a revision of their banking statistics ; see in particular, *Monthly Report of the Deutsche Bundesbank*, April, 1969).

INTERNATIONAL CAPITAL MOVEMENTS

Table 22, " International bond issues outside the U.S. market ", is designed to give comprehensive information on new foreign bond issues placed outside the U.S. on both national security markets of the OECD area and the Euro-bond market. Foreign issues are considered to be floated on a national security market if they are handled by a national banking consortium and if they are denominated in the currency of the lending country. Euro-bonds are essentially defined as bond issues (with maturities of five years and more) handled by international banking consortia and simultaneously offered in more than one national market.

Sources : For 1967 and 1968 data are taken drom the Bank for International Settlements' Annual Report. Data for the first five months of 1969 are estimates, based on listings of single issues compiled by the Secretariat. Information on new issues is obtained from the financial press, commercial banks, the Fédération Bancaire de la Communauté Economique Européenne, " World Financial Markets " published by the Morgan Guaranty Trust Company, published and unpublished records of central banks and issue prospectuses.

USE OF CURRENT NATIONAL STATISTICS

Unless otherwise stated, all the national statistics quoted in the *Economic Outlook* are taken from the *Main Economic Indicators* published monthly by the OECD (MEI). Starting in September 1967, supplements to MEI have been published describing in detail the sources and methods of these statistics. The following notes are therefore confined to some methodological points of special importance for the understanding of the text.

Merchandise trade

Except where otherwise indicated, merchandise import and export data are taken from OECD foreign trade statistics as published in MEI and the OECD Foreign Trade Bulletins[1]. Except for Canada, whose trade is recorded f.o.b. place of shipment, exports are recorded f.o.b. frontier and imports c.i.f. frontier. For the United Kingdom and Ireland, the export series used include re-exports. United States trade figures are taken from national publications; both import and export data are f.o.b. frontier and relate to general trade; exports exclude Department of Defence shipments.

Seasonal adjustments are made by the Department of Economics and Statistics except for Canada, the United Kingdom and the United States[2], where national estimates are used.

Data for total OECD trade by areas differ from the aggregates published in MEI on account of:

i) revisions of back data to adjust for significant changes in coverage, such as the inclusion of trade in pearls and precious stones in United Kingdom statistics from 1964 onwards, and changes in the definition of United States " Special Category " exports, which are not allocated regionally;

ii) adjustments for inconsistent recording of intra-OECD trade from the import and export sides respectively, arising from differences in timing, coverage and evaluation, and inconsistencies in the seasonal adjustment of individual series. These adjustments could only be applied to major aggregates of OECD trade; where relevant, they are signalled by a footnote.

Unemployment Statistics

The figures are taken from the OECD Main Economic Indicators, which generally reproduces the most usually quoted national series, the figures being seasonally adjusted by the OECD Secretariat[3]. These series however, vary considerably from one country to another insofar as methods of collection, coverage and definition are concerned.

The Italian unemployment figures are based on national *sample surveys*, carried out in the first months of each quarter. The figures for Germany, Netherlands, Norway, Sweden and the United Kingdom relate to *registered unemployed*. (In Sweden there is also a quarterly sample survey on employment and unemployment which usually shows a higher unemployment figure). For the United Kingdom, it should be noted that the figures relate to the whole country and include school-leavers and the temporarily stopped, in contrast to the commonly quoted figures relating to wholly unemployed in Great Britain only, seasonally adjusted by the U.K. Ministry of Labour. There is usually a difference of about one-fifth between the two figures. The figures for Austria, France and Ireland relate to *registered job applicants*. These figures depend very much on the proportion of unemployed who usually register. In France this proportion is estimated to be slightly more than one-half of the total number of unemployed according to the census definitions. The figures for France exclude throughout repatriates from Algeria who inflated registered unemployment in 1962-63, but count for only a few thousand in the most recent period. In Belgium and Denmark the figures relate to *insured unemployment* and do not include unemployed not entitled to unemployment benefits (a similar series is also available for France but it covers onlys a fraction of total employment).

In a number of countries, including Germany and France, sample surveys of employment are carried out at yearly or more infrequent intervals and their results are of some use for the correction and interpretation of the monthly unemployment figures.

Price indices (Country Charts)

The coverage and methods of calculation of the *consumer price indices* vary a great deal from country to country. In some countries the weights used to calculate the index are revised fairly frequently on the basis of family expenditure surveys using large samples; and in such cases the index generally moves quite closely in line with the price deflator for private consumption. In some countries, however, the weighting system relates only to low income groups and or is seriously out of date; and in such cases the weight given to food is generally high, and that given to services low, compared with the pattern of expenditure for private consumption as a whole. Coverage varies considerably and also the degree to which seasonal price changes are eliminated.[4]

The lack of uniformity is even more marked when it comes to *wholesale price indices*. The components of this index are based on *net sector flows* in the United Kingdom, on commodity groupings by *degree of processing* in Canada, U.S.A., France and Italy and on commodity groupings by *end-use* in Japan. Differences in coverage are particularly important with regard to the degree to which the index covers finished goods in addition to raw materials and semi-finished products. The number of items included varies from a few hundred to several thousand.

Wages (Country Charts)

The wage indices are also not comparable from country to country, not only because of the wide variety of sources and methods of calculations, but also because of important differences in definitions (e.g. hourly rates, hourly earnings, monthly earnings, inclusion or exclusion of fringe benefits, etc.). Apparently, seasonal movements are important in some countries because of the tendency for wage settlements to bunch at the same period of the year.

Index of industrial production (Table 1, country tables and charts)

The figures shown include, as far as possible, mining, manufacturing and public utilities, but exclude construction. The exact coverage, the weighting system and the methods of calculation vary from country to country but the divergencies are somewhat less market than in the case of the price and wage indices. With the exception of Austria and Germany, the indices are seasonally adjusted by national statistical offices, using different methods, derived from the U.S. Bureau of the Census Method II. The new Italian index, introduced in January 1966, has not yet been seasonally adjusted by the Italian Statistical Office: the adjusted figures are therefore rough OECD estimates.[5]

1. The OECD publishes three sets of Foreign trade bulletins. *Series A*—overall trade by countries; *Serie B*—trade by commodities, analysis by main trading areas; and *Series C*—trade by commodities, detailed analysis in the form of trade matrices.

2. For the United States, data seasonally adjusted by the Department of Economics and Statistics on the basis of the OECD definition of trade are also published in MEI. In the *Economic Outlook* these are used in calculating OECD aggregates.

3. More detailed Labour force statistics on an annual basis, can be found in *Labour Force Statistics* 1956-66, OECD, Paris, 1968.

4. A supplement included in *Main Economic Indicators* every three months shows recent consumer price developments in eight selected countries, analysed in terms of four standard sub-indices: food; all goods less food; rent; and all services less rent.

5. *Industrial Production*, a quarterly supplement to *Main Economic Indicators*, contains an internationally comparable selection of industrial output indices for individual industrial sectors.

Seasonal Adjustment

As noted above, some of the series used have been seasonally adjusted by the Department of Economics and Statistics, notably in the area of foreign trade but also in some cases for industrial production, unemployment, and retail sales. The method used is an OECD variant of U.S. Bureau of the Census Method II known as X-10 and programmed for processing by electronic computer. (Further details can be obtained from the OECD Statistics Division). Where unadjusted series published by countries do not take into account the effects of unequal length of month and the incidence of public holidays, a prior calendar adjustment is carried out to eliminate possible distortions in the final seasonally adjusted series. Prior adjustments are also made where major irregularities such as strikes might interfere with the determination of seasonal factors.

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