CHAPTER 7

The International Economy in 1974

IN 1974, THE WORLD ECONOMY experienced severe setbacks. Inflation in most major industrial countries reached the highest level in more than 20 years. The rate of real economic growth declined. Sharp price increases in energy, food, and other basic materials distorted price relationships and created new and large payments imbalances, affecting nearly all countries. Massive international capital movements of unusual complexity were required to continue the financing of world trade, which in terms of dollars rose by about 50 percent from mid-1973 to mid-1974.

Specifically, consumer prices in the industrial countries comprising the Organization for Economic Cooperation and Development (OECD) rose by almost 14 percent on the average from 1973 to 1974. This rate of advance was nearly double the average rise of 7½ percent from 1972 to 1973, and nearly four times as high as the annual rate of increase of 3½ percent during the period 1959–72.

Economic growth came to a virtual standstill as the growth of real GNP in the OECD countries, which had averaged about 5.4 percent per annum from 1959 to 1972, fell nearly to zero in 1974. Efforts to check the acceleration of inflation coincided with ongoing cyclical downturns in many countries, and the high costs and reduced availability of energy reinforced the adverse development of both prices and output.

In international trade, the sharp rise in the prices of crude oil implemented in October 1973 and January 1974 by the countries belonging to the Organization of Petroleum Exporting Countries (OPEC) created massive deficits in the current account balances of the oil-importing countries. This placed strains on the world's financial markets and raised the prospect for the long term of a large transfer of real resources or of ownership of nonfinancial assets from the oil-importing to the oil-exporting countries. Nonindustrial countries, particularly in Asia and Africa, were in many cases seriously afflicted by food shortages and the slowdown in world economic activity.

The international financial and economic system displayed a notable resilience in adjusting to some of these disturbances. Broadly speaking, countries have refrained from beggar-my-neighbor policies through which they might have tried to shift some of their domestic and international problems to other countries at the cost of a shrinkage in world trade and a loss in economic welfare. In the financial sphere, the world capital markets ab-

sorbed and recycled massive amounts of petro-dollars and provided most of the financing of international payments deficits and surpluses, with some assistance from official lending operations conducted either by the International Monetary Fund (IMF) or between governments. The existing system of floating exchange rates helped countries avoid massive movements of speculative funds.

The international monetary system was thus able to cope with differing rates of domestic inflation, the increased costs of energy and other basic goods, and the heavy capital movements associated with the accumulation of large amounts of liquid assets by OPEC countries.

STAGNATION AND INFLATION IN THE INDUSTRIAL WORLD IN 1974

The stage for "stagflation" during 1974 was largely set in 1970–71. Beginning in late 1969, a slowdown in economic activity occurred in industrial countries that, while relatively mild, was more widespread than any downturn in the postwar period. The stimulative measures which a majority of countries adopted almost in unison in 1971 and maintained well into 1972 resulted in a strong upswing in economic activity in 1972–73 throughout the industrial world.

The expansion in demand added to the inflationary tendencies; the rise in consumer prices in the seven largest OECD countries, that had been 4 percent from 1971 to 1972, was 7½ percent from 1972 to 1973. Moreover, the coincident upswing in business activity led to a sharp increase in demand for industrial commodities and strained the capacity of producers to supply that demand. The index of spot prices of world industrial materials (excluding fuel) rose by 80 percent between 1971 and 1973. Poor harvests in the Soviet Union and other parts of the world added to the emerging price pressures on food. World food prices almost doubled as the world commodity index for food (1970=100) gradually rose from 95 in 1971 to 173 in 1973.

The policy makers in most major industrial countries were confronted early in 1974 with the difficult task of dealing simultaneously with high inflation and slackening economic growth. Superimposed on these problems were domestic and international dislocations created by the sharp rise in the prices of crude oil. Deep concern about inflation prompted fairly restrictive fiscal and monetary policies to be maintained in most countries throughout the first half of the year.

The resulting pattern of economic change has been remarkably uniform in the major industrial countries during 1974. Table 45 highlights some measures of the economic performance of these countries. The growth of private consumption expenditures that had been the dynamic factor in the economic expansion in virtually all major countries during 1973 slowed down sharply in 1974.

TABLE 45.—*Changes in real gross national product and major components for selected industrial countries, 1962 to 1974*

[Seasonally adjusted annual rate]

Country and component	Percent change				
	1962 to 1971 average	From preceding year		From preceding half year	
		1972	1973	1974	
				1st half	2d half [1]
France:					
Real GDP [2]	5.7	5.5	6.0	4.5	4.2
Private consumption	5.5	5.8	6.0	4.6	3.5
Government current expenditures	3.3	4.0	3.4	2.6	2.5
Gross fixed capital formation	8.2	7.6	6.5	5.6	5.0
Germany:					
Real GNP	4.7	3.5	5.3	2.0	.0
Private consumption	4.9	4.2	2.9	1.0	2.2
Government current expenditures	4.4	4.1	3.8	3.0	1.5
Gross fixed capital formation	5.3	2.7	1.1	—5.3	—8.5
Italy:					
Real GNP	5.0	3.1	6.0	4.9	.0
Private consumption	5.6	3.3	6.2	4.0	—1.0
Government current expenditures	3.9	4.6	3.3	3.6	.0
Gross fixed capital formation	3.7	.4	9.0	4.7	—2.2
United Kingdom:					
Real GDP [2]	2.6	3.1	5.3	—3.4	5.0
Private consumption	2.3	6.0	4.6	—2.0	4.5
Government current expenditures	2.1	4.0	3.7	—.4	—.5
Gross fixed capital formation	4.0	2.4	4.8	—5.7	—7.5
Japan:					
Real GNP	10.3	8.9	10.2	—9.3	3.0
Private consumption	8.9	9.1	8.6	—6.6	5.5
Government current expenditures	6.7	9.6	6.9	—1.2	7.0
Gross fixed capital formation	13.0	9.5	15.2	—28.2	3.2
Canada:					
Real GNP	5.5	5.8	6.8	5.6	2.5
Private consumption	4.9	6.9	8.0	6.6	3.0
Government current expenditures	5.8	4.0	4.1	8.6	5.0
Gross fixed capital formation	5.8	5.3	10.4	8.4	.0

[1] Estimate.
[2] Gross domestic product.

Source: Organization for Economic Cooperation and Development.

With few exceptions, the tight monetary policies of early 1974 caused severe declines in residential construction in virtually all countries. Industrial investment in machinery and equipment, which had risen vigorously during 1973, dropped off sharply in response to much higher long-term interest rates and the deterioration of the business outlook.

The softening in economic activity was accompanied by rising unemployment; the 1974 unemployment rate exceeded the average of the past decade in most major industrial countries. Recent changes in unemployment in several OECD countries are summarized in Chapter 3.

In late 1974 the demand management policies in a number of countries began to move cautiously toward greater ease; but inflation continued to be of major concern to the policy makers. Assessing these policies, the OECD

583-280 O - 75 - 13

in its *Economic Outlook* of December 1974 has projected a moderate upturn in economic growth and some easing of inflationary pressures in all major countries by the second half of 1975.

INTERNATIONAL REPERCUSSIONS OF THE OIL PRICE INCREASES

The oil embargo and the subsequent fivefold increase in the Persian Gulf price of crude over September 1973 levels imparted the most severe shocks to the world economy since World War II. The broad economic implications of these developments for production, consumption, and economic growth in the United States are discussed in Chapter 2. For other industrial and developing countries of the world the implications were qualitatively similar, but the force of the impact varied in proportion to the dependence of individual countries on imported oil as a source of energy.

In analyzing the effects of the increase in the price of oil on the world economy, one can single out four broad areas: income and output, prices, the current account, and the capital account.

Income and Output Effects

Given the relatively low short-run price elasticity of demand for oil, the economic consequence of the oil price rise was a diversion of consumption expenditures in the oil-importing countries from domestically produced goods to imported petroleum products. To the extent that prices of other consumer goods did not decline, the immediate result of such a diversion was a reduction in the real income of consumers in the oil-importing countries. When the purchasing power created in the production of domestic goods and services is transferred to the oil-exporting nations, and these nations do not increase their imports correspondingly, aggregate demand would tend to decline in the short run unless the reduction is offset by domestic policy action.

The gross transfer of purchasing power realized through export receipts of the OPEC countries in 1974 has been estimated at nearly $100 billion, all but about $5 billion of which were received in payments for exports of oil. This represented a more than threefold increase in revenues over 1973.

The increased exports to OPEC countries could offset only a small part of the reduction in aggregate demand stemming from the increase in the oil bill borne by the oil-importing countries. All estimates of non-oil transactions by the OPEC countries are subject to a great deal of uncertainty. It appears, however, that OPEC imports of goods and services increased by about $15 billion in 1974 to about $35 billion—approximately a third of the OPEC revenues. After subtracting grants to developing countries and adding income on their investments, the OPEC countries were left with roughly $60 billion as current account surplus in 1974.

The nature and direction of investment of the surplus funds by the OPEC countries in 1974 are discussed below. As far as the immediate impact of

the oil price increase on income and output in the oil-consuming world is concerned, the surplus may be viewed as increased "saving" that resulted from the shift of world income from economic units with a relatively high average propensity to consume (consumers in the oil-importing countries) to economic units with an extremely high average propensity to save (oil exporters). The OPEC savings were made available to the oil-importing countries through the reflow of funds. To the extent that such funds were channeled toward financing current consumption or real investment in individual oil-importing countries, the reflow of financial capital into the credit markets of those countries has cushioned the demand-dampening effect of the higher bill for oil imports. How far the slack in demand created by the oil price rise was offset either by the return flow of OPEC funds or by the internal demand management policies of individual countries cannot be precisely determined. Domestic policies to dampen inflationary pressures, and the depressed state of the economies in many of the oil-importing countries provided little incentive for using the inflow of the OPEC funds to increase real investment or consumption.

In addition to the demand-dampening effects of the increase in "saving," the high price of energy reduced demand for goods that use energy intensively. This shift created structural unemployment of resources, since many factors of production are highly specialized in the short run and yield low productivity in other uses. The demand for autos, for instance, fell sharply in virtually all major countries, causing widespread unemployment in the world auto industry.

In the longer run, as the OPEC countries develop the capacity to increase their imports of goods and services, further structural changes will have to take place in the economies of the oil-importing nations: resources must be shifted to increase the production of goods and services for export. Thus, the real income of consumers in the oil-importing countries will be reduced as more domestically produced goods and services are exchanged for imports from the OPEC countries. Unlike the reduction in real income experienced in the short run, this reduction cannot be offset by domestic monetary or fiscal policies, since it represents the "real" payment for oil.

Price Effect

In general, a direct link between the increase of a specific price and that of the general price level exists only in the short run. For practical purposes the duration of the "short run" depends on the monetary and fiscal restraint accompanying the price rise. It is therefore difficult to quantify precisely the contribution that the rise in the oil price made to the inflation in the oil-importing countries during 1974.

The short-run effects of increased oil prices on the general price level in different countries occurred through several channels. The most obvious one was the direct impact arising from the higher prices that consumers in individual countries must pay for petroleum products like gasoline and heating oil. This effect is directly evident in the consumer price index (CPI)

of individual countries, depending on the weight these commodities are given in the market basket.

An indirect impact also occurs as increases in the prices of other goods and services follow from the rise in the price of petroleum products used in production. The strength of this indirect effect depends on the extent to which oil price increases are passed through to the prices of final products, absorbed by the producers, or amplified under a system of markup pricing. Finally, the higher prices of oil heighten the demand for substitute sources of energy, driving up their price and raising production costs. How long the effect on the general price level lasts and how output develops under such strains depend on the way in which demand management policies react to the dilemma, as discussed in Chapter 4.

While it would be hard to establish the total effect of these influences on price behavior, the direct effect of price increases for gasoline alone leaves no doubt that the oil price increase contributed significantly to the price pressures in the world economy during 1974. For example, the increase in the price of gasoline from October 1973 to August 1974 added between 1 and 2 percentage points to the rise of the consumer price index in Great Britain, Italy, and the United States.

Current Account Effect

The increase in the price of oil by the OPEC countries led to a large deficit in the current account of the oil-importing countries, and a matching surplus in the current account of the oil-exporting nations. Table 46 highlights the change that occurred between 1973 and 1974.

The magnitude of the imbalance has been and will continue to be the result of interaction among the following factors: the quantity of oil imported by the oil-consuming nations; the price of oil set by the OPEC cartel; the value of their imports of goods and services from the rest of the world; the flow of earnings on the financial assets of the OPEC countries; and the grants and aid donations they choose to make to the developing countries of the world.

TABLE 46.—*Balance on current account of major areas, 1973–74*

[Billions of dollars]

Area	1973	1974 [1]	Change, 1973 to 1974 [1]
OPEC countries [2]	5.0	60.0	55.0
Industrial countries [3]	2.5	−37.5	−40.0
Rest of world	−7.5	−22.5	−15.0

[1] Preliminary.
[2] Organization of Petroleum Exporting Countries.
[3] The 24 countries of OECD.

Sources: Department of the Treasury and Organization for Economic Cooperation and Development (OECD).

The ability of the oil-consuming nations to lower their oil imports in response to the higher price has been limited. Oil represents an important source of energy for industrial countries and for many developing nations. The growth in world oil consumption came to a halt during 1974; a substantial reduction, however, must await implementation of further measures and development of alternative sources of energy.

The power to raise prices has been derived from the strong monopolistic position of the OPEC countries. An individual country cannot increase the price of a homogeneous commodity without facing sharply reduced exports and lower revenues, if there are alternative sources of supply. If a number of exporting countries act jointly to drive up the price, however, and the supply forthcoming from the remaining exporting countries cannot readily be increased, output restrictions can indeed be effective. With respect to the OPEC, this has clearly been the case so far, although the growing responsiveness of non-OPEC output and total import demand to the higher prices set by the OPEC should make maintenance of these relative prices more difficult over time.

The highly unequal distribution of income characteristic of the OPEC countries and the confinement of income gains from trade to narrow segments of the population precluded significant increases in demand for many imported products in the short run. For other countries in the OPEC group, the long lead time required in developing major projects was the main constraint limiting their ability to increase imports by the full amount of the increase in revenues. Most OPEC countries, particularly those with relatively small populations like Saudi Arabia and Kuwait, have been spending only a fraction of their additional oil revenues on imports of goods and services, because their ability to absorb additional imports has so far been limited. Thus it may be several years before the OPEC countries develop the capacity to increase imports of goods and services substantially.

Finally, while actual grants and commitments for future donations by the OPEC countries have risen sharply, current and prospective grants still represent only a small portion of their total revenue derived from oil. Furthermore, the flow of investment income from the financial and real assets acquired by the OPEC countries has been growing rapidly.

Given these factors, the elimination of the deficit poses special problems. Some of these can be identified conceptually by contrasting the increase in the price of oil with a hypothetical revaluation of the OPEC currencies. Analytically the oil price increases may be viewed as if they had been produced by an export tax. For the importing countries, the administrative increase in the price of foreign oil caused current account deficits that were larger than those that would have materialized if, instead of imposing an "export tax," the OPEC countries had chosen to revalue their currencies to achieve the same increase in the price of oil to importers. Given the low price responsiveness of demand by oil importers, even a revaluation might have the abnormal effect of raising the OPEC surplus if the import

demand of the OPEC countries is also quite unresponsive to any change in the domestic price of their imports. Conceptually, a revaluation is equivalent to a tax on all exports plus a subsidy of all imports. Compared to this, the OPEC countries chose to tax only the oil exports and not to subsidize imports, thus assuring that increased revenue from oil exports would not be accompanied by revenue losses from other exports and increased spending on imports due to lower prices.

Under present circumstances a current account deficit of the oil-consuming nations as a group vis-a-vis the oil-exporting nations must be accepted. Efforts by one of the oil-consuming nations to reduce the deficit, either by currency depreciation or by special measures designed to boost exports or reduce imports from other oil-importing countries, would inevitably mean an increase in the current deficits of others, leaving the total deficit of the oil-consuming nations largely unchanged. For the time being, oil-induced current account deficits must therefore be financed by drawing on reserves, by selling equities, or by accumulating international indebtedness.

To supplement the capacity of the world's money and capital markets to finance the deficits experienced by individual countries, special financial arrangements have been put into effect and are being developed further. Also, in May 1974 the OECD nations pledged not to take unilateral measures which would tend to shift deficits to other nations. Specifically, the governments of 24 member countries agreed, for one year, to avoid introducing restrictive measures affecting trade or other current account flows. The pledge will very likely be renewed in May 1975. In the United States, passage of the Trade Reform Act by Congress at the end of 1974 signified that pressures to restrict trade, which have been intensified by the oil crisis, will be resisted. Moreover, the act assures that the long-delayed multilateral trade negotiations can get under way. The purpose of these negotiations is to improve access to international markets for both buyers and sellers by reducing restrictions on imports and by limiting any restrictions on exports that prevent foreign buyers from competing with domestic buyers for certain basic materials, food, and feedstuffs on an equal footing.

The Capital Account Effect

The current account surplus experienced by the OPEC countries in 1974 was matched by the accumulation of financial claims on the oil-consuming world. This, of course, follows as a balance of payments accounting identity: funds received in payment for goods and services or as aid, and not spent on goods and services or given away as aid, must simply end up as financial claims or real assets of various forms in the hands of countries in the surplus area. What was true as an accounting identity for the oil-importing world as a whole, however, was not true for individual countries: there is no *a priori* reason why the oil-related current account deficit of an individual country should be matched by an inflow of funds directly from the oil-exporting countries. As expected, given a choice of where and how to invest their surplus funds, the oil-exporting countries have turned to those national mar-

kets that best meet their objectives with respect to security, return, and maturity.

Preliminary estimates for 1974 indicate that about $11 billion of the $60-billion surplus accruing to the OPEC countries has been invested directly in the United States. This was less than the increase in the U.S. bill for oil imports from the OPEC countries. Roughly half of this investment in the United States was in short- or long-term marketable Government and agency securities. Less than a billion was placed in U.S. real estate and private securities, and the remainder in banking and money market liquid assets, such as large negotiable certificates of deposit.

About $7½ billion of the OPEC surplus was invested in the United Kingdom in pound sterling assets such as bank deposits, other money market instruments, and government securities. About $5½ billion was lent by the OPEC countries to official and quasi-official institutions in other industrial countries, around $2½ billion to the developing countries, and about $3½ billion to international financial institutions. At least $21 billion of the OPEC surplus was held as Eurocurrency deposits in banks in London and in other financial centers around the world. (The functioning of the Eurocurrency and Eurodollar markets is discussed in the supplement to this chapter.) The remainder, about $9 billion, includes investment in European investment management accounts, in real estate and corporate securities in Europe and Japan, and in direct loans to private industry.

The financial intermediation by the world's commercial banks through both domestic and Eurocurrency markets has played an important role in financing the large current account deficits in the oil-importing countries during 1974. Such activity, in effect, accommodated the preferences of the OPEC countries for investment of their surplus funds, then redistributed these funds to countries where funds were needed. Banks operating in the Eurocurrency market publicly announced more than $15 billion of Eurocurrency credits to developed countries during the first 3 quarters of 1974, $4 billion more than was announced during all of 1973. Announced credits to developing countries were about $7½ billion. Some of these credits were not actually drawn during the period; but it is assumed that sizable loans for which details are not available have been made by the Eurocurrency banks without prior, publicly announced commitments. International lending by U.S. banks also rose sharply in 1974, following the removal of restrictions on such activity and termination of the Interest Equalization Tax in January 1974. U.S. banks increased their claims on foreigners by about $14.5 billion during the first 3 quarters of the year.

The recycling of OPEC funds by the international banking system has not, however, been accomplished without some strains. The concentration of liquid OPEC investments in a relatively small number of banks has raised questions about the absorptive capacity of some of these institutions under their present capital structures. Because the deposits by OPEC governments

in some banks are so large, and because they are concentrated among few depositors, the risk associated with the traditional banking practice of borrowing short and lending long is significantly increased. At the same time, the growing indebtedness of some borrowers increases the risk of default. Thus, questions have also been raised about the ability of the private banking system to continue to accommodate adequately the financial needs created by the oil crisis.

To supplement private market channels a special lending facility was established in June 1974 in the International Monetary Fund and expanded in January 1975. Loans are approved by the Fund after assessment of the balance of payments needs of deficit countries. Borrowers are expected to cooperate with the Fund in resolving difficulties in their balance of payments. The Fund had lent approximately $2 billion by the end of 1974.

The pattern of international payments for 1975 is not easy to foresee. It is widely recognized, however, that additional reinforcement of the private financial markets may be required to provide for the financing needs of individual countries. The United States accordingly has advocated a three-track approach to official multilateral arrangements:

1. Financing under the regular procedures of the International Monetary Fund should be expanded, and the Fund should make fuller and more effective use of the currency resources which it now possesses.
2. A temporary trust fund should be established to provide longer-term, concessional assistance to a few of the very low-income countries which have special problems in adjusting to the current situation. The United States has proposed that this trust fund be financed by contributions from those individual countries which are in a position to help, as well as through the use of part of the IMF's gold holdings.
3. Resources of the IMF and other institutions should be supplemented by a new financial support arrangement of $25 billion. The arrangement is designed to encourage cooperation in energy matters and to provide a financial "safety net" for participating OECD members. Early establishment of this support fund has been agreed to by the major industrial countries.

THE LESS DEVELOPED COUNTRIES IN 1974

Although many of the problems created by the oil price increases are common to both developed and less developed economies, there are several important differences. The less developed oil-importing countries are obviously far less able to afford the higher current prices, but their diversity makes generalizations difficult.

Developing countries that export primary products, such as iron ore and bauxite, for which demand was strong, have been able to offset a part of their increased oil bill with additional export earnings. A commodity boom which began in late 1972 drove up the prices of many primary products, but the prices of most of these commodities declined in the second half of 1974 with

the worldwide slowing of business activity. Moreover many countries which are heavily dependent on imports of oil, food, and fertilizer have not experienced increases in prices of their primary exports, and droughts and floods have compounded their problems.

The surplus revenue of the OPEC countries is derived in part from sales to other less developed nations that import oil; but relatively little of this surplus has yet been recycled directly by OPEC countries to the less developed ones. Partly because of the limited capital markets in these countries, initial placements of funds by oil producers have not been large. The consequences of the failure to recycle funds to the less developed countries are qualitatively similar to those facing the industrialized nations: if they cannot finance their deficits, they must cut back on imports. However, many less developed countries can reduce imports of oil or other inputs only at the immediate expense of their industrialization programs.

As has been true for many years, some form of foreign aid may be the only way to alleviate the deficiencies in financing and resources of the poorest countries. Special arrangements such as the IMF facility have helped in some measure and will probably continue to do so. At a time when even many industrial nations are in difficulty, more of the surplus of OPEC nations should be mobilized to help countries most in need of the funds, and these funds should be available at rates which do not further increase the already heavy burdens of debt service in developing nations.

RECENT DEVELOPMENTS IN INTERNATIONAL FINANCE

The international financial system has been fundamentally changed since August 1971, when the United States announced suspension of the convertibility into gold of dollars held by foreign monetary authorities. Following this action, major exchange rate realignments, coupled with devaluation of the dollar in terms of gold, were negotiated in December 1971 and February 1973; and negotiations were launched on a comprehensive reform of the international monetary system with establishment of the Committee of Twenty (C–20) under the auspices of the International Monetary Fund in July 1972. In March 1973, in response to great uncertainty and speculation in the foreign exchange markets following the second realignment, virtually all of the major industrial countries abandoned efforts to confine exchange rate movements within a narrow band around established par values. When the C–20 met during the IMF annual meetings in September 1973, it set July 31, 1974, as its target date for agreement on comprehensive monetary reform.

The oil price increases announced in October and December 1973, the acceleration of worldwide inflation, and *de facto* adoption of widespread floating radically altered the circumstances surrounding the C–20 negotiations. At its Rome meeting in January 1974, the C–20 shifted the focus of its negotiations. Instead of the early development of a comprehensive reform agreement, it began to work out a series of individual, less comprehensive

steps that were of particular importance in the current economic situation. In mid-June the C–20 Ministers agreed on a program for immediate action and released the *Outline of Reform* and accompanying annexes that described both the status of the negotiations on longer-term reform and the direction in which the Ministers believed the system could evolve in the future.

The program of immediate action was consistent with the longer-term *Outline of Reform,* constituting in essence a proposed first step in the evolution toward a fundamentally reformed system. It included:

1. Creation of an Interim Committee of the IMF with advisory powers to guide the adjustment process and oversee the operations of the system pending the establishment, through amendment of the IMF *Articles of Agreement,* of a Ministerial Council with decision-making powers.
2. Establishment of a Development Committee, also at the ministerial level, under the joint auspices of the IMF and the International Bank for Reconstruction and Development, to deal with questions relating to the transfer of resources to developing countries.
3. Establishment of guidelines for floating exchange rates.
4. An interim change in the method of valuation of special drawing rights (SDR's) to widen the base for calculating the transactions value of SDR's so that currencies other than the dollar are included.
5. Provision for IMF members to subscribe to a declaration against taking restrictive trade or other current account measures for balance of payments purposes without IMF approval.
6. Improved measures for surveillance of the adjustment process and of developments in global liquidity.
7. A request that the Executive Directors of the IMF prepare a series of amendments to the IMF *Articles of Agreement* for consideration when IMF quotas are reviewed early in 1975.

Among other items on which draft amendments were to be prepared were: establishment of a permanent IMF Council; "legalization" of floating exchange rates; a permanent declaration against trade restrictions for balance of payments purposes; the role of gold; and various modifications of the general and SDR accounts of the IMF.

The longer-term *Outline of Reform* put forward by the C–20 called for a more effective and symmetrical system of adjustment, in which efficient operation of the adjustment mechanism would not be obstructed by controls or restrictions on current or capital account transactions for balance of payments purposes. The *Outline* envisaged that the role of the SDR would be enhanced and that the roles of gold and reserve currencies in international reserves would be reduced. At the end of 1974, the transactions value of SDR's was around $1.22 per unit of SDR.

Recognition that exchange rate flexibility must play a greater part in an efficient economic adjustment process was a key element of the reform

proposals. In sharp contrast to the central role of fixed par values and narrow margins of exchange rate fluctuations around par values in the Bretton Woods system, the *Outline* called for a system in which countries could either establish adjustable par values or allow their currencies to float in response to market forces. Agreement was lacking, however, on the relative roles of floating and par values, the conditions under which the par values would be adjusted, and the provisions for authorization of floating in the future system. The United States favors provisions that would permit a country to float its currency so long as it adhered to internationally agreed rules of conduct, without the need for further authorization or approval by the IMF. Some others favor a more constrained "floating option" under which floating would be limited to specified situations and subject to specific authorization by the IMF.

At its first session during the IMF annual meetings in early October 1974, the new Interim Committee of the IMF approved a work program focusing on energy-related financial problems and balance of payments adjustment in the light of the energy crisis. Pursuant to this work program, the Interim Committee, meeting in mid-January 1975, reached agreement on a broad range of key issues. The Committee agreed on:

1. A limited extension of the IMF oil facility in 1975, with borrowings of up to SDR 5 billion and with an indication that it would be appropriate to make greater use of the Fund's own resources. In conjunction with the Development Committee, the Interim Committee also endorsed a suggestion by the IMF's Managing Director that special provision be made to reduce the interest burden on oil facility borrowing by the poorest developing countries.
2. An IMF quota increase of 32.5 percent overall, "rounded up" to a new quota total of SDR 39 billion, with a doubling of the quota shares of the major oil-exporting countries as a group and no reduction of the collective share of other developing countries. No agreement was recorded on quota shares for other groups or for individual countries. It was agreed, however, that since an important purpose of increasing quotas is to strengthen the Fund's liquidity, arrangements should be made to ensure usability of all IMF currency holdings in accordance with Fund policies.
3. A request that the Executive Directors continue work on a narrowed range of amendments to the IMF *Articles of Agreement* and submit drafts to the Committee on: establishment of the Ministerial Council; legalization of floating; improvements in the general account, including elimination of requirements to make gold payments to the IMF and establishment of arrangements to ensure the usability of IMF currency holdings; and improvements in the characteristics of the SDR.

Progress was made toward agreement on a comprehensive set of amendments on gold, including abolition of the official price and freedom

for national monetary authorities to enter into gold transactions under certain specific arrangements with each other in order to ensure that the role of gold in the international monetary system would be gradually reduced. Additional agreements related to the financial support arrangement among the members of the OECD, described earlier in this chapter, and to other matters.

MANAGED FLOATING

The interim guidelines that have been recommended by the C–20 for the present situation of widespread floating represent a first effort to address in a formal way the complex issues that can arise under a floating system, as well as to develop codes of behavior that might apply under a regime of managed floating over the longer term. Under the guidelines, countries with floating rates may intervene to moderate sharp and disruptive fluctuations from day to day and from week to week in the exchange value of their currencies. Intervention should not be used, however, to moderate movements in the exchange value of any currency over longer periods like months or quarters, unless such official intervention is consistent with actual and expected world market conditions, and unless it accords also with a pattern of exchange rates considered reasonable as a medium-term norm by that country and the international community. For example, a rate of inflation substantially higher than that of a country's main trading partners or competitors would normally lead to expectations of a further depreciation of its currency. In that case, attempts to fix the exchange rate for an extended period, whether undertaken by the country itself or by its trading partners, might be viewed as violating the intent of the guidelines, since intervention for this purpose would be disequilibrating.

Even without imposing direct controls on the flow of goods and capital in international trade, official monetary agencies can modify the course of exchange rates, at least temporarily, under a system of managed floating. The techniques of management can take a variety of forms. The most common is for central banks to intervene in the international money markets by selling domestic currency for foreign currencies, thereby leaning against an appreciation of their currency. Alternately they may engage in the converse operation, possibly with exchange reserves that are supplemented through official borrowing of foreign currencies, to slow a depreciation of their currency. If, however, in the attempt to slow movements of the exchange rate in either direction by "leaning against the wind," intervention continues on the same side of the market for an extended period, the level of the exchange rate may be affected even after intervention has ceased. This would occur if persistent one-sided intervention repressed exchange rate movements substantially. Since any lasting distortion of the exchange rates achieved through one-sided intervention influences the pattern of international trade and investment after a lag, this changed pattern may reflect back on subsequent exchange rate levels.

Foreign Exchange Management Since March 1973

Although attempts to fix the exchange rates of all major countries within narrow ranges vis-a-vis the dollar were officially abandoned in March 1973, a group of European countries agreed on new sets of exchange rates, which they would maintain within 2¼ percent of the agreed parities relative to each other. The United Kingdom and Italy did not join this group, however, and the joint float was further eroded when France withdrew from the group in January 1974. By the end of 1974 only Germany, the Benelux countries, Denmark, Norway, and Sweden floated jointly against the dollar; and some other nations tied their exchange rates to those of other countries. Managed floating had thus become the rule among the industrial countries.

Since the start of generalized floating, the pattern and net amount of official intervention have not been the same as those prevailing before 1973. The direction of official intervention has changed more frequently. As exchange reserve decumulations were followed by accumulations, U.S. liabilities to foreign official institutions were only slightly higher at the end of the third quarter of 1974 than at the end of the first quarter of 1973. From that time until February 1974, the drop in U.S. liabilities to the official agencies of other industrial countries outweighed the increase in liabilities to the OPEC governments, so that total U.S. liabilities actually declined. By comparison, official claims on U.S. residents had more than quadrupled from the end of 1969 to the end of March 1973, and industrial countries accounted for almost all of this increase.

The reserves of industrial countries remained relatively stable, but only because of substantial international borrowing on the part of deficit countries. Some of this borrowing was carried out by the domestic banking system without direct governmental action; in other cases credits were raised by official entities either in the private money market or with foreign monetary authorities. Most deficit countries have used the proceeds of loans from official and private sources to counteract any large decline in their international reserves. Government-to-government loans by surplus countries to deficit countries may be treated as foreign exchange reserves by the former, whether or not they result in marketable claims on the latter. Still there was little growth in the official reserves of industrial surplus countries as exchange rates were allowed to rise to dampen inflows of funds. Specifically, of the countries whose currencies appreciated against the dollar, Canada, Germany, and Switzerland had approximately the same amount of reserves at the end of the third quarter of 1974 as at the end of the first quarter of 1973, and only a few of the countries with depreciating currencies, most notably Japan, lost reserves.

The pattern of reserve movements suggests a change in central bank behavior compared to the period prior to 1973, but a number of countries have continued to influence movements of their exchange rate through indirect forms of intervention in 1974. To slow the rise of its franc,

Switzerland discouraged interest payments on nonresident deposits and maintained higher reserve requirements on nonresident than on resident deposits. In October, Switzerland lifted the interest ban but soon afterwards imposed taxes at the rate of 3 percent per quarter on nonresident deposits in excess of normal working balances, in order to discourage the inflow of funds. Other countries, however, discouraged capital outflows. For instance, France took steps to reduce franc loans to nonresidents, and Japan required the sale of private dollar holdings to the central bank for use in foreign exchange intervention. Among the deficit countries, only Italy imposed direct restrictions affecting international trade and payments when it imposed a 50 percent deposit requirement on most categories of imports in May 1974.

For short periods during 1974 disturbances originating in the private market prevented foreign exchange markets from functioning efficiently. When daily fluctuations in exchange rates become large, and severe losses by various market participants add to the uncertainty, broad participation in the exchange markets may be discouraged and the fulfillment of contracts may become less certain. Risk premiums were raised by the failure of the German Herstatt bank in June 1974 and the disclosure that large losses from private exchange trading had occurred, involving a number of other institutions not only in Germany but also in Switzerland, Britain, Italy, and the United States. Banks were less willing to take foreign exchange positions; and official efforts to discourage participation even further—for instance in Germany—made the markets thinner. Under such conditions markets are less efficient in smoothing out temporary imbalances in spot offerings or in contracts for future delivery, bid-ask spreads are likely to widen, and hence the costs of financing international trade may rise.

On the whole, however, the fact that a number of important exchange rates were no longer fixed brought several distinct advantages. With no formal commitments about exchange rates or margins, the authorities have much more flexibility in dealing with speculative exchange pressures. That is, those interested in shifting funds from one currency to another can no longer make massive purchases or sales of foreign currencies at set prices in a short period and count on the country's monetary authorities' being committed to meeting exchange demands without allowing the rate to move, as was the case in earlier years. Rather, authorities can let their rates adjust to eliminate exchange rate imbalances.

The new system has also enabled countries to manage their money supply with a greater degree of independence. Prior to the adoption of generalized floating there were periodic complaints, particularly from some European countries, that efforts to achieve domestic monetary policy objectives were being overwhelmed by movements in dollar reserves occasioned by the official intervention required to maintain the exchange rates. The system of quasi-fixed exchange rates still existed among the major trading countries at that time; and when the dollar came under pressure, foreign central banks found it difficult to offset the growth in domestic bank reserves resulting

from their dollar purchases. It was therefore argued that inflation was transmitted between countries by reserve asset acquisitions on the part of the surplus countries causing their rates of monetary growth to rise while money supply growth was not allowed to fall symmetrically in the deficit countries. Yet around $30 billion, or over 40 percent of the dollars held by foreign official agencies at the end of March 1973, were acquired after the summer of 1971, when the convertibility of the dollar into gold had already been suspended. In the interim, many countries appeared disinclined to have their currencies appreciate relative to the dollar, thus revealing more concern about promoting exports than avoiding the inflationary consequences of the dollar inflows.

Since March 1973, changes in official reserve holdings have shown no consistent relation to changes in the monetary base of most countries, and official intervention has been entirely discretionary. Hence, even if international reserve flows might have raised the monetary rates of growth more than some countries desired during the period of fixed exchange rates, they cannot have had this effect since that time unless countries chose to make exchange rate objectives paramount.

RECENT EXCHANGE RATE DEVELOPMENTS

Foreign central banks as a group ceased to observe formal intervention limits against the dollar after the international currency exchanges reopened on March 19, 1973, and the dollar declined soon afterwards. After falling through the first week of July, the value of the dollar increased in terms of most foreign currencies through August and then changed little through October.

With the cutback in oil supplies by the OPEC, the dollar soon strengthened relative to all major European currencies and the yen, since it was known that the United States was far less dependent on imported oil than Western Europe or Japan. Not only was the impact of the oil price increase on the U.S. trade balance and the domestic rate of inflation initially expected to be less, but it was widely anticipated abroad that a major share of the additional OPEC revenues would eventually be reinvested in the United States. This market assessment prompted a strong movement of short-term funds into the dollar and out of the major European currencies and the yen. Even though foreign central banks sold dollars to moderate the decline in their currencies, by mid-January the dollar prices of the German mark and the Swiss franc had fallen roughly 20 percent from their peak levels of early July 1973. Other major currencies had also declined sharply, and both the British pound and the Japanese yen were about 15 percent lower. Only the Canadian dollar remained approximately unchanged against the U.S. dollar.

The strengthening of the dollar did not continue past January 1974, because both the arrangement of substantial Eurocurrency loans to finance payments imbalances and the ending of capital controls by the United States began to depress the exchange value of the dollar. During the first half of

1974 the rate of inflation remained considerably lower in both Germany and the Netherlands than in the United States; and the trade surplus of these countries continued while the U.S. trade balance registered increasingly large deficits. The German mark, the Dutch guilder, and the Belgian and Swiss francs appreciated by about 14 percent against the dollar from mid-January to mid-May.

During the first half of 1974 the value of the dollar rose on balance in terms of the currencies of France, Italy, and Japan, because the rise of the dollar in late spring and early summer more than offset any earlier decline. The trade balances of these countries had deteriorated abruptly after the turn of the year, and inflation was much higher than in the United States. In spite of the high rates of inflation prevailing in the United Kingdom, the pound sterling rate deviated from this pattern because of unusually high short- and long-term interest rates in London and because the oil companies had expanding needs for sterling to meet tax and royalty payments to oil-exporting countries.

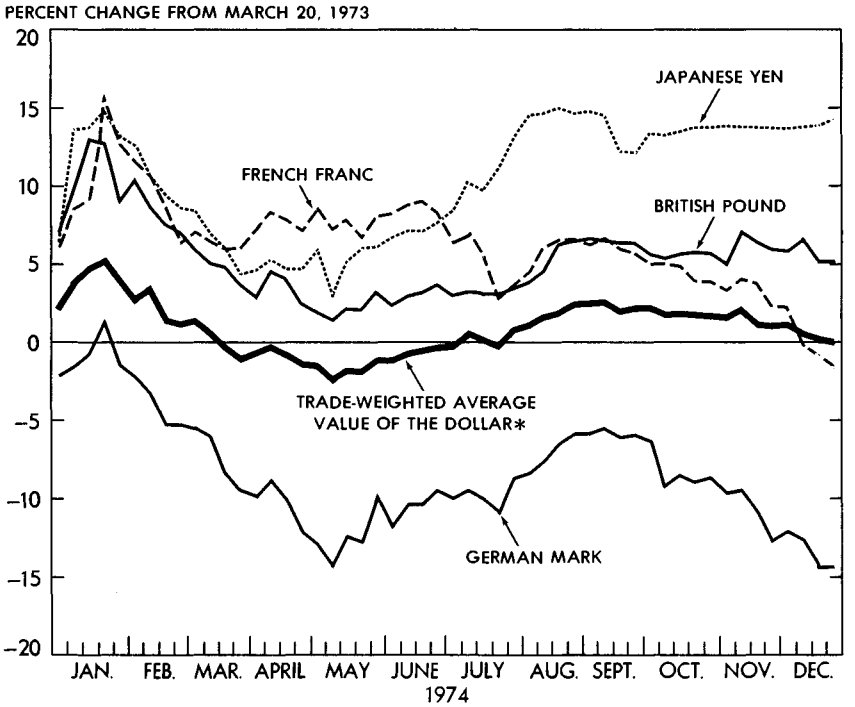
Around the middle of the year the United States and France were implementing some measures to reduce domestic rates of monetary growth in the hope of eventually lowering their rates of inflation, while other countries, particularly Germany, began to shift to more expansionary fiscal policies to combat rising unemployment. The French trade deficit fell and the German surplus declined, but the U.S. deficit grew little from the second to the third quarter. With interest rates reaching record levels in the United States, the dollar steadied or rose against all major currencies except the French and Swiss francs.

During the last quarter of the year, however, the dollar again declined against most currencies. The German mark recovered to its previous peak reached in May 1974, the French franc continued to rise, the Italian lira and British pound appreciated slightly, and only the Japanese yen continued to decline. Toward the end of the year the pound was jolted, but only temporarily, when Saudi Arabia announced that it would abandon its practice of taking about 25 percent of its oil payments in sterling. The effect of this statement was soon softened, however, by the Saudi announcement that it planned to continue investing in the London market. In addition, the Swiss franc rose sharply, by about 17 percent, during the fourth quarter.

Chart 11 shows that for the year as a whole the dollar depreciated against the German mark and the French franc, while it remained approximately unchanged against the British pound and appreciated against the Japanese yen. These movements were far from steady, however, during the course of the year. The Department of the Treasury's index of the change in the value of the U.S. dollar in terms of a trade-weighted basket of 22 foreign currencies indicates that the average value of the dollar declined from the end of January to May 1974; it then recovered most of its earlier losses before slipping again in the fourth quarter. At the end of 1974, the Treasury index

Chart 11

Change in the Value of the U.S. Dollar Relative to Selected Foreign Currencies



*RELATIVE TO THE 22 OECD CURRENCIES; COMPUTED BY DEPARTMENT OF THE TREASURY.
NOTE: FOR INDIVIDUAL CURRENCIES, WEDNESDAY PRICES WERE USED. FOR TRADE-WEIGHTED INDEX, THURSDAY PRICES WERE USED UNTIL JULY 17; THEREAFTER WEDNESDAY PRICES WERE USED.

SOURCE: DEPARTMENT OF THE TREASURY.

shows the value of the dollar to have been about the same as on March 20, 1973, just after the system of managed floating had come into full operation.

CHANGES IN INTERNATIONAL RESERVES

From September 1973 through the end of March 1974, total international reserves grew very little; they subsequently increased by $22.5 billion from the end of March to the end of September (Table 47). All but $3.1 billion of this increase accrued to the OPEC countries, mostly in the form of increased foreign exchange reserves held outside the United States. Thus, while the OPEC countries held a stable 7 percent of the world's reserves from March through September 1973, their holdings had increased to 10 percent by the end of March 1974 and to 18 percent by the end of September 1974. The shift was mainly at the expense of the industrial countries, whose share

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TABLE 47.—*Composition and distribution of international reserve assets, selected months, 1973–74*

Type of reserve asset	Value of reserve assets (billions of U.S. dollars) [1]				Percent of total reserve assets			
	March 1973	September 1973	March 1974	September 1974	March 1973	September 1973	March 1974	September 1974
All countries: [2]								
Total reserve assets	179.2	187.6	187.8	210.3	100	100	100	100
Gold stock	43.2	43.2	43.1	42.4	24	23	23	20
SDR	10.5	10.6	10.6	10.5	6	6	6	5
Reserve position in IMF	7.5	7.5	7.5	9.0	4	4	4	4
Foreign exchange	118.0	126.3	126.5	148.3	66	67	67	71
U.S. liabilities	71.3	69.8	65.5	72.5	40	37	35	34
OPEC countries: [3]								
Total reserve assets	11.9	13.2	19.0	38.4	100	100	100	100
Gold stock	1.4	1.4	1.4	1.4	12	11	8	4
SDR	.4	.4	.4	.4	3	3	2	1
Reserve position in IMF	.3	.4	.4	1.0	3	3	2	3
Foreign exchange	9.8	11.0	16.8	35.6	82	84	88	93
Industrial countries: [4]								
Total reserve assets	120.8	121.2	113.5	117.9	100	100	100	100
Gold stock	35.9	35.9	35.9	35.3	30	30	32	30
SDR	7.9	8.0	8.0	8.0	7	7	7	7
Reserve position in IMF	5.7	5.6	5.4	6.6	5	5	5	6
Foreign exchange	71.3	71.8	64.2	67.9	59	59	57	58
Other countries: [5]								
Total reserve assets	46.6	53.1	55.3	53.9	100	100	100	100
Gold stock	5.8	5.8	5.7	5.7	13	11	10	11
SDR	2.2	2.3	2.3	2.1	5	4	4	4
Reserve position in IMF	1.5	1.6	1.7	1.4	3	3	3	3
Foreign exchange	36.9	43.4	45.6	44.8	79	82	82	83

[1] End of period.
[2] Total of groups of countries listed in this table. Excludes Communist countries except Yugoslavia.
[3] Algeria, Ecuador, Indonesia, Iran, Iraq, Kuwait, Libya, Nigeria, Saudi Arabia, and Venezuela. Qatar and the United Arab Emirates are not included because the IMF does not publish data for these countries.
[4] United States, Canada, Japan, Austria, Norway, Sweden, Switzerland, and all EEC countries except Ireland.
[5] Nonindustrial countries other than OPEC countries.

Note.—Detail may not add to totals because of rounding.

Source: International Monetary Fund (IMF).

of the enlarged global reserves declined from 65 to 56 percent although the dollar value of their reserves did not decline significantly. The share held by the nonindustrial countries outside OPEC fell from 28 to 26 percent.

Globally, the liabilities of the United States and Britain to foreign official institutions have risen little since March 1973, but official holdings by the OPEC countries both in the United States and in the United Kingdom, as well as holdings in the form of Eurodollar and other Eurocurrency claims on private foreigners, have risen rapidly. This increase accounted for most of the growth in international reserves in the second and third quarters of 1974, and it changed the composition of reserves substantially as the share of official claims on private institutions increased relative to claims on other official institutions, including the IMF.

Another shift in the composition of international reserves could occur in 1975 if the quantity or valuation of monetary gold holdings were to change. At the end of September 1974 the industrial countries still owned 83 percent of the world's stock of monetary gold. The price of gold in the

free market has been subject to large fluctuations. At the end of 1974, the London price per ounce was $186½ as compared with $112¼ at the end of 1973. Compared to alternative forms in which international reserves can be held, however, gold yields no interest, nor has it yielded liquidity services in recent years. When the two-tier gold system was adopted in March 1968, central banks agreed to refrain from buying or selling gold in the private market. Neither has it been used in official settlements since the official accounting price fell to a fraction of its free-market price. From February 1973 through June 1974, monetary gold was valued at $42.22 per ounce, while the free-market price was three to four times as high. No significant changes occurred in the distribution of gold reserves from the time that convertibility of the U.S. dollar into gold was suspended officially on August 15, 1971, until the end of 1974.

Several steps have been taken to help countries mobilize their gold holdings to assist in financing balance of payments deficits. Termination of the 1968 two-tier gold agreement in November 1973 permitted countries to sell gold on the private market, although official purchases of gold at prices above the official price of 35 SDR per ounce continued to be prohibited by the IMF. In June, 10 major industrial countries agreed in principle that gold could be used as collateral for international borrowing at a price to be determined by the borrower and the lender. Soon afterwards, Germany extended a $2-billion loan to Italy that was backed by gold valued at approximately $120 per ounce. Later in the year some countries discussed the possibility of valuing monetary gold at market prices, and France indicated that it planned to do so early in 1975. Also in January 1975, the United States sold a small amount of its monetary gold to private purchasers to satisfy demand that might have materialized after removal of the prohibition against private ownership of gold bullion, which had been in effect since 1934. Nevertheless, both the transactions value and the effective liquidity of gold in international reserves remained uncertain at the start of 1975.

From their inception the value of special drawing rights has been set at one ounce of gold equals 35 SDR's. From January 1970 through June 1974, the conversion of SDR's into dollars was made at the official U.S. price of gold. When this official price was raised from $35 to $38 per ounce as of December 1971, the transactions value of 1 SDR therefore rose from par with the dollar to $1.0857, and it rose to $1.20635 after the official price of gold had been raised to $42.22 per ounce in February 1973. In order to enhance the transferability of SDR's and to move away from exclusive reliance on the official dollar price of gold in determining the value of SDR's, the IMF decided to widen the base for calculating the transactions value of SDR's by including currencies other than the dollar after July 1, 1974. Since that date, the currencies of 16 IMF member countries whose export trade amounted to more than 1 percent of the world

total in the 5-year period from 1968 through 1972 have entered into the "standard basket" valuation of the SDR. Countries whose currencies appreciate against the dollar consequently no longer find that the domestic book value of their SDR holdings with the IMF is reduced regardless of whether their currencies depreciate against third currencies that are now included in the standard basket. The relative weight of these currencies in the basket is proportional to each country's share in the world's total exports, but with some modification. Weights do compensate for the fact that the share of exports does not always accurately measure the importance of some currencies in the world economy. This applies particularly to the dollar, whose share is set at 33 percent. However, the standard basket valuation technique adopted in July 1974 represents only an interim agreement without prejudice to a new system of SDR valuation that may be negotiated in 1975.

U.S. INTERNATIONAL TRANSACTIONS IN 1974

The impact of world inflation, recession, and oil-related financing on flows of trade and capital was reflected in the international accounts of the United States in 1974. The physical volume of U.S. exports grew less than in the previous year because of the slowdown in economic growth in many foreign countries. Higher import prices, particularly for oil, led to a sharply higher value of U.S. imports despite a slightly decreased physical volume. These trends combined to push the merchandise trade account into deficit in 1974, after a surplus in 1973. In the monetary arena, the U.S. financial system was called upon to play a major role as intermediary, since U.S. capital markets were an important depository of the oil revenues which the foreign producers could not spend on imports from oil-consuming nations.

Merchandise Trade

The increasing deficit in the trade account during 1974 came after a strengthening of the U.S. trade position in the previous year. Cumulative depreciation of the dollar, combined with special factors such as shortfalls in foreign crop production and domestic price controls, produced a trade surplus in 1973. This surplus declined in January and February of 1974, and in March the United States registered the first deficit since June 1973.

During the first 3 quarters of 1974 the United States imported $4.3 billion more than it exported, and by the third quarter the quarterly trade deficit had risen to $2.6 billion. Although both imports and exports rose in current dollars, price increases were greater for the imported goods than for exports. As indicated in Table 48, from the first 3 quarters of 1973 to the first 3 quarters of 1974, the value of all merchandise exports grew 42 percent, and the value of imports 48 percent. The more rapid growth in the value of imports is attributable largely to the sharp rise in the price of imported oil; the value of all other imports increased only 24 percent during the year. The effect of higher oil prices is reflected in the 17

percent decline in the U.S. terms of trade from the pre-embargo third quarter of 1973 to the third quarter of 1974.

Table 48 also presents percentage changes in trade volume. The volume of exports was 11 percent greater in the first 9 months of 1974 than in the same period in 1973. While the rate of increase was less than in the preceding year, it was still remarkably high in view of the weakening world economy. Imports in constant dollars actually declined 1 percent in response to both the general decline in U.S. demand and the higher relative prices of imported goods.

TABLE 48.—*U.S. merchandise trade by principal end use categories, 1973–74*

Category	Value 1st 9 months 1974 (billions of dollars) [1]		Percent change, 1st 9 months 1973 to 1st 9 months 1974 [2]			
			Value		Volume	
	Exports	Imports	Exports	Imports	Exports	Imports
Total	71.0	75.3	42	48	11	−1
Agricultural goods	16.7	7.8	33	28	−6	−3
Nonagricultural goods	54.3	67.4	45	51	17	0
Foods, feeds, and beverages	13.8	8.0	31	22	−8	−2
Industrial supplies	22.6	38.4	60	95	10	−4
Petroleum and products	.6	18.8	48	250	−19	−3
Capital goods, except autos	21.5	7.0	39	23	21	10
Automobiles and parts	5.8	8.9	27	17	14	9
Consumer goods	4.7	11.0	39	12	29	−10
All other	2.6	2.0	33	35	.....	.....

[1] Seasonally adjusted; detail may not add to totals because of rounding.
[2] Based on seasonally adjusted data.

Note.—Bureau of the Census trade data have been reconciled to balance of payments basis.

Source: Department of Commerce (Bureau of the Census and Bureau of Economic Analysis).

Considering the value of exports by major categories, agricultural items rose, but solely because of higher prices. World production of grains during 1974 declined for the second time in 3 years, reducing the available supply and driving up the price. The major food-exporting countries suffered declines in output. The shortfall in the United States—where late planting, summer drought, and early frost led to a 20 percent decline in feed grain production—had a major impact on world prices.

Exports of industrial materials, particularly coal, paper, and steel, remained strong throughout the first 3 quarters of 1974 despite the worldwide slowdown in economic growth. Exports of capital goods remained especially strong in the first 9 months of 1974; sales in this category were sustained by a continued demand from abroad for specialized equipment such as computers and machinery used in construction, mining, agriculture, and communications.

Imports were influenced by many of the same factors as exports, particularly by higher prices. Oil was the major cause of increases in import value, although volume in this commodity declined 3 percent. Despite the weakening U.S. economy, strong demand for capital goods throughout the first 3

quarters resulted in a 10 percent volume increase in this category compared to the same period the year before.

Services

Investment income, the major component of the services account, rose in the first 9 months of 1974 compared to the same period a year earlier. Higher earnings among foreign affiliates of U.S. oil companies accounted for most of the rise, but this effect was partially offset by the impact of foreign takeovers on the U.S. capital account. Interest income from loans to foreign borrowers increased because of higher U.S. rates and larger loan volume, but this effect too was countered by higher rates abroad and by the increase in U.S. liabilities to foreigners.

Long-Term Private Capital Flows

The net outflow of total long-term capital was $0.5 billion in the first 9 months of 1974, compared to an inflow of $0.8 billion in the same period a year earlier.

TABLE 49.—*U.S. balance of payments transactions, 1973–74*

[Billions of dollars; seasonally adjusted]

Type of transaction	First 3 quarters		1973 IV	1974		
	1973	1974		I	II	III
Goods [1]	−0.7	−4.3	1.2	−0.1	−1.6	−2.6
Services [1]	2.3	6.6	1.5	3.0	1.4	2.2
Military transactions	−2.1	−1.6	−.1	−.5	−.7	−.5
Investment income [2]	3.9	7.1	1.4	3.1	1.8	2.2
Other [3]	.6	1.1	.3	.4	.3	.5
GOODS AND SERVICES	1.6	2.4	2.7	2.9	−.2	−.3
Unilateral transfers, net [4]	−2.7	−6.1	−1.2	−3.0	−1.9	−1.2
CURRENT ACCOUNT	−1.1	−3.7	1.6	−.1	−2.1	−1.6
Long-term capital	.8	−.5	−2.3	1.8	−.4	−2.0
U.S. Government [5]	−.7	1.9	−.9	1.3	.6	.0
Direct investment	−1.7	−1.2	−.7	.7	.2	−2.0
Other private	3.2	−1.2	−.8	−.1	−1.1	.0
CURRENT ACCOUNT and LONG-TERM CAPITAL	−.3	−4.3	−.7	1.8	−2.5	−3.6
Nonliquid short-term private capital, net	−3.0	−11.1	−1.3	−4.0	−5.4	−1.7
Errors and omissions	−3.4	3.6	1.1	1.1	1.7	.8
NET LIQUIDITY BALANCE	−6.7	−11.7	−.9	−1.1	−6.2	−4.5
Liquid private capital, net	−1.2	7.9	3.5	2.1	1.7	4.1
OFFICIAL RESERVE TRANSACTIONS BALANCE	−8.0	−3.8	2.7	1.0	−4.5	−.3
Financed by:						
Liabilities to foreign official agencies	7.7	5.4	−2.6	−.8	4.9	1.3
U.S. official reserve assets	.2	−1.6	.0	−.2	−.4	−1.0

[1] Excludes military grants of goods and services.
[2] Excludes direct investment fees and royalties, included under other.
[3] Includes travel and transportation and other services, net.
[4] Excludes transfers under military grants.
[5] Excludes official reserve transactions and includes transactions in some short-term U.S. Government assets.

Note.—Detail may not add to totals because of rounding.

Sources: Department of Commerce, Bureau of Economic Analysis.

Much of the turnaround represents reductions in purchases of U.S. stocks and bonds by foreign investors, traceable to the poor outlook for stock and bond prices during much of 1974. Although foreign purchases of U.S. equities declined, foreign direct investment in the United States increased; takeovers involving U.S. corporations engaged in petroleum operations abroad accounted for much of the increase. There was also a substantial rise in U.S. residents' purchases of foreign securities, primarily bonds issued by Canada. Despite the January 1974 removal of the Interest Equalization Tax, purchases of other foreign securities showed little change from 1973. Bank loans to foreigners reflected the greater demand for credit to finance higher oil bills, and they contributed to the outflow of long-term capital.

Short-Term Private Capital Flows

During 1974 there were substantial inflows of private capital into readily marketable assets. At the same time, large outflows of short-term capital took place in the form of bank loans and acceptance credits. Net nonliquid short-term private capital outflow was $11.1 billion in the first 9 months of 1974, $8.1 billion more than in 1973. Nonliquid claims on foreigners increased sharply in the first 2 quarters of the year, but the increase was reduced in the third quarter. The large outflow in the first part of the year was a reflection of the removal of restrictions on foreign lending by U.S. banks in January 1974. The diminished outflow later in the year may be attributable to higher U.S. interest rates.

Official Capital Flows

Official agencies of foreign governments purchased $5.4 billion of U.S. assets during the first 3 quarters of 1974. Since OPEC government purchases during the period are estimated at $7.2 billion, liabilities to official agencies of other nations declined during this time by $1.8 billion. The preference for U.S. dollar reserves revealed by the official agencies of oil-exporting countries has implications for the U.S. balance of payments measures discussed below.

The Net Asset Position of the United States

Figures compiled during 1974 indicate that U.S. net assets increased during 1973 by $11.8 billion, after declining $6.4 billion in 1972 and $11.5 billion in 1971. The value of U.S. assets abroad at the end of 1973 was $226 billion, compared to $163 billion in U.S. liabilities to foreigners.

The net asset position is affected not merely by balance of payments transactions, but also by factors not included in the balance of payments accounts. For instance, earnings reinvested by U.S. firms abroad (less earnings reinvested by foreign firms in the United States) added more than $7 billion to the net asset position during 1973. Adjustments for price changes in the foreign securities held by U.S. residents and in the U.S. securities held by foreign residents also affect the net asset position. Data on reinvested earnings and valuation adjustments for 1974 are not yet available.

THE BALANCES

Under the regime of fixed exchange rates, foreign monetary authorities were required to intervene in foreign exchange markets to maintain the value of their currency within a narrow band. A deficit in the official reserve transactions balance of the United States then indicated that foreign central banks had purchased dollars, because at the parity rates (plus or minus a narrow margin) the private demand for dollar holdings by foreigners had been less than the available supply. The accumulation of these assets by foreign monetary authorities was taken as a gauge of pressure on the dollar in foreign exchange markets.

The net liquidity balance, which takes into account the net change in liquid liabilities to private parties as well as to official agencies in other countries, was designed as a broader indicator of potential as well as actual pressures on the U.S. currency.

The trend toward flexible exchange rates has made these two measures of the balance of payments unsuitable for analyzing exchange rate pressures. Since intervention has become discretionary, pressures on exchange rates are in large part allowed to move the exchange rates instead of being reflected in reserve movements. While official intervention under managed floating can be used to dampen exchange rate fluctuations, the balances do not serve as acceptable indicators even of these limited actions to remove pressure.

Because of the huge surplus of investable funds accruing to the oil-exporting countries, a large negative shift in the U.S. official reserve transactions balance can now result on account of the preference of the oil-exporting countries for placing their funds in the United States. Moreover, the net liquidity balance is far less significant than under the regime of fixed exchange rates, since the foreign central banks are not obligated to acquire dollars from private holders. Finally, the distinctions between liquid and nonliquid assets and liabilities and between private and official foreign exchange assets have become increasingly blurred.

Thus, reliance on these balances could lead to serious analytical misjudgments. The question of how the organization of our balance of payments data can be made more useful is currently under review.

SUPPLEMENT

The Eurocurrency and Eurodollar Markets

The discussion of the international financial aspects of the "energy crisis" brought into public focus the Eurodollar market as an important channel for moving funds from the oil-exporting countries to borrowers. The recycling of "petro-dollars" has been merely one of many functions performed by the Eurodollar market over the years of its existence.

The Eurodollar market, as such, has no specific location. Its physical dimension is a network of international telecommunications media which link financial centers around the world and through which Eurodollar transactions are conducted. Eurodollars are dollar-denominated claims on commerical banks located outside the United States, largely but not exclusively in Europe. They are dollar funds placed with foreign banks by either U.S. or foreign residents, and maintained on the books of these banks as dollar-denominated liabilities to the depositors. Dollars deposited with the foreign banks may be in the form of U.S. currency, but they seldom are. In virtually all instances, they are dollars held on deposit in U.S. banks. In establishing a Eurodollar deposit, the depositor, in effect, transfers the ownership of his deposit in a U.S. bank to the receiving foreign bank. When the foreign bank lends these dollars, it transfers their ownership to the borrower. Finally, when the original depositor "withdraws" the deposit, he in effect exchanges the dollar-denominated claim on the foreign bank for a dollar-denominated claim on a U.S. bank.

Eurodollars, while by far the largest, are merely one of several types of foreign-currency denominated deposits maintained by commercial banks around the world in currencies other than that of the country where the bank is located. Deposits denominated in British pounds (Eurosterling), German marks (Euromarks), Swiss francs (Eurofrancs), and others are also held and traded by banks domiciled outside the countries issuing these currencies.

The emergence and growth of the Eurodollar market may be viewed as a classic example of free market forces at work, overcoming obstacles created by regulations, and responding to market incentives to accommodate various needs. After World War II, when the dollar emerged as the major trading currency, the initial impetus to the growth of the Eurodollar market was given by certain Eastern European countries. Anxious to hold dollars to finance their badly needed imports from the West, but concerned that their dollar balances might be blocked or confiscated in retaliation for their expropriation of American-owned properties if such balances were held in banks under U.S. Government jurisdiction, these countries began placing their dollar balances with commercial banks in Western Europe. Since the late fifties, when most major countries removed restrictions on the holding of foreign exchange (including dollars) by their residents, higher interest rates offered by foreign banks, relative to interest rates offered by the U.S. banks, provided the main incentive for holders of dollar funds to place these with foreign banks rather than banks located in the United States.

The ability and willingness of foreign banks to offer a more attractive return than U.S. banks has been predicated on several factors. The U.S. banking authorities do not allow commercial banks in the United States to pay interest on deposits of less than 30 days, and they regulate the rate of interest that may be paid on deposits of longer maturity. Commercial banks abroad

are mostly exempt from such restrictions. Also, unlike U.S. banks, commercial banks in countries where the growth of the Eurodollar market has been the most spectacular are not subject to reserve requirements on their dollar-denominated liabilities. As a result, the net cost of such funds to these banks is reduced, and they can offer a higher yield. On the other hand, the willingness of foreign banks to offer a higher return has been predicated on the strong demand for dollar loans that has not been fully met by the U.S.-based banks, particularly when such lending was impeded by the existence of the Voluntary Foreign Credit Restraint Program and the Interest Equalization Tax.

Given these constraints, the U.S.-based banks were able to compete for dollar deposits with foreign-based banks through foreign subsidiaries and branches that were not subject to the same restraints as their parent institutions in the United States. Through these media, the U.S. banks have maintained significant participation in the Eurodollar market. The elimination or suspension of certain U.S. regulations in 1970 and 1974 has removed most of the impediments to the direct participation of U.S. banks in the global trade in dollars. By this time, however, the Eurodollar market had acquired a momentum of its own that assured its continued existence for years to come.

MEASURING THE SIZE OF THE EURODOLLAR MARKET

For a number of years, the Bank for International Settlements (BIS) in Basle, Switzerland, has been providing the most comprehensive set of statistics on the Eurodollar market, based on reports of foreign-currency denominated assets and liabilities of commercial banks in Belgium-Luxembourg, France, Germany, Italy, the Netherlands, Sweden, Switzerland, the United Kingdom, Canada, and Japan. The original reports include all foreign-currency denominated liabilities to residents (banks, individuals, and corporations) of countries other than the country in which the reporting bank is located, that is, all external liabilities. These totals are published as gross Eurocurrency positions.

Table 50 shows the size of the external Eurocurrency liabilities by the individual reporting countries. For the end of 1973, the BIS reported that total external liabilities in foreign currencies of banks in the reporting European countries identified in the table amounted to $191 billion; roughly two-thirds of these liabilities were denominated in dollars.

TABLE 50.—*External liabilities denominated in foreign currencies of banks in selected countries, 1970–73*

[Billions of U.S. dollars; end of period]

Country	1970	1971	1972	1973
Selected countries	85.8	110.8	147.5	215.7
Reporting European countries	75.3	97.9	131.9	191.4
Belgium-Luxembourg	6.8	10.5	14.8	24.0
France	9.2	13.9	19.2	27.2
Germany	2.9	3.1	4.0	5.8
Italy	9.4	12.4	18.8	24.1
Netherlands	4.0	4.9	6.4	9.6
Sweden	.5	.6	.7	.9
Switzerland	6.1	6.5	8.5	9.2
United Kingdom	36.4	45.9	59.8	90.7
Canada	5.5	6.3	8.1	11.5
Japan	5.0	6.6	7.5	12.8

Note.—Detail may not add to totals because of rounding.

Source: Bank for International Settlements.

In addition to gross figures, the BIS publishes data on net Eurocurrency liabilities. The net liability measure is an estimate of the amount of credit outstanding in the Eurocurrency market, after an adjustment to exclude interbank deposits. Deposits by one Eurobank at another are made for several reasons. First, banks usually observe limits on loans to particular borrowers or markets. When limits are reached, many banks will lend to another bank which wants to increase the supply of loans to its nonbank borrowers. A second reason is that many banks whose lending is specialized by either function or region will supply funds to another intermediary for more general operations. The redepositing gives rise to double counting when the same funds pass through several banks on their way to final borrowers. The practice of the BIS has been to net out of the gross figure all interbank deposits within the reporting area, on the assumption that they result in duplication along the credit chain. Interbank deposits between this area and the areas not covered by the BIS reports, however, are assumed to derive from actual credit flows initiated by nonbank market participants and carried out by the banking intermediaries. Thus, interbank deposits between banks within the European countries comprising the reporting area are excluded, while deposits of banks outside the area are included in the net measure. Also included in the net measure are Eurocurrency liabilities of the area banks to the residents of the country in which the bank is located. On this net basis, the BIS had estimated the size of the Eurocurrency market at $132 billion in the reporting European countries at the end of 1973. Of that total the Eurodollar component was estimated at $97 billion.

In recent years banks in other financial centers such as Singapore and the Bahamas sharply increased their Eurocurrency deposits. Data on these liabilities are not included in the BIS figures. However, the Morgan Guaranty

Trust Company of New York, utilizing published national banking statistics of various countries, has been compiling data on the world Eurocurrency market. According to their estimates, the gross foreign currency liabilities of banks around the world (including interbank deposits and foreign-currency denominated liabilities to residents) amounted to $295 billion at the end of 1973. Of the world total, $215 billion were Eurodollar deposits; about $80 billion of these were held at foreign branches of U.S. banks. After an adjustment for double counting resulting from interbank deposits, the net size of the world Eurocurrency market at the end of 1973 was estimated by Morgan Guaranty at $155 billion, of which $115 billion consisted of liabilities denominated in U.S. dollars.

In the first 3 quarters of 1974 the world Eurocurrency market expanded considerably. On a net basis it has been estimated that the deposits rose globally by some $35 billion, from $155 billion at the end of 1973 to $190 billion at the end of September 1974. A large portion of that increase apparently took place at banks in the United Kingdom where gross Eurocurrency deposits rose by $16 billion to $106 billion.

Receiving foreign currency deposits and establishing foreign-currency denominated liabilities is, of course, only one side of the Eurobanks' activities. Lending the funds received and establishing foreign-currency denominated claims represents the other phase of their operations. The BIS also collects and publishes data on the asset side of the balance sheet of Eurobanks for the European countries comprising the reporting area. Table 51 shows the distribution of such assets around the world.

TABLE 51.—*Foreign-currency denominated claims of banks in reporting European countries, 1973*

[Billions of dollars [1]; end of 1973]

Area and country	Foreign-currency denominated claims		
	Total	Dollars	All other currencies
Claims on residents of			
Reporting European countries [2]	106.6	67.3	39.3
Other areas	81.3	66.5	14.8
Other Western Europe	11.4	6.6	4.8
Eastern Europe	7.8	4.9	2.9
Canada	5.1	4.4	.7
Japan	8.1	7.5	.6
Latin America	11.3	10.3	1.0
Middle East	2.5	2.0	.5
United States	14.5	13.8	.7
Other	2[illegible].6	17.0	3.7

[1] Foreign currencies expressed in billions of U.S. dollars.
[2] Belgium-Luxembourg, France, Germany, Italy, Netherlands, Sweden, Switzerland, and United Kingdom.

Note.—Detail may not add to totals because of rounding.

Source: Bank for International Settlements.

Eurodollars are not included in the U.S. monetary aggregates (M_1, M_2, M_3); only dollars held by foreigners as currency or as deposits in U.S. banking institutions are included. Indeed, Eurodollar deposits must first be "converted" into deposits in U.S. banks before they can become means of payment in the United States. In general, such "conversion" has no impact on the U.S. money supply. On the other hand, owners of Eurodollar deposits undoubtedly consider them highly liquid dollar-denominated assets, and some degree of arbitrariness inevitably enters into distinctions between such assets and money.