INTERNATIONAL ECONOMIC SITUATION AND DEVELOPMENTS

INTRODUCTION

In view of the major developments occurring in the International Monetary Fund (IMF), this article considers first the general global economic situation and, secondly, the moves recently taken by the Fund to meet some of the problems facing the world economy.

The international economy is currently influenced by two main forces; the second oil shock, and the tight policies adopted by the industrial countries to meet it. Both are deflationary. Most of the major countries are still in the recession substantially induced by the oil price rises of 1979/80, and deepened by the restrictive anti-inflation policies implemented. Some success has been achieved in limiting the pass-through of higher oil prices into the domestic price/wage spiral but the cost has been slower growth of output and trade, and increasing unemployment.

Generally there has been better adjustment to the second increase of oil prices than to the first and a smooth recycling of oil funds to date by the private markets. Also a break in the previous close link between economic growth and oil consumption has emerged. Even so, the current economic situation facing most countries remains difficult. In May 1981, the Interim Committee of the IMF Board of Governors outlined the broad problem areas as world-wide inflation, growing unemployment, slow growth of output and world trade, high level of interest rate volatility and associated exchange rate movement and the financing of large external payments imbalances, particularly among non-oil producing developing countries.

A reduction of inflation and inflationary expectations is widely considered a necessary condition for the achievement of lower interest rates, more buoyant private investment and sustained, faster economic growth. This stance calls for demand restraint policies supplemented with appropriate supply-side policies, the latter designed to improve the climate for investment and economic efficiency.

The large external deficits of many of the non-oil producing developing countries also present very real financing and adjustment problems. It is to this aspect in particular that the Fund has addressed its attention. Developments in Fund policy over the past year have placed the IMF in a better position to provide financial assistance to its members for the purpose of facilitating the adjustment process.

GROWTH

World economic growth slowed considerably in 1980 reflecting the deflationary impact of the strong 1979/80 oil price rises and the swing towards restriction in the economic policies of the major industrial countries. Four key measures of world economic activity (total ouput, manufacturing output, total trade, and trade in manufactures) recorded in 1980 their third lowest growth rates of the past 25 years (being less favourable only in 1958 and 1975).

In the 24 OECD countries as a group, economic activity decelerated in the first half of 1980 and contracted in the second half. For the year as a whole the combined real GNP for these countries rose 1.3 percent last year, against 3.3 percent in 1979 and 3.9 percent in 1978.

Output in the oil exporting countries fell almost 3 percent in 1980 due to a large decline in oil sector production. But although real GNP growth in the non-oil producing developing countries as a group has averaged 5 percent in recent years, this reflects the relative success of a number of the larger countries; for the majority of this group, growth rates have been modest.

Given the strong deflationary forces still acting on the OECD economies, recovery of the industrial world from recession is expected to be restrained and hesitant. The consequences of the higher real oil prices will probably still affect demand throughout 1981 and the projected tight stance of fiscal and monetary policies allows for little growth in government consumption or investment. Some reduction in fiscal stimulus was achieved last year (with the notable exception of the United States) but budgetary plans for 1981 indicate a widespread, more pronounced shift toward restraint, estimated to be equivalent to 1 percent cut in GNP for the whole OECD. Monetary policy also will continue to dampen demand. The main expansionary forces will come from OPEC imports and a recovery in consumption as real incomes resume modest growth. As a result, continued low

GROWTH OF REAL GNP
(% change)

	Average 1968-78	*From Previous Year 1978*	*1979*	*1980*	*1981 (est)*
United States	2.9	4.4	2.3	-0.2	2.1
Japan	6.6	6.0	5.9	4.2	3.3
Federal Republic of Germany	3.5	3.5	4.5	1.8	-1.7
France[1]	4 4	3.3	3.3	1.3	0.0
United Kingdom[1]	2.3	3.5	1.5	-1.8	-1.9
Italy[1]	3.4	2.6	5.0	4.0	-1.7
Canada	4.4	3.4	2.8	0.1	2.3
Australia[1]	3.7	2.9	4.4	2.7	6.2
New Zealand[1]	2.9	-1.9	-0.4	2.7	2.8
Austria	4.4	1.5	5.1	3.6	-0.7
Belgium	4.0	2.5	2.4	1.4	-0.3
Denmark[1]	3.2	1.0	3.5	-1.0	0.2
Finland[1]	4.0	1.4	7.2	5.3	2.8
Greece[1]	5.9	6.2	3.8	0.6	0.9
Iceland	5.6	4.2	2.3	2.5	0.0
Ireland[1]	4.3	6.1	1.9	1.0	1.8
Netherlands[1]	3 9	2.4	2 3	0.8	-1.4
Norway[1]	4 3	3.0	3.2	3.7	0.6
Portugal	4.8	3.2	4.8	4.7	3.5
Spain[1]	5 0	2.5	0.8	1.7	1.9
Sweden[1]	2.1	2.4	3.8	1.4	-1.2
Switzerland	1.7	0.2	2.2	3.2	0.9
Turkey	6.3	3.0	0.6	1.0	4.1
Total OECD	3.8	3.9	3.3	1.3	1.1

Source OECD
[1] GDP

growth of around 1 percent is projected for this year followed by a modest recovery in the order of 2–2.5 percent in 1982.

The very low average growth rates for 1980/81, together with the limited improvement projected for 1982, are indicative of widespread economic sluggishness in the industrial world. There is, however, considerable variation across countries in the timing and magnitude of the shortfalls in real GNP growth. Although lower than in recent years, Japan's relative strength is largely due to the contribution of its foreign balance.

In North America, growth of output has strengthened unexpectedly since mid-1980, but the rates (8.4 percent annualised in the first quarter for the U.S.), are not expected to be maintained due to the moderating impact of high interest rates.

The combination of monetary restraint and severe inflation has led to a rapid increase in interest rates, surpassing historic levels in many countries, notably in the U.S. The high levels of U.S. rates of interest, together with a markedly stronger dollar, has had the side effect of constraining the policy options of other countries. The European countries with current account deficits have been particularly affected, their exchange rates being vulnerable to international currency flows. This has meant the maintenance of interest rates at levels higher than warranted by domestic conditions. Until their current account position improves therefore, the outlook for the main European economies remains weak.

Activity in the United Kingdom remains severely depressed, and the authorities have reaffirmed their commitment to the medium-term strategy, which involves monetary and fiscal restraint aimed at reducing inflation.

EMPLOYMENT

Employment levels rose in all major industrial countries except the U.K. in 1980, but the growth of 0.4 percent was considerably less than in 1979 (1.7 percent) and was confined to the first half of the year and concentrated in the non-manufacturing sectors. The deceleration in employment growth, together with a civilian labour force increase in excess of 1 percent resulted in unemployment worsening. The rate of unemployment of the OECD labour force rose from 5.1 percent in 1979 to 5.8 percent in 1980, comparable to rates recorded in the 1974/75 international recession.

Further overall deterioration is projected given the expectation of continued labour force growth and sluggish economic activity. The OECD projects that unemployment will rise to around 7.5 percent by the end of 1982, amounting to 26 million unemployed.

PRICES

Inflation, although moderating, is still a major problem in most countries. In the OECD countries consumer prices increased 13 per cent in 1980, while the rate of the oil exporting group of countries accelerated to 14 per cent (up from 11 per cent in 1979) and in the non-oil developing countries averaged 33 percent compared to 24 per cent in 1979. All are at historically high levels.

The increasingly restrictive monetary policies of the industrial countries and the lessening of oil price pressures have led to some slowing of inflation in the last twelve months, and a decline to an average of around 10 per cent is projected for the industrial countries for 1981. A further small decline is forecast for 1982.

The strength of inflationary expectations remains a real barrier to the permanent reduction of inflation. The IMF has accordingly advocated significant reductions in the rate of growth of nominal demand, more effective implementation of supply-side measures (such as incentives to the private sector to save and invest; reduction in dependence on imported oil) and the possible use of incomes policy.

Wage increases to date have tended to contribute to the gradual deceleration in inflation throughout the industrial world. For the seven largest industrial countries as a group, the average rate of increase in hourly compensation of employees in manufacturing industries rose by only 1.5 percentage points (from 9.5 to 11 per cent) from 1978 to 1980 against a 5 percentage point increase in consumer prices (from 7 to 12 per cent) in the same period. Some lagged 'catch-up' was evident in the middle of 1980, but even if there is a reversion towards more customary rates of increase, overall growth in real wages this year seems likely to be fairly moderate by recent standards. (Real wage gains in the 1970s averaged 6 per cent in the first half of the decade and 3 per cent in the second.) It is anticipated that nominal wage gains will move in line with, but not fully equal, consumer price changes. Thus, the difficulties of reducing nominal wage increases will remain, although the presence of under-utilised labour resources, reinforced by a deceleration in consumer prices, should exert a dampening influence.

CONSUMER PRICES
(% Change, Annual Rates)

	Average				*12 months to March*
	1961-70	*1971-77*	*1979*	*1980*	*1981*
United States	2.8	6.6	11.3	13 5	10.6
Japan	5.8	10.1	3.6	8.0	6.2
Federal Republic of Germany	2.7	5.6	4.1	5.5	5.5
France	4.0	9.0	10.8	13.6	12.5
United Kingdom	4.1	13.9	13.4	18.0	12 6
Canada	2.7	7.5	9.1	10.1	12 5
Italy[1]	3.9	13.1	14.8	21.2	20.4
Australia	2.5	11.0	9.1	10.2	9.5
New Zealand	3.8	11.7	13.8	17.1	15.2
Total OECD	3.4	8.5	9.8	12.9	10.8

Source OECD
[1] Break in series in 1977

COMMODITIES

The International Monetary Fund's overall index of primary commodity prices (excluding oil and gold) rose 10 per cent in U.S. dollar terms in 1980, down 2 per cent in real terms. The index peaked in the first quarter of the year, stabilising at a slightly lower level for the remainder of 1980.

There were wide differences between commodity groups. Food prices gained 34 per cent largely due to sharp increases in sugar prices as crop failures in the major producing countries resulted in world sugar production being less than consumption for the first time since 1973. On the other hand, prices of beverage crops (coffee, tea and cocoa) fell 12 per cent, reflecting abundant supplies. Average prices of agricultural raw materials and metals rose modestly by 5 per cent and 10 per cent respectively. Both these groups of commodities are particularly sensitive to variations in demand.

Commodity prices since the beginning of 1981 have been adversely affected by the sharp appreciation of the U.S. dollar and a clear weakening in the underlying market balance of some commodities (notably sugar and some metals). Current indications and crop projections show supplies of most commodities to be adequate, and given the rather pessimistic outlook for growth in the economies of the industrial countries coupled with high interest rates discouraging stockholding, world demand for agricultural raw materials and metals is not expected to improve significantly before 1982.

The world oil market over the past year has weakened. This is due to a combination of factors — a substantial fall in world oil consumption, comfortable inventory positions, increased production outside the OPEC members, and the maintenance of a high production level by Saudi Arabia. The outbreak of hostilities between Iran and Iraq last September led to a temporary rise in spot prices, but fears of the trouble becoming widespread proved unfounded and prices subsequently eased. Prices in the spot market for medium-grade crude oils have fallen from a peak in November 1980 of about $40 per barrel (a level also reached in late 1979) to $32 by June 1981.

The average price of oil in the first quarter of 1981 is estimated at slightly over $35 per barrel, more than 170 per cent above the 1978 level. The dampening effect of this large rise in oil prices on demand and economic activity in the oil-importing countries, together with increasing exports from Iran and Iraq, has led to an over-supply of crude oil and resulted in OPEC nations agreeing at their May 1981 meeting to freeze prices. The world oil market is expected to remain soft during the remainder of 1981 and into 1982, but there still remains the risk of new, unanticipated supply interruptions.

INTERNATIONAL TRADE

After four years of strong expansion, the growth in world trade volumes slowed considerably in 1980, rising just 1 per cent compared with 6 per cent in 1979. The sharp slowdown largely reflected a 10 per cent fall in petroleum movements (to levels below that of 1973) but slower growth in trade of both manufactures and agricultural products also contributed.

The global pattern of balances on current account, as in the 1974/75 period, has altered markedly over the past two years. The changes were initiated by the upsurge in oil prices during 1979 and the early part of 1980. But trade patterns are now being increasingly affected by the slowdown of demand and economic activity in the industrial countries.

The industrial countries experienced a sharp terms of trade depreciation in the order of 8 per cent last year and this, together with low trade growth, resulted in their combined current account deficit growing further to $75 billion in 1980 from a surplus position in 1978. Among the major countries, those nations that recorded the largest adverse movement in their external position between 1978 to 1980 were for the most part those with the strong surpluses at the beginning of the period, namely Japan, Germany, Italy and France. The two countries with the largest current account deficits in 1978 (the U.S. and Canada) were among the few showing improvement over the two years, thus broadly aiding the international adjustment process..

Strong demand from the oil exporting countries and recession-depressed import levels in the industrial countries are expected to result in some improvement in the latter countries' external position over the next 18 months. But this improvement is expected to be largely concentrated in the major countries. The deficits of the smaller industrial countries are forecast to remain high. While financing is not expected to be a major problem, adjustment will be necessary in some of the countries to prevent interest and amortisation payments absorbing too large a share of foreign exchange receipts.

Of more concern, the non-oil producing developing countries have also recorded a marked deterioration in their combined current account deficit, from $23 billion in 1978 to $55 billion in 1980. Countinued deterioration in their external position is projected for this year, signifying growing strains for an increasing number of countries, particularly the low income countries sub-group, where the burden of interest payments required to service the external debt is already exceedingly high.

Countering these movements, the combined current account surplus of the oil exporting countries in the two years to 1980 rose from $5 billion to $120 billion. A small decline is forecast for 1982 but little change is expected this year.

GLOBAL STRUCTURE OF CURRENT ACCOUNT BALANCE[1]
(Billions of US Dollars)

	1977	*1978*	*1979*	*1980*	*1981 (est)*
OECD	-24	10	-35	-75	-70
OPEC	29	4.5	68	120	120
Non-oil Developing Countries	-12.5	-22.5	-37	-55	-62
Other	- 8.5	- 9.5	- 3	1	- 4
Total[2]	-16	-17.5	- 7	-10	-15

Source OECD
[1] Includes official transfers
[2] Reflects statistical errors and asymmetrics

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

	1977	*1978*	*1979*	*1980*	*1981 (est)*
United States	-14.1	-13.5	-0.7	0.1	4.5
Japan	10.9	16.5	-8.8	-10.8	- 2
Federal Republic of Germany	4.2	8.8	-5.5	-15.5	-15.2
France	- 3.3	3.7	1.2	- 7.4	- 9.2
United Kingdom	0.5	1.8	-3.5	6.4	10
Italy	2.5	6.4	5.1	- 9.9	-10.5
Canada	- 4.0	- 4.6	-4.4	- 1.3	- 3.5
Australia	- 2.6	- 4.0	-2.2	- 3.7	- 6.7
New Zealand	- 0.9	- 0 5	-0.8	- 1.0	- 1.2

Source OECD
[1] Includes official transfers

INTERNATIONAL CURRENCY MARKETS

Following large exchange fluctuations in early 1980, exchange rate developments since mid-1980 have been characterised by the steady strength of the U.S. dollar and relative weakness of European Monetary System (EMS) currencies. Exchange rates within the EMS have been relatively stable although intervention by EMS members in both US dollars and EMS currencies has been substantial at times. One currency realignment has occurred in the system since 1979, involving a 6 per cent devaluation of the central rate of the Italian lira in March 1981, and tension was also evident following M. Mitterand's presidential election victory in France in May 1981.

The two main factors influencing the exchange markets are current account development and expectations, and the high sensitivity of exchange rates to changes in interest rate differentials. Political factors have dominated only temporarily, while inflation differentials have apparently not been important. This has tended to lead to large changes in competitive positions as the favourable current account developments have generally been in high inflation, high interest rate countries, namely the U.K. and U.S., and the unfavourable current account developments have generally been in low inflation, low interest rate countries such as Germany and Switzerland.

Over 1980 as a whole, the U.S. dollar firmed 2 per cent in effective terms (rising a further 6 per cent in the first quarter of 1981), while the Japanese yen and sterling increased 23 per cent and 12 per cent respectively. The EMS currencies eased by 4 — 10 per cent and the Swiss franc by 6 per cent.

INTERNATIONAL MONETARY FUND

Recognising the difficult adjustment problems confronting many of its members and the need for adequate balance of payments financing, the Fund has made a number of changes in lending policy during the past year, enabling it to play a growing role in the adaption to, and financing of, such external imbalances. Moves have also been taken to further enhance the use of the institution's special drawing right (SDR) as an international reserve asset and unit of account. This is in accordance with the objective of making the SDR the principal reserve asset in the international monetary system.

(a) Lending Policy

In general terms, the steps recently taken by the Fund to assist member countries with their external difficulties have been to substantially increase the access to its resources by individual countries, allowing them to borrow more relative to their quotas; to lengthen the adjustment periods under the stand-by arrangements, enabling countries to take the longer-term periods necessary to deal with the fundamental structural problems; and to extend the maturities on some of its lending operations.

Under revised guidelines, annual access to IMF resources by countries making strong efforts to correct their balance of payments problems has been increased to 150 per cent of quota, and up to 450 per cent maximum over a three year period. Cumulative borrowing, net of scheduled repayments and excluding low conditionality drawings under the compensatory and buffer stock financing facility and outstanding drawings under the oil facilities, is now equivalent to 600 per cent of quota. In line with Fund policy, these amounts are available in conjunction with the implementation of a strict economic adjustment programme, designed to achieve a viable balance of payments position.

Additional measures to help meet the financing requirements of the low-income developing countries have also been taken. A subsidy account was established in December 1980 to reduce the high market-related cost of using the supplementary financing facility. Part of the repayment of, and interest on, trust loan funds along with voluntary contributions will be used to finance this account.

These initiatives are designed to move some way from the traditional emphasis on limiting the use of Fund credit to bridge internally-induced and temporary balance of payments problems, to one that provides longer-term support and flexibility to adjust to prolonged external deficits originating largely from external sources.

Following a suggestion by the Food and Agricultural Organisation and the World Food Council balance of payments assistance has also recently been extended to cover the financing of temporary increases in the cost of cereal imports. This assistance, which is provided from the Fund's ordinary resources, is available whether the inflated cost is due to crop failure or an increase in world prices of such items.

Fund resources have been increasingly drawn upon in the past 18 months. Commitments by the Fund to provide members with balance of payments assistance under stand-by and extended arrangements amounted to SDR 7.2 billion (US$9.2 billion) in 1980, compared with SDR 2.2 billion (US$2.9 billion) in 1979. In the first four months of 1981 alone, new loan commitments stood at SDR 4.6 billion.

NEW LOAN COMMITMENTS AND OTHER USE OF FUND RESOURCES (Billions of SDRs)

	Calendar Year				*Jan-April*
	1977	*1978*	*1979*	*1980*	*1981*
New Loan Commitments	5.2	1.9	2.2	7.2	4.6
Industrial Countries	3.8	0.1	–	–	–
Developing Countries	1.4	1.8	2.2	7.2	4.6
Purchases under Low Conditionality Facilities	0.3	0.7	0.7	1.0	0.4
Trust Fund Loans Disbursed	0.2	0.7	0.5	1.3	0.4
Total	5.7	3.3	3.4	9.5	5.4

Source IMF

(b) Borrowing Policy

The Fund has augmented its liquidity through the 1980 general quota increase but other avenues to supplement this are being considered, more particularly borrowing from the major surplus countries and, for the first time, borrowing from the private capital markets.

A loan agreement with the Saudi Arabian Monetary Agency was concluded in May 1981 under which the Fund can borrow up to SDR 8 billion over the next two years (with the possibility of an additional SDR 4 billion) to help finance the Fund's policy of enlarged access. Agreement in principle has also been reached with the central banks or official agencies of thirteen industrial countries to make available to the Fund the equivalent of SDR 1.1 billion over the next two years. About one-half of this amount will be made available under a borrowing agreement with the Bank for International Settlements and the balance will be borrowed by the Fund under direct bilateral arrangements with the lenders.

(c) **Special Drawing Rights**

To enhance the SDR on world markets three important changes have recently been effected to the characteristics of the asset.

The currency basket that determines the daily value of the SDR was simplified from 16 to 5 currencies as from 1st January 1981. The new valuation method results in one unified basket (comprising the U.S. dollar, deutsche mark, franc, yen and pound sterling) being used for the determination of both the value of and the interest rate on the SDR. Public reaction to the change has been positive, as evidenced by increasing private use, notably the establishment of an SDR certificate of deposit market in London, and the denomination in SDRs of Euromarket issues.

Secondly, the reconstitution requirement that each SDR participant maintain a minimum average holding of SDRs equal to 15 per cent of its average net cumulative allocation was removed in April 1981. This removes the credit characteristic of the SDR and it is now purely a monetary instrument.

The third notable move taken to strengthen the SDR, taken in May 1981, was to raise the SDR interest rate from 80 per cent to 100 per cent of the combined market rate of interest, thus making it increasingly attractive to hold SDRs voluntarily.

The Fund allocated SDR 4.1 billion to member countries at the beginning of this year, bringing cumulative allocations to SDR 21.4 billion. New Zealand was allocated SDR 23.7 million (6.8 per cent of New Zealand's quota) and its total allocations are now SDR 141.3 million. The question of further SDR allocations to supplement existing world reserves is being reviewed at the present time.

(d) **Membership**

At the time of writing, Fund membership totalled 141 countries. Zimbabwe's application was approved in July 1980 and in April last year the Executive Board of the Fund decided that the Government of the People's Republic of China would be recognised as the representative of China in the Fund.

(e) **Quota Increases**

Quota increases under the Seventh General Review of Quotas became effective on 29th December, 1980 for all those members who had notified the Fund of their consent to the increase and had paid the increased subscription. The increase, proposed in 1978, provided for an overall rise in members' subscriptions of 50 per cent, increasing total quotas by SDR 20 billion to SDR 60 billion. As a consenting member, New Zealand's quota accordingly rose by 50 per cent to SDR 348 million. The forthcoming Eighth General Review of Quotas is expected to be more complex, taking into account developments in members' positions within the world economy, and including a review of the criteria by which quotas are calculated.

A special increase in Saudi Arabia's quota from SDR 1.0 billion to SDR 2.1 billion (now the sixth largest quota), was authorised in April 1981. The selective increase was granted on the basis of the country's rapidly increasing relative economic position and its major creditor position with the Fund.

(f) **Annual meeting Observers**

The question of observer status for the Palestine Liberation Organisation remains unresolved. Following the rejection of the PLO's request for observer status at the Fund/World Bank 1979 Annual Meetings and the impasse of the committee set up to consider the matter, the resulting dispute led to no observers being invited to the 1980 meetings. A subsequent review has again failed to resolve the matter and the issue remains politically contentious.

CONCLUSION

The current difficult international situation features large and widespread economic imbalances among countries and groups. This has led the IMF to take a number of steps to promote balance of payments adjustment, facilitate the recycling process, and improve the international monetary system in order to contribute to the improvement of the world economy.

The economies of the industrial countries are in a phase of stagflation and non-oil producing developing countries are also experiencing seriously growing deficits on current account. Consequently, the sustained pursuit of sound economic policies and strong international co-operation is a necessary prerequisite for sustained world economic recovery in the immediate future.