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Investment in the Community in 1976 and its Financing

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CONTENTS

CONVERSION OF NATIONAL CURRENCIES

All statistical data published in this Report are provisional for 1976 and often for 1975 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".

For 1972 and 1973 the unit of account equivalent of 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 29 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 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 per cent from the conversion rate in use. In each of the years 1972 and 1973 a weighted average of these conversion rates in force during the year was applied to the available statistical material.

Statistics relating to 1974, 1975 and 1976 have been derived from rates of conversion between national currencies and the new European Unit of Account based on a "basket" of Member States' currencies. The composition of this basket is such that, as at 28 June 1974, the sum of the component currencies would have been equal in value to the International Monetary Fund's Special Drawing Right. For 1974, conversion rates into the new European Unit of Account as at 30 December 1974 have been applied. The conversion rates applicable to statistics for 1975 and 1976 have been based on the average of quarterly rates, the latter being those obtaining on the last working day of the previous quarter. The average conversion rates applicable for 1976 between the European Unit of Account, its component currencies and the U.S. dollar were as follows:

1 unit of account =

DM	2.86357	£	0.611212	Bfrs	43.8998
Ffrs	5.29738	£Ir	0.610789	Lfrs	43.8998
Lit	906.824	Fl	3.00802	Dkr	6.83439
US $	1.12633				

INTRODUCTION

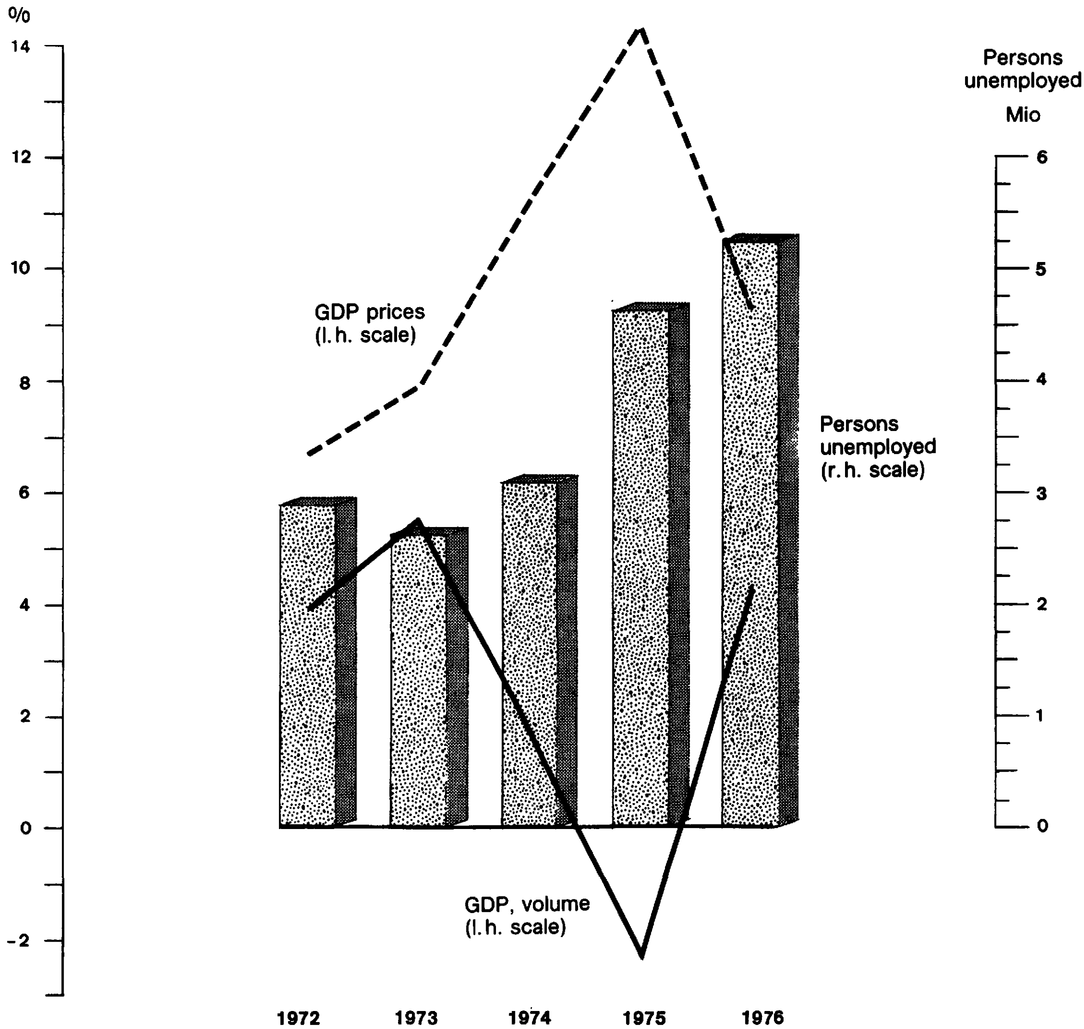
The economic recovery which began around the middle of 1975 continued in the Member Countries of the European Economic Community during 1976 but not without signs of stress and strain. Rates of growth in the various countries were uneven and at times faltering. Despite the increase in output, most economies were running well below capacity and unemployment remained obdurately high. Although some progress was made in the struggle against inflation, by the end of the year the rise in prices was beginning to quicken again in a few countries. The problems of promoting economic growth and controlling inflation were made more difficult by bouts of weakness in foreign exchange markets of several Community currencies, notably the Italian lira, the French franc and the pound. Where authorities were obliged to defend the external values of currencies, the steps they took in the form of tightening credit and raising interest rates had unhelpful repercussions on economic growth and the investment climate.

The promotion of investment by the business sector as well as by public authorities was however clearly seen to be an essential ingredient of plans for economic recovery in the European Community. In addition to helping towards restoring economic growth, increasing business investment offered a means of tackling the serious unemployment problem which existed in most countries. Nevertheless businesses whose propensity to invest had suffered from low profit margins for a number of years remained to a large extent hesitant to increase their fixed investment while surplus productive capacity existed and the outlook remained uncertain. It should not be a matter for surprise therefore that gross fixed investment fell in volume in some Member Countries during 1976 and in some others rose less than output.

The conditions for the financing of investment varied between countries as much as growth rates and rates of inflation but there was no correlation apparent between the cost of finance and investment performance. Denmark for example achieved a higher rate of growth of fixed investment in 1976 than any other country in the Community and also experienced a faster rise in interest rates to a level above those prevailing elsewhere in the Community. In the Benelux countries on the other hand, interest rates increased by only a little and towards the end of the year were falling, while fixed investment declined in volume. As a general rule interest rates tended to rise in countries which experienced a weakening of the exchange values of their currencies: this meant in particular Italy, the United Kingdom and Ireland but applied also to France, Belgium and, in the middle period of the year, to the Netherlands. In Germany on the other hand short and long-term interest rates declined for most of the year. Share markets were less affected by the movement of exchange rates than by the low level of confidence and uncertainty about the economic outlook. Consequently share prices tended downwards, taking 1976 as a whole, on all markets in the Community, except in Luxembourg.

The volume of personal saving continued to rise during 1976 if less rapidly than a year earlier. Company profits also seem to have improved a little on balance, thanks to higher output and a slackening in the rise in costs. Because of the hesitancy of businesses to invest, demand for finance was relatively modest, though there were additions to working capital as activity picked up and in some countries short-term finance was sought for the purpose of rebuilding stocks. The main impression is that finance was readily available (particularly on the international capital market where liquidity was very high) for investment purposes and that, where the terms of borrowing became more costly, it was because the authorities were reacting to pressures on the exchange rate.

Chart I — **The Community's economic performance 1972 — 1976**



See "Principal Sources" 1.a and b.

CHAPTER 1

INVESTMENT

1.1 THE ECONOMIC BACKGROUND TO INVESTMENT

In 1976, gross fixed investment increased in volume in five countries, Denmark, Germany, France, Ireland and Italy. However, owing to the declines in new investment in these countries in the previous two years, it was only in France that the level of investment in real terms in 1976 exceed that of 1973. In Denmark, the rise in the volume of capital expenditures in 1976 was remarkable, although some retrenchment is expected in the current year. The increase in fixed investment in Germany on the other hand was more solidly based. In Ireland and Italy, the modest rise in investment that occurred last year did little to erase the very sharp reduction experienced in 1975. The volume of new investment declined further last year in four countries, the United Kingdom, the Netherlands, Belgium and Luxembourg. However, in all Member Countries there was a rise, sometimes quite appreciable, in investment in value terms last year, with price inflation continuing to be a problem in some countries.

The growth in volume of fixed investment during 1976 followed a decrease of 5 per cent in the previous year; in value terms fixed investment was 12 per cent higher in 1976. The turnaround in investment was encouraged by an increase in volume of the Gross Community Product of 4.3 per cent last year though the accumulation of stocks, contributing about one-third of the total growth in economic activity, featured more prominently in the expansion than fixed investment. The rebuilding of stocks tended to lose momentum by mid-year, however, and correspondingly less progress towards economic recovery was made in the second half of 1976. Successes were achieved here and there in controlling price inflation, leaving more scope for tackling the problem of unemployment which, however, continued to worsen.

It can be seen from Table I that there was a considerable divergence among the Community countries as to the performance of fixed capital expenditures. Some countries experienced a resumption in the growth of investment in real terms last year; certain other countries suffered a decrease in new investment volume in 1976, continuing the decline of the previous year and sometimes of the previous two years.

In *Denmark,* as in a number of other Community countries last year, the economic recovery of late 1975 and Spring 1976 tended to peter away into stagnation by the middle of the year. However, the benefits of earlier, stimulative policies contributed to a rise in Gross National Product in real terms of 4.9 per cent. The strong growth of personal expenditures and the rebuilding of stocks were major factors in encouraging an increase in industrial output and hence the incentive to raise investment. The volume of total fixed capital expenditures rose by 17 per cent in 1976, following a decline of about 10 per cent in 1975. But the shift in emphasis of economic policies in the third quarter clouded the business outlook once more towards the end of the year and the prospects for investment in 1977 are not auspicious.

The recovery had been initiated by the expansion of export demand and the buoyancy of consumer spending induced largely by the temporary reduction — until 1st March — of the VAT rate from 15 per cent to 9.25 per cent. Government fiscal policies which were aimed initially at stimulating the economy, particularly in the construction industry, gained some success but were less successful in attaining the parallel objective of reducing unemployment. However, it became clear that the costs asso-

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

Countries	In Value					In Volume				
	1972	1973	1974	1975	1976	1972	1973	1974	1975	1976
Germany	+ 7.0	+ 5.1	− 2.1	− 1.3	+ 8.5	+ 3.0	+ 0.5	− 8.1	− 4.6	+ 5.1
France	+12.7	+15.1	+18.2	+ 6.9	+14.0	+ 7.1	+ 6.7	+ 1.3	− 4.4	+ 4.4
United Kingdom	+11.2	+21.1	+17.0	+23.2	+12.4	+ 2.1	+ 4.0	− 2.4	− 1.3	− 4.3
Italy	+ 6.5	+25.9	+33.1	+ 4.3	+21.3	+ 1.0	+ 8.4	+ 3.7	−12.7	+ 2.3
Netherlands	+ 4.0	+11.5	+ 6.3	+ 6.1	+ 6.3	− 3.5	+ 5.5	− 4.2	− 3.9	− 1.9
Belgium	+ 8.1	+14.2	+24.2	+ 7.3	+ 4.4	+ 3.6	+ 7.3	+ 7.5	− 3.4	− 1.5
Denmark	+15.2	+19.6	+ 7.3	− 0.7	+24.1	+ 8.2	+ 6.1	− 8.9	−10.7	+17.2
Ireland	+15.0	+26.9	+ 9.6	+10.6	+23.1	+ 2.6	+14.0	−10.3	− 6.6	+ 4.4
Luxembourg	+ 7.9	+17.2	+17.3	+ 1.6	+ 3.3	+ 3.1	+10.1	+ 3.6	−10.1	− 4.5
Total Community	+10.0	+10.9	+ 8.6	+ 4.8	+12.1	+ 3.3	+ 4.4	− 2.6	− 5.1	+ 2.7

(1) The percentages for 1976 are approximations based on orders of magnitude.
(2) For individual countries, percentages are based on amounts in national currencies. For the Community total, amounts in national currencies have been converted into units of account at exchange rates prevailing in the relevant year.

See "Principal Sources" 1.a, 2.b, 3.b, 4.b, 5.b, 6.b, 7.c, 8.b, 9.b, 10.a.

ciated with these policies, in terms of a substantially higher budget deficit, a resurgence of price inflation and an influx of imports, could not long be supported and were causing strains both on domestic financial markets and externally for the exchange rate.

For 1976 as a whole the consumer price index rose by 13.1 per cent compared with 4.3 per cent in 1975, although the underlying growth rate of prices, excluding VAT rate changes, was less severe at 9.5 per cent. Thus, in August the emphasis of fiscal policy was turned towards curbing the growth of nominal incomes and to an increase in indirect taxes on a number of consumer products. This step was further reinforced by restrictive prices and incomes measures adopted by Parliament in December. These measures were felt necessary to cut excess consumer demand and hence the accompanying rise in imports of consumer goods, which in 1976 as a whole were a major factor behind the increase in the current account deficit of the balance of payments to an amount four times as large as in 1975. Probably by the end of 1976 the new restrictions were beginning to exert a discouraging influence on investment plans.

Economic and investment growth in *Germany* in 1976, on the other hand, laid the foundations for a further advance. In spite of weakness, particularly in the summer and autumn of last year, the upturn in economic activity which began in the autumn of 1975 was sustained during 1976. The volume of the Gross National Product increased by 5.7 per cent in 1976 following the 2.5 per cent decline in the previous year. Among the main sources of this growth seem to have been higher demand from the private sector, emanating in particular from the revival of new investment in machinery and equipment but partly also from a larger volume of consumption. A further contribution came from stockbuilding and from a substantial growth in orders from export markets. Nevertheless the effect of official measures to stimulate the economy began to wear off in the summer months. Unemployment remained exceptionally high and seemed likely to be reduced only to a small extent in the near term.

An important development in the economic recovery last year was the improvement in business sentiment. Major factors contributing to this improvement were the rise in industrial output of 6.7 per cent in 1976, resulting from a general increase in demand. The higher output was achieved with, on average, a smaller labour force and so productivity per man-hour rose sharply by 5.5 per cent. At the same time the increase in wages and salary costs of 5.9 per cent in 1976 was considerably less than in 1975 and led to a significant improvement in company profits.

These factors were important in enabling enterprises to compete more effectively and through such competition they contributed towards a reduction in the rate of price inflation. In this context the appreciation of the Deutschemark against all other currencies offset a substantial part of the rise in the cost of imports. The annual rate of increase in the cost of living index which had declined to 3.9 per cent by December 1976, was not surprisingly the lowest rate of inflation in the Community.

The improvement in the profits of enterprises was reflected in an expansion of certain categories of business investment — more in the installation of machinery and equipment, for example, than in new construction. The smaller difference between the real and nominal increases in investment (including residential construction and public authorities' capital spending) compared with 1975 reflects the lower rate of price inflation affecting capital goods; the value of capital investment in 1976 was 8.5 per cent higher than in the previous year, whereas the volume increase was 5.1 per cent.

Rates of real growth of output and investment in *France* were similar to those in Germany but were not achieved without strain on the prices and balance of payments fronts. The revival of economic activity which followed the introduction of stimulatory measures in September 1975 continued into 1976. Even though the pace of the recovery slowed from the spring of 1976 onwards, for the year as a whole the Gross Domestic Product was 5 per cent higher than in 1975. However a lack of balance in this growth, stemming as it did largely from a strong expansion of private consumption, led to a speeding up of the rise in prices and to a deterioration in the balance of payments. The effect of the increase in domestic consumption was augmented by a recovery in the volume of exports which in 1976 as a whole grew by a little more than 9 per cent. The increase in industrial output, while substantial, covered only a part of the rise in total demand and consequently the volume of imports rose by over 19 per cent, despite the depreciation of the franc against a number of major currencies. The deterioration of the external trade deficit in 1976 was accentuated by the effect of the serious drought during the middle of the year both on exports and imports of, in particular, foodstuffs. Taking into account these various pressures on the economy, an anti-inflationary plan bearing the name of the prime minister, M. Barre, who was its author, was introduced during the autumn.

Gross fixed investment rose in volume almost in step with the domestic product but this was largely because of the investment projects of public enterprises and of the public authorities which were implemented as part of the programme to restimulate the economy. Enterprises in the private sector also increased their investment, particularly in the first half of the year, but the existence of surplus capacity and difficulties in obtaining the finance they needed tended to cause them to postpone their investment plans. Housing investment, which fell sharply in volume during 1975, declined again during 1976.

The increase in the volume of fixed investment in *Ireland* during 1976 was very similar to that in France but economic growth was somewhat lower and the rate of inflation much higher. The annual rate of economic growth in Ireland in fact reached 3 per cent in 1976. However, it was not until August that the rapid increase in manufacturing production of about 11.5 per cent last year began to be reflected in a check in the rise in the numbers unemployed which, at 9.5 per cent of the labour force, were proportionally higher than elsewhere in the Community; until then the main effect had been to reduce short-time working and to expand job opportunities for a growing labour force. The principal growth elements were a re-stocking movement, an increase in fixed capital investment and a rise of 17 per cent in the volume of industrial exports. The volume of gross fixed investment rose by 4.4 per cent in 1976 under the stimulus of higher business and public authorities' capital expenditures, following a decline of 6.6 per cent in 1975.

A major concern of the business sector and the public authorities was the threat of a progressive loss of competitiveness of Irish products through increased labour costs and prices. Indicative of the problem, the consumer price index rose by 20.6 per cent over the twelve months to November 1976. The need to restrain incomes growth received general support in negotiations leading towards a renewal of the National Pay Agreement. However, the Associated Banks' employees, not in fact covered by the Pay Agreement, sought through industrial action to improve their position; this action closed the major part of the banking system between late June and early September.

With agricultural exports depressed last year following the sharp expansion in 1975, the value of total merchandise exports grew at a slower pace than that of imports — in part due to the increase in capital goods imports — and led to the worsening of the current account deficit of the balance of payments from £ Ir. 18 million in 1975 to £ Ir. 150 million last year. The depreciation of the Irish pound of 8.7 per cent on a trade-weighted basis in 1976 had a two-fold effect; in external trade it helped to offset to some extent the effects of the domestic rate of inflation and so to maintain the competitiveness of Irish exports but internally it raised the prices on the domestic market of imported goods.

The investment climate in *Italy* was also adversely affected by a high and rising rate of inflation and, as in Ireland, most of the volume increase in fixed investment was attributable to the capital expenditure programmes of the public authorities. The rise in the volume of Gross Domestic Product in Italy last year of 5.6 per cent was one of the most rapid in the Community, being in part a rebound from the steepness of the recession in the previous year. Industrial output was 12 per cent higher in 1976 but even this gain was insufficient to compensate for the decrease in 1975. The rebuilding of finished product stocks in the first half of 1976 contributed significantly to the economic recovery but tended to fade later in the year. The strength of consumer demand on the other hand remained considerable throughout 1976 and led to a rise of some 38 per cent in the value of merchandise imports. Largely as a result, the current account deficit of the balance of payments deteriorated from under Lit 400 milliard in 1975 to almost Lit 2 400 milliard last year.

This deterioration was largely responsible for the decline in the year to December 1976 of the exchange rate for the Lira averaging 20 per cent against the currencies of Italy's main trading partners, weighted according to their importance. As a result of the severe depreciation of the Lira and the rundown of foreign currency reserves, the previously stimulative budgetary policy, largely involving investment incentives, had to be reversed. Furthermore, one of the commitments entered into at the time of the granting by the EEC of a $ 1 milliard loan to Italy in March of last year, was that the public sector deficit would be limited to Lit 13 800 milliard in 1976. The tightening of economic policies, and more particularly the austerity programme introduced in October which involved increased indirect taxes and higher public service charges, was linked to the need both to contain the growth of the public sector deficit, and hence the proportion financed by an expansion of the monetary base, and to reduce the growth of imports.

The slowing of price inflation to 11.2 per cent as of end-1975 proved short-lived and the annual rise in the cost of living had almost doubled by December 1976 to 21.8 per cent. Major factors behind this rise were the depreciation of the Lira and the consequent rise in import prices, increases in indirect taxes and the index-linked increases in wage rates. Although the Government introduced measures in the fourth quarter to limit the inflationary impact of index-linked salary rises for higher income groups, wage compensation per employee in 1976 as a whole averaged some 21 per cent more than a year earlier. Under such conditions of accelerating inflation, uncertainties as to future economic policies and recurring pressure on the exchange rate, business investment was relatively subdued last year. While total investment in the economy rose by some 2.3 per cent in volume terms, the major thrust behind capital spending derived from the public sector's investment programmes.

As in Italy exchange rate problems in the *United Kingdom* imposed constraints on policy which rendered the control over the rate of inflation and the stimulation of economic activity, including investment, more difficult. The rate of inflation in the U.K., as indicated by the increase in the retail price index, declined during 1976 to just over 15 per cent compared with about 25 per cent a year earlier. Even so the rate remained higher than those of most other trading partners. Moreover, the initial slowing of inflation in the first seven months of 1976, in response to the Government's wage restraint policy, was checked and even reversed in the latter part of the year as import prices expressed in terms of sterling rose as a result of the depreciation of the currency.

The ensuing problems were reflected in a slackening of economic growth after a relatively buoyant first quarter and for 1976 as a whole the Gross Domestic Product was only 1.0 per cent higher in volume than in 1975. Personal disposable incomes declined in real terms for the second successive year and the business sector's confidence remained low. The numbers of unemployed increased further during the course of the year and averaged 5.4 per cent of the labour force compared with 3.9 per cent in 1975. The visible trade deficit worsened sharply in the second quarter and, together with the comparatively high inflation rate, had an adverse effect upon the confidence of non-resident holders of sterling and contributed to a sharp depreciation in the exchange value of the pound against the currencies of the United Kingdom's main trading partners. These developments limited the scope for stimulative action and made even more imperative the continuation of existing anti-inflationary policies.

The voluntary restraint on wage and salary increases, which was introduced for one year in August 1975 and came to be known as "stage one" of the current incomes policy, succeeded in restraining the increase in hourly earnings in manufacturing to some 15 per cent during its period of operation. "Stage two" of the incomes policy sought to consolidate this improvement and reduce earnings growth even further, to 8 per cent in the August 1976 – July 1977 period. Reductions in direct taxes, amounting to some £ 900 million, which were announced with the April 1976 Budget as conditional upon the general acceptance of the new proposals for the restraint of increases in incomes, helped the Government in the pursuit of its policy. Both public and private spending on fixed investment were reduced in 1976 – the former because of the need to limit the growth in the public sector's financing requirement, and the latter because of the slow growth and consequent doubts about the need for further capacity and about being able to earn an adequate return. As a result, the volume of total fixed capital investment fell by 4.3 per cent during 1976, the third consecutive year of decline.

Fixed investment in the Benelux countries also declined in 1976, but this occurred against a generally stronger economic background than in the U.K. Progress towards economic recovery in the *Netherlands* in 1976 was slight until the last four months of the year, when output took a step upwards as a result of which the volume of Gross National Product rose by some 4 per cent. This pattern was evident in the performance of the index of industrial production which, after rising sharply towards the end of 1975, gained no further ground until the last four months of 1976, when it rose suddenly and then levelled out again; the resultant annual average of the index was 6 per cent higher than in the previous year. The main sources of the revival in economic activity were increases in private and public expenditure on consumption and a movement to rebuild stocks. Exports grew rapidly and also contributed towards the general recovery. Fixed investment, however, remained depressed but fell less in volume than in 1975.

As in other countries in the European Community, the Government was confronted with the need to reconcile its attempts to provide a fresh stimulus for the economy with its efforts to reduce inflation. The increase in the Government's current expenditures occasioned by the introduction of a series of stimulative measures during the year, coupled with the larger transfer payments resulting partly from the high level of unemployment, widened the budget deficit. In addition to developing new techniques for borrowing, the Government raised the rate for VAT on 1 October by 2 per cent though this, however, increased prices further. The increase in VAT had originally been planned for 1 July but was postponed so as not to impair too seriously the Government's main strategy in tackling inflation through controls over prices and incomes, rather than through reducing liquidity with a consequent risk of exerting an undesired upward pressure on interest rates. The limitation of price increases introduced in earlier years was continued during 1976, but with a permitted leeway. Wages and salaries were frozen at their real levels in November 1975 for a period of six months (compensation for price increases being allowed), but as from July 1976 controls over pay increases began to be relaxed so as to allow an increase in the real income and purchasing power of those earning lower incomes. The continuation of wage restraint resulted in the increase in average wages per employee being held to 8 per cent in the twelve months to December 1976 compared with a rise of 12 per cent in the previous year.

The influences on prices were rather more complex. The smaller rise in wage costs was a significant element in 1976 and to a certain extent the appreciation of the external value of the guilder (despite the depreciation against the Deutschemark within the European currency snake in October 1976) against most currencies helped to lower the cost in guilders of imported goods. Both these developments contributed to the effectiveness of the policy of price restraint and as a result prices rose less in the Netherlands in 1976 than in all other Member Countries except Germany. The consumer price index, for example, levelled out after the increase in VAT in October and its rise in the twelve months to December 1976 was thereby curtailed to 8.3 per cent.

After experiencing a squeeze on profits for several years, the profitability of enterprises improved a little in 1976 but business sentiment remained dull. Domestically the scope for further increases in profits was severely limited. Externally exports were more competitive than in the previous year, thanks to the relative improvement in costs of production, but here also the scope for increasing prices and profit margins was limited by the rise in the exchange value of the guilder against the currencies of several of the Netherlands' trading partners. Because there appeared to be little prospect of an improvement in profitability either in the domestic market or in exporting and because of the persistance of a considerable amount of unused productive capacity, the incentive in 1976 for enterprises to invest was low. Largely as a result of this, gross fixed capital formation rose modestly in value by 6.3 per cent which, translated into terms of volume, represented a fall of 1.9 per cent, only slightly less of a decline than in 1975.

In *Belgium* last year the business outlook improved a little from time to time as industrial production rose to almost the level attained two years earlier, and profitability tended to recover. Fixed investment declined but by a little less than in the Netherlands.

The volume of Gross National Product increased by about 3 per cent in 1976, with the principal impetus deriving from higher consumer spending and a strong growth in public authority capital expenditures. An important factor in sustaining the rise in manufacturing production early in the year was the need to rebuild stocks in anticipation of a business recovery: but with the worsening in the outlook in the second half of the year the re-stocking movement largely ceased. The growth in demand both from manufacturers (for raw materials) and from consumers led to a faster growth of imports in 1976 than exports and hence to a deterioration in the visible trade balance which in turn had a weakening effect on the currency and, through this, on the capital market.

Government incomes policy, and more specifically the April stabilization measures (including the temporary suspension of indexation for incomes above a certain level, the freezing of rents and professional incomes, and the reduction of permitted dividend disbursements) contributed to the slowing of the growth in money incomes and prices. Average hourly earnings of industrial and transport workers increased by only 9.5 per cent during 1976 as compared with a rise of 17.4 per cent in the previous year. Owing largely to the rise in manufacturing output, productivity per man-hour rose by an estimated 9 per cent in the first half of 1976 and the increase in salary costs per unit of output fell sharply compared with the previous year. The impact of this improvement is evidenced both by the progressive curbing of the rate of price inflation (to an annual rate of 7.6 per cent at the end of 1976 as against 11 per cent a year earlier) and a simultaneous improvement in company profits. However, this was not enough to overcome the pessimism regarding the economic outlook which deepened in the second half of the year and fixed capital formation by businesses fell further. Mainly because of this fall, total fixed investment declined in 1976 by about 1 per cent after having been reduced by 3 per cent the previous year.

The decline in the volume of investment in *Luxembourg* of 4.5 per cent in 1976, after a steeper decline in the previous year was the most serious in the Community. The signs of the beginnings of a recovery in markets for steel products in early 1976 proved short-lived and consequently the growth of the Luxembourg economy which depends heavily on steel tended to slacken in the second half of the year. The decline in output in the steel industry of 1.3 per cent last year was offset to some extent by the expansion of production in the chemicals and rubber industries and by a continuation of the rapid growth of the services sector. The volume of Gross Domestic Product increased by about 3 per cent in 1976 after having declined by 8 per cent in the previous year. This recovery stemmed from the growth in exports of goods and services (particularly of invisible receipts associated with the financial sector) while domestic demand in real terms remained weak. Consumer spending rose only slightly, even after the stimulus to purchases of consumer durables occasioned by the removal in April of restrictions on hire-purchase credit, and investment expenditures continued to lag behind the economy as a whole.

Because the Luxembourg economy is so open and susceptible to international influences, with most domestic industries producing principally for export, Government policies have been directed more towards limiting the adverse effects of such influences, such as compensation for partial employment, rather than introducing stimulative counter-cyclical policies which would tend to draw in imports. However, the authorities resorted to special public works programmes and to fiscal incentives for the encouragement of new investment by the steel industry.

The rise in prices tended to be moderated. The consumer price index, taken as a whole, rose by 8.5 per cent in 1976 largely because a relatively small increase in the cost of imported articles coupled with a freeze on the retail margins of selected food items offset an acceleration in the rate of increase in the prices of other domestically produced goods.

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

In terms of current prices fixed investment in the European Community rose in step with the Gross Domestic Product, remaining at 21 per cent of the latter in contrast to the 23 per cent or so recorded at the beginning of the decade. The sectoral breakdown of gross fixed investment outlined in Table 2 indicates that the acceleration of investment in 1976 was limited to the business and housing sectors.

Business capital expenditures rose by 12.0 per cent in 1976 compared with a gain of 6.4 per cent in the previous year. Taking the Community as a whole, it seems probable that fixed investment by businesses rose moderately in volume in 1976. The reasons for this seem to have been the gradual improvement in the business climate and outlook as the various economies began to recover from recession. A slowing of the rise in costs and higher capacity utilization resulted in many instances in an encouraging increase in profitability. To this was added an improvement in the prospects for sales.

Housing construction expanded even faster than business investment, rising by 14.1 per cent in value in 1976. In general the housing market in many countries entered into a tentative recovery phase after the pressures of the last few recessionary years in which the extent of unsold housing units tended to inhibit the resumption of growth in new house construction. In a number of countries a movement away from multi-unit housing towards single family dwellings, probably represented the effect of rent controls which discouraged the construction of housing for rental.

While public authority capital expenditures grew faster than other forms of investment in 1975, this situation was changed in 1976 when public authority investment in rising by only 9.1 per cent was less buoyant than that of other sectors. In a number of countries the counter-cyclical stimulative programmes of Governments continued to exert an upward influence on capital expenditures but began to taper off during the year.

Chart II indicates the extent of changes in individual sectors of investment for the members of the Community, while Table 3 outlines the proportions of each sector of investment in relation to the whole. From this table, one can clearly see the effect of the decline in the public authorities' investment in the United Kingdom and Germany in 1976. The counterpart was a rise of 1—2 percentage points in the proportion of business investment to total investment in these two countries.

The main weakness of fixed investment during 1976 in a number of Member Countries appears to have been hesitancy on the part of the business sector to increase productive capacity. This applies particularly to Belgium, Luxembourg and the Netherlands in which business investment declined in volume. The United Kingdom also experienced a decrease in the volume of business investment though this decrease was smaller than in investment by the public authorities.

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

Sectors	In milliard units of account at current prices					Percentage of total	
	1972	1973	1974	1975	1976	1972	1976
Business investment	97.1	108.5	121.1	128.8	144.2	55.9	55.5
Housing	49.2	56.5	62.3	64.7	73.8	28.4	28.4
Investment by public authorities	27.2	29.3	34.6	38.5	42.0	15.7	16.1
Total Community	173.5	194.3	218.0	232.0	260.0	100.0	100.0

(1) The statistics for 1976 are estimates of orders of magnitude.

See "Principal Sources" 2.b, 3.b, 4.b, 5.b, 6.b, 7.c, 8.b, 9.b, 10.a.

In Italy, on the other hand, the growth of investment by the public authorities far outweighed the modest rise in business investment; this pattern occurred in a less pronounced form in Ireland. In France, Germany and Denmark business investment increased faster in volume than the domestic product.

As mentioned earlier, business expenditure in *Belgium* on fixed capital investment declined in volume by 11.4 per cent in 1976 following a drop of 4.3 per cent in the previous year. While the underlying business situation was strengthened last year, the faltering of the recovery in the second half tended to inhibit the expansion of new business investment.

On a number of fronts, however, the foundations were being laid for a future increase in investment activity. The counterpart to the rise in manufacturing output was the improvement in capacity utilization which increased from a low point of 71 per cent in October 1975 to 76.6 per cent in May 1976, when however it stabilized. In addition, the very small increase in unit wage costs of production, in relation to potential price gains, enabled the average enterprise to recoup some of the profitability which had been severely eroded during the recession. Nevertheless profit margins in certain key sectors of industry such as steel, non-ferrous metal products, chemicals, paper and textiles, continued to be under pressure owing to the weak order position.

In contrast, the volume of housing construction increased by 5 per cent in 1976 and, after taking into account the rise in prices of new housing, rose by 24 per cent in value terms. Major factors in this substantial surge in activity were the carry-over of unsatisfied demand from the previous year, the ready availability of mortgage funds at reasonable rates and, to a certain extent, the temporary raising (until early 1976) of the amount of grants available to stimulate new construction activity in certain regions of the country. New building permits increased so rapidly in the first half of 1976 that the authorities felt compelled to restrict the availability of new mortgages in order to avoid excess pressure on the construction industry and on financial resources.

The volume of investments by the public authorities grew in 1976 by almost 5.5 per cent, largely because the counter-cyclical acceleration of Government construction programmes which began in 1975 remained in force last year.

Luxembourg while benefiting similarly from special public works programmes, also experienced a fall in the volume of business investment which declined by about 7 per cent in 1976. This was the third consecutive year of contraction but, on this latest occasion, the weakness of the steel industry's markets was not to blame, since steel investment increased by an estimated 44 per cent in value last year. In view of the importance of the industry to the Luxembourg economy (contributing 30 per cent of total business investment), the Government initiated fiscal incentives in December 1975, which were the key factor in stimulating an expanded investment programme. New business construction by the rest of the economy, however, was very much lower than in 1975; indicative of this, the usage of cement was reduced by some 16 per cent last year. With a view to encouraging investments in general, the Government has decided to raise the rate of investment premiums from 9 per cent to 12 per cent, but this measure will only take effect in 1977.

New residential construction also declined, by some 13.5 per cent in volume terms, reflecting the lower demand for housing which has prevailed in recent years. As in 1975, the fall in construction was centred on new apartments since demand for houses appears to have stabilized. One effect of the reduced activity has been to bring the rate of price inflation in the residential construction sector more into line with the rest of the economy than in recent years.

Fixed investment by the public authorities rose in the neighbourhood of 20 per cent in value terms last year which implied an expansion in volume of about 10 per cent. The special public works programme instituted by the Government as an employment stimulant was a major factor which added roughly 13 per cent to the value of capital expenditures by public authorities between September 1975, when the programmes started, and March 1977.

In spite of the granting of substantial investment allowances and their increase as from the month of June, the volume of business capital expenditure in the *Netherlands* declined by a further 4.5 per cent in 1976 or to the same extent as during the previous year but rather less than that in its Benelux partners. The lack of growth in new productive investment stemmed directly from a relatively high degree of unutilized capacity and uncertainty as to whether business conditions would improve. Under such circumstances new investment tended towards the installation of labour-saving machinery and equipment rather than extensions to capacity through new construction.

A problem for the residential construction sector in recent years has been the saturation of the market and the need for the industry to adjust its size to the reduced level of household formation. There is some evidence that a new state of balance had been reached in 1976 following years of decline in new construction. Although the number of dwellings completed was lower in 1976, that of housing starts was moderately higher than a year earlier. Capital spending on new housing increased by about 11 per cent in value and by about 2 per cent in terms of volume. The pattern of demand in the Netherlands, as in a number of other countries in the European Community, appears to have shifted towards detached dwellings rather than apartments.

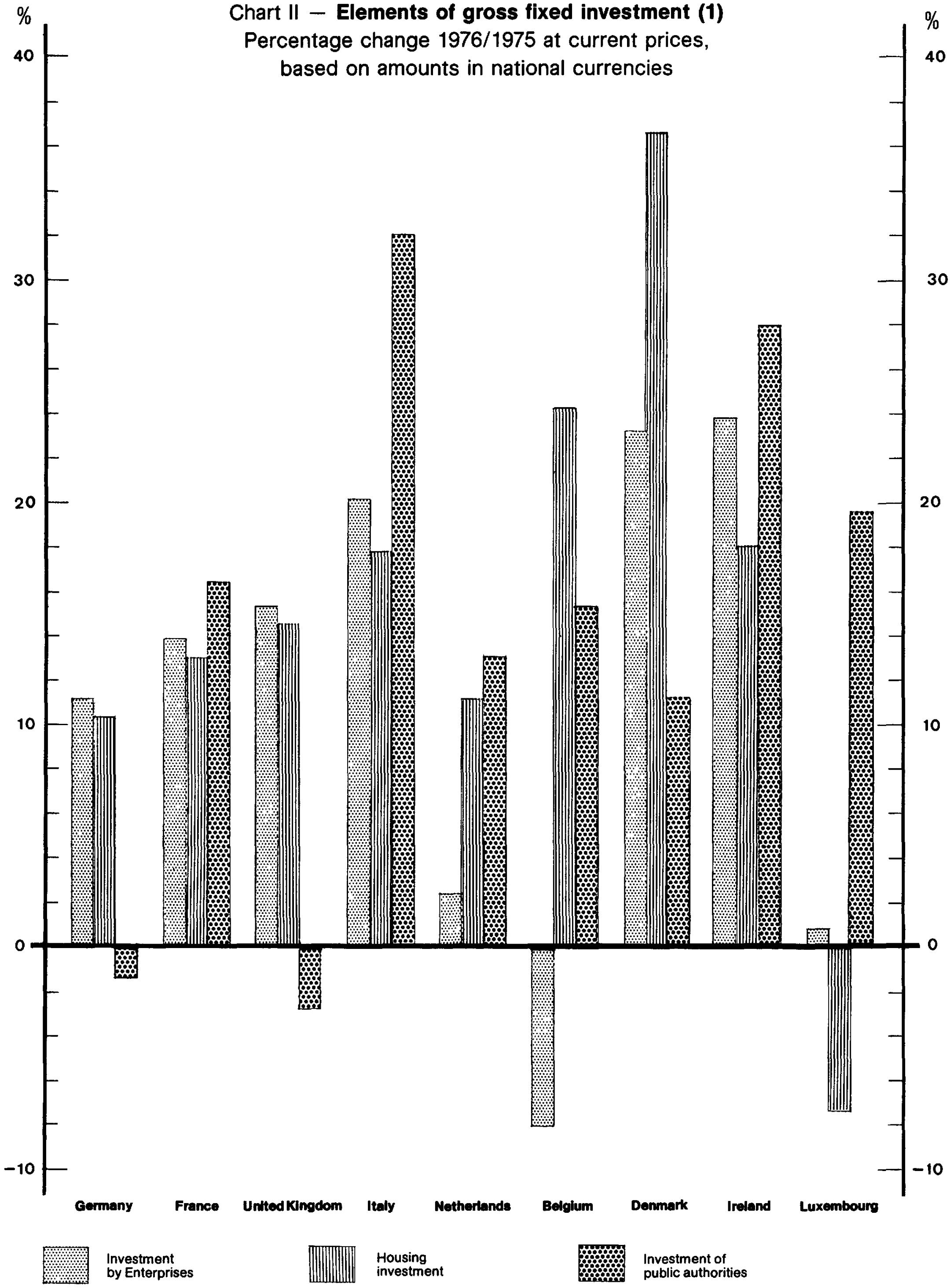
The volume of public authority investment increased by 3.5 per cent in 1976, roughly as in the previous year. This expansion reflected the continuing emphasis of the public authorities on providing new employment opportunities, particularly in the depressed construction industry.

The *United Kingdom* authorities have also sought to expand job opportunities, aiming to achieve this by encouraging productive investment. The reduction of some of the higher rates of VAT in the April 1976 Budget was expected to stimulate consumer expenditure and so to create a climate in which domestic output might rise, bringing idle productive capacity into use. In August, a revision of the Price Code to allow applications to raise prices to take a greater part of the cost of investment into account probably eased the financial position of companies. The significant increase in the value of trading profits in 1976 might have been less but for these two measures.

On the other hand, business sentiment was adversely affected to some extent by the raising of social security contributions payable by employers. Greater discouragement, however, came from the slow growth of industrial production which, for 1976 as a whole, was only 0.5 per cent higher than a year earlier. The volume of new business investment declined by 3.1 per cent in 1976; but after reaching a low point in the present investment cycle in the first quarter, capital expenditures moved irregularly higher during the remainder of the year. Indicative of the need for an improvement in the business climate was the volume of new investment in manufacturing industries which reached a low in 1976 some 22 per cent below that of 1970. In contrast has been the continued high rate of investment connected with the North Sea oil programme.

The volume of new residential construction was virtually unchanged from that of 1975. However, this result derived from the carryover of dwellings in course of construction from the end of 1975 and in the earlier part of 1976; after this, activity in both the private and public housing sectors was very depressed and housing starts in the fourth quarter of 1976 were 32 per cent lower than a year earlier. In the private sector, the rise in interest rates in the second half of 1976 posed problems for the Building Societies in their attempts to attract funds. Interest rates on new mortgages were increased with effect from 1 November in anticipation of the rise in interest rates offered to depositors which followed a few weeks later.

Chart II — **Elements of gross fixed investment (1)**
Percentage change 1976/1975 at current prices, based on amounts in national currencies



(¹) Estimates based on orders of magnitude.

See "Principal Sources" 2.b, 3.b, 4.b, 5.b, 6.b, 7.c, 8.b, 9.b, 10.a.

Uncertainty over the availability of funds for financing new construction tended to limit the willingness of private builders to construct housing without sales being assured. In the public sector, the introduction in July of curbs on local authorities' housing schemes, which were part of the more general controls on public sector expenditure, were a significant constraint on new public authority housing in the latter part of 1976.

The volume of public authority expenditure on other forms of fixed investment declined by some 14.5 per cent in 1976 and was almost at the same level in real terms as a decade earlier. The reduction last year was due to two factors; the series of decisions to curtail central and local Government expenditures taken from late 1975 onwards bore most heavily on discretionary capital expenditures and secondly the success of the revised system of administrative controls on departmental budgets which held expenditures within the reduced budgets.

The curtailment of capital expenditure by the U.K. public authorities was in sharp contrast to the policy followed in *Italy,* where public authority capital expenditures increased by some 32 per cent in value in 1976, continuing the very rapid expansion of investment by the public sector in recent years. A major stimulative programme announced in August 1975, introduced a new series of public works projects and unlike changes of policy in some other Community countries which have sought to restrain investment by the public sector, there was no cutback in capital spending in Italy in response to commitments to limit the growth of the public sector deficit.

Business capital expenditures rose rather less than those of public authorities. The increase was 20.1 per cent in value terms in 1976 which implies, if one excludes the rise in prices, only a marginal increase of perhaps 1 per cent in volume. Conflicting trends limited a clear-cut advance in business investment, despite the severe decline in real terms in the previous year. On the one hand, industrial output and exports were particularly buoyant in 1976, the first rising by over 12 per cent in volume and the second by some 33 per cent in value terms. At the same time it appears that company profitability rose during the course of 1976, albeit from a very low base, due in part to a rise in demand which enabled prices to be increased and in part to the much slower growth in labour costs per unit of output. It has also been the case that the rise in labour costs in recent years and, furthermore, the high potential costs involved in any eventual redundancies have encouraged companies to increase their capital intensiveness without necessarily adding to their work-force. A by-product has been the continued rise in unemployment in 1976. Despite the increase in output, capacity utilization remained relatively low at about 75 per cent at end-1976 compared with 68 per cent in the fourth quarter 1975. Similarly, it was clear that much of the rise in industrial output was linked to a once-for-all rebuilding of business inventories which, correspondingly, overemphasized the recovery in underlying demand. A further factor which may well have influenced investment decisions at the margin, was the very high interest rates (more than 20 per cent for most of the second half of 1976) payable on new bank loans by businesses.

New residential construction last year continued to be affected, as in 1975, by rent controls. Total housing investment rose by almost 18 per cent in value, which implied a small decline in real terms of about one per cent. A factor in this decline was undoubtedly the very high rates payable on mortgage loans which, with the rent freeze, offset the incentives for private proprietors to expand investment in accommodation for renting. But in total the volume of residential construction, both in the public and private sectors, was stimulated by the Government programmes introduced in mid-1975. Public sector housing, although contributing a small share of total residential construction, showed the strongest growth as a result of the injection of public funds for social housing purposes.

In *Ireland* the increase of about 28 per cent in 1976 in the value of public authorities' investment, as in Italy, reflected the adoption of poli-

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

Countries		Gross Domestic Product at current market prices	Gross fixed investment			
			As % of gross domestic product	Sectoral shares in %		
				Business investment	Housing construction	Investment by public authorities
Germany, DM milliards						
	1975	1 029.4	21	54	27	19
	1976	1 121.3	21	55	28	17
France, Ffrs milliards						
	1975	1 437.1	23	51	34	15
	1976	1 657.4	23	51	33	16
United Kingdom, £ millions						
	1975	103 294	20	65	20	15
	1976	120 911	19	67	20	13
Italy, Lit milliards						
	1975	114 215	21	55	29	16
	1976	142 128	20	55	28	17
Netherlands, Fl milliards						
	1975	205.4	21	58	24	18
	1976	232.9	20	56	25	19
Belgium, Bfrs milliards						
	1975	2 289.4	22	57	28	15
	1976	2 544.4	21	51	33	16
Denmark, Dkr milliards						
	1975	203.7	20	62	21	17
	1976	232.8	22	62	23	15
Ireland, £Ir millions						
	1975	3 666	24	54	26	20
	1976	4 473	24	55	25	20
Luxembourg, Lfrs milliards						
	1975	81.7	29	47	28	25
	1976	87.5	28	46	25	29
Total Community	1975	1 086.1	21	56	28	16
u. a. milliards	1976	1 237.8	21	56	28	16

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

See "Principal Sources" 2.b, 3.b, 4.b, 5.b, 6.b, 7.c, 8.b, 9.b, 10.a.

cies aimed at reducing unemployment. Nevertheless the Irish authorities' capital expenditure did not expand to the extent budgeted for the year.

The weak point in investment was the volume of new residential construction which declined by perhaps more than 5 per cent in 1976 but increased in value by 18 per cent. The volume decline was shared by the private and local authority housing sectors, both of which experienced a decrease in the numbers of houses started and completed. The closure of the Associated Banks during the summer months may have contributed to the difficulties of the housing market, both from the point of view of builders operating on borrowed funds and of house-owners unable or unwilling to conclude financial commitments at such an uncertain time.

Business capital investment on the other hand was perhaps the most expansive sector of the Irish economy in 1976 with growth in value terms of about 24 per cent. Much of this upsurge consisted in the inflation of capital goods prices, and it appears that a few large projects formed the bulk of the growth in business investment. There was a notable expansion of investment in the agricultural sector which may have been associated with the increase of farm incomes in 1975. The substantial increase in export orders for industrial products may also have required some extension of capacity for certain industries even though the seriousness of the unemployment situation suggests that many firms were not working close to full capacity. A further contribution to new investment no doubt derived the success in attracting new industry from abroad by means of generous investment and tax credits particularly for industries engaged in production for export.

Business investment played an even more important role in *France*. The growth in the volume of business investment (excluding housing) in France during 1976 of 7.3 per cent, which followed a decline of 7.2 per cent in 1975, was very largely due to the stimulation of investment by public enterprises through the apportionment, under the plan introduced in September 1975 for promoting economic recovery, of FF 13 milliard of budgetary funds for purchasing plant and machinery for the public sector. In the same plan a stimulus was also given to private enterprises through the grant of tax concessions for investment in productive capacity amounting to FF 2.8 milliard. Inverment activity by private enterprises as well as by public enterprises consequently rose during the first half of 1976. The vehicle construction industry, and the distributive and service industries increased their fixed investment during 1976 more than other industrial sectors. Later in the year, however, the outlook for profit margins became more uncertain; wage costs continued to rise strongly — hourly wage rates increased by 15 per cent in 1976 — even after prices were frozen until the end of the year under the "Barre" anti-inflationary plan and increases in interest rates put up the cost of investment at a time when there was surplus productive capacity in most industrial sectors. Not surprisingly private enterprises tended to defer the implementation of their investment plans.

Possibly as a consequence of the decline in investment in dwellings during 1975 the number of housing completions fell in 1976. However, the number of authorizations for building new dwellings began to rise again from the first quarter of 1976 onwards. This upswing was not particularly vigorous because of the uncertain economic outlook and generally low level of confidence and so investment in housing continued to decline in volume last year. As in a number of other Member Countries of the European Community, however, the demand for individual housing units increased while that for apartment blocks fell.

Fixed investment by the public authorities, which had expanded rapidly, by 10.5 per cent in volume, during 1975 as part of the effort to restimulate the economy, fell back to an annual rate of 5.4 per cent during 1976 and was slowing even more towards the end of the year. The pace of this expansion appears to have been accompanied by an increase in building costs of about 14 per cent in 1976 after having risen by just over 7 per cent the previous year. One of the main elements in the inflation of costs was hourly wages of construction workers, which had increased by 14 per cent during 1975 and rose by a further 19 per cent last year.

The growth of business investment in *Germany* was at about the same rate as in France although the economy had moved further towards economic recovery. The volume of business investment in 1976 rose by about 7.5 per cent compared with a decline of 1.3 per cent in the previous year. The most notable improvement was in the form of investment in new machinery and equipment, mainly intended for rationalization and replacement rather than in new additions to capacity. After fluctuations in the earlier months of the year, investment in capital equipment picked up considerably from the autumn onwards. As a result new orders received by firms supplying capital goods on the domestic market rose sharply towards the end of 1976, and the value of imported capital goods increased by 19 per cent in the fourth quarter 1976 compared with a year earlier.

Industrial firms were on average operating at 81.2 per cent of capacity in October 1976; while this represented some improvement compared with a year earlier, the degree of unutilized capacity acted as a constraint on new construction in some industries. The investment premiums on new construction offered by the Government (until mid-1977 or a year longer than a similar concession on capital equipment) encouraged a rapid rise in the first half of 1976 in permits to build, but these declined later in the year. In 1976 as a whole, however, the volume of new business construction rose by rather more than a year earlier.

New housing construction rose in volume terms by 6.7 per cent in 1976; but this improvement only partly compensated for the 10.4 per cent reduction experienced by this sector of investment in 1975. The turn-around nevertheless indicated a rise in demand from families for housing and the effects of the provision of public funds for modernisation. In general, there do not appear to have been any constraints from the financing point of view as mortgage funds were in plentiful supply at lower interest rates than for many years. The pattern of new house construction shows a continuation of the shift away from multi-unit housing and towards detached and semi-detached dwellings. Demand for multi-unit housing again fell, probably because the current rent act prevents property companies or individual landlords from charging rents sufficient to cover costs.

The volume of new capital expenditures by the public authorities contracted by almost 4 per cent in 1976 and even in value terms was 1.4 per cent lower than in the previous year. The public authorities have sought to contain discretionary expenditures so as to achieve a further reduction in the heavy cash deficits which were largely the result of lower tax revenues and social security contributions during the recession and of steeply rising expenditure on extensive programmes for sustaining economic activity as well as on social security disbursements by the Federal, Länder and municipal authorities during 1975 and 1976. As capital projects constitute a major portion of discretionary expenditures, the impact of budgetary curbs on the investment programmes of the public authorities has been particularly heavy. In addition certain infra-structural investment such as in hospitals and schools appears to be catching up with demand.

Fiscal incentives in *Denmark* aimed at reducing unemployment resulted in a higher growth in the volume of business investment than elsewhere in the Community. The rise of about 18 per cent in volume terms, however, followed a sharp decline in 1975 of 14 per cent. Industrial output increased by about 8 per cent in 1976 in response to the rapid expansion of consumer demand on the home market and the rise of export sales of about 7 per cent in volume terms. This increase was accompanied by a gain in profitability in 1976 after a depressing year for company earnings in 1975. As a result, there was increased willingness on the part of businesses to envisage additions to capacity and to commit funds for new investment. These factors were reinforced by the tax reliefs on new investment (up to 20 per cent reduction on taxable profits for investments made before end-1976), subsidies and loan guarantees granted by the Government in the autumn of 1975 and extended further in August 1976. Since these fiscal incentives are to be reduced in 1977, this may tend to dampen the pattern of investment in the current year. Unlike in a number of other Community countries where the recovery in investment has been directed mainly towards additions to machinery and equipment, the expansion of new capital expenditures in Denmark last year occurred equally in the construction sector. The amount of new industrial and commercial buildings under construction was 27 per cent higher in 1976 than in the previous year.

A quite pronounced pattern was evident for new residential construction in 1976. Late in the previous year and in the first quarter of

1976 the housing sector was favourably influenced by the lower VAT rate applicable at that time and by the longer payment periods available temporarily on mortgages for houses commenced before the 1st April. Subsequently, the number of starts on new housing units declined from the rate of the previous year, perhaps partly as a consequence of the high mortgage interest rates charged in the second half of 1976. However, the number of dwelling units under construction was generally rather higher than in 1975 and the volume of new residential investment rose by about 27 per cent in 1976. Statistics of expenditure on housing include reconstruction work which expanded considerably last year.

The public authority sector contributed less than others to overall investment growth last year, but nonetheless capital expenditures rose by about 4 per cent in real terms and by 11 per cent in value. Although the Government was active in expanding certain public works programmes with a high employment content, the need to contain discretionary expenditures in view of the very large budget deficit undoubtedly limited the scope for expanding investment.

CHAPTER 2

FINANCING OF INVESTMENT

2.1 THE FINANCIAL BACKGROUND

In early 1976 the scene was set for a high rate of activity on capital markets as monetary policies were accommodating, short-term interest rates and bond yields were on a downward trend, and capital markets were receptive to the flow of new issues. However, pressures soon developed on currency exchange rates then prevailing throughout the Community, and indeed the Italian foreign exchange market was closed for 6 weeks early in the year, such that capital markets were constrained by the backwash of events and the reactions of monetary policy to these essentially external difficulties. Currency pressures occurred mainly during two periods of the year, from mid-January to March and from late August to mid-October. Furthermore, it became evident during the year that the stimulative Government policies introduced during the economic recession were raising the size of the public sector's financing requirement in some Member Countries.

In many countries short-term money market rates rose higher than long-term bond yields and at such times investors tended to neglect the bond markets as funds moved into more profitable, shorter term instruments. It is hardly surprising, therefore, that total issues of securities in 1976 did not quite match the very large amount of issues in the previous year. With sometimes difficult issue conditions prevailing on capital markets during periods of the year, the proportion of bank credits in the total of financing in 1976 increased in relation to that of new bond and share issues — as can be seen in Table 5. In contrast, new public bond issues on the "European" international market rose by 105 per cent in 1976 in response to the declining trend of yields on that market and an abundance of funds seeking investment outlets.

Stimulative Government policies, while achieving their objective of raising economic growth, also resulted in some instances in higher import propensities and a deterioration of the current account deficit of the balance of payments. At the same time latent inflationary pressures were aggravated in some countries either by the economic expansion or by the increased cost in domestic currency of imported goods resulting from the decline in exchange rates. Consequently, monetary policy in a number of Member Countries had to be tightened during the year, despite the continued existence of high unemployment.

The tightening of monetary policy, more particularly when this coincided with periods of currency pressure, resulted in very sharp rises in interest rates in the United Kingdom, Italy and Denmark. Interest rates also rose in Ireland largely as a result of the close financial links with the United Kingdom. The rise in bond yields in these countries was almost continuous from February until October, as can be seen from Chart III. In the last two months of the year interest rates in these countries started to decline, thereby encouraging a resurgence of issue activity on most bond markets. In France, the authorities raised short-term money market rates in defense of the exchange rate in the first and third quarters of the year; bond yields were initially little affected but tended to edge higher from the summer onwards. Rather similar exchange rate pressures affected interest rates in Belgium and Luxembourg and bond yields moved irregularly higher during the year. In the Netherlands, bond yields moved lower in the first few months of 1976 in line with comparable rates in Germany. But currency pressures during the summer months raised yields abruptly and they did not decline again until the realignment of currencies within the "Snake" agreement in mid-October. Germany was the only Member Country in which bond yields showed a clear-cut decline over the balance of the year.

In the opening months of 1976 the external and domestic monetary situation in the *United Kingdom* was relatively stable, buttressed by a drawing on the International Monetary Fund oil facility. Interest rates declined during the first two months of the year and a sizeable amount of bond and share issues was absorbed by capital markets.

But from early March until the end of May the external value of sterling slid rapidly, losing some 12 per cent whether valued against the U.S. dollar or a trade-weighted basket of other currencies. This slide was checked in early June by the announcement that the Government had arranged a $ 5 300 million stand-by credit over three months (but extendable) from major creditor countries. In the meantime, the monetary authorities sought to rebuild the short-term interest rate differential in favour of the U.K. so as to discourage capital outflows.

During this period of rising interest rates the market in fixed interest securities turned hesitant. Concern also began to be shown that the growth of the public sector financing requirement would add to inflationary pressures. Influenced by this, the Government announced plans in July to limit the growth of expenditures (mostly capital spending) in the 1977-78 fiscal year and to hold the expansion of the money supply, broadly defined, to about 12 per cent for the year to end-March 1977. By September it was becoming evident that the money stock was increasing at a rate greatly in excess of this target, due to the slowing of gilt-edged sales to the non-bank public during the summer months and to more lending by the banks. The resultant blow to confidence brought sterling under renewed pressure in September and October when the exchange rate fell by a further 10 per cent on a trade-weighted average.

A further tightening of monetary policy was therefore found to be necessary. Two separate increases in special deposits were required to be made by the banks with the Bank of England, amounting to £ 750 million between late September and early November; but, while these measures severely reduced banks' liquidity, they did not immediately constrain bank lending. Also in November came the reintroduction of a system (known as the "corset") of supplementary reserve requirements against the growth of interest-bearing deposits with severe penalties on any growth above a given ceiling. This measure was aimed at discouraging too rapid a rate of increase in the money stock and in bank lending, without necessarily raising interest rates. During the same month, in a move to strengthen sterling, new lending to finance trade between third countries in the former Sterling Area was prohibited. The further step taken by the Government to agree in December the terms and conditions for obtaining a S.D.R. 3 360 million stand-by credit, drawable in stages over a two year period, had little impact on the capital market in what remained of 1976 but was one of the main influences in the restoration of confidence in early 1977.

The two periods of tension, from March to May and from September to November, were characterised by increases in yields on medium and long-term securities as well as sharp rises in short-term interest rates. Early in the year the base lending rate of the London clearing banks declined from 11 per cent to reach 9.5 per cent by the end of February before rising to 10.5 per cent three months later; between January and May yields on medium-term fixed interest securities issued by local authorities rose by a full percentage point to just over 14 per cent (annual compounding of interest). September and October saw three further rises in the base lending rate of the clearing banks which took it to 14 per cent. During these two months the Bank of England's minimum lending rate, which had been increased in May to 11.5 per cent in reflection of money market conditions, was raised in two stages to the record figure of 15 per cent. Meanwhile the average yield on medium-term local government securities climbed to about 16 per cent (annual compounding of interest). In the last two months of the year, however, yields were tending to fall, a movement which encouraged non-bank investors to take up Government securities on a massive

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

(Percentages)

	1972	1973	1974	1975	1976	Annual average 1972—1976
I. Depreciation	**48.4**	**48.4**	**52.6**	**58.2**	**57.5**	**53.0**
II. Long- and medium-term external resources raised on national capital markets	**18.7**	**19.0**	**12.0**	**20.7**	**16.8**	**17.5**
of which:						
shares	4.8	4.0	2.7	4.4	3.8	4.0
bonds	13.9	15.0	9.3	16.3	13.0	13.5
III. Other resources including net self-financing and bank and other credits	**32.9**	**32.6**	**35.4**	**21.1**	**25.7**	**29.5**
Total financing for gross fixed capital formation	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**

See "Principal Sources" 1.a, 2.a and b, 3.a, b and c, 4.a and b, 5.a and b, 6.a and b, 7.a, b and c, 8.a and b, 9.a and b.

scale towards the end of 1976 and to continue to do so in 1977.

The capital market and availability of credit in *Italy* were also seriously affected by a tightening of monetary policy aimed at correcting external disequilibrium and alleviating pressures on the exchange rate. Monetary policy remained restrictive throughout the year and had to be supplemented from time to time by direct administrative measures.

Among these measures was the closure of foreign exchange markets for a period of 6 weeks from 21 January onwards, so as to limit the loss of reserves resulting from supporting purchases of the currency. The value of the Lira vis-à-vis the U.S. dollar declined by roughly 11 per cent in dealings abroad during the period when the official market was closed. Meanwhile, the official discount rate was raised in several steps from 6 per cent at end-January to 12 per cent by 18 March. The banks likewise raised their base lending rates by 6 percentage points to 18 per cent during March. Bond yields did not react initially with such a large or rapid movement but increased progressively from 10.9 per cent in December 1975 to 14.0 per cent in June and then stabilized a little below this peak during the summer months. As a consequence of the pressures on foreign exchange markets, rising interest rates and tight monetary conditions, private investors were virtually absent from the bond market for most of the year. While this reduced the potential demand for new issues, the requirement that the banks hold 30 per cent of the increase in their deposits in the form of public sector bonds, underpinned the new issue market. This support was broadened by the raising of the bond holding requirement to 42 per cent of the increase in deposits between end-May and end-November 1976.

However, monetary conditions were tightened by a whole series of measures introduced in February. The reserve requirement of the banks was raised from 15 per cent to 15.75 per cent and, furthermore, a supplementary deposit of 0.75 per cent of deposits outstanding as at end-1975 was required of the banks. A further restrictive measure was the revocation of existing credit lines furnished by the Italian Exchange Office to the banks for the financing of short-term export credits. Also in February, the authorities countered the "leads and lags" element of pressure on the lira, by reducing the time allowed for the conversion of export receipts into lira to 15 days (previously 30-60 days); this period was cut further in May.

A scheme of prior deposits on imports, introduced in early May, resulted in a very significant drain on bank liquidity amounting to some Lit 4 000 milliard between May and August. From October onwards, over a period of several months, the measure was gradually phased out, thus releasing these funds to the economy.

In order to bolster the official reserves, a temporary loan agreement was reached with the EEC in March on condition that an attempt would be made to adhere to certain financial targets, notably the limitation of the public sector deficit. By the autumn, it was becoming clear that these targets would not be attained without further measures and urgency was given to their introduction by a fresh bout of currency weakness in October. During that month an austerity programme was announced which sought to reduce the Government financing requirement through increases in indirect taxation and higher public service charges. At the same time, the expansion of bank credit had exceeded the target agreed with the EEC, owing in part to the effects of the import deposit scheme, and the authorities decided to set a strict ceiling on the growth of bank credit, determined on a monthly basis, from October until March 1977.

In response to the renewed pressure on the currency in late September and October, restrictive monetary measures were reinforced. Official discount rate was raised by 3 percentage points to 15 per cent and bond yields reached a peak of 14.9 per cent in October before declining to 14.2 per cent at the end of the year. The bond market had been recovering slightly during the late summer, as a result of the stability in exchange markets and in interest rates, but weakened again following the events in October.

Balance of payments and exchange rate pressures accompanied by high and rising interest rates were also a feature of the financial situation in *Denmark*. The difficulties with which Danish monetary policy is normally faced, namely the need to encourage capital inflows as a counterweight to current account deficits, were accentuated by the growth of that deficit from Dkr 2.9 milliard in 1975 to Dkr 11.5 milliard last year. An objective of monetary policy in recent years has been the maintenance of sufficiently tight credit conditions and high short-term interest rates, to encourage the private sector to seek funds from abroad while avoiding, as far as possible, hindrance to domestic economic growth. In support of this policy, external borrowing by the public sector rose from Dkr 0.9 milliard in 1975 to Dkr 10.2 milliard last year, and the consequent capital inflows were a major factor stabilizing the external position. To contain pressures on the bond market the authorities reached agreement with the mortgage bond institutes that the latter would keep their new issues in 1976 within an agreed ceiling. Nevertheless, the financing of the Central Government deficit, which was much the same size in 1976/77 as in the previous year but much higher than earlier in the decade, encountered some reluctance on the part of investors on the domestic bond market in the first half of the year.

In following a policy of neutralizing excess liquidity the central bank called for substantial Special Deposits from the banks in late 1975 and early 1976, and started to offer short-term deposit certificates for tender with the intention of acquiring additional finance for the regulation of bond markets. The growth of the external payments deficit in the first quarter of 1976 and the extensive sales of foreign currency in support of the kroner, contributed to a sizeable reduction of banking liquidity. The banks consequently began to sell securities but the effect on bond prices was reduced by supporting purchases by the monetary authorities. Nevertheless, yields in Government bonds rose by about one percentage point between January and February, and the official discount rate was raised by that amount in mid-March. Under such circumstances, non-institutional investors were reluctant to take up new issues and this attitude extended into April when the newly announced Government tap issues attracted little support.

An aspect of monetary policy has been the setting of a bank credit ceiling based on loan

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

(milliard units of account)

Country	1973	1974	1975	1976
Germany	27.05	23.02	19.57	29.66
France	22.30	24.20	28.51	33.11
United Kingdom	20.86	14.08	8.00	14.36
Italy	20.86	14.07	20.96	22.75
Netherlands	6.75	8.07	7.84	10.87
Belgium	3.36	3.60	4.25	5.86
Denmark	3.98	3.68	3.53	5.25
Ireland	0.58	0.42	0.49	0.82
Luxembourg	0.18	0.28	0.28	0.48
Total Community	105.92	91.42	93.43	123.16
of which: shares	5.41	3.82	6.82	6.82
bonds	3.30	2.03	5.12	4.25
short, medium & long-term credits	97.21	85.57	81.49	112.09

See "Principal Sources" 2.a, 3.a and c, 4.a, 5.a, 6.a, 7.a and b, 8.a, 9.a, 10.b.

commitments which has, in recent years, been raised only by small amounts, thus restraining credit growth. This ceiling was raised by 2 per cent at end-August but purchases of foreign currency by the business sector between August and mid-October were financed to a large extent by borrowing and resulted in a rapid increase in bank lending. The strong demand for credit , combined with further strains on bank liquidity resulting from increased demand for forward exchange cover, raised money market overnight rates to over 20 per cent by early October. This coincided with the raising of the official discount rate by 2.5 percentage points to 11 per cent. These higher rates were allowed to influence the yield for medium-term Government bonds but had less effect on the long-term mortgage bond market. The average yield on Government bonds rose from 13.4 per cent in August (annual compounding of interest) to 16.1 per cent in October. A decline in the official discount rate in December had no direct effect on bond yields which remained high until the end of the year.

These very high yields on Government securities prompted a revival of investor interest on the bond market and the public sector was able to issue twice the amount of securities in the fourth quarter 1976 as in the three other quarters of the year combined. Contributing to the much improved demand conditions for Government bond issues was the substantial reflux of funds into Denmark following the realingment of the kroner within the "Snake" agreement on 18 October.

After a hiatus in the middle months of 1976 the bond market in *Ireland* also revived strongly during the final quarter. In early 1976, the financial situation in Ireland was characterized by slack loan demand, a high degree of banking liquidity, an absorptive bond market and declining interest rates. These conditions augured well for the financing of the very large Central Government financing requirement which, though it turned out some 25 per cent lower than originally budgeted, still was the equivalent of 11.5 per cent of GNP in 1976. While almost two-thirds of the Government's financing requirement for 1976 was met through borrowings from abroad, which amounted to almost twice the increased deficit on current account of the balance of payments, the remainder was financed in a non-inflationary manner mainly by sales of Government medium and long-term securities to the non-bank public and through the receipt of small savings. In January and February 1976 the Government was able to place a considerable amount of new bond issues on a receptive market. At this time short and long-term interest rates were declining, but they then climbed intermittently until October as conditions on capital markets hardened. The Government, however, resumed its public issues of bonds in the final quarter of the year when the market began to improve after the labour dispute which closed the Associated Banks (these banks account for more than two-thirds of banking activity in Ireland) between 28 June and 6 September. The recovery late in the year of the Irish capital market owed a good deal to a parallel improvement in the United Kingdom market.

Bank credit grew rapidly during the bank dispute, particularly to the personal sector and the manufacturing industries. Business was inevitably transferred to Non-associated Banks and other financial institutions unaffected by the dispute but much of the increase in bank lending stemmed in fact from the Associated Banks as non-clearable cheques drawn on bank accounts during the dispute were apparently accepted to a greater extent than expected.

The Government's financing position worsened during the period of the bank dispute, despite substantial borrowing from abroad, because most of its revenues were drawn on non-clearable cheques. The amount of such cheques accumulated by the Exchequer during the strike totalled some £Ir 230 million or roughly 45 per cent of the total annual financing requirement. The market for new bond issues was understandably quiescent owing to the difficulties of clearing funds. In the interim the Government's financing requirement was met by drawing down its balances with the Central Bank, by using its overdraft facilities with the latter and through previously arranged external borrowings.

There was also a substantial capital inflow into *France* during 1976 as may be seen in Table 10. The marked improvement in the balance of payments and the decline in the rate of inflation during 1975 allowed the authorities to pursue relaxed fiscal and monetary policies in the interests of stimulating the economy and combatting unemployment. In 1976, however, it soon became apparent that corrective measures would have to be introduced because the revival of activity began to have a seriously adverse effect on the balance of payments, resulting in pressure in foreign exchange markets against the external value of the currency. In addition progress in the struggle against inflation was checked and fears were aroused that prices might begin to rise more quickly.

The authorities were faced with the difficult task of maintaining control over the economy while still endeavouring to reduce unemployment and to encourage investment. The first quarter of 1976 accordingly saw the rate of interest on the ordinary loans of the official long-term credit institution, the Crédit National, reduced by one percentage point to 10.5 per cent and the introduction of a series of measures, including an extension of the initial period of tax exemption and the provision of special credits, to encourage the establishment of small and medium-sized industrial enterprises. In early April, a further step was taken in making available some Ffrs 2 milliard of budgetary resources for lending to enterprises, mainly in the steel industry, which were seriously afflicted by the recession, for periods of ten to fifteen years at the preferential rate of interest of 9.5 per cent. On the other hand, the period for term credits for purchases of consumer goods was reduced slightly towards the end of March as an anti-inflationary measure.

Largely in response to intermittent bouts of weakness of the franc in foreign exchange markets from late January 1976 onwards the French authorities reduced money market liquidity to the effect that short-term interest rates rose in February and March (the French franc was withdrawn from the European currency "Snake" during the latter month). The commercial banks raised their base lending rate on 1 April from 8.6 per cent to 8.8 per cent. They were to raise it subsequently to 9.2 per cent on 26 July and to 9.6 per cent on 27 September as their expectations of a tightening of credit were fulfilled. All these moves followed periods of particular weakness of the franc in foreign exchange markets. Similarly, the Bank of France raised its discount rate from 8.0 per cent to 9.5 per cent on 22 July and to 10.5 per cent on 23 September with corresponding changes in its other rates in order that these rates might remain effective in the face of a general rise in the interest rate structure. These increases in official rates of interest were however designed to indicate the resolve of the monetary authorities to defend the external value of the currency as well as to preserve room for manoeuvre.

An extension of the policy of limiting the increase in credit was foreshadowed when the Bank of France announced at the end of April that credit ceilings on bank lending would remain in force until the end of 1976. Through this measure the rate of growth of the money stock was reduced from 15.9 per cent in 1975 to 12.6 per cent in 1976, well within the increase in GDP at current prices.

The rise in short-term interest rates resulting from these developments had a limited impact both on the primary and the secondary markets. The primary market was particularly active at the beginning of 1976 when conditions favoured borrowers. Yields did not begin to rise on the primary market until March but over the year as a whole they increased by 0.80 per cent to about 11 per cent on new issues carrying a government guarantee and by 0.60 per cent to 11.40 per cent on new issues without such a guarantee. Yields declined a little on the secondary market but then rose similarly. The fact that the real return on fixed interest securities remained positive throughout 1976 contributed to the generally better tone of the bond market. The long-term credit institution, the Crédit National, which reduced its interest rate on its ordinary loans at the beginning of the year by 1 per cent was obliged to increase this rate in October by 0.5 per cent to 11 per cent. In spite of official intentions to hold the cost of long-term borrowing stable, these developments tended to raise borrowing costs. Moreover, when the Government launched, as part of the Barre anti-inflationary plan, a Ffrs 3.5 milliard loan in October in order to on-lend the proceeds to small and medium-sized enterprises at a subsidized rate of interest, the terms available to other borrowers on the market worsened in consequence.

As in France, a major influence on the money market in *Belgium* last year was the occurrence of pressures on the exchange rate which began in February-April, reappeared last July and persisted until mid-October. As a result of these pressures there were considerable outflows of short-term capital in the first and third quarters of the year which were largely reversed in the second and fourth quarters. These outflows, however, caused simultaneous shortages of funds on the money market and short-term interest rates rose accordingly. This disturbed the normal functioning of financial markets principally by driving enterprises to seek funds at longer term.

The difficulties of the long-term capital market were aggravated by the very large financing requirement of the public authorities as a whole, which had roughly doubled in two years. Owing to the outflows of foreign exchange and the liquidity squeeze on the money market, institutional investors were not always in a position to subscribe adequately to issues of short-term Government paper on the money market. At such junctures the Government was forced to rely heavily on funds from the Central Bank to cover its financing requirements.

Realizing that the maintenance of the exchange rate for the currency within the "Snake" currency alignment would lessen the risk of engendering increased inflationary forces in the economy, the National Bank of Belgium acted in defence of the franc by tightening monetary policy. As from mid-February, and for most of the year until mid-December 1976, the Central Bank instituted a split-level rediscount facility with the upper tier of the facility being charged at a rate sometimes considerably greater than the official discount rate. Similarly, for much of the year from mid-March onwards, financial intermediaries were required to hold public authorities' securities against a determined proportion of specified liabilities. However, the calming of the exchange rate situation after the realignment of currency parities within the "Snake" in mid-October 1976, permitted the Central Bank to ease its policy progressively towards the end of the year.

Owing to the closeness of the financial links arising from the Belgium and Luxembourg Economic Union, the *Luxembourg* authorities have only limited scope for initiating monetary policy actions distinct from the Union itself. Furthermore, the importance of non-resident funds in the functioning both of capital markets and the financial services sector far outweighs domestic sources of funds.

For example, some 80 per cent of total banking assets/liabilities relate to non-residents, underlining the need for monetary policy initiatives to be selective to achieve the desired impact on the domestic financial situation. With this in view, the Government announced that it would pursue an expansionary but prudent monetary policy in 1976. The ceiling on the growth of consumer credit was abolished on 1 April, and the money supply (broadly defined) was allowed to increase at an annual rate of 19 per cent to December.

The market for new domestic bond issues was active last year, as in 1975, despite the fact that long-term bond yields tended to rise for most of the year, those on Government securities increasing from 6.80 per cent in December 1975 to 7.69 per cent in December 1976. Although the budget was initially expected to be in moderate surplus (in fact the out-turn was a large surplus), the Government sought financing early in 1976 by means of its first bond issue in three years.

Long-term bond yields in the *Netherlands* ended the year very slightly below those at the beginning, although they rose fairly sharply in mid-year. January 1976 saw a continuation of the easier stance of monetary policy adopted by the Dutch authorities in the latter part of 1975 with the dual objective of providing adequate support for the nascent economic recovery and of promoting by means of relatively low domestic interest rates capital outflows which would compensate for the normal current account surplus on the balance of payments. Non-resident borrowers were freely admitted in the market for private placements, as a means of increasing the outflow of capital.

However, because of the guilder's strength in foreign exchange markets, the first quarter of 1976 showed on balance a continued appreciable inflow of funds from abroad, which contributed to a substantial growth in liquidity. After the end of the quarter sentiment in foreign exchange markets moved against the guilder, causing a reversal of capital movements into a strong outflow which resulted in a deficit in the balance of payments as a whole. The Netherlands Bank consequently increased its discount rate several times, raising it between May and August from 4 to 7 per cent, with concomitant increases in rates for its advances to banks. The immediate effect of the latter, welcome in view of the rapid increase in domestic bank credit and the money supply, was to increase the cost of short-term bank credit to the private sector. Other short-term interest rates moved upwards too; rates on 3-month loans to local authorities, for example, rose from a low in March of 2.99 per cent to 12.22 per cent in September. Yields on issues of long-term Government bonds rose more moderately to reach a peak of 10.03 per cent in August.

Under the circumstances a feeling of uncertainty prevailed in financial markets. The reversal of the normal short/long-term interest rate relationship had an additional adverse effect on the long-term capital market generally and from May until the autumn issue conditions were difficult. In order to limit this deterioration, the market in private placings was closed to non-residents from May onwards. Following the return of calm in the foreign exchange markets after the realignment of "Snake" currencies in mid-October and a reduction of capital outflows, the monetary authorities acted, through the provision of special loans and other measures, to reduce short-term interest rates as quickly as possible and so ensured a resumption of normal capital market activity. Discount rate was reduced to 6 per cent at the end of November and to 5 per cent on 7 January 1977. The return of normal market conditions permitted the authorities to readmit private placings by non-residents at the beginning of 1977.

In contrast to the experience of other markets within the Community, yields on the bond market in *Germany* fell appreciably during 1976 as a whole, although they rose briefly in the summer and to a smaller extent than in the Netherlands. The prolonged suspension of new bond issues by the public authorities in the second half of 1975, allied with supporting purchases by the Bundesbank, helped to restore liquidity and to strengthen the bond market which proved to be an abundant source of financing throughout 1976. At the turn of the year and in the early months of 1976, expectations of a decline in interest rates enabled a substantial amount of new issues to be absorbed without stress. During the course of the year progress in combatting inflation added to market confidence. Falling yields and rising bond prices provided further encouragement to investors to purchase long-term securities. Both the commercial banks and the non-bank public were active in taking up new bond issues. The banks which held sizeable free liquid reserves were able to purchase these bonds in spite of a strong upsurge in demand for credit emanating from private enterprises.

The administration of monetary and credit policy was conducted in a flexible manner throughout 1976. While the authorities sought to maintain support for the recovery in the economy, a number of initiatives were taken to contain a potentially excessive growth in the monetary aggregates which might have added to price inflation. Loan demand by enterprises was already rising in the early part of 1976 and strengthened in the second half of the year, largely because of the need to finance rebuilding of stocks and the recovery in fixed investment spending, and in consequence the monetary aggregates began to grow more rapidly.

However, much of the upward pressure on the growth of the money supply was in the form of temporary inflows of foreign exchange attracted to Germany by the strength of the Deutschemark within the European "Snake" arrangement. In February and March capital inflows amounted to some DM 10 milliard and, on their reappearance between August and October brought in a further DM 7 milliard. During the early summer and after the realignment of currencies in mid-October foreign exchange tended to flow out of Germany.

In order to reduce the effect of capital inflows in the early part of 1976 on the monetary aggregates, the Federal Government moved its previously large balances with the commercial banks back to the Bundesbank in March, thus reducing excess liquidity in the banking system until such time as the funds were disbursed as Government expenditure. With a similar aim in view the banks' minimum reserves with the Bundesbank were raised in two stages in May and June. In May and again in July the Government placed a considerable amount of medium-term notes directly with the commercial banks. This placing of notes with banks not only absorbed liquidity from credit institutions and covered part of the budget deficit over a longish period, but also placed less of a strain than bond issues on a market which had weakened during the second quarter of 1976 when declining interest rates turned investors away. In a further move to reduce liquidity the Bundesbank sold between end-1975 and end-November 1976 some DM 6.5 milliard of the security holdings it had accumulated in the summer and autumn of the previous year.

The public authorities' ability to finance their heavy deficits to a certain extent other than through public bond issues helped bond prices. Almost twice as much finance was raised through increased sales of Federal Savings Bonds and medium-term notes in 1976 as through public bond issues. Moreover, the continuation of a substantial interest differential in favour of yields on bonds compared with short-term interest rates in the money market encouraged an appreciable flow of funds, particularly those held privately, into longer-term investments. For the first time in four years a private sector borrower, taking advantage of the reduced cost of finance, launched a straight bond issue in a normal market operation.

It was only in the last quarter of 1976 that a certain, partly seasonal, tightness of monetary conditions brought about a narrowing of the differential between short and long-term interest rates. This was due to the higher loan demand towards the year-end and the reversal of capital inflows after the October realignment of currencies. Yields on public authority bonds declined from 8.6 per cent in December 1975 to 7.6 per cent in April but then, under the influence of heavy borrowings from the bond market by the public sector, rose to 8.1 per cent in July/August. The subsequent improvement in the outlook for prices and the maintenance of an expansionary stance in monetary policy led to a fresh decline in yields with those on public authority bonds falling to 7.2 per cent in December. The downtrend in yields on the bond market suffered a brief check at this stage but was resumed in the early months of 1977.

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

The expansion of total net financing to the non-government sector in 1976, 32 per cent higher at 123.2 milliard units of account, appears to have been a consequence of the recovery in capital investment last year. To this was added the increase in working capital requirements resulting from higher output and more particularly the rebuilding of stocks. The increase in finance provided in 1976 was principally by means of new credits rather than through capital market issues which nevertheless were only slightly lower than in the previous year. New bond issues by the public authorities, as indicated in Table 6, were 12 per cent lower in 1976, more of public sector financing requirements being met through borrowings from abroad. In a number of countries the launching of new bond issues, whether by private or public sector borrowers, was rendered difficult by rises in interest rates which attracted funds into shorter-term money market instruments. New bond issues by financial and non-financial enterprises were also a little lower in 1976 than in the previous year, with issues by credit institutions decreasing by 9 per cent to 23.7 milliard units of account.

As can be seen from Table 6, the total of financing made available through capital markets declined slightly to 57.2 milliard units of account in 1976, although this amount remained more than twice as high as in 1974. Share markets throughout the Community remained weak during 1976 because business prospects were dull but new issues declined by only 3 per cent in 1976 to 8.2 milliard units of account. Undoubtedly, the increase in company profitability and the improvement in sales prospects contributed to the attractiveness of new equity issues. The need for enterprises, and particularly credit institutions, to rebuild their equity to debt ratios which had been eroded by the high pace of inflation was still considerable in 1976.

There was less emphasis on precautionary saving in 1976 in most Member Countries than earlier in the recessionary phase of the economic cycle. In consequence the flow of new savings was generally a little less than in 1975. However, owing to the relatively slow growth of loan demand by businesses (with investment growth still subdued in many Member Countries), the banking system was often in a fairly liquid position at least at the beginning of 1976. Consequently few constraints hindered the availability of finance for investment from the banks, as credit controls generally excluded any restrictions on finance for productive investment. Since the statistics on bank credits include those at short-term it seems probable that an important proportion of the growth in this type of finance was for the purpose of augmenting stocks of raw materials and finished products. In view of higher company profitability and the relatively moderate increase in business investment of 12 per cent in the Community as a whole in 1976, it seems possible that the self-financing capacity of enterprises was improved in aggregate last year.

It can be seen from Table 5 that the largest increase in net financing in terms of actual value in 1976 was in Germany. Furthermore by far the largest part of the increase for this country came from the extension of bank credits, as can be seen in Table 9. Nevertheless there was a solid gain in the amount of new shares issues by enterprises, who were no doubt encouraged by the recovery in business prospects. In the Netherlands, also, the increase in total financing provided approached 40 per cent, with bank credits, in this instance furnishing all of the expansion. But in the Netherlands share is-

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

(milliard units of account)

Type of securities	1973		1974		1975		1976	
Shares	**6.63**		**4.87**		**8.43**		**8.16**	
of which:								
Credit institutions		1.22		1.05		1.61		1.34
Enterprises		5.41		3.82		6.82		6.82
Bond issues	**36.90**		**22.68**		**55.21**		**49.08**	
of which:								
Public authorities		12.41		5.69		24.06		21.17
Credit institutions		21.19		14.96		26.03		23.66
Enterprises		3.30		2.03		5.12		4.25
Total Securities	**43.53**		**27.55**		**63.64**		**57.24**	

See "Principal Sources" 2.a, 3.a and c, 4.a, 5.a, 6.a, 7.a and b, 8.a, 9.a, 10.b.

sues, as indicated in Table 7, were subdued owing both to the insufficient profitability of businesses, and to a lack of confidence that the business sector would have full scope to extend its activities. In France the expansion of new financing was less pronounced, and was only slightly greater than the rate of inflation. In Luxembourg and Belgium, the expansion of total financing was at a faster pace and in Belgium in particular, was based to a greater extent on the rise in bond issues (Table 8). The pattern of financing in Denmark, Ireland, the United Kingdom and Italy was influenced by currency fluctuations and the high interest rates prevailing during most of 1976. This affected bond market financing in particular and amounts raised by the non-government sector through new issues in 1976 were lower in all four countries than in the previous year. The counterpart was that financing through credit institutions increased very substantially for all these countries with the exception of Italy where the rise was more modest.

In *Germany* savings in the form of savings and time deposits (excluding inter-bank accounts), savings certificates and savings with building societies rose only slightly in 1976 following an exceptionally large increase in 1975. However saving by private households, taken as a whole, fell sharply in 1976. On the other hand companies' retained earnings seem to have increased substantially last year in reflection of the cyclical upturn in output and the moderation of cost increases.

The strong demand for market securities on the part of private investors and non-residents set the scene for a substantial increase in new bond issues at decreasing cost by the Federal Government in 1976. Net new bond issues by the public authorities as a whole rose by 25 per cent. To place this scale of activity in perspective, the amount of new issues last year was about five times higher than two years previously. New bond issues by financial institutions, although declining by 10 per cent, were still appreciably higher than two years earlier. Both private and public non-financial enterprises raised very small amounts by way of bond issues last year, continuing the pattern of disengagement from the market. The favourable outlook for profits and dividends aided share markets and new share issues by non-financial enterprises rose by 2.6 per cent (excluding the Mercedes Holding company purchase) in 1976. A large proportion of these issues took place at the very beginning of the year when share prices were on an uptrend; subsequently, share prices declined steadily to end about 6 per cent lower in December than a year earlier.

New bank credits rose sharply last year in response to the recovery in economic activity and the increased demand for the financing of fixed investment, additional working capital and stocks. The commercial banks commenced the year in a very liquid position which was augmented by substantial inflows of capital from abroad during the first and third quarters of 1976. Taken in conjunction with the reduced growth of their security holdings, the banks had ample opportunity to expand their loan portfolios. Much of the new bank lending to enterprises was long-term, rather than short-term, in nature. In contrast, the distributive trades, which borrowed more from banks in 1976 than other forms of businesses sought mainly short-term credit for the purposes of stock rebuilding. Loans to manufacturing companies, which comprise about one-third of the total of outstanding loans to enterprises as a whole, were fairly modest in 1976 but this compares with a net repayment of loans in the previous year. Within the manufacturing sector, the greater part of bank lending was to metal manufacturers, much of it at short-term, probably in order to tide these companies over a difficult period rather than to expand investments. The counterpart of this was a net repayment of short and medium-term loans by the chemical and petroleum industries which were recovering from a decline in markets.

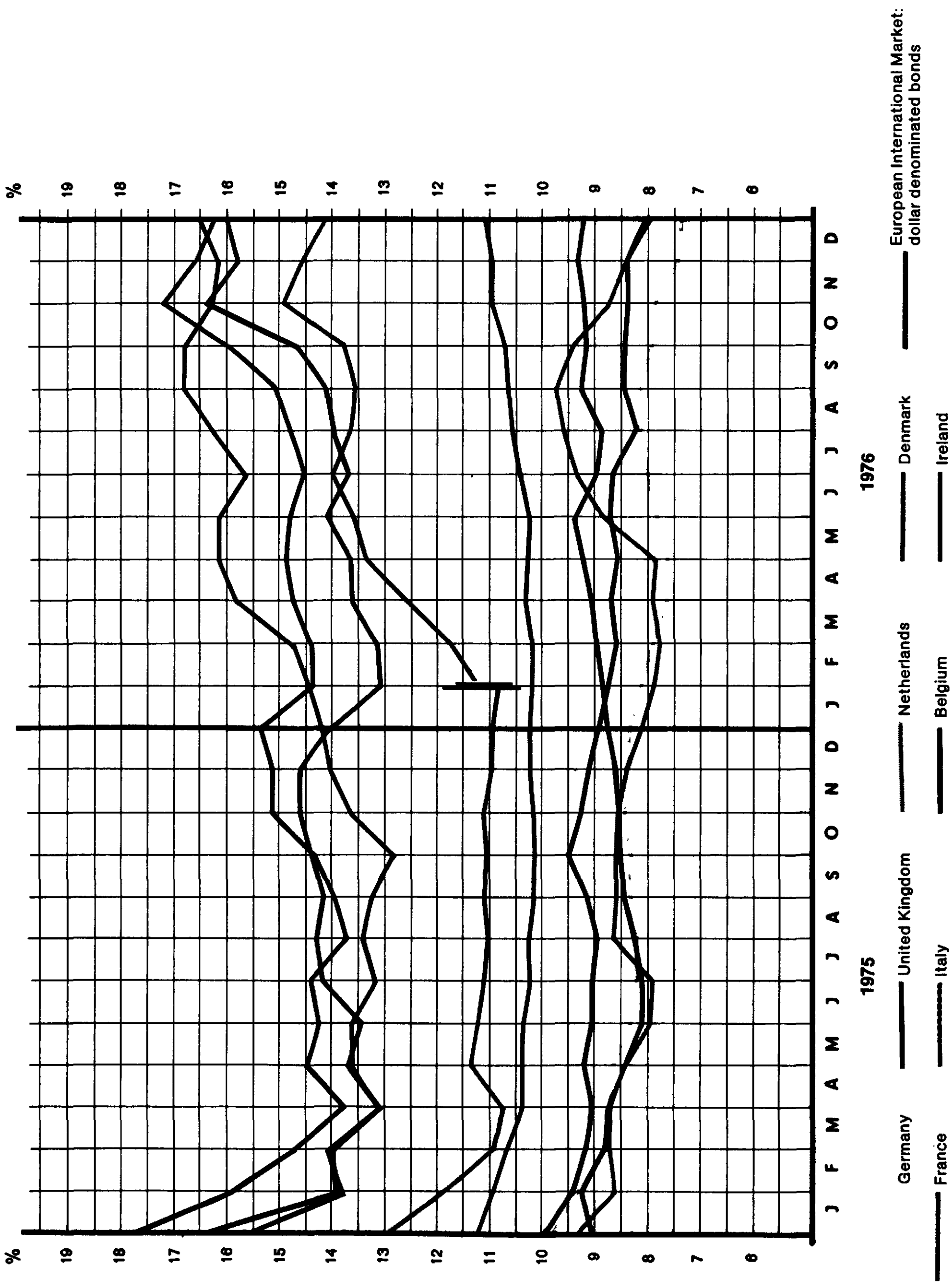
Personal savings behaved rather similarly in the *Netherlands.* The rate of personal saving, taken as a whole, appeared to change very little during 1976 despite a sharp increase in the component represented by new savings and time deposits. The growth of time deposits consisted at least in part of a switching of resources from demand deposits in response to the rise in interest rates at mid-year. The addition to saving in the form of savings accounts or deposits was offset by the growth in consumer credit, sometimes in the form of mortgage loans taken out for the purchase of durable consumer goods. Although the self-financing capacity of enterprises may have recovered only slightly in 1976 — and still seems to be less than desirable — there was clearly an improvement compared with the deterioration experienced in the previous year.

New bond issues by the Government increased by 42 per cent in 1976 in order to cover its large budget deficit. In February the Government announced that it would in future make issues on the market for private placings and this quickly became an important supplementary source of financing. Government issues of debt certificates (onderhandse leningen) which include such placings amounted to Fl 1 380 million in 1976 but because these borrowing operations do not take the form of public issues, they are not included in the tables of issues on the bond market. The difficulties in floating new public bond issues during the middle of the year affected private sector borrowers more than the public authorities. New bond issues by non-financial enterprises declined by 55 per cent in 1976 and those of financial institutions were 32 per cent lower than a year earlier. New share issues remained relatively unimportant as a source of finance.

New loans to the non-government sector more than doubled in 1976, primarily under the impetus of increased mortgage credits and of loans to the distributive trades to finance the rebuilding of stocks. In addition there was some further increase in loans guaranteed by the public authorities (in the form of "subordinated loans" furnished by the Nationale Investeringsbank in which its claims on company assets are subordinated to the claims of existing and future debt instruments), and extended primarily to companies experiencing temporary difficulties aggravated by the recession. On the other hand there was a small reduction in debt certificates (onderhandse leningen) issued by private sector borrowers; the amount borrowed through these certificates, which is included in the statistics of bank credit, fell from Fl 8 341 million during 1975 to Fl 8 051 million during 1976. About one-quarter of all loans outstanding to the private sector have been made to productive industries, and about a further one-quarter have been extended to the service industries. Loans outstanding to productive industries increased only moderately last year but with the construction and food industries borrowing more than other sectors.

Personal savings produced a rather less favourable result in *France* than in Germany and the Netherlands. The sharp rise in consumer ex-

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



See *"Principal Sources"* 2.a, 3.a and c, 4.a, 5.a, 6.a, 7.a and b, 8.a, 9.a, 10.b.

penditure in France during 1976 was reflected in a fall in the ratio of personal saving to disposable income to 16.8 per cent from 18.6 per cent the previous year. The amount of new saving placed on deposit with savings banks and other banking institutions or held in the form of Treasury bonds again rose, though by only 8 per cent in 1976 in contrast to the 39 per cent gain recorded in 1975. Company saving remained too low last year to provide an adequate volume of internal finance for investment but the situation was slightly better in that the self-financing ratio rose from 53.3 per cent in 1975 to 57.1 per cent in 1976.

The inadequacy of internal finance proved to be a serious obstacle during 1976 to renewed investment activity by private enterprises. The bond market remained an important source of finance but the net amount raised by such enterprises was 13 per cent less than in 1975. Financial institutions in the private sector in fact raised 47 per cent more money through bond issues in 1976 than during the preceding year but private non-financial enterprises raised 21 per cent less at a time when expenditure on investment was rising relatively quickly in terms of current prices. Public enterprises suffered an even sharper fall of 32 per cent in resources raised through their bond issues.

The share market which would have been expected to gain in buoyancy with the degree of economic recovery achieved in 1976 remained relatively depressed because of a general lack of confidence. Non-financial enterprises managed to raise virtually the same amount of capital through share issues in 1976 as in 1975 but financial enterprises raised much less. The uncertain economic outlook in France affected foreign investors and their direct investment, in contrast to recent years, declined during 1976.

The difficulty in obtaining finance either from internal sources or from securities markets led to increased demand being made of the banks for credit. Excluding credits to local authorities, short, medium and long-term banking-type credits rose by 15.7 per cent during 1976, much faster than in the previous year. Most of the increase in 1976 was in medium and long-term credit, a substantial part of which was no doubt devoted to the financing of investment. It should be recalled that this occurred during a period when the growth of bank lending was being restrained through the imposition of a credit ceiling. The index of bank lending subject to the ceiling in fact exceeded the prescribed limits in April, May, July, August and December 1976 but, because the banks were able to utilise shortfalls in their lending in earlier periods, the banking system, taken as a whole, accommodated the demand for credit without exceeding the official limits.

An increase in savings in *Luxembourg* in 1976 contrasted with the experience in most other Community members. The amount of time and savings deposits outstanding in the names of Luxembourg residents rose by 22 per cent in 1976 after having shown a net decline in the previous year. Profits of financial enterprises, which include the numerous banks participating in new issues on the eurobond market, no doubt increased rapidly in line with the expansion of eurobond issues last year. In contrast, the profits of non-financial businesses remained under pressure, notably in the steel industry where losses continued in 1976 albeit at a reduced rate.

The amount of bond issues by the public authorities increased in 1976, following four years of net redemptions of existing bonds, due to the Lfrs 1.0 milliard issue by the Central Government in January. Although issues by the enterprise sector declined by 29 per cent in 1976, activity remained very much higher than in earlier years. There was a single, but sizeable share issue in 1976 which resulted in a four-fold increase in the resources raised in comparison with the previous year.

New bank credits granted to the non-government sector rose by 80 per cent in 1976, with much of the gain attributable to short-term lending. Owing to the removal in April of the ceiling on the growth of consumer credits, new loans for this pupose accelerated sharply in succeeding months. New property loans (both residential and non-residential) were also considerably higher in 1976 but a large part of the growth in residential housing loans was for the purchase of existing dwellings rather than for new construction.

As might be expected from the existence of the monetary union between *Belgium* and Luxembourg, the availability of new credits from Belgian financial intermediaries also expanded rapidly in 1976, rising by around 30 per cent compared with the previous year. This growth was concentrated in new credits to individuals rather than in business loans. Owing to the rise in consumer spending, particularly on durable goods, the amount of new hire-purchase credits increased substantially. Long-term loans to the personal sector, principally mortgages, also rose in response to the expansion in housing construction that occurred in 1976. The increase in new mortgages tended to slow somewhat in the second half of the year following a limitation, as of end-May, by the authorities in the granting of new credits for house construction.

While banks were extending more credit in 1976, the total of gross savings by individuals and undistributed profits (including depreciation) of enterprises rose by 12 per cent . But the pattern of this growth as between individual and corporate savings was the converse of the previous year. In 1976, the profitability of many companies improved from the low base of the previous year while the value of business fixed capital investment rose only slightly: despite

Table 7 — **Share issues by country**

(milliard units of account)

Country	1973		1974		1975		1976	
Germany	**1.08**		**1.17**		**1.98**		**2.12**	
Credit institutions		0.33		0.32		0.60		0.52
Enterprises		0.75		0.85		1.38		1.60
France	**1.88**		**1.92**		**1.82**		**1.78**	
Credit institutions		0.44		0.34		0.25		0.17
Enterprises		1.44		1.58		1.57		1.61
United Kingdom	**0.32**		**0.25**		**2.36**		**1.77**	
Credit institutions		0.08		0.15		0.57		0.46
Enterprises		0.24		0.10		1.79		1.31
Italy	**2.80**		**0.95**		**1.67**		**1.87**	
Credit institutions		0.21		0.07		0.01		—
Enterprises		2.59		0.88		1.66		1.87
Netherlands	**0.05**		**0.03**		**0.16**		**0.06**	
Credit institutions		0.03		—		0.08		0.03
Enterprises		0.02		0.03		0.08		0.03
Belgium	**0.35**		**0.43**		**0.38**		**0.42**	
Credit institutions		0.07		0.08		0.06		0.07
Enterprises		0.28		0.35		0.32		0.35
Denmark	**0.10**		**0.05**		**0.03**		**0.09**	
Credit institutions		0.04		0.02		0.02		0.06
Enterprises		0.06		0.03		0.01		0.03
Ireland	**0.03**		**0.02**		**0.03**		**0.03**	
Credit institutions		—		0.02		0.02		0.01
Enterprises		0.03		—		0.01		0.02
Luxembourg	**0.02**		**0.05**		**0.00**		**0.02**	
Credit institutions		0.02		0.05		0.00		0.02
Enterprises		0.00		0.00		—		—
Total Community	**6.63**		**4.87**		**8.43**		**8.16**	
of which:								
Credit institutions		1.22		1.05		1.61		1.34
Enterprises		5.41		3.82		6.82		6.82

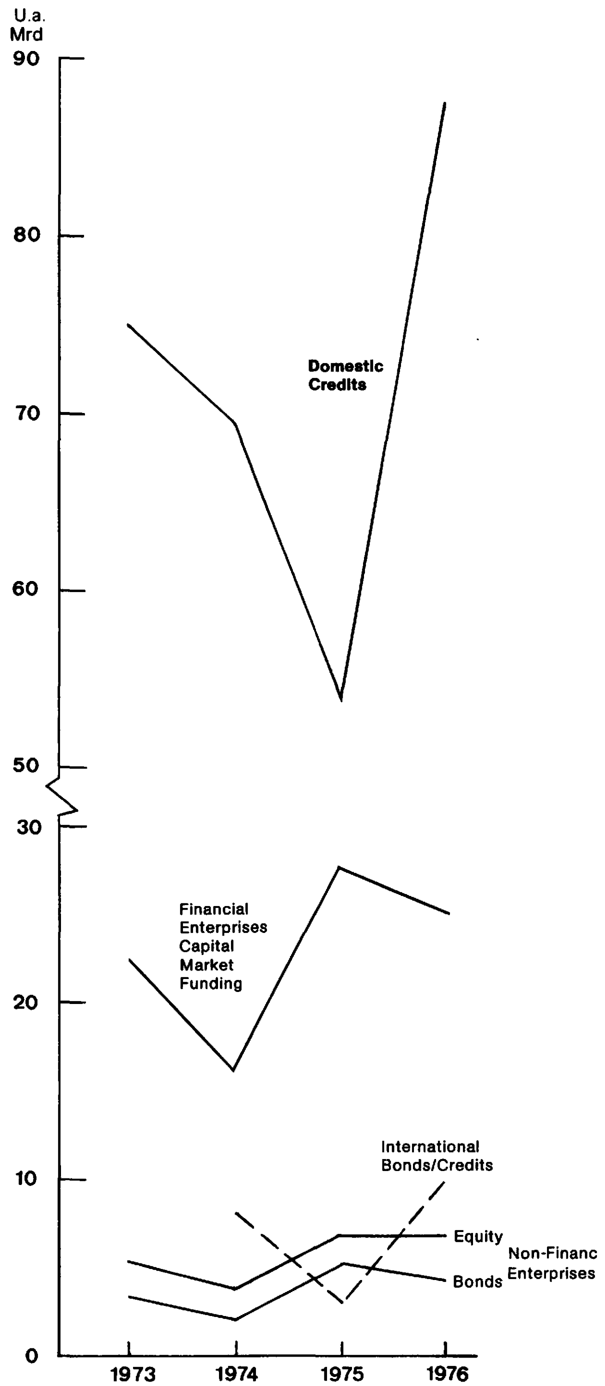
See "Principal Sources" 2.a, 3.a and c, 4.a, 5.a, 6.a, 7.a and b, 8.a, 9.a, 10.b.

the need to finance considerable additions to stocks in the first half of the year, the net self-financing capacity of enterprises moved higher. The rise in the acquisition of financial assets by the corporate sector was, however, artificially inflated by the arbitrage, or "round-tripping", activities of large companies which borrowed on priviliged terms from banks whenever higher interest rates were available on the money market. Financial savings by individuals in 1976 are estimated to have been at a slightly lower rate than during the previous year: it seems that some redistribution of available resources took place with enterprises raising their share relative to that of households. A further possible reason was that personal incomes increased at a much slower pace than in 1975.

Much of this saving went towards security purchases. However, in launching new bond issues to finance a large public sector deficit, the authorities had to offer investors a yield perhaps three-quarters of a point higher than those on quoted public sector bonds. Meanwhile the average yield on quoted Government long-term bonds rose from 8.80 per cent in January to 9.35 per cent in May and fluctuated a little below this rate in the remaining months of last year. Bond issues by the business sector rose considerably in 1976, raising more than double the amount of new funds of the previous year. In spite of the dividend payment restraints imposed by the Government in April and the decline of about 10 per cent in share values in the twelve months to December 1976, new share issues in the first seven months of 1976 were about 25 per cent higher than in the comparable period a year earlier.

In *Denmark* also the terms of new bond issues had to be made more attractive to investors. Net new bond issues by the Government on the domestic market were only 2 per cent higher in 1976, perhaps a reflection of the unchanged size of the financing requirement. In April, the authorities announced a new series of tap issues but , owing to the lack of investor demand at market yields then prevailing, very few securities were taken up initially. It was not

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



See "Principal Sources" 2.a, 3.a and c, 4.a, 5.a, 6.a, 7.a and b, 8.a, 9.a, 10.a and 11.

until the fourth quarter, after a relative rise in the yields of Government bonds and an improvement in sentiment on the bond market, that substantial sales of these securities could be made. The amount of new mortgage bond issues was in effect restricted by the ceiling (based on nominal values) agreed between the mortgage credit institutes and the Nationalbank. While this ceiling was reached in 1976, the market value amount of net bond issues by mortgage credit and other financial institutions was some 5.6 per cent lower than in the previous year. New share issues, although on small scale compared to the bond market, more than doubled in reflection of the temporary improvement in business prospects apparent in the first half of the year.

Business and private investors took up many more new bond issues than in 1975, perhaps in part owing to the recovery in corporate profitability in 1976 following its severe decline in the previous year, and in part to the attraction of higher yields. It nevertheless appears that the savings rate of households in Denmark declined in 1976 as consumer expenditures increased by about 15 per cent in value terms and exceeded the estimated growth of about 13.5 per cent in personal disposable incomes. This is substantiated to some extent by the reduction of 13 per cent in the growth of new time deposits with the banks.

The permitted ceiling on bank loan commitments was raised in three stages by a total of 7 per cent in 1976. However, the utilisation of these loan commitments by the commercial banks increased from 70.6 per cent in January to 79.1 per cent in December. Consequently, the growth of bank loans was at a much greater rate than indicated by the ceiling on credit commitments and amounts outstanding rose by 16.9 per cent in 1976. The pressures against the value of the kroner increased temporarily the utilisation by companies of their loan facilities, but the fact that the higher utilisation rates were maintained and even raised after calm had returned to foreign exchange markets indicates the underlying growth of demand for credit. Historically, over the past ten years, personal loans have shown the largest increase as a proportion of total bank credit outstanding, their share rising from about 7 per cent to 25 per cent. In contrast, the proportion of loans granted to the manufacturing sector during the same period has declined from 22 per cent to 15 per cent. These trends may have been influenced by the fact that the business sector has been encouraged, by the conduct of monetary policy, to borrow abroad while the personal sector has been restricted to seeking loans from domestic sources.

In *Ireland* as well as in Denmark there was a sharp increase in bank lending. The amount of credits outstanding to the non-government sector increased by 25 per cent in 1976, with much of the gain occurring during the summer. While it is likely that some of this growth was linked to the need to maintain companies' working capital in the face of non-clearable cheques accepted during the bank dispute, it also appears that the expanded business investment programme was at the root of a revival in private sector demand for credit, especially in the second half of the year. All sectors of the economy, except the financial services sector where a slight drop was experienced, shared in the expansion of new bank loans. Bank loans outstanding to manufacturing industries rose by about 35 per cent between February 1976 and February 1977, the biggest increase (over 70 per cent) occurring in the textiles, leather and clothing sector.

The total of new savings by the private sector in Ireland, by and large, increased in 1976 at a somewhat lower rate than that experienced in the previous year. To a certain extent the deterioration in employment prospects until the early autumn may have ensured a continuation of precautionary saving by those still at work. Understandably, savings with the Associated Banks grew less in 1976 (since they were closed for a part of the year) than in 1975; conversely, savings growth with the Non-associated Banks and other financial institutions was rather stronger than in the previous year. The placement of funds in the public sector savings banks rose sharply, in part as a result of the bank strike and in part as a result of the introduction late in 1975 of two new index-linked savings schemes designed to attract the small investor.

Issue activity on the domestic bond market was effectively in suspense during four months in the middle of the year. Partly for this reason the net amount of new funds raised through notes and bond issues on this market by the public authorities totalled some 52 per cent less than in 1975. Yields on long-term Government bonds declined in early 1976, but then rose from 14.3 per cent (annual compounding of interest) in February to a peak of 17.1 per cent in October . Investor expectations of a

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

(milliard units of account)

Country (')	1973		1974		1975		1976	
Germany	**8.37**		**8.26**		**14.43**		**15.25**	
Public authorities		1.13		0.68		2.98		3.94
Credit institutions		6.85		6.96		11.72		11.18
Enterprises		0.39		0.62		-0.27		0.13
France	**5.00**		**2.64**		**6.43**		**6.21**	
Public authorities		1.28		0.09		0.25		0.77
Credit institutions		2.33		1.54		3.00		3.03
Enterprises		1.39		1.01		3.18		2.41
United Kingdom	**3.23**		**1.24**		**9.87**		**9.00**	
Public authorities		3.12		1.29		9.71		9.01
Credit institutions		0.05		0.08		0.11		0.01
Enterprises		0.06		-0.13		0.05		-0.02
Italy	**14.51**		**4.26**		**14.68**		**8.53**	
Public authorities		4.47		1.50		6.30		2.83
Credit institutions		8.88		2.64		6.68		4.59
Enterprises		1.16		0.12		1.70		1.11
Netherlands	**0.50**		**0.85**		**1.47**		**1.10**	
Public authorities		0.12		0.29		0.64		0.56
Credit institutions		0.31		0.41		0.64		0.47
Enterprises		0.07		0.15		0.19		0.07
Belgium	**2.88**		**2.94**		**3.72**		**4.79**	
Public authorities		2.03		1.61		2.64		2.81
Credit institutions		0.64		1.08		0.86		1.45
Enterprises		0.21		0.25		0.22		0.53
Denmark	**2.18**		**2.27**		**3.85**		**3.84**	
Public authorities		0.05		0.01		0.83		0.92
Credit institutions		2.12		2.25		3.01		2.92
Enterprises		0.01		0.01		0.01		-0.00
Ireland	**0.22**		**0.23**		**0.72**		**0.32**	
Public authorities		0.22		0.23		0.72		0.32
Credit institutions		—		—		—		—
Enterprises		—		—		—		—
Luxembourg	**0.01**		**-0.01**		**0.04**		**0.04**	
Public authorities		-0.01		-0.01		-0.01		0.01
Credit institutions		0.01		-0.00		0.01		0.01
Enterprises		0.01		-0.00		0.04		0.02
Total Community	**36.90**		**22.68**		**55.21**		**49.08**	
Public authorities		12.41		5.69		24.06		21.17
Credit institutions		21.19		14.96		26.03		23.66
Enterprises		3.30		2.03		5.12		4.25

(') 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.

See "Principal Sources" 2.a, 3.a and c, 4.a, 5.a, 6.a, 7.a and b, 8.a, 9.a, 10.b.

subsequent decline in yields, which were fulfilled by a reduction from the October peak to 16.1 per cent in December, and a surplus of liquid funds created a favourable climate on the bond market for the substantial sales of securities which the Government made in the fourth quarter. New capital issues by industrial and commercial enterprises rose appreciably in 1976, albeit from a low base, while those by financial institutions declined.

Developments in the Irish capital market were strongly influenced by those in the *United Kingdom* where the market improved late in 1976. New bond issues by the U. K. public authorities were only 2.1 per cent higher than during the previous year, but more important was the pattern of this financing. In January and February 1976, declining interest rates assured a substantial uptake of new issues; there followed a period of rising or fluctuating interest rates, lack of investor confidence and reduced gilt-edged sales, particularly in the third quarter. The revival of the bond market in the fourth quarter coincided with a tendency of interest rates to decline once more which led to as large a volume of sales of gilt-edged securities as in the rest of the year combined. Companies continued last year to prefer to build up their capital base, and improve their capital ratios adversely affected by inflation through new equity issues rather than to raise new loan issues. Thus, there was a net redemption of loan stock by companies in 1976. New equity issues were in fact some 17 per cent lower than in 1975 when there was a sharp surge in such issues but remained very much higher than during earlier years of the decade.

New lending by banks to the non-government sector was 133 per cent higher in 1976 than in 1975, much of this growth being the result of borrowing by industrial and commercial companies. It would seem probable that much of the new lending to this sector was applied towards the rebuilding of stocks in the latter part of the year and other working capital requirements, since the increase in the value of business investment last year was relatively small. New mortgage loans to the personal sector rose by a modest 12 per cent in 1976 and thus did not quite match the rate of price increase in the residential sector.

Interest rates payable on deposits by the Building Societies were slower to decline in the ear-

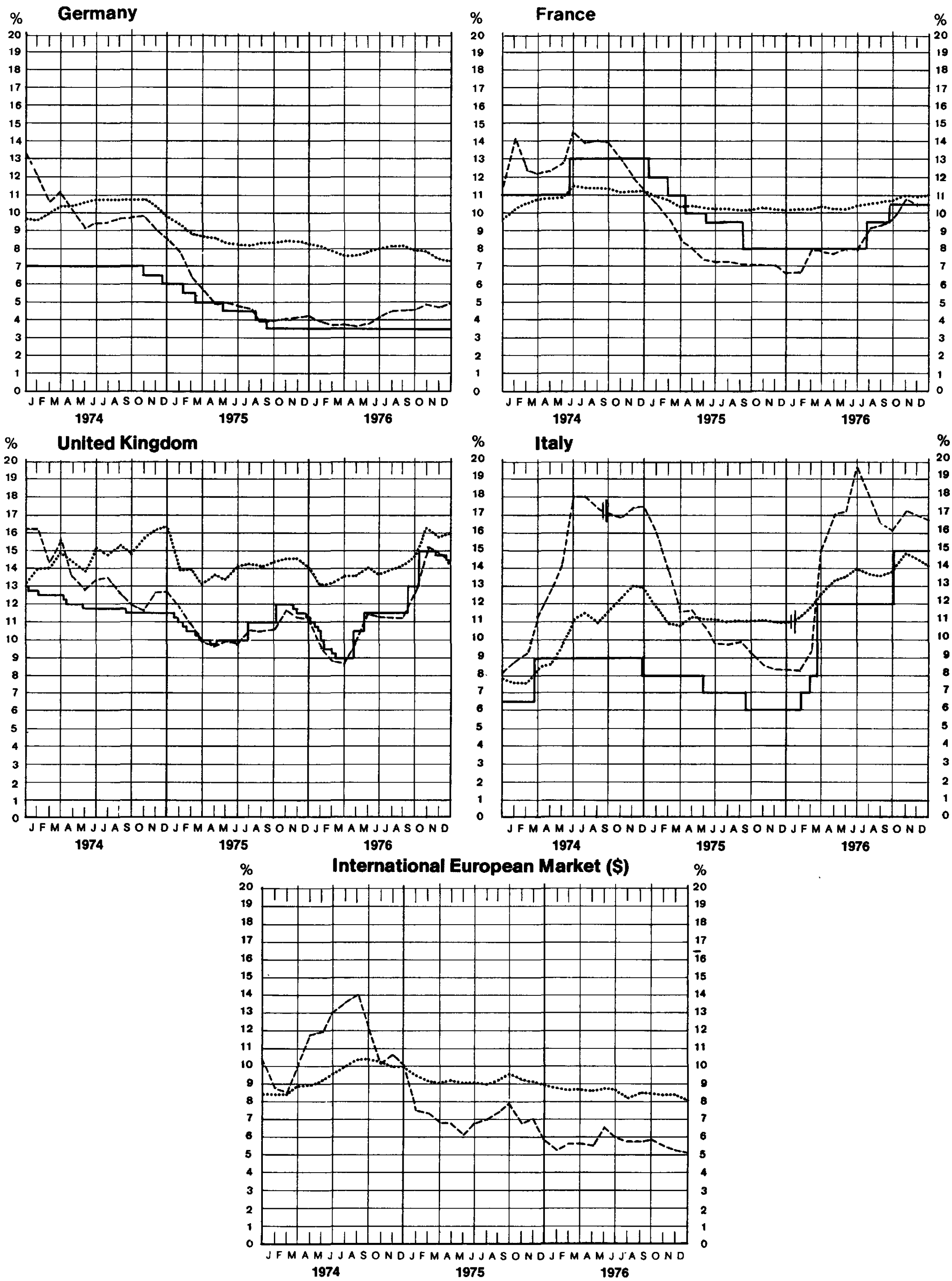
Table 9 — **Short, medium and long-term credits to the non-government sector**
(Variation in amounts outstanding at year's end)

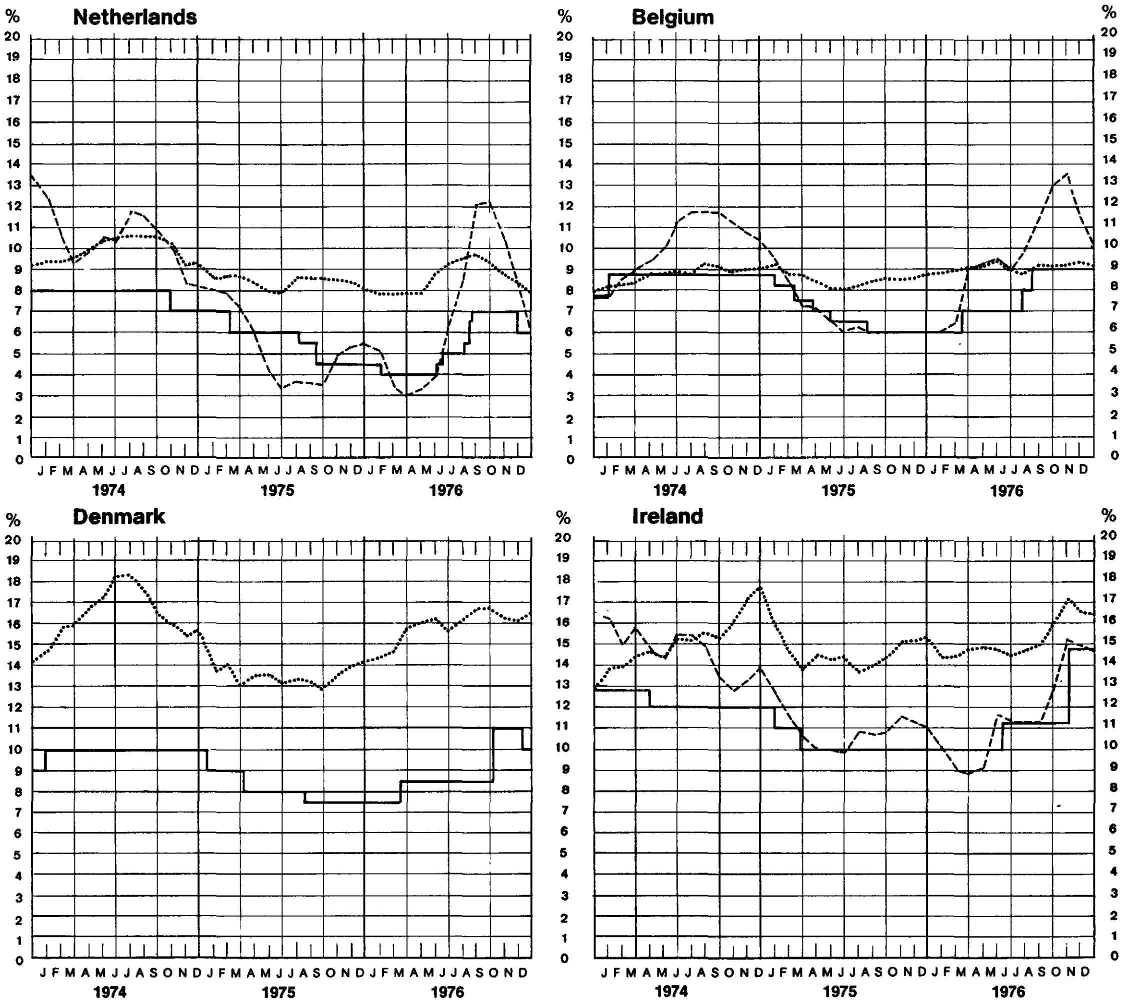
(milliard units of account)

Country	1973	1974	1975	1976	of which funds raised through security issues by credit institutions			
					1973	1974	1975	1976
Germany	25.91	21.55	18.46	27.93	7.18	7.28	12.32	11.70
France	19.47	21.61	23.76	29.09	2.77	1.88	3.25	3.20
United Kingdom	20.56	14.11	6.16	13.07	0.13	0.23	0.68	0.47
Italy	17.11	13.07	17.60	19.77	9.09	2.71	6.69	4.59
Netherlands	6.66	7.89	7.57	10.77	0.34	0.41	0.72	0.50
Belgium	2.87	3.00	3.71	4.98	0.71	1.16	0.92	1.52
Denmark	3.91	3.64	3.51	5.22	2.16	2.27	3.03	2.98
Ireland	0.55	0.42	0.48	0.80	—	0.02	0.02	0.01
Luxembourg	0.17	0.28	0.24	0.46	0.03	0.05	0.01	0.03
Total Community	97.21	85.57	81.49	112.09	22.41	16.01	27.64	25.00

See "Principal Sources" 2.a, 3.a and c, 4.a, 5.a, 6.a, 7.a and b, 8.a, 9.a, 10.b.

Chart V — **Short and long-term interest rates**





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.

See "Principal Sources" 2.a, 3.a, 4.a, 5.a, 6.a, 7.a, 8.a, 9.a.

ly part of the year than those of the clearing banks and so until August the Societies' net receipts of funds were relatively high. This situation was abruptly reversed in September/October when the clearing banks' interest rates were raised by several percentage points before the Building Societies reacted to the generally tighter monetary conditions, and the societies' receipts fell drastically in the fourth quarter of the year. Personal savings in the United Kingdom increased by 10 per cent in value last year which implies some decline in real terms, given that the rate of price inflation was significantly higher than that figure. For 1976 as a whole, the ratio of personal savings to disposable income decreased only slightly compared with the previous year, and thus remained at a historically high level.

Gross trading profits of companies, excluding stock appreciation but including depreciation provisions, rose by 24 per cent in 1976. This performance raised nominal profits to a point only a little higher than in 1973 which implies a substantial decline in real terms in the interval. The limited recovery of profits from the recession conditions in 1974/75 was probably helped by the recognition by the Government that some easing of the interpretation of the Price Code was necessary if productive investments were to be encouraged. In addition a potential threat to the financial position of companies was postponed when the temporary relief from taxation on increases in stock appreciation resulting from inflation was extended. Within the total of private and public enterprises, the gross trading profits of the nationalised industries responded strongly to the new directive of the Government to such corporations to earn an adequate return on the capital invested. Furthermore, exporters seem to be gradually changing to quoting export prices in foreign currency and, by maintaining prices unchanged as the value of sterling declined, may have increased the unit profitability (in sterling) of their exports. On the other hand construction companies engaged in residential construction have continued to contend with difficult financial conditions.

There appears to have been a similar sharp recovery in nominal company profits in *Italy* in 1976, admittedly from the very low point reached in 1975. The self-financing capacity of manufacturing enterprises, based on a sample of limited dimensions, recovered from 47 per cent in 1975 to an admittedly still low 70 per cent in 1976. Although new savings by individuals, as represented by time and savings deposits with banks and the Post Office Giro, declined by 20.3 per cent in 1976, they had more than doubled in the previous year and thus the flow of new savings remained considerably above that of earlier years. While incomes continued to increase rapidly, the buoyant growth of personal spending which was a major factor behind the expansion of the economy in 1976 absorbed a greater proportion. A smaller part of the residual saving found its way to the bond market.

The tendency for interest rates to rise in Italy for much of 1976, largely as a result of pressures on the exchange rate, created difficult conditions on the bond market and new public issues by both the public and private sectors were lower than in the previous year. New bond issues by public and private enterprises declined 27 per cent in 1976 while those by financial institutions decreased 23 per cent. Capital issues by financial and non-financial enterprises were mostly made on the first quarter of the year, in September before the renewal of pressures on the exchange rate and in December when interest rates had started to decline. The uptake of new issues by individuals was very much reduced and almost three-quarters of the total of bond issues in 1976 was taken up by the commercial banks, compared with a proportion of a little over half in 1975. This pattern reflected the increase (to 42 per cent) in the requirement that banks hold a proportion of their new deposits in the form of public sector bonds. New bond issues by the public sector were however halved in 1976 compared with the previous year, a result which was attributable to the lack of interest by non-bank investors in new issues rather than any decline in the public sector financing requirement. Despite the decline in share values of about 8 per cent in 1976, new share issues by enterprises rose by 25 per cent compared with the previous year. This would seem to be a reflection partly of the increase in business confidence during the earlier part of the year, and partly of the compliance by companies which had suffered losses in recent years with a legal obligation to reconstruct their capital.

New credits to the non-government sector increased by 25.8 per cent in 1976, but if this is related to the rise in prices of some 19 per cent, it can be seen that the growth in real terms was relatively modest. All of the expansion was in the form of short-term credits and more particularly those arranged in connection with the financing of the deposits required by the controls over purchases of foreign exchange. The ceiling on credit growth introduced in October certainly restrained the expansion of new credits in the last few months of the year. Furthermore, the difficulties encountered by the specialised credit institutions in placing their bonds with investors last year tended to limit the availability of credit from this source. But private enterprises, and particularly small companies, as opposed to public enterprises appear to have been the main beneficiaries of the expansion of lending in 1976.

Loans to manufacturing industries as a proportion of total bank loans outstanding amounted to 55 per cent, forming the largest proportion to manufacturing in all the Community countries. Loans to the non-financial services and construction industries took a further 31 per cent of loans outstanding.

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

The United States capital market which was reopened to public issues by foreigners in 1974 began cautiously but by 1975 had already over-

Table 10 — **The contribution of external capital flows to domestic financing** (1), **1976**
Provisional estimates
(+ inflow; — outflow)

(million units of account)

	Germany	France	United Kingdom	Italy	Netherlands	Belgium/Luxembg	Denmark (2)	Ireland
Private long-term capital								
Net direct investment	−762	−1040	+ 281	− 61	− 560	+421	+ 34	− 85
Net portfolio investment including loans	−139			− 48	−1314	−432	+ 329	
Total private long-term capital flow	−901	−1040	+ 281	− 109	−1874	− 11	+ 363	− 85 (3)
Public sector long-term capital flow, including loans, total	+835	+ 75	−1328	+ 53	− 184	+ 95	+1495	+507
Short-term capital flow, total (4)	+378	+3504	−2691	+1591	− 227	−510	− 1	+149
Total capital account of Balance of International Payments (5)	+312	+2539	−3738	+1535	−2285	−426	+1857	+571

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

See "Principal Sources" 2.a, 3.a, 4.a, 5.a, 6.a, 7.a, 8.a, 9.a.

taken the Swiss market in foreign issues as a supplier of capital to Community borrowers. In 1976 when banks and institutions in the Community raised a total of $ 1 200 million, equivalent to 1 065 million units of account the gap widened further.

There were only seven borrowers from the Community who approached the New York market in 1976, though some of them did so twice. These included the European Economic Community itself which raised $ 100 million as part replacement for a floating rate dollar credit, the European Coal and Steel Community which obtained $ 325 million in two operations and the European Investment Bank which also tapped the market twice in raising $ 175 million. The remaining $ 600 million was all borrowed by French institutions, the Caisse Nationale des Télécommunications ($ 225 million in two operations), Electricité de France ($ 200 million in two loans), the Société Nationale des Chemins de Fer ($ 100 million) and the Banque Française du Commerce Extérieur ($ 75 million).

As a general rule foreign borrowers on the New York market may expect to pay nearly a percentage point more than a comparable domestic borrower making a similar issue. The relatively high yields which have to be offered by borrowers other than first class names, as well as more elaborate and costly registration procedures than on the international market in Europe, explain why there were so few borrowers from the Community. In the last four months of 1976, however, the terms of issue moved in favour of borrowers.

On the Swiss market in public issues, banks, non-financial institutions and companies from the Community raised Sfrs. 1 250 million in 1976, equivalent to 441 million units of account, appreciably more than the equivalent of 310 million units of account collected the previous year. In contrast to the New York market, there were no fewer than sixteen different borrowers, none of whom was permitted by the regulating authorities to approach the market twice.

Offering yields on an issue of fifteen year bonds declined during the course of 1976 by over two percentage points. Reflecting the low rate of inflation in Switzerland, yields were less than in any other market open to foreign borrowers. At the end of 1976, for example, the yield offered on a fifteen year bond was around 5.55 per cent, probably over three percentage points less than would have been required on the U.S. market. For most borrowers, however, the exchange risk attached to issuing a loan in Swiss francs would probably have been greater.

CHAPTER 3

INTERNATIONAL CAPITAL MARKETS

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

The consolidation during 1975 of the recovery in the international capital market laid the foundations for a boom in activity last year throughout which the market was well supplied with funds. The international banks were very liquid and looking for means of employing their idle resources; some it seems were buyers of bonds for their own account. Redemption proceeds from earlier bond issues grew in volume in 1976 and their reinvestment provided a firm base for new issue operations. The gap between interest rates on short-term euro-currency deposits and bond yields remained wide enough throughout the year to encourage funds to flow towards the bond market. In combination, these factors led to a doubling of the amount of new public issues of bonds (taking issues managed by domestic syndicates as shown in Table II together with those managed by international syndicates) from 5 348 million units of account in 1975 to 10 978 million units of account in 1976. The change between the two years in private placings, on the other hand, was relatively minor (see Table 13). The statistics of private placings, derived from data published by the OECD, may not represent the full extent of such issues which are often secretly arranged. They indicate, however, that private placings have remained an important source of finance, even if they form a smaller proportion of the primary market than in recent years.

The dollar sector of the international bond market continued to be the largest, accounting for approximately two-thirds of new issues whether public or private. New public issues denominated in U.S. dollars more than trebled for the second year in succession to reach the equivalent of 6 773 million units of account. Canadian dollar issues also more than trebled, thereby accounting for 12.5 per cent of public bond issues. However, they remained less than Deutschemark issues which formed a fifth of the total. The popularity of Canadian dollar issues, in 1976, appears to have been temporary, lasting while the currency stood above par against the U.S. dollar. Private placings in Dutch guilders were 20 per cent lower in 1976 than in 1975 mainly because of the suspension of placings by non-residents between May and December. Issues denominated in other currencies raised relatively small amounts.

Somewhat surprisingly, in view of the intermittent unrest in foreign exchange markets during 1976, little resort was made to issues denominated in units of account. Issues in European units of account (the classic formula and not the unit based on a basket of currencies) fell by 72 per cent between 1975 and 1976. The 1975 experiment of issues denominated in Special Drawing Rights was not repeated last year nor were any issues made in European Currency Units.

The strength of the international bond market during 1976 was underlined by the downtrend in yields on the primary as well as on the secondary market, despite the surge in issuing activity. Yields on the secondary market in dollar securities declined from just under 9 per cent at the beginning of 1976 to just over 8 per cent at its end; during the same period yields on Deutschemark bonds fell from a little over 9 per cent to about 7.75 per cent. On the primary market, average issuing yields of dollar bonds fell during 1976 from about 9.2 per cent to 8.25 per cent; similarly yields on Deutschemark securities dropped from just over 8 per cent to

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

(million units of account)

	Domestic Syndicates		International Syndicates	
	1975	1976	1975	1976
Convertible bonds	**—**	**11**	**100**	**654**
U.S. dollars	—	—	100	561
Deutschemarks	—	—	—	91
Dutch guilders	—	11	—	2
Bonds with warrants	**—**	**—**	**—**	**36**
U.S. dollars	—	—	—	36
Straight bonds	**626**	**646**	**4 622**	**9 631**
U. S. dollars	—	—	2 057	6 176
Canadian dollars	—	—	409	1 288
Deutschemarks	346	461	1 321	1 735
French francs	28	47	205	42
Dutch guilders	131	116	—	47
Belgian francs	66	—	—	—
Luxembourg francs	55	22	—	—
Norwegian kroner (DM option)	—	—	34	—
Australian dollars	—	—	—	17
Kuwaiti dinars	—	—	135	220
Dirhams/U.A.E.	—	—	—	24
European units of account	—	—	292	82
Special drawing rights (SDR)	—	—	137	—
European currency units (E)	—	—	32	—
Total Issues of Securities	**626**	**657**	**4 722**	**10 321**
Borrowers in Europe (¹)	**461**	**310**	**2 649**	**5 204**
Within the Community	401	160	1 461	3 318
— European Economic Community	—	—	—	440
— European Investment Bank	219	11	168	232
— Commission of the European Communities (on behalf ECSC)	112	110	87	279
— Other Community borrowers	70	39	1 206	2 367
Outside the Community	60	150	1 188	1 886
Borrowers on the American Continent	**—**	**—**	**851**	**3 223**
U.S.A.	—	—	167	792
Others	—	—	684	2 431
Japanese borrowers	**—**	**—**	**615**	**874**
Miscellaneous	**165**	**347**	**607**	**1 020**

(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.

Source: E.I.B.

a little under 7 per cent (though with a temporary rise in mid-year back to 8 per cent when the currency appeared to lose some of its potential for appreciation).

The decline in yields was accompanied by a sharp increase in the size of a number of loans and by a gradual extension of maturities of new issues to something like the terms prevailing before the oil crisis disrupted the market in 1974. A number of dollar issues had begun to carry, before the end of the year, terms to maturity of fifteen years. In the Deutschemark sector there was only one issue (by Norsea Gas) with twelve years to maturity but several issues with a ten-year term made their appearance. The market also demonstrated its capacity for handling really large issues, in some instances of up to $ 300 million in amount.

Borrowers in the European Community made use of the opportunity during 1976 to obtain finance from the international capital market on favourable terms. Some 3 478 million units of account were raised through public issues on the international market last year as against 1 862 million units of account in 1975. Substantial though this increase was, the proportion of the market total obtained by borrowers within the European Community fell to 32 per cent in 1976 from 35 per cent the previous year. This pattern was more or less repeated by European borrowers outside the Community. Borrowers in the U.S.A., on the other hand, who had been largely absent from the market in 1975 returned in 1976 to raise nearly five times as much as in the previous year. A large part of the increase in issues by non-U.S. borrowers on the American continent consisted of operations launched by Canadian residents, often in raising Canadian dollars. Included in "Miscellaneous" and accounting for a substantial part of the growth of this item is a $ 300 million issue by Australia.

The proportionate allocation of resources raised through public bond issues on the international capital market as between sectors of activity varied remarkably little between 1975 and 1976 in spite of the doubling of the total. The proportions of the total raised directly by energy and mining, by transport and communications and by the public authorities in 1976 were fairly close to those of the previous year. The proportion raised by manufacturing industry, however, was sharply lower. On the other hand, the financial sector and international institutions (mostly financial also) increased their shares significantly, benefiting from the more favourable terms of borrowing. The resources obtained in this way by the financial sector would, in the normal course of events, be on-lent to other sectors, adding to the amounts obtained by them directly from the market.

In this section, apart from the statistics of private placings which, as explained earlier, have been obtained from the OECD, the figures of public bond issues relate to:

- 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

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

(milliard units of account)

	1975	1976
Net issues on the national markets of Member Countries	63.64	57.24
Issues on the European international market (¹)	1.46	3.32
Issues on other national markets	0.80	1.63
Total Community	65.90	62.19

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

Sources: E.I.B. and those on Table 6.

in that country's currency, are placed in several countries by the issuing syndicates in so far as the syndicates include foreign banks;

- bonds to which special monetary clauses are attached (units of account, EURCO, ECU, SDR and other multiple currency issues).

3.2 INTERNATIONAL MEDIUM-TERM CREDITS

The market in internationally syndicated medium-term credits expanded by 7 865 million units of account in 1976 or by nearly 48 per cent. This expansion more than matched the increase of about 5 600 million units of account in public bond issues, although in percentage terms it was much less than the 105 per cent achieved by the bond market. International medium-term credits thus resumed their rapid growth after falling back in 1975, this time accompanying a similar development in the bond market.

Most categories of borrowers shared in the greater volume of bank lending in 1976. The European Economic Community, for example, increased its borrowing from 1 239 million units of account in 1975 to 3 877 million units last year. Borrowing by public authorities in the Community, including a $ 300 million credit raised by the Community itself in 1976 (and subsequently funded by bond issues for an equivalent amount), rose between the two years from 467 million to 1 238 million units of account. The deterioration in the balances of payments of a number of Member Countries led to a reactivation of the policy of securing foreign exchange for national reserves through international borrowing by public authorities, including the national Governments of Denmark and Ireland. Nationalised enterprises (which are classified as "enterprises" in Table 14 as elsewhere in this review of investment and its financing) were similarly encouraged during 1976 to borrow internationally, examples being the Post Office, the National Water Council and the Electricity Council in the United Kingdom and Electricité de France. This practice accounts in large measure for the increase in borrowing by "enterprises" in the Community from 772 million units of account in 1975 to 2 638 million units of account in 1976, although it is also true that private enterprises obtained

Table 13 — **Private placings of bonds on the International market** (¹)

(million units of account)

	1975	1976
Currency of issue:		
DM	746.9	564.3
Fl	521.8	415.1
US $	1 367.1	1 880.2
Other	124.4	71.6
Total	2 760.2	2 931.2
Issuers:		
OECD countries	1 871.6	1 265.8
of which EEC. countries	593.7	466.0
Non — OECD countries	217.0	141.5
International Organizations	671.6	1 523.9

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

See "Principal Sources" 11.

more finance from this source last year than previously.

Outside the European Community, developing countries borrowed more during 1976 in the form of international medium-term credits. In part this was because borrowers in a number of petroleum-exporting countries returned to the market for funds but there was also an increase in the number and volume of credits granted to borrowers in other developing countries. International banks have improved their appraisal techniques in lending to such countries, some of them having experienced default or near default on the part of one or two of their customers. A number of banks have, in this respect, found it useful to link the provision of finance to the implementation of agreed projects.

Throughout 1976 the banks operating in the market in international credits maintained for different borrowers much the same scale of interest margins over a specified base rate fixed every three or six months (usually the London inter-bank offered rate or LIBOR in short). The European Economic Community secured a 1 per cent margin on its $ 300 million credit in March 1976, but for most first class borrowers in industrialised countries this meant around 1.25 per cent whereas borrowers in developing countries were asked to pay between 1.75 and 2.25 per cent. As the year progressed it became clear that the banks were highly liquid and, partly because of the low level of loan demand in the U.S.A. itself, were looking for opportunities to lend. The pressure from borrowers for a reduction in margins which ensued was resisted firmly by the banks. A $ 500 million credit obtained by Electricité de France in June 1976 admittedly carried a margin of 1 per cent for the first two years of its term and one of 1.125 per cent for the remaining five years while in October the Venezuelan Government secured a margin of 1.125 per cent on a $ 1 000 million seven year loan. These, however, were exceptions and it was not until early 1977 that the banks reluctantly lowered their margins in lending to a few special borrowers.

The term to final maturity of most international medium-term credits remained during 1976 in the five to seven year bracket. Seven years was rarely exceeded.

Table 14 — **Publicized medium and long-term international bank loans** (¹)

(million units of account)

	1975	1976
Currencies:		
U.S. $	15 921.6	22 602.9
Other	567.1	1 750.9
Total	16 488.7	24 353.8
Borrowers:		
OECD countries	4 986.4	9 020.2
of which: EEC countries	1 239.4	3 876.9
comprising: public authorities	467.0	1 238.8
enterprises	772.4	2 638.1
Non-OECD countries	11 502.3	15 333.6
of which: developed countries	2 494.5	2 895.2
developing countries	9 007.8	12 438.4

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

See "Principal Sources" 11.

CONCLUSION

The year 1976 probably represents a transitional stage as far as investment in the Community and its financing are concerned. Just as in promoting economic recovery, progress in re-establishing a normal rhythm of investment, was uneven. In some countries investment was still falling in volume and in others efforts to achieve a large increase in real terms resulted in overstrain. Business investment was particularly hard to reactivate on a satisfactory scale.

The volume of personal saving seemed to have fallen back from an exceptionally high level but appeared still to be adequate. A modest recovery in retained earnings of businesses made a welcome appearance in a number of countries.

In view of the modest increase in fixed investment in 1976 the flow of financial resources seems to have been adequate. In some markets borrowing may have been discouraged by the high cost which, however, resulted not from an excessive demand for finance but from action taken to defend the external value of the currencies in question. Potential borrowers on such markets would in most instances have been discouraged from approaching other, cheaper, markets — where they were free to do so by the generally higher degree of exchange risk in such operations. To this extent therefore exchange rate movements in 1976 exercised a disruptive influence on investment.

But the main reasons for a somewhat sluggish performance in the field of business investment seem to have been the existence of surplus capacity, the need for a further strengthening of internal financial structures and a lack of confidence in the face of an uncertain economic outlook. Companies still face balance sheet problems in providing adequately for the replacement of fixed investment, the replacement cost of which has continued to be affected by high rates of inflation. The slowing of the increase in prices in most Member Countries during 1976 would have been more welcome if it had been general and had not been reversed here and there towards the end of the year. The revival of demand as economic activity grows coupled with the return of more stable financial conditions should help to encourage a more general willingness to invest.

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