European
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# Investment in the Community in 1975 and its Financing

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# CONVERSION OF NATIONAL CURRENCIES

All statistical data published in this Report are provisional for 1975 and often for 1974 as well. Throughout this Report data for the Community as a whole refer to the present nine member countries: statistics for years prior to 1973 have been adjusted to add data for the three new Member Countries to those of the original "Six".

The equivalent in units of account of amounts in national currencies has been calculated at exchange parities or central exchange rates as appropriate. For currencies which began floating in 1972 exchange parities declared to the International Monetary Fund were replaced as from mid-1972, initially by the middle closing rate on 29th December 1972. For the currencies which began floating in early 1973, exchange parities were replaced initially by the middle closing rate on the 19th or 20th of March, as appropriate. The conversion rates for currencies with floating exchange rates were subsequently altered whenever the monthly average of market rates varied by more than 5 % from the conversion rate in use. These conversion rates were applied to the available statistical material in the following manner:

- for individual operations and for amounts outstanding at any particular time, the conversion rate appropriate to the period was used
- for annual totals (such as for Gross National Product or Gross Fixed Investment), a weighted average of conversion rates in force during the year was used.

The conversion rate for the EURCO which consists of the sum of fixed amounts of the currencies of all the Member Countries of the European Community was taken to be that in force when the first EURCO issue was made in September 1973.

Statistics relating to 1974 and 1975 have been derived from rates of conversion between national currencies and the new European Unit of Account based on a "basket" of member states' currencies. The composition of this basket is such that as at 28th June 1974 the sum of the component currencies would have been equal in value to the International Monetary Fund's Special Drawing Right when calculated on the same basis as the latter, and hence the same as the Bank's statutory unit of account by virtue of the common gold content of the unit of account and the S.D.R. For 1974, conversion rates into the new European Unit of Account as at 30 December 1974 have been applied. The conversion rates applicable to statistics for 1975 have been based on the average of rates in each quarter, the latter being taken as at the last working day before the commencement of the quarter.

# INTRODUCTION

The first economic recession to affect the European Community as a whole which began to develop in 1974 increased in severity in the first half of 1975. This downswing in the business cycle was probably accentuated by the decline in the volume of investment which took place in most Member States in 1974 and became general throughout the Community in 1975. In the prevailing conditions of slack demand, however, inflationary pressures began to abate while in most countries reduced imports led to an improvement in the balance of payments. The authorities thus had room to manoeuvre in introducing or reinforcing measures aimed at restimulating economic activity and at checking the serious and widespread rise in unemployment.

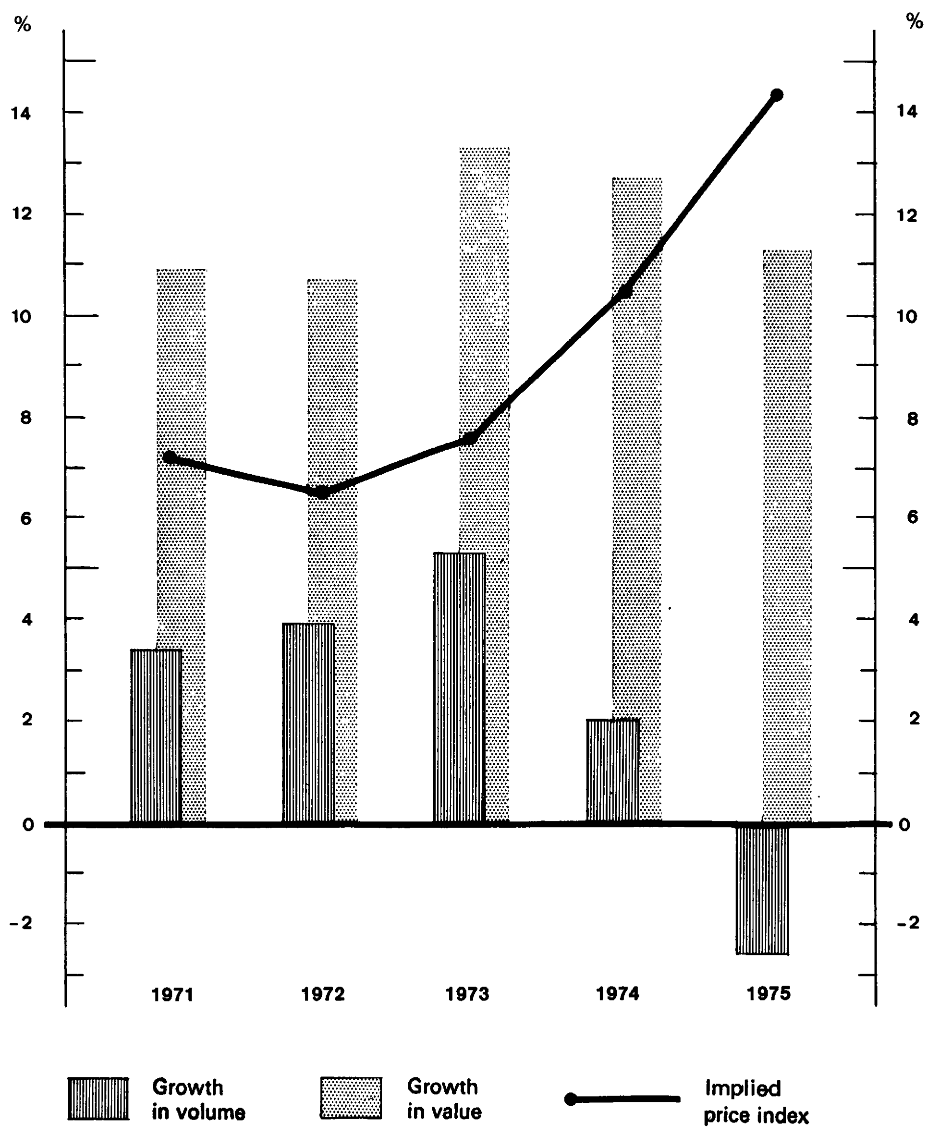
The running-down of stocks by enterprises in the first half of the year, while tending to depress output still further in that period, paved the way for the beginning of a restocking movement in some countries in the second half of the year and thus helped to strengthen the impact of official counter-cyclical measures. This improvement in the investment outlook came too late to affect the out-turn in the fixed investment of businesses in 1975, although by the end of the year orders for plant and machinery were beginning to rise in some countries.

The general relaxation of monetary and fiscal policy in the Community paved the way for a further reduction in short-term interest rates from the very high levels which had prevailed on most markets during a substantial part of 1973 and 1974. As a result of the re-establishment of a more normal relationship between short-term interest rates and long-term yields (see Chart V), bond markets were able once more to attract investors who showed increasing willingness in the last quarter of the year to purchase longer-dated securities. Bond markets thus ended 1975 in a healthier state than for nearly two years. Prices rose also on all share markets except that of Italy, though the amount of new share issues was perhaps less than it might have been because of the continuing uncertainty of the economic outlook.

The volume of personal saving was exceptionally high in 1975. It would appear that individuals tended to save more, partly as a precautionary measure in the face of rising unemployment, but partly also as an adjustment to higher price levels and rates of income. Financial intermediaries tended to have means for lending as well as for investment but demand for credit by enterprises was relatively weak, except in some countries during the fourth quarter when stocks began to be rebuilt.

The slowness of enterprises to embark on new fixed investment in 1975 appears not to have been occasioned by difficulty in raising new capital. The uncertainty of the economic outlook during the greater part of the year was an important influence but it also appears that profit margins were adversely affected by low capacity utilisation, by the rapidly rising cost of labour and by keener price competition as rates of inflation declined. In addition to the discouragement of lower profitability, the financial structure of enterprises was impaired by the effect of inflation on the replacement cost of fixed assets in comparison with which provisions for depreciation, based on the historic cost of existing fixed assets, were inadequate. For these reasons the capacity of enterprises to finance the acquisition of new fixed assets from internal resources appears to have suffered further during 1975.

**Chart I – Growth in Gross Community Product, 1971–1975**
(percentage change from previous year)



CHAPTER 1

# INVESTMENT

## 1.1. THE ECONOMIC BACKGROUND TO INVESTMENT

The extent to which the Gross National Product of the Member States declined in real terms in 1975 is indicated in Chart I. As explained in the Introduction, most of the fall occurred in the first half of the year and was followed in the second half by beginnings of a revival of activity in a number of countries. Gross fixed investment was already declining, by over 2 per cent in volume, in 1974 and probably helped to accentuate the depth of the recession in 1975 when it fell by a further 4.6 per cent or so. Coupled with a lower rate of inflation than in 1974, this performance resulted in an increase of just under 6 per cent in current prices compared with over 13 per cent the previous year.

The preliminary statistics in Table 1 of gross fixed investment suggest that its fall in volume varied considerably from one country to another. The sectoral pattern, however, was fairly consistent in that most of the decline was concentrated in the business sector accompanied by a small fall in the total for housebuilding, while fixed investment by public authorities generally rose under various plans for stimulating economic activity.

The deterioration in investment in 1975 was most rapid in three countries, Italy, Belgium and France, where there was still some growth in volume in 1974. In two other countries, Denmark and Luxembourg, where the volume of investment was already declining in 1974, there was a further but limited deterioration in 1975. In the Netherlands, in the same manner, the contraction of investment continued at a slightly faster pace while in Germany it fell to a smaller extent in 1975. The United Kingdom and Ireland also experienced less of a fall in investment in 1975. These two countries, however, were distinguished from all the others, with the exception of Italy, by their relatively high rates of inflation which resulted in their recording the largest increases in investment in current price terms.

In *Italy*, the decline in investment activity in 1975 was at the core of the recession in the economy, as the volume of total fixed capital expenditures, after rising by over 4 per cent in 1974, contracted by nearly 13 per cent. This movement was most marked in the first half of 1975 with some recovery occurring late in the year. The Gross National Product declined by about 4.5 per cent in volume terms, reflecting the worst economic recession for over 25 years. Owing to the constraints placed on the shedding of labour by employers, the numbers of unemployed rose only moderately, despite the severity of the recession. On the other hand, short-time working and partial unemployment were considerably higher and would in turn have tended to depress demand further. The slackening of consumer demand and new orders, reinforced by the disposal of finished product stocks, contributed to a decline in industrial production of about 10 per cent in 1975. But the slowing in industrial activity was perhaps not sufficient by itself to account for the much greater decline in business investment: in this respect the very tight restrictions on credit introduced by the authorities in 1974 together with a sharp reduction in profitability, undoubtedly played a role in decisions to postpone or abandon investment planned for 1975.

From the beginning of 1975 both the fiscal and monetary policies of the authorities, having previously been aimed at countering inflation, turned progressively towards stimulating the economy. Following measures introduced earlier in the year, the government proposed an emergency programme in August, amounting to over Lit. 4 000 milliard or about 4 per cent of G.N.P., of aid for boosting investment in social housing, public works and the productive industries. Since it was not until mid-October that this plan was approved, very little of these funds was disbursed in 1975. This easing of economic policies was facilitated by the attain-

Table 1 – **Gross fixed investment in the Community**(1) (2)
Percentage change from previous year

| Countries | In Value | | | | | | In Volume | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | 1970 | 1971 | 1972 | 1973 | 1974 | 1975 | 1970 | 1971 | 1972 | 1973 | 1974 | 1975 |
| Germany | 23.9 | 12.2 | 7.0 | 5.1 | –2.1 | –1.3 | 11.0 | 4.5 | 3.0 | 0.5 | –8.1 | –4.1 |
| France | 13.1 | 11.6 | 12.4 | 13.3 | 18.8 | 6.0 | 5.8 | 6.6 | 7.4 | 5.9 | 2.9 | –4.5 |
| United Kingdom | 9.6 | 10.9 | 11.4 | 19.5 | 17.1 | 23.8 | 2.1 | 2.0 | 2.5 | 2.6 | –2.8 | –0.5 |
| Italy | 14.2 | 3.7 | 5.8 | 25.3 | 34.1 | 4.3 | 2.7 | –3.1 | 0.4 | 8.2 | 4.2 | –12.7 |
| Netherlands | 18.3 | 13.4 | 4.0 | 11.5 | 6.3 | 6.1 | 10.1 | 3.3 | –3.5 | 5.5 | –4.2 | –3.9 |
| Belgium | 18.6 | 6.4 | 8.9 | 14.6 | 22.3 | 9.3 | 8.4 | –1.7 | 4.4 | 7.8 | 5.6 | –3.3 |
| Denmark | 10.3 | 9.3 | 15.2 | 19.4 | 6.5 | –1.1 | 3.0 | 4.4 | 7.9 | 6.1 | –10.4 | –11.5 |
| Ireland | 8.6 | 20.3 | 10.1 | 29.6 | 16.6 | 11.9 | 0.2 | 9.4 | –0.2 | 16.4 | –5.7 | –5.5 |
| Luxembourg | 21.2 | 23.4 | 7.9 | 18.7 | 5.4 | 3.2 | 10.7 | 12.9 | 3.2 | 11.3 | –7.2 | –5.1 |
| Total Community | 16.6 | 10.5 | 9.0 | 13.2 | 13.1 | 6.1 | 6.7 | 3.3 | 3.5 | 3.9 | –2.2 | –4.6 |

(1) The percentages for 1975 are approximations based on orders of magnitude.
(2) For individual countries, percentages are based on amounts in national currencies. For the Community total, amounts in national currencies have been converted into units of account at exchange rates prevailing in the relevant year.

ment of a much reduced rate of price inflation. The year-on-year increase in the consumer price index to December 1975 was 11.2 per cent compared with a rise of 24.5 per cent during the previous twelve months. However, this improvement has proved short-lived since wage rates at end-year were increasing at a rate about double that of inflation.

As did Italy, *Belgium* experienced its worst economic recession since the second World War. GNP declined in constant price terms by close to two per cent in 1975 compared with a gain of four per cent in the previous year. Consumer demand tended to be sustained if at a low level but, as a substantial part was met by running down stocks of finished goods rather than from new output, industrial production fell by around 10 per cent. This downturn was most acutely felt in the business sector of the economy where the ensuing decline in confidence, coupled with lower capacity utilization and profitability, led to a reduction in investment in new plant and equipment. Because the threat of an increase in inflationary pressures still persisted, when the Belgian Government felt compelled to adopt counter-cyclical fiscal and monetary policies, it instituted price control measures beginning in May 1975. Initially there was a two month freeze which was subsequently eased to exempt selected items. Controls had a limited success in checking inflation since the rate of increase in retail prices diminished on a year-on-year basis from 15.7 per cent in December 1974 to 11.0 per cent in December of last year. The effort to limit the rise in prices tended to squeeze company profitability. Nevertheless the inflation rate was relatively high compared with some of Belgium's main trading partners.

Total fixed capital expenditures by all sectors of the economy declined in real terms by 3.3 per cent in 1975, after having risen by 5.6 per cent in 1974. At current prices however, total fixed capital expenditures rose by 9.3 per cent in 1975, reflecting the comparatively high rate of price inflation.

In 1975 *France* which had previously withstood other post-War contractions in economic activity experienced a recession along with its partners in the European Community. In order to check the serious growth of unemployment, official policy which in the preceding year had sought to reduce inflation and to halt the deterioration in the balance of payments shifted towards a selective restimulation of the economy. The change of attitude was made easier by falling interest rates abroad, by a declining rate of inflation on the domestic market and by an improvement in the external trade balance. This last feature, however, resulted from a reduction in imports rather than from an increase in exports and was in turn partly explained by a sharp contraction in domestic demand and partly by the running down of stocks of industrial raw materials, particularly of petroleum. The measures aimed at stimulating the economy, on the other hand, were neutralised for a while by an increased volume of precautionary saving and it was not until the last quarter of the year that demand and, finally, output began to recover but not enough to prevent a fall of 3 per cent in the volume of Gross Domestic Product.

The weakness of demand affected business confidence to the extent that investment by private enterprises fell sharply in volume in 1975 and outweighed an increase in investment by public enterprises. Housing investment was also lower in 1975 after rising rapidly to mid-1974. Only investment by public authorities showed any real advance in 1975. In total, fixed investment fell by 4.5 per cent in volume whereas in 1974 it rose by nearly 3 per cent.

In *Denmark* the impact of the economic recession was less than in the three foregoing countries, being mitigated to a large extent, at least in the personal sector, by government counter-cyclical policies. The decline in volume of GDP was limited to a relatively modest 1 per cent in 1975, although gross fixed investment calculated at constant prices fell a little faster than in 1974. The authorities played a very active role in introducing measures to stimulate consumer spending and new investment with the aim of checking the growth of unemployment. At the very beginning of 1975 direct taxes on personal incomes were reduced, raising disposable income by about D.Kr. 7 milliard, and thus contributing to a simultaneous growth of consumer expenditures and personal savings. In September a major programme was instituted which included the reduction of the value-added tax rate, until end-February 1976, from 15 per cent to 9.25 per cent. This also helped to restore the volume of personal spending to where it stood before the decline which occurred in 1974 but, to the extent that rising demand was met from imports, official policy did not entirely succeed. The number of registered unemployed rose by about 30 per cent during the year to December 1975, though the worsening trend seemed to be flattening out by the fourth quarter. On the other hand the steps taken by the Government in the general climate of reduced economic activity had a dampening effect on earnings and price increases. The initiative of the authorities in March 1975 in freezing collective wage agreements was partly responsible for the lowering of the rate of expansion in annual earnings to about 15 per cent in the year. The simultaneous freezing of company profit margins exercised a restraining influence on price rises while the temporary cut in VAT introduced in September lowered the consumer price index by almost 4 per cent. As a result, this index rose by only 4.3 per cent during 1975 compared with 15.5 per cent during the previous year.

The freezing of collective wage agreements would perhaps have improved prospects for investment were it not for the accompanying freezing of profit margins. Thus, despite a succession of direct or indirect measures of encouragement, total fixed capital expenditures declined in volume by about 11.5 per cent in 1975, slightly more than the 10.4 per cent recorded in 1974. Demand for investment goods remained the weakest aspect of the Danish economy in 1975 and was accentuated by a slackening in demand from export markets. The volume of export sales of manufactured products, taken as a whole, declined by about 7 per cent in 1975 and was undoubtedly a major factor in the build-up of surplus industrial capacity and in the rise of unemployment.

The *Luxembourg* economy suffered particularly from the extent of the cutbacks in the steel industry in 1975 which had an adverse effect upon unemployment, business income, investment and exports, and were largely responsible for a serious 7.7 per cent decline in the volume of GDP. The steel industry provides almost 60 per cent of industrial output of the country and so the decline of 31 per cent in its production last year was severely felt, though by the end of the year an upturn in new orders indicated that the lowest point of the recession had probably been passed. During 1975 the public authorities engaged on a two-pronged programme – amounting to some Flux 640 million – involving first, the promotion of selective schemes to create employment opportunities and secondly, the compensation of firms for retaining workers on a part-time basis. However, industries orientated towards the domestic market, such as agriculture and the service industries, experienced rather better trading conditions which helped to soften the impact of the recession.

With the exception of public authority expenditure programmes, gross fixed investment declined again last year. After a fall in volume of over 7 per cent in volume in 1974, it declined by about 5 per cent in 1975. Taking into account the relatively rapid rise in the prices of investment goods, there was an increase of 7 per cent in capital expenditures at current prices compared with the previous year. Anti-inflationary fiscal and monetary policies in fact met with only very limited success, owing in part to the openness of the Luxembourg economy, as the consumer price index rose 10.9 per cent during the twelve months to December 1975, virtually the same as the 11.2 per cent recorded in the previous year.

The downturn of economic activity in the *Netherlands* last year was severe but perhaps less pronounced than in many other Community countries. At the same time certain underlying structural problems in the economy, notably the need for higher profitability in the enterprise sector to encourage new investment, were coming into sharper focus. In volume GDP declined by about 1.8 per cent in 1975 compared with a rise of 3.3 per cent in the previous year. Much of this fall resulted from contractions in the volume of new fixed investment of 4.2 per cent in 1974 and 3.9 per cent in 1975, although in both years there was a rise of between 6 and 7 per cent at current prices. The run-down of stocks in 1975 combined with a 5 per cent reduction in the volume of exports to bring about a contraction in demand for new production, as exemplified by the 7 per cent decline in industrial output last year. In certain other sectors of the economy, however, the recession had less effect. Consumer spending, in which purchases of cars figured prominently in the early part of the year, rose in volume by 3.5 per cent in 1975 – somewhat faster than the 2.5 per cent achieved in the previous year. But unemployment rose as businesses sought to cut back on labour costs which were mounting rapidly at a time of reduced output and productivity. In addition there was concern as to the shortfall in employment opportunities related to investment expenditure.

The fiscal policies of the Netherlands government which were introduced in 1974 and reinforced in 1975 were highly expansionary, being aimed at alleviating social problems caused by rising unemployment; they consisted in part in reducing taxation and in part in additional expenditure. At the same time price controls were maintained in a continuing effort to slow the rate of price inflation. As the recession deepened, the authorities introduced further measures, specifically in November 1974, in February and April of last year and in the 1976 Budget, to promote industrial relocation and to provide aid for special construction projects. A main concern of the authorities was the adverse influence on employment of the obsolescence of the industrial structure and ensuing low productivity. In mid-year measures were introduced to ease the pressures on corporate profit margins by not allowing growth in nominal wage rates to compensate for the rise in the cost of living in the first half of the year, and restricting the growth in real wages in the second half-year to zero. Nevertheless during 1975 hourly wage rates rose by 12.5 per cent compared with a rise in the consumer price index of 10.2 per cent. This performance of wage rates last year no doubt contributed to the smallness of the decline in the rate of price inflation over the year. Manufactured exports declined in volume by about 6.5 per cent in 1975, rather more sharply than the average of world trade, a feature which raised concern about the continued competitiveness of Dutch products.

In common with the rest of the Community, *Germany* suffered during 1975 from a severe business recession, but the economy displayed greater strength than others as the year progressed. GNP which was still increasing, if marginally, in 1974, declined last year by 3.2 per cent in terms of volume. The contraction of activity would have been even greater but for higher government expenditures resulting from the implementation of counter-cyclical fiscal measures. These official steps were successful to the extent that from July onwards industrial output began to rise and other signs of recovery to appear. Thus, despite the relatively poor out-turn for 1975 taken as a whole, a change of direction was achieved.

The volume of gross fixed investment declined in 1975 by 4.1 per cent compared with a contraction of 8.1 per cent in the preceding twelve months. The fall in investment for two consecutive years no doubt reflects the extent to which business confidence was undermined by the recession; in turn it contributed to the decline in activity. A further factor was the strength of price competition which developed on the domestic market and export markets in conditions of reduced demand. The volume of exports of goods and services, for example, fell by 8.7 per cent in 1975. While these difficulties impeded the raising of product prices and so contributed towards overcoming inflationary tendencies, they often resulted in a serious erosion of profit margins and a consequent discouragement of business investment. A large part of the fall in volume of investment was therefore concentrated in that of the business sector and the only growth in 1975 was in the Government sector but even this was much lower than in the previous year.

During the second half of 1975, however, the outlook improved in all sectors of the German economy. The public authorities introduced new measures in late August to aid in the economy's recovery, aimed particularly at the construction sector. With the strengthening of the domestic market and with a faster inflow of orders from abroad, the business sector started to raise its investment intentions in the latter part of the year. This improvement was particularly evident in the demand for machinery and equipment.

The United Kingdom and Irish economies displayed a number of similar characteristics which tended to distinguish them from those of other Member States. The slowing of activity developed rather later and, while the ensuing trough was perhaps less marked, the rate of inflation tended to be appreciably higher than in most other Community countries. Fixed investment in both countries fell less in volume in 1975 than in 1974. The decline in the volume of GDP in the *United Kingdom* was relatively small at 1.7 per cent in 1975, but the rate of price inflation was unprecedentedly high. In December the retail price index was still rising by 25 per cent year-on-year, although the bulk of the increase had occurred earlier in the year and inflation was slowing in the second half. The core of the authorities' anti-inflationary policy – the voluntary limitation of pay increases to approximately 11 per cent of average earnings – took effect only in August but was closely adhered to thereafter. This policy was framed in the light of an assessment that the loss of external competitiveness caused by accelerating inflation had to be corrected if the growth of unemployment was to be contained and that the problem was less likely to be solved by the simple stimulation of internal demand.

As external as well as internal demand in fact fell, industrial production declined sharply in the second quarter of the year and for 1975 as a whole was 4.9 per cent lower than in the previous year. The deflationary incomes policy and the disposal of stocks of finished goods were further factors in reducing the need for new production although some of their impact was absorbed by a lower growth in the volume of imports. Under such conditions, unemployment continued on its rising trend and by December represented 5.0 per cent of the labour force compared with 3.1 per cent at the beginning of 1975. Some signs that the trough of the recession had been reached by early autumn had not been followed by any significant upturn by year-end. Businesses were operating below capacity throughout the year and did not need to invest. Total fixed capital investment by all sectors of the economy thus declined by 0.5 per cent at constant prices in 1975 following a decline of 2.8 per cent in the previous year. The inability to improve profitability, either because of competitive pressures on shrinking markets or because of a system of administrative controls on prices and profit margins, does not seem to have been a major influence in 1975.

In *Ireland* a fall in volume of 6 per cent and a rise in value terms of 12 per cent in gross fixed investment in 1975 covers a wide difference between that undertaken by enterprises and by public authorities during 1975. The investment plans of enterprises suffered a serious set-back from world recession. A sharp fall in domestic and foreign demand affected manufacturing and service industries at a time when non-agricultural labour incomes were rising relatively fast under the terms of the 1975 National Pay Agreement. Because demand was so depressed stocks were run down sharply, leading to further cut-backs in production and apparently also to a lowering of productivity. Agricultural output and exports were exceptions in an otherwise sombre picture in that net output was over 12.5 per cent up in volume and exports rose by 47 per cent in value compared with 1974 but, even in this sector, demand was met partly through the running down of stocks. The net result was a fall of 1.0 per cent in GNP in volume terms, although in current price terms there was an increase of 21.6 per cent. A turning point was, however, reached during the year after approximately eight months of decline. During the remaining months a modest recovery began as industrial output and exports improved. At the same time consumer demand had become buoyant and the rise of unemployment was halted.

The combination of falling output and rapidly rising prices deterred not only domestically owned enterprises from extending their productive capacity, but also some foreigners from investing in Ireland as the inflow of private capital which was £ 144 million in 1974 dwindled to about £ 5 million in 1975. The public authorities, on the other hand, were striving to combat the recession by stimulating economic activity while at the same time aiming at a reduction in the rate of inflation. With these two not easily reconcilable aims in view measures were introduced in June in the form of cuts in value-added tax, the introduction of subsidies and increased capital expenditure. The beginning of a recovery of manufacturing output in the fourth quarter of 1975 may have been partly a consequence of these measures. The increase in public capital expenditure in areas such as housing, industry and telephones in 1975 was particularly marked, as a result of which total fixed investment by the public authorities probably did not fall at all in volume in 1975.

## 1.2. INVESTMENT IN THE COMMUNITY COUNTRIES BY SECTOR: BUSINESS CAPITAL EXPENDITURES, HOUSING CONSTRUCTION, AND PUBLIC AUTHORITIES INVESTMENT.

Gross fixed investment in the European Community rose in terms of current prices during

1975 in all the three sectors shown in Table 2. In the business sector, however, the increase of 5.7 per cent over 1974 was well below that of prevailing rates of price increases and implies a substantial fall in volume. The reasons for this are not far to seek in the circumstances of world-wide recession; low demand, surplus capacity, low profitability, the general uncertainty of the economic outlook all no doubt played a part in influencing business decisions to cut back or postpone investment projects. In some countries, however, it seems possible that towards the end of 1975 a number of businesses were beginning to take a more optimistic view as an upturn in economic activity began.

Housing construction increased by only 3.4 per cent at current prices during 1975 and so probably fell more sharply in volume than business investment. In some countries the overhang of new unsold houses which appeared in the recent past seems to have exercised a dampening influence. As regards private housebuilding, it seems probable that there was general reticence on the part of individuals to embark on the purchase or construction of new dwellings while unemployment was rising and the economic outlook remained uncertain.

As might be expected, the selective investment programmes initiated or reinforced by public authorities throughout the Community with the common aim of restimulating their separate economies resulted in a fairly sharp increase in their total capital expenditure of almost 12 per cent during 1975. This was less than the 16 per cent rise recorded during the previous year but, if allowance is made for the reduction in the rate of inflation in the interval, the growth in terms of volume during the two years was probably similar.

Changes in investment in the business, housing construction and public authorities sectors in individual countries appear in Chart II while the proportions that fixed investment in these sectors form of the total is shown in Table 3. Both are represented in terms of current prices and in the circumstances of wide differences in price increases as between countries and as between sectors, Table 3 is perhaps a more reliable guide to relative performance. The combination of a shrinking proportion of business investment with a rise in the share of investment by public authorities, characteristic of the trough of a recession in which official measures to restimulate activity had been brought into play, stood out clearly in most Member States. The fall in the proportion formed by business investment was particularly marked in the smaller countries, Ireland and Luxembourg, counterbalanced in the latter by an equally sharp rise in the share of investment by the public authorities. In Denmark also the public authorities' share increased substantially. The same pattern appeared in less sharp relief in France, Italy and Belgium. In the Netherlands, on the other hand, the business sector maintained its share while in Germany it accounted for an increased proportion of the total; in both these countries public authorities' in-

Table 2 – **Gross fixed investment in the Community: by sector** (1)

| Sectors | In milliard units of account at current prices | | | | | | Percentage of total | |
|---|---|---|---|---|---|---|---|---|
| | 1970 | 1971 | 1972 | 1973 | 1974 | 1975 | 1970 | 1975 |
| Business investment | 89.9 | 99.9 | 107.5 | 120.1 | 135.0 | 142.7 | 61.1 | 59.5 |
| Housing | 34.3 | 38.0 | 44.7 | 51.0 | 56.2 | 58.1 | 23.3 | 24.3 |
| Investment by public authorities | 23.0 | 25.0 | 26.8 | 29.9 | 34.7 | 38.8 | 15.6 | 16.2 |
| Total Community | 147.3 | 162.8 | 179.0 | 200.0 | 225.9 | 239.6 | 100 | 100 |

(1) The statistics for 1975 are estimates of orders of magnitude.

vestment also rose in relation to the total and only housing construction contracted. The main exception to the general pattern was the United Kingdom in which both business investment and housing construction increased proportionately while the share of public authorities was reduced.

In *Ireland,* the depressed business outlook and the squeeze on profit margins resulting from reduced output and higher costs largely explain the relatively small rise of about 6 per cent in the value of gross fixed investment by enterprises in 1975. In terms of volume this meant a not surprising fall of the order of 11 per cent, there being little incentive to expand productive capacity. The building of factories and of business premises generally seems to have suffered more in this contraction than the installation or replacement of plant and machinery.

Residential construction which increased by a quarter in value in 1975 showed real growth in that the number of new houses rose by over 2 per cent. This was entirely attributable to the housebuilding activities of local authorities which, having received substantial financial support from the Central Government, rose by some 45 per cent at current prices. In the uncertain economic and financial climate, private housebuilding performed less well, falling by about 7 per cent in volume.

Apart from their effort in housing, the public authorities in Ireland increased their capital expenditure by 22 per cent at current prices. Their fixed (non-housing) investment therefore probably increased slightly in volume and in two areas at least, that of improving telecommunications, and of providing capital for industrial promotion, there was significant real growth.

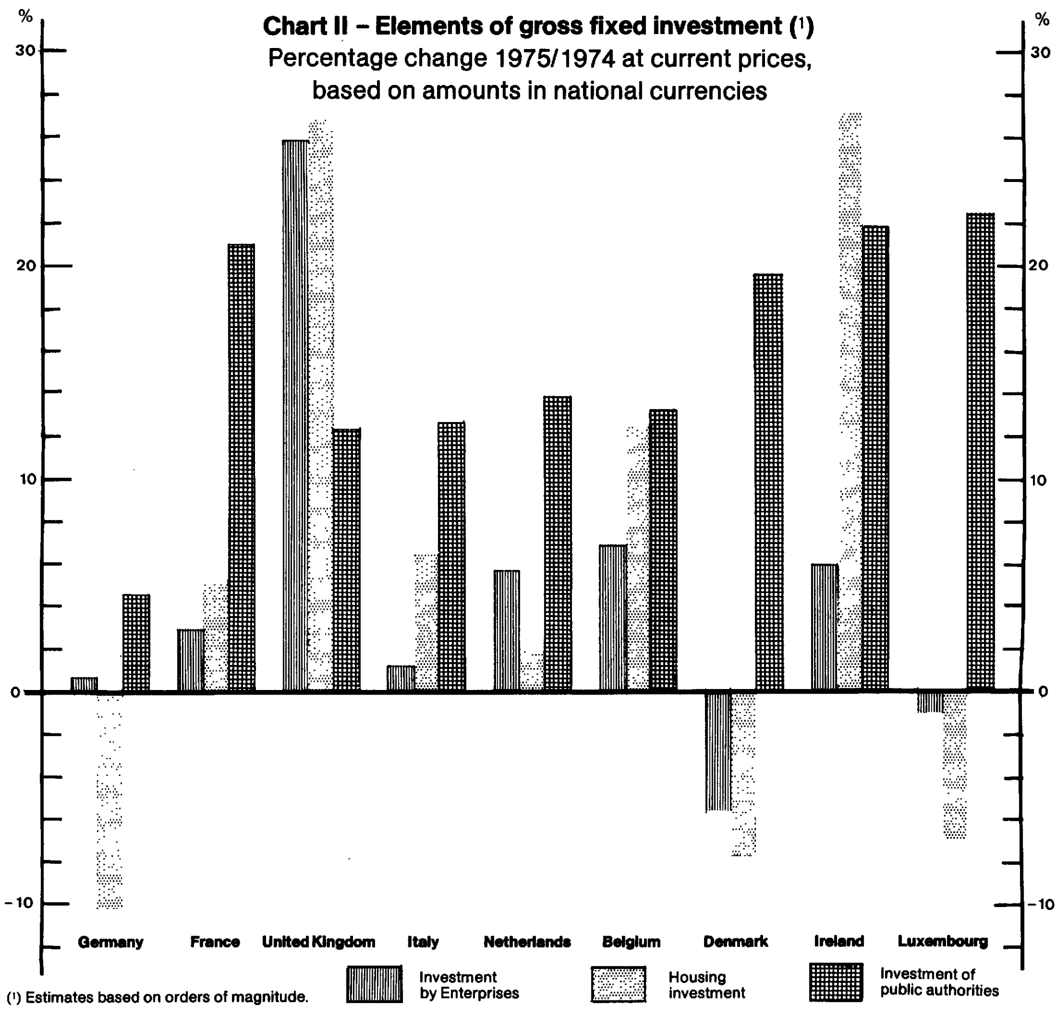
The pattern of investment in *Luxembourg* differed slightly from that in Ireland in that it was non-housing investments by the public authorities rather than housing construction which offset the fall in the share of investment by enterprises.

In Luxembourg, the latter form of investment declined by about 11 per cent in volume and by one per cent in terms of current prices. Profitability was reduced and with surplus capacity becoming available as output declined, particularly in the steel industry, there was less incentive to undertake the installation of new plant and equipment. Consequently, capital expenditures tended last year to be limited to the replacement of obsolete or worn-out equipment. New investment by the services sector or by the publicly owned railways was less severely curtailed than in industry.

Residential construction also declined by over 20 per cent in volume in 1975, largely because the bulge in housing requirements of recent years had been met and the need for new housing stabilised at a lower rate. A rise in construction prices of the order of 15 per cent was an additional element affecting decisions on new housing investment. New residential building permits issued in 1975 declined by 42 per cent, and those for new apartments declined to an even greater extent. However, after restrictions on the granting of mortgage credit had been eased in September there was a limited revival towards the end of the year in the number of new housing units planned.

The increased emphasis by the Luxembourg government on counter-cyclical programmes was a principal factor in raising public authority investment at current prices by about 22 per cent in 1975. This was directed mainly towards educational building and equipment, telecommunications and infrastructural projects.

In contrast to developments in the two preceding countries, the fall in 1975 in the proportion of total fixed investment in *Denmark* consisting of investment by enterprises was equalled by that of the share of housing construction, though the underlying reasons differed considerably. The slackening of new investment by enterprises in the autumn of 1974 continued into the first half of last year. The weakening of business confidence by the deterioration in sales prospects at home and




(1) Estimates based on orders of magnitude.

abroad was accentuated in March by the freezing of gross profit margins. However, government programmes allowing accelerated depreciation on new investments, and granting tax credits and subsidies, which were introduced in June and September, moderated the decline in new capital expenditures towards the end of 1975. Nevertheless, fixed investment by enterprises declined by about 15 per cent at constant prices last year. Reflecting this, the amount of new industrial and commercial building commenced in 1975 was 35 per cent lower than in the previous year.

Residential construction on the other hand suffered from the consequences of the very low number of housing units started in 1974, as the number of houses under construction was 33 per cent lower at mid-1975 than in the previous year. Residential investment was thus reduced by about 17 per cent in volume terms in 1975. However, global figures are somewhat misleading in that activity in this sector was definitely becoming stronger during 1975 and the cumulative total of housing starts for 1975 was about 30 per cent higher than in 1974. Significant factors in encouraging the upturn in new housing investment were the appreciable decline of between 4 and 5 percentage points in mortgage interest rates last year and the introduction by the Government of a number of measures to promote residential construction.

The easing of restrictions on capital expenditures by the Central Government in October 1974, and by the local authorities in August 1974 and in February of last year, as part of an overall plan to counter the rise in unemployment, particularly in the construction industry, culminated in an increase of around 6 per cent in the volume of investment by the public authorities for 1975. This was the only area of investment to expand significantly. A major programme of public works totalling D.Kr. 650 million was introduced in September 1975 but much of this investment is likely to be made in the current year.

Changes in the sectoral distribution of investment in *France,* as recorded at current prices, conformed to the general pattern, but were not so marked as in some of the smaller Member Countries. The proportion of the total formed by fixed investment by the business sector shrank by only 2 percentage points during 1975, although in volume terms this category of investment fell by 7.2 per cent in comparison with 1974. Apart from the food manufacturing industry which was able to maintain the level of its production, industries generally were working below capacity. This was largely because demand was lower but the liquidation of the excess stocks built up during 1974 also played a part. In addition profits were falling and the capacity for financing investment from internal resources seems in many instances, particularly in the steel and chemical industries, to have been impaired. As the outlook did not improve until the autumn, there was little incentive for privately-owned businesses to enlarge their productive capacity. Publicly owned enterprises, on the other hand, invested 13.1 per cent more in volume terms than a year earlier, largely because investment programmes were accelerated in order to help restimulate the economy. Most of the increase was concentrated in telecommunications, energy and transport and many of the projects were related to regional development. As a result of the additional effort made by public enterprises, the decline in investment by the business sector was limited to 7.2 per cent.

The volume of housing construction also fell during 1975, by about 5.2 per cent, as a result of lower demand. House buyers were understandably reluctant to commit themselves to paying the higher prices demanded for new dwellings while the economic outlook remained uncertain and borrowing was relatively expensive. The cost of building was perhaps rising a little less rapidly by the end of the year as inflationary pressures abated. This together with an easing of costs of borrowing from the autumn onwards probably helped to revive house purchases.

In marked contrast to the performance of other sectors, the public authorities increased the volume of their investment by about 9 per cent during 1975. This resulted from budgetary provisions which were aimed at restimulating the economy. The infrastructural projects that were financed in this context were related mainly to regional development programmes and laid the foundations for future industrial redeployment.

In 1975 fixed investment in each sector in *Italy* suffered to a greater extent than in France though there were similarities in the overall pattern. Fixed capital expenditures by Italian enterprises rose by about 1 per cent at current prices during 1975, which implied a decline in volume of about 15 per cent. Business investment was particularly affected in the early part of the year by the carry-over of the effects of credit restrictions that had been implemented in 1974. Private sector companies were more affected than the state-supported enterprises which not only were in a more privileged position insofar as obtaining funds was concerned, but deliberately avoided cutting back their investment, particularly in the less developed regions, so as not to be seen to be hindering official counter-cyclical policy. Furthermore, funds borrowed abroad by State enterprises during 1973 and 1974 at the request of authorities, and which had been required to be deposited with the central bank, were progressively released to the borrowers.

Residential construction was similarly affected by the legacy of high borrowing costs of the previous year, and of the difficulties in obtaining mortgage funds. New housing units started were sharply lower towards the end of 1974 and during 1975 as a whole, so that work in progress was reduced last year. Construction costs of new housing had risen quite sharply in 1974 and this, in conjunction with the rent freeze in force during the year, no doubt cut into the profitability of providing new rented accomodation. Investment in new residential construction declined by nearly 10 per cent in volume terms but rose by 6.5 per cent in value. While the Central Government set aside (in August) an additional sum of Lit. 600 milliard for the promotion of social housing, it seems evident that the benefits of this injection of funds had not been felt by end-1975.

Investment expenditure by the public authorities, in rising in value by 12.6 per cent in 1975, was the least affected by the economic recession. However, there was probably a small reduction in the volume of fixed investment, which would represent a continuation of the declining trend of recent years. The countercyclical fiscal measures introduced during the spring and summer included an amount of Lit. 1000 milliard for increasing public works (notably hospitals) but because of the inevitable time lag in activating such investment programmes, they had little impact on the out-turn for 1975.

In *Belgium*, a carry-over of investment activity in the business and housing sectors helped to soften the impact of the recession but otherwise the experience of the various sectors conformed to the general pattern. A decline in the capacity utilization ratio from 85.1 per cent in May 1974 to only 71 per cent in October last year tended to be concentrated in certain industries. In the steel, chemical and textile industries trading conditions were particularly difficult but in contrast the automotive industry had a good year and the services sector in general was less affected by the recession. Rising unemployment moreover did not reflect the full extent of the deterioration in capacity utilization which led to reduced productivity on account of the lower output, and was accompanied by substantially higher labour costs and narrowed profit margins. The general outlook discouraged embarking on new investment projects and the volume of capital expenditure would have been even less but for the completion of existing projects. In the event, investments by enterprises declined by between three and four per cent in 1975 in constant price terms; but in value terms, investments rose by about seven per cent.

The volume of residential capital expenditures would likewise have been lower but for the carry-over of construction work which had a long lead time. Building permits for housing construction slackened markedly towards the end of 1974 and for the first nine months of 1975 were 26 per cent below the comparable 1974 period. The housing market in general suffered a reaction from the strong demand conditions experienced in 1973 and 1974. High mortgage rates, the rapid increase in construction costs and the downturn of the economy tended to reduce the demand for new housing below that prevailing in earlier years. In view of this evident slackening, and the prospect of rising unemployment in the construction sector, the public authorities instituted a series of measures during the course of the year, initially easing, and finally abolishing the restrictive measures carried over as a residue from the expansive period in 1974. In addition, the public authorities introduced an expanded programme of social housing which helped sustain the rhythm of activity of housing construction. Total residential investment nevertheless decreased in real terms by about 3 per cent in 1975 which represented a sharp contraction from the 11 per cent growth of the previous year. Price inflation in this sector, at 16 per cent last year, continued to be a problem. Public authority capital expenditures showed

Table 3 – **Shares of capital investment in Community countries** (1)

| Countries | | Gross National Product at current market prices | Gross fixed investment | | | |
|---|---|---|---|---|---|---|
| | | | As % of gross national product | Sectoral shares in % | | |
| | | | | Business investment | Housing construction | Investment by public authorities |
| Germany, DM milliards | 1974 | 997.0 | 22 | 59 | 23 | 18 |
| | 1975 | 1 043.6 | 21 | 60 | 21 | 19 |
| France, FF milliards | 1974 | 1 281.0 | 27 | 61 | 27 | 12 |
| | 1975 | 1 405.0 | 26 | 59 | 27 | 14 |
| United Kingdom, £ millions | 1974 | 82 333 | 20 | 64 | 19 | 17 |
| | 1975 | 103 039 | 20 | 65 | 20 | 15 |
| Italy, Lit. milliards | 1974 | 99 056 | 23 | 58 | 29 | 13 |
| | 1975 | 111 809 | 21 | 56 | 29 | 15 |
| Netherlands, Fl. milliards | 1974 | 188.1 | 22 | 58 | 25 | 17 |
| | 1975 | 204.3 | 21 | 58 | 24 | 18 |
| Belgium, BF. milliards | 1974 | 2 105.6 | 22 | 58 | 28 | 14 |
| | 1975 | 2 348.8 | 22 | 56 | 29 | 15 |
| Denmark, Kr. milliards | 1974 | 186.95 | 22 | 56 | 24 | 20 |
| | 1975 | 206.55 | 20 | 54 | 22 | 24 |
| Ireland, £ millions | 1974 | 2 928 | 25 | 58 | 25 | 17 |
| | 1975 | 3 561 | 23 | 54 | 28 | 18 |
| Luxembourg, Flux. milliards | 1974 | 82.28 | 25 | 53 | 24 | 23 |
| | 1975 | 79.34 | 27 | 51 | 21 | 28 |
| Total Community u. a. milliards | 1974 | 975.6 | 23 | 60 | 25 | 15 |
| | 1975 | 1 082.5 | 22 | 60 | 24 | 16 |

(1) This table is based on estimates, at current prices, of orders of magnitude. Strict comparisons of gross fixed investment cannot validly be made because of differences of definition and composition from one Member Country to another.

a relatively low growth in real terms of 2.4 per cent in 1975 despite the extensive investment programmes put forward by the Government during the year. To some extent this tendency was due to the normal lag between the initiation of projects and the commencement of construction, and to some extent to delays in obtaining legislative approval for investment programmes.

In contrast to the majority of countries capital expenditure by enterprises in the *Netherlands* maintained its position in relation to such expenditure in other sectors in 1975, but its volume declined further, by about 4.8 per cent following a reduction of only 0.1 per cent in 1974. In the last quarter of 1975 there was a more than seasonal increase in business investment but for the greater part of the year capital expenditures were pruned or postponed because of the existence of surplus capacity and poor business conditions. The rise in input costs combined with lower export sales and price controls on the domestic market resulted in a severe deterioration in the profit margins of enterprises in 1975. It has been estimated that a fairly large proportion of Dutch companies were only a little above break-even point, but with some companies in industries particularly affected by the recession registering heavy losses. There was a tendency, as in 1974, for new capital investment to take the form of labour saving machinery and equipment. This often involved replacing equipment which was becoming obsolescent at an increasing pace and resulted in new investment taking place in capital-intensive rather than labour-intensive industries.

The decline in the volume of residential construction of 6.8 per cent last year was smaller than the 12.8 per cent recorded the previous year but, as this was due to improved statistics of construction, it should not be interpreted as a slowing of the downtrend which resulted from a virtual over-supply of housing in the early part of the decade. On a small scale, there has also been shift in the form of supply from new construction to the renovation of old houses. There were 120 800 new dwellings completed in 1975 which compares with an average of about 150 000 units completed in each of the previous three years. The number of housing units started had declined sharply in 1974 and the lower overall demand for housing continued into 1975. The reduced activity in construction, both residential and non-residential, would probably have been greater but for special government programmes to counteract this and the rise in the number of unemployed.

An important part of the special government measures introduced in late 1974 and early 1975 was designed specifically to boost the construction sector, often through public works programmes in economically retarded regions. There was a considerable injection of funds into the economy which contributed to an increase in the public sector financing requirement from Fl. 5.1 milliard in 1974 to an estimated Fl. 9.9 milliard last year. Nevertheless, the expansion of public authority investments last year reversed a decline in this sector which had persisted for a number of years. Capital expenditures by the public authorities rose by 4 per cent in volume terms in 1975 and by about 14 per cent at current prices.

Business investment in *Germany* continued to be affected adversely during a large part of 1975 by the cyclical decline in sales and output which had begun a year earlier, but appeared to be more resistant than in most other Member States, including the Netherlands. It accounted for a larger proportion of total fixed investment in the German economy than in the previous year and by the last quarter of 1975 was even rising sharply in volume. The favourable influence of reductions in raw material prices and a distinctly smaller wage increase in the 1975 round of wage negotiations were insufficient, at least in the earlier part of the year, to compensate for the effect on investment intentions of seasonally declining sales, falling output, a negligible rise in productivity and the generally uncertain economic outlook. In the second half of the year, however, the prospects for investment improved as sales picked up. Investment in machinery and equipment began to increase after mid-year and the influence carried through to industrial and commercial building during the fourth quarter. In the fourth quarter also, construction permits granted increased by around 30 per cent compared with the same period of the previous year. The investment grant scheme continued to be a major factor behind this improvement, because some building permits, requested before the end-June expiry of the scheme, were not issued until the fourth quarter. Taking 1975 as a whole, however, total business capital expenditures declined by about 3.3 per cent at constant prices. With price inflation much reduced, business investment at current prices increased by about 0.6 per cent.

Residential investment in Germany fell again during 1975, the decline being about 10 per cent when measured at current prices and about 12.4 per cent at constant prices. Housing units started during 1975 were very much reduced from the record number started two years earlier, but were beginning to recover somewhat in the fourth quarter of last year. Demand from private house-buyers was relatively good but not strong enough to offset the contraction in housing construction by the public sector and by property owners for the purpose of renting.

Following the major effort made by the German public authorities in 1974 when they increased their fixed investment by over 20 per cent in value and about 11 per cent in volume in order to counteract recessionary influences, the further growth in investment in this sector during 1975 of 2 per cent in volume and 4.5 per cent in value was relatively modest. The very much higher public sector borrowing requirement in 1975 at DM 65 milliard, compared with the DM 24 milliard required the previous year, was not attributable to the implementation of Government investment programmes but mainly to social security payments.

For a variety of reasons, including the general effect of a historically high rate of inflation which exceeded that in other Member Countries, the pattern of expenditure at current prices on fixed investment in the *United Kingdom* during 1975 differed from patterns established elsewhere. The share of enterprises and of housebuilding rose while that of the public authorities fell. In terms of volume, however, the relatively small 1.5 per cent decline in business capital expenditures covers a divergence of trends in its various sub-sectors. The volume of new investment in the manufacturing industries declined abruptly during 1975, by 13.9 per cent, or to about the same extent as during the previous year. This reduction stemmed principally from the adverse trading conditions, in volume terms, both on the domestic market and in export sales. With the decline in industrial output last year, the proportion of companies reporting their operations as being below full capacity reached a record of 78 per cent as of January 1976. In addition, the need for enterprises to bring financial commitments more into line with their available cash flow which, despite inflation, was often no higher in 1975 than in previous years, resulted in a closer appraisal of the likely return on capital projects. This was made more pressing since the impact of price inflation of the order of 27 per cent on capital investment expenditures was particularly severe last year.

Certain measures were introduced by the government in late 1974 and during the course of last year to boost investment, particularly in the manufacturing industries, but these seem to have had only a marginal effect in slowing the decline in business capital expenditures generally. Nevertheless, one area of expansion was that of capital equipment for the development of oil and gas supplies. With the onset of the production phase of North Sea development, expenditures on extraction equipment, port facilities, pipelines and processing plants for gas and oil have assumed some importance in the overall pattern of business investment in the United Kingdom. The nationalised industries also increased their capital spending in constant price terms by more than 10 per cent in 1975.

Residential capital expenditures last year recovered some of the ground lost in the previous two years in rising by 6 per cent in volume and by 27.5 per cent at current prices. Private housebuilding was relatively more expansive than that of the public sector, with new housing units started during 1975 being 40 per cent higher than in the previous year compared with an increase of 13 per cent in the public sector. The private housing market thus experienced a limited recovery from the very depressed conditions existing in 1974. This improvement may have been due, in part, to the slower rise in new house prices than in previous years (and slower than the rise in incomes), and in part to the ready availability of funds from the Building Societies. Nevertheless, a relatively large stock of completed but unsold houses continued to hang over the private residential market at the end of 1975 and the volume of investment was still about one-sixth below the peak in 1972.

Non-residential capital expenditures by the public authorities declined by 3.3 per cent in volume last year, but rose by 16 per cent at current prices. It appears the growing financial deficit of the authorities stemmed, in the United Kingdom as in Germany, from the expansion of current expenditures, associated in part with counter-recessionary policies, rather than from the increase in capital spending.

CHAPTER 2

# FINANCING OF INVESTMENT

## 2.1. THE FINANCIAL BACKGROUND

The problems which had loomed large at the beginning of 1974, inflation and the financing of large balance of payments deficits on current account, diminished in size during 1975. The rise in prices tended to moderate as demand contracted and the most serious recession since the Second World War took hold. At the same time the imports of most industrialised countries, fell in volume while the oil exporting countries began to spend their newly gained wealth more freely. This left room for a further easing of monetary and fiscal policies in developed countries in the interests of restimulating economic activity.

Demand for credit by the private sector remained weak. On the part of businesses, the uncertain outlook tended to lead to a running-down of stocks which lessened the requirement for working capital and to an abandonment or a postponement of investment plans. Private individuals, on the other hand, tended to hesitate over taking on new commitments while unemployment was rising strongly and to save a higher proportion of their incomes than in the recent past. In consequence banking systems were generally very liquid.

Against this, the increased expenditure of public authorities both on current and capital account resulted in a sharp increase in budgetary deficits in most countries and to historically large public sector borrowing requirements. The decline in short and long-term interest rates which occurred during 1975 might have been larger but for substantial demands made by public authorities for finance from capital markets. As it was, short-term interest rates fell during 1975 to well below bond yields on all markets, re-establishing a more normal interest rate structure than that which had prevailed, in many instances, for more than a year. Investors accordingly found it profitable once more to invest at longer term and towards the end of 1975 it became possible to launch bond issues with longer maturities, even if these maturities were not quite as long as those regarded as normal before the inflationary crisis.

Up to a point the performance of the international capital market was similar. Short-term interest rates on euro-currency deposits declined appreciably in the first five months of 1975, but then rebounded for the next four months before declining again in the final quarter of the year. International syndicates were not faced, as in 1974, with demands from national authorities for massive euro-currency credits for the pre-financing of expected oil deficits though, on the other hand, they received less in the way of deposits from oil exporting countries. The initial fall in short term euro-currency rates was nevertheless large enough to revive the interest of investors in the euro-bond market where the volume of issuing activity rose markedly in 1975 and perhaps ruled out the possibility of a further fall in longer term interest rates.

The movement towards a lower interest rate structure began in France in mid-1974. The Netherlands and Germany followed suit within a matter of months. Interest rates probably fell more in Denmark than anywhere else in the Community but this was from an exceptionally high level. There was also a marked fall in long-term interest rates in the United Kingdom, Ireland and Italy but their movement after the first quarter of 1975 was somewhat irregular. The problem of inflation was beginning to emerge again in Italy at the end of the year, as it had from mid-year onwards in Belgium largely under the influence of which interest rates rose in the second half of 1975 both in Belgium and in Luxembourg to end the year more or less where they were twelve months earlier.

Table 4 – **Methods of financing the fixed investment of enterprises in the Community**
(Provisional)

(Percentages)

| | 1971 | 1972 | 1973 | 1974 | 1975 | Annual average 1971–1975 |
|---|---|---|---|---|---|---|
| I. Depreciation | **46.9** | **47.7** | **46.6** | **51.5** | **54.4** | **49.4** |
| II. Long and medium-term external resources raised on national capital markets | **15.5** | **18.0** | **18.4** | **11.5** | **20.0** | **16.7** |
| of which: shares | 3.9 | 4.6 | 3.9 | 2.5 | 4.2 | 3.8 |
| bonds | 11.6 | 13.4 | 14.5 | 9.0 | 15.8 | 12.9 |
| III. Other resources including net self-financing and, bank and other credits | **37.6** | **34.3** | **35.0** | **37.0** | **25.6** | **33.9** |
| Total financing for gross fixed capital formation | **100.0** | **100.0** | **100.0** | **100.0** | **100.0** | **100.0** |

During 1975, fiscal and monetary policies in *France* were directed increasingly towards re-stimulating the economy while avoiding the creation of new inflationary pressures. In recent years the budget has normally been in balance, but the need to provoke a revival of economic activity led the authorities to budget for a deficit in 1975 of F.fr. 43 milliard, equivalent to 3.4 per cent of GDP, and with more than 80 per cent of this being financed by the banking system. The main programmes covered by the additional expenditure were announced in April and September. In April the decision was taken to inject some F.fr. 20 milliard into critical sectors of the economy of which F.fr. 1 milliard was to be allocated for lending to public enterprises; only F.fr. 6.9 milliard of the total represented new money to be obtained from sources external to the Government. Also within the overall programme, F.fr. 5 milliard was intended to be raised in the form of a joint-issue by various public institutions and carrying a government guarantee, the proceeds of which were to be devoted to the purchase of machinery and equipment for installation in productive enterprises. The measures, totalling F.fr. 30.5 milliard, announced in September went further than the provision of finance for investment. In addition to an amount of F.fr. 15.9 milliard allocated for financing public and industrial or other forms of productive investment, some F.fr. 5 milliard was earmarked for stimulating consumption and the final date for the payment of company taxes amounting to F.fr. 9.6 milliard was postponed. It seems probable that the September measures played a significant role in the brightening of economic prospects in the fourth quarter of the year.

Monetary policy also played an important role during 1975 in creating conditions which favoured the restimulation of the economy. Policy had not really been restrictive during the last quarter of 1974 but at the end of the year short-term interest rates nevertheless remained higher than long-term rates, standing in an inverse relationship which clearly needed to be corrected in the changed circumstances of 1975. The authorities were nevertheless anxious not to impair the progress that had been made in combatting inflation and in restoring equilibrium in the balance of payments on current account.

The first half of 1975 accordingly saw the adoption of a series of cautious and selective measures to create a climate more favourable to investment. It proved possible to apply a further sharp stimulus in September. The banks' minimum reserve requirements against sight deposits were reduced in three stages, in January, June and September, from 17 per cent at the beginning of the year to 11 per cent by mid-year and to 2 per cent by the end of the third quarter, thus freeing a total of some F.fr. 35 milliard of resources. Increases in bank credit were permitted under a system of progressive ceilings on a monthly basis adjusted for seasonal influences. In September these ceilings were raised for financial institutions specialising in term credits in support of other measures aimed at a selective stimulation of consumer expenditure. The structure of short-term interest rates declined fairly steadily during the year and the discount rate of the Bank of France, having been reduced in four steps during the first six months of 1975 from 13 per cent to 9.5 per cent, was cut further in September by 1.5 per cent to 8 per cent. Meanwhile, in line with the intentions of the authorities to reduce the cost of credit to enterprises adversely affected by the recession, the easing of monetary policy induced the banks to lower their base lending rate in stages, from 11.9 per cent in January 1975 to 8.6 per cent in December. The reduction in short-term interest rates on a broad front helped to turn the attention of investors from the short-term money market to longer term placements on the bond market.

At the same time the substantial long-term capital inflow from abroad which was a feature of the balance of payments in 1974, as France sought to cover the merchandise trade deficit resulting from the increase in oil prices, disappeared and was replaced by a small outflow in 1975. The inflow of short-term capital was, however, larger in 1975, and by mid-year the strength of the franc facilitated its re-entry, at least temporarily, into the European currency snake.

While interest rates in the *Netherlands* moved downwards during 1975 virtually in parallel with those in France, the movement had very different origins. Initially there was a carry-over of the effects of rapid monetary expansion in 1974 and subsequently the authorities were engaged in promoting capital outflows to offset the balance of payments surplus on current account. The broad objective of monetary policy towards the end of 1974 and in early 1975 was to lower the growth in the monetary aggregates, which had increased rapidly during 1974, as a part of overall anti-inflationary policy. These aims were pursued through raising the liquid reserve requirements on short-term deposit liabilities so as to reduce the margin of free liquidity of the banks, and the reintroduction of a ceiling on credit expansion was actively considered. Towards mid-1975, however, the rate of growth of credit expansion had flattened out and the authorities reduced the liquid reserve requirement on short-term deposits. In addition the target margin of free liquidity was raised to a minimum of 2 per cent from the 0.5–1 per cent which had prevailed since July 1974. With a lower pattern of loan demand from the private sector the banking system became highly liquid from mid-May onwards. The consequent decline in interest rates helped the authorities in persuading the banks to place funds abroad, thus increasing their net foreign assets. In this way it was hoped to avoid a major increase in the country's official external reserves which would otherwise result from the excess of the current account surplus in the balance of payments over the expected capital outflow. The outflow of funds was also actively encouraged by the opening at mid-year of the capital market to public placements by foreign governments and private borrowers (private placements had been allowed previously). Around the same time the local authorities were granted direct access to the capital market instead of being required, as in the preceding ten years, to seek funds only from certain specialised credit institutions.

Bond markets improved until mid-year under the influence of a ready supply of capital and private, as well as institutional, investors contributed substantially to the better tone. However, at end-June there was a turning in the market and bond yields tended to rise when it was announced that the Government's deficit for 1975 would have to be revised upwards. Reductions in discount rate in mid-August and mid-September indicated that the authorities were still trying to turn away capital inflows. But by October the demand for credit was reviving in the Netherlands and the banks' obligatory reserves were again reduced to zero.

Interest rates declined in *Germany* between the beginning and end of 1975 but not without some tension in the third and part of the fourth quarter. A further decline in the rate at which prices were increasing left the authorities with room for manoeuvre in their attempts to re-stimulate the economy. In the field of monetary policy, the discount rate of the Bundesbank was reduced in stages between February and September by two and a half percentage points to 3.5 per cent. During the same period the Bundesbank's Lombard rate for advances against security was brought down even further, from 8 per cent to 4.5 per cent. These moves which were sometimes synchronised with increases in discount ceilings or releases from the banks' legal reserve requirements were aimed initially at persuading the banks to reduce their interest rates on term loans which had come down less than the interest rates which they had offered on their deposits. The money supply, widely defined (M 3), nevertheless grew relatively slowly at a seasonally adjusted annual rate of 3.4 per cent during the first half of the year for which slackness of loan demand from the business sector was largely responsible.

Towards the middle of the year, however, investors began to expect an up-turn in long-term interest rates. The main reason was the fear that an additional strain would be placed on the bond market by the covering of financial deficits in supplementary budgets introduced by the Federal Government and some of the Länder. Investors were also disturbed by a temporary rise in the rate of inflation around mid-year. A third factor was a rise in long-term interest rates in some external capital markets. In order to give the bond market an opportunity to regain its strength, it was closed to new issues by public sector borrowers from 11 July until almost the end of the year. The Federal Government announced plans for improving the structure of its budget and for avoiding deficits over a period of several years but, during the suspension of new issues, it covered its borrowing requirements by placing debt certificates and Treasury bills with financing institutions up to August and by resorting thereafter to obtaining loans from the banking system. An increase in money supply (M 3) during the second half of the year at an annual rate of 13.8 per cent eased the task of the public authorities in raising the necessary finance.

The impact of external transactions during 1975 on the capital market was quite minor. The reduction over the year as a whole of the net outflow of capital was partly attributable to the steps taken at the end of August to allow banks to pay the same interest rates on non-resident deposits as on resident deposits, and to borrow abroad on behalf of public authorities through placings of notes, though it is a little early to judge the precise effect. Thus the open-market operations of the Bundesbank to which the authorities found it necessary to resort during the third and part of the fourth quarter were occasioned mainly by the weakened confidence of domestic investors. These open-market operations which reached a total of DM 8 milliard by the time they were suspended in the fourth week of October, were successful in that they prevented yields on bonds issued by public sector borrowers from rising more than marginally on the secondary market. When towards the end of the year public sector borrowers were again permitted to launch new bond issues, a part of the public sector's financial requirements for 1976 had been covered and the market itself was in better shape, being willing to accept longer-dated securities than previously.

Interest rates also fell in *Denmark* during 1975 but their starting point was higher than in any of the three preceding countries. Monetary policy was broadly accomodating in the latter part of 1974 and during last year in that credit ceilings were repeatedly raised – by a cumulative total of 10 per cent between November 1974 and December 1975 – so as to avoid placing any constraint on bank lending which might retard a recovery in business activity. While loan

Table 5 – **Financing of the non-government sector from the domestic market and banking sources**

(milliard units of account)

| Country | 1972 | 1973 | 1974 | 1975 |
|---|---|---|---|---|
| Germany | 30.63 | 27.50 | 23.65 | 17.42 |
| France | 22.09 | 22.53 | 24.16 | 27.88 |
| United Kingdom | 21.67 | 20.73 | 14.07 | 8.36 |
| Italy | 15.75 | 20.97 | 14.13 | 18.42 |
| Netherlands | 5.17 | 6.75 | 8.10 | 7.94 |
| Belgium | 2.92 | 3.35 | 3.61 | 4.22 |
| Denmark | 2.77 | 3.51 | 3.07 | 3.44 |
| Ireland | 0.68 | 0.59 | 0.42 | 0.53 |
| Luxembourg | –([a]) | 0.18 | 0.28 | 0.28 |
| Total Community | 101.68 | 106.11 | 91.49 | 88.49 |
| of which: shares | 5.05 | 5.40 | 3.84 | 6.82 |
| bonds | 4.61 | 3.30 | 2.03 | 5.14 |
| short, medium and long-term credits | 92.03 | 97.41 | 85.62 | 76.53 |

([a]) Estimates are incomplete

commitments rose moderately, actual utilization of credit lines barely increased at all owing to the slowing in business activity. On the other hand there was extensive liquidity in the financial system as personal savings were exceptionally high in 1975. The ready availability of funds, combined with the low demand for credit, enabled the financial institutions to take up a much larger amount of new issues on the bond market at interest rates below those of the previous year. Much of the liquidity stemmed from the sharp increase in the Central Government's budget deficit. The need to finance this in a non-inflationary manner prompted the Government to embark on a very large D.Kr. 6 milliard programme of bond issues under the favourable conditions which existed during the summer and early autumn. As a further measure to reduce liquidity, the banks were required from November until the end of the fiscal year at the end of March 1976 to place special reserve deposits with the central bank.

An important facet of Danish monetary policy in recent years has been the need to maintain a strong inflow of capital from abroad in the form of business and financial loans to the private sector. This has been necessary to offset the current account deficit of the balance of payments and to maintain the country's external reserves. Thus, the monetary authorities have had to maintain a delicate balance in credit policy, in providing adequate liquidity to finance a revival of activity while not allowing interest rates to fall too far. If too easy, terms for borrowing on the domestic market could encourage some switching from foreign markets.

The next three countries, the United Kingdom, Ireland and Italy also experienced a decline in interest rates during 1975, though they were grappling with rather more serious inflationary problems than others. In the *United Kingdom*, the financial setting last year was dominated by the extent of price inflation, and its consequent impact on financial assets and on the external competitive position. As noted in an earlier section, retail prices rose by 25 per cent in 1975, which was at least twice as much as in any continental Community country. Capital markets, however, provided more funds than in 1974. Individuals greatly expanded their savings with the financial intermediaries even though there was a negative real rate of return. The external financing requirements of industrial and commercial companies were substantially reduced through cutting back expenditures on fixed investment and not replacing stocks. Capital markets were also aided, more particularly from mid-year onwards, by greater optimism that the government's incomes policy would be successful and that inflation would decline.

The growing size of the public sector deficit was a major concern to the financial community. Despite direct tax increases in April, and so-called "fiscal drag" (the tendency of tax revenues to rise faster than incomes as these become liable for tax at increasing rates), the public sector borrowing requirement rose by 49 per cent in the calendar year 1975 to £ 10.45 milliard. The monetary authorities followed a course of trying to meet this requirement in a non-inflationary manner through the bond market, but at the same time maintaining monetary expansion and interest rates at levels which would accommodate an eventual recovery in investment demand. Recourse to the bond market by the Central Government was thus very considerably increased, but the uptake of issues was eased by the carry-over from the previous year of a high degree of liquidity among non-bank institutions. The U.K. market was encouraged by declining rates of interest in other financial centres and by the growing evidence that inflationary pressures were being overcome. This paved the way for a reduction in short-term interest rates on the domestic market which, in turn, encouraged a move into longer-term commitments on the part of investors.

The downward movement of interest rates, however, was circumscribed by the need to maintain an interest rate differential in favour of sterling. Most of the depreciation of the pound sterling during 1975 as a whole of about 11 per cent occurred during May and June and short-term interest rates which had moved lower in the first quarter of 1975, were forced upwards by the monetary authorities during the summer as a defensive measure against a continued slide in the exchange rate. In order to allow greater room for manoeuvre with respect to interest differentials between the domestic market and abroad, the U.K. Government decided to apply to the International Monetary Fund, towards the end of the year, for additional reserve backing amounting to some $ 2000 million of which $ 700 million was drawn in December and the balance in January 1976.

The year-on-year increase in retail prices in *Ireland* of nearly 17 per cent to November 1975 was appreciably less than in the United Kingdom but nominal interest rates in the two countries continued to move in parallel. An expansion of 55 per cent in the public sector borrowing requirement in 1975 resulted largely from the growth of expenditure directed towards restimulating the economy. Money supply on a wide definition (M 3) increased during 1975 by 20 per cent while GNP expressed in current prices rose by 21.5 per cent; this was broadly in line with the original target of monetary policy which was that the increase in the two indicators should be of the same order.

Credit ceilings were raised at the end of 1974 and the official discount rate was lowered in two steps in January and March 1975, from 12 per cent to 10 per cent. The deposit and lending rates of the main Irish banks were also reduced. The potential inflationary impact of the public sector deficit was, however, rather less than it might have been because nearly one-third of it was covered by borrowing from domestic investors other than banks. Almost the same amount was financed by medium-term borrowing from abroad.

The easing of monetary policy, slackness of demand for credit on the part of the private sector, and a larger volume of private saving contributed towards a better climate on the capital market. The structure of interest rates continued to be influenced by conditions on the London market but, subject to this constraint, long-term rates fell in the first quarter of 1975 and did not rise again until the fourth quarter by which time a number of issues had been successfully floated by enterprises as well as by the public authorities. Enterprises also found it possible to raise some new share capital in 1975, but the capital market remained only a minor source of finance for the business sector in comparison with bank credits.

The rise in retail prices in *Italy* in 1975 of just over 11 per cent represented a marked improvement on performance in 1974 but signs that this reduction would turn out to be only temporary were beginning to appear by the end of the year. The underlying problems in Italy thus bore a degree of resemblance to those in the United Kingdom and Ireland. From the very beginning of 1975 a large number of measures were introduced by the Italian authorities in relaxation of the previously restrictive credit and monetary policies. The 15 per cent ceiling on the growth of bank credit was eased and finally abolished at end-March, although a general limitation on the expansion of credit, as agreed with the International Monetary Fund, was maintained. At the same time the non-interest-bearing import deposit scheme whereby 50 per cent of the cost of selected imports were frozen with the Bank of Italy was phased out and these funds were released gradually to the economy. The liquidity of the banking system was expanded further with the release of Lit. 300 milliard of obligatory reserves in January. A simultaneous modification of the system of reserve requirements had a broadly neutral effect. Also in January an agreement was reached among the major commercial banks to limit interest rates payable on deposit accounts. The Bank of Italy reinforced this agreement by giving rediscounting priority to those banks lowering their deposit rates. In consequence the rate of interest on inter-bank deposits declined steeply from 17.5 per cent in December 1974 to 9.8 per cent in June of last year, and subsequently drifted lower to 8.3 per cent by end-year. A factor contributing to the continued decline in rates was that substantial amounts of funds were made available by the central bank for the financing, at very low cost, of short-term export credits by the banking system. It seems probable that the low demand for credit resulting from the fall in domestic business activity and investment also played an important part in the decline in interest rates.

Concomitant with the easing of credit restrictions, the authorities set out to encourage the transfer of savings into the bond markets so as to facilitate the financing of both the increased government deficit and the capital needs of the business sector. The banks were required to invest 40 per cent of their new deposits in bonds within a stipulated period which thus assured a continuing flow of funds to the market. This bond-holding requirement was reduced to 30 per cent of new deposits for the period from end-May to end-November of last year. However, owing to the slack demand for bank loans, there is some evidence that the banks took up more than the amount of bonds required as a proportion of new deposits. Nevertheless the reduction in long-term bond yields was modest in comparison with that of short-term interest rates in the banking system and so a general inducement emerged for investors to place funds directly on the bond market.

A central feature of the financial scene in Italy in the past few years has been the growth in the public sector deficit. In 1975 the borrowing requirement almost doubled to about Lit. 16 600 milliard compared with just under Lit. 9000 milliard in the previous year. This was despite undertakings, given in connection with the funding in 1974 of an earlier short-term loan from the Community into a medium-term credit, to try to hold the public sector deficit in 1975 below Lit. 15 000 milliard. Much of the financing of the deficit, as in the previous year, took the form of additions to the monetary base through the issuance of government securities to the Bank of Italy, amounting to some Lit. 7000 milliard.

After a promising beginning to the year, financial conditions in *Belgium* deteriorated to a greater extent in the second half of 1975 than in other Member States. At the start of 1975 monetary policy was geared to combatting excess demand pressures through relatively high interest rates and credit restrictions; but within a month the monetary authorities were already turning towards lowering the official discount rate and other interest rates, and raising rediscount quotas. The new, easier, orientation of policy in the direction of supporting economic activity was pursued throughout the remainder of 1975, as was evidenced by the successive lowering of the official discount rate in five steps from 8.75 per cent in early January to 6 per cent in August where it remained for the rest of the year.

Following the reduction in official interest rates, the rate on day-to-day money declined from 6.47 per cent in January to 3.94 per cent in December of last year. Yields on long-term bonds issued by public sector borrowers did not respond to the same extent and were only slightly lower at 8.7 per cent in December 1975 than the 9.0 per cent at which they stood a year earlier, though they reached a low point of 8.1 per cent in June 1975. The reasons why the strong flow of personal savings and a high availability of liquid funds in financial institutions did not bring about a significant fall in yields were various. Fears of inflation in a year in which consumer prices rose by 11 per cent played an important part; they were reinforced by the failure to secure legislative approval by the year's end for proposals, introduced in September, to limit increases in wages and salaries. The public sector borrowing requirement which reached B.fr. 141 milliard in the first ten months of the year compared with B.fr. 83 milliard in the comparable period in 1974 was substantially augmented by the introduction of counter-recessionary fiscal measures instituted by the Government and its size was cause for concern. Investors were also plainly disturbed by the uncertainty of the economic outlook in Belgium and hence preferred to remain liquid.

Because of the monetary union between the two countries, financial conditions in Belgium influenced those in *Luxembourg* to a certain extent. For much of last year the Luxembourg monetary authorities, whose scope for intervention tends to be rather limited, pursued a restrictive credit policy aimed at reducing price inflation. Gradually, as the economic recession deepened and the threat of unemployment became more acute, restrictions on the availability of mortgage credits were eased and finally abandoned. On the other hand, limitations on the availability of consumer credit from the banking system were maintained throughout the year.

The banking system's search for investment outlets contributed to a remarkable upsurge in activity on the bond market where new issues by both domestic and foreign enterprises were very much higher than in recent years. For their part, borrowers were encouraged by the decline of about one percentage point in the yield on new issues in the first half of the year.

## 2.2. FINANCING IN THE COMMUNITY COUNTRIES BY SECTOR: PERSONAL AND CORPORATE SAVINGS, NEW CAPITAL ISSUES ON DOMESTIC MARKETS, BANK AND OTHER CREDITS TO THE NON-GOVERNMENT SECTOR

One of the outstanding features of 1975 was the strong revival of issuing activity on bond markets. As can be seen in Table 6, net bond issues on national markets during 1975 totalled 55.37 milliard units of account or 32.78 milliard more than in the previous year. The public authorities took 18.33 milliard, or more than half of this increase, in covering their borrowing requirements which were enlarged by the implementation of measures to revive economic activity. Credit institutions also borrowed more in 1975 in accounting for 11.34 milliard of the growth in bond issues; they were evidently encouraged to build up their resources by the decline of interest rates on most markets.

The behaviour of enterprises towards raising capital, on the other hand, appears to have been influenced by the slowing of investment activity as well as by the improvement of conditions on capital markets. They raised a net 5.14 milliard units of account against bond issues during 1975 compared with just over 2 milliard the previous year. Share issues during 1975 were appreciably higher, at 6.82 milliard units of account, than in 1974 when they amounted to 3.84 milliard. This might suggest that a number of companies improved the structure of their balance sheets in nominal terms but to put the matter in perspective the totals of bond and share issues by enterprises should be compared with new credits from financial institutions of 76.53 milliard units of account in 1975 (see Table 5). The total of credits was admittedly 11 per cent lower than that recorded in 1974, but, as it includes short-

Table 6 – **Net domestic public issues of securities**

(milliard units of account)

| Type of Securities | 1972 | | 1973 | | 1974 | | 1975 | |
|---|---|---|---|---|---|---|---|---|
| Shares | **6.95** | | **6.62** | | **4.84** | | **8.40** | |
| of which: | | | | | | | | |
| Credit institutions | | 1.90 | | 1.22 | | 1.00 | | 1.58 |
| Enterprises | | 5.05 | | 5.40 | | 3.84 | | 6.82 |
| Bond issues | **27.02** | | **36.87** | | **22.59** | | **55.37** | |
| of which: | | | | | | | | |
| Public authorities | | 6.79 | | 12.38 | | 5.58 | | 23.91 |
| Credit institutions | | 15.62 | | 21.19 | | 14.98 | | 26.32 |
| Enterprises | | 4.61 | | 3.30 | | 2.03 | | 5.14 |
| **Total Community** | **33.97** | | **43.49** | | **27.43** | | **63.77** | |

term credit for the financing of stocks, it was probably affected by the running down of inventories last year. It therefore seems likely that any improvement that there might have been in company balance sheets, disregarding the deterioration resulting from prolonged price inflation, would have been minor and temporary.

Capital markets benefited during 1975, especially towards the end of the year, from a general rise in personal savings. The increase in such savings seems mainly to have had a precautionary motive stemming from the growing threat of unemployment but it may also have been partly an adjustment to a higher level of prices and incomes. Whatever the motive for the saving, investors tended to be hesitant at various times during 1975 and to wait until the economic outlook was less uncertain before committing themselves to purchases of longer term securities. Company profits on the other hand seem to have suffered from reduced output, keener price competition and rising costs, particularly those of labour.

The bond market in Italy recovered to a greater extent in 1975 than those in any other Member State (see Table 8). Share issues were also higher (see Table 7) even though the Italian market was the only one in the Community on which prices fell. The total of new issues on the United Kingdom market in fixed interest securities was impressive but here the scene was dominated by the borrowing operations of the public authorities and the share market served enterprises better. In spite of being closed to new issues by public sector borrowers for several months, the German capital market absorbed a much larger volume of new bond issues than in recent years. Enterprises, which were net redeemers of bonded debt tended instead to raise funds through share issues. In France, on the other hand, the bond market was a useful source of capital for enterprises in 1975 but new share issues fell back despite rising prices on the secondary market. In Denmark it was the credit institutions followed by the public authorities who were the main beneficiaries of improved issuing conditions on the bond market, whereas in Belgium the reverse was true. In Denmark enterprises again raised relatively little by way of bond issues and in Belgium they raised less than in 1974; share issues were reduced in both countries but net bank credits rose. The increase in the volume of capital raised on the Netherlands market was more modest but the public authorities, credit institutions and non-financial enterprises all derived some benefit; share issues also increased in 1975. Activity in 1975 on the fixed interest security markets of Ireland and Luxembourg was small in relation to that on other markets but new issues in Ireland virtually trebled in comparison with the previous year, while in Luxembourg the net amount raised represented a swing from a net redemption of bonds in 1974.

Turning to the pattern of financing in individual countries, a resurgence of issue activity on capital markets following the difficulties in 1974 was an important means of financing investment in *Italy* last year. New bond issues by non-financial enterprises rose to Lit. 1396 milliard in 1975 from Lit. 96 milliard in the previous year, with both public and private enterprises sharing in this expansion. Specialised credit institutions which are important as a source of finance increased their new issues last year by 162 per cent to Lit. 5638 milliard. The public sector also took advantage of the improved issue conditions in raising over four times the amount of bonds last year as in 1974. The high degree of liquidity of the commercial banks and the requirement that a certain proportion of new deposits be invested in securities provided a sound base for increased market activity. In addition the yields prevailing on the bond market which, at least from the summer months onwards, were high in comparison with interest rates on deposits, attracted a greater participation by the non-bank public. Despite the decline in share values from March/April onwards the equity market provided almost 80 per cent more capital in 1975, to the benefit principally of non-financial enterprises.

The amount of new savings available in the form of increased savings deposits with the banks and savings institutions more than doubled in 1975, in rising by 110 per cent. As in 1974 there was a tendency in the first half of the year for new savings to flow into time deposits rather than traditional savings deposits. However, as short-term money and deposit rates declined towards the summer months, time deposit accounts lost some of their attraction in relation to both longer-term savings accounts and to the placing of funds directly with the bond market. In the fourth quarter of 1975 the Government initiated a reduction in direct taxation, backdated to January 1, 1975, to compensate for the effects of inflation. This resulted in a considerable boost to disposable incomes late in the year, much of which was retained in the form of savings. Corporate profitability, on the other hand, suffered from the effect of the business recession. At the same time labour costs continued to move upwards rapidly in 1975 and, taken in conjunction with lower output, resulted in a 34 per cent rise in unit labour costs. With average capacity utilization at only 68 per cent in the third quarter of last year, the operating rates of many plants probably fell below the break-even point. In recognition of the pressures on business profitability the government introduced, towards the end of 1975, measures allowing a 40 per cent revaluation of balance sheet assets with the aim of reducing the tax liability of companies.

New credits to the non-government sector which rose by about 13.5 per cent in 1975, grew fairly slowly for an era of high price inflation. Demand for short-term bank credit by business enterprises was relatively slack last year, but there was a tendency, as interest rates declined, for some conversion of short-term credit into longer-term loans. The loan/deposit ratio of the commercial banks declined from around 65 per cent at mid-1974 to just above 60 per cent during the same period last year and remained around this level until the year-end. In contrast institutions specialising in longer-term lending experienced a relatively strong demand for credit, indicative of preparation by the business sector of plans for expanding productive capacity in the upswing of the business cycle.

In line with developments elsewhere in the Community, a very substantial expansion in personal savings took place in the *United Kingdom*, amounting to a rise of some 24 per cent in 1975, which may have been due either to precautionary savings at a time of economic uncertainty, or to the desire to counteract the loss in the real value of liquid assets due to inflation. The clearing banks reduced their rates on time-deposits under £ 10000 by about 2.5 per cent during the course of 1975 while the building societies lowered their deposit rates by only 0.5 per cent during the same period. In consequence, liquid personal savings were channelled mainly into building society shares and deposits, with the amount of new holdings more than doubling compared with 1974. Placements with other non-bank intermediaries, including insurance companies and pension funds, also increased considerably. In contrast the flow into time-deposits with banks dwindled to a trickle compared with the previous year. The slow growth of bank deposits and the sales of central government debt direct to the general public were factors in the quite modest increase in the money stock (M 3) last year of only 8 per cent, which was well below the rate of price inflation.

Undistributed profits (including depreciation provisions and stock appreciation) of industrial and commercial companies declined by about two per cent in 1975 but those of financial companies experienced a rise in the region of 40 per cent. The fall in profits of industrial and commercial companies resulted in part from the decline in output and the tight market conditions prevailing last year, and in part from the controls on prices and margins which prevented an expansion of profitability where this might otherwise have been possible. Nevertheless, the financial position of companies came much closer to balance and contrasted with the very heavy financial deficit existing in 1974. While retained profits of industrial and commercial companies were lower, the disposal of stocks and the slower growth in fixed capital expenditures (even at current prices) reduced the

Table 7 – **Share issues by country**

(milliard units of account)

| Country | 1972 | | 1973 | | 1974 | | 1975 | |
|---|---|---|---|---|---|---|---|---|
| **Germany** | **1.18** | | **1.08** | | **1.17** | | **1.98** | |
| Credit institutions | | 0.39 | | 0.33 | | 0.32 | | 0.60 |
| Enterprises | | 0.79 | | 0.75 | | 0.85 | | 1.38 |
| **France** | **1.67** | | **1.88** | | **1.92** | | **1.79** | |
| Credit institutions | | 0.38 | | 0.44 | | 0.34 | | 0.25 |
| Enterprises | | 1.29 | | 1.44 | | 1.58 | | 1.54 |
| **United Kingdom** | **1.66** | | **0.32** | | **0.25** | | **2.36** | |
| Credit institutions | | 0.94 | | 0.08 | | 0.15 | | 0.57 |
| Enterprises | | 0.72 | | 0.24 | | 0.10 | | 1.79 |
| **Italy** | **1.96** | | **2.80** | | **0.95** | | **1.70** | |
| Credit institutions | | 0.12 | | 0.21 | | 0.07 | | 0.01 |
| Enterprises | | 1.84 | | 2.59 | | 0.88 | | 1.69 |
| **Netherlands** | **0.02** | | **0.05** | | **0.03** | | **0.15** | |
| Credit institutions | | – | | 0.03 | | – | | 0.07 |
| Enterprises | | 0.02 | | 0.02 | | 0.03 | | 0.08 |
| **Belgium** | **0.37** | | **0.34** | | **0.42** | | **0.38** | |
| Credit institutions | | 0.04 | | 0.07 | | 0.05 | | 0.06 |
| Enterprises | | 0.33 | | 0.27 | | 0.37 | | 0.32 |
| **Denmark** | **0.05** | | **0.10** | | **0.05** | | **0.03** | |
| Credit institutions | | 0.02 | | 0.04 | | 0.02 | | 0.02 |
| Enterprises | | 0.03 | | 0.06 | | 0.03 | | 0.01 |
| **Ireland** | **0.04** | | **0.03** | | **–** | | **0.01** | |
| Credit institutions | | 0.01 | | – | | – | | – |
| Enterprises | | 0.03 | | 0.03 | | – | | 0.01 |
| **Luxembourg** | **–** | | **0.02** | | **0.05** | | **0.00** | |
| Credit institutions | | – | | 0.02 | | 0.05 | | 0.00 |
| Enterprises | | – | | 0.00 | | 0.00 | | – |
| **Total Community** | **6.95** | | **6.62** | | **4.84** | | **8.40** | |
| of which: | | | | | | | | |
| Credit institutions | | 1.90 | | 1.22 | | 1.00 | | 1.58 |
| Enterprises | | 5.05 | | 5.40 | | 3.84 | | 6.82 |

financial deficit in 1975. A contributing factor to this improvement may have been a limited relaxation of price controls and the easing of tax regulations with respect to profit on stock appreciation.

New issues on the U.K. bond market by the public authorities increased very considerably in 1975 as a counterpart of the growth in the public sector borrowing requirement. New bond issues by the Central Government at £ 5.2 milliard were almost eight times the amount placed in the previous year, with most of the issues being concentrated in the first and fourth quarters of 1975 when the market's absorptive capacity was at its best. Most of these issues were taken up by the non-bank sector. The amount of private sector bond issues was relatively small last year compared with the upsurge in new equity funding which raised a total of over £ 1300 million, almost ten times the amount in 1974. Prices on the stock market improved dramatically in the first quarter of 1975 and companies took advantage of the improved tone of the market to bring forward, from March onwards, a steady stream of new equity issues, many of them in the form of rights issues, thus helping to offset the deterioration in financial structures that had occurred over the past two years.

As against the expansion of issues on the capital market, new bank lending was distinctly subdued last year. New credits made available to industrial and commercial companies declined by 84 per cent in 1975 and, taking into account their increased holdings of bank deposits, non-financial companies were net suppliers of funds to the banking system for the first time in four years. The moderate upturn in the housing market raised the demand for new mortgage loans which increased by about 70 per cent last year, despite the continuance of relatively high interest rates on mortgages throughout 1975.

Enterprises were not short of finance in *Germany* even though the public authorities tended to dominate the bond market as in the United Kingdom. The gross income of business continued to rise in 1975 while profit margins tended to stabilise. Expenditure on inputs appeared to decline to the same extent as sales – in part because of short-time working and the reduction in the numbers of employees – while the cost of units of output benefited from the more modest rise in wages and salaries per person employed which at 7.0 per cent was lower than the 11.4 per cent recorded in 1974. Partly because demand was depressed and competition keen, the cost of living index in December 1975 was only 5.4 per cent higher than twelve months earlier. In the fourth quarter of the year there was a considerable improvement in the tone of the domestic market with the sales, earnings and profit margins of enterprises recovering partially from the low points reached earlier in the year.

For 1975 as a whole internally-generated funds in the business sector, excluding residential construction firms and financial institutions, which were available for financing investment, rose by 11.0 per cent. Businesses' capital investments, however, were lower last year than in 1974, even at current prices, so that the ratio of capital expenditure requirements which were financed from internal sources rose appreciably to 92.2 per cent in 1975 compared with 79.6 per cent in the previous year. This indicates the extent to which enterprises were able to temper their demands on capital markets during the year. While financial enterprises took advantage of more buoyant market conditions in raising 88.4 per cent more capital through new share issues than in 1974, non-financial enterprises did almost as well in achieving a 51.3 per cent increase. As with United Kingdom enterprises, these additions of share capital would have helped to strengthen balance sheets after the stagnation of the share market in 1974. Enterprises in the private sector were able to continue with their net redemptions of bond issues during 1975, while enterprises in the public sector, taken as a group, also achieved a net reduction in their bonded debt. After the heavy resort to short-term borrowing from financial institutions in 1974, enterprises as a whole tended during 1975 to replace short-term by longer-term credit. In the fourth quarter, however, enterprises were borrowing heavily at short as well as at longer-term in financing higher turnover and the rebuilding of stocks.

The banking system was well placed to increase its lending to the domestic private sector in the form of medium and long-term credits which rose by 8.8 per cent in 1975, all of this in the second half of the year. Public enterprises borrowed from the banking system throughout the year but much more heavily in the second half when they had to forego making new issues.

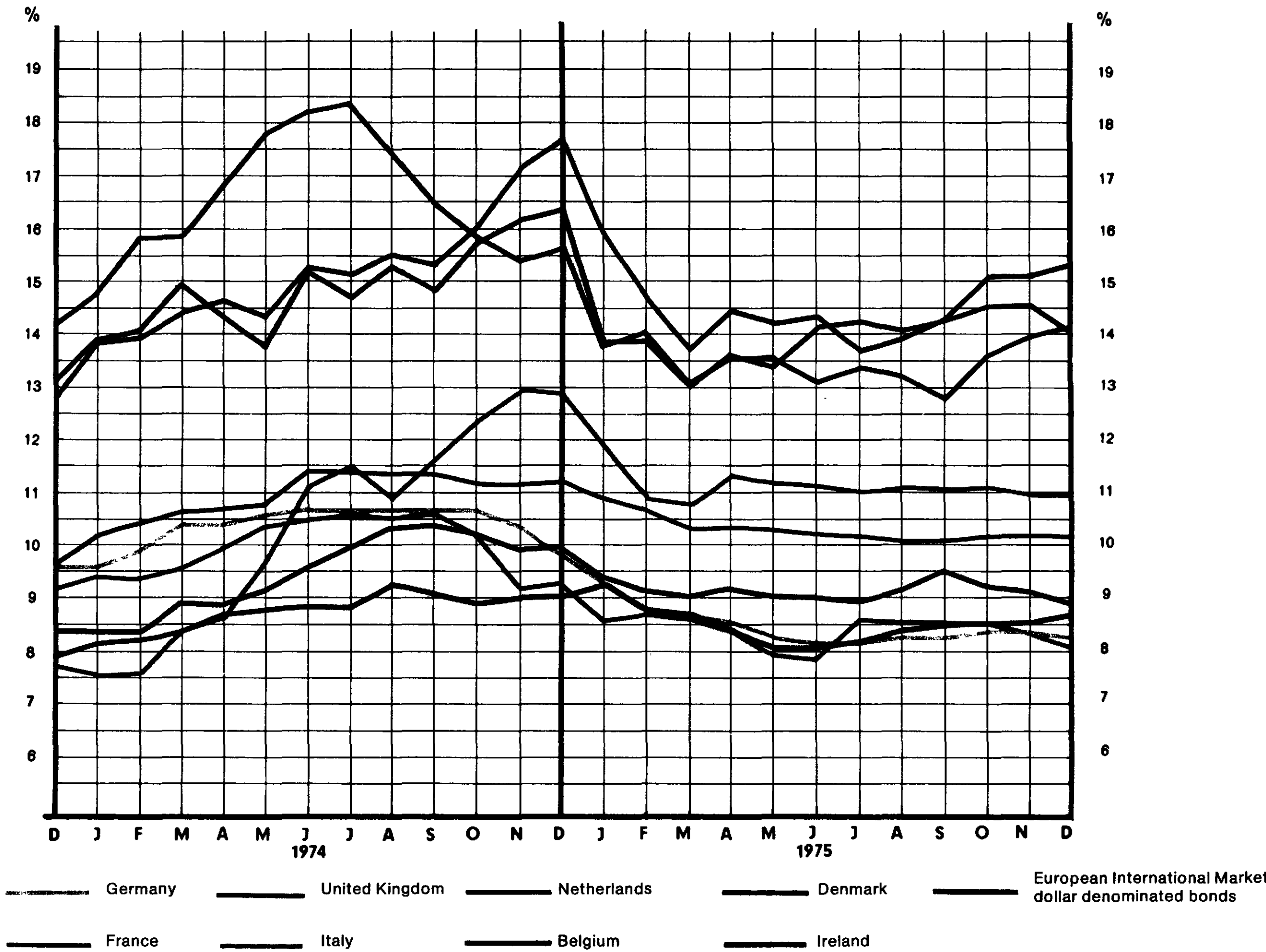
At a time of greater uncertainty as to the economic future and an extension of short-time working, it seems that private households tended to defer spending on less essential items and to increase their savings. This was particularly evident in the first half of the year when the ratio of savings to personal disposable income rose to 16.8 per cent compared with 14.4 per cent in the comparable 1974 period. The losses on personal incomes through short-time working or unemployment were offset in aggregate by tax reliefs and by the social assistance programmes of the Government which were greatly expanded last year. The supply of funds to the financial intermediaries through new time and savings deposits increased by 59 per cent in 1975. In addition sums raised by financial institutions in the form of tap issues of securities placed directly with investors amounted to DM 35.6 milliard in 1975 compared with DM 21 milliard in 1974 and DM 23 milliard in 1973. It seems that a substantial part of private saving took the form of purchases of these securities. In spite of the abundant liquidity of the financial system new mortgage credits for residential construction declined in 1975 because of the depressed demand for housing.

The growing volume of saving in Germany, by adding to the liquidity of financial institutions and enabling them to increase their security purchases, helped to strengthen the bond market. Towards the middle of the year, however, the bond market showed signs of strain. As a result of the protective steps taken by the authorities and described in the first sub-section of this chapter, the average yield on bonds issued by public sector borrowers, which had stood at 9.8 per cent at the beginning of the year and had fallen to 8.2 per cent by the end of June, only rose to 8.4 per cent at its highest during October/November, before falling back to 8.3 per cent at the end of 1975.

In spite of the closure of the bond market for almost half the year to public sector borrowers, new bond issues accounted for a net DM 49 milliard of new finance in 1975 as a whole, approximately double the amount in the previous year. The public authorities in fact raised over a net DM 9 milliard in 1975. To this amount should be added DM 11.5 milliard obtained by the Federal Government against the issue of discountable Treasury bonds and Federal savings bonds in the course of financing its exceptionally large deficit and a further DM 0.5 milliard against the issue of similar bonds by the Länder.

The benefit of the revival of the bond market in *France* was more evenly distributed between public and private sector borrowers than in other countries. Contributing to this revival, new saving in the form of term and savings deposits with banks and deposits with savings banks together with Treasury bonds rose sharply by 38 per cent in 1975 or at double the rate of the previous year. Uncertainty regarding employment suggests that there was a large precautionary element in such saving as well as an adjustment of holdings of relatively liquid assets to rising incomes and prices. The reduced profitability of enterprises, on the other hand, seriously impaired their capacity to finance investment from their own resources. Investment by enterprises probably rose by about 4 per cent in value in 1975 while declining sharply in volume. Even this modest increase in value terms resulted in a fall in the self-financing ratio to about 47 per cent in 1975

## Chart III – Gross bond yields
### based on quotations on securities similar to those issued by the European Investment Bank

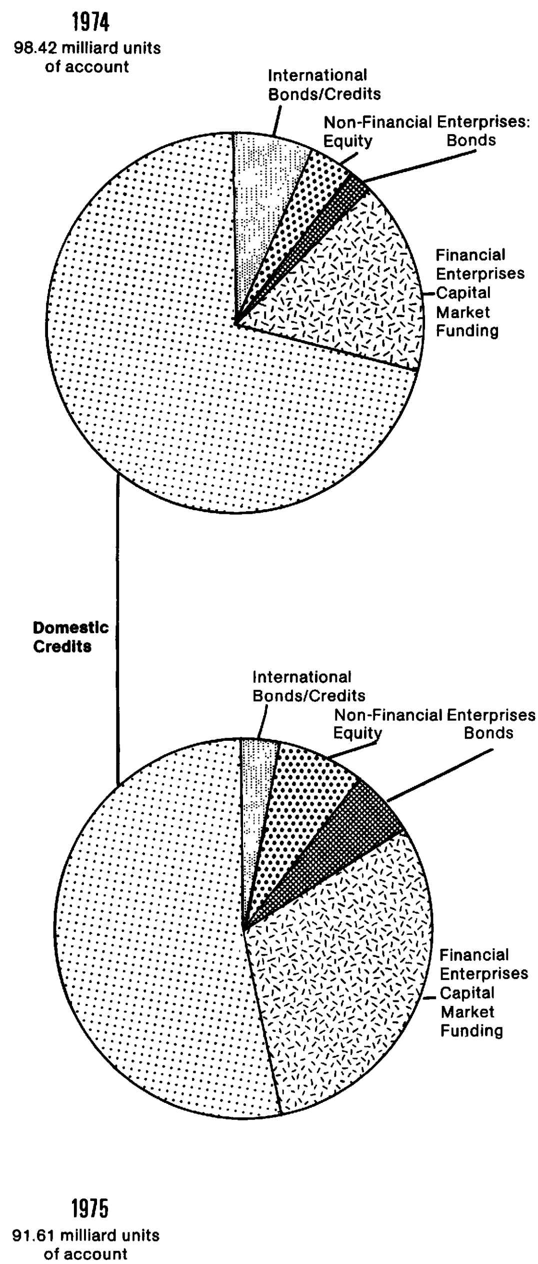


from 64 per cent in the previous year and thus resulted in a massive increase in indebtedness.

The marked improvement in the flow of saving into the bond market in 1975 was influenced by a decline in short-term interest rates on the one hand and by a reducing rate of inflation on the other and enabled enterprises to cover a large part of their financial requirements. As far as enterprises in the private sector were concerned offering yields on new bond issues without government guarantee fell from about 11.90 per cent at the end of 1974 to about 10.63 per cent in September 1975, though they rose again to 10.90 per cent in the last two months of the year as issuing activity accelerated. Net new bond issues by non-financial private enterprises rose by 168 per cent from F.fr. 3.7 milliard in 1974 to F.fr. 9.9 milliard in 1975. In the same period issues by public enterprises (Electricité de France, Air France, Postes Télégraphes et Télécommunications, the railways etc. but excluding financial intermediaries) rose even more sharply from F.fr. 1.9 milliard to F.fr. 7.2 milliard or by 279 per cent, while bond issues by banks and specialised long-term credit institutions (but excluding Societies for Regional Development) approximately doubled, from F.fr. 8.6 milliard to F.fr. 16.1 milliard. Rising share prices were a misleading indicator of the state of the share market which was relatively depressed and new issues fell to F.fr. 9.6 milliard in 1975 from 10.7 milliard in the previous year, reflecting the uncertainty of the economic outlook for most of the year.

In these circumstances resort to bank credit was relatively modest. The total of new credit advanced by financial institutions rose by only 3.3 per cent in 1975 compared with a little over 10 per cent a year earlier. Within the total, the proportion of new short-term credit fell to about

**Chart IV – The provision of capital for the non-government sector from domestic and international sources**



25 per cent in 1975 as against a relatively high 37 per cent in 1974 as a result of reduced activity and the liquidation of stocks. The banking system was thus able to satisfy the demand for credit while remaining well within the permitted credit ceilings.

As in France a high volume of saving in *Denmark* aided the recovery of the bond market to the benefit of the private as well as the public sector. Following the reduction in early 1975 of personal income taxes, much of the increase in personal disposable incomes was, for precautionary reasons, retained by individuals in the form of savings. Savings in the form of new time deposits with the banking system rose by 12.3 per cent last year, and relatively few account-holders took advantage of the release

Table 8 – **Net domestic public issues of bonds in the Community**

(milliard units of account)

| Country (1) | 1972 | 1973 | 1974 | 1975 |
|---|---|---|---|---|
| **Germany** | **9.26** | **8.37** | **8.26** | **14.43** |
| Public authorities | 0.62 | 1.13 | 0.68 | 2.98 |
| Credit institutions | 7.67 | 6.85 | 6.96 | 11.72 |
| Enterprises | 0.97 | 0.39 | 0.62 | −0.27 |
| **France** | **3.31** | **4.97** | **2.52** | **6.33** |
| Public authorities | 0.47 | 1.25 | −0.03 | 0.16 |
| Credit institutions | 1.53 | 2.33 | 1.54 | 2.99 |
| Enterprises | 1.31 | 1.39 | 1.01 | 3.18 |
| **United Kingdom** | **−0.33** | **3.23** | **1.24** | **9.84** |
| Public authorities | −1.09 | 3.12 | 1.29 | 9.68 |
| Credit institutions | 0.21 | 0.05 | 0.08 | 0.11 |
| Enterprises | 0.55 | 0.06 | −0.13 | 0.05 |
| **Italy** | **9.29** | **14.51** | **4.26** | **14.94** |
| Public authorities | 4.21 | 4.47 | 1.50 | 6.26 |
| Credit institutions | 3.88 | 8.88 | 2.64 | 6.96 |
| Enterprises | 1.20 | 1.16 | 0.12 | 1.72 |
| **Netherlands** | **0.77** | **0.50** | **0.85** | **1.47** |
| Public authorities | 0.28 | 0.12 | 0.29 | 0.64 |
| Credit institutions | 0.17 | 0.31 | 0.41 | 0.64 |
| Enterprises | 0.32 | 0.07 | 0.15 | 0.19 |
| **Belgium** | **2.76** | **2.88** | **2.95** | **3.73** |
| Public authorities | 2.07 | 2.03 | 1.62 | 2.65 |
| Credit institutions | 0.44 | 0.64 | 1.08 | 0.87 |
| Enterprises | 0.25 | 0.21 | 0.25 | 0.21 |
| **Denmark** | **1.71** | **2.18** | **2.27** | **3.85** |
| Public authorities | −0.01 | 0.05 | 0.01 | 0.83 |
| Credit institutions | 1.72 | 2.12 | 2.25 | 3.00 |
| Enterprises | −0.00 | 0.01 | 0.01 | 0.02 |
| **Ireland** | **0.24** | **0.22** | **0.25** | **0.74** |
| Public authorities | 0.24 | 0.22 | 0.23 | 0.72 |
| Credit institutions | – | – | 0.02 | 0.02 |
| Enterprises | 0.00 | – | – | – |
| **Luxembourg** | **0.01** | **0.01** | **−0.01** | **0.04** |
| Public authorities | 0.00 | −0.01 | −0.01 | −0.01 |
| Credit institutions | −0.00 | 0.01 | −0.00 | 0.01 |
| Enterprises | 0.01 | 0.01 | −0.00 | 0.04 |
| **Total Community** | **27.02** | **36.87** | **22.59** | **55.37** |
| Public authorities | 6.79 | 12.38 | 5.58 | 23.91 |
| Credit institutions | 15.62 | 21.19 | 14.98 | 26.32 |
| Enterprises | 4.61 | 3.30 | 2.03 | 5.14 |

(1) The issues entered under "Public authorities" include all issues by the government and public institutions, although the proceeds of these issues may sometimes make it possible to grant loans to enterprises.

of funds to individuals in September from the obligatory savings scheme initiated in 1974 to withdraw funds from these special savings deposits. Corporate profits, however, were under considerable pressure from reduced sales, increased competition (especially in export markets) and the freezing of gross profit margins imposed by the authorities in March. These factors, and the rise in labour costs per unit of output which was itself lower in volume, narrowed the scope for enterprises to maintain net income at the previous year's level.

Net new issues of bonds by private sector borrowers which rose by 36 per cent in 1975, reflected the improved issue conditions prevailing on the market. As discussed earlier there was a ready supply of funds available from the banks which took up 55 per cent of the new bonds issued on the market last year (both private and public sector bonds), compared with only 10 per cent of new issues in 1974. The very large government financing operation in the third quarter, which comprised three D.Kr. 2 milliard tranches of short-to-medium dated stocks, was the first sizable approach to the domestic bond market by the Government for more than 15 years. This issue tightened market conditions, and yields on special mortgage bonds which had declined from about 15.5 per cent at end-December 1974 to 13.1 per cent in June subsequently stabilised at around this rate until mid-October. A modification of the supply/demand relationship for funds on the bond market occurred in the final quarter of the year and yields rose to around 14 per cent, despite supporting purchases of securities by the monetary authorities. This deterioration prompted the central bank and the mortgage credit institutes to reach an agreement as to market regulation, in the context of which the institutes stipulated that their issues in 1976 would be limited to a total somewhat lower than last year. The small market for equity funds suffered a 35 per cent reduction in new issue activity, as non-financial enterprises in particular were less able to convince investors on the prospects for growth in corporate earnings.

The easing of the credit ceiling in successive steps during the course of 1975 resulted in a four-fold expansion of new loan commitments by the banks compared with the previous year. However, the proportion of these "loan commitments" in fact drawn was sharply reduced by 59 per cent in 1975 with the slowing of business and investment activity. Loans for new residential and non-residential construction were particularly affected. The demand for bank credit seemed to be little affected either by reductions in interest rates payable on loans, or by the regulation by the authorities from March onwards of the margin between deposit and loan rates.

The bond market in *Belgium* strengthened during 1975 as in other Member States, benefiting from a high volume of personal saving but the financial position of enterprises seems to have suffered more than in most other countries. Gross financial savings by companies and individuals combined was estimated to have increased by 14 per cent in 1975. Precautionary saving by individuals faced with the economic recession increased substantially last year as indicated by the increase of about 40 per cent in new deposits with the financial system by individuals and enterprises. Corporate saving, on the other hand, appears not to have increased at all as a result of constraints on profit margins. It has been estimated that labour costs (wages plus social security expenses) per unit of production increased by nearly 30 per cent in the twelve months to the March–May period of 1975. The sharpness of this increase was due principally to the lowered industrial output which had to support increased wage costs and higher social security expenses payable by employers (since the ceiling on certain of these expenses had been removed last year) at a time of reduced productivity per employee. Prices could not be raised sufficiently to match cost increases, either because of competitive influences in a declining market or because of government price controls, and profit margins took the impact. Towards the end of 1975 the rise in wage costs slowed, but industrial output continued to be depressed.

In spite of the liquidity of capital markets during 1975 net new bond issues by enterprises contracted by nearly 19 per cent. Companies in the energy sector, however, were prominent in tapping the market. The generally diminished activity in the private sector was more than counterbalanced by a rise of nearly 64 per cent in new bond issues on behalf of public sector borrowers which helped towards covering the increased deficit of the public sector as a whole. Share prices rose until April/May of last year but then faltered as the seriousness of the economic recession became more evident. They nevertheless stood about 16 per cent higher at the end of the year than at the beginning. The value of new share issues declined by roughly 10 per cent last year or slightly more than they did under similar circumstances in France.

It appears that less was available to enterprises from internal sources and less from new issues to finance a slightly larger amount of capital expenditure during 1975 than in the previous year. The remaining solution seems to have been recourse to the banking system. New credit made available to the non-government sector by Belgian financial intermediaries accordingly increased substantially in 1975, rising by about 72 per cent over the previous year. This compares with a decline of 19 per cent in 1974. The circumstances of this rapid expansion in the availability of credit were the relaxation of monetary policy in general and, more particularly, the easing of the tight credit ceilings that had existed in 1974. The consequent general lowering of interest costs on loans would have helped borrowers.

As economic activity in the *Netherlands* was less severely cut back during 1975 than in many other countries, the changes in the sources and application of finance tended to be less marked and may in some instances have been in the opposite direction to those occurring elsewhere. The saving of the private sector, for example, instead of increasing, declined as a proportion of net national income from 13.6 per cent in 1974 to 12.4 per cent last year. This was reflected in a reduction of 24 per cent in the total of new savings and time deposits during 1975. Company savings are included in the above statistics along with those

Table 9 – **Short, medium and long-term credits to the non-government sector**
(Variation in amounts outstanding at year's end)

(milliard units of account)

| Country | 1972 | 1973 | 1974 | 1975 | of which: funds raised through security issues by credit institutions | | | |
|---|---|---|---|---|---|---|---|---|
| | | | | | 1972 | 1973 | 1974 | 1975 |
| Germany | 28.87 | 26.36 | 22.18 | 16.31 | 8.06 | 7.18 | 7.28 | 12.32 |
| France | 19.49 | 19.70 | 21.57 | 23.16 | 1.91 | 2.77 | 1.88 | 3.24 |
| United Kingdom | 20.40 | 20.43 | 14.10 | 6.52 | 1.15 | 0.13 | 0.23 | 0.68 |
| Italy | 12.71 | 17.22 | 13.13 | 15.01 | 4.00 | 9.09 | 2.71 | 6.97 |
| Netherlands | 4.83 | 6.66 | 7.92 | 7.67 | 0.17 | 0.34 | 0.41 | 0.71 |
| Belgium | 2.34 | 2.87 | 2.99 | 3.69 | 0.48 | 0.71 | 1.13 | 0.93 |
| Denmark | 2.74 | 3.44 | 3.03 | 3.41 | 1.74 | 2.16 | 2.27 | 3.02 |
| Ireland | 0.65 | 0.56 | 0.42 | 0.52 | 0.01 | – | 0.02 | 0.02 |
| Luxembourg | –([a]) | 0.17 | 0.28 | 0.24 | –0.00 | 0.03 | 0.05 | 0.01 |
| Total Community | 92.03 | 97.41 | 85.62 | 76.53 | 17.52 | 22.41 | 15.98 | 27.90 |

([a]) Estimates are incomplete

of individuals and would have accounted for part of the deterioration. However for the enterprise sector as a whole the decline during 1975 in the proportion of interest and profits per unit of sales seems to have been slightly less than in 1974, except in manufacturing industry where the fall between 1974 and 1975 was of the order of 46 per cent. The pressure on profit margins seems mostly to have been rather less last year when the rise in wage rates and earnings moderated and some raw material prices fell, combining to offset the adverse effect to reduced output on productivity. Individuals on the other hand may have felt less need to save in 1975 because the future seemed more secure. While the private sector's saving declined, its expenditure on fixed investment fell even faster, leaving scope for an increased contribution through the mechanism of the capital market towards financing the public sector's deficit.

As indicated in an earlier section the bond market improved steadily until mid-year under the favourable influence of declining short-term interest rates. Yields on long-term bonds issued by public sector borrowers declined from 9.3 per cent in December 1974 to 7.9 per cent in June of last year; a sharp upwards adjustment in July was partially compensated by some decline in subsequent months and the bond market ended the year on a favourable note. Owing to the slack demand for credit and the consequent liquidity of the financial system, there was an abundant supply of funds for taking up new bond issues.

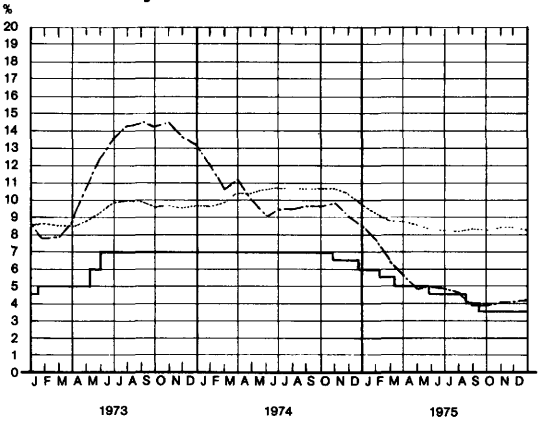
The larger budget deficit incurred by the central government last year was reflected in a total of Fl. 1 934 million of new bond issues by the State compared with only Fl. 471 million in 1974. The total of bond issues by the enterprise sector rose by 27 per cent in 1975, with the major part of this increase coming from the substantial expansion in issues by the mortgage banks. Public and non-financial private enterprises also raised much more through new placements last year. On the share market prices rose by nearly 29 per cent during the year with most of the improvement coming in the first half and in December. In the more favourable climate the amount of new share issues increased six-fold in 1975 compared with the previous year, but they still formed only a modest proportion of total financing. A significant factor last year was that banks felt impelled to seek an improvement in their capital structures by increasing their issues of subordinated bonds to Fl. 627 million from Fl. 58 million in 1974 but they also made substantial new equity issues while market conditions were favourable. Thus new share issues by financial institutions totalled Fl. 219 million in 1975 compared with none in the previous year. In recognition of the difficulties which enterprises in general were having in raising equity capital, the Nationale Investeringsbank was authorised to issue up to Fl. 500 million of "subordinated loans" which would be regarded as companies' "own funds" for balance sheet purposes until they could be replaced by new issues of equity. By the end of 1975 only a small proportion of the total available had been committed.

The low profile of business conditions was reflected in the decline of about 40 per cent in new credit made available to the economy. The poor performance was due more to the lack of demand for investment funds than to any shortage in the potential supply. Nevertheless, as business prospects improved towards the end of 1975 there was some resurgence of demand for loans in the fourth quarter, possibly in connection with the rebuilding of stocks. Issues of debt certificates (onderhandse leningen) by enterprises to financial institutions are included in the total of new credit, as these issues being in the nature of private placings do not figure among public bond issues. While other forms of credit contracted, issues of debt certificates rose, reflecting the preference of enterprises for increasing their funded debt to extending their short-term loan commitments.

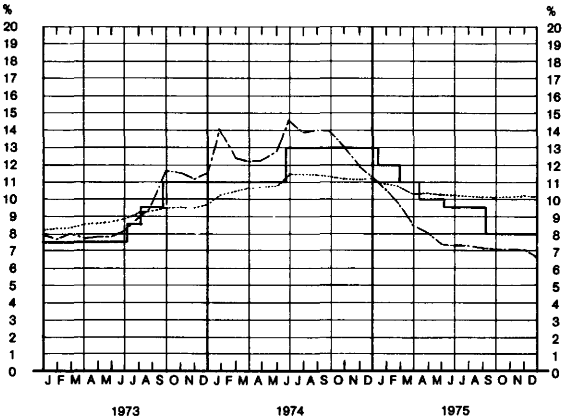
In *Ireland* many of the financing patterns in the larger Member States were repeated on a smaller scale; personal saving was high and the

## Chart V – Short and long-term interest rates

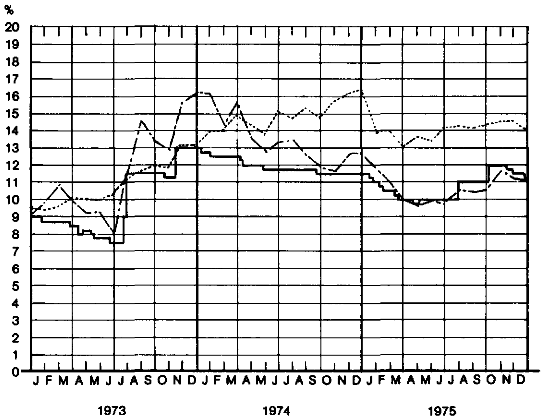
### Germany



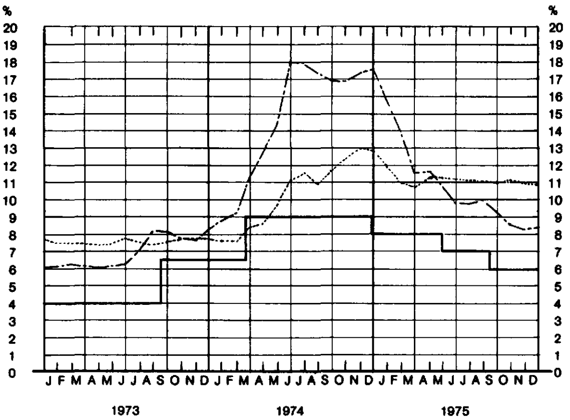

### France



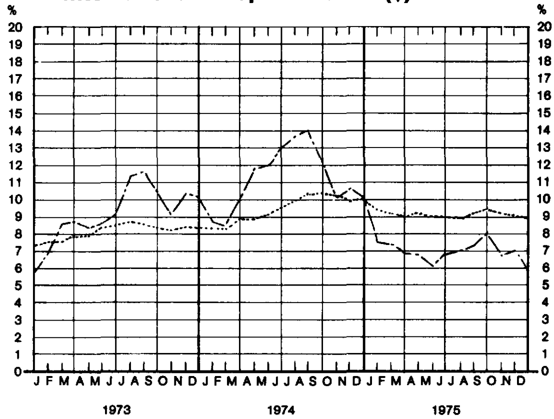

### United Kingdom

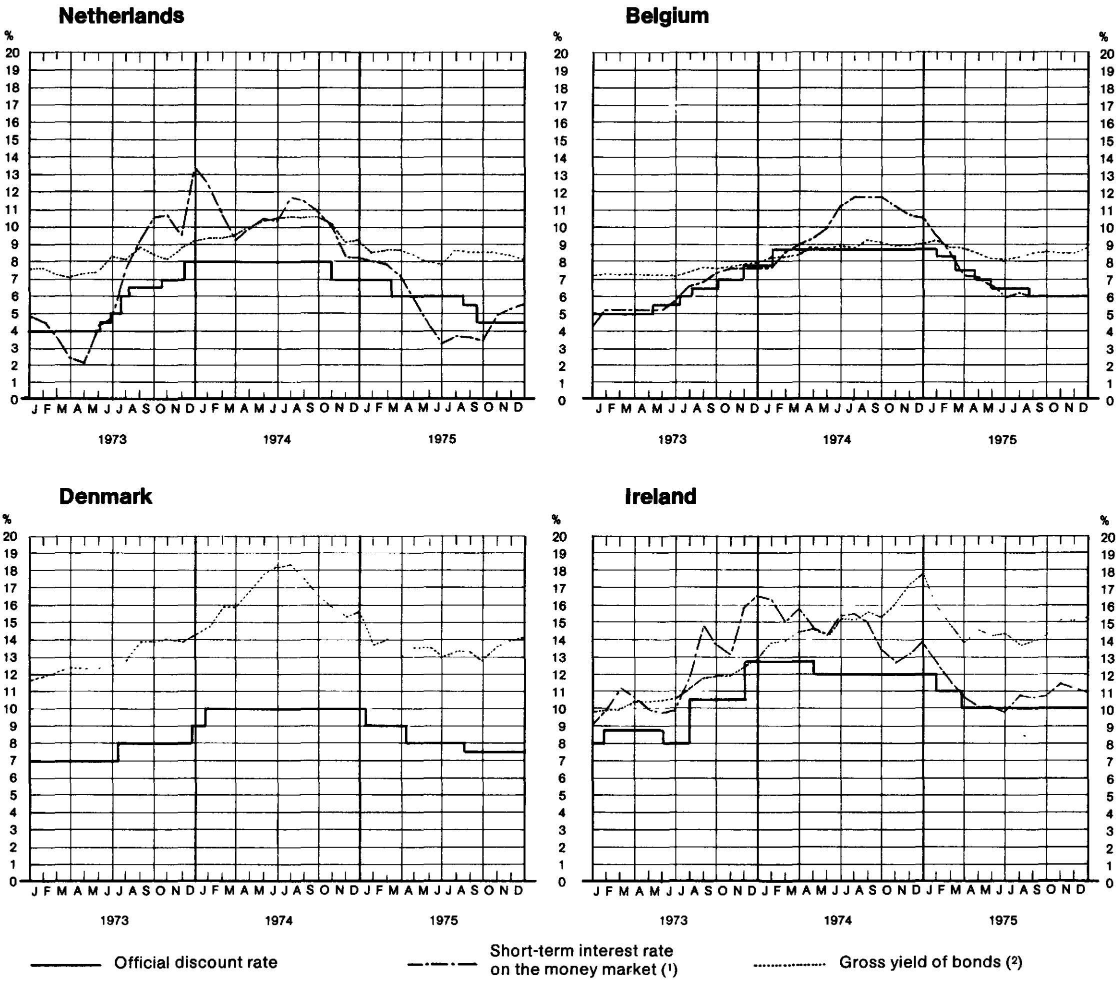



### Italy




### International European Market ($)






(1) The short-term interest rates are, according to the countries concerned, the following:
Germany: rate for 3-month inter-bank loans.
France: rate for 3-month inter-bank loans against private bonds.
United Kingdom: 3-month sterling lending rate on inter-bank market.
Italy: rate for inter-bank sight deposits.
Denmark: no representative data available.
Netherlands: rate for 3-month bank loans to local authorities.
Belgium: rate for transfer to banks of 3-month cash certificates.
Ireland: rate for 3-month funds on the inter-bank market.
International European Market: rate for 3-month U.S. dollar deposits with London Banks.

(2) The gross yields for bonds are those of bonds quoted on stock exchanges in the different financial markets in the Community, the characteristics of which at issue come closest to those of the European Investment Bank's bonds.

bond market revived but was tapped mainly by the public authorities. Rising unemployment and the uncertainty of the economic outlook in 1975 appear to have led to an increase in personal saving as a precautionary measure. Money incomes were also rising but not as fast as personal saving which was of the order of 50 per cent up on the previous year. Incomes in the agricultural sector probably increased more than those of other sectors and, as farmers normally have a higher propensity to save than others, they probably saved more. A minor additional stimulus may have been derived from the introduction of two government savings bond schemes in October in which the real value of the capital invested is preserved by adjusting amounts repayable according to changes in the consumer price index.

In contrast, the real value of company profits declined. Costs of production rose more than prices of final output and as a result the increase in the value of company profits of the order of 10 per cent was lower than the rate of inflation. Consequently, the capacity of enterprises to finance investment from internal resources was reduced.

The necessity of financing the very large public sector borrowing requirement of some £ 675 million or so in 1975 resulted in an exceptionally large increase in the amount of new government bond issues brought on the market. Gross new issues by the State totalled £ 410 million last year compared with only £ 138 million in 1974. The supply of funds from the non-bank public was unexpectedly large in that a net £ 190 million of new State issues was taken up compared with only £ 30 million in the previous year. New bond and equity issues by the enterprise sector also increased appreciably in 1975, to £ 18 million, although financing from the capital markets in Ireland is relatively small compared with the amount of credits made available from the banking system.

In spite of the efforts of the authorities to stimulate activity in the manufacturing and construction industries, demand for credit remained depressed. Bank lending to the personal sector, on the other hand, was buoyant during the year. As indicated in the June 1975 budget, the Central Bank of Ireland reached an agreement with the Associated Banks under which the latter would provide £ 40 million over two years for house purchases. Under this scheme the banks approved loans to the value of £ 12.5 million during the second half of 1975. During the year as a whole mortgages advanced by the Building Societies increased substantially, and the increase in interest rates, as from 18 November for new borrowers, on Building Society mortgages from 11.50 per cent to 12.50 per cent had no significant impact during the remainder of 1975.

The fall in personal and corporate savings in *Luxembourg* as represented by new time and savings deposits which fell by 90 per cent last year as compared with 1974 contrasted the pattern in many other Community countries. Business profits were inevitably reduced by the lower sales volume and by the narrower profit margins induced by increased competition and lower productivity. Insofar as the steel sector was concerned, this deterioration extended to all firms. In contrast, banking institutions situated in Luxembourg generally experienced a strong improvement in profits, not least as a result of increased activity on the eurobond market.

Reduced business activity and lower investment demand contributed to a decline of 14 per cent in new credit made available to the non-government sector. At the same time restrictions on the granting of consumer credit and, for part of the year, mortgage credit, undoubtedly had an impact on loan growth. With respect to consumer credit, amounts outstanding were limited to an expansion of only 5 per cent between October 1974 and end-September of last year. The progressive removal of restrictions on mortgage credit, however, led to some resurgence in these loans granted during the course of 1975.

A brisk expansion in the number of new issues floated on the bond market last year was largely attributable to demand by domestic private sector borrowers who raised Flux 2.2 milliard in 1975, following a net redemption of bonds in the previous year. The upsurge of new bond issues was shared equally by financial and non-financial enterprises. Public sector borrowers, however, continued the pattern of recent years in that there was no recourse to the bond market in 1975 but instead a net redemption of existing bonds. In January 1976, the Government departed from this because of an anticipated increase in budgetary commitments and approached the bond market for a loan of Flux 1 milliard.

## 2.3. DEBT ISSUES BY COMMUNITY BORROWERS ON THE SWISS AND U.S. MARKETS

In 1974 when the Swiss market was closed to foreign borrowers for a number of months, new public issues of bonds by Community borrowers contracted sharply. The market regained its strength however in 1975 and issues by Community borrowers leaped upwards by 136 per cent to almost S.fr. 1 milliard, thus improving on their total in 1973. The growth of Community borrowing during 1975 was in line with that of the market as a whole and its proportion of the total of S.fr. 2490 million of approximately two-fifths was, if anything, slightly less than in the previous year.

The remarkable expansion of foreign public issues in Switzerland reflects the efforts of the Swiss authorities to offset capital inflows which were tending to cause the currency to appreciate in value against a number of other major currencies. The bi-monthly quota for foreign bond issues was raised progressively from S.fr. 230 million in January/February to about S.fr. 400 million in July/August where it remained for the rest of the year; the limit on individual issues was increased in March from S.fr. 60 million to S.fr. 80 million. Monetary policy was eased, as indicated by successive reductions in discount rate from 5.5 per cent at the beginning of 1975 to 3.0 per cent in October. Interest rates in Switzerland re-

Table 10 – **The contribution of external capital flows to domestic financing (1), 1975**
Provisional estimates
(+ inflow; – outflow)

(million units of account)

| | Germany | France | United Kingdom | Italy | Netherlands | Belgium/ Luxembg. | Denmark | Ireland |
|---|---|---|---|---|---|---|---|---|
| Private long-term capital: | | | | | | | | |
| Net direct investment | – 543 | – 121 | –619 | +230 | –290 | +563 | + 4 | n.a. |
| Net portfolio investment including loans | –5 300 | | | –909 | – 76 | –706 | + 35 | n.a. |
| Total private long-term capital flow | –5 843 | – 121 | –619 | –679 | –366 | –143 | + 39 | + 9 (2) |
| Public sector long-term capital flow, including loans, total | + 371 | – 139 | –830 | +306 | – 81 | –130 | +124 | +344 |
| Short-term capital flow, total (3) | +1 603 | +3 442 | +711 | –315 | –300 | –118 | + 30 | n.a. |
| Total Capital Account of Balance of International Payments (4) | –3 869 | +3 182 | –738 | –688 | –747 | –391 | +193 | +353 |

(1) This table is based on national balance of payments data and national definitions, while similar, may differ slightly as between countries. In most cases public enterprises have been included in the public sectors.
(2) Includes short-term capital flow.
(3) Includes net external position of the private banking sector, except for Denmark.
(4) Unidentified flows have been excluded except for Ireland and Denmark

mained lower than in all other major markets but, while this proved attractive to a number of borrowers, the obvious exchange risk of a currency with a high potential for appreciation appeared to temper the enthusiasm of others.

The other main market open to public issues, that of the United States, subscribed during 1975 to an even larger amount of public issues launched by residents in the Community, including the European Investment Bank and the European Coal and Steel Community. The total of issues by Community borrowers of $ 585 million was equivalent to 469 million units of account whereas the equivalent of Community borrowing in Swiss francs was 310 million units of account.

Community issues on the American market have thus grown rapidly since the suspension of the interest equalisation tax at the beginning of 1974, a year in which they amounted to a modest $ 100 million. They are still well below the annual volume of the dollar sector of the international capital market in Europe which appears to have withstood the competition that was threatened when the interest equalisation tax was suspended by the American authorities.

Community borrowing on the Swiss and United States markets would normally be covered in the statistics of international capital movements assembled in Table 10 under net portfolio investment. As it happens the net movement of private long-term capital during 1975 was mostly outward, whereas the public sector seems to have been more or less in balance. The more advantageous situation of the public sector on a number of domestic bond markets was thus repeated in international transactions. It should be noted, however, that capital movements within the Community are included in the figures of the Table.

CHAPTER 3

# INTERNATIONAL CAPITAL MARKETS

## 3.1. PUBLIC BOND ISSUES ON THE EUROPEAN INTERNATIONAL MARKET AND ISSUES BY NON-RESIDENTS ON NATIONAL MARKETS

The fall in short-term interest rates on the international market in the latter part of 1974 which took them to below long-term yields set the scene for a strong revival of the bond market during 1975. The re-establishment of a normal relationship between short and long-term interest rates was clearly important in persuading investors resident in the petroleum-exporting countries as well as others to place some of their surplus financial resources at longer term. The participation of a growing number of Arab financial institutions in issuing syndicates was partly an effect and partly a cause of the attraction of Middle East funds into the bond market. The high liquidity of international banks and redemptions of earlier euro-bond issues also helped to provide a receptive market for new issues. In addition bond dealers were encouraged to rebuild their inventories of securities by the lower cost of short-term finance.

If the totals in Table 11 for issues managed by domestic syndicates are combined with those for issues managed by international syndicates, it will be seen that new issues increased more than four times in amount from an exceptionally low 1307 million units of account in 1974 to 5348 million units of account in 1975. Virtually all sectors of the market shared in this marked expansion. Issues denominated in U.S. dollars, taking straight bonds and convertibles together, more than trebled to 2157 million units of account but this was not nearly so sharp as the almost six-fold increase in Deutschemark denominated securities to 1667 million units of account. In the earlier part of 1975 Deutschemark issues were leading U.S. dollar issues in volume but by late July the German authorities suspended new issue activity and did not reopen the primary market until the end of October. During this period investors were attracted to U.S. dollar issues by the appreciation of the currency after its earlier weakness and the market became very active. Canadian dollar issues, in which the borrowers were all Canadian residents, also attracted investors by the prospect of appreciation of the currency. Issues denominated in Belgian and Luxembourg francs rose more or less in line with others and the sectors denominated in French francs and Dutch guilders reopened for new issues during the course of 1975, the former receiving a stimulus from the re-entry in July of the franc into the European currency snake. The story of units of account on the other hand was chequered; issues denominated in the now classic European unit of account (not the basket of currencies) rose satisfactorily and the European currency unit was revived for a single issue but the EURCO remained unused. Three issues were denominated in SDR but the rise in the exchange value of the U.S. dollar against this unit discouraged any further attempts to use it.

The improvement in the international capital market during 1975 was not confined to the total of new issues. Yields fell in most sectors both on primary and secondary markets. On U.S. dollar securities the decline was of the order of one percentage point while on Deutschemark securities it was nearly double this. A further indication of the returning health of the market was the gradual lengthening of maturities on new issues after being cut to around five years in the difficulties experienced in 1974. By the end of 1975 ten year issues denominated in U.S. dollars were not uncommon. But for the temporary closing of the Deutschemark sector a similar trend seemed to be developing in issues in that currency; as

Table 11 – **Public issues of bonds on the "European" international market**

(million units of account)

| | Domestic Syndicates | | International Syndicates | |
|---|---|---|---|---|
| | 1974 | 1975 | 1974 | 1975 |
| **Convertible bonds** | – | – | **68** | **100** |
| U.S. dollars | – | – | 68 | 100 |
| **Bonds with warrants** | – | – | **20** | – |
| U.S. dollars | – | – | 20 | – |
| **Straight bonds** | **90** | **626** | **1 129** | **4 622** |
| U.S. dollars | – | – | 635 | 2 057 |
| Canadian dollars | – | – | 46 | 409 |
| Deutschemarks | 50 | 346 | 195 | 1 321 |
| French francs | – | 28 | – | 205 |
| Dutch guilders | – | 131 | – | – |
| Belgian francs | 16 | 66 | – | – |
| Luxembourg francs | 24 | 55 | – | – |
| Norwegian Kroner/DM option | – | – | – | 34 |
| Austrian schillings | – | – | 13 | – |
| Kuwaiti dinars | – | – | 41 | 135 |
| European units of account | – | – | 139 | 292 |
| European composite units (EURCO) | – | – | 60 | – |
| Special drawing rights (SDR) | – | – | – | 137 |
| European currency units (₠) | – | – | – | 32 |
| **Total issues of Bonds** | **90** | **626** | **1 217** | **4 722** |
| **Borrowers in Europe** [1] | **90** | **461** | **738** | **2 649** |
| Within the Community | 74 | 401 | 520 | 1 461 |
| – European Investment Bank | 9 | 219 | 112 | 168 |
| – Commission of the European Communities (on behalf of E.C.S.C.) | 58 | 112 | 56 | 87 |
| – Other Community borrowers | 7 | 70 | 352 | 1 206 |
| Outside the Community | 16 | 60 | 218 | 1 188 |
| **Borrowers on the American Continent** | – | – | **166** | **851** |
| U.S.A. | – | – | 76 | 167 |
| Others | – | – | 90 | 684 |
| **Japanese borrowers** | – | – | **114** | **615** |
| **Miscellaneous** | – | **165** | **199** | **607** |

[1] The geographical classification of borrowers has been based upon the nationality – and hence the the location of the registered office – of the issuers except for holding companies which are affiliates of foreign companies; these holding companies have been classified according to the nationality of their parent companies.

things were, the stretching of maturities reached eight years. It was however possible to raise longer term money in European units of account.

Before proceeding to examine the uses to which funds borrowed on the international capital market were put, it should be explained that the statistics cover public issues of:

- bonds issued in one or more countries by non-residents, but which are not denominated in the currency of the country of issue;
- bonds which, although issued by residents of a specific country in their own currency, are expressly reserved for subscription by non-residents;

- bonds which, although issued in a specific country by non-residents and denominated in that country's currency, are placed in several countries by the issuing syndicates in so far as the syndicates include foreign banks;
- bonds to which special monetary clauses are attached (units of account, EURCO, ECU, SDR and other multiple currency issues).

Turning now to the destination of the funds raised on the international market, borrowers within the Community took 1 862 million units of account in 1975 or 35 per cent of the total as against 45 per cent of a much smaller amount in 1974. Borrowers in Europe outside the Community, for example in Norway, were again active but those in the U.S.A., now relieved by the withdrawal of official guidelines of the need to raise funds externally for their overseas investments, remained relatively quiet. Borrowers on the American continent other than in the U.S.A. increased their offtake of funds substantially, much of this being the borrowing of Canadian dollars by Canadian residents. Last but not least Japanese borrowers secured a larger share (15 per cent in 1975 as against nearly 9 per cent the previous year) of the available resources of the market.

The uses to which loan proceeds were put changed considerably between 1974 and 1975. Bearing in mind that the 1975 total was about four times as large as that for 1974, the share obtained by international institutions fell from 13.8 per cent to 5.7 per cent and that of transport and communications from 16.5 per cent to 10.2 per cent. In contrast to what happened on several national capital markets, the proportion of borrowing by public authorities also fell, declining from 25.4 per cent to 20.1 per cent. The sectors showing the largest increases in market shares, again in contrast to the out-turn on several domestic markets, were manufacturing industry (up from 16.0 per cent to 24.9 per cent), energy and mining (from 9.7 per cent to 15.8 per cent) and financial institutions (from 15.0 per cent to 21.4 per cent). The differences between this allocation of resources and that on most national markets may be explained partly by the preference of some national authorities to borrow mostly on their domestic markets where this aids control over the financial system and partly by the greater economic strength in times of recession of the industrial borrowers who normally seek finance on the international market.

Statistics of privately placed bond issues are naturally more difficult to obtain than those of public issues. The OECD, however, has been publishing a compilation of private international placings (as has the World Bank) which is reproduced in summary form in Table 13. The increase in private placings in 1975 over those in 1974 was not nearly so marked as in public issues. In 1974 private placings substantially exceeded public issues, mainly because the surplus funds of petroleum exporting countries were being sought through private arrangements while difficulties were being experienced on the normal primary market. As explained

Table 12 – **Total resources raised by Community borrowers through public issues on the financial markets**

(milliard units of account)

| | 1974 | 1975 |
|---|---|---|
| – Net issues on the national markets of member countries | 27.43 | 63.77 |
| – Issues on the European international market (1) | 0.52 | 1.46 |
| – Issues on other national markets | 0.21 | 0.78 |
| Total Community | 28.16 | 66.01 |

(1) As the volume of redemptions effected on Eurobonds in circulation cannot be assessed accurately, the figures given here relate to gross amounts raised.

Table 13 – **Private placings of bonds on the international market** ([1])

(million units of account)

| Currency of issue | 1974 | 1975 |
|---|---|---|
| DM | 281.7 | 774.8 |
| Fl | 305.0 | 526.8 |
| U.S. $ | 1 753.8 | 1 367.1 |
| Other | 15.0 | 124.4 |
| Total | 2 355.5 | 2 793.1 |
| **Issuers** | | |
| O.E.C.D. countries | 929.6 | 1 876.5 |
| of which E.E.C. countries | 457.2 | 598.7 |
| Non-O.E.C.D. countries | 3.2 | 245.0 |
| International Organizations | 1 422.7 | 671.6 |

([1]) This table is based on O.E.C.D. data and the definition of private placements is complementary to that of public issues compiled in Table 11. However, the definitions of the two may, in rare instances, overlap and some double-counting may occur. The table covers international markets throughout the world in addition to the European international market.

earlier in this chapter, the primary market's problems had virtually been resolved by 1975.

The amount raised by borrowers resident in the European Community remained fairly modest at almost 600 million unis of account in 1975 according to these statistics. This was nevertheless a slightly higher proportion (21.4 per cent) of total placings than was recorded in 1974 (19.4 per cent).

## 3.2. INTERNATIONAL MEDIUM-TERM CREDITS

The market in internationally syndicated credits in 1975 again progressed in an opposite direction to that of the bond market and so, for two consecutive years, these two sectors of the international market compensated one another. In part this was due to the relationship between short and long-term interest rates and the consequent supply of financial resources to each sector. On the other hand the 1974 total includes a very large amount of borrowing by national governments, either directly or through selected institutions in the public sector, to cover balance of payments deficits that were expected to result from the five-fold increase in the price of oil imposed by petroleum-exporting countries. By 1975 the problem of the so-called oil deficits loomed less large because oil-exporting countries had begun to spend their additional revenues more rapidly than was thought likely. Some of these countries even returned to the euro-currency market as borrowers.

According to statistics of publicised medium and long-term international bank loans which have been published by the OECD and are summarised in Table 14, the total of such loans fell in 1975 by 6.2 milliard units of account to 16.3 milliard or by 28 per cent. Within the total, loans granted to borrowers resident in Community countries fell by 8.6 milliard units of account to 1.7 milliard, a drop of 83 per cent, less than half of which was explained by the comparative absence of government borrowing in 1975 and the remainder by an apparent lack of demand on the part of enterprises.

The decline in the EEC share was partly offset by larger borrowing by petroleum-exporting countries, by other high income developing countries and by countries in Eastern Europe.

Table 14 – **Publicised medium and long-term international bank loans** (1)

(million units of account)

| Currencies | 1974 | 1975 |
|---|---|---|
| U.S. $ | 21 875.7 | 15 709.8 |
| Other | 649.5 | 579.1 |
| Total | 22 525.2 | 16 288.9 |
| **Borrowers** | | |
| O.E.C.D. countries | 14 746.7 | 4 839.9 |
| of which: E.E.C. countries | 10 292.4 | 1 703.1 |
| comprising: public authorities | 4 186.7 | 467.0 |
| enterprises | 6 105.7 | 1 236.1 |
| Non-O.E.C.D. countries | 7 778.5 | 11 449.0 |
| of which: developed countries | 1 722.3 | 2 239.3 |
| developing countries | 6 056.2 | 9 209.7 |

(1) This table is based on O.E.C.D. data and covers international markets throughout the world in addition to the European international market.

As the market was shaken by a small number of banking failures during 1974 international banks became more circumspect in their lending. Some found that their own resources had shrunk in relation to their liabilities and that they were nearing self-imposed limits on their loan portfolios. After these experiences, 1975 was probably a period of consolidation for the market as a large scale provider of capital for industrialised countries. The margins over inter-bank interest rates which are charged to borrowers and which form the basis of the banks' earnings in floating interest rate loans tended to widen in the latter part of 1974 and in 1975. A first class borrower in an industrialised country, for example, would have been required to pay about 0.5 per cent or perhaps slightly more during the first half of 1974 whereas in 1975 a similar borrower would have been charged around 1.25 per cent.

The margins charged on credits extended to developing countries were also widened but without checking the rapid growth in such credits. The demand for capital by developing countries is so vast and so urgent that relatively minor increases in the cost of borrowing have little restraining effect. This places more responsibility on the lender and, with the gift of hindsight, it seems that the lending banks could have been more judicious in their assessment of some borrowers during the course of the rapid expansion of credit to the Third World in 1975.

While the widening of margins helped to restore profitability which had been impaired by the inflation of costs and so to improve the financial structure of banks participating in the market, more resources became available from American banks which turned to the international market to employ their funds because of the slackness of demand for credit in the U.S.A. itself. The two or even three-tier system of inter-bank rates which had prevailed for part of 1974 disappeared in the new circumstances and the circle of banks finding themselves able to participate in international syndicates consequently widened. It thus became possible to spread credit risks over a larger number of banks. In addition when it appeared in the latter part of 1975 that there was likely to be renewed growth of demand for international credits, the banks concerned took it upon themselves to examine the standing of potential borrowers more critically in preference to widening margins further.

# CONCLUSION

The conditions for investment and its financing were far from typical during 1975 in that the year spanned the trough of the worst recession experienced by the European Community since its inception. Hopefully these conditions will not recur but nevertheless there are perhaps some pointers for the future which can be drawn even from an exceptional year.

Superficially 1975 conformed to accepted ideas of a recession in which a decline in consumption is followed by a general fall in the volume of fixed investment, the running down of stocks and a sharp rise in unemployment. This leads to the question why, if the recession conformed to a classic pattern, classic remedies in so far as they were applied did not work sooner. The answer seems partly to be that the recession was preceded by a period of serious inflation and, for several countries, of balance of payments problems. Too vigorous an easing of monetary and fiscal policies would probably have revived these difficulties within a short time without necessarily checking the fall in demand and the rise in unemployment.

On the assumption that approximately the right mix of policies was adopted, the question still remains why the selective measures designed to stimulate investment did not have a quicker and greater effect. The existence of surplus capacity and uncertainty over economic prospects were clearly important factors. Equally clearly lack of finance from sources external to the business was not. It is true that on many national bond markets, the public authorities borrowed more heavily than the private sector but this was the consequence of financing in a non-inflationary manner the programmes that were aimed at restimulating economic activity. The general decline in long-term interest rates during 1975 is prima facie evidence that bond markets were able to meet the demands for finance that was placed upon them. Presumably the financial demands of the public authorities should abate as the tempo of activity rises and economic recovery programmes, having achieved their aim, are cut back, leaving more scope for borrowing by enterprises.

If external finance was not a problem, the answer to the sluggish response to investment incentives is perhaps to be found internally. The "normal" financial structure of companies varies from country to country and from industry to industry, but evidence suggests that there has been a secular, widespread, deterioration in company balance sheets. This seems to have been accentuated during 1974 and 1975 by inflation which partly took the form of a faster rise in wage costs than in output prices which continued after output began to fall. At the same time the replacement cost of capital installations continued to rise rapidly, rendering provisions for depreciation based on historic cost hopelessly inadequate. In short it seems possible that company profit margins over a wide range of activities have been squeezed so far and their capacity for self-financing so depleted that they have had to restrict their investment expenditure in order to avoid excessive debt commitments and consequently were slow to respond to official stimulus. Special schemes for strengthening the financial structure of companies have been introduced or are planned, such as the subordinated loans scheme in the Netherlands and similar provisions in France and Denmark, whereby shortages of internal funds may be eased, if temporarily. It remains to be seen whether the weakness in company finances, which is partly cyclical, can be corrected without external help as normal trading conditions are restored, or whether further special assistance from national authorities will be required.

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