European
Investment
Bank

Investment in the Community in 1974 and its Financing

Research Department

CONTENTS

CONVERSION OF NATIONAL CURRENCIES

All statistical data published in this Report are provisional for 1974 and often for 1973 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.

For statistics relating to 1974 expressed in national currencies, conversion rates as at 30 December 1974 of a newly defined unit of account based on a "basket"of Member States' currencies have been applied. The composition of this basket is such that as of 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.

INTRODUCTION

The year 1974 was one of transition for the European Community as a whole from boom conditions at its beginning to the onset of recession at its end. In the process economic activity and capital markets were subjected to exceptionally strong and varied influences which had a marked impact on investment and its financing.

The momentum of the expansion of activity in 1973 continued in most countries into 1974, bringing in its train high and rising rates of inflation to which was added the effect of a five-fold increase in the price of petroleum imposed by the oil-exporting countries. In order to counter these threats to the financial stability and balances of payments of Member Countries, there was a general move by national authorities to reinforce policies for the containment of inflation and, where necessary, to strengthen their international reserve positions by external borrowing.

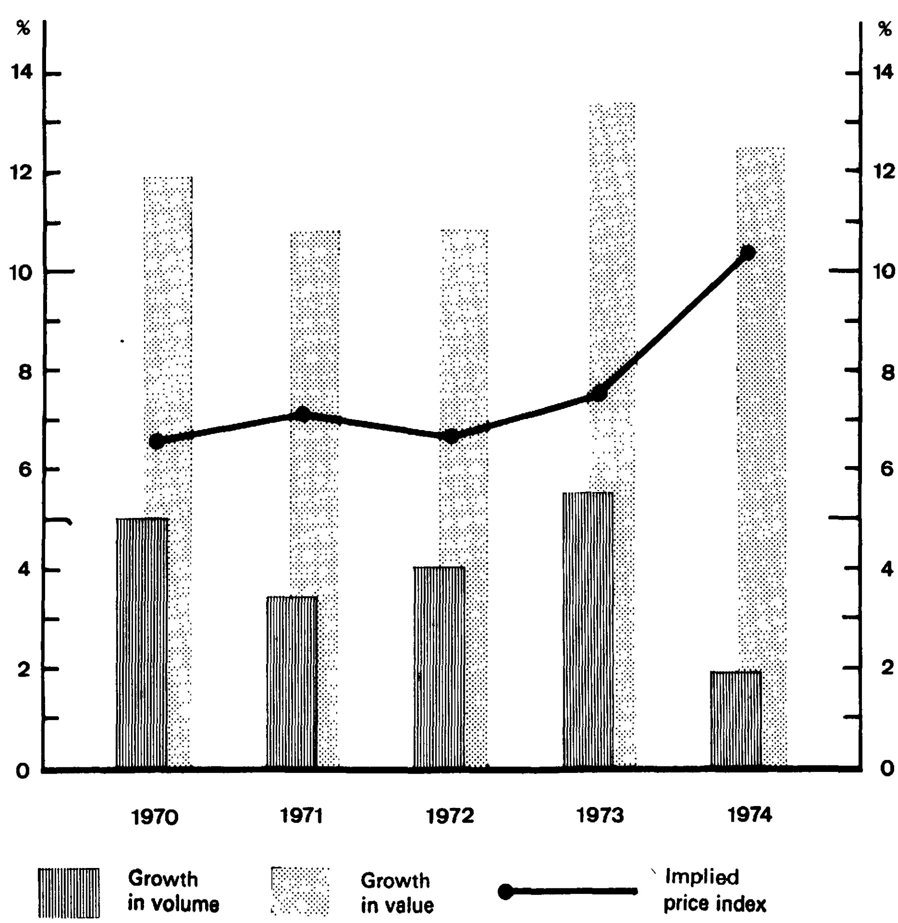
Essential as it was to tackle these serious problems without delay, it is possible that the measures adopted in the first half of 1974 accentuated the cyclical downturn in economic activity which began during the summer months. It is at least clear that the measures led to a sharp and widespread increase in short-term interest rates which drained funds from long-term capital markets at a time when the confidence of investors who normally purchased long-term securities was already shaken by exceptionally high rates of inflation. Another feature operating in the same direction was the preference shown by oil exporting countries for placing their surplus revenue in short-term markets.

Long-term capital markets accordingly suffered serious difficulties around the middle of the year; yields rose sharply and the terms to maturity of new issues, where these were still feasible, had to be drastically curtailed. Undoubtedly these difficulties and the high cost of finance were discouraging to prospective borrowers, but they seem not in themselves to have been mainly responsible for the falling away of fixed investment activity.

The reduction in fixed capital formation which occurred in many Member countries during 1974 seems, on the other hand, to have been mainly attributable to waning confidence on the part of enterprises which were able to foresee the development of a recession. Consequently fixed investment remained depressed in the last quarter of 1974 even after the direction of policy had been changed from restraint to ease and investors had begun to return to long-term capital markets.

It is worth noting that while the profit margins of enterprises suffered in many instances from official restraints on prices as well as from the rising cost of inputs, thus reducing the amount of finance available from internal resources for new investment, the reduction in the volume of fixed capital formation which occurred in several countries nevertheless helped to preserve self-financing ratios. Another apparently paradoxical development in the difficult financial climate of 1974 was the maintenance of a high volume of personal saving, even at negative real rates of interest, which was probably influenced from mid-year onwards by perspectives of rising unemployment.

Chart I — Growth in Gross Community Product, 1970-1974
(percentage change from previous year)



CHAPTER 1

INVESTMENT

1.1. INVESTMENT AND THE ECONOMIC SETTING

After the boom in 1973 and the shock of a five-fold increase in petroleum prices towards the end of that year, industrialised countries experienced a slowing of economic growth which from mid-1974 onwards developed into a slide into recession. The persistence of high and rising rates of inflation during 1974 which had been generated during the preceding boom had adverse repercussions on capital markets and hence on prospects for raising long-term finance. In consequence, the outlook for fixed investment activity was generally unfavourable. Total investment expenditures in the European Community declined last year by 2.2 per cent in volume terms. As can be seen from Table 1 the value of Gross Fixed Investment Formation rose by 13.1 per cent in 1974 which was a slightly lower figure than in the previous year.

There was nevertheless a marked disparity in the investment performance of Member States. In three countries, France, Belgium and Italy, the volume of fixed investment in fact increased. This reflected the prolongation of the strong expansion of activity in 1973 into 1974 and resulted in an impressive out-turn for the year as a whole, even though by the last quarter conditions were deteriorating, particularly in Italy. In three countries, Germany, Luxembourg and the Netherlands, investment volume fell in 1974 largely because of the earlier onset of business stagnation. In the last group of countries, comprising the United Kingdom, Ireland and Denmark, where the volume of fixed investment also fell last year, business confidence was affected by a wider range of factors including higher than average rates of inflation and serious current account deficits in their balances of external payments.

In *France,* among the first group of countries, the prolongation into 1974 of the economic growth which was re-stimulated in 1973 extended into the holiday period in August. Subsequently, there was a clear change of direction as recessionary tendencies, accentuated by official anti-inflationary policies, became apparent and led to an increase in unemployment.

The change from growth to decline in the index of industrial output illustrates this change of direction during 1974. In the eight months to August, output (including building) averaged 4.1 per cent more than a year earlier, but in the last four months it was 1.7 per cent lower. This slackening in the economy had an impact on employment and the numbers of unemployed increased by 42 per cent (seasonally adjusted) between the end of August and the end of December. It also affected Gross National Product calculated at constant prices which rose less in 1974, by 3.8 per cent, than previously expected. These developments were, however, masked in a 15.6 per cent increase in the value of G.N.P. because of an average rise of about 11.5 per cent in prices.

The restrictive stance of monetary policy which was adopted in December 1972 continued throughout 1973 and 1974. This policy succeeded in reducing liquidity and in causing enterprises to re-examine their investment programmes, but developments in the earlier part of 1974 seemed to require further measures. The precautionary consumer buying surge in the first quarter of the year which had caused temporary shortages of supplies seemed to make it essential to reverse inflationary expectations. At the same time a rise in imports of capital equipment to meet the still appreciable requirements of enterprises added to France's deficit on current account in the balance of payments. Monetary policy was accordingly tightened in January and, as part of a wider range of measures to cool the economy, again

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

	In Value						In Volume					
	1969	1970	1971	1972	1973	1974	1969	1970	1971	1972	1973	1974
Germany	17.2	23.9	12.2	7.0	5.1	−2.1	11.3	11.0	4.5	3.0	0.5	−8.1
France	16.3	13.1	11.6	12.4	13.3	18.8	9.4	5.8	6.6	7.4	5.9	2.9
United Kingdom	4.7	9.6	10.9	11.4	19.5	17.1	0.2	2.1	2.0	2.5	2.6	−2.8
Italy	14.1	14.2	3.7	5.8	25.3	34.1	7.4	2.7	−3.1	0.4	8.2	4.2
Netherlands	3.6	18.3	13.4	4.0	11.5	6.8	−2.1	10.1	3.3	−3.5	5.6	−4.2
Belgium	9.8	18.6	6.4	8.9	14.6	22.3	5.3	8.4	−1.7	4.4	7.8	5.6
Denmark	18.9	10.3	9.3	15.2	19.4	6.5	13.2	3.0	4.4	7.9	6.1	−10.4
Ireland	28.4	9.2	18.0	15.0	24.3	14.0	20.4	−0.9	7.2	3.7	12.8	−8.3
Luxembourg	16.7	21.2	23.4	7.9	18.7	5.4	7.8	10.7	12.9	3.2	11.3	−7.3
Total Community	13.3	16.6	10.5	9.0	13.2	13.1	7.4	6.7	3.3	3.5	3.9	−2.2

(1) The percentages for 1974 are approximations based on orders of magnitude.
(2) For individual countries, percentages are based on amounts in national currencies. For the Community total, currencies are converted into units of account at 1970 rates.

in June, by increases in reserve requirements and reductions in credit ceilings. The counterpart in fiscal policy, announced at the start of the new Presidency, included increases in taxes on income, a reduction in the rate of depreciation allowances, the freezing of profits resulting from inflation, and a cut in government expenditure in 1974. It should be added, however, that because of the deterioration in economic conditions towards the end of 1974, the orientation of monetary and fiscal policy was changed in early 1975.

The response of gross fixed investment to the introduction or reinforcement of restrictive measures normally tends to be delayed and its performance in 1974 proved to be no exception in that it continued to grow (2.9 %) in volume, if at a slower rate than in recent years. Owing to a much higher degree of price inflation, however, the increase in the value of capital investment of 18.8 per cent in 1974 was greater than the 13.3 per cent recorded in 1973.

France was not alone in experiencing a carry-over of the momentum of expansion into 1974 as the *Belgian* economy continued in the first half of that year to be strongly influenced by the expansionary forces evident in the previous two years. Many of the indicators of economic activity showed a more pronounced upward movement for the year as a whole than in most other countries of the Community. The volume of Gross National Product increased by 4.3 per cent, one of the highest rates of growth in the EEC last year. Industrial output by the third quarter was about six per cent above a year earlier, while unemployment was only slightly higher than in 1973. In short, the downturn of the economic cycle was delayed in Belgium until the late summer which happened to coincide with a marked stiffening in official policies, and particularly in the monetary sphere. This policy reinforcement was prompted by an acceleration in the rate of price inflation. The retail price index which had risen 7.3 per cent in the 12 months to December 1973, rose more rapidly during 1974 and in December was 15.7 per cent above a year earlier. The potential loss of competitiveness vis-à-vis Belgium's trading partners, particularly in the Community, caused concern.

Capital investment expenditures increased rapidly in 1974 as a result of the expansionary climate in the first half of the year. Both domestic and external demand were such that a number of Belgian industries reached peak capacity utilisation and investment in new capacity became necessary. As in other sectors, however, the peak growth in investment activity took place before August. In that month a number of measures were introduced by the public authorities, including a halt to permits on very large buildings and restrictions on mortgage credit, designed to restrain inflationary demand pressures, and these began to make themselves felt before the end of the year. Total capital expenditures rose in volume by about 6 per cent in 1974, and by about 22 per cent in value terms. Belgium was one of the relatively few countries of the Community in which real investment growth last year exceeded that of the economy as a whole.

This was not the case in *Luxembourg* although the overall economy experienced a very satisfactory expansion in 1974 despite some weakening towards the end of the year. Gross National Product at current prices was estimated to have increased by about 16 per cent last year, of which real growth formed about 4.5 per cent. The basis for this relatively strong performance, as in 1973, was the continuation of good markets for crude steel (steel being Luxembourg's main industry) stimulating an 8.8 per cent rise in output to which was added a 26 per cent increase in prices. As a result of higher volume and prices for steel, total exports of goods and services rose by some 28 per cent in value last year—not far short of the 31 per cent increase in 1973. The agricultural sector registered a modest 3.3 per cent increase in the value of output, as lower produce prices tended to offset a rise in production. In October, however, there was a sharp deterioration in the markets for steel products, adversely affected by stagnation in the economies of other Community countries and by particular problems in certain industries such as automobiles.

Investment activity in housing and on the part of public authorities was quite substantial but that of businesses was markedly weak. In total the value of fixed investment in Luxembourg is estimated to have risen by 5.4 per cent last year, but of this amount about 11 per cent was attributable to higher prices, volume having declined by around 7 per cent.

To some extent the experience of *Italy* in 1974 resembled that of the three Member Countries examined above in detail in that the momentum of the 1973 expansion carried over into the following year. Until June-July there was a moderate, though, waning degree of underlying strength in the economy deriving from a rapid increase in industrial expansion and from capital investment expenditures. The downturn is clearly illustrated by the industrial production index which during the second quarter of 1974 averaged 9.6 per cent more than in the comparable period of 1973, but which fell in the fourth quarter to 8.2 per cent below its level a year earlier. Nevertheless, in 1974 as a whole, Gross Domestic Product increased by 3.4 per cent in volume terms while the value of GDP including an appreciable element of price inflation rose by 20.6 per cent.

The downturn in activity in the second half of the year was brought about partly by official action to tackle the acute problems that expansion brought in its train and partly by a general decline in confidence. One of the more serious problems was that of price inflation which accelerated from an annual rate of 12.5 per cent in December 1973 to 24.5 per cent a year later. The increase in price inflation had a sharply adverse effect upon the external payments deficit already suffering under the impact of the oil crisis and wide, if unjustified, concern was felt that control over economic forces might slip from the grasp of the national authorities.

Higher oil import costs taken in conjunction with the increased flow of imports resulting from the economic expansion of the first half of the year, resulted in a rapid build-up of the deficit on current account of the Italian balance of payments. In the first six months of 1974 the current account deficit was approaching four times that of the corresponding 1973 period and there was an abrupt loss of reserve assets. This situation impelled the public authorities to seek supplemental finance from abroad, and in the first quarter of 1974 a 1 000 million S.D.R. stand-by credit was arranged with the International Monetary Fund.

As part of this arrangement, the Italian government agreed to pursue stiffer monetary and fiscal policies than hitherto. A limit of Lit. 22 400 milliard on the overall expansion of domestic credit originating from all sources was agreed as well as a limit on the size of the central government's financial deficit. In a separate move, the Italian authorities made the ceilings on bank credit, which had been in force since mid-1973, more effective from end-March 1974 onwards. Later in the year other credit and swap facilities were obtained, including a loan from the Deutsche Bundesbank and the conversion of short-term assistance granted by the Community in 1973 into a medium-term credit.

As these necessary remedial measures were taken in the attempt to contain the external deficit and to bring inflation under control, the second half of the year proved to be one of retrenchment. By end-year these efforts were coming closer to success, and while the non-oil external trade balance achieved a surplus in the month of December, it was not until the first half of 1975 that there was any significant reduction in the annual rate of price inflation.

In the second half of 1973 a resurgence of capital investment went hand in hand with the strong growth of industrial output at that time. This continued into the first half of 1974 but fixed investment suffered thereafter from the effect of a decline in confidence as a result of the loss of equilibrium both domestically and in the external payments position. Total capital investment rose by 4.2 per cent in volume in 1974 and by about 34 per cent in value terms.

In the second group of countries in which the onset of a recession depressed investment activity, *Germany* experienced its lowest rate of growth since 1967. The implementation of policies designed to curb inflation and to meet the challenge presented by the greatly increased cost of oil imports coincided with a cyclical slowing of the economy. Although the worst of the current recession was yet to come, the German economy was in a better position by end-1974 than some other member countries of the Community. The efforts of the authorities were successful in that they prevented any further rise in the rate of inflation, as measured by the cost of living index, and even conduced to a lower monthly rate of increase in prices than in the previous year. Meanwhile, a strong tendency towards surplus in Germany's external payments had shrugged off the negative impact of higher oil prices.

However, success in overcoming the economic problems prevalent in 1974 was only made possible at the cost of higher unemployment and a reduction in capacity utilisation. The volume of Gross National Product increased by only 0.4 per cent last year, compared with a gain of 5.1 per cent in 1973. At current prices, GNP increased by 7.0 per cent last year with the major impetus being provided by government expenditures.

It was against this background of weak domestic demand, a diminution in confidence as to future business prospects and a squeeze on profit margins, that capital investment expenditures tended to be reduced in 1974, both in volume and value terms. The volume of capital investment in Germany declined by 8.1 per cent last year and this decline was shared almost equally by the new construction sector and the machinery and equipment sector. In value terms the decline was not so severe and total capital investment was only 2.1 per cent lower than in the previous year.

The downturn in capital expenditures may have been moderated by the attempt of the German authorities, who were particularly concerned over the serious effects being felt by the construction and equipment manufacturing industries, to boost fixed investment by fiscal measures, including repeal of the investment tax in December 1973.

Somewhat similar trends prevailed in the *Netherlands* and the development of the economy in 1974, apart from the temporary uncertainties caused by the oil crisis, was basically a reaction to an over-rapid expansion in 1972 and 1973. Thus the slowing of growth was mainly the result of internal factors such as a decline in the volume of private consumption and a reduction of investment activity. To a minor extent the slackening of economic activity in neighbouring countries also exercised a slowing influence on the growth of the Netherlands' economy. It was not in fact until the fourth quarter that industrial production, including the output of mining and public utilities, fell below the level reached a year earlier. Gross National Product in volume terms rose by 3.3 per cent in 1974 which represented a slowing in the growth rate from the 4.7 per cent achieved in the previous year. At current prices GNP increased by 12.3 per cent as the value of government and consumer expenditures increased sharply under the influence of rising prices.

Some encouragement for investment in the important sector of industries producing for external markets may have been derived from an increase in the value of exports of the order of 36 per cent in 1974, with a large part of this being attributable to price inflation. But generally, in an era when price inflation overshadowed economic growth and the recuperation of increased costs proved both difficult and slow, the private sector was reluctant to expand capital investment. Public sector investment had been declining for some years because requirements had already been met in many important aspects. Last year, the value of total capital investment rose by 6.8 per cent, but in volume terms declined by 4.2 per cent. This weakness of capital expenditures in 1974 was shared by the public and private sectors alike.

Among the countries experiencing the complex problems of low growth, high rates of inflation, rising unemployment, and serious external deficits, the *United Kingdom* was again in difficulty last year. Not only were its problems among the worst in the Community countries, but events were proving stronger, by the end of last year and in early 1975, than the countervailing government policies to stem these adverse trends. The pattern of industrial activity for the year was shaped at the outset by the three day working week in January and February, declared as a result of the miners' industrial dispute and the consequent energy shortage. This event curtailed industrial production by 5.5 per cent compared with output in the previous quarter (seasonally adjusted). Thereafter, in succeeding quarters, industrial output and the economy as a whole worked towards making up the ground lost. By the fourth quarter, however, increasing slackness in demand was becoming evident both domestically and externally. For the year as a whole, industrial production fell by 3.4 per cent. Gross Domestic Product was a little less affected and increased in volume by 0.6 per cent in 1974, but was nevertheless one of the lowest growth rates in the Community.

The deterioration in the visible trade deficit from £ 2.3 milliard in 1973 to £ 5.3 milliard last year was mostly attributable to the increased deficit on oil transactions and only partly to the weakening of export performance. The U.K. authorities accordingly took the view that these oil-inspired trade deficits should be financed by capital inflows and a large-scale programme of public sector borrowing was embarked upon. The floating exchange rate for the pound hence scarcely deteriorated though the build-up of inflationary pressures suggested that there would probably be trouble later from the fact that earnings were rising faster than prices. The Government wage policy, founded on voluntary restraint, met with little response in that average earnings throughout industry had increased by 25.4 per cent in the year to the fourth quarter of 1974 compared with an annual growth of 12.7 per cent a year earlier. Over the span of twelve months to December 1974 the retail price index which rose by 19.1 per cent was signficantly accelerating in contrast to most other countries of the Community.

In view of the difficulties experienced last year it was hardly surprising that total capital investment declined in volume terms by 2.8 per cent. At current prices gross fixed investment rose by 17.1 per cent. Despite the financial pressures resulting from the three-day week, price control and the surge of input prices of materials and labour, capital investment in certain sectors, particularly manufacturing, continued to expand even in volume terms. Investment projects, being of a long-term nature, cannot always be immediately adapted to changed economic circumstances and the capital expenditure cycle tends to lag behind that of the economy as a whole. Moreover, the existence of potential capacity shortages in the United Kingdom has long been recognised with the result that work on long-term projects continues despite shorter-term difficulties.

In *Ireland* there was also a marked slackening in the growth of economic activity last year following the rapid expansion of 1973. The volume of Gross National Product rose only marginally, by 0.2 per cent in 1974, compared with an increase of over 5 per cent in the previous year. However, these bald figures, while indicating the difficulties faced last year, hide a number of disparate trends. The upsurge of import prices led to a sharp increase in the current account deficit of the balance of payments to almost four times that of the previous year, or the equivalent of more than 10 per cent of GNP. However, this potential drain on the external reserves was offset by the sharply increased capital inflows, not only through government borrowing abroad but also by inflows to the private sector which made a valuable contribution to financing investment in 1974.

Problems were encountered last year by the farming community as lower prices for cattle and higher feed costs resulted in a reduction of farm incomes of about 12 per cent in terms of current prices in 1974. Since agriculture contributed almost 20 per cent of national income in Ireland in 1973 (by far the highest proportion in the Community) the set-back of this sector had a serious effect on the economy as a whole. Manufacturing output fared somewhat better in that an increase oi about 2.5 per cent was registered for 1974, although there was a declining trend in activity from the first quarter onwards, with output in the final quarters being lower than in corresponding quarters of the previous year.

Capital investment conformed closely to the general pattern of high inflation and low real growth that characterised the Irish economy last year. Total capital expenditures are estimated to have risen about 14 per cent in value terms, but because prices rose strongly, such as the more than 25 per cent increase in the capital goods sector, there was a decline in volume of about 8.3 per cent.

The *Danish* economy entered 1974 in a rather firmer state than the United Kingdom or Ireland in that it was still benefitting from the residual of the relatively strong growth experienced in the previous year. Thus, for part of last year, until early summer, a number of economic aggregates reflecting consumer demand, production and capital investment continued to advance appreciably, despite warning signs that the economy was not in balance. Concern over the heavy external payments deficit inherited from the previous year was reinforced by the substantially higher cost of oil imports during 1974. In addition, wage and price inflation were eroding the competitiveness of Danish products in international markets at a time when those markets were beginning to experience the onset of a recessionary phase. Faced with the threat of these adverse factors the authorities felt it necessary to introduce more restrictive fiscal policies in the first half of the year and to tighten even further the already fairly stringent monetary policy. Over the year as a whole the volume of Gross Domestic Product increased by only 0.8 per cent in 1974, compared with an expansion of 3.4 per cent in the previous year.

Capital investment naturally tended to reflect the changing pattern of the economy, although with the usual time-lag associated with this activity. Thus the first half of 1974 saw the momentum of total investment expenditures carry the 1973 expansion further. Later in the year, however, the worsening economic situation began to impinge on this performance and, for 1974 as a whole, total capital expenditures declined sharply in volume terms by about 10.4 per cent compared with the previous year. In value, including a large price element, total capital expenditures rose by about 6.5 per cent in 1974.

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

The value of business investment in the Community as a whole increased by 12.9 per cent in 1974 to 134.6 milliard units of account. This figure represented 59.4 per cent of the total of Community gross fixed investment of all kinds, as can be seen from Table 2. The larger increase in the value of business investment last year than in 1973 owes much to faster rates of inflation. In volume terms, the pattern of the year was one of slower growth or decline of business investment in the various Community countries as anti-inflationary policies were reinforced and later as recessionary tendencies took a firmer hold of their economies.

In order to limit the growth of government expenditures during an inflationary period there was often pressure to cut back on public authorities' investment as being one of the few areas of discretionary spending. However, accelerating increases in prices tended to frustrate this aim of policy and the current cost of total investment by public authorities in the Community rose by 17.4 per cent to 34.4 milliard units of account last year.

Throughout the Community dwelling construction came under pressure from the aftermath of the boom conditions experienced in most countries in the early 1970's. Often there was a surplus of unsold new houses at high prices overhanging the market and depressing prospects for a recovery. Total Community investment in new dwellings thus showed the lowest growth of the three sectors, rising in value by only 10.8 per cent in 1974. This compares with an expansion averaging 16.7 per cent in the 1971-73 period, a time when price inflation was less significant.

The performance at current prices of individual sectors can best be seen in Chart II on page 11. In Belgium and Italy which led the way with substantial increases in the overall volume of fixed investment in 1974, there were very large rises in the amounts spent on business and housing investment with relatively little change in those spent by public authorities. The volume of fixed investment also rose, if by rather less, in France but here the increase in investment expenditure was much more balanced. Similarly in the United Kingdom and Ireland the growth of capital expenditures in terms of current prices was fairly evenly balanced as between sectors though, in contrast to France, the total volume of investment had begun to fall.

In the Netherlands, Germany and Denmark the volume of fixed investment fell even more sharply in total. These three countries shared the experience of seeing amounts spent on housing fall in 1974. In Germany investment expenditures by enterprises also fell but this was counterbalanced by higher capital spending on the part of public authorities.

For example in *Belgium,* investment by business enterprises was encouraged last year by the good profit position, the capacity shor-

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

Sectors	In milliard units of account at current prices						% share of total	
	1969	1970	1971	1972	1973	1974	in 1969	in 1974
Business investment	75.5	89.7	99.5	107.1	119.2	134.6	59.9%	59.4%
Housing	31.1	34.3	38.0	44.7	51.8	57.4	24.7%	25.4%
Investment by public authorities	19.4	23.3	25.2	27.0	29.3	34.4	15.4%	15.2%
Total Community	126.0	147.3	162.7	178.8	200.3	226.4	100%	100%

(1) The statistics for 1974 are estimates of orders of magnitude.

tages, the need to develop alternative energy sources and the desire to forestall higher prices for investment goods in the future. Thus the value of capital expenditures by the manufacturing industries rose by about 34 per cent in 1974 compared with 14.6 per cent in the previous year. In the finance and distribution sectors fixed capital investment gained about 13 per cent last year in contrast to a decline in 1973. However, the development of non-residential construction appears to have been constrained by the controls on large buildings instituted in the third quarter of the year.

As regards new housing construction, however, the speculative influences backed by the rise in money incomes in 1973 and 1974 encouraged an increase in volume of about 14 per cent last year with most of this gain occurring before the late summer. Again owing to speculative influences residential investment experienced a relatively high rate of price inflation of about 20 per cent in 1974 which led to its increasing in value by 34 per cent. The trend was reversed from September onwards, when the number of starts on new housing units dipped below year earlier figures largely as a result of the restrictions placed by the authorities at mid-year on the availability of mortgage funds and of the steep rise in interest rates at that time.

Public authority capital expenditures in 1974 were restrained, as in the previous year, by an anti-inflationary budgetary policy and the volume of expenditures declined for the second year in succession. More particularly, capital expenditures by the Belgian public authorities were limited to about 80 per cent of those originally planned for 1974. At the end of the year, however, the rising trend of unemployment and the prospect of further weakness in certain key industries and in international trade, led the public authorities to introduce measures designed to increase public sector investment in 1975.

In *Italy,* business investment in early 1974 was influenced in much the same manner as in Belgium by the carry-over effect from the boom conditions prevailing in the previous year. However, after the first few months of 1974 industrial production turned downwards as confidence was undermined. The volume of domestic sales was even more sharply curtailed, in part the result of the rise in indirect taxes, higher petrol prices and other fiscal measures introduced in July, and a substantial build-up of finished product stocks resulted in the period from August onwards. This process effectively discouraged plant expansion and hence led to a reassessment of business investment plans but mostly too late to affect the year's statistics.

Thus for 1974 as a whole there was an increase in the volume of business investment of about 6 per cent, Italy being one of the few Community countries in which the growth of business investment in volume terms exceeded that of the economy as a whole. The value of business capital expenditures, boosted by price inflation, rose by 34 per cent. The very large rise in prices created some problems for the financing of investment at a time when a 15 per cent limit was placed on the annual growth of credit. These problems were however taken into account in the renewal of the obligation on banks to hold a certain proportion of their portfolios in bonds issued by specialised financial institutions.

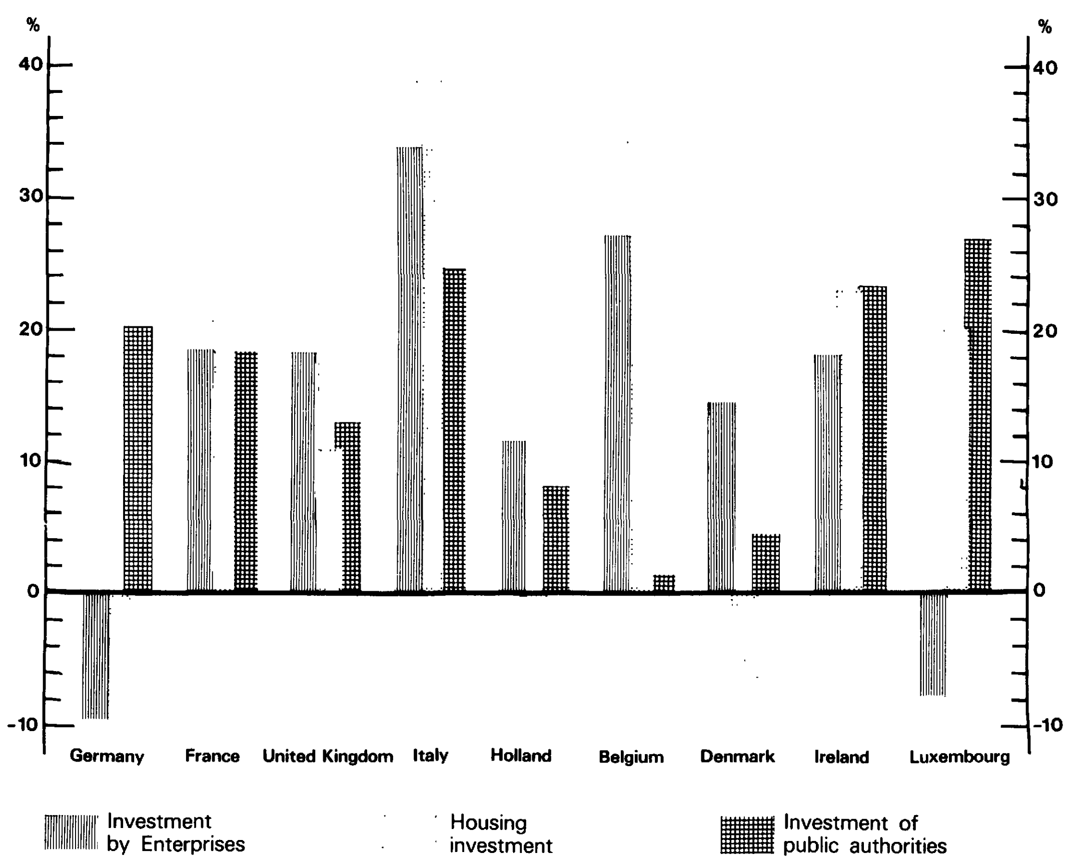
Residential investment in Italy experienced a somewhat similar pattern as that of business investment, with higher activity in early 1974 followed by a contraction later in the year. Housing starts had increased rapidly in 1973 (particularly in the fourth quarter) after a period of weakness and this provided the basis for the modest increase of 4.7 per cent in the volume of residential construction last year which was accompanied by a rise of almost 39 per cent in value. The trend of new housing starts, however, began to weaken and in the first nine months of last year they were 16 per cent lower than in the comparable period of 1973. Credit restrictions in force during the year bore heavily on the personal sector and no doubt limited the availability of finance for new house construction. Falling real incomes and rising construction costs were a further source of discouragement, particularly towards the end of 1974.

The commitment of the government to restrain public expenditures and to limit the budgetary deficit to less than Lit. 9 200 milliard seems to have contributed to the decline in public sector investment last year. The volume of public sector capital investment in Italy in 1974 accordingly continued its downward tendency of recent years. But as evidence accumulated in late 1974 and early 1975 on the growing recession of the economy, and particularly in the investment sector, it became evident that some selective relaxation of the tight monetary and fiscal policies might be appropriate in view of the weaker state of the economy. Thus in early 1975 a package of fiscal measures was introduced, including some intended to directly stimulate public investment expenditures.

Expenditure on fixed investment in 1974 was more balanced in *France* than in Belgium and Italy, though the influences operating in each sector were different. During the first half of the year there was a lively demand by the business sector for machinery and equipment in response to the economic conditions prevailing at that time. As this led to a more rapid increase than usual in imports of capital goods, it was necessary to redeploy the economic effort of the country in such a way as to moderate demand for such imports and at the same time to allow capital goods producing industries to channel more of their output into exports and to cater for the needs of investment in new sources of energy. The reduction at mid-year in the availability of credit was directed towards this end. Subsequently, the deteriorating economic outlook also served to discourage investment. By the fourth quarter of last year sales and output were falling in a

Chart II — Elements of gross fixed investment (1)

Percentage Change 1974/1973 at current prices, based on amounts in national currencies



(1) Estimates based on orders of magnitude.

number of key industries such as those for automotive, steel, textile, chemical and rubber products. Not only were plans for future investment affected but existing projects, such as in the property sector, suffered from the cost of finance and speculative expectations of a high net return on leasing building space were undermined.

The volume of investment by public sector enterprises was, however, more affected than that of the private sector, partly because of governmental policies of direct restraint and partly because of the impact of the overall limitation of budgetary expenditure on purchases of capital equipment during a period of rapidly rising prices. The out-turn for 1974 as a whole was not unimpressive in these circumstances. Expenditure on fixed investment by non-financial enterprises, including those of the public sector, rose by 2.8 per cent in volume and by 18.6 per cent in value.

A broadly similar pattern occurred in residential investment in France which rose by 0.4 per cent in volume last year and by 20.5 per cent at current prices. In the first half of 1974 speculative influences associated with a desire to acquire physical assets in a time of uncertainty contributed to the fairly large number of housing starts during this period which in turn assured a modest growth in the residential construction industry. The housing market was, however, affected by the high cost of mortgages and the number of dwellings commenced fell sharply in the fourth quarter.

The increased emphasis on social programmes in France last year probably had a minor influence on public sector investment. Capital expenditures by central and local governments seem to have been less affected by the cutback in budget expenditure at mid-year than public sector enterprises and they consequently rose by 2.7 per cent in volume and by 18.2 per cent in value or by only slightly less than the whole business sector.

However, in *Luxembourg* not all the sectors participated equally in the modest increase in the value of capital investment in 1974. Business investment suffered a check in the face of lowered expectations of future economic activity, declining by about 8 per cent in value terms. A principal factor in this decline was the reduction in investment by the steel industry of about 12 per cent compared with 1973. Capital expenditures by the new non-steel industries declined as a result of the termination of many of recent plant expansion programmes.

New residential construction was adversely affected by the restrictions on mortgage credit imposed in mid-1973. Speculative demand influences took some while to diminish but the number of new permits for residential construction declined on a year-on-year basis from the second quarter onwards, and for 1974 as a whole they were 7 per cent lower. The index of construction activity, comprising both residential and non-residential sectors, was 7 per cent higher on average in 1974 than in 1973. Investment by the Luxembourg public sector was appreciably higher last year in value terms, mainly as a result of the expanded road-building programme and other infrastructural expenditures.

In contrast to the first three countries mentioned above in detail, the *United Kingdom* experienced an overall fall in the volume of investment. This fall was, however, unevenly distributed. Within the business sector, manufacturing capital expenditures performed well, rising in volume by 10.8 per cent last year. A number of manufacturing industries (the automative trades excepted) experienced good sales both domestically and abroad and, financial considerations apart, were in a good position to extend capacity. However, the service and distribution industries, and more particularly the transport and property sectors, were very conscious of troubled economic circumstances and capital investment declined in volume by 6.7 per cent in 1974. Total business capital expenditures in the United Kingdom rose in volume by 0.3 per cent and by 18.1 per cent in current prices. Capital expenditures by public corporations provided much of the support for this level of activity in increasing by 7.6 per cent in volume terms. Investment in the private

Table 3 — **The share of capital investment in the economies of the Community countries** (1)

Countries		Gross national product at current market prices	Gross fixed investment				
			As % of gross national product	Sector shares in %			
				Investments by enterprises	Housing construction	Investments by public authorities	Total
Germany, DM milliards	1973	916.9	25	60	26	14	100
	1974	980.9	23	59	24	17	100
France, FF milliards	1973	1 108.1	24	61	27	12	100
	1974	1 281.0	25	61	27	12	100
United Kingdom, £ millions	1973	72 315	19	61	21	18	100
	1974	81 927	20	63	20	17	100
Italy, Lit. milliards	1973	80 963	21	57	30	13	100
	1974	97 182	23	57	31	12	100
Netherlands, Fl. milliards	1973	166.48	23	56	28	16	100
	1974	187.04	22	58	26	16	100
Belgium, BF milliards	1973	1 767.6	22	59	24	17	100
	1974	2 069.4	23	60	26	14	100
Denmark, Kr. milliards	1973	164.56	23	52	28	20	100
	1974	183.71	22	55	25	20	100
Ireland, £ millions	1973	2 651	24	34	26	40 (2)	100
	1974	2 879	25	33	26	41 (2)	100
Luxembourg, Flux. milliards	1973	71.44	28	60	21	19	100
	1974	82.82	26	53	24	23	100
Total Community, u.a. milliards	1973	840.2	23	60	26	14	100
	1974	920.4	23	60	25	15	100

(1) The table is based on estimates, at current prices, of orders of magnitude. In a strict sense, comparisons of gross fixed investment cannot be made because of differences of definition and composition from one member country to another.
(2) Includes some element of fixed investment by semi-State corporations.

enterprise sector slackened somewhat in the fourth quarter of the year in response to the slowing of the economy at that time and the difficulties of financing increased working capital requirements.

Housing investment was also mixed, private residential housing declining sharply compared with 1973, while local authority housing expanded rapidly as a counterbalance. The private housing sector in the United Kingdom was depressed in 1974. Demand for new houses was slack, mortgage finance was costly and, in the first half of the year, difficult to obtain. From the builders' viewpoint construction costs of new housing had continued to increase rapidly but at the same time the stock of unsold homes depressed the market, and, with high interest charges on borrowings, profitability was often pared to vanishing point. Private sector housing started during 1974 was down 51 per cent from the previous year while total new private sector housing investment in the United Kingdom declined in volume by 20.5 per cent. Even at current prices capital investment in private sector housing declined by 4.8 per cent.

Public sector housing was increased energetically last year in the United Kingdom as an element of government policy. While public sector housing starts rose by 30.1 per cent this was not immediately translated into a corresponding rise in the volume of investment, which in the event increased 12.4 per cent.

Public sector non-residential capital expenditures declined by 8 per cent in volume last year. In this context the relatively large government expenditure cuts announced in 1973 started to be reflected in the investment programme. On the other hand, in terms of current prices public sector investment increased at a rate similar to that of the other two main sectors.

The public sector apart, the behaviour of investment in *Ireland* in 1974 bore some resemblance to that in the United Kingdom. Investment by the business sector rose by about 18 per cent at current prices last year mainly as a result of higher machinery and equipment expenditures. Imports of producers' capital goods which are indicative of investment performance, rose by an estimated 25 per cent in value terms. Non-residential business construction, however, was perhaps more affected by the unsettled business environment, with long-term prospects clouded by rising inflation.

The pattern of expenditure on residential construction was mixed. Investment in housing by the private sector was reduced last year in constant price terms, as a result of difficulties which the Building Societies in Ireland experienced in attracting funds. Any reduction, however, was more than compensated by the sharp increase in public authority expenditures on dwellings, the value of which rose by over 30 per cent last year. Total residential investment increased almost 23 per cent in value in 1974.

The value of Irish public authority investment (excluding housing) expanded by an estimated 23 per cent last year although direct comparisons with 1973 are not possible owing to a change in the financial year. The central government pursued an actively stimulative investment policy in 1974 which was reflected in a higher borrowing requirement. Local authority capital expenditures (excluding housing), which are almost entirely financed by the central government, did not increase to the same extent.

The pattern of investment expenditure in the *Netherlands* in 1974 was more uneven than in the United Kingdom and Ireland as the business sector did not share in the fall in the volume of fixed capital formation. A certain benefit accrued to enterprises in the Netherlands last year from the re-introduction of investment allowances for tax purposes, and this factor, together with new energy diversification projects, no doubt maintained business investment on a higher plane than might have otherwise been the case. Capital expenditures by private and public enterprises were nevertheless retarded initially by the uncertainties of the oil crisis. However, as it became clear that supply problems were less acute than feared, there was an element of catching up in the summer period and, in 1974 as a whole, the value of business capital expenditures increased by over eleven per cent while in real terms there was virtually no change. Because of the rising cost of labour the private sector resorted to deepening its investment in capital equipment. Expenditures on new machinery and equipment were little affected by the economic slowdown but, in terms of volume, investment in buildings declined, partly for cyclical reasons but also because of the persistence of a secular downtrend. In an attempt to counteract this, further tax incentives on investment on new buildings were introduced in the fourth quarter of last year.

The demand for housing in the Netherlands appeared to be nearing satiation in 1974 and it was not altogether unexpected that expenditure on new dwellings was 13 per cent lower in volume terms than in the previous year. The rise in mortgage interest rates to a very high level by the third quarter of last year was not a major factor but it may have had a marginal effect upon private unsubsidised housing in that plans for building may have been delayed in the hope that interest rates would soon fall. It seems that as housing completions appreciably exceeded starts during the fifteen months to end-1974, thus depleting the amount of work in progress, the reduction in building activity may have continued into early 1975. To meet this problem, the Dutch public authorities announced in October of last year a revised programme of subsidies for housing, to take into account higher mortgage rates and the inflation of land and building costs.

The public authorities in the Netherlands have pursued for some years a policy of limiting their total expenditures to the volume of resources available after the demands of the private sector and the balance of payments had been met. In implementing this policy it has proved easier to restrict the public sectors' capital investment than its current expenditure. There has thus been a secular decline in public investment over the last few years and, although short-term programmes of public works have been introduced to combat unemployment, the total of Dutch public sector investment continued to fall last year. The measures introduced towards the end of 1974 to counteract the rise in unemployment and the economic slowdown that was then occurring were designed to stimulate investment in the public as well as the private sector. Nevertheless total capital expenditures by central and local government in 1974 were 19 per cent lower in real terms than six years previously.

The pattern of investment in *Germany* in 1974 was also uneven. Certain aspects of construction activity, particularly new housing, were distinctly weak in the first half of 1974. New dwelling construction was affected by the downswing in the economic cycle, as evidenced by the ending of the property boom of the early part of the decade, and the large stock of unsold houses. Higher interest rates tended to delay any resurgence in private residential construction and as a result the value of new construction declined in 1974 by 10.5 per cent from a year earlier. To counter this slackness in private sector dwelling construction the German public authorities inaugurated programmes to increase the numbers of houses erected with government assistance.

A similar pattern was evident in private non-residential building. The hesitancy of private industry in placing orders for new capacity, was compensated to a large extent by a sharp expansion in building and civil engineering projects by the German public authorities, many of which were acting under various special programmes designed to offset slackening demand. The value of total public sector capital expenditures increased by 20.2 per cent last year.

Capital expenditures on machinery and equipment by the German business sector declined in 1974, by about 2.9 per cent in value and by about 9 per cent in volume terms. These figures reflect the slackening of demand combined with what was, by international standards, a relatively low rate of price inflation during the year, a consequence of which was a narrowing of profit margins. The declining trend in investment in new machinery and equipment was closely related to the state of industry as a whole. A number of industries such as motor vehicles and construction were adversely affected by economic circumstances from the beginning of the year and later, in the second half of 1974, the chemical, textiles and steel industries suffered a reduction in sales, thus adversely affecting orders for new equipment. The very strong export order book formed the mainstay for the industries concerned (providing some support for certain suppliers of new equipment) but, towards the closing months of the year, even the export sector saw a decline in orders relative to those received earlier in 1974. Total non-residential business investment in Germany, comprising both new construction and equipment, declined by 9.6 per cent in value terms last year.

Investment patterns in *Denmark* in 1974 bore more resemblance to those in the Netherlands than in Germany. Capital expenditures by the business sector constituted one of the stronger elements in the overall investment scene during the first half of the year. During this early period investments by private and public enterprises were stimulated by the carry-over of orders from 1973, the quite strong pattern of industrial production, the need to expand capacity following the 1973 boom, and the good profit position of a number of sectors of the economy, particularly agriculture. During the latter half of the year, however, business capital expenditures slackened as a result of the downturn in the economy as a whole. Investments in new buildings and similar construction work having long lead times before completion, seem on the other hand to have been less affected by the sudden slowing in business activity than investments in machinery and equipment, especially transportation equipment. Thus, in the year 1974, Danish business investment declined by 2.4 per cent in volume following a 14.6 per cent gain in 1973. Price inflation contributed to raising its value by about 14.4 per cent in 1974.

Housing investment in Denmark was hard hit by the very high cost of mortgage finance prevailing for most of the year, and by the aftermath of the 1972 and 1973 building boom which left a large stock of unsold houses. These factors coincided with a downturn in consumer confidence and uncertainty as to the employment situation, resulting in a sharp reduction of about 25 per cent in the volume of housing investment in 1974. The depressed state of residential construction is made even clearer by the continual decline in each quarter of last year in the number of dwelling units started. For 1974 as a whole the number of dwelling units started in Denmark was reduced to only 25 708 units compared with a total of 50 399 units started in the previous year. In contrast, housing completions totalled 48 595 units in 1974.

Public authority capital expenditures were sharply curtailed last year as a result of the deliberate policy in Denmark of halting government building and public works construction. This limitation which lasted from April until August of last year for local governments, and until October for the national government, was a reflection both of the long-standing desire to restrain the role of government in the economy and of the need to give force to anti-inflationary policies which were introduced at that time. As a result of this enforced halt on public authority construction in Denmark for a good part of the year, the volume of government capital expenditures for 1974 was about 14 per cent lower than in the previous year, continuing the declining trend evident since 1971. Following the resumption of public authority construction activity towards the third and fourth quarters of last year, it would seem that capital expenditures by the government might well increase quite considerably in 1975, compared with the level of activity evident in mid-1974.

CHAPTER 2

FINANCING OF INVESTMENT

2.1. THE FINANCIAL SETTING

At the beginning of 1974 national authorities were confronted with the need to overcome the serious problems of inflation and of adjustment to the sharp increase in petroleum prices demanded by oil exporting countries. In the main the first of these problems was tackled by the introduction of measures to reduce the availability of credit in order to bring about a slackening of demand and of pressures exerted on prices by rising costs. Apart from relatively minor cutbacks in consumption, the main approach to the second of these problems adopted by countries likely to be in heavy deficit on current account in their balance of payments, was to seek to borrow substantial sums on the international capital market.

Both these policies had an inevitable impact on capital markets. The first of these resulted in a rise in short-term interest rates on national capital markets through the operation of restrictive monetary policies. The second on the other hand, helped to sustain, and possibly to raise, interest rates on short-term eurocurrency markets from which the banking syndicates extending the large scale credits drew their resources. The high rates of interest available on eurocurrency deposits certainly attracted the surplus revenues earned by oil exporting countries and probably were a contributory cause from time to time of shortages of liquidity on national money markets.

Long-term capital markets in fixed interest securities suffered from the upsurge in short-term interest rates on the international market and on national markets which in a number of instances resulted in the appearance of a reverse yield gap with short-term rates higher than long. As the prevailing rates of inflation mostly exceeded the yield on long-term investments, bond markets looked decidedly unattractive for a large part of 1974. Movements out of long-term securities into short-term placements undoubtedly took place with a consequent increase in long-term rates but possibilities for such rearrangements of portfolios were limited by the capital losses that would have been involved. The rise in long-term yields was, however, sufficient to discourage new borrowing.

New issues of shares also suffered. Additional difficulties in share markets were the uncertainty over the profitability of enterprises in an inflationary climate and the unmistakable signs of an impending recession which became apparent from mid-year onwards.

As the threat of recession grew, official policies changed direction. This occurred largely during the early autumn and by the last quarter of the year interest rates were turning downwards in most member countries and activity on capital markets was beginning to revive.

The improvement in monetary conditions towards the end of 1974 was so marked in Germany, the Netherlands, Belgium and Luxembourg that prevailing long-term interest rates ended the year more or less where they began (see Chart 3). In Denmark and France there was a marked decline in interest rates from mid-year onwards but they remained a percentage point or two higher at the end of the year than at the beginning. On the other hand in the United Kingdom, Ireland and Italy where the problems of inflation and current account deficits were more acute for a large part of the year than elsewhere, the cost of borrowing continued to rise virtually to the year's end.

While in the early months of last year there was a continuation of the relatively tight credit policies instituted in *Germany* in 1973, towards the summer there was some easing of this policy, which became more pronounced in response to liquidity problems caused by the outflow of capital in the third quarter. Finally, from October onwards, there was a distinct shift of emphasis in monetary policy aimed at countering the gathering recession of the economy and the mounting numbers of unemployed.

The success in reducing price inflation in Germany was attributable not only to a gradual weakening of demand but also to special factors working in favour of a limitation of price increases. The increase in the cost of living over a span of twelve months was 7.4 per cent at the beginning of last year; by end-1974 the annual increase in prices was down to less than 6 per cent—the lowest in the Community. Two special factors contributed to this performance; the decline in the producer prices of a number of food items contained in the cost of living index, and the increase in the external value of the Deutschemark, especially towards the end of 1974, which helped to offset the rate of price inflation of imported products. On the other hand, the control over inflation was not helped by a faster rise in wage rates in 1974 than during the previous year, which thereby placed a squeeze on profit margins.

In the first half of 1974, however, the overriding aim of the German monetary authorities was to stabilise the economy in the face of a rising rate of wage inflation and the exigencies of the oil crisis. The money supply on a broadly defined basis (M2 corrected for changes in the composition of reporting banks) rose by 7.9 per cent between June 1973 and June 1974, which compared with an increase of 18 per cent in the previous 12 month period. The intent of credit policy continued to be oriented in the summer months towards producing stability, although by this time the demand for credit was slackening. The existing restrictions consequently did not appear to need tightening. The Bundesbank was concerned primarily with compensating for the drain on liquidity which resulted largely from capital outflows by offering unlimited "lombard" loan facilities and lowering the minimum reserve ratios on the banks' domestic liabilities (in September). Also in September the Bardepot reserve requirements on funds borrowed abroad was lifted.

At least some of the liquidity problems suffered by banks (especially smaller banks) during the summer period were attributable to the aftermath of the failure of the Herstatt Bank. Aside from taking measures of a general nature to ease liquidity problems, the Bundesbank also established, in conjunction with members of the banking community, a "Liquidity Consortium Bank" to provide assistance to any essentially sound credit institution which might find itself in difficulties. The Bundesbank was particularly concerned with preventing a general loss of confidence in the banking system.

In the final quarter of 1974, there was a reversal of many of the trends evident earlier in the year. Not only was there a revival of large capital inflows—and a sharp strengthening of the Deutschemark exchange rate—but also a rapid increase in the money supply and in the free liquid reserves of the banks. Between end-August and end-December of last year the broadly defined money supply (M2) rose by 6.2 per cent, although at least part of this rapid expansion was due to seasonal factors. Interest rates in Germany in 1974 assumed a divergent pattern, with short-term money market rates declining steeply for most of the year from their 1973 peaks, while yields on long-term bonds rose during the first six months before declining late in the year. Rates on three-month inter-bank loans declined from 13.20 per cent in December of 1973 to 8.60 per cent in December of last year. This very rapid downward movement, and the lower yields on domestic bonds compared with those on most bonds quoted internationally, contributed to the outflow of capital during the late summer.

In the *Netherlands,* unlike in many other countries, there was a relatively full flow of credit available for financing investment last year—albeit at high interest rates especially in the second and third quarters—as monetary policy adjusted towards easing the impact of reduced economic activity. The restrictions which were introduced in 1973 to counteract speculation against the guilder and the possible impact of the oil crisis began to be eased in 1974. These relaxations had no internal effect. For example, the Nederlandsche Bank was able, in the absence of incentives for foreign investors to place their funds in securities denominated in guilders, to abolish the "O-guilder" regulations which had prevented foreign capital from reaching the domestic bond market.

Dutch policy regarding wages was designed to ensure that lower income groups did not suffer any reduction of real earnings from the effects of the oil crisis. This involved some element of redistribution of incomes. The price controls in force during the year were intended, on the other hand, to limit and delay the impact of inflation. Enterprises consequently found themselves faced with the serious problem of rising wage payments and a limitation on the prices they were allowed to charge, which thus culminated in a squeeze on their profit margins.

Capital markets within the Belgian/Luxembourg monetary union were also beginning to surmount their difficulties by end-1974. The principal emphasis of the *Belgian* authorities' anti-inflation policy last year was on monetary rather than fiscal policy. At the beginning of 1974 there was some uncertainty as to the possible effects of the oil crisis and consequently a flexible attitude was adopted towards credit policy. By March, however, it was clear that this approach was doing little to curb the rate of credit expansion and, with effect from April 1, a credit ceiling was introduced which was in force for the rest of the year, having been considerably toughened in June.

Monetary policy was also aimed at lessening speculative activities and, with this in mind, the Belgian authorities acted to raise interest rates. While the official discount rate was only raised once, in February, from 7.75 to 8.75 per cent, various measures were taken to apply the higher rates on the central bank's special loan facilities to a broader spectrum of loan business. Short-term money rates climbed upwards until late summer under the influence of a similar movement in other external markets; the three month treasury bill rate in Belgium, which in January had been 7.65 per cent, averaged 11.75 per cent during the months July-September and subsequently declined to 10.50 per cent only in December. Long-term yields followed a similar pattern, those for government bonds rising from 8.14 per cent in January to 9.26 per cent in August before receding to 9.03 per cent in December.

In *Luxembourg* price inflation, which was relatively low in 1973, steadily worsened last year and consumer prices which had risen at an annual rate of only 6.8 per cent in January 1974 showed a rate of inflation of 11.2 per cent by year-end. In order to slow the expansion of credit and to stimulate saving, the public au-

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

(Percentages)

	1970	1971	1972	1973	1974	Annual average 1970-1974
I. Depreciation	**46.5**	**47.2**	**47.6**	**47.4**	**50.7**	**47.9**
II. Long and medium-term external resources raised on national capital markets:	**12.3**	**15.4**	**17.8**	**18.1**	**11.3**	**15.0**
of which: shares	3.8	3.9	4.5	3.8	2.5	3.7
bonds	8.5	11.5	13.3	14.3	8.8	11.3
III. Other resources including net self-financing and, bank and other credits	**41.2**	**37.4**	**34.6**	**34.5**	**38.0**	**37.1**
Total financing for gross fixed capital formation	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**

thorities introduced or extended measures in July and August to restrict mortgate lending and to raise interest rates. The latter step had the dual purpose of encouraging savings (initially not very successfully) through higher savings deposit rates and discouraging the demand for loans by a parallel increase in interest rates on loans.

In common with those in the remaining five Member Countries, financial markets and intermediaries in *Denmark* experienced difficulties last year in meeting the demand for investment funds in the face of a stringent limitation on the availability of credit and interest rates consequently soared. The authorities tightened monetary conditions during the first half of the year both through a squeeze on bank liquidity and by the simple expedient of not raising the ceiling on bank lending until August. The government also introduced an unusual scheme in February to dampen the effect on prices of increases in index-linked labour costs by reimbursing companies with a proportion of the increase they were compelled to bear. On the side of demand, a compulsory savings scheme for individuals was introduced and, in May, indirect taxes were increased. Monetary policy, however, probably contributed more than these last measures towards reaching the objectives of containing inflation and reducing the trade deficit.

Largely as a result of these restrictive policies, interest rates rose steeply until mid-year; the average yield on mortgage bonds on the Danish market rose from 13.78 per cent in December 1973 to 17.68 per cent in July last year before retreating to 14.54% in December. The stance of monetary policy was changed, in recognition of a weakening of the economy, by the relaxation of the ceiling on bank lending in August and, in November, this ceiling had to be raised again because of a further deterioration in the business outlook. The decline in interest rates from their peak in July can thus be ascribed mainly to the easing of monetary policy (which was facilitated by the general downtrend in the same period of interest rates on the international and other national capital markets) but the underlying recessionary tendency of the economy also played a part.

The tight monetary policy which *France* had been experiencing since it was introduced in late 1972 was reinforced at the beginning of 1974. The monetary authorities tended to operate on the level and composition of banks' reserves as a means of achieving interest rate objectives which were an important element in their anti-inflationary policy. The situation was complicated by substantial outflows of capital in a bout of speculation against the French franc in January as a result of which the reserve requirement on non-resident deposits was suppressed in an effort to encourage the funds to remain in the system and so to prevent a further cost to the overall balance of payments.

As a result of the general restraint on bank liquidity in the first half of 1974, the whole structure of interest rates rose by between one and two percentage points from the end of 1973 to July 1974. At a time when inflation was eroding the real value of capital there was a fear that saving would not be sufficiently encouraged by the interest rates on offer at the beginning of the year. Similarly it was judged that higher interest rates would help to discourage the speculative activities which were tending to add to inflationary pressures in the first half of the year. On the other hand, the indications are that genuine investment activity suffered in the latter part of 1974 from a deterioration of the economic outlook rather than the high cost of borrowing. The selective easing of monetary policy in the closing months of the year in fact led to a decline in some market rates of interest, for example on bonds issued by public sector or semi-public sector borrowers. The average yield on long-term bonds issued by private sector borrowers, however, having risen from 9.83 per cent in December 1973 to 11.93 per cent in June 1974 remained close to that figure until the years' end.

The *United Kingdom* was among the three countries which did not experience an improvement in their capital markets in the final quarter of 1974. Business confidence was undermined early in the year by the oil crisis, the miner's strike, the resort to a three-day working week and growing inflationary pressures. Rapidly rising costs of labour and other inputs placed severe strains on company finances during the year. The search for larger nominal amounts for working capital and fixed investment was rendered more difficult by reduced trading profits (after eliminating windfall gains from stock appreciation), higher costs of borrowing and higher tax liabilities. In the property sector, on the other hand, it was a fall in property values which combined with higher charges on bank borrowings to create problems not only for the sector itself but also for the banking sector. A number of the smaller banks and finance houses encountered difficulties in retaining deposits owing to their often heavy involvement in loans to the property sector at a time when confidence had generally been weakened. To remedy the situation the Bank of England took active steps to organise support for these smaller financial intermediaries.

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

(milliard units of account)

Country	1971	1972	1973	1974
Germany	23.37	30.60	27.70	24.72
France	16.92	22.09	22.12	24.05
United Kingdom	9.96	21.97	21.23	13.80
Italy	12.56	15.75	20.97	14.23
Netherlands	3.68	5.17	6.71	8.10
Belgium	2.05	3.03	3.40	3.47
Denmark	1.99	2.77	3.50	3.06
Ireland	— (a)	0.69	0.58	0.40
Luxembourg	— (b)	— (b)	0.18	0.28
Total Community	70.54 (a)	102.08	106.39	92.11
of which: shares	4.36	5.04	5.39	3.83
bonds	4.23	4.64	3.30	1.99
short, medium and long-term credits	61.95	92.40	97.70	86.29

(a) Following an industrial dispute involving the banking system in Ireland, statistical material with respect to 1971 is not available for this table in a form comparable with later years. This has affected the total for the Community to a certain extent.
(b) Estimates for early years are incomplete.

As regards tackling the symptoms of inflation, the U.K. authorities continued to control the rise in prices through regulation of profit margins and through subsidies, to hold down prices on basic household products. But such supporting measures, including compensation for price restraint in the nationalised industries, began to add to the public sector's financial deficit.

A great deal was therefore left to monetary policy to accomplish. In the aftermath of the three-day working week, business demand for loans began to lessen and it looked for a while in the spring as if short-term interest rates might be turning downwards. By mid-year, however, it was no longer possible to contemplate a reduction in domestic interest rates in view of the rises that were occurring in other markets and of the need for balance of payments reasons to maintain an interest differential in favour of the United Kingdom. Thus, as an illustration of market conditions, the average yield on long-term government bonds rose from 12.37% at end-December 1973 to reach 17.39 per cent a year later, with relatively minor interruptions on the way.

The authorities in *Ireland* took a rather different view to the problem of inflation than in most other countries, the intent of monetary policy in 1974 having been to allow bank credit and the money supply to increase in line with the growth in value of Gross Domestic Expenditure. The fact that inflationary pressures were often imported from abroad led the monetary authorities to follow a middle course of neither allowing credit policies to aggravate domestically-induced inflation, nor so restricting credit as to add further to unemployment for the sake of controlling inflation. A limitation of credit to the personal, financial and property sectors was, however, in force from May of last year onwards.

Interest rates which in Ireland are particularly susceptible to the movement of comparable rates in the United Kingdom, rose progressively throughout the year for longer-term securities. Yields on fifteen-year government bonds rose from 12.33 per cent in December 1973 to reach a peak of 16.86 per cent twelve months later. However, short-term interest and deposit rates declined slightly from the very high peaks experienced in December 1973 and early in 1974, 3-month money on the inter-bank market retreating from 16.50 per cent in December 1973 to 13.94 per cent at the end of last year.

Monetary policy was very restrictive in *Italy* last year as the public authorities sought to regain equilibrium in the economy. Principal instruments of this policy were the import-deposit scheme, the reduced central bank purchases of government securities with a consequent effect upon liquidity creation, and the credit ceiling in force throughout the year but which was tightened considerably from end-March onwards. At the same time short-term interest rates were raised to very high levels. These policy actions contributed to an abrupt cessation of the excess demand that had prevailed in the first quarter of the year.

The government deficit for 1974 which was restrained below Lit. 9 200 milliards as part of the agreement with the I.M.F. in obtaining a stand-by credit, did not swell the monetary base as much as expected since the large external deficit absorbed some of the increase. Short-term interest rates reached very high levels during the year, with the rate on interbank deposits reaching a peak of 18.02 per cent in June, but yields on long-term government bonds remained relatively low, being 9.33 per cent at mid-year and rising to only 10.78 per cent in December.

Concern about the external trade position prompted the government to introduce an import scheme in May in which 50 per cent of the value of imports, with the exception of raw materials and later food, was deposited in a non-interest bearing account for six months with the Banca d'Italia. This had the effect not only of abruptly curbing non-essential imports but of further reducing bank liquidity.

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

As already noted in the previous section, bond markets were adversely affected by the sharp rise in short-term interest rates in 1974 and by uncertainties over the course of inflation. Most bond markets thus suffered a set-back as investors hesitated to commit their resources at long term and borrowers were reluctant to pay the high cost demanded of them. The markets in the Netherlands, Belgium and Denmark nevertheless managed to expand in 1974.

In share markets, a loss of confidence accompanied the trend towards economic recession in many of the Community countries and it became much more difficult to raise capital through equity issues. While the total of new share issues for the Community as a whole declined by 27 per cent last year, it is noticeable from Table 7 that companies in Germany, France, Belgium and Luxembourg went against the trend in increasing slightly the amount of capital raised from this source.

Corporate profitability came under pressure from several directions, principally from rising costs, price restraints and falling turnover towards the end of the year. For these reasons corporate profits in general did not rise in 1974 to the same degree as in the previous year. Where there were good increases in profits these were usually the result of stock appreciation (as in France and the United Kingdom) rather than through improved trading results.

There was no discernible pattern as to the growth of personal savings among the Community countries last year. In the majority there was a satisfactory increase in savings, with a minority of countries experiencing a decrease. However, in view of the interest advantage available on shorter-term time deposits there was a continuation of the trend in previous years to prefer such deposits to traditional savings deposits. Taking all market and banking sources of finance together (see Table 5) the United Kingdom and Italy, both of which experienced serious balance of payments difficulties, evidently suffered most from the adverse financial climate of 1974. These countries were followed by Germany, Denmark and Ireland where perhaps the main influence was a fall in the demand for finance rather than its availability. On the other hand, Luxembourg, Belgium, the Netherlands and France seem to have weathered the difficult conditions fairly well.

In view of the growing inflationary pressures in the *United Kingdom* personal savings performed surprisingly well, increasing by about 23 per cent from a year earlier. As a proportion of personal disposable income, savings rose to 12.4 per cent compared with 11.3 per cent a year earlier. However, personal savings in the form of new bank and building society deposits declined by 4.8 per cent in 1974, as a portion of the savings flowed into local authority short-term debt. Company profits (excluding stock appreciation) arising from U.K. operations were reduced by 19 per cent last year with most of this decline the result of the shortened work week in the first quarter. Nevertheless, the increase in profits from stock appreciation and from operations abroad ensured that net after-tax corporate income, prior to providing for depreciation, rose by 15 per cent. The squeeze on company liquidity that developed during the year arose from the need to finance the inflated cost of capital expenditures and the increase in the cost of holding stocks. In the manufacturing, mining and oil industries the value of capital investment at current prices increased by 39 per cent last year and financing requirements certainly exceeded the available income. For industrial and commercial companies as a whole the financial deficit rose from just over £ 500 million in 1973 to £ 3 600 million in 1974. For the most part this deficit was financed through net bank borrowings which, after discounting the counterbalancing growth of bank deposits, rose by 126 per cent in 1974 compared with the previous year.

It should be recalled that a feature of 1973 was the extent of arbitrage operations taking advantage of the temporary inverse relationship between bank loan and large deposit interest rates. These arbitrage operations artificially raised both gross bank lending and the increase in deposits in that year; likewise the unwinding of these operations noticeably reduced the growth of these totals in 1974. As a result, the gross amount of new credit made available by the banking sector to the U.K. private sector declined by 32.6 per cent last year compared with the flow of new credit in the previous year.

New mortgage loan activity was severely reduced in the first half of 1974 and the Building Societies suffered a trying year. The inflow of funds was reduced in the first quarter to only 32 per cent of the amount in the corresponding period of the previous year, and in the second quarter the U.K. public authorities intervened to make available up to £ 500 million in loan facilities. As a result of this assistance and the improved inflow of funds from normal private sector sources in the second half of the year the total of gross new mortgage advances was reduced by only 21.6 per cent for the year as a whole. The public sector borrowing requirement, which includes the financing needs of public enterprises, was exceptionally large in 1974. Its impact on the domestic market was reduced by external borrowing by nationalised enterprises and by a \$2.5 milliard credit negotiated on the euromarket by the central government (via domestic banks) of which about half was used in 1974. A substantial volume of finance was also obtained from abroad by the private sector (see Table 10).

The decline of share values on the stock exchange greatly inhibited the functioning of capital markets in the United Kingdom last year, as in 1973. Net new issues of equity capital declined by 14 per cent even from the depressed levels of the previous year. While uncertainty as to future business prospects and

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

(milliard units of account)

Type of Securities	1971	1972	1973	1974
Shares	**5.31**	**6.94**	**6.61**	**4.85**
of which:				
Credit institutions	0.95	1.90	1.22	1.02
Enterprises	4.36	5.04	5.39	3.83
Bond issues	**30.71**	**26.91**	**36.69**	**22.41**
of which:				
Public authorities	14.88	6.64	12.21	5.45
Credit institutions	11.60	15.63	21.18	14.97
Enterprises	4.23	4.64	3.30	1.99
Total Community	**36.02**	**33.85**	**43.30**	**27.26**

profitability were at the root of the problem in equity markets, the very high long-term rates of interest prevailing during the year were equally a debilitating factor in the market of fixed interest securities of the private sector. New loan issues by listed U.K. public companies were almost non-existent and redemptions of existing loans exceeded the raising of new capital.

The amount of new savings available to the *Italian* economy in the form of the increase in savings deposits with banks and savings institutions rose by 24.8 per cent in 1974, about in line with the inflation rate. Within this overall gain, however, there was a marked shift towards more liquid short-term deposits as a result of the uncertainties experienced during the year. Rates of interest on bank deposits in Italy rose sharply during the course of the year and, for demand deposits, stood at an average of 10 per cent in December (and in some cases much higher) compared with only 4.7 per cent a year earlier. This more attractive rate of return tended to drain small investors funds away from securities markets into bank deposits. Corporate profitability which was no doubt quite healthy at the beginning of the year owing to the good output performance at that time, turned downwards with the softening of the economy and despite the ending of the price freeze at mid-year.

There was a very substantial decline in new bond issues by all categories of borrower in 1974. Total new bond issues on Italian markets declined in 1974 to only one-third the amount of the previous year. Within this total, new bond issues by public and private enterprises were 88 per cent lower last year than in 1973. For the most part this was due to the virtual withdrawal of private investors from the Italian market which thus resulted in unfavourable conditions for new issues. In 1973 private investors had taken up some Lit. 1 400 milliard of new bonds; last year, however, there was net dis-investment by private investors to the extent of some Lit. 1 700 milliard. To counter this weakness in the market the monetary authorities at end-June increased by a further 3 per cent, to 12 per cent, the proportion of the banks' total deposits against which they were required to hold bonds issued by the specialised credit institutions. The amount of new share capital raised last year was also much lower than in 1973 owing to the reduced expectations for economic growth and the general loss of confidence that took place. New share issues were more than 60 per cent lower in 1974.

At the beginning of the year a 12 per cent ceiling limiting the annual growth of credit in Italy was already in existence but applied only loosely to certain categories of short-term credit. While this ceiling was raised to 15 per cent for twelve months to end-March 1975 (and 8 per cent growth for the six months to end-September), it was nevertheless applied more rigidly to all categories of borrower, excluding only small industrial enterprises and certain utilities. Moreover certain other circumstances prevailing during the year tended to reinforce the restrictive effects of this credit ceiling. In May the import deposits scheme was introduced (covering about 40 per cent of imports) and this syphoned off a large amount of the available credit growth, since funds had to be deposited with the Banca d'Italia. Importers often could not obtain the necessary finance from abroad as the banks were required to withhold credit backing for such short-term external borrowing. Furthermore, it can be appreciated that a 15 per cent ceiling on credit growth at a time of price inflation of about 25 per cent per annum placed severe constraints on the economy.

As a result of the crisis in the bond market and the restrictions on credit availability, new loans by the financial intermediaries declined by 10.5 per cent in 1974. Within this overall decline there was some swing towards shorter-term credits, the flow of which increased by some 32 per cent last year.

In order to protect the external reserves while the new restrictive policies were beginning to take effect a series of major international credits were arranged for Italy including SDR 1 milliard from the I.M.F., $1.7 milliard from the Community and about $2 milliard from Germany. Additional foreign exchange was obtained, at least in the first half of the year, by the requirement of the public authorities that State enterprises borrow as much as possible, even in excess of their own needs, in capital markets

Table 7 — **Share issues by country**

(milliard units of account)

Country	1971		1972		1973		1974	
Germany	**1.29**		**1.18**		**1.08**		**1.17**	
Credit institutions		0.26		0.39		0.33		0.32
Enterprises		1.03		0.79		0.75		0.85
France	**1.45**		**1.67**		**1.88**		**1.91**	
Credit institutions		0.26		0.38		0.44		0.34
Enterprises		1.19		1.29		1.44		1.57
United Kingdom	**0.63**		**1.66**		**0.32**		**0.25**	
Credit institutions		0.25		0.94		0.08		0.15
Enterprises		0.38		0.72		0.24		0.10
Italy	**1.56**		**1.96**		**2.80**		**0.95**	
Credit institutions		0.05		0.12		0.21		0.07
Enterprises		1.51		1.84		2.59		0.88
Netherlands	**0.04**		**0.02**		**0.05**		**0.03**	
Credit institutions		0.01		—		0.03		—
Enterprises		0.03		0.02		0.02		0.03
Belgium	**0.28**		**0.37**		**0.33**		**0.42**	
Credit institutions		0.11		0.04		0.07		0.05
Enterprises		0.17		0.33		0.26		0.37
Denmark	**0.05**		**0.05**		**0.10**		**0.05**	
Credit institutions		0.01		0.02		0.04		0.02
Enterprises		0.04		0.03		0.06		0.03
Ireland	**0.01**		**0.03**		**0.03**		**0.02**	
Credit institutions		0.00		0.01		—		0.02
Enterprises		0.01		0.02		0.03		0.00
Luxembourg	**0.00**		—		**0.02**		**0.05**	
Credit institutions		0.00		—		0.02		0.05
Enterprises		0.00		—		0.00		0.00
Total Community	**5.31**		**6.94**		**6.61**		**4.85**	
of which:								
Credit institutions		0.95		1.90		1.22		1.02
Enterprises		4.36		5.04		5.39		3.83

abroad. There was also a considerable inflow of private long-term capital.

The reduction in the amount of finance provided by the capital market and the banking system in *Germany* had a different origin from those of the two countries described above. Owing to the low level of economic growth and investment last year there was little evidence of any shortage of funds for financing corporate investment, despite the initially restrictive monetary policy followed by the authorities and the undoubted profits squeeze engendered by rising input costs. Net retained income of enterprises (excluding certain financial intermediaries) was reduced in 1974 to only 20 per cent of the amount available in the previous year. Nevertheless, depreciation provisions were higher in absolute amount so that

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

(milliard units of account)

Country (1)	1971	1972	1973	1974
Germany	**5.55**	**9.26**	**8.37**	**8.26**
Public authorities	0.33	0.62	1.13	0.68
Credit institutions	4.19	7.67	6.85	6.96
Enterprises	1.03	0.97	0.39	0.62
France	**2.94**	**3.31**	**4.97**	**2.55**
Public authorities	−0.04	0.47	1.25	0.02
Credit institutions	1.45	1.53	2.33	1.54
Enterprises	1.53	1.31	1.39	0.99
United Kingdom	**9.32**	**−0.33**	**3.23**	**1.24**
Public authorities	8.66	−1.09	3.12	1.29
Credit institutions	0.17	0.21	0.05	0.08
Enterprises	0.49	0.55	0.06	−0.13
Italy	**8.00**	**9.29**	**14.51**	**4.26**
Public authorities	3.62	4.21	4.47	1.50
Credit institutions	3.57	3.88	8.88	2.64
Enterprises	0.81	1.20	1.16	0.12
Netherlands	**0.78**	**0.78**	**0.49**	**0.84**
Public authorities	0.37	0.28	0.12	0.29
Credit institutions	0.23	0.18	0.30	0.40
Enterprises	0.18	0.32	0.07	0.15
Belgium	**2.64**	**2.76**	**2.88**	**2.95**
Public authorities	1.79	2.07	2.03	1.62
Credit institutions	0.66	0.44	0.64	1.09
Enterprises	0.19	0.25	0.21	0.24
Denmark	**1.34**	**1.71**	**2.18**	**2.27**
Public authorities	0.01	−0.01	0.05	0.01
Credit institutions	1.33	1.72	2.12	2.26
Enterprises	−0.00	−0.00	0.01	0.00
Ireland	**0.14**	**0.12**	**0.05**	**0.05**
Public authorities	0.14	0.09	0.05	0.05
Credit institutions	—	—	—	—
Enterprises	—	0.03	—	—
Luxembourg	**0.00**	**0.01**	**0.01**	**−0.01**
Public authorities	0.00	0.00	−0.01	−0.01
Credit institutions	0.00	0.00	0.01	−0.00
Enterprises	0.00	0.01	0.01	−0.00
Total Community	**30.71**	**26.91**	**36.69**	**22.41**
Public authorities	14.88	6.64	12.21	5.45
Credit institutions	11.60	15.63	21.18	14.97
Enterprises	4.23	4.64	3.30	1.99

(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.

internal resources available for financing investment decreased by only 3.5 per cent last year. Since capital investment expenditures (excluding certain financial intermediaries) decreased by 9.5 per cent during 1974, the effective self-financing ratio of German enterprises was raised quite substantially to 80.2 per cent of requirements as against 75.1 per cent in 1973. A significant factor in the relative liquidity of the enterprise sector last year was that investment expenditures tended to be lowered even faster than the decline in internal resources.

In contrast, the pressures on the public authorities in Germany to alleviate the social impact of the economic recession, seen most clearly through the rise in the numbers of unemployed, resulted in a swing in the Government's accounts from financial surplus in 1973 to a heavy deficit in 1974. This swing arose from a greater emphasis on counter-recessionary programmes and from wage inflation in the current expenditures as well as from a large rise in capital expenditures.

The financial deficits of enterprises and the public authorities were met in part by the capital markets. After allowing for redemptions, net new bond issues by the public authorities in the long-term German capital market raised 45 per cent less than in 1973. Much of this decline, however, was offset by a sharp increase in federal savings bonds' issues, which offered an attractive yield for a short maturity period. At the same time the increased government financial deficit required heavier recourse to bank loan financing. The amount of bonds issued by public enterprises represented an increase of 25.9 per cent from the previous year. On the other hand, private non-financial enterprises continued to redeem part of their bonded debt while credit institutions issued a net amount of DM 20 990 million in 1974, a figure of 8.75 per cent below the previous year.

Private savings increased by 14 per cent in 1974. The lower rise in consumption expenditures than in disposable incomes, a concomitant factor in the economic slowdown in Germany, reflected a greater propensity to save. These additional funds available to the financial system in 1974 were, to a larger extent than in the previous year, directed towards increasing loans to the public authorities, while the balance of payments surplus on current account tended to raise the net external assets of the German banks. Enterprises enjoyed adequate liquidity in 1974 and took on the financing of a large part of foreign trade without recourse to borrowing from domestic banks. New bank credits, net of repayments, made available to the domestic private sector declined by about 25 per cent in 1974. But it will be recalled that with an appreciably higher self-financing ratio, the borrowing requirements of enterprises were rather lower last year than in 1973. On the other hand, bank lending to the domestic public authorities rose by 90 per cent last year and was an important element in the funding of public sector financial deficits.

In *Denmark* the availability of funds from the private sector in support of the investment programme was hampered last year by a number of adverse pressures. In the corporate sector the combination of fast rising wage costs and some limitation on passing on the whole of these extra costs, impaired the ability of companies to finance investment from internal sources. In the second half of 1974, the sharp contraction in consumer demand and industrial production no doubt reduced profits even further. The growth of bank deposits, often used as an indicator of personal savings, declined sharply for most of the year but recovered in the closing months; nevertheless, the flow of new deposits to the banking system for 1974 as a whole, was 20 per cent down on the previous year. The upturn in deposit growth in the last quarter of the year may, in part, have been due to the scheme of obligatory savings which was introduced by the Danish authorities early in the year, but which took effect as from October. In addition, the fiscal measures taken by the authorities may to some extent have increased the propensity to save through discouraging consumer expenditures. It is also possible that there was some precautionary saving in the face of a threat of rising unemployment.

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

The flow of savings into the bond market, however, declined sharply in 1974, the supply of funds for new bond issues from business and private investors, insurance and pension funds being reduced by one-third compared with the previous year. A discouraging factor was undoubtedly the steep fall in bond prices which was the counterpart of the rise in interest rates during the first seven months of the year. In contrast the Danmarks Nationalbank and social security funds more than doubled their participation in taking up new bond issues. The net result was that in total, new non-government bond issues declined by 2.3 per cent last year compared with the 26 per cent gain in 1973. The stock market was likewise under the pressure of falling prices and new share issues declined to less than half the amount in the previous year (although new share issues are relatively unimportant compared with the very large bond market). Foreign capital inflows, in contrast, have assumed some importance in recent years and in 1974 they were 12 per cent higher than in the previous year at an estimated D. kr. 5.8 milliards. One reaction to the difficulties, including the high cost, of obtaining finance last year was the increase in business and commercial loans negotiated from foreign sources.

As far as the domestic banks were concerned, the fixed ceiling on their lending commitments remained in force until August after which there was a gradual easing. Inconvenient as this ceiling was during a period in which inflation was adding to the nominal value of financing requirements, it was still possible for customers to obtain credit, if at high cost, against existing commitments. However, bank lending was also limited by a liquidity shortage as was evidenced by the failure of their deposits to grow during the first nine months of 1974 and their extensive recourse to borrowing facilities at the Danmarks Nationalbank. Under these influences the amount of new credit extended to the non-governmental sector by the commercial and savings banks contracted sharply in 1974, being 48 per cent lower than in the previous year.

In *Ireland* the supply of funds through the banking system is more important for the financing of investment than securities markets. Last year, the flow of savings available to the Irish financial system, as expressed by the increase in bank and other deposits in relation to the rise in the previous year, showed a small four per cent decline in the twelve months to December. This relatively stagnant tendancy of savings was perhaps the result of the contraction in agricultural incomes during the year. On the other hand, company profitability was not likely to have been greatly affected until the fourth quarter at which time industrial output, retail sales and industrial exports were all on a downward trend as activity generally slackened.

Fiscal policy was clearly expansionary last year with the Irish government borrowing requirement rising substantially, mainly because of higher government capital expenditures. Subscriptions received for the annual National Loan issued by the government increased by 30 per cent last year. However, a major portion of the Irish government's borrowing requirement was met through financing from abroad—involving an increase in gross external borrowing of over £ 160 million. The size of these borrowings can be better appreciated when comparison is made with the annual National Loan issue on domestic markets which attracted £ 28 million of new capital. Share issues by non-financial enterprises raised 38 per cent less capital last year, no doubt partly the result of depressed share markets.

The availability of bank credit, and the demand for it, was very strong in the early months of 1974 and at this time there was some squeeze on the liquidity of the banking system, with the banks being forced to make increased use of central bank rediscount facilities. From the second quarter onwards, however, the demand for bank credit in Ireland eased and there was a consequent growth of bank liquidity. For 1974 as a whole, new bank credit made available to the private sector declined by 17 per cent compared with the supply of new credit in the previous year. However, the

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	1971	1972	1973	1974	of which: funds raised through security issues by credit institutions			
					1971	1972	1973	1974
Germany	21.31	28.84	26.56	23.25	4.45	8.06	7.18	7.28
France	14.20	19.49	19.29	21.49	1.71	1.91	2.77	1.88
United Kingdom	9.09	20.70	20.93	13.83	0.42	1.15	0.13	0.23
Italy	10.24	12.71	17.22	13.23	3.62	4.00	9.09	2.71
Netherlands	3.47	4.83	6.62	7.92	0.24	0.18	0.33	0.40
Belgium	1.69	2.45	2.93	2.86	0.77	0.48	0.71	1.14
Denmark	1.95	2.74	3.43	3.03	1.34	1.74	2.16	2.28
Ireland	— [a]	0.64	0.55	0.40	0.00	0.01	—	0.02
Luxembourg	— [b]	— [b]	0.17	0.28	—	—	0.03	0.05
Total Community	61.95	92.40	97.70	86.29	12.55	17.53	22.40	15.99

[a] Following an industrial dispute in 1970 involving the banking system in Ireland, statistical material on credits is not available for the year shown. This had affected the total for the Community to a certain extent.
[b] Estimates for early years are incomplete.

private sector, like the public authorities, made much more extensive use of financing from abroad than in the previous year. Net capital inflows to the private sector from abroad totalled about £ 118 million in 1974 compared with only £ 48 million in the previous year. New financing made available by the Irish Building Societies slackened last year compared with 1973. This reduced activity seems to have been due to a slowing in the inflow of funds resulting from the lower interest rates offered on deposits and shares with the Building Societies than sometimes available elsewhere.

For the greater part of 1974 *Luxembourg* experienced relatively stable financial conditions. The ability of business enterprises to increase their capacity for self-financing undoubtedly followed the broad trend of business activity in Luxembourg. The appreciable rise of product prices in the steel industry and the strong sales position prevailing until autumn of last year contributed to improved profitability. But in the final quarter of 1974 there was a deterioration in market conditions in the steel and chemical industries and, in early 1975, the onset of price competition for the fewer orders that were available.

There was a clear demarcation between the first three quarters of last year when the supply of funds was abundant and investment demand yet expansive, and the period from October onwards into early 1975 when the stagnation of the economies of Luxembourg's trading partners was becoming more pronounced and business pessimism was growing. This differentiation between the two periods was hallmarked by the trend of savings retained in the form of bank deposits. The flow of new savings in time and savings deposits increased in the twelve months to October 1974 by 124 per cent in relation to the previous year. But from October onwards and into the early months of 1975, there was net dis-saving, taking seasonal influences into account, as the amount outstanding of these deposits declined. The restrictions on mortgage credit in force throughout 1974 brought about a 6.7 per cent decline in the value of new mortgage loans granted last year.

Financing trends in *Belgium* were also less affected by external developments or the cyclical downturn than in most other countries. The availability of internal funds for the financing of investment by corporate enterprises was determined last year to a large extent by the trend of industrial activity. As a result of the strong sales expansion in the first half of 1974 and the gains from stock appreciation, profits gained significantly during this period. In the second half of the year, however, a number of factors such as the slowing of the economy, the extension from three months to six months for the prior notification of price increases, and the pressures of price-linked wage costs, took their toll on profitability. For the year as a whole, non-agricultural business profits in Belgium rose more slowly than in 1973 while farm incomes suffered from lower produce prices.

In the latter past of 1974 there was an attempt to stimulate savings which earlier had been depleted by a buying surge on the part of consumers. This was done both through higher rates of interest on savings deposits and through tax concessions. Nevertheless, personal savings as measured by the flow of new savings and time deposits, decreased by 30 per cent in 1974 compared with an increase of 16 per cent in the previous year.

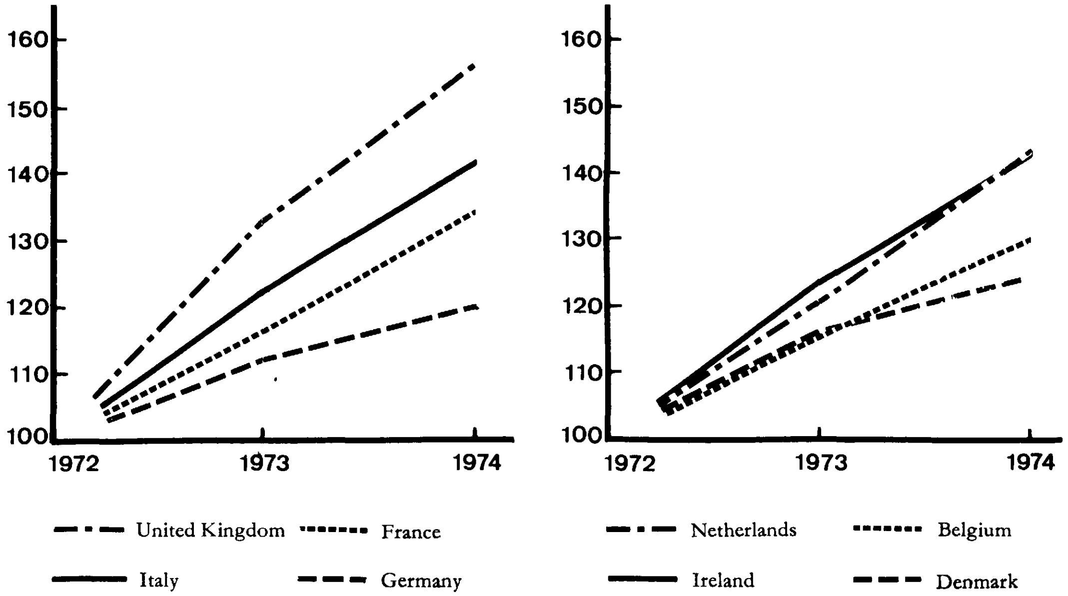
New credit made available by Belgian financial intermediaries declined by 7 per cent last year following a 26 per cent increase in 1973. This moderate decline can be attributed in part to the ceiling on the growth of new credit and in part to the general slackening of activity in the second half of the year. The structure of interest rates also played a role in limiting the demand for credit last year, since the cost of new loans granted by financial intermediaries was markedly higher than in 1973.

Net new bond issues by enterprises on the Belgian market rose by 44 per cent last year, compared with a gain of 24 per cent in 1973; issues by financial intermediaries accounted for much of this increase. There was however a contraction in the amount of new bond issues on behalf of public sector borrowers which were 26 per cent down in 1974 from a year earlier. Share markets were quite active with the value of new issues exceeding that in 1973 by 19 per cent. This resilience was the more unusual in view of the decline in share values during the year.

The relatively low profile of investment activity in the *Netherlands* last year was rather similar to that of Germany but the pattern of financing bore a closer resemblance to that of Belgium. The flow of new savings to the Dutch economy, as evidenced by new savings and time deposits, declined by about 27 per cent in 1974 compared with the exceptionally large flow of such new savings in the previous year. It has to be noted that time deposits are normally regarded as falling within the wider definition of the money supply because they represent, in large measure, a reserve of liquidity for enterprises which use them to finance capital investment in a cyclical upturn. However, the relative shift from placing funds in traditional savings deposits to placing them in higher yielding time deposits which continued in 1974 may have been only a temporary phenomenon which developed in response to the interest rate differential. In time this movement could be reversed and thus the growth of time deposits in 1974 may well have represented genuine saving. The overall availability of self-generated funds for the Dutch corporate sector was probably reduced somewhat last year despite the 16 per cent rise in depreciation provisions by enterprises. The maintenance of a price freeze last year with provisions for passing on only certain specified costs, and those only after a delay, no doubt squeezed profit margins in the Netherlands at a time of rising costs of raw material inputs. In addition labour costs for industry as a whole were estimated to have risen by 15 per cent in 1974.

However, any shortfall in the availability of self-financing for enterprises last year was at least in part made up by increased recourse to the capital markets. For the purposes of this study, issues of debt certificates (onderhandse leningen) are not treated as bond issues in the Netherlands, but as part of the credit extended by financial institutions to enterprises. As these debt certificates far exceed the total of bond

Chart IV — Growth of bank and other credits outstanding to the non-government sector*
Index: Dec. 1972 = 100



* This chart demonstrates the growth in amounts of credit outstanding.
Elsewhere in the text and in the tables, the amounts specified are for *new* credit, after allowing for repayments, rather than amounts outstanding.

issues, the importance of the latter in the financing of investment in the Netherlands should not be exaggerated. This observation applies to the 32 per cent increase in 1974 in bond issues by the private sector, including financial institutions. Net bond issues by local authorities increased by 63 per cent while the central government passed from a net reduction of bonds in 1973 to raising a small amount in 1974. A noticeable feature of 1974 was the decline in the net outflow of portfolio capital from the Netherlands. In part this was due to the inflow of funds following the abandonment of the "O-guilder" bond circuit, and in part to a reduced demand for foreign securities. Borrowings by multi-national companies would also have shown up in the balance of payments statistics as a capital inflow but, because the proceeds may only be spent outside the Netherlands, these borrowings had no effect on the domestic economy.

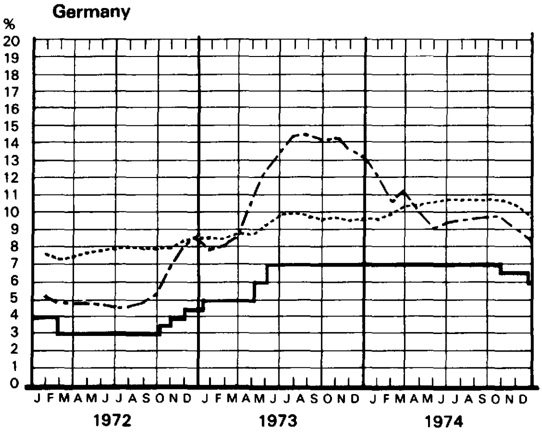
It is probable that the high interest charges on bank loans in the Netherlands last year, ranging from 11.75 per cent to 14 per cent during the third quarter, according to the class of borrower and type of credit, caused some postponement of marginal investment plans. This may have been true of credits against mortgage debt certificates on which the base rate of interest rose from 9.5 per cent in December 1973 to 12.0 per cent in the third quarter of last year. Thus, the flow of new credit to enterprises against debt certificates showed a small fall in 1974 of around two per cent. Similarly, the flow of new credit from the commercial banks declined from an exceptionally high level in 1973. Taking all forms of credit together, it seems that they were ample enough not to have constrained the financing of investment.

Pressures on the financial system in *France* were less severe than elsewhere in the Community. Nevertheless, the existence of a pattern of high interest rates, which for medium-term credits ranged from 13 to 16.5 per cent from the second quarter onwards, tended to deter borrowers from taking on longer-term loans. Instead, borrowers increased their new short-term indebtedness, particularly in the form of borrowing in foreign exchange, the annual rate of growth of which almost tripled, in the expectation that interest rates would eventually turn downwards. The total of new credits made available to the French economy, however, showed an increase of only about 11.4 per cent last year. In the first half of 1974 the demand for new credit had been strong but the falling off of economic activity in the later months caused a contraction of new credit business. Nevertheless, the high rate of price inflation resulted in a business sector external financing requirement totalling about FF 30 milliard last year, of which only about FF 24 milliard was financed from identifiable domestic sources. As a result funds made available to French borrowers from foreign sources were an important element in financing investment last year. The inflow of long-term capital from non-residents doubled in 1974 to FF 14 900 million. Much of this amount was in the form of direct investment, especially for property development, but also there was a sizeable inflow of long-term business loans.

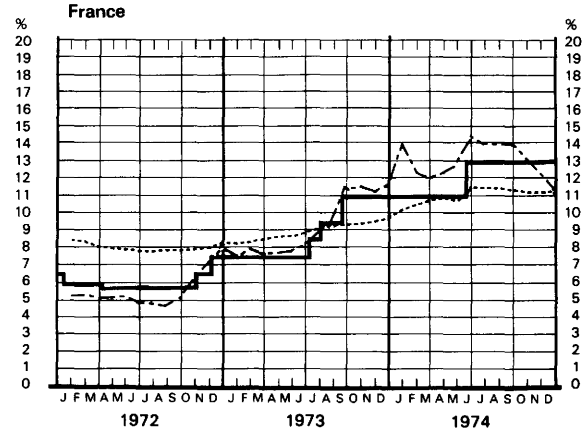
Savings under the management of the banking system, namely those in the form of new savings and term deposits, increased by around 17.9 per cent last year. Nevertheless, estimates indicate that the rate of personal savings as a proportion of disposable income in France declined from 17.8 per cent in 1973 to about 17.2 per cent last year. Direct investment in new housing by individuals was estimated to have declined somewhat in real terms while increasing in value at current prices. Corporate profitability no doubt followed the trends in the overall economy, being particularly strong in the first half of the year but weakening, particularly in the fourth quarter, as industrial output and sales declined. Gross trading profits by French private and public enterprises (including stock appreciation) rose by about 17 per cent in 1974; excluding stock appreciation the increase was only 10 per cent. The need to finance much higher values of stock weighed heavily on the self-financing ratio which for private sector companies declined from 62.6

Chart V — Short and long-term interest rates

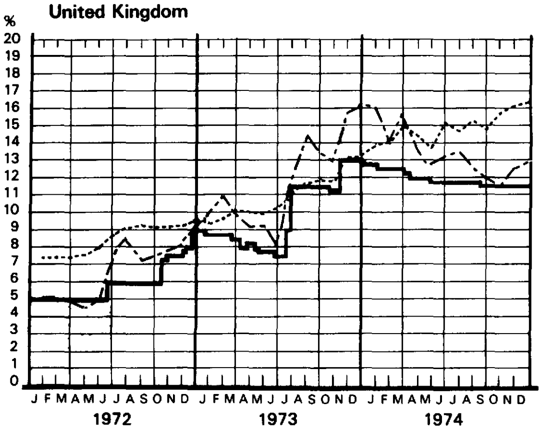
Germany



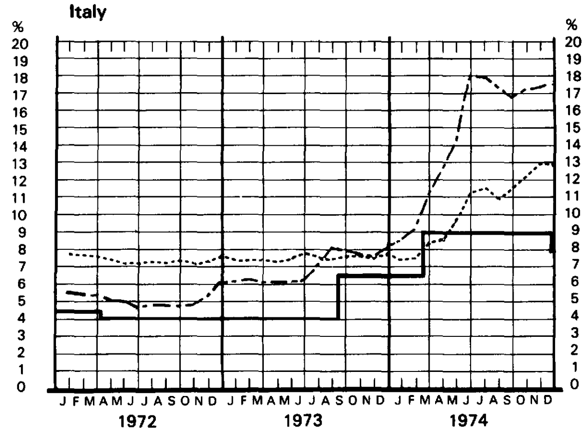
France



United Kingdom

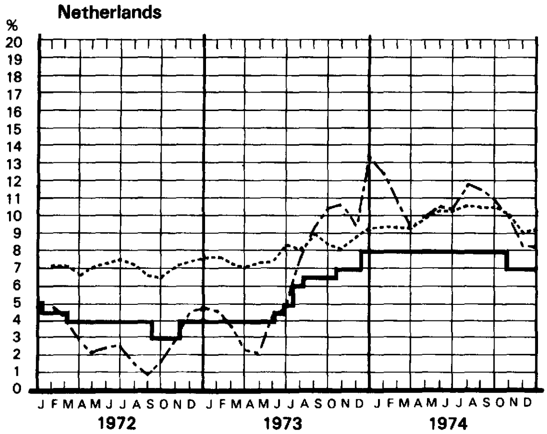


Italy

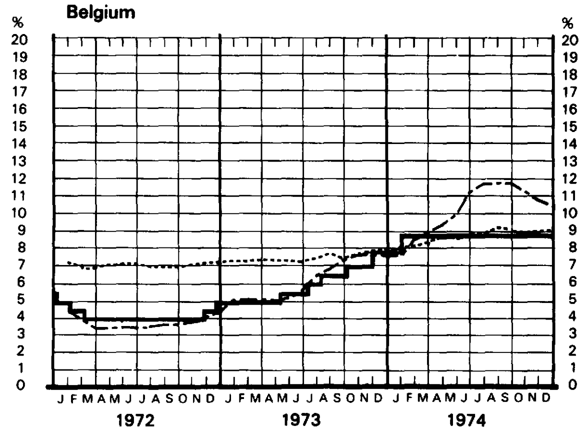


International European Market ($)

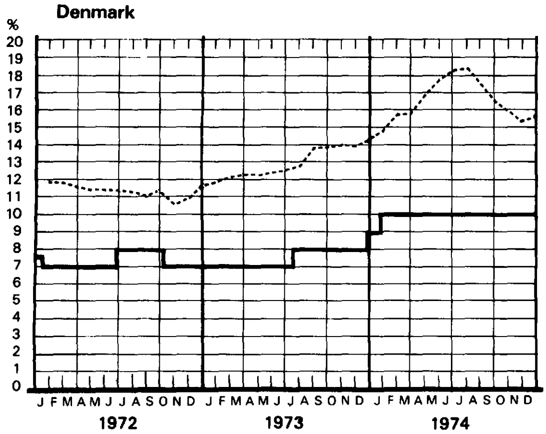
Netherlands



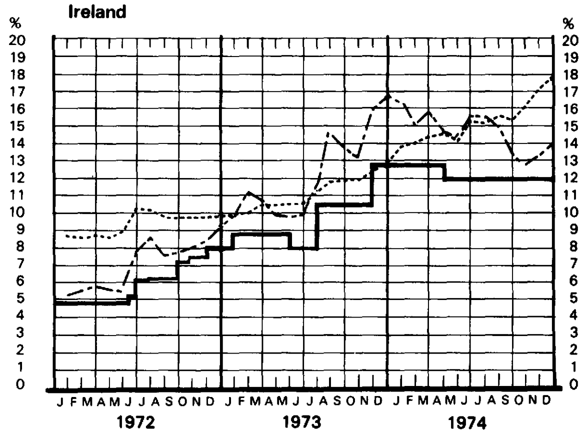
Belgium



Denmark



Ireland



——— Official discount rate — · — · — Short-term interest rate on the money market (1) ············ Gross yield of bonds (2)

(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.

per cent in 1973 to 58.5 per cent in 1974. The self-financing ratio for public enterprises was less affected and declined only from 74.3 to 73.8 per cent between 1973 and 1974 respectively.

A feature of the French bond market in 1974 was the decline in net new issues by the financial institutions of the private sector. In recent years there has been a trend towards financing, by means of bond issues, a portion of new long-term credit provided by institutions specialising in this form of lending to the economy, but in 1974 the special financial institutions became temporarily less willing to lend and their need for finance was correspondingly reduced. As a result total new bond issues by financial institutions on the French market declined by 34 per cent last year (but it should be added that in 1975 the institutions vigorously resumed their lending and borrowing operations). Similarly, it was the gloomy outlook, rather than the high cost of borrowing, which led to a reduction in new issues by non-financial enterprises of 28.5 per cent. Compared with the large amount of bond issues totalling almost FF 7 milliard in 1973, new issues by the public sector last year were almost non-existent and the authorities resorted to the banking system on a larger scale. New share issues increased marginally last year by 2 per cent, which was a better performance than might otherwise have been expected in view of the decline in share prices during the year.

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

There was a sharp contraction of new public debt issues by Community borrowers on the Swiss market in 1974; gross new issues totalled F.S. 422 million (134 million units of account), a decline of almost 50 per cent from the previous year. The principal reasons for this decline were the restrictions on bond placings enforced by the Swiss monetary authorities during the year. For the months of February and March the total of foreign bond issues denominated in Swiss Francs was limited to F.S. 240 million. Within this total for those two months, Community borrowers issued bonds worth F.S. 134 millions.

Later, at end-May, the Swiss monetary authorities suspended all capital exports and issue markets were effectively closed to foreign borrowers until September. For the months of September and October the permitted amount of foreign bond issues was again limited to F.S. 240 million and this authorised limit was further reduced to F.S. 200 million for the last two months of the year. Community borrowers in fact took up F.S. 140 million of the new bond issues allotment for November and December.

These restrictions certainly curtailed the amount of foreign bond placings on the Swiss market in 1974, the total of gross new issues declining to F.S. 1 011 million compared with F.S. 2 876 million in 1973. Community borrowers thus took about 42 per cent of all foreign bond issues authorised on the Swiss market in 1974, with the majority of activity taking place at the beginning and the end of the year. The attraction of the Swiss market to borrowers was the generally lower interest rates payable on borrowed funds, an advantage which was tempered by the prospect of higher repayment costs derived from a rising currency exchange value.

As from 29 January 1974 the controls on the outflow of capital from the United States were suspended, thus opening up the possibility of non-resident borrowers seeking capital on U.S. markets. Certain obstacles remained, however, to potential borrowers in that the U.S. Securities and Exchange Commission regulations had to be met and a rating obtained on the credit-worthiness of bonds to be issued. These obstacles delayed the re-commencement of bond issues by non-resident borrowers until the fourth quarter of last year. In November, the European Coal and Steel Community made a $100 million bond issue (rated triple A) with a 5-year maturity, and which carried a coupon of

8.75 per cent. It is worth noting that at the time of issue, a borrower would have had to concede a rather higher rate of interest on most other issue markets. At the same time the evidence seems to suggest that a triple A rated non-resident borrower on the U.S. bond market is required to offer a slightly higher return to investors than a similarly rated domestic borrower.

While in 1974 there was only one bond issue by a Community borrower on the U.S. market, this situation has been improved in the current year. Though difficulties remain, the U.S. capital market might be regarded as a potential source of funds for companies and institutions based in the Community.

Capital raised on the Swiss and U.S. markets by borrowers resident within the Community would normally be included in the statistics assembled in Table 10. These statistics illustrate the very substantial capital flows between countries. Last year in particular, many Community countries made it official policy to borrow funds abroad on a very large scale and to encourage private enterprises to follow suit, in the expectation that large current account deficits would be incurred. It should be noted that intra-Community capital movements are included within the figures shown in Table 10.

Table 10 — **The contribution of external capital flows to domestic financing (1), 1974**
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	+ 498			+ 323	−508	+601	+ 85	n.a.
Net portfolio investment incl. loans	−2 136	+1 953	+1 923	+2 101	− 75	−687	+241	n.a.
Total private long-term capital flow	−1 638	+1 953	+1 923	+2 424	−583	− 86	+326	+222 (2)
Public sector long-term capital flow, incl. loans, total	− 266	− 394	+1 048	+1 625	−208	−134	+ 99	+451
Short-term capital flow total (3)	−6 544	+3 262	+1 128	−1 515	+ 41	−410	+396	n.a.
Total Capital Account of Balance of International Payments (4)	−8 448	+4 821	+4 099	+2 534	−750	−630	+821	+673

(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 sector.
(2) Includes short-term capital flow.
(3) Includes net external position of the private banking sector, except for Denmark.
(4) Residual error has been excluded except for Ireland and Denmark.

CHAPTER 3

INTERNATIONAL CAPITAL MARKETS

3.1. THE CONTRAST BETWEEN THE LONG-TERM BOND MARKET AND THE MARKET IN MEDIUM-TERM INTERNATIONAL CREDITS

If the public bond issues placed on behalf of non-residents by "domestic" banking syndicates shown in Table 11 are grouped together with those placed by international syndicates, it will be seen that the international bond market underwent a further contraction during 1974 of the order of 60%. The year began well enough for bond issues denominated in dollars and there were brief periods in the spring when hopes were engendered of a revival in issues denominated in other currencies or in European units of account only to be dashed by the emergence of a very large interest differential in favour of short-term interest rates. The reverse yield differential between dollar euro-bonds and three-month euro-dollar deposits was at its highest, rather more than 3%, in June and was not eliminated until the fourth quarter.

Thus investors were attracted away from bond markets for a large part of the year by high short-term interest rates and for the same reason bond dealers found it too costly to finance inventories of bonds. When bond markets finally began to revive in the fourth quarter, their character had altered in that the maturities of new issues were appreciably shorter, being in the five to seven year range or about half the term that had come to be regarded as normal for the euro-bond market, and the amounts of individual issues were smaller.

The pattern of developments in the market in medium-term international credits was practically the mirror-image of that of the bond market. About 70% of these international credits were contracted during the first half of the year, with the second quarter alone accounting for 45% as countries confronted with huge balance of payments deficits, largely as a result of the increase in petroleum prices, sought to provide for their financing. The market began to show signs of indigestion after mid-year but nevertheless increased in 1974 as a whole by 24% over the previous year's figure. It should be explained that these statistics of medium-term credits are derived from World Bank sources and are related to contracts and thus tend to over-emphasise the activity in the first half of the year; the drawing down of the credits would have continued well beyond mid-1974.

The amounts raised through bond issues, on the other hand, are recorded at the time the issues are made. A change has, however, been made in this study from the practice adopted in earlier studies on the same theme, in combining in the same tables issues placed by national banking syndicates on behalf of non-residents with those placed by international syndicates. This is because national syndicates have been tending more and more to invite the co-operation of international banks in handling issues which they formerly handled exclusively themselves. The conventional distinction has thus become less and less meaningful but for the time being it has been preserved in the two columns of Table 11.

Examples of the changed coverage of the statistics are:

— 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, ARCRU, and other multiple currency issues).

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

The rise in short-term interest rates up to the third quarter of 1974 which had such an adverse effect upon international bond issues, was only partly attributable to the demands placed upon the short-term euro-currency market for lines of credit to cover prospective balance of payments deficits.

The anti-inflationary policies, which were vigorously pursued in industrialised countries to combat the exceptionally high rates of price inflation generated in the economic boom in 1973 even before the successive increases in petroleum prices began, also exercised a powerful influence on short-term interest rates. High rates of inflation in fact had a double impact on bond markets in undermining the confidence of investors in long-term fixed interest securities which carried a negative real interest rate. On the other hand, the year 1974 was notable for the absence of strong speculative movements on foreign exchanges, the floating of the French franc in January and the weakening of the dollar being accepted more or less calmly. In this the high cost of financing speculative positions by short-term borrowing was probably a contributory factor.

The contraction in international bond issues in 1974 was general. In addition to the influences mentioned above, a fall of 43% in straight bond issues denominated in U.S. dollars was ascribable at least in part to the reopening of the U.S. domestic capital market to borrowers in other industrial countries, brought about by the suspension of the Interest Equalisation Tax which had been applied to such borrowers (except those in Canada) since 1963. The simultaneous removal of constraints on foreign investment by U.S. residents apparently did nothing to increase the flow of resources to the international bond market with which U.S. investors were naturally unfamiliar. However, the restoration of the ability of U.S. enterprises to borrow on this domestic market for the financing of projects outside the U.S.A. instead of covering their needs by means of international capital issues may have benefited the eurobond market.

The decline in dollar-denominated convertible bond issues and in issues of bonds with warrants was even sharper than that in straight bond issues. The unpopularity of such issues was largely ascribable to the growing threat of world-wide recession.

In Europe the pressure on domestic capital markets had an adverse effect upon international issues denominated in European currencies. Offering yields at issue were higher on the German domestic market for a greater part of the year than in the Deutschemark sector of the international market which was closed for new issues between December 1973 and May 1974, except for a brief period in February. As a result issues denominated in Deutschemarks fell by 78 %. Similar contractions were evident in the sectors denominated in the currencies of other Member States of the European Community.

In their efforts to re-stimulate what appeared to be a moribund market, the issuing banks resorted to promoting issues in Canadian dollars, Austrian schillings and Kuwaiti dinars. A unit composed of Arab currencies, the ARCRU, was developed but, like the earlier EURCO, was not extensively used (the ARCRU operation is not recorded in Table 11 because it consisted of a private placing which falls outside the scope of the statistics). Among these smaller compartments of the international mar-

Table 11 — **Gross issues of securities on the "European" international market**

(million units of account)

	Domestic Syndicates		International Syndicates	
	1973	1974	1973	1974
Convertible bonds	—	—	**398**	**68**
U.S. dollars	—	—	398	68
Bonds with warrants	—	—	**119**	**20**
U.S. dollars	—	—	103	20
Deutschemarks	—	—	16	—
Straight bonds	**454**	**90**	**2 297**	**1 129**
U.S. dollars	—	—	1 112	635
Canadian dollars	—	—	—	46
Deutschemarks	330	50	792	195
French francs	36	—	126	—
Belgian francs	51	16	—	—
Luxembourg francs	37	24	76	—
Sterling/DM option	—	—	27	—
Austrian schillings	—	—	—	13
Kuwaiti dinars	—	—	—	41
Lebanese pounds	—	—	32	—
Units of account	—	—	82	139
European composite units (EURCO)	—	—	50	60
Total Issues of Securities	**454**	**90**	**2 814**	**1 217**
Borrowers in Europe [1]	**287**	**90**	**1 762**	**738**
Within the Community	249	74	1 459	520
— European Investment Bank	116	9	253	112
— Commission of the European Communities (on behalf ECSC)	106	58	69	56
— Other Community borrowers	27	7	1 137	352
Outside the Community	38	16	303	218
Borrowers on the American Continent	**36**	—	**813**	**166**
U.S.A.	36	—	566	76
Others	—	—	247	90
Japanese borrowers	—	—	**21**	**114**
Miscellaneous	**131**	—	**218**	**199**

(1) The geographical classification of borrowers has been based upon the nationality—and hence 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.

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

(milliard units of account)

	1973	1974
— Net issues on the national markets of member countries	43.30	27.26
— Issues on the European international market [1]	1.46	0.52
— Issues on other national markets	0.26	0.21
Total Community	45.02	27.99

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

ket, it was only that denominated in European units of account that enjoyed any sizeable support from investors, increasing in size by 70% in 1974. In the confusion which existed in capital markets, a number of investors turned to the European unit of account possibly because it represented less of a risk than individual national currencies.

Borrowers in the European Economic Community raised 65% less through international and foreign public issues in 1974 than they did a year earlier. This fall is greater than could be accounted for by a slowing in the growth of fixed investment and is mostly, if not entirely, ascribable to the difficult conditions prevailing in the international market. Borrowers in the United States similarly cut back their demands, by 87% in 1974, but Japan's share of the market increased several times as Japanese banks and a large industrial combine sought to cover their foreign exchange needs.

Not surprisingly the contraction of issuing activity, the accentuation of problems facing governments and the increased cost of borrowing affected the sectoral distribution of the resources raised through international and foreign issues. National governments and public authorities, taken together, accounted for a quarter of such issues during 1974 as against 17.5% in 1973. International institutions increased their share from 11% to 14% over the same period while that of the financial sector remained more or less stable at 15%. The main sufferers from the deterioration of the market were the manufacturing sector which took 16% in 1974 compared with 25.5% a year earlier and energy and mining which found its share almost halved at a little less than 10%. The transport and communications sector performed differently from the others in borrowing more, not only proportionately, but also in absolute amount during 1974 when it secured 16.5% of the funds coming on to the market and subsequently applied the greater part of these towards the financing of motorways, though with some going towards railways and shipping. This pattern of borrowing, being largely the result of the special circumstances obtaining in 1974, may well prove to be temporary.

3.3. INTERNATIONAL MEDIUM-TERM CREDITS

The surge in internationally syndicated credits during the first half of 1974 was attributable principally to the increase in the cost of petroleum. The prospect of heavy balance of payments deficits on current account resulting from the higher cost of petroleum imports induced national governments both in developing as well as industrial countries to take the precaution of arranging extensive lines of credit with international banking syndicates. This led to the conclusion of contracts totalling some $19 milliards (according to statistics based on publicised credits) in the first six months of 1974 compared with $22 milliard in the whole of 1973. The role played by public authorities in this expansion may be judged by the fact that, of the $12.7 milliard contracted by industrialised countries, some 76% consisted of contracts entered into by national governments, public financial institutions or public utilities.

On the supply side, the petroleum exporting countries quite plainly preferred to place their excess revenues in short-term deposits, whether in the euro-currency markets, the U.S.A. or the United Kingdom. This was not simply a matter of responding to higher interest rates; the petroleum exporting countries were not over-familiar with long-term capital markets and were initially reluctant to embark upon long-term placements of their funds. The result was that the short-term euro-currency market received back a substantial part of the increase in oil revenues, thus facilitating the credit operations of the international banks.

This rapid expansion of the market, however, caused the banks involved to look with concern at the impact on their capital ratios. Their concern was increased at mid-year by the failure of a limited number of other banks. The third quarter thus saw a reaction in the form of a number of changes in market practices as well as in the volume of activity in the market.

The contraction in the size of the euro-currency market in this period occurred in the inter-bank sector, as banks in general began to place their funds with more circumspection. The London inter-bank offered rate (LIBOR in short) which had come to be accepted as a reference rate of interest in most international credits was affected by these developments. Because of increasing discrimination on the part of lending banks, the interest rates offered as between banks became two or even three tier. The less favoured banks thus tended to find it more difficult if not impossible to participate in international syndicates. The premium which some of the smaller banks, or banks without the unequivocal backing of a major parent institution, or indeed banks in some of the countries in substantial balance of payments deficit, had to pay in excess of LIBOR was occasionally as much as 2%.

The Governors of the central banks of the Group of Ten countries helped to restore the confidence of the market by confirming, in September, their acceptance of responsibility for the international market. Subsequently, the Bank of England and the Luxembourg monetary authorities sought and obtained acknowledgement from the parent companies of consortium banks of their links with their affiliates while the U.S. Federal Reserve declared that it would be willing to act as lender of last resort to any member bank of the Federal Reserve System which found itself short of liquidity as a result of an abrupt withdrawal of deposits.

The market in internationally syndicated credits had meanwhile taken steps to protect its financial position against the impact of cost inflation as well as other pressures. At the beginning of 1974 the average margin above LIBOR which the banking syndicates normally charged first class borrowers seeking credits on floating rate terms was around 0.5%. Less favoured borrowers were generally charged 0.75%. By the fourth quarter of the year these margins had risen to ranges of 1.0-1.24% and 1.75-2.0% respectively. In addition, the standard term to maturity of the credits had come down from around ten years to about five years.

Short-term interest rates, however, had begun to decline from September onwards and so offset the increase in borrowing costs resulting from the higher margins. The fourth quarter of 1974 accordingly saw a revival of activity in international medium-term lending, this time with developing countries entering into contracts equivalent to half the total.

Thus for 1974 as a whole international medium-term credits accorded to developing countries was more or less unchanged at a total of just over $9 milliard. About 60% of this total consisted of credits to governments, public financial institutions and public activities, much as in industrialised countries. Credits granted to government borrowers have sometimes been extended directly by the governments of petroleum producing countries, but, although such "disintermediation" has been noticeable, it seems not to have interfered seriously with normal international banking business.

While credits to developing countries remained the same in 1974 as in the previous year, there was a significant change in the type of recipient country. Borrowing by petroleum exporting countries fell away sharply, as might have been expected, but this movement was counterbalanced by a rise in the borrowing of the so-called higher- and middle-income developing countries. Those countries which increased their borrowing the most were Spain, Senegal, Argentina and Brazil. The last two are petroleum producers if not exporters, a factor of importance in assessing their creditworthiness. On the other hand, the poorest group of developing countries only achieved a minimal increase in borrowing in 1974 and then only because the Sudan benefited from a credit extended by other Arab countries.

The market in international medium-term credits thus underwent a transformation during the course of 1974. For the most part, the banking institutions operating in it weathered their difficulties and appear to have emerged with improved techniques. There seems to be a role for this market to play in redistributing financial resources from countries earning balance of payments surpluses to those in deficit, particularly when the latter happen to be creditworthy developing countries.

CONCLUSION

The European Community managed to overcome the severe economic and financial pressures to which it was subjected during 1974 but at a high cost in terms of accepting a lower level of output and investment than would otherwise have been achieved. It has emerged with a different set of policy aims, even if inflation has still to be overcome; in the short-term the main priority is the re-stimulation of activity and in the longer term an energy policy has to be implemented which will entail certain structural changes.

The Community's financial markets have survived remarkably well, if with a number of technical modifications. The nominal amount of personal saving appears in fact to have increased and the consequences of the increase in petroleum prices seem to have been less serious than was initially feared. There has been increasing evidence that a part of the surplus of oil revenues (which have turned out to be smaller than forecast) is being invested at long-term. The capacity of long-term financial markets for meeting the requirements of fixed investment thus seems to have been safeguarded.

Perhaps the main lesson from the experience of 1974 is the importance of the role of confidence in the field of investment. The availability of funds for investment and the existence of adequate financial machinery, without this essential element, are not enough to assure the volume of investment needed to sustain the rhythm of an economy.

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