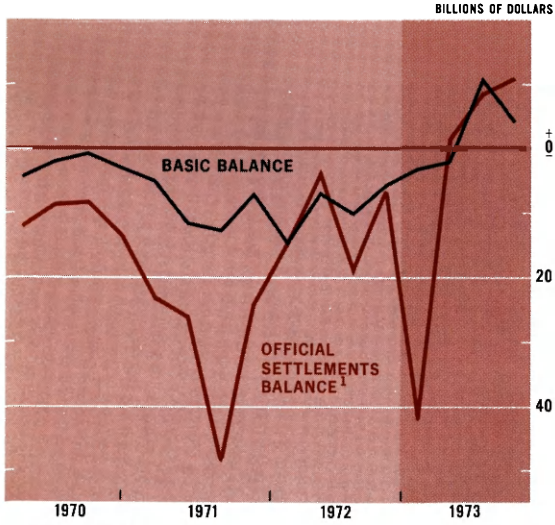
International Developments

During 1973 the U.S. balance of payments registered steady gains in the goods and services balance, and net flows of private long-term capital were inward for the year. As a result the basic balance (current account plus long-term capital flows) for the year moved into surplus for the first time since 1957, a striking reversal of the $10 billion basic deficit in 1972.

In the early part of the year, however, confidence that the balance of payments would recover was at a low ebb and massive flows of funds into other currencies precipitated a second devaluation of the dollar in February. Subsequently six of the members of the Euro-

U.S. BALANCE OF PAYMENTS



[1] Excludes SDR allocations.

NOTE.—Dept. of Commerce data at seasonally adjusted annual rates; fourth quarter partly estimated.

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pean Economic Community (EEC) allowed their currencies to float against the dollar, while remaining fixed among themselves. After a period of stability in the spring, the six EEC currencies, led by the German mark, appreciated against the dollar as well as against the Canadian dollar, the British pound, and the Japanese yen. By July the dollar had dropped substantially relative to EEC currencies, and on a weighted average basis the dollar exchange rate against 10 leading foreign currencies was about 23 per cent below the level of May 1970 and 15 per cent below the level at the start of 1973.

Exchange rates stabilized after the middle of July following moderate amounts of intervention by the Federal Reserve and the German Federal Bank. In the autumn the exchange rate for the dollar began to appreciate markedly, reflecting improvement in the U.S. trade balance. A major new impetus to the strengthening of the dollar was imparted by the actions of the Middle East oil producers in announcing limitations on production in October, followed by the more than threefold boost in the price of oil exports by the producing countries in two steps in October and December.

Limitations on supply, even if applied most severely to the United States, were expected to be more harmful to the economies of other countries more dependent on oil imports as a source of energy for industry. When increases in production were resumed, attention shifted to the huge increases in the monetary reserves of oil-producing countries that would result if the new price structure were sustained, and the general view was that these asset accumulations would tend to strengthen the dollar relative to other currencies because of the likelihood that U.S. money and capital markets would provide the best opportunity for absorbing investment flows of such potential magnitudes, both directly and through the Euro-dollar market.

Recovery in the U.S. balance of payments was supported by the continuing effects of the exchange rate changes that had begun in 1970, and also by the steep rise in the quantity and price of agricultural exports. Economic activity abroad continued to advance, supporting export gains, while real output in the United States was slowing down, reflecting in part supply bottlenecks. The improvement in the trade balance during the year, in real terms, was a con-

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siderable offset to the slackening in the growth of effective demand in other sectors of the economy. However, while rising demands abroad aided the U.S. trade balance, they also added to upward pressures on prices, especially for world-traded basic commodities, and helped to expose a growing problem of imbalances between demand and available supply.

Despite supply problems and the gyrations in exchange rates, world trade in real terms grew at a phenomenal rate in 1973. At times pressures on particular exchange rates became severe and led either to sizable interventions by monetary authorities or to wide fluctuations in exchange rates, but on the whole the successive crises were accommodated by the market without major disruption.

As the year ended, the improvement in the exchange value of the dollar accelerated, despite large sales of dollars by some foreign monetary authorities. During January 1974 the weighted-average exchange rate for the dollar came near the rate at the beginning of 1973. In view of the change in the balance of payments outlook, the controls on outflows of U.S. private capital were relaxed in December 1973 and terminated in January 1974. A moderate drop in the exchange value of the dollar followed the termination.

PROGRESS TOWARD EQUILIBRIUM

The U.S. trade balance swung into a small surplus in 1973, the first surplus in more than 2 years and a dramatic turnaround from the $7 billion deficit in 1972. Exports rose very steeply, by nearly 45 per cent, while imports increased by a more moderate 25 per cent. The expansion in exports was paced by an exceptionally large rise in shipments of agricultural commodities as harvests outside the United States were far below normal and the U.S.S.R. and People's Republic of China became large purchasers of U.S. farm products. Price increases accounted for over two-thirds of the increase in the value of agricultural exports in 1973, as world demand exceeded available supplies.

Exports of nonagricultural commodities also rose quite sharply—by over 30 per cent—in 1973. More than half of the increased value of such exports reflected larger volume. Major reasons for the growth in nonagricultural exports were the strong economic expansion abroad and the cumulative effects of the depreciation of the

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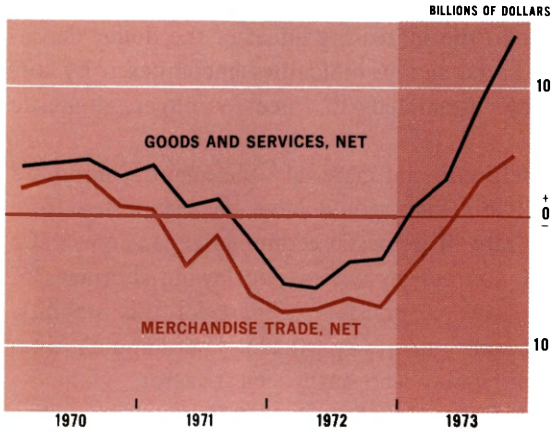
GOODS AND SERVICES



NOTE.—Dept. of Commerce data at seasonally adjusted annual rates.

dollar that had begun in 1970 and had made U.S. goods much more competitive in world markets. Also the tightening of price controls in June held domestic prices of some goods below world prices (in dollars) of comparable products, encouraging export sales at higher dollar prices by domestic producers of fertilizers, chemicals, and various metals. This incentive to export was partially removed later in the year as the Cost of Living Council removed or relaxed domestic price controls on metals and fertilizers.

As a result of the exceptionally rapid growth in the volume of U.S. exports of manufactures, the U.S. share of total world trade in manufactures rose in 1973, after many years of decline.

The increase in the value of imports in 1973 stemmed almost entirely from higher prices; import volume remained stable except for fuels, which increased steadily throughout most of 1973. Near the end of the year, however, the volume of oil imports dropped as a consequence of the embargo by Middle East oil-producing countries.

The volume of nonfuel imports in 1973 was very slightly higher than in 1972, and this behavior was evident in most major import commodity categories—automobiles and other consumer goods, industrial materials (other than fuels), and foodstuffs. Only in capi-

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tal equipment did the volume of imports rise strongly. The decline in the import volume of other types of finished goods is probably attributable in large part to the increasing effect of the dollar depreciations, combined with some supply difficulties encountered by foreign producers as they attempted to meet stronger domestic demands.

With respect to nonfuel industrial materials, the quantity imported rose only slightly, much less than would have been expected from past relationships to the rate of domestic economic expansion. Shifts of user demands to U.S. sources, as well as worldwide shortages of these goods, apparently were responsible in part for this stability. Increased availability of some metals (particularly aluminum) from U.S. Government stockpiles may also have been a factor.

Improvement in the U.S. trade balance in 1973 was reflected in balances with most areas. The trade deficit with Japan, which had persisted for many years and had totaled $4 billion in 1972, fell to about $1¼ billion in 1973, with only small monthly deficits recorded in the second half. The trade balance with Western Europe, which had shifted from a traditional surplus with those countries to a deficit in 1972, swung back into a substantial surplus in 1973. The trade balance with the less developed countries as a group also improved in 1973. The balance with Latin America and the Middle East countries improved despite the increase in oil imports from those regions, but a trade deficit with Africa developed because of larger oil imports from that area. A considerably enlarged trade surplus with Eastern Europe in 1973 reflected the heavy shipments of grain and soybeans to the U.S.S.R.

The outlook for the U.S. trade position in 1974 depends, to a considerable degree, on the effects of the present energy crisis. The import bill for petroleum could rise to more than $20 billion in 1974 compared with about $8 billion in 1973, even if quantities continue to be reduced by the embargo. Prospects for exports are clouded by the possibly severe effects of the energy problem on economic growth in other industrial countries and on the import capabilities of some developing countries whose oil import costs may be especially burdensome. In addition, one effect of the recovery in the value of

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the dollar in the exchange markets since mid-1973 is likely to be the erosion of some of the competitive shift derived from the earlier rate movements.

The usual U.S. surplus from investment income and services increased substantially in 1973, rising to a total of nearly $6 billion, more than double the surplus in 1972. Returns on U.S. investments abroad rose very sharply (in terms of dollar amounts) as a result of the change in exchange rates, stronger economic activity abroad, and higher petroleum prices. Interest payments to foreigners on their assets in the United States also rose in 1973, but more moderately. Sales of military equipment to foreigners increased sharply while military expenditures abroad showed little change. Also, receipts from foreign travelers to the United States rose more than expenditures abroad by U.S. travelers.

Flows of long-term private capital tended to strengthen the U.S. balance in 1973, despite a major outflow of U.S. direct-investment capital early in the year when further depreciation of the dollar was expected. Thereafter outflows by U.S. investors diminished, while foreign investors placed record amounts in the United States to purchase equity securities and to finance growing foreign direct investments in this country. Net foreign purchases of U.S. corporate stocks were nearly $3 billion for the year.

Inflows of foreign capital for direct investment, that is, investment involving a substantial voice in management, appear to have approached $2 billion in 1973—far exceeding any previous experience. Such inflows were spurred in part by the lower exchange value of the dollar and the consequent rise in the relative advantage of producing goods in the United States. There may also have been some inflows directly or indirectly out of the rising revenues of the oil-producing countries. However, a factor of growing importance may have been the restoration of confidence in the comparative strength and stability of the U.S. economy.

Flows of U.S. private capital in shorter-term forms were strongly outward in the first quarter of the year—including large unrecorded outflows—but were a less significant element thereafter. After market rates of interest in the United States moved up sharply in the first half of the year, and the dollar strengthened in the market, there were inflows of foreign funds to U.S. banks.

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Table 11: U.S. BALANCE OF PAYMENTS

In billions of dollars, seasonally adjusted

Item	1972	1973 e	1973			
			I	II	III	IV e
Merchandise trade balance	**− 6.9**	.7	− 1.0	− .3	.7	1.2
Exports	48.8	70.3	15.3	16.8	18.2	20.0
Imports	55.7	69.6	16.3	17.0	17.4	18.9
Services, net	2.3	5.8	1.1	.9	1.4	2.3
Balance on goods and services	− 4.6	6.4	.2	.7	2.2	3.5
Remittances and pensions	− 1.6	− 1.8	− .4	− .4	− .4	− .6
U.S. Govt. grants and capital, net	− 3.5	− 3.6	− .7	− .6	− .9	− 1.5
Long-term private capital, net	− .2	.9	−(1)	− .3	1.7	− .4
Balance on current account and long-term capital	− 9.8	1.9	− .9	− .6	2.5	.9
Nonliquid short-term private capital, net	− 1.6	− 4.0	− 1.8	− 1.4	.2	− 1.0
Errors and omissions	− 3.1	− 5.8	− 3.8	.4	− 1.2	− 1.2
Liquid private capital, net	3.5	2.6	− 3.9	1.9	.6	4.0
Of which: Liabilities to foreign commercial banks	3.9	2.9	− 1.9	.7	.8	3.2
Official settlements balance (excluding SDR allocations)	−11.1	− 5.3	−10.5	.3	2.1	2.7

e Estimated.
1 Less than $50 million.
NOTE.—Dept. of Commerce data with some Federal Reserve estimates. Details may not add to totals because of rounding.

Late in 1973 a broad relaxation of the restraints on capital outflows from the United States was announced—and such controls were terminated in January 1974. At the same time other countries were reducing their barriers against inflows of foreign capital, reflecting the shift that had been occurring in balance of payments positions.

INTERNATIONAL MONETARY SCENE

During 1973 financial and foreign exchange markets were affected strongly by changes in the outlook for the balance of payments of the United States and other major industrial countries. Early in the year the U.S. dollar came under severe selling pressure, as there was continuing skepticism about the prospect for adequate improvement in the U.S. trade balance in response to the Smithsonian realignment of exchange rates. Large flows of funds from the United States to EEC countries with strengthening trade positions—notably Germany

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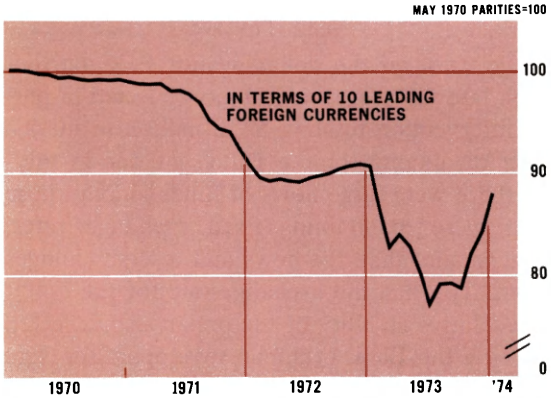
—produced a U.S. deficit on official reserve transactions of more than $8 billion in the first 2 weeks of February. Following the February 12 devaluation of the dollar by 10 per cent, there was a partial reversal of the earlier flows, but by early March renewed heavy demand for European currencies led to further large reserve gains by EEC countries; all official intervention in exchange markets ceased; and these markets were officially closed.

In early March six EEC countries (Germany, France, Belgium, Luxembourg, the Netherlands, and Denmark) plus Norway and Sweden agreed to maintain a fixed exchange rate relationship among their currencies, while permitting them, as a group, to float against the dollar. After exchange markets were officially reopened on March 19 on the new basis, the exchange rate for the dollar against these EEC currencies remained relatively stable until mid-May, when demands for EEC currencies increased sharply, reflecting in part political and economic uncertainties in this country and in part the strong German trade account and the progressive tightening of financial policies in Germany.

With the demand for German marks pulling rates for all EEC currencies higher against the dollar than they otherwise would have

INTERNATIONAL VALUE OF THE U.S. DOLLAR



NOTE.—Monthly-average market exchange rate of U.S. dollar against 10 major foreign currencies weighted by foreign trade in 1972. The weight for each currency is the share of that country's total trade (exports plus imports) in the total trade of the 10 countries plus the United States.

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been, by mid-1973 the dollar had depreciated against the EEC currencies by an average of 15 per cent from its February level. The German mark was revalued at the end of June. However, the dollar remained strong against the currencies of our major trading partners —Japan and Canada—and, reflecting sales of dollars by Japan while most other central banks were not intervening in the market, there was actually a reduction in U.S. official reserve liabilities in the second quarter of the year.

By early July exchange markets for the dollar against EEC currencies had become disorderly. Beginning July 10 the Federal Reserve undertook intervention to stabilize the exchange rate for the dollar, drawing on recently enlarged swap lines, and sold $273 million of foreign currencies (marks, French francs, and Belgian francs) by the end of the month. This action was reinforced by coordinated purchases of dollars by the German Federal Bank and relaxation of a credit squeeze in the German interbank market. The appearance of central bank intervention, together with the joint statement on July 18 of the Chairman of the Federal Reserve Board of Governors and the Secretary of the Treasury that intervention would take place "in whatever amounts are appropriate for maintaining orderly market conditions," helped to restore exchange markets to more normal functioning. The dollar strengthened by about 3 per cent during the first weeks of August, and the Federal Reserve purchased the currencies required to repay the drawings it had recently made on the swap network.

Thereafter the exchange value of the dollar against EEC currencies changed little through late October; this stability reflected in part further Federal Reserve intervention totaling $236 million in marks, particularly following the revaluation of the Dutch guilder in mid-September. At that time there were large flows of funds among those European countries that were maintaining fixed exchange rates, although these flows were smaller than the flows and reserve changes that had occurred in February when the exchange rate for the dollar had also been fixed. The relative stability of the dollar also reflected continued sales of dollars by the Bank of Japan to support the yen. These sales led to an official settlements payments surplus for the United States of $2 billion in the third quarter.

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At the end of October the demand for dollars began to increase markedly, reflecting a fundamental reassessment of the underlying strength of the U.S. balance of payments. The proximate cause for the shift was publication of a large trade surplus for the month of September, but of more lasting importance was the shift in market judgment concerning the impact on international payments of sharply higher oil prices. Between late October and the year-end the dollar had appreciated by 8 per cent on the average, despite central bank sales of substantial amounts of dollars. As a result the United States had a surplus of nearly $3 billion in the official reserve transactions balance during the final quarter of 1973. From year-end 1973 through late January 1974 the dollar appreciated still further, accompanied by heavy foreign central bank intervention. Following the removal of U.S. capital controls on January 29, and the subsequent decline in U.S. interest rates, however, the dollar depreciated and by late February was back to slightly below its year-end levels.

The periods of exchange market pressure during the year were accompanied by sharp increases in the market price of gold. When exchange markets stabilized, these increases were partly reversed, but the price of gold rose sharply again in early 1974. In mid-November 1973 the United States and the other participating European countries agreed to terminate the agreement of March 1968 regarding official gold transactions, removing an obstacle to official sales in the private market and thus permitting greater flexibility of action in the future.

Against the background of adjustment and accommodation to the strong forces that were influencing payments developments during 1973, officials continued to work on the development of agreed rules under which the international monetary system might function with more stability in the years ahead. The Committee of Twenty of the International Monetary Fund presented a First Outline of Reform at the Fund's annual meeting in Nairobi in September. This report set forth the general shape of a possible reformed system. Among other things it suggested a regime of stable but adjustable exchange rates, with provision for floating exchange rates in particular situations. After the Nairobi meeting, technical groups were organized to examine in detail various aspects of the system. These include the

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process of adjustment of payments imbalances; provisions for the settlement of international payments imbalances and for official intervention in exchange markets; global liquidity and the possible consolidation of outstanding reserve currency balances; and the transfer of real resources to developing countries.

While discussions of monetary reform issues look to the future functioning of international economic relationships, they are continuously influenced and modified by the changing economic environment and, in turn, provide one of the forums for dealing multilaterally with pressing current problems. The effects of the energy crisis on economic activity, and especially on international trade and financial relationships, were a major concern of the meeting of the Committee of Twenty in January 1974 and of the special conference on energy problems held in Washington in February.

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International Developments

A series of dramatic events combined to make 1974 a year of great economic stress in the world economy, foreshadowing major challenges for economic policy in the year ahead. In retrospect, the force initiating much of the difficulty was the coincident surge in demand in nearly all industrial countries beginning in 1972 and reaching a peak after mid-1973. That surge exposed bottlenecks in the supply of many basic commodities, and rising costs of materials aggravated demand inflation and facilitated the raising of prices by the Organization of Petroleum Exporting Countries (OPEC). Adding to pressures on consumer prices, world production of foods fell as demand rose, and food inventories were reduced to dangerously low levels.

Faced with these problems, industrial countries had shifted toward policies of demand restraint in 1973. This shift added to the already strong depressing effect on demand of higher oil prices, bringing a slowdown in industrial production by early 1974. By the end of the year industrial countries were operating well below capacity. For the industrial countries (other than the United States) as a group, it appears that real GNP rose only slightly over 1 per cent in 1974 (in the 1960–70 period growth had averaged 6.3 per cent annually) and would be far below the long-run average in 1975. If the U.S. performance is included, real GNP growth for the 2 years would be considerably lower.

Policymakers are constrained in their efforts to revive demand by rates of inflation that are far too high in every country, though some countries have been more successful than others in restraining inflation. In terms of GNP deflators, industrial countries as a group experienced a price increase of 12½ per cent in 1974 compared with a 3.6 per cent annual average in 1960–72. Weaknesses in prices of many industrial commodities began to show up clearly by mid-1974, but upward pressure on prices was sustained by several factors: escalating wage settlements as labor attempted to maintain or restore purchasing power; declining productivity as capacity utilization fell off; short supplies of foodstuffs; and the maintenance by OPEC of the high price of oil despite declining demand and great excess capacity.

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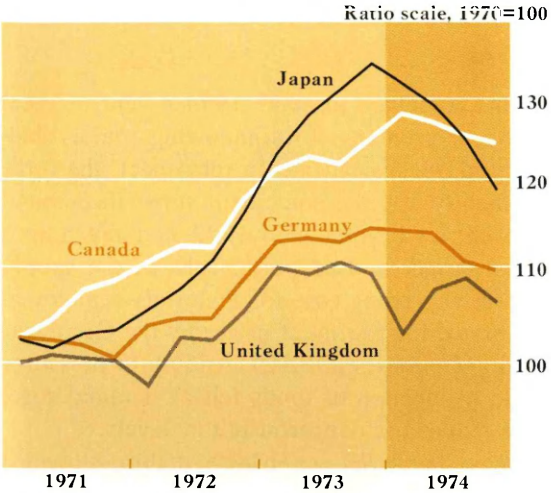
FOREIGN INDUSTRIAL PRODUCTION



NOTE.—Seasonally adjusted quarterly data from Organization for Economic Cooperation and Development. Q4 partly estimated.

When the oil producers quadrupled the price of oil, they created not only pervasive stresses on world prices and economic activity but also a challenge to the stability of world capital markets and to international economic cooperation. Financial markets have been strained as oil-consuming countries have borrowed on a long-term basis to finance their deficits, while OPEC countries have tended to concentrate on those kinds of assets that best meet their needs for liquidity, safety, and yield.

To satisfy these needs, the OPEC countries placed their investible surplus (the amount left from receipts from exports and investment income after payment for imports and outlays for military purposes and aid)—probably amounting to some $55 billion in 1974—mainly in money market assets in the United States (20 per cent) and in the U.K. and the Euro-currency markets (50 per cent). They also made large investments in direct loans to industrial oil-consuming countries (10 per cent) and in loans to the special oil facility established in the International Monetary Fund and to other multinational institutions (6 per cent). The remainder was dispersed through many channels, including some longer-term investments in industrial countries.

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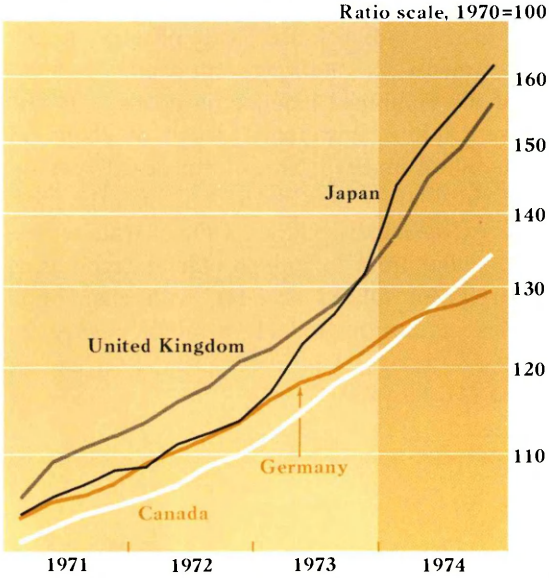
FOREIGN CONSUMER PRICES



NOTE.—Seasonally adjusted quarterly data from Organization for Economic Cooperation and Development. Q4 partly estimated.

The world's banking system faced multiple problems in 1974. Commercial banks needed to adjust not only to the vast inflow of OPEC funds and the financing requirements of oil consumers, but also to the weakening of confidence caused by the failure of a few banks with large losses in foreign exchange and other dealings. In addition, banks generally recognized that they had been expanding their operations more rapidly than was prudent in relation to their capital resources. Reacting to this situation and to the measures taken by concerned monetary authorities to preserve sound banking systems, banks tightened both their domestic and their foreign lending operations.

U.S. INTERNATIONAL TRANSACTIONS

The course of U.S. international transactions is reflected in the balance of payments accounts and also, under a system permitting substantial exchange-rate movement, in changes in the exchange rate for

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the dollar. In terms of broad aggregates of international transactions, the surplus on goods and services declined slightly from 1973 to 1974, with a sizable drop in the trade balance partly offset by higher net income on foreign investments. Private long-term capital outflows rose sharply in 1974, and the combined balance on goods, services, remittances, and long-term capital registered a deficit of about $8 billion, compared with $1 billion in 1973. Short-term private capital outflows, net, were only slightly larger than in 1973, though the gross flows through banks were extraordinarily large. Official transactions included an increase in U.S. liabilities to foreign official accounts of $9.4 billion—almost entirely for OPEC account, with changes in holdings by other countries netting out to only a minor change for

Table 10: U.S. INTERNATIONAL TRANSACTIONS

In billions of dollars, seasonally adjusted

Item	1973	1974[e]	1974			
			Q1	Q2	Q3	Q4[e]
Merchandise trade balance	.5	−5.8	−.1	−1.6	−2.6	−1.5
Exports	70.3	97.1	22.3	24.1	24.6	26.1
Imports	−69.8	−102.8	−22.3	−25.7	−27.2	−27.6
Investment income, net	5.3	8.8	3.1	1.8	2.2	1.7
Other service transactions, net	−1.4	−.5	−.1	−.4	(1)	.....
Balance on goods and services	4.3	2.6	2.9	−.2	−.3	.2
Remittances and pensions, net	−1.9	−1.9	−.4	−.5	−.5	−.5
U.S. Govt. grants and capital, net	−3.5	−3.8	−1.2	−.9	−.8	−.9
Long-term private capital, net	.1	−5.0	.5	−1.0	−2.0	−2.5
Balance on current account and long-term capital	−1.0	−8.1	1.8	−2.5	−3.6	−3.7
Short-term private capital, net	−2.0	−3.3	−1.8	−3.8	2.6	−.2
Of which- Foreign assets of U.S. banks	−5.0	−17.1	−5.0	−6.6	−2.0	−3.6
Foreign liabilities of U.S. banks	4.2	15.0	4.7	2.8	4.0	3.4
Liabilities to foreign official agencies	5.1	9.4	−.8	4.9	1.4	3.9
Of which- Oil-exporting (OPEC) countries, not seasonally adjusted	(.4)	(9.4)	(1.0)	(2.4)	(3.9)	(2.1)
Change in U.S. reserve assets	.2	−1.4	−.2	−.4	−1.0	.1
Errors and omissions	−2.3	3.4	1.0	1.8	.6	−.1
MEMO: Official settlements balance	−5.3	−8.0	1.0	−4.5	−.4	−4.1
Official settlements balance excluding liabilities to OPEC countries, not seasonally adjusted	−4.9	1.4	2.0	−2.2	3.6	−2.0

[1] Less than $50 million.
[e] Estimated.

NOTE.—Details may not add to totals because of rounding.
SOURCE.—U.S. Dept. of Commerce and F.R. estimates.

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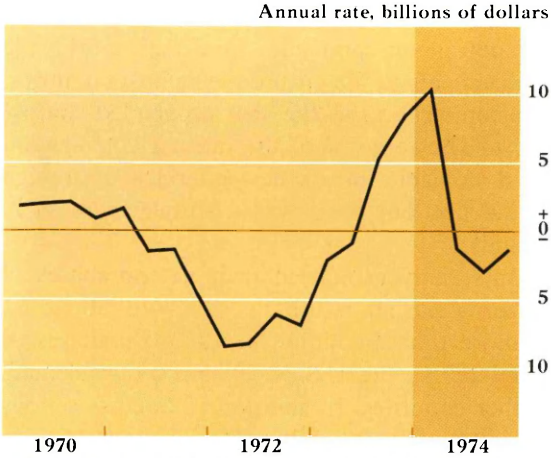
the year. There was also an increase of $1.4 billion in U.S. reserve assets. During the year errors and omissions in the accounts were generally on the receipts side, suggesting some net unrecorded inflow of capital.

As in the case of other countries, the jump in oil prices was the greatest single influence affecting both current and capital transactions in 1974, but other factors were also at work. The effective depreciation of the dollar since 1970 by about 16 per cent was probably still having a significant effect on the trade balance, supporting a strong export performance and restraining imports. On the other hand, the removal of controls on outflows of U.S. private capital in January (while barriers to inflows were coming down in other countries), together with declining interest rates in the United States early in the year and again toward the end of the year, tended to encourage the outflow of capital from the United States.

Despite an additional cost of over $18 billion for imports of fuels in 1974, the over-all trade balance declined by only $6 billion. Exports, in value terms, rose by $27 billion, including a rise of about $4 billion for agricultural exports. In volume terms agricultural ex-

BALANCE ON GOODS, SERVICES, AND REMITTANCES



NOTE.—Dept. of Commerce data at seasonally adjusted annual rates. Q4 partly estimated.

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ports were about 10 per cent lower in 1974 than in 1973, but nonagricultural exports were up by 12 per cent, following a strong—22 per cent—increase in 1973. The 1974 performance was especially impressive, given the weakening of demand in other industrial countries.

On the import side, nonfuel imports rose about $15 billion in 1974, but in volume terms they were cut back by about 2 per cent, reflecting in large part the decline in domestic economic activity. The volume of fuel imports was about 3 per cent less in 1974 than in 1973, but the price (unit value) of a barrel of imported crude oil rose from an average of $3.33 in 1973 to $11.00 in 1974.

It appears that net receipts of investment income scored a substantial gain in 1974—rising to a record of about $9 billion, compared with $5.3 billion in 1973. Most of the increase reflected larger profits by the petroleum companies from their foreign operations, though these may now diminish as initial inventory profits will not be repeated and ownership of the crude-oil-producing properties is relinquished to the host countries.

Long-term private capital transactions appear to have resulted in a net outflow of about $5 billion in 1974, based on incomplete data. This would be the largest net outflow since the imposition of capital controls in the early 1960's and a considerable shift from the near-balance in these flows in 1972 and 1973. Early in the year the net flow was inward, reflecting primarily the collection of funds in this country by international petroleum companies from their worldwide sales in advance of disbursements to the oil-producing host countries. Payments of taxes and income shares as the year progressed sharply raised the rate of outflow. The removal of the interest equalization tax in January 1974 did not spur major new offerings of foreign issues now relieved of the tax, but there was a sizable increase in offerings of Canadian bonds.

Foreign private investors sharply reduced their net purchases of U.S. securities other than Treasury issues in 1974—to about $1 billion, compared with more than $4 billion in 1973. Purchases of U.S. corporate stocks fell off as the U.S. stock market weakened, along with markets in other countries. In addition, U.S. corporations offered much smaller amounts of their bonds in foreign markets since

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they no longer needed to borrow abroad to satisfy the requirements of the controls on outflows of funds from the United States. Foreign direct investments in the United States, apart from special transactions related to certain petroleum companies, were substantially less than the 1973 peak amount.

Short-term private capital flows were very large in both directions in 1974, but preliminary data suggest that there was only a small increase in the net outflow from the United States. U.S. banks provided large amounts of credit to foreign countries, especially Japan, increasing their short- and long-term claims on foreigners by $18 billion in the year. The elimination of controls at the beginning of the year and the lower cost of borrowing in the United States for part of the year tended to raise the outflow from the U.S. offices of banks. After August there was some reduction in the rate of bank lending, in part because a number of the early borrowers had taken care of their needs for the year or had arranged borrowings from OPEC sources, and in part because of the general tightening of banks' lending policies. However, bank lending to foreigners was stepped up again in the closing months of the year. Although the increase in banks' foreign claims was enormous by past standards, it was nearly matched by a $15 billion increase in their liabilities to private foreigners—primarily through their branches and other banks in the Euro-dollar market.

In addition to magnified flows of private short-term capital, a major new element in the U.S. balance of payments in 1974 was the direct acquisition of U.S. money market assets by authorities of the OPEC countries. Such acquisitions amounted to about $9½ billion for the year, mainly in purchases of U.S. Government obligations.

Funds held in the United States by monetary authorities of non-OPEC countries were nearly unchanged for the year as a whole. At times during the year some countries—notably the United Kingdom, Italy, and Japan—drew on their dollar reserves, as well as on borrowings, to limit depreciation of their currencies. Toward the end of the year countries with strengthening currencies added to their holdings of dollar assets in the United States. U.S. reserve assets rose mainly as a consequence of drawings of dollars by some countries from the IMF.

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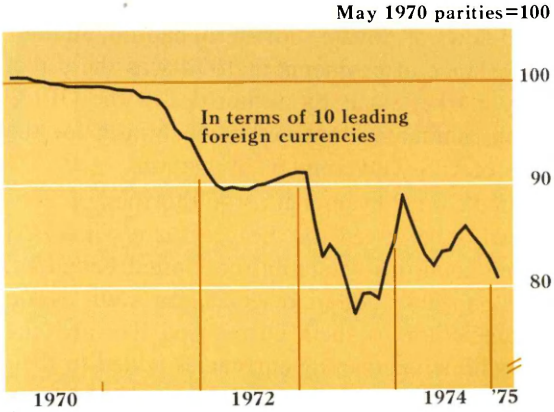
INTERNATIONAL FINANCIAL SCENE

International financial markets were under strong pressures in 1974 arising from the uncertainties created by the flow of oil payments and revenues; by rampant world inflation; and toward the end of the year, by the onset of worldwide recession. Exchange rates showed considerable variability as the market reacted to each new bit of information in this uncertain environment. The weighted-average exchange value of the U.S. dollar varied by about 10 per cent over the course of the year, and rates of exchange between the dollar and some continental European currencies varied by much more than that.

These fluctuations in exchange rates encouraged a number of banks—notably European banks—to take large open positions, particularly in the first half of the year, and some of these banks reported large foreign exchange losses. Such losses were directly responsible for the failure of a German bank that was relatively small in terms of its total assets but was a major participant in the exchange market; hence its failure had widespread effects. After that failure the volume of interbank trading declined sharply, as banks

INTERNATIONAL VALUE OF THE U.S. DOLLAR



NOTE.—Monthly-average market exchange rate of U.S. dollar against 10 major foreign currencies weighted by foreign trade in 1972. The weight for each currency is the share of that country's total trade (exports plus imports) in the total trade of the 10 countries plus the United States.

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restricted their dealings to only those banks deemed most creditworthy and reduced their limits on foreign exchange lines to nonbank as well as bank customers.

This extreme contraction of the market subsequently eased, but in general, banks have maintained a more cautious attitude toward exchange market transactions and have substantially tightened internal control procedures related to such transactions. In some major countries the authorities have increased their surveillance and/or control over banks' foreign exchange operations in the aftermath of the experience of foreign exchange losses by some banks in their jurisdictions.

After appreciating very sharply in the fourth quarter of 1973 and into January of 1974, the dollar depreciated from the end of January through mid-May, declining by 10 per cent on a weighted-average basis. Major factors in the dollar's depreciation in this period included the removal of controls on capital outflows by the United States and the relaxation of restrictions on inflows by most major foreign countries; the demonstration by several European countries of their willingness to engage in large-scale official borrowing in the Euro-currency markets to support their currencies while paying more for oil; and the continuation of large export surpluses in Germany, despite sharply higher oil payments, at a time when the trade balances of most other industrial countries were moving heavily into deficit.

The dollar's slide ended in mid-May with reports that the Federal Reserve, the German Federal Bank, and the Swiss National Bank had agreed upon the desirability of concerted exchange intervention in markets. Sharp increases in U.S. interest rates relative to foreign rates and, after June, market uneasiness stemming from the difficulties of some German banks contributed to a strong dollar until early September. At that time U.S. interest rates began a rather steady decline that continued into 1975, and the dollar's exchange value followed U.S. interest rates downward. By the year-end the dollar had depreciated by some 4.4 per cent from the beginning of the year on a weighted-average basis. Contributing to this decline in the dollar's exchange value was the asymmetry in intervention policies between countries with weaker currencies and those with strengthening currencies. Intervention sales of dollars by countries

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supporting weaker currencies exceeded purchases of dollars by countries resisting the appreciation of their currencies. The net effect of these operations was to add to the market supply of dollars, depressing the dollar's average exchange rate.

The Euro-currency market continued to expand at a very rapid rate during the first 4 months of 1974. The disclosure in May of the financial difficulties of a large U.S. bank, followed in June by the aforementioned failure of a German bank, led to greater caution on the part of lenders in the market and brought the market's growth to a halt. Between the end of April and the end of September there was a slight decline in the external foreign-currency liabilities of banks in London, the market's largest center. In part this leveling reflected an actual cutback in interbank redepositing. During this period lenders began to discriminate more sharply among borrowers and to evaluate risks more carefully. This caution produced a rate structure involving many more tiers than before, with smaller or lesser-known banks paying substantial premiums for funds, and also brought about a greater concentration of deposits with the larger banks.

In the fourth quarter, growth of the market resumed as concern for the safety of banks engaging in the Euro-currency business lessened somewhat. A factor that may have contributed to this easing of tensions in the Euro-currency market was the statement issued by the Governors of the Bank for International Settlements on September 9 to the effect that the Governors were satisfied that means were available to provide temporary liquidity to sound banking institutions and that those means would be used if and when necessary.

The rise in oil prices had a variety of impacts on the Euro-currency market. The oil-exporting countries placed perhaps 40 per cent of their estimated $55 billion surplus on current account in the Euro-currency market in 1974, generally at call or in other very short maturities. In London the oil-exporting countries' share of the gross total of Euro-currency deposits rose from 5 per cent at the end of 1973 to 14 per cent at the end of September 1974.

In the first quarter of 1974 new commitments of longer-term Euro-currency loans rose dramatically as several European governments sought funds to pay for oil. But commitments declined in the next two quarters, partly because lending banks became more wary of

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lending for balance of payments purposes. Italy, which had borrowed heavily in the market for longer-term loans in recent years, did not enter the market for further loans after early spring. In indirect reflection of swollen bills for oil imports, Japanese banks increased their takings from the Euro-currency market very sharply in the first half, for which they were obliged to pay substantial premiums. But their net borrowings do not appear to have increased much, if at all, in the second half of the year as the Japanese authorities moved to curb additional net foreign borrowings by the banks.

Reflecting the tightening of credit availability, spreads on Euro-dollar loans to nonbank borrowers widened by about ½ to ¾ percentage point between May and October, and there was a marked shortening of the average maturity of Euro-dollar loans of more than 1 year.

Gold was the subject of heightened interest as its dollar price nearly doubled from the middle of the fourth quarter of 1973 to the end of the first quarter of 1974 when the price reached $180 per ounce. As inflation in the major countries accelerated, people apparently sought refuge in gold. In the second and third quarters prices for gold fell sharply, influenced in large part by soaring interest rates, particularly on dollar assets. In the fourth quarter, however, interest rates declined, again particularly on dollar assets; this decline, together with the anticipation of U.S. residents' newly legalized purchases of gold at the close of the year, pushed the price to a new high in London of $195.25 per ounce in late December. When demand by U.S. residents for the 2 million ounces of gold offered by the U.S. Treasury in early January 1975 turned out to be unenthusiastic, the price dropped to a range of $170 to $180 per ounce in mid-January.

At the turn of the year many acute problems beset the world economy that will test severely the determination of countries to deal with their domestic concerns while contributing to the achievement of common interests. Many countries are faced with sagging economies and would normally look to an improved trade balance as a source of support—and many will do so with the added incentive of covering the cost of imported oil. But many industrial countries will have to revise their customary view of what constitutes an acceptable trade balance. Even though a considerable gain in exports to the oil

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producers can be expected, the industrial oil-consuming countries as a group must accommodate a large deficit with the OPEC countries, and any individual country's efforts to gain a trade advantage through restrictive devices would be at the expense of other oil-consuming nations. In addition to the matter of oil imports there are major discrepancies in the balance of payments performance of individual industrial countries that will require adjustment.

Apart from the adjustments needed to accommodate differences in economic performance, some of the industrial countries, and many of the less-developed countries, will need to finance continuing incremental payments for oil and related products. Such financing requirements could go beyond the limits of their ability to borrow on reasonable terms from the market.

Recognizing such needs, the Ministers of the Group of Ten at a meeting in Washington in January 1975 agreed that a solidarity fund open to all members of the Organization for Economic Cooperation and Development should be established, and the Interim Committee of the Board of Governors of the IMF agreed that the Fund's Oil Facility should be continued for 1975 with new resources of SDR 5 billion to be sought—primarily from the OPEC countries. Also in connection with the energy problem, the International Energy Agency was organized in 1974 for the purpose of implementing a program designed to deal with shortages of oil and to develop substitute energy sources.

In this period of severe economic change, it is especially difficult to make progress on the basic issues of the international monetary system. Nevertheless, discussion has continued on those issues; tentative agreement was reached in January on an increase in IMF quotas to SDR 39 billion, and the Executive Directors of the Fund were instructed to draft a number of amendments to the Articles of Agreement involving most of the outstanding issues, including the role of gold and the legalization of floating exchange rates. Through effective use of these institutional structures it should be possible to act in cooperation to meet the many acute problems of the world economy. □

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