Part I

THE WORLD ECONOMY AND THE FUND
In many respects the past year was a highly satisfactory one for the world economy. World industrial production and, in particular, international trade—including the exports of the primary producing countries—were substantially higher than in the preceding year. However, within 1964 there was a slowing down of economic activity in several major countries, and the rate of increase in world trade was somewhat lower than during the preceding year, although still substantial. In the last quarter of the year, while there were signs of a moderate upturn in industrial activity, an exceptionally large imbalance in world payments, concentrated in the two main reserve centers, put more strain on the international monetary system than had been experienced for some time. For all these reasons, economic prospects at the end of the year appeared much more uncertain.

During 1964 and the early months of 1965, economic activity continued to expand in the United States and Canada under conditions of substantial price stability, while some further progress was made toward reducing the relatively high rate of unemployment. In Europe, high levels of employment and strong pressures on wages and prices continued in most countries, although their experience was by no means uniform. In Germany, an acceleration in economic activity had been stimulated in 1963 by acute demand pressures in neighboring countries, mainly Italy and France. Throughout 1964, production continued to rise strongly, as an increase in domestic demand made up for a relaxation of demand pressures emanating from these other countries; prices rose only moderately. In Italy, pressures of demand were threatening both internal and external stability at the beginning of 1964. However, the economic policies which had been introduced progressively after May 1963 brought about a dramatic change from a large deficit to a large surplus in the balance of payments, and some slowing in the rise in prices and wages—but also a decline in industrial production until late in the year. In France, where policies to stabilize the economy were pursued throughout 1964, the rise in industrial production came virtually to a halt, and some progress was made in reducing the upward movement of prices. In a few other countries in continental Europe, where the containment of inflationary pressures had also become the primary objective of economic policy, there was a deceleration of the rise of output in the course of the year.

In the United Kingdom, the rise in production during 1964 was markedly less than in 1963, when it had been unusually large and had been accompanied by a gradual deterioration in the current account of the balance of payments. The budget introduced in April 1964 was aimed at limiting the rise in demand so as to correspond to a rise in real output of some 4 per cent per annum. However, despite this adjustment in policy, a large deficit in the balance of payments persisted through the year; the measures taken to deal with this are described below. At the beginning of 1964, Japan, too, was facing a balance of payments deficit, and this was a main factor limiting the rise in production. Here, however, effective measures to adjust the balance of payments, necessitated by the very rapid expansion in domestic demand that had taken place in 1963, were introduced at an early stage. During 1964, the rise of output slowed down moderately, and the balance of payments recovered; by the end of the year, the Japanese Government was relaxing its policies of economic restraint.

The net result of these developments was that late in 1964 the forces of expansion operating in the industrial countries as a group were less vigorous than at the beginning of the year. Some slowing down in economic growth was perhaps to be expected after the exceptionally rapid rise in production that took place in virtually all the industrial countries during 1963. It is probably unavoidable that from time to time countries will find it necessary to introduce temporary measures
of restraint to maintain internal and external stability. Indeed, some progress was made in 1964 in containing upward pressures on prices and wages where these had been excessive.

Although the slowdown continued in some countries in Europe in the early part of 1965, there are some grounds for belief that the pause in expansion may be only temporary. Expansion appears to be continuing at a substantial rate in several other countries in Europe, particularly in Germany, and in the United States and Canada, while the change in direction of monetary policies in Japan augurs a new upswing in that country. But the substantial enlargement of the world payments imbalance that took place in the course of 1964 imparted considerable uncertainty to the otherwise moderately favorable outlook for 1965.

**International Payments**

At the beginning of 1964, a reasonable degree of stability of international transactions prevailed. The balance of payments of the United States was close to equilibrium for the first time since the trough of the 1961 recession, even though the U.S. economy, after three years of continued growth, was still expanding at a substantial rate. The European Economic Community (EEC), which had been in persistent surplus for many years, also appeared to be close to equilibrium in its transactions with the rest of the world, even though there were considerable imbalances in countries within the area; these imbalances were sharply reduced early in the year. Lastly, the primary producing countries generally found themselves in improved balance of payments positions as a result of a rapid rise in their export earnings. But this pattern of relative stability was not maintained; 1964 was marked by a major deterioration in the balance of payments of the United Kingdom and the re-emergence of a sizable deficit in the United States and of a large over-all surplus in the EEC. In the last-mentioned area, the radical improvement in the Italian balance of payments was a most important factor. At the same time, the surplus position of the primary producing countries as a group was sharply reduced, and the balances of payments of many individual developing countries showed signs of strain. Thus, among the industrial countries, deficits again became concentrated in the two main reserve centers and surpluses in the European continent. Simultaneously, the gradual deterioration in the positions of primary producing countries, which hold a large proportion of their reserves in dollars and sterling, threatened to add to the pressures on the two reserve centers arising from their own balances of payments.

The deficits of the United Kingdom and the United States arose from rather different causes. In the United Kingdom, the deficit was for the most part due to a deteriorating current account position, associated with a rise in domestic demand, which had been stimulated by earlier fiscal and monetary measures; the rise in exports was less than in most other industrial countries and was insufficient to make up for the sharp rise in imports. In 1964, a large deficit on current account was augmented by a larger-than-usual net outflow of long-term capital. During most of the year, the deficit on current and long-term capital account was running at an annual rate of more than $2 billion (equivalent to about two thirds of U.K. reserves at the beginning of the year). In the months to September, however, this deficit was largely offset by an inflow of short-term capital, and some assistance (mainly in August and September) from foreign central banks; reserves did not change much. In October, when a new Government had taken office, a program for dealing with the deficit problem was announced, including a temporary surcharge on imports of 15 per cent (lowered to 10 per cent in April 1965) and a system of rebates of tax on exports, averaging 1.9 per cent of their value. At that time, however, confidence in sterling was rapidly diminishing and, even though the Bank of England raised its discount rate to 7 per cent in November, a sharp reversal of the inflow of short-term capital, superimposed on the basic deficit, raised the over-all deficit to a record level in the fourth quarter. This created a serious crisis which was only overcome after it was announced that further international support for sterling, totaling $3 billion, had been organized in the form of commitments to assistance by 11 countries and the Bank for International Settlements. In December, the United Kingdom drew $1 billion from the Fund. The Fund obtained $405 million of this amount by borrowing under the General Arrangements to Borrow, which were activated for the first time,
and $250 million by the sale of gold. However, though there was a major improvement in the United Kingdom’s current account position, its balance of payments remained under pressure in the early months of 1965 as outflows of capital continued. The budget introduced in April, which was again aimed at restraining domestic demand, and measures introduced to stem the outflow of capital helped, however, toward restoring confidence in sterling. In May, the United Kingdom made a second drawing from the Fund—$1,400 million, of which $525 million was obtained by the Fund under the General Arrangements to Borrow and $400 million by the sale of gold.

In contrast to the situation in the United Kingdom, the deterioration in the over-all U.S. balance of payments occurred in spite of a record surplus on goods and services account. The rise in the over-all deficit after the first quarter of 1964 was entirely attributable to private capital movements. During the first half of 1963, there had been a sharp rise in the outflow of U.S. portfolio capital, to which the U.S. authorities had responded by proposing in July the imposition of an Interest Equalization Tax applicable to the purchase of outstanding foreign securities and, with certain exceptions, to new issues. A subsequent reduction in the outflow of U.S. capital contributed to an improvement in the over-all balance of payments culminating in the first quarter of 1964. After that quarter there was a new upsurge in the outflow of U.S. capital, a contributory factor being a continuance of moderately expansionary policies in the United States in combination with policies of financial restraint in a number of the other industrial countries. The rise in the capital outflow included a large increase in bank loans, which were not covered by the proposed Interest Equalization Tax, enacted in September. The outflow increased during the last quarter of 1964, when there was a temporary rise in new issues, mainly of Canadian securities, following confirmation of the proposed exemption of these securities from the Tax. A further factor was the deferment, because of the sterling crisis, of payments by the United Kingdom of interest and amortization on its postwar loans, due in December.

The large increase in the outflow of U.S. capital in 1964 was accompanied by an increase in the inflow of foreign private liquid funds, which reduced the pressure on U.S. reserves and, together with some other factors, helped to minimize the outflow of gold. Calculations of the U.S. deficit differ—and for 1964 more than for any other recent year—mainly because some definitions do, and some do not, allow for this inflow of liquid funds. According to the concept generally used by the Fund for the analysis of world payments problems, which makes such an allowance, the U.S. deficit in the last quarter of 1964, on a seasonally adjusted basis, was about the same as the quarterly average for 1963, although the deficit for 1964 as a whole was considerably smaller than that for 1963. These calculations are lower than those based on the conventional concepts of the U.S. Government. It is, of course, impossible to express in a single figure all the varying facets of strength and weakness of the U.S. balance of payments, but whatever viewpoint is adopted there is no doubt that the re-emergence of a U.S. deficit at a substantial rate after the first quarter of 1964—following six years of large deficits—created a very difficult situation.

During the early months of 1965, pressures on the U.S. balance of payments were augmented by a dock strike, while a further outflow of capital appeared to be stimulated by an expectation that additional measures to reduce the outflow of capital would soon be introduced. In February, the U.S. Government announced a new and comprehensive program to deal with the balance of payments problem, the main features of which were a broadening of the scope of the Interest Equalization Tax and the enlistment of the voluntary cooperation of banks and other financial and non-financial corporations in reducing bank and other loans to foreigners and the placing of liquid funds and direct investment abroad. In formulating this program, an attempt was made to avoid as far as possible discouraging the outflow of capital to developing countries and to other countries (such as the United Kingdom), whose balances of payments were relatively weak. Special treatment was also accorded to Canada and Japan, which are heavily dependent on the U.S. capital market.

Early indications of the operation of this program suggest that it is being reasonably successful, although the precise nature of the market reactions and policy responses which it may induce in other countries cannot yet be known. While con-
control of the direction of its impact is administratively difficult, the intention is that the impact should fall mainly on continental Europe as the major surplus area. In those countries where inflows of capital from the United States have added to inflationary pressures, a reduction in these inflows should enable the authorities to relax somewhat the restrictive policies that they have applied to contain these pressures, where this can be done without endangering internal stability. Such relaxations should help to reduce the repercussions on the U.S. balance of payments of the market reactions and policy responses referred to above. These repercussions could still be important, however, to the extent that the initial impact falls on countries in weak balance of payments positions.

Meanwhile, the normal processes of adjustment of underlying current account positions have continued. Costs and prices in the European area again rose in 1964 in relation to those in the United States. The U.S. current account position continued strong through the year, and the rise in the combined current surplus of the EEC countries in the second half of the year appeared to be attributable mainly to a slowdown in economic activity in certain countries, and thus likely to be of a temporary character. Indeed, one of the interesting aspects of the balance of payments situation late in 1964 was that, in contrast to the typical situation some years ago, the major surplus positions were not accompanied by excess demand, but by relative slack in the domestic economies of the countries concerned. Although these surplus countries remain subject to pressure on prices and wages—a fact that has to be taken into account—the slack in their economies should facilitate the adoption of policies that would assist in the process of international adjustment without damage to their internal stability.

As discussed in the next chapter, attitudes toward the role of capital movements in international payments have recently changed considerably. The large outflows of capital from the United States, mainly toward the other industrial countries—and in particular their resumption in 1964 at a higher rate than ever before in spite of the introduction of the Interest Equalization Tax—made it apparent that, for the time being, market forces alone would not bring about a pattern of capital movements consistent with balance of payments equilibrium among the major industrial countries. The past year has seen increased interference with the free movements of capital through measures of taxation, direct controls, and voluntary programs. While these programs raise important issues, they should in present circumstances assist in reducing the imbalance in international transactions. At the same time, an effort has been made to avoid undesirable repercussions on the balances of payments of the developing countries that might tend to slow down their rate of growth.

**Primary Producing Countries**

For the primary producing countries 1964 was, in general, a good year. On the average, prices of primary products exceeded the 1963 level by 5 per cent, and they were higher than they had been in any of the last eight years. However, prices for manufactured products also rose, and the terms of trade of the primary producing countries as a group were, on the average, only slightly more favorable than in 1963; they appeared to be worsening during the latter part of the year. In general, the experience of the more industrialized members of the group continued to be much more favorable than that of the less developed countries; the terms of trade of the former were, on the average, about 13 per cent higher than in 1958, whereas those of the latter had deteriorated slightly since that year.

The increase in the prices for primary products in general was accompanied by a rise in the volume of trade, and the rise of about 10 per cent from 1963 to 1964 in the export receipts of the primary producing countries was the highest recorded in a decade. Foreign aid remained at much the same level as in 1963, while the inflow of private capital expanded somewhat, and there was a substantial increase in the imports of the primary producing countries. Although the more industrialized members of the group increased their imports much more than the less developed countries, nevertheless the latter experienced the largest rise in several years in the volume of imports. As a result, the aggregate balance of payments surplus of the primary producing countries, which had been quite large in 1963, was reduced considerably in the course of 1964. The more advanced members continued to be in aggregate surplus through the year, but the less developed...
countries incurred a small deficit in the second half. In many countries, signs of increasing strains were appearing toward the end of the year.

The prices for metals and minerals, which during 1964 had shown the most pronounced increase of any primary product prices, continued to rise during the early months of 1965. The prices of most other primary products remained comparatively stable during most of 1964 at the relatively high levels reached in the early months, but they tended to weaken for a brief period at the end of the year. In general, they recovered slightly in the early months of 1965. Nevertheless, the international demand situation made it doubtful that the value of the exports of these products would continue to rise at the same rate during 1965 as in the preceding two years. Since the economic growth of developing countries depends largely on a sustained and adequate rise in the purchasing power of their exports, any weakening of their trading position would give new urgency to international measures to improve their export earnings, including reinforcing their access to markets in the industrial countries. This is a matter to which the Fund has given considerable attention over the years. In the course of 1964, the United Nations Trade and Development Board was established for the continuous study of the trade and development problems of the developing countries. The Fund has declared its intention to work with the new United Nations organs being established for this purpose, as it has for a long time done with other international agencies concerned with international trade problems and the special problems of the developing countries.

At the United Nations Conference on Trade and Development (UNCTAD) in 1964, certain recommendations were adopted under the heading "Study of Measures Related to the Compensatory Credit System of the International Monetary Fund." Some of these recommendations were addressed to members of the Fund rather than to the Fund itself, but all of them are being kept under consideration in connection with the continuing review of the still comparatively untried compensatory financing facility.1 This facility was set up after a long period of study; thus far, evidence as to how it works has been scanty, thanks to the generally favorable export experience of the developing countries. Indeed, during the past fiscal year the Fund did not receive any requests for drawings under its compensatory financing facility; before that, only two countries had made use of it. This situation cannot in the nature of things be expected to continue for long, and another compensatory drawing has been made recently. As more experience is gained, it will become easier to form conclusions as to the desirability of effecting reforms in the present arrangements. The Fund is also cooperating with the IBRD in its current study of proposals to supplement the Fund's compensatory financing facility, which has been initiated by another resolution of the UNCTAD.

The balance of payments positions of the primary producing countries which prevailed during most of the past year were such that comparatively few of these countries made use of the Fund's resources. Drawings by these countries during 1964 were the smallest for five years and were exceeded by repayments. In the early months of 1965, however, their drawings rose substantially, and several new stand-by arrangements with non-industrialized countries were made, including one for $200 million with India and one for $125 million with Brazil.

A cause of strain in the payments positions of the developing countries that has recently become significant arises from their increasing international debt burden. Expenditures for the servicing of foreign debt take a large and growing share of the export earnings of many of these countries, and it has become a matter of urgency to prevent a further rise in the burden of debt service. Some countries with heavy debt burdens have asked the Fund to assist, in an advisory capacity, in their negotiations for a rescheduling of debt; this aspect of the Fund's activity is reviewed in some detail elsewhere in this Report. In the Fund's consultations, therefore, increasing emphasis is being placed on the implications for the balance of payments prospects of member countries of their debtor positions, on long-term as well as short-term account. The Fund is also taking steps to improve its statistical reporting of indebtedness payable in the near future, in order to be able to
be of more effective assistance to debtor and creditor countries alike. On all these problems, the Fund is working in close contact with the IBRD.

In several other directions, the Fund is expanding the services that it renders to the developing countries. The new Central Bank Service has been engaged on a considerable scale in advising on legislative proposals for establishing new central banks in newly independent countries and on the reorganization and administration of existing institutions. In addition, the panel of central bank experts that the Service has organized has provided executive staff for central banks operated by several of the Fund's members, and requests for such experts are increasing in number. The Fund is also giving, through its Fiscal Affairs Department, advice and technical assistance on taxation and fiscal administration, and is organizing a panel of fiscal experts, in order to be able to supply resident advisors on the request of member countries. By thus assisting member countries to strengthen the instruments of monetary and fiscal control, the Fund actively supports their efforts to promote economic growth in a favorable climate of monetary stability.

Countries' Reserves and International Liquidity

The increase in world reserves—apart from those of the Sino-Soviet area—in 1963 was the highest figure in any year since World War II, $3.4 billion. In 1964, the increase was some $0.9 billion less, at $2.5 billion, the decline being due mainly to a reduction in the rate of accumulation of dollars in the reserves of other countries, and to increased gold hoarding. In the first quarter of 1965, international reserves fell by about $800 million. Contributory factors appear to have been conversion of existing foreign exchange balances into gold by certain countries and continued private gold hoarding on a large scale.

The major event during 1964/65 in the field of international liquidity was the adoption by the Board of Governors of the Fund of two resolutions submitted to them by the Executive Directors for increasing Fund members' quotas. These resolutions (reproduced in Appendix I, p. 124) provided for a general increase of 25 per cent of members' quotas, together with additional increases for 16 countries whose quotas were considered to be out of line as a result of their recent economic development. If all the proposed increases become effective, total quotas in the Fund will rise from the current figure of about $16 billion to about $21 billion. This will add substantially to the conditional liquidity available to Fund members. The Executive Directors also decided to adopt policies and procedures designed to prevent gold subscriptions from reducing unduly the amount of reserves available to individual member countries, and in addition to mitigate the impact on the gold stock of the two major reserve centers of the subscriptions of other members.

Another noteworthy event was the activation of the General Arrangements to Borrow in connection with the two drawings by the United Kingdom in December 1964 and May 1965. The activation of the Arrangements not only was a demonstration of their usefulness but also led to the creation by the Fund of reserve assets in a new form as eight industrial countries acquired loan claims on the Fund to an amount of $930 million.

Continuing studies of international liquidity and of the functioning of the international monetary system are being conducted both by the Fund and by the Group of Ten. While there is wide agreement that there is no urgent need for additional international liquidity, the situation could alter if the United States succeeds in its program to eliminate its payments deficit. In that event, the environment in which international payments have taken place for more than a decade would be fundamentally changed. The rest of the world would, after many years, cease to run a large aggregate balance of payments surplus. Further increases in international reserves would be limited largely to the amount added to world monetary gold holdings. In the absence of deliberate international action to increase international liquidity, this change in the environment of international payments would reduce the impact which, in past years, has been exercised by the annual additions to world reserves. In these circumstances, it is generally recognized as important that consideration should continue to be given to the twin problems of international liquidity and the workings of the international monetary system. These questions, including the contribution which the Fund can make toward their solution, are discussed in Chapter 2.