

International: new strains emerge

The recovery of the world economy from the 1974-75 recession slowed down considerably in 1977. Economic growth (as measured by changes in real gross national product) in the industrial countries comprising the membership of the Organization for Economic Cooperation and Development (OECD),¹ declined from a 4 percent annual rate in the first half to 3¼ percent in the second half. This brought the growth for the year to about 3½ percent, compared to the approximately 5¼ percent recorded in 1976. The slowdown in the aggregate rate of growth between 1976 and 1977 was the result of a leveling off of growth in Japan and the United States, and a considerable reduction in the rate of growth in virtually all of Europe.

With economic growth generally below the 4½ percent rate necessary to absorb new additions to the labor force, total unemployment in the OECD countries rose to 16.3 million (about 5.4 percent of the civilian labor force) at the end of 1977, some half million higher than the low point of the recession in 1975. The rise in unemployment was particularly marked in the European member countries where, unlike in the United States, unemployment has been rising steadily, from 4.7 million at the beginning of 1975 to over 7 million today.

The slow rate of growth was one of the contributing factors to the easing of inflationary pressures in the OECD countries during the year. The rate of increase in consumer prices declined from an 11 percent annual rate during the first four months of the year to about 6 percent in the four months ending October. But, for the year as a whole,

¹The United States, Japan, Germany, France, the United Kingdom, Canada, Italy, Australia, New Zealand, Austria, Belgium, Denmark, Finland, Greece, Iceland, Ireland, Luxembourg, the Netherlands, Norway, Portugal, Spain, Sweden, Switzerland, and Turkey.

the rate of inflation—averaging about 8 percent for the industrial countries—was about the same as in 1976.

The slow and divergent rates of economic growth in the major industrial countries accentuated some existing problems in the world economy and contributed to the emergence of new ones during the year. The slow rate of growth in the industrial countries depressed their demand for primary commodities produced largely in the developing countries. As a result, balance-of-payment deficits experienced by many of the developing countries (particularly since the sharp increase in energy prices) persisted and led to further increases in their already large international indebtedness as they attempted to finance the deficits by borrowing abroad. Commercial banks in the industrial countries continued to be the main source of financing. The growth of indebtedness of the developing countries, and of some smaller industrial countries of the OECD group, to these banks perpetuated concern of the regulatory authorities both here and abroad about the possible adverse consequences of the growing foreign “exposure” and raised questions about future financing.

The dollar declines in value

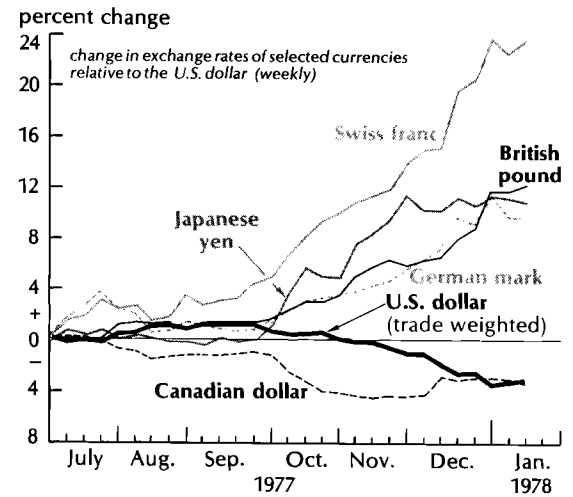
The relatively rapid rate of economic growth in the United States as compared to the rest of the industrial world was the major contributing cause to the emergence of large trade and current account deficits in the U.S. international accounts (for details see below). The excess supply of dollars on the foreign exchange markets associated with such deficits was not being fully absorbed by demand for dollars for private investment purposes. As a result, by midyear the U.S. dollar began to weaken against the currencies of certain ma-

major countries, particularly those experiencing large surpluses in their international accounts. Initially, unlike the foreign central banks, whose currencies were being affected, the U.S. authorities refrained from actively moderating the decline of the dollar. This relative "inaction" reflected the U.S. policy of intervening only to counter disorderly market conditions; and the dollar's decline up until the fourth quarter was not generally disorderly. However, in the closing weeks of the year, increasing doubts about the ability and willingness of the United States to reduce the deficit led to the emergence of a strong speculative undercurrent in the foreign exchange markets that resulted in wide gyrations and rapid movements of the exchange rates. To deal with the unsettlements the U.S. Treasury and the Federal Reserve in the early days of 1978 announced their intention to actively intervene in the markets. Their action, together with forceful support provided by the European central banks, stabilized the markets. At the time of the writing of this report, the international monetary system appeared to have weathered the strains created by the disequilibrium in the world payments situation.

U.S. balance of payments position deteriorates

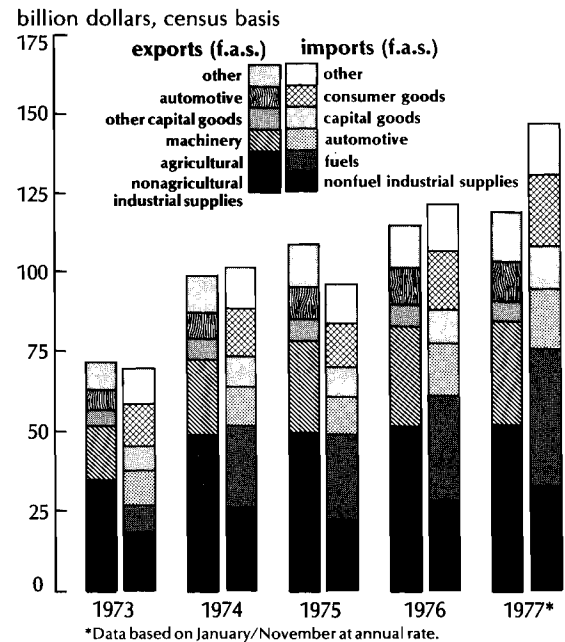
The strong economic growth in the United States, accompanied by an increasing reliance on foreign oil, led to rapid growth in imports during 1977. This, combined with the sluggish economic growth abroad that hampered U.S. exports, served to extend the deterioration in the U.S. balance of payments observed in 1976 through 1977. The merchandise trade balance (census basis), which had shifted from an \$11 billion surplus in 1975 to a \$5.9 billion deficit in 1976, plunged further in deficit during 1977 with a shortfall of exports to imports of \$26.7 billion. A strong U.S. demand for foreign goods, both petroleum and nonpetroleum products, resulted in a surge in imports by nearly 22 percent during the year. Among nonfuel imports, the categories of manufactured goods, machinery, and foods

U.S. dollar declines relative to most major currencies



showed especially strong gains of 20 percent or more, while fuel imports were up nearly 33 percent over the year-earlier period. Exports were up 4.5 percent from 1976, but second-half shipments were only marginally greater than those in the first half.

U.S. trade deficit surges



*Data based on January/November at annual rate.

Trade flows, especially of exports, were severely disrupted in the second half of the year by an East and Gulf coast longshoremen's strike against containerized shipping operations which lasted from October 1 through November.

The deterioration in the U.S. trade balance was reflected in trade patterns between all major trading regions. While the United States continues to run a trade surplus with the European Economic Community, by the end of October that surplus was \$2.4 billion less than over the same period in 1976. The United States recorded a trade deficit with the developed countries of \$2.9 billion for January/October, a deterioration of \$6.1 billion from a year ago. The U.S. trade deficit with the Organization of Petroleum Exporting Countries (OPEC) amounted to \$16.5 billion (an increase of some \$6.4 billion) while the deficit in trade with other developing countries reached \$4.5 billion (an increase of some \$5.3 billion).

The excess of payments to foreigners over the receipts from abroad implied by the current account deficit has been more than offset by financial flows recorded in the U.S. capital account. During the third quarter of 1977 net acquisition of U.S. assets by foreigners amounted to \$12.9 billion, while

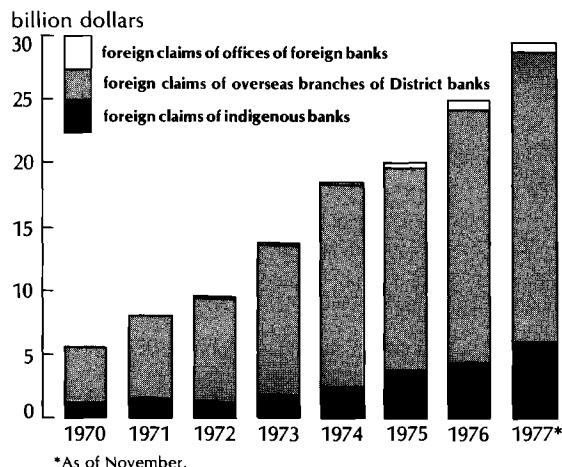
holdings of foreign assets by U.S. residents increased \$3.4 billion, leaving a net capital inflow of \$9.5 billion during the quarter. This followed net capital inflows of \$2.8 billion in the first quarter and \$3.5 billion in the second quarter. A major factor influencing the net capital inflow was the purchase of U.S. Government securities by foreign official institutions with dollars acquired by them through intervention in foreign exchange markets in an effort to moderate the rise of their currencies relative to the dollar. A net reduction in loans to foreigners by U.S. banks as a result of improved lending opportunities in the United States vis-a-vis foreign countries also played a significant role.

International banking activities in the District expand

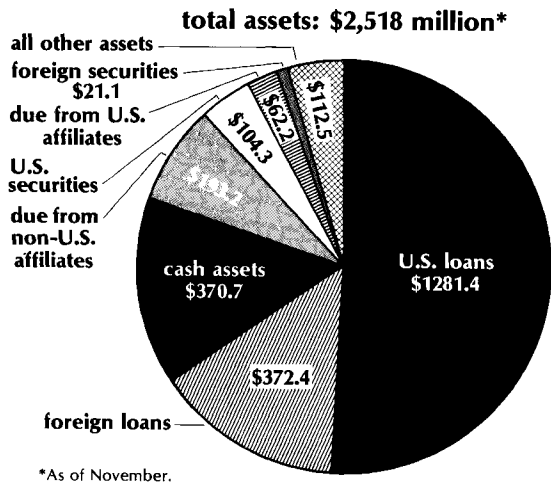
International banking activity in the District during 1977 continued its expansion, which began in the early 1960s. Over the last five years the foreign assets of Seventh District banks increased by over 200 percent, and the total stood at \$29.5 billion in November 1977. There have been three major channels through which District banks conducted their international business: (1) head offices; (2) foreign offices of District banks; and (3) District branches and subsidiaries of banks domiciled in foreign countries. The domestic offices of District banks had claims on foreigners of \$6.0 billion towards the end of 1977, a sizable increase over the \$4.1 billion in the same period a year ago. District banks had liabilities to foreigners of \$2.5 billion—an increase of \$300 million over the 12-month period. Domestic offices of Seventh District banks presently account for 10.2 percent of the total claims on foreigners held by all domestic offices of U.S. banks. This was a significant increase over the District's share in 1976.

Over the last decade the major means by which the Seventh District banks have engaged in foreign lending has been through their overseas branches. While in 1967 District banks operated only six overseas branches, by

Foreign claims of the District banks continue to rise



Assets of the District's foreign banks increase in 1977



1977 there were 74 overseas branches maintained by 19 District banks. In November these branches had total assets of \$22.7 billion, an increase of \$4.0 billion over the prior 12 months.

The Seventh District's position as an international financial center was strengthened in 1973 when the Illinois General Assembly passed legislation permitting foreign banks to establish agencies, branches, and subsidiaries in Chicago. In the four years since the passage of that legislation, 30 offices of foreign banks were opened in Chicago, including seven in 1977. The offices of foreign banking institutions in the District had assets of \$2.5 billion as of the end of November, an increase of \$400 million in a 12-month period. Chicago is presently the third largest foreign banking center in the United States.