International: inflation and slowing growth plague the world economy

Inflation cast a deep shadow over the world economy in 1979. Rapidly rising prices of goods and services in nearly every country in the world eroded the purchasing power of consumers everywhere, disrupted business investment decisions, left deep marks on the balance of payments and external values of currencies of individual countries, and, together with the rising political tension in the world, contributed to the skyrocketing price of gold. A growing concern of governments in industrial countries over the pernicious impact of inflation on their economies led, in many instances, to the adoption of increasingly stringent monetary and fiscal policies. These policies tended to impede the industrial countries' economic growth, and—given the high degree of economic interdependence in today's world—stymied economic progress worldwide. In the meantime, a sharp increase in oil prices by OPEC during the year gave a new boost to inflationary pressure everywhere and severely disrupted progress toward regional equilibrium in the world's balance of payments. And so, the world economy entered 1980 with the gloomy prospects of declining economic activity, rising unemployment, high inflation, and major disequilibria in balance of payments.

Rising inflation . . .

In the closing months of 1979, the average rate of inflation in the 24 major countries comprising the Organization for Economic Cooperation and Development was a two-digit figure for the first time since 1974-75 when a fourfold increase in the price of oil and sharply rising commodity prices boosted the rate of increase in consumer prices to those levels. Rising prices of commodities in general, and oil in particular, again played a significant role in last year's resurgent inflationary pressures in the industrial countries.

From January to October, the food commodities index increased about 23 percent and exceeded the previous high in April 1977 by nearly 15 percent. Short supplies of grains in the Soviet Union, coupled with continued strong demand for grain elsewhere, pushed corn and wheat prices upward throughout most of the year. Beef prices worldwide increased dramatically, continuing an upward trend that began in 1977. Coffee prices soared again after declining from the record levels of early 1977 as an early frost in Brazil raised expectations of short supplies.

The industrial commodities price index had increased about 25 percent by early October. Large price increases in copper, lead, rubber, and tin were primarily responsible for the upward movement in the index. Upward pressures on prices came in response to fairly strong industrial demand for metals and tight supplies resulting from extended strikes and political unrest in some producing countries.

OPEC's formal action at midyear, raising the price of oil some 60 percent, combined with the disruption of supplies from Iran and with the continued strength of world demand, led to a steep runup in prices of energy around the world, giving a further boost to inflation.

Also contributing to the upward thrust in prices in the industrial countries were sharply increasing labor costs as lagging productivity gains were outrun by rising wage demands.

. . . leads to slower growth . . .

Efforts to restrain the emerging inflationary pressures by applying restrictive monetary and fiscal policies led to a slowdown in real economic growth in the industrial world. In the second half of 1979, the combined GNP of the 24 industrial countries comprising the OECD was growing at an annual rate of around 3 percent, compared with 4.3 percent in the second half of 1978. A further significant slowdown to less than 1 percent growth is projected for the industrial countries in 1980.

The slowdown in growth was and is expected to be particularly pronounced in the United States and in the United Kingdom, where growing labor problems contributed to the sluggishness of the economy. The combined weight of these two countries significantly influenced the aggregates for the area as a whole, both in 1979 and the projections for 1980. Other countries that fared fairly well in 1979, however, are expected to share in the decline in economic activities in 1980 and to experience rising unemployment.

. . . and balance-of-payments disequilibria

Rising prices of oil and other commodities sharply boosted the import bill of the industrial countries. This, combined with a substantial decline in their exports to OPEC, caused their aggregate trade balance to swing from a $5 billion surplus in 1978 to a $34 billion deficit in 1979. A broader measure, the current account balance (which includes not only trade in goods but also trade in services, aid, and unilateral transfers) reflected this deterioration. It moved from a $9 billion surplus to a $30 billion deficit. The current account deficit of the nonoil-developing countries also deepened, from $36 billion in 1978 to $47 billion in 1979.

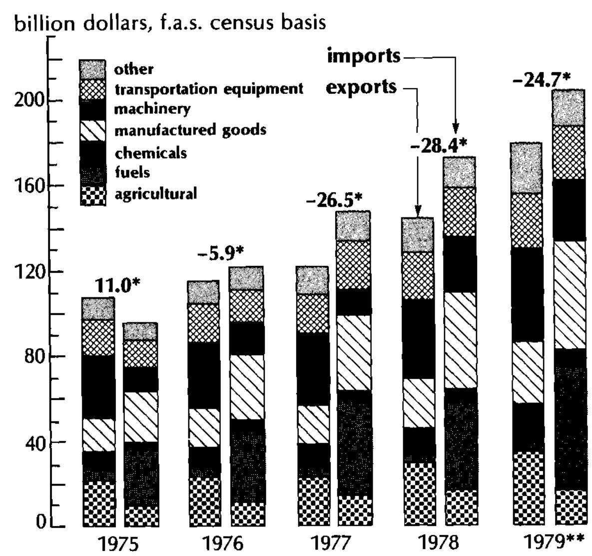
A direct counterpart of the deterioration in the international accounts of industrial and developing countries was the increase in the current account surplus of OPEC countries. It rose from $7 billion in 1978 to $65 billion in 1979. Further substantial increases in the OPEC surplus—and accompanying deficits for the rest of the world—are projected for 1980.

These trends have led to renewed concern over the financing of the deficits, particularly for developing countries already strapped with heavy external debt. For the past several years, developing countries have financed their largely oil-related balance-of-payments deficits by loans from banks in industrial countries. As a result, their combined debt to these banks rose from around $33 billion in 1974 to an estimated $150 billion at the end of 1979. In 1980, the combined deficit of the nonoil-developing countries has been estimated to run well in excess of $60 billion. Some of this deficit will no doubt be financed from foreign exchange reserves that are, in the aggregate, much higher than they were only a few years ago. But a good portion must be financed by borrowing. In light of the apparently growing reluctance of commercial banks around the world to continue lending to these countries, new sources of financing must be found if the developing world is to avoid severe economic problems in the coming year.

U.S. balance of payments improves . . .

Developments in the United States both influenced and were influenced by developments in the world economy. Somewhat faster economic activity abroad

U.S. trade deficit declines



*Annual trade balances.
**Category data are based on January-November at an annual rate.

contributed to a reduction in the U.S. trade deficit from $34 billion in 1978 to around $28 billion in 1979. This improvement came as U.S. exports to industrial countries and nonoil-exporting developing countries increased nearly a third while imports from these areas increased less than half that fast. Much of the improvement in the U.S. trade balance recorded elsewhere was blunted, however, by declining exports to the oil-exporting countries and an increase of about a third in the value of oil imports.

Petroleum imports still dominated U.S. import trade. The nearly one-third increase in the value of petroleum imports last year was due primarily to increases in the price. The amount of oil imported increased only about 2 percent. But by November, the per-barrel price of imported oil had been boosted more than 70 percent.

Although oil prices were still being raised by individual OPEC members when the year ended, the slowdown in the world's economies and expanding inventory accumulations in consuming countries appeared to have had some moderating effect on oil spot prices, if not on the official prices set by OPEC members.

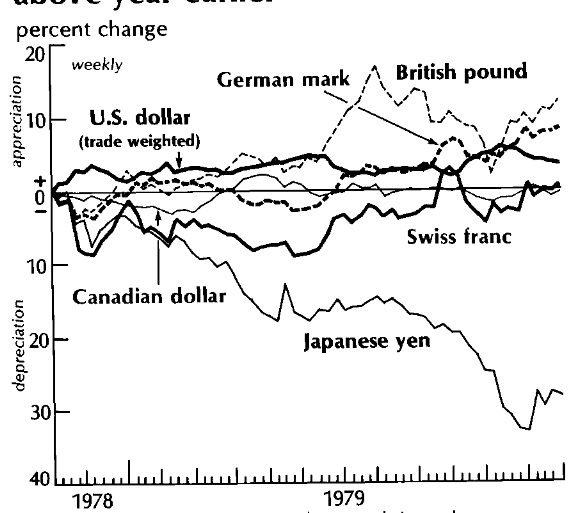
A continued increase in the surplus in trade in services contributed substantially to the reduction in the current account deficit. In the first nine months of the year, the services surplus totaled more than $25 billion—$7 billion more than in the same period a year earlier. The dramatic increase in the services surplus came mainly from a more than 50 percent increase in receipts of income of U.S. assets abroad over payments to foreigners of income from foreign assets in the United States.

. . . and the dollar steadies

Improvement in the U.S. international accounts was partly responsible for the marked improvement in the trends in the value of the dollar relative to other major currencies in the first half of 1979. The stage for the improvement was actually set in late 1978 when, after a precipitous drop in the international value of the dollar between June and October, the U.S. government announced, on November 1, 1978, a series of measures signaling its determination to defend the external value of the dollar. Through the last two months of 1978, the dollar was rising steadily from its October 31 low, and the momentum carried it well into 1979, as the initial, largely psychological impact of the November package was reinforced by rising U.S. interest rates and by the improving U.S. balance-of-payments position. By the end of May, the value of the dollar had increased by 8 percent over its October low, relative to the German mark, 13 percent relative to the Swiss franc, and almost 19 percent relative to the Japanese yen. On the trade-weighted basis (which takes into account the dollar value relative to currencies of 14 major U.S. trading partners, weighted by the respective volumes of trade) the dollar improved more than 6 percent. By the end of May, its value stood only 1.6 percent below the point at the inception of the general floating of major currencies in February 1973.

The dollar began weakening in early June, however, as the gap in interest rates between the United States and major foreign money markets narrowed. The change came with the increasingly tight monetary policy

Dollar volatile—ends 1979 above year earlier



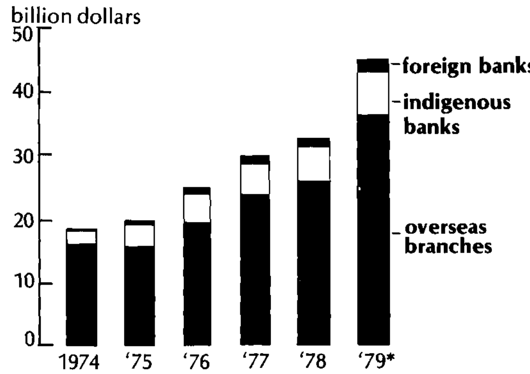
NOTE: Data are percentage changes, relative to the dollar, from November 1, 1978 base.

abroad that caused net capital outflows from the United States and rising U.S. inflation that reduced confidence in the dollar. The weakening continued through the summer but was sharply reversed in early October when the Federal Reserve announced a package of credit-tightening measures to dampen inflation in the United States. Some post-October gains in the value of the dollar were partially offset in the final weeks of the year as tension between the United States and Iran deepened. Nevertheless, the dollar ended the year at roughly the same value (on the trade-weighted basis) as at the beginning—some 2.5 percent below its value in February 1973.

Banking in the district

International banking activity picked up in the Seventh District last year, continuing the expansion that began in the early 1960s. Foreign assets of banks in the district increased more than twofold in the past four years, totaling $45.1 billion in September, compared with $31.8 billion a year earlier. Domestic offices of district banks held claims on foreigners totaling $6.2 billion, up from $5.2 billion a year earlier. Liabilities to foreigners totaled $4.7 billion, an increase of $2.8 billion over the previous 12-month period.

Foreign claims of district banks continue to rise



*As of October 1979.

The past decade saw a rapid increase in foreign lending through overseas branches. Banks in the district operated six overseas branches in 1967. By 1979, there were over 70 branches operated by 20 district banks. Assets of these district maintained branches totaled $36.8 billion in September, compared with $25.6 billion a year earlier.

Chicago has expanded steadily as an international financial center since 1973, when Illinois passed legislation allowing foreign banks to establish offices in Chicago. Since then, 34 offices of foreign banks have opened in Chicago. At year-end these offices had assets of over $5 billion.