INTERNATIONAL SITUATION AND EVENTS — SIX MONTHLY REVIEW

INTERNATIONAL ECONOMIC DEVELOPMENTS: SUMMARY

In the face of a steep rise in oil prices, accelerating inflation and stricter macro-economic policies the growth in real GNP for the OECD countries as a whole in 1979 is estimated at 3.25 per cent, down from the 3.9 per cent growth achieved in 1978. The slowdown in GNP growth rates in 1979 became most apparent in the second half of the year. In the first half of 1979 the GNP annual growth rate of the OECD countries was 3.1 per cent but, with increasing inflationary pressures and the cumulative effects of tightening monetary policy, was estimated to have fallen to 2.25 per cent in the second half of 1979.

The United States and the United Kingdom have borne the brunt of the faltering growth rates. From 4.4 per cent for 1978 the growth rate of real GNP for the United States is estimated at only 1.6 per cent over 1979 while for the same period the United Kingdom suffered a fall from 3.3 per cent to an estimated 0.7 per cent. In contrast the other OECD countries, notably Japan and West Germany, experienced faster growth rates in 1979 than in 1978 although a slowdown was evident in the latter half of 1979.

But any attempts to increase or sustain growth rates are constrained by the risks of further increasing inflation rates. In the first half of 1979 the consumption deflator for the seven major countries[1] rose at an annual rate of 7.4 per cent and is expected to have increased to 10.2 per cent in the second half of the year. A large part of the increase in inflation rates is attributable to oil price increases but there are strong pressures from adverse unit labour cost movements and rising industrial material costs. For the smaller OECD countries the rate of inflation in 1979, estimated at 8.5 per cent, was almost 1 percentage point below that recorded in 1978 but this improvement is expected to be short-lived.

Private consumption grew rapidly in most OECD countries in the first half of 1979, largely as a result of strong real income growth, but only slowly in the United States. However as real incomes are depressed by the effects of oil and commodity price increases consumption growth is expected to have slowed markedly in the second half of 1979. The rate of growth of private non-residential investment, which was unexpectedly strong over the year to mid 1979, was expected to have decelerated in the last half of the year, reflecting lower expected profits and higher interest rates, although remaining strong in Japan and West Germany relative to the average of the major countries.

A feature of the recent period has been the very slow growth of public consumption, reflecting attempts to restrain public sector deficits. The OECD Secretariat expects this trend to continue into 1980, placing restraints upon the growth in overall domestic demand.

There was continued modest growth in employment in the OECD area in the first half of 1979, most noticeably in North America and Japan, although employment remained static in the smaller OECD countries taken as whole. However productivity growth fell by 1.25 percentage points between the second half of 1978 and the first half of 1979, particularly in the United States, in line with the decline in GNP growth. Unemployment in the OECD area remained at 5.1 per cent over the year to mid-1979, but is expected to deteriorate to around 6 per cent in late 1980 as employment growth eases in line with an expected slowdown in economic activity.

The current account balance of the OECD area was in deficit at an annual rate of over $US19 billion in the first half of 1979 after recording a surplus of $US9 billion in 1978. This reversal is largely attributable to higher oil and other commodity prices together with reduced exports to the OPEC countries. The current account deficit for 1979 is expected to be about $US30 billion as the additional increases in oil prices in mid-year take effect.

The outlook for 1980 is very uncertain. The inability of OPEC to agree on a common pricing policy at their December meeting in Caracas makes it difficult to make any definitive statement about the price of oil over the coming year, a factor which vitally affects the growth prospects of the non-OPEC countries. On the assumption that the real price of oil would remain at the mid-year level the OECD secretariat had forecast a 1.25 per cent growth rate in gross national product for the area for 1980. However a preliminary assessment of the likely affect of the latest round of oil price increases sees a reduction in this rate of growth to no more than 0.3 per cent.

The prospects are not however for a recession such as that which occurred after the 1973 'oil shock'. At that time all the major economies peaked and entered a down-turn in concert, exacerbating the severity of the recession. The prospect for 1980 is for a desynchronised movement in domestic demand in different major countries. While the absolute level of output in both the United States and the United Kingdom is expected to fall, only a modest slowdown of current growth rates is expected in West Germany and Japan. The down-turn is therefore expected to be more moderate and of a shorter duration than would otherwise occur.

GROWTH

Following a year of rapid growth, output slowed markedly in the *United States* in the first half of 1979, GNP growing at an annual rate of only 1.3 per cent. There was an actual decline of 2.3 per cent (annual rate) between the first and second quarters. Although activity was surprisingly strong in the third quarter of 1979 the growth rate of GNP for 1979 overall is estimated at only 1.6 per cent. The downturn in the USA economy is largely attributable to high and increasing inflation rates which has led to hesitant business confidence and falling real income.

Supported by strong domestic demand real GNP in *Japan* grew at an annual rate of 6.8 per cent in the first

[1] United States, Japan, Federal Republic of Germany, France, United Kingdom and Italy.

half of 1979 with only a slight reduction in the growth rate expected over the remainder of the year. The strength of domestic demand has offset the impact of the dramatic turnaround in the current account of the balance of payments. Falling export incomes and a surge in import payments (aided by markedly higher energy prices) have swung the current account from a surplus of $US16 billion in 1978 to an estimated deficit of $US5 billion in 1979. With the underlying rate of inflation accelerating in the second half of 1979 a more restrictive monetary stance has been adopted and together with a less expansionary fiscal policy and the effects of a depreciating yen the rate of growth of GNP was forecast by the OECD to fall to 5.5 per cent (annual rate) in the first half of 1980 though the latest oil price increases could imply a downward revision to this figure.

GROWTH OF REAL GNP
(% Change)

	Average 1967–1976/7	From Previous Year 1977	1978	1979[2]	1980[2]
United States	2.8	4.9	4.4	1.6	-1.2
Japan	7.8	5.4	5.6	6.0	5.4
Federal Republic of Germany	3.6	2.6	3.5	4.1	2.3
France[1]	4.6	3.3	3.3	2.6	2.1
United Kingdom[1]	2.1	1.2	3.3	0.7	-0.7
Italy[1]	3.9	2.0	2.6	4.1	2.2
Canada	4.7	2.7	3.4	2.7	1.9
Australia[1]	4.6	1.2	2.4	4.7	2.7
New Zealand[1]	2.9	-1.8	0.5	0.3	1.0
Austria	4.6	3.7	1.5	5.2	2.0
Belgium	4.5	1.2	2.5	2.9	2.4
Denmark[1]	3.6	2.0	1.0	2.3	0.8
Finland[1]	4.4	0.3	1.4	7.2	4.4
Greece[1]	6.0	3.7	6.3	3.4	0.0
Iceland	3.8	4.8	4.1	2.6	3.6
Ireland[1]	4.3	5.5	6.1	3.0	3.6
Netherlands[1]	4.4	2.3	2.4	2.8	4.5
Norway[1]	4.6	3.5	3.5	2.8	2.4
Portugal[1]	5.5	5.8	3.2	3.0	2.3
Spain[1]	5.2	2.4	3.1	1.6	1.0
Sweden[1]	2.4	-2.1	2.8	4.0	3.1
Switzerland	2.1	2.7	0.2	0.3	2.0
TOTAL OECD	4.2	3.7	3.9	3.25	1.4

Source: OECD
[1] GDP
[2] Estimates

As in Japan, the *Federal Republic of Germany* experienced strong domestic demand in the first half of 1979 and for the year the growth in real GNP was around 4 per cent. However some slowdown was experienced late in 1979 and this is expected to continue into 1980 for which a growth rate of 2.5 per cent is forecast. As in most countries inflationary pressures intensified in 1979 with steep rises in the prices of imported goods. This led to a stronger anti-inflationary monetary policy stance which together with a somewhat less expansionary fiscal stance, should lead to the forecast slowdown in activity in 1980.

The rate of growth of real GNP slowed markedly in the *United Kingdom* in the first half of 1979 and an actual decline was experienced in the third quarter, primarily reflecting losses in industrial production stemming from labour disputes. There was also a weakening of consumer demand in the third quarter following heavy second quarter demand in anticipation of the June budget VAT increases. These developments were accompanied by accelerating inflation which for the year to September 1979 reached 16.5 per cent. For 1979 the OECD expects GNP to have risen by only 0.7 per cent.

With weak domestic demand forecast and continued tight monetary and fiscal policies the outlook for 1980 is for falling activity, rising unemployment and continued strong inflation. The United Kingdom Treasury currently forecasts a 2 per cent drop in gross domestic production in 1980.

PRICES

Inflationary pressures in OECD countries intensified throughout 1979. Over the six months to September 1979 consumer prices in OECD countries rose at an annual rate of almost 13 per cent, compared with 7.9 per cent in the whole of 1978. In the second half of 1979 the seven major economies experienced a marked acceleration in inflation rates, partly attributable to higher indirect taxes, lower productivity and increasing industrial materials costs. But the major part of the deterioration is attributable to the sharp rise in OPEC oil prices, the full effects of which have not yet been absorbed. Further oil price increases are likely as a result of the December meeting of OPEC countries and with cut-backs in oil production likely in 1980, the pressure on oil prices is likely to be sustained.

CONSUMER PRICES
(% Change, Annual Rates)

	Average 1961–70	1971–76	1977	1978	12 Months to October 1979
United States	2.8	6.6	6.5	7.7	12.2
Japan	5.8	11.1	8.1	3.8	4.2
Federal Republic of Germany	2.7	5.9	3.9	2.6	5.7
France	4.0	8.9	9.4	9.1	11.3
United Kingdom	4.1	13.6	15.9	8.3	17.2
Canada	2.7	7.4	8.0	9.0	9.3
Italy[1]	3.9	12.2	17.0	12.1	18.2
Australia	2.5	10.8	12.3	7.9	9.2[2]
New Zealand	3.8	11.3	14.3	12.0	15.2[2]
TOTAL OECD	3.4	8.6	8.7	7.9	11.0

Source: OECD
[1] Break in series in 1977
[2] Twelve months to September 1979

EMPLOYMENT

Over the first six months of 1979 the unemployment rate in the OECD countries remained virtually unchanged from the second half of 1978 level of 5.1 per cent of the labour force. The unchanged unemployment rate disguises differing experiences. In the United States the unemployment rate remained relatively constant, but it rose marginally for the smaller OECD countries and increased steadily in France up to the second quarter of 1979. In Japan, West Germany, the United Kingdom and Canada the rate of unemployment fell.

Over the same period employment rose steadily with North America and Japan recording the largest increase. But productivity growth, with the exception of Japan, has been low, falling by over one percentage point between the second half of 1978 and the first half of 1979. In the United States and Canada there was an absolute reduction in productivity of around 1.5 per cent at an annual rate. Productivity growth is forecast to continue to decelerate to mid 1980 in line with the decline in GNP but may pick up thereafter.

Although unemployment rates appeared to be holding in the third quarter of 1979 it is forecast that unemployment in the OECD countries may deteriorate to 6 per cent in the second half of 1980, the strongest rises being likely to occur in the United States and the United Kingdom.

INTERNATIONAL TRADE

During 1979 the volume of exports of the OECD countries is estimated to have increased by 6.25 per cent and that of imports by 7.5 per cent. Both figures are higher than those recorded in 1978. An increase in stockbuilding in early 1979 led to large rises in raw materials imports and over the first half of 1979 import volumes rose by 8-9 per cent while real GNP increased at an annual rate of only 3 per cent. But a running down of stocks and slower growth in consumer demand are expected to slow import growth to 3 per cent in 1980 although some recovery may occur in the latter part of that year.

Export volumes were affected early in 1979 by a decline in imports by some OPEC countries, including the temporary cessation of imports by Iran, but recovered in the second half of the year. Total export volumes of the OECD countries are expectd to increase by 5 per cent in 1980. Slower growth in the OECD area and weakening demand by non-oil developing countries will be only partially offset by increasing spending by OPEC countries.

The OECD area experienced a 2 per cent terms of trade gain in 1978 on its total trade but this was more than reversed in 1979 because of higher prices for commodities. Both export and import prices accelerated early in 1979 but whereas the rate of growth of export prices remained relatively steady throughout the year import prices accelerated further in the second half of the year following the big jump in OPEC dollar oil prices. From the second half of 1978 to the second half of 1979 import prices moved from a 1 per cent growth rate to one estimated at almost 25 per cent.

The higher commodity prices and reduced exports to OPEC moved the OECD area's current account into deficit early in 1979 and for 1979 the deficit on current account is likely to be $US30 billion with a further deterioration to about $US50 billion possible in 1980. The current account surplus of the OPEC countries improved dramatically in 1979 and is expected to increase further in 1980.

In contrast, the combined current account deficit of the non-oil developing countries continues to worsen and by the end of 1980 is projected to be running at an annual rate of over $US60 billion, equal to 30 per cent of expected export earnings in that year.

On a seasonally adjusted basis the *United States* current account deficit was sharply reduced throughout 1978 and a surplus on current account of $US415 million was recorded in the first quarter of 1979. But this development was reversed in the second quarter and the OECD expects that the U.S.A.'s current account will revert to deficit in 1980. The improvement in the current account up to early 1979 reflected a rapid growth in exports aided by increasing competitiveness due to exchange rate developments and a more moderate growth in imports. However export growth is forecast to decelerate rapidly as world demand slackens in 1980 and U.S. products lose some competitiveness due to high domestic inflation. The effect of reduced export growth is expected to be partially offset by a decline in import volumes as domestic demand weakens.

Japan has experienced a substantial deterioration in its current account balance over the last eighteen months. In the second half of 1978 a current account surplus of $US13 billion in seasonally adjusted annual rate terms was recorded but by the September quarter of 1979 Japan was running a deficit at an annual rate of about $US15 billion. The turnabout in the current account is attributable to increases in the prices of crude oil and other primary product imports, a downturn in the growth of export markets (notably the United States) and the appreciation of the yen prior to October 1978. The latter led to a slowdown in export growth and an increase in imports, aided by the emergency import scheme. Although the yen had depreciated by 30 per cent by late 1979 the export response to the increased competitiveness of the yen had not yet materialised and the current account is forecast to remain in deficit at least to the end of 1980.

After recording a surplus of $US10.5 billion in 1978 the current account of the *Federal Republic of Germany* is forecast to be roughly in balance in 1979. The disappearance of the surplus is due to a high level of imports early in 1979 associated with considerable stock building and a sharp rise in import prices, which were 19.5 per cent higher in October 1979 than a year

CURRENT ACCOUNT BALANCES[1]
(Billions of U.S. Dollars)

	1975	*1976*	*1977*	*1978*	*1979*[2]
United States	21.3	7.8	-11.3	-10.7	-2.0
Japan	-0.4	3.9	11.1	16.8	—
Federal Republic of Germany	7.1	7.2	8.5	13.1	5.5
France	1.0	-5.1	-2.1	5.3	1.5
United Kingdom	-3.2	-0.5	2.6	4.1	2.5
Italy	0.7	-1.6	4.0	8.9	7.0
Canada	-4.6	-3.9	-3.9	-4.7	-6.0
Australia	-0.6	-1.4	-2.6	-3.9	-3.7
New Zealand	-1.4	-0.7	-0.9	-0.7	-0.9

Source: IMF
[1] Goods, Services, Private Transfers
[2] Estimates

GLOBAL STRUCTURE OF CURRENT ACCOUNT BALANCE[1]
(Billions of U.S. Dollars)

	1967–73 Average	*1975*	*1976*	*1977*	*1978*	*1979*[2]
Major Oil Exporting Countries	1.5	35.0	40.0	31.8	6.2	5.0
Industrial Countries	11.2	23.8	5.4	0.3	32.2	2.5
Other Non-Oil						
more developed	-1.3	-14.8	13.7	12.7	-6.0	-9
less developed	-8.6	-38.2	-26.0	-21.0	-32.0	-45

Source: I.M.F.
[1] Goods, Services, Private Transfers
[2] IMF Estimates

previously. Although a steady decline in the growth of import volumes and favourable competitive position is expected by the OECD Secretariat the current account balance is forecast to deteriorate moderately in 1980, especially over the first half of the year.

After a surplus of $US2 billion on current account in 1978 the *United Kingdom* recorded a deficit of $US2.5 billion in the first nine months of 1979. The deterioration in the current balance reflects a marked appreciation of sterling and increased penetration of the domestic market by imported manufactures. The OECD expects the deficit on current account to persist through 1980 as competitiveness is further reduced by high domestic cost pressures, leading to essentially static non-oil export volumes even though self sufficiency in oil is expected by mid-1980.

INTERNATIONAL CURRENCY MARKETS

The gradual recovery of the dollar in the six months to April 1979, largely as a result of the supportive measures taken in October 1978, was reversed in June and July with the Deutschmark and the Swiss franc gaining relative to the dollar. The reversal in the value of the dollar was influenced by the June oil price rises, inflation trends and prospects in the United States, and doubts about the effectiveness of monetary policy despite rising nominal interest rates. In early October the dollar, while appreciating against the yen, had fallen over 5 per cent against the pound sterling and nearly 10 per cent against the Deutschmark and Swiss franc since early June. But on October 4 the U.S. authorities announced a series of measures designed to help curb speculative excesses in financial, foreign exchange and commodity markets, slow the expansion of money and bank credit and consequently dampen inflationary pressures. The measures consisted of:

— a 1 per cent increase in the discount rate at the Federal Reserve Bank of New York to 12 per cent;

— the establishment of an 8 per cent marginal reserve requirement on increases in 'managed liabilities' i.e. liabilities that had been actively used to finance rapid expansion in bank credit;

— a change in the method used to conduct monetary policy by placing greater emphasis on the supply of bank reserves and less emphasis on confining short term fluctuations in the Federal funds rate.

Following the announcement of these measures the dollar rebounded markedly, especially against the Deutschmark and Swiss franc, and at mid-October the depreciation of the dollar against these currencies from early June was reduced to 6.5 per cent. The dollar continued to appreciate against the yen which was weakened by Japan's large balance of payments deficit and heavy dependence on imported oil. However in November the dollar weakened against most major European currencies following widespread interest rate rises and the crisis in the Iranian-United States political relationship.

The West German authorities intervened on a large scale over the four months to mid-October to limit the appreciation of the Deutschmark against the dollar and other European Monetary System (EMS) currencies. The strength of the Deutschmark put heavy pressure on the Danish krone and the Belgian franc and resulted in a realignment of the EMS currencies in late September. The Deutschmark was revalued by 5 per cent against the Danish kone and by 2 per cent against other EMS currencies.

The pound sterling rose against virtually all currencies from the beginning of 1979 to late July. Expectations of rapid inflation in the United Kingdom and the abolition of exchange controls led to the gain being halved by mid-September but this was more than offset by the effects of the mid-November increase in the minimum lending rate from 14 to 17 per cent.

After a period of relative stability in June the price of gold resumed its upward trend and reached a level of $437 per ounce on the London market in early October. The equivalent price in October 1978 was $US218. After easing through the remainder of October and the first half of November gold prices recovered to reach $US450 in early December. The demand for gold is in response to a pessimistic appraisal of the world economic outlook and political uncertainties in the Middle East and Iran.

The latter aspect was emphasised early in 1980 when, following events in Afghanistan and renewed concern over the crisis in Iran, the price of gold rose through the $500 and $600 levels and by mid-January had reached almost $670 in New York, up to that time the highest price ever on any major market.

THE INTERNATIONAL MONETARY FUND

The 1979 meetings of the Fund and the World Bank were held in October. The central theme of these meetings was the necessity of combating inflationary pressures worldwide together with deep concern over the world economic outlook. The Interim Committee of the Fund endorsed policies in the industrial countries giving priority to the reduction of inflation and reaffirmed its view that "in many countries progress in reducing inflation was an essential precondition for the resumption of rigorous economic growth". The Committee also noted the very large shifts in current account balances both among and within groups of countries but added that the problem of the distribution of current account balances among the industrial countries appeared to be receding and saw this development as evidence of a better working of the international adjustment process.

Grave concern was expressed at the meetings over the position of the non-oil developing countries whose deficit on current account, about $US45 billion in 1979, is expected to be $US53 billion in 1980. Amongst widespread agreement that these countries will need assistance from the industrial and oil exporting countries as well as the Fund, the World Bank and other international organisations, the IMF put forward proposals to ease lending terms for countries in difficult positions. These proposals included:

— that the Executive Board of the IMF give further consideration to increasing the maximum repurchase period for purchases under the Extended Financing Facility from eight to ten years. The approval of this proposal was announced in December 1979.

— that the Board consider ways of lowering the interest costs of the Supplementary Financing Facility.

Other measures which will be of assistance to non-oil developing countries are:

— the proposed increase in quotas under the Seventh General Review of Quotas which will raise total quotas from SDR39 billion to SDR58.6 billion. The Interim Committee and a number of Governors of the Fund urged member countries to take action as quickly as possible to enable them to consent to the proposed increases in their quotas;

— compensatory financing to meet shortfalls of export earnings is to be extended from 75 per cent to a possible 100 per cent of a member's quota.

A significant development arising from the meetings was a request by the Committee for the Executive Board to give priority to designing a substitution account plan and to report progress at the Committee's next meeting in April 1980. Such an account, administered by the Fund, would accept deposits of U.S. dollars from members of the Fund and certain other official holders in exchange for an equivalent amount of SDR-denominated claims. The Interim Committee concluded that "such an account, if properly designed, could contribute to an improvement in the international monetary system and would constitute a step toward making the SDR the principal reserve asset in the system. In order for the account to achieve widespread participation on a voluntary basis and on a large scale, among other things it should satisfy the need of depositing members, both developed and developing; its costs and benefits should be jointly shared among all parties concerned, and it should contain satisfactory provisions with respect to the liquidity of the claims, their rate of interest and the preservation of their capital value."

In line with recent measures enlarging the ways that member country participants in the SDR Department may transfer SDRs among themselves the IMF recently authorised the use of SDRs in swaps and forward operations. Under the decision on swaps a participant may transfer SDRs to another participant in exchange for an equivalent amount of currency or another monetary asset, other than gold, with an agreement to reverse the exchange at a specified future date and at an exchange rate agreed by the two parties. With regard to forward operations participants are now free to buy and sell SDRs for delivery at a future date, against another currency or another monetary asset, other than gold, at an exchange rate agreed between the participants.

Monetary Policy Measures

ON 19TH DECEMBER 1979, THE MINISTER OF FINANCE, THE RIGHT HON. R. D. MULDOON, announced an easing in the reserve asset ratios applied to trading banks and a reduction in the Government Security ratios applied to trustee and private savings banks.

The Minister said that domestic inflation rates and a deteriorating external current account mean that monetary policy will need to remain generally firm over the year ahead. However, real activity has been slowing recently and it is Government policy to ensure that the economy is stabilised and does not slip into a short-term recession. "I have already taken some fiscal measures over the last few months aimed at maintaining real economic activity at a stable level," Mr Muldoon said. "It is important that monetary policy, while remaining firm, should not lead to monetary conditions that are unduly tight."

"The reduced fiscal deficit in the current year, coupled with more active public debt policies, has already reduced the growth rates of the monetary aggregates and the reserve base of the financial system," Mr Muldoon added. "The narrow money supply M1 is currently growing at only about 4 per cent a year. Though the growth rates of broader monetary aggregates and private sector credit are still well in excess of this rate, the growth of M1 and the reserve base are usually leading indicators and the growth of the broader aggregates is expected to slow markedly over the next year," Mr Muldoon said.

The Government has decided to act in anticipation of these trends in order to maintain a smooth transition to more stable monetary conditions.

As the first step, the reserve asset ratios applied to trading banks will be eased slightly from the very tight positions which had been applied since July 1979. As from January 1980 reserve ratios will be set on the basis of an estimated level of free reserves of $50 million. "This is still a firm position but it should help moderate interest rate pressures during the March quarter," Mr Muldoon said.

The other measure announced by the Minister to take effect in the March quarter is a reduction in the Government security ratios applied to trustee and private savings banks. The trustee savings bank ratio will be reduced by 1 percentage point from 39 per cent to 38 per cent and the private savings bank ratio will be reduced by 2 percentage points from 56 per cent to 54 per cent. These reductions will take effect from 1st February 1980 and will release approximately $34 million for investment by the savings banks in the private sector.