Financial review

Introduction

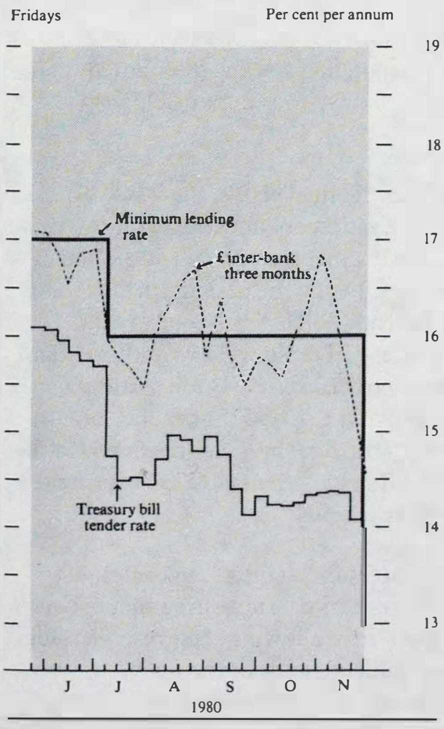
The review describes developments in various markets, mainly during the period August to October.

Money-market conditions and the reserve asset position of the banking system continued to be very tight. To offset the constant upward pressures on short-term interest rates, the special measures of assistance provided by the Bank were regularly renewed, until they were eventually terminated in late November and early December. Minimum lending rate (MLR) was reduced from 16% to 14% as part of a package of measures announced by the Chancellor of the Exchequer on 24 November.

Disappointing money supply statistics were a restraining factor on the gilt-edged market. Yields showed little change and turnover was lower than in earlier months. Nevertheless, net official sales were well maintained through the period, helped by calls falling due on stocks issued earlier.

The foreign exchange markets became increasingly unsettled during the period. Sterling, supported by the trade surplus (and in particular by North Sea oil), rose strongly against the dollar and European currencies. The dollar strengthened against all major currencies except sterling and the Yen.

Short-term interest rates in London



Money markets

Extreme pressure on the liquidity and reserve asset position of the banking system continued almost throughout the August to October period. This was largely caused by the payment of instalments on gilt-edged stocks previously issued and, at the close of the period, by heavy official sales of stocks. Substantial tax payments occasionally contributed to market shortages, though in contrast to the preceding months the net exchequer position was generally favourable to the market.

Because of these tight conditions, short-term interest rates remained under recurrent upward pressures, and to offset such pressures the Bank continued to use special measures of assistance. These were designed to supply sufficient reserve assets to enable banks to maintain their reserve ratios, and to do so by a sufficient margin to relieve the pressure on short-term rates. The two special facilities with listed banks and finance houses for the purchase and resale of gilt-edged stocks, which were due to expire on 11 and 18 August, were renewed initially to 8 and 15 September, at a slightly reduced level of 1% and $1\frac{1}{2}$% of each institution's mid-July eligible liabilities. These facilities provided the banking system with some £1.2 billion of liquidity. Against a background of intense stringency resulting from substantial tax payments and a resurgence of official sales of gilt-edged stocks, both facilities were again extended on maturity, to 6 and 13 October. Conditions by that time were easier, the net exchequer position having moved in the market's favour, but, with an early renewal of reserve asset pressures expected, both facilities were once again extended, at a level of 1% and $1\frac{1}{2}$% of mid-August eligible liabilities, to 7 and 17

November. A slightly smaller proportion of the facilities offered was taken up at this renewal, the total liquidity provided being reduced to about £1.1 billion. Both facilities were again extended on maturity, but for a reduced total of 2% of mid-October eligible liabilities, and for periods of less than one month (to 24 November and 3 December). On these dates, in response to a marked easing of money-market conditions which was expected to continue until early 1981, both facilities were allowed to lapse.

Partly as a result of this special assistance, short-term inter-bank rates were generally lower during August to October than in the preceding months. Seven-day rates eased during the first fortnight in August to around $16\frac{1}{2}$%. Towards the end of the month and in early September some renewed firmness in both seven-day and one-month rates was evident, but by mid-September, following the renewal of the two gilt-edged stock repurchase facilities, both rates fell back, and thereafter averaged around $16\frac{1}{2}$% until mid-October. Short rates then rose sharply, to above 17% at one month and to over 18% at seven days. This initially reflected special pressures associated with the monthly make-up day (when banks supply balance sheet statistics and their reserve asset position to the Bank of England), and subsequently further heavy tax payments and large official sales of gilt-edged stocks.

Longer rates were very firm at the beginning of the period, the three-month rate reaching $16\frac{11}{16}$% in early September, while rates at one year reached a peak of $15\frac{1}{4}$%. A very sharp decline in these rates followed the Treasury's statement on 9 September that bank lending and public sector borrowing were expected to moderate considerably in the second half of the financial year, and for most of the remainder of the period the three-month rate remained under 16%, with rates at one year at around $13\frac{7}{8}$%. In late October, however, these longer rates hardened somewhat.

On 24 November, as part of a package of economic measures, MLR was reduced from 16% to 14%. Short-term interest rates moved in sympathy, dropping back by over $1\frac{1}{2}$% at one month, to about $14\frac{1}{2}$%; longer rates, though, had already discounted the move to some extent, and the twelve-month rate held firm at $13\frac{3}{4}$%–$13\frac{7}{8}$%.

In addition to the special facilities detailed above, the Bank provided regular assistance to the market on most days during this period, except at the beginning of October, and again at the end of the month when, for the only time during the period, surplus funds were absorbed by the sale of Treasury bills. Assistance to the market took the form of purchases of Treasury, local authority and commercial bills. The last were purchased mostly for resale at future dates, but towards the end of the period the practice of making outright purchases of commercial bills was resumed for the first time in over two years. The Bank also lent at MLR overnight and, very infrequently, for longer periods.

During the period, the upward pressure on inter-bank rates just before make-up day became more marked, suggesting that between make-up days a number of banks were allowing their reserve assets to fall below the required minimum of $12\frac{1}{2}$% of their eligible liabilities. Attempts by these banks to secure reserve assets as the reporting day approached were causing overnight and, to some extent, seven-day rates to rise sharply. One effect of these upward movements in rates was to provide opportunities for hard arbitrage ('round tripping') where overdraft facilities with the clearing banks, available to commercial customers at a fixed percentage over base rate, could be used to make deposits at a higher rate with another bank. Although in practice such activity does not appear to have been very significant, it can inflate both the total of bank lending to the private sector and the money stock, and thus have a distorting effect on monetary statistics. In order to avoid the possibility of such distortions, and to enable incipient pressures to be observed more accurately, the Bank reminded banks on 24 October that their obligation to observe the reserve asset ratio is continuous and indicated that it would carry out a series of spot checks to ensure that the ratio was being observed.

Clearing bank base rates and seven-day deposit rates stood at 16% and 14%, respectively, until the reduction in MLR on 24 November, when banks reduced base rates to 14% and deposit rates to either $11\frac{1}{2}$% or 12%.

Capital markets

The gilt-edged market

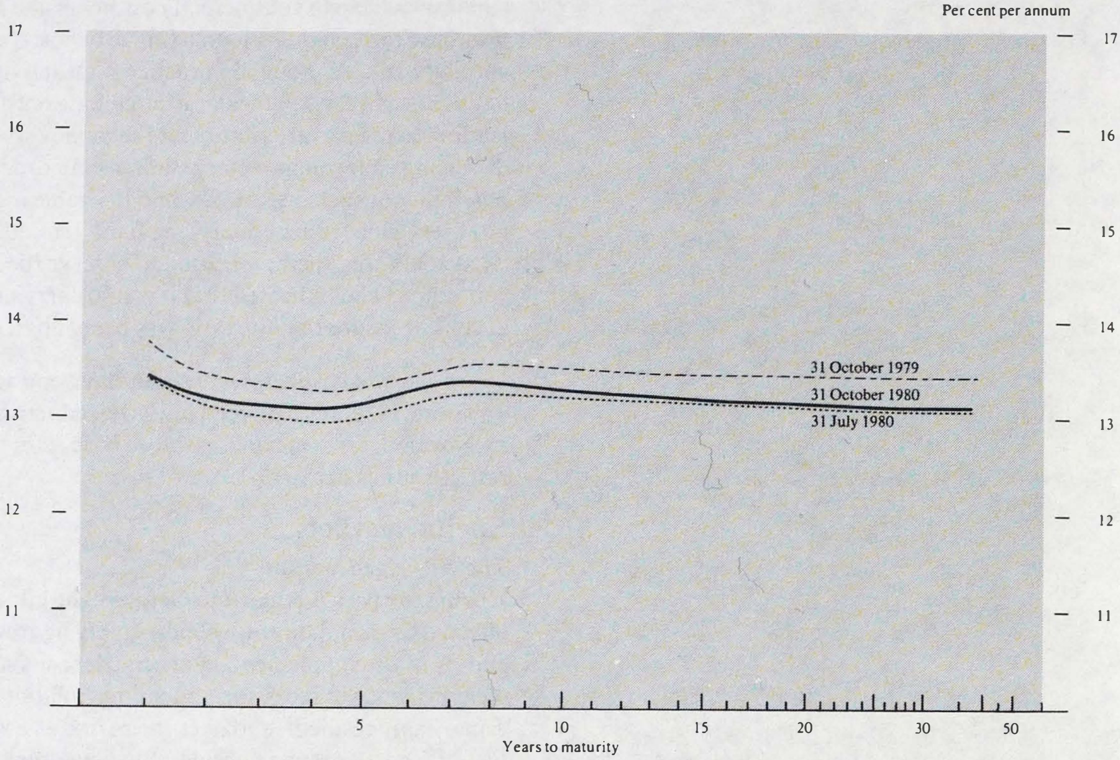
During the period August to October, the gilt-edged market was affected by disappointing money supply figures following the ending of the supplementary special deposits scheme; but with clear evidence of recession and falling inflation it proved remarkably resilient, and over the period as a whole yields were little changed, despite considerably lower turnover than in June and July.

In early August, the market became increasingly nervous in the expectation of a poor set of banking statistics following the removal of the corset. In the event, the figures were worse than had been feared, and prices fell sharply in confused trading. The market continued to be weak as a succession of disappointing economic indicators were released, including details of unexpectedly high public sector borrowing. The rise in US interest rates was an additional unsettling influence, and by the end of August yields had risen by about 1%.

During the first week of September the market steadied, with attention focusing on developments in the real economy and on inflation, which was falling faster than had been generally expected. Amid reports of renewed overseas investment, coupled with an easing of conditions in the money markets, sentiment improved. On 5 September, the Government Broker responded to bids for the medium-dated tap stock, $11\frac{3}{4}$% Treasury Stock 1991 'A'—the first sales of a tap stock since the end of July. With the market continuing firm, this stock was exhausted at a price of £$46\frac{1}{4}$ per cent (in £50 per cent paid form) on the morning of 9 September.

On the afternoon of the 9th, the Treasury announced plans to issue a new index-linked national savings certificate, available to those aged sixty and over and in larger amounts than previously, and to raise the limit on monthly payments under the Save As You Earn (SAYE) scheme—see below. The statement also indicated a better prospect for the course of both the money supply and the public sector borrowing requirement (PSBR). At about the same time, the preliminary banking statistics for the month to mid-August were released: these were calmly received and, with the market also encouraged by the implications for gilt-edged yields of the new index-linked national savings certificate, prices moved ahead strongly.

Time/yield curves of British government stocks[a]



(a) The lines measure the nominal rate of interest which a stock at each maturity should bear if issued at par. The curve runs from the shortest-dated stock with a life of more than one year to the longest-dated stock. A revision to the construction of these curves was described in the June 1976 *Bulletin* (page 212). The relevant program is available from the Bank at the address given on the reverse of the contents page.

On 12 September, the issue of a second tranche of 12% Exchequer Stock 1998[1] was announced, with £50 per cent payable on application and the balance on 24 October. By the time of issue, however, the market had weakened because of a threatened national dock strike and, in the event, applications were minimal.

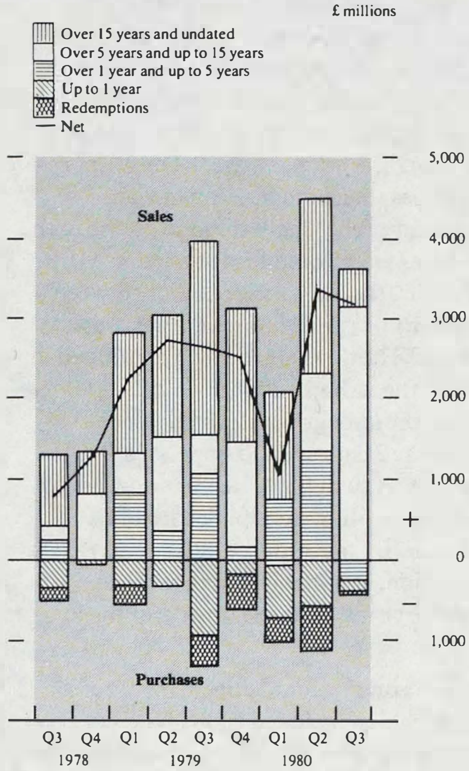
The market remained uncertain until the beginning of October. The dock dispute was resolved on 21 September—just before strike action was due to take place—and the conflict between Iran and Iraq led to increased demand for sterling, but the continuing rise in US interest rates discouraged investors. There was further speculation about a cut in MLR, but by the time of publication of the preliminary banking statistics for the month to mid-September, the general market view was that an imminent fall was unlikely.

On 10 October, a new stock, $11\frac{3}{4}\%$ Exchequer Stock 1986,[2] was announced to replace the previous near-short tap stock (exhausted in July) and to help refinance 13% Exchequer Stock 1980, maturing in November. In the following week, gilt-edged prices moved ahead strongly, encouraged by the agreement of the engineering workers' union to a national wage settlement of $8\frac{1}{4}\%$. The low-coupon stock, 3% Exchequer Stock 1983 'A', was declared exhausted on 13 October, and two days later, on rumours of further overseas interest, the long-dated stock, 12% Exchequer Stock 1998 'A', was also declared exhausted. There were sizable applications for $11\frac{3}{4}\%$ Exchequer Stock 1986 on 16 October.

(1) £1,000 million of this stock was issued on 18 September, with a further £300 million reserved for the National Debt Commissioners. It was allotted at the minimum tender price of £92.50 per cent (to give a yield of 13.07%). £800 million of this stock had been issued in 1978.

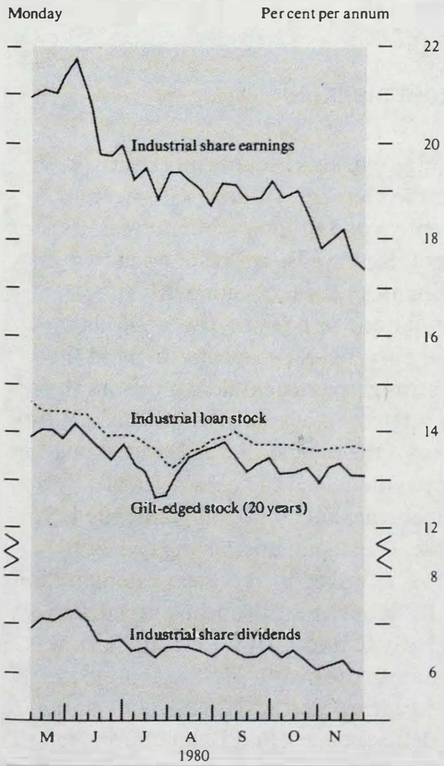
(2) £800 million of this stock was issued on 16 October, with a further £350 million reserved for the National Debt Commissioners. It was allotted at the minimum tender price of £95.75 per cent (to give a yield of 12.88%) with £30 per cent payable on issue and the balance of £65.75 on 14 November.

Official transactions in gilt-edged stocks by maturity[a]



(a) Components are on occasion too small to be shown separately.

Security yields



The market continued to be reasonably firm, and on 24 October another new issue was announced—a further £400 million tranche of the low coupon stock, 3% Treasury Stock 1985.[1]

At the beginning of the period, yields on gilt-edged stocks were generally between 13% to $13\frac{1}{4}$%, rising to about 14% by the end of August. During the remainder of the period, yields fell back steadily and, by the end of October, were much the same as in early July. Following the reduction in MLR on 24 November, yields on short-dated stocks fell by about 1%; yields on long-dated stocks showed little change.

In the third quarter, cash raised from official sales of stocks and from instalments paid on stocks issued in the previous quarter amounted to £3,185 million, net of buying in and redemptions.

Sales of long-dated stocks amounted to £470 million, and of stocks within one to fifteen years of maturity to £2,870 million. Official purchases of stocks within one year of maturity totalled £135 million. No stocks matured in the period, but about £20 million was paid out in respect of stocks that matured in previous quarters. Out of the net cash raised of £3,185 million, the non-bank private sector provided £2,905 million.

National savings

Net receipts from national savings fell to £182 million in the third quarter, the lowest quarterly inflow for a year. On 9 September, the Government announced measures to boost the contribution of national savings to the financing of the PSBR and thus ease pressure on the gilt-edged market and hence on long-term interest rates. As a first step, a new index-linked certificate was made available on 17 November to everyone aged sixty and over, subject to a maximum holding of £3,000. This was expected to raise £1.5 billion (net) during the remainder of 1980/81. Additionally, the limit on monthly payments under the SAYE scheme (third issue) is to be increased from £20 to £50.

Other markets

The local authority market remained inactive during the August to October period. Once again, there were no new issues of local authority stocks; redemptions were £90 million. Issues of negotiable bonds (£181 million) exceeded redemptions by only £4 million.

In the market for company fixed-interest securities, turnover fell back from the high level of the May to July period. Yields rose during August and early September, but generally fell thereafter, for a net gain of only one third of a point over the three months. New issues of loan capital and preference shares totalled £151 million, most of which was accounted for by Rio Tinto Zinc (£127 million of convertible unsecured loan stock). Redemptions were £94 million. There were no debenture issues, and gross issues of preference shares totalled £17 million.

Throughout the period the equity market oscillated between optimism that there would be an early cut in MLR and pessimism

(1) The stock was issued on 29 October, payable in full at issue. It was allotted at the minimum tender price of £72.50 per cent (to give a yield of 10.79%). £600 million of this stock had been issued on 29 May.

about the underlying industrial situation. Prices, which had fallen slightly at the end of July, continued to drift downwards in early August, and on the 6th the FT-Actuaries industrial (500) share price index fell by four points to 288 on the news of the large increase in the money stock during banking July. The slowing in the rate of increase of retail prices and the visible trade surplus in July helped towards a recovery, but this was not sustained and the index fell back sharply towards the end of the month when ICI's disappointing second quarter figures were released. The index rose to 308 on 12 September on hopes that a moderation in wage demands and the announcement of the smallest monthly rise in the retail price index for over three years would lead to a cut in MLR. However, poor company results, the escalating conflict between Iran and Iraq and rises in US prime rates led to some nervous trading and the index fell back. The downward trend continued in early October and by the 10th the index had fallen to 295. Thereafter a reaction set in as the strength of sterling, which reached a seven-year high on the 21st, renewed hopes of a reduction in MLR. Optimism was such that prices rose despite evidence of the bleak industrial position exemplified by ICI's trading loss in the third quarter. By the 30th the index had risen to 320, its highest since compilation, and it ended the month at 318—a net rise of twenty-three points over the three months.

New money raised by issues of equity capital during the three months totalled £289 million, which included rights issues of £60 million by BTR and £49 million by Blue Circle Industries. The amount raised was very similar to that in the three months from May to July but was considerably higher than in the previous three periods, when the average amount raised was £118 million.

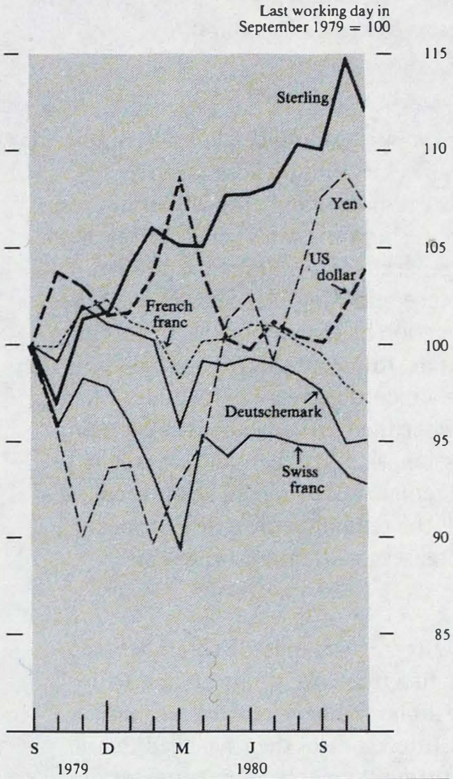
During the three-month period, net sales of unit trust units were £30 million, with gross sales of £121 million and gross repurchases by the managers of £91 million.

Foreign exchange and gold markets

Summary

Although quiet at first, exchange markets became increasingly unsettled in the period August to October. Interest rates were reduced in some European centres and in Japan, but increased in the United States as the Federal Reserve Board responded to signs that the economy was emerging from the recession with an uncomfortably high rate of inflation. As a result, the US dollar strengthened against all major currencies except sterling and the Yen (the latter experiencing strong investment demand from the Middle East). The rise in US interest rates relative to those in West Germany and the implications of the conflict in the Middle East for the West German balance of payments led to heavy sales of deutschemarks, and the deutschemark fell by 7% against the US dollar. In the United Kingdom, the strong underlying energy position and continuing trade surplus led to very heavy demand for sterling, which rose against the dollar and European currencies to levels not recorded since the early to mid-1970s. Only the Yen was stronger. Sterling's effective index rose by 6%. The exchange rate mechanism of the European Moneary System (EMS) came under considerable pressure as the deutschemark and Belgian franc fell to their bilateral intervention points against the French franc and Dutch guilder. The lira remained the weakest currency overall, particularly after the resignation of the Italian Government at end-September, but was never close to breaching its 6% permitted margin of fluctuation. An extension of exchange controls and higher interest rates helped to stem the lira's fall. The price of gold reached $720½ per fine ounce following the outbreak of hostilities in the Middle East, but it later fell back to close the period at $629, no doubt affected in part by publicity about sales of gold by the USSR.

Indices of effective exchange rates



Sterling

At the close on 1 August, with the dollar very firm, sterling stood at $2.3335 (its lowest in the three months to end-October) with the effective rate index (ERI) at 74.5. But it quickly recovered, to reach $2.37 by 8 August, helped by rumours of a rise in Saudi Arabian oil prices and by strong Middle East and commercial buying interest. Sterling continued to be firm against all currencies in August—the July banking figures dispelling fears of an imminent cut in MLR. On 26 August, following the July trade figures, the announcement from Texaco of a significant North Sea oil discovery led to a swift rise in the rate, and it closed the month at $2.3940. Against the deutschemark, sterling closed at DM 4.29½, after DM 4.18 at the beginning of August and DM 4.30 on 27 August; sterling also rose strongly against other major currencies and the ERI reached 76.2 at end-August.

In early September, sterling breached $2.40 in New York and closed at $2.42 on 4 September, the highest since March 1975. Other currencies, however, were also stronger against the dollar, and the ERI was only slightly higher, at 76.5. The release of the August banking figures led again to strong expectations of a cut in MLR; and, with US prime rates edging toward 12%, sentiment turned and sterling fell back. The threat of a national dock strike added to the pressure, and sterling closed at $2.3844 and DM 4.27 (ERI 75.6) on 18 September. Later, some reductions in European interest rates and, more particularly, the outbreak of hostilities in the Middle East, rapidly pushed sterling to new peaks against the continental currencies, which fell sharply against the dollar. Sterling closed at DM 4.35 on 23 September (ERI 76.7), though at only $2.4022 as the US dollar continued to strengthen. It then drifted back and closed the month at $2.3883 and DM 4.32½, with the ERI at 76.0.

In October, sterling was at first weaker as the September banking statistics again suggested the possibility of an early cut in MLR and as the dollar continued to strengthen. However, the absence of any change in MLR and tight conditions in the UK inter-bank market led to renewed overseas interest in gilt-edged stocks and demand for sterling. The agreement by the engineering workers' union to a national wage settlement of 8¼%, a better-than-expected trade surplus for September, and an increase in retail prices of less than 16% for the year to end-September stimulated demand for sterling. External factors—the continuing conflict in the Middle East and the easing of interest rates in Europe—also played a part in pushing sterling to $2.4495 on 24 October, the highest close since September 1973, before it fell back to close the period at $2.4375. It was also very strong against major European currencies at end-October: at DM 4.64, the highest for over four years; Sw. Fcs. 4.16, the highest for three years; and Fr. Fcs. 10.66, the highest for nearly six years. As a result, the ERI stood at 79.2.

The UK reserves fell by $246 million in the three months to October, to $28,026 million. On 14 July, the Government announced its intention to repay in advance in 1980 the $1½ billion

HMG euro-dollar loan raised in February 1977 and re-negotiated in August 1978: early repayments of $250 million and $900 million were made in August and September. A further $80 million under the International Monetary Fund (IMF) oil facility was repaid in October, and a final payment of $123 million was made to the IMF under the 1977 stand-by, though the latter payment had no net effect on the UK reserves as the UK reserve position in the Fund is also included in the UK reserves. Public sector borrowing under the exchange cover scheme totalled $327 million and repayments $162 million. Finally, the quarterly renewal in October of the swap with the European Monetary Co-operation Fund[1] gave rise to a revaluation gain of $82 million. After allowing for these factors the underlying increase in the reserves was $741 million.

US dollar

The record increase in money supply announced in mid-August, and the belief that the Federal Reserve might adopt more restrictive tactics, led to higher domestic and euro-dollar interest rates, including the first increase in prime rates since their peak in early April. The dollar rose generally, exceeding DM 1.80 on 18 August for the first time since mid-May. A period of weakness in early September followed action by the authorities to curb the rise in the rate for Federal funds. Interest rates then turned up again after the publication of a record increase in the index of leading indicators for July underlined the view that the economy might be coming out of recession, that loan demand was likely to rise and that inflation would remain fairly high. The outbreak of hostilities in the Middle East, the reduction of some European interest rates and further increases in US interest rates, all sustained the dollar.

A fall in the weekly monetary aggregates in late September (the first since mid-August) brought a temporary halt to the rise in interest rates, and also in the dollar, which remained around DM 1.80 until mid-October. Interest rates then renewed their upward trend in the face of further increases in the monetary aggregates, a 1% rise in the consumer price index for September and large increases in business loans: by late October, prime rates stood at $14\frac{1}{2}\%$ and the three-month euro-dollar rate at over 15%. By 31 October, the dollar had risen in the three-month period some 7% against the deutschemark and 5% against the European Currency Unit (ECU). In effective terms, however, it rose less than 1%, largely because of its weakness against sterling and the Yen.

Other currencies

The EMS came under the heaviest pressure for a year as the dollar strengthened against all European currencies: the spread between the strongest and weakest of the currencies observing a $2\frac{1}{4}\%$ margin widened from $1\frac{1}{4}\%$ in late August to the permitted $2\frac{1}{4}\%$ maximum by late October as the deutschemark and Belgian franc fell to their bilateral intervention points against the two strongest currencies—the French franc and the Dutch guilder. The divergence indicators of both the deutschemark and the French franc touched 70.[2] The French franc, at first the strongest of the EMS currencies, fell back as the current account deficit widened. It regained the top position in mid-October, however, and there were substantial purchases of deutschemarks by the French authorities

(1) See the additional notes to Table 19.1 in the statistical annex.
(2) See the June 1979 *Bulletin*, page 190, for an explanation of the EMS.

as the two currencies approached their bilateral intervention point of Fr. Fcs. 230.33 = DM 100. The deutschemark was often the weakest currency observing a $2\frac{1}{4}\%$ margin—first, after the cut in Lombard rate to 9%, but more particularly from mid-October, after the DM 3 billion increase in West German banks' rediscount quotas and on uncertainties about the West German balance of payments. In the three months to end-October, the rate fell 7% against the dollar. The Danish krone remained comfortably around the middle of the narrow band and the Danish authorities were able to reduce discount rate to 11% in two stages. The Dutch guilder alternated with the French franc as the strongest currency; Dutch discount rate was also cut in two stages, in September and October. By the end of October, the guilder was $2\frac{1}{4}\%$ adrift from the Belgian franc and the deutschemark, and bilateral intervention was required. The Belgian franc at times replaced the deutschemark as the weakest of the currencies in the narrow band.

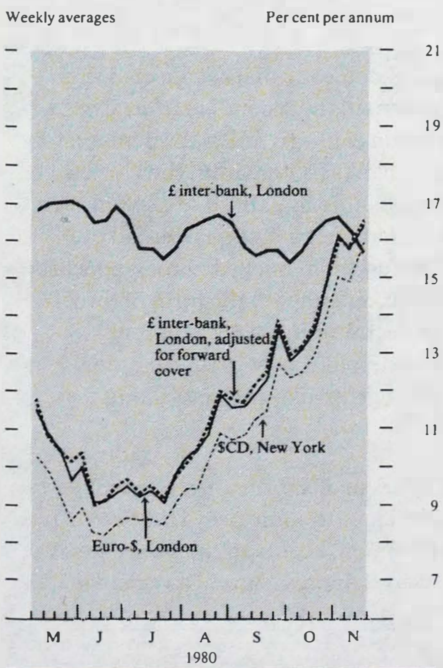
The lira continued to suffer at first from rumours of a devaluation as the trade deficit widened and inflation showed no signs of abating. Following the fall of the Government in late September, the rate fell to over $3\frac{3}{4}\%$ from the strongest EMS currency (though remaining well within its 6% margin). Official intervention, an increase in the discount rate to $16\frac{1}{2}\%$, and the extension of exchange controls stemmed the fall. The Irish pound, helped at first by the strength of sterling, was briefly the strongest currency in late August, but it weakened in October in line with the other EMS currencies. Its discount to sterling widened from under 10% at the start of the period to 19% at the end.

The Swiss franc fell less than the other European currencies against the dollar and strengthened to Sw. Fcs. 0.90 against the deutschemark. But for substantial intervention the Norwegian krone, buoyed up by North Sea oil, would have risen even further against most European currencies. The Swedish krona, on the other hand, continued to require support until the second half of September.

Outside Europe, the Yen strengthened on balance by some 7% against the dollar and by some 10% in effective terms. The smaller-than-expected cut in discount rate in mid-August led to strong demand, which pushed the rate to ¥216 in early September. By mid-September, following an apparent agreement on oil purchases by Japan against oil-producers' investment in Japan, the rate reached ¥211. It quickly shrugged off the implications of the Middle East conflict and touched ¥208 on 21 September on heavy Middle East investment demand. Then profit-taking and fears of a further cut in discount rate saw the rate fall back to close at ¥211.

The Canadian dollar weakened against the US dollar as interest rates rose less than in the United States, but favourable trade account developments and the existence of indigenous energy reserves moderated the fall.

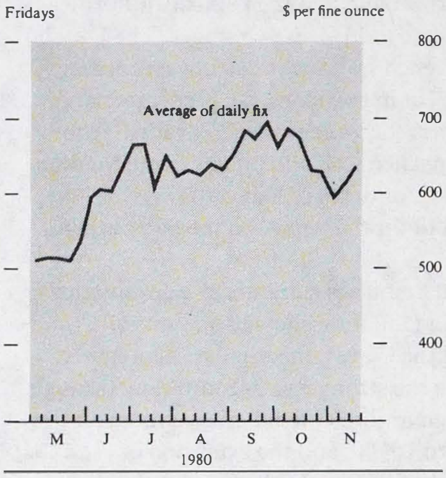
UK and US three-month interest rates



Interest rates and differentials

The three-month euro-dollar rate, which had fallen to 10% by early August, rose to $12\frac{1}{2}\%$ by the end of the month before falling back to $11\frac{1}{4}\%$ in early September. It reached $13\frac{5}{8}\%$ by 2 October, before easing to 13%. It firmed in the last week of the month to close at $15\frac{1}{4}\%$. The three-month inter-bank sterling rate eased from $16\frac{3}{8}\%$ in early August to $15\frac{1}{2}\%$ by mid-September; it then fluctuated between $15\frac{1}{2}\%$ and 16% until tightness in the domestic

London gold price



market in October pushed it back to 16¼%, and later to 16¾% by the close of the month. The three-month forward discount on sterling reached a peak of 6⅝% in early August and then fell steadily to 1⅝% by end-September, before widening to 2¾% on 22 October. It closed the period at 1½%. The covered differential remained close to interest-rate parity throughout the period.

Gold

The price of gold remained around $625 for the first half of August, although it touched $605 on the 12th. Developments in Poland and more rumours about the US hostages in Iran saw the price test $650, before fixing at $645¼ on 21 August. By 12 September, it had reached $693½ as the dollar weakened and the silver price moved up. Precautionary buying ahead of the OPEC meeting was also a factor. The price was fixed at $720½ on the morning of 23 September following the outbreak of hostilities in the Middle East, but profit-taking and a calmer market attitude to the conflict led to a fall to around $675. The higher financing costs of running positions and more hopeful news relating to the release of the American hostages combined to push the price down to $634½ on 23 October. It closed the period at $629—depressed in part by publicity about sales of gold by the USSR—a net increase of $14¾ over the three months.

International banking and euro-currency markets

International developments (second quarter of 1980)

According to data published by the Bank for International Settlements (BIS),[1] the gross external claims of banks within the BIS reporting area grew by some $88 billion in the second quarter of 1980; after allowing for the statistical effects of exchange rate fluctuations (the dollar depreciated over the period), the growth is estimated to have been approximately $50 billion. If inter-bank redepositing is excluded, the net size of the market is estimated to have increased by some $45 billion, compared with $35 billion in the previous quarter, suggesting faster growth in lending to 'final' borrowers. Because of the significant statistical effects of exchange rate fluctuations, figures quoted in the rest of this section are on an exchange rate-adjusted basis, and therefore differ from those in Table 17 in the annex.

The changed conditions in the US domestic market affected the whole international banking system in the second quarter. Credit ceilings and the economic recession caused a fall in the demand for domestic credit, enabling the US banks (both within the United States and also in their adjacent offshore branches) to expand their external claims by nearly $19 billion after a first quarter fall of $2 billion. Although some of the funds channelled abroad appear to have returned to the domestic market either in the form of direct bank credit to the US non-bank sector or in the form of inter-company flows, there was a considerable boost to international lending. Apart from US banks the growth of external claims slowed markedly.

US banks, including their branches in offshore centres, accounted for all new lending to non-oil developing countries. These countries doubled their borrowing to $10 billion, although their deposits rose by $1½ billion. However, the overall figures conceal a variety of

(1) See Table 17 in the statistical annex. The figures cover external business in domestic and foreign currencies of banks in the Group of Ten countries, Austria, Denmark, the Republic of Ireland and Switzerland, and of branches of US banks in certain offshore centres.

activity, and the borrowing of a few nations heavily influences the apparent trend.

Of the East European countries, Hungary and Poland once again significantly increased their borrowing; together with a reduction of deposits of just under \$3 billion—mostly by the USSR—this resulted in an increase in the bloc's net recourse to the market, from just over \$2 billion to \$4½ billion.

The oil exporters continued to be large net suppliers of funds to the market, although their contribution was smaller than in the first quarter (\$10 billion against \$15 billion) as their borrowing grew more rapidly than their deposits. In contrast to past experience, they invested most of their funds in the second quarter in the domestic market of the currency involved, rather than being placed offshore. Their domestic Yen deposits rose by the equivalent of almost \$2 billion, after Japanese banks had been permitted to pay competitive rates of interest on deposits of this nature.

Limited data for the third quarter suggest that the rate of growth of international lending may have slowed somewhat.

Euro-sterling

Although the euro-sterling market remains a small proportion of the total euro-currency market in the BIS reporting area—2%[1] at end-June 1980—it has been growing very rapidly, and expanded by 40% in the first half of 1980. A major factor behind this growth has been the abolition of UK exchange controls, which removed restrictions on the supply of sterling to the market from UK banks and other residents. UK residents' euro-sterling deposits more than doubled in the first half of 1980 to £2.7 billion (of which £1.7 billion was held by banks) and account for almost a quarter of total euro-sterling deposits. Other major depositors in the market are European residents (largely banks) and oil-exporting countries. Deposits by central monetary institutions grew from £0.1 billion at end-1977 to £1.0 billion at end-March 1980 but there was no further increase in the following three months.

At end-June, banks had switched about 30% of their euro-sterling liabilities into other currencies. Of the sterling which was on-lent, almost 40% (£3 billion) were claims on UK residents, most of which (£2.2 billion) were on UK banks.

Euro-sterling market[a]

£ billions

	1977	1979			1980	
	Dec.	June	Sept.	Dec.	Mar.	June
Deposits by:						
UK banks	0.8	0.6	0.6	0.7	1.0	1.7
UK non-banks	0.2	0.4	0.4	0.6	0.9	1.0
Other Western Europe	2.0	4.1	4.5	4.4	5.4	5.6
Oil-exporting countries	0.2	0.5	0.6	0.7	1.1	1.1
Other	0.8	1.3	1.6	1.4	1.6	1.6
Total	**4.0**	**6.9**	**7.7**	**7.8**	**10.0**	**11.0**
Claims on:						
UK banks	1.3	1.0	1.1	1.7	1.6	2.2
UK non-banks	0.3	0.3	0.3	0.9	0.8	0.8
Other Western Europe	1.5	3.2	3.4	3.2	3.8	3.8
Other	0.3	0.5	0.7	0.5	0.6	0.8
Total	**3.4**	**5.0**	**5.5**	**6.3**	**6.8**	**7.6**

Source: Bank for International Settlements

(a) The table shows sterling liabilities and claims of banks in the Group of Ten countries (except the United States and—by definition—the United Kingdom), Austria, Denmark, the Republic of Ireland and Switzerland. Loans to, and deposits from, residents of the countries in which the reporting banks are situated are not available for all countries; the table therefore slightly understates the true size of the market.

London market (third quarter of 1980)

After adjustment for the (small) effects of exchange rate fluctuations, the London euro-currency market—as measured by the gross foreign currency liabilities of UK banks—grew by some \$13 billion in the third quarter, compared with \$18 billion in the second. The American banks were largely responsible for the slower increase, their foreign currency liabilities falling by some \$3½ billion. In contrast, the liabilities of the Japanese banks increased by almost \$11 billion.

New deposits from oil-exporting countries amounted to \$4½ billion, the largest quarterly increase so far this year. The drawing down of deposits by the non-oil developing countries which had been recorded earlier in the year appears, in general, to have ceased in the third quarter.

UK banks' liabilities and assets by customer[a]

\$ billions

	1979		1980		
	28 Sept.	31 Dec.	31 Mar.	30 June	30 Sept.
Foreign currency liabilities of UK banks to:					
Other UK banks	78.0	87.5	96.1	103.7	109.1
Other UK residents	10.4	11.5	11.9	13.5	13.5
Overseas central monetary institutions	58.4	61.4	57.9	61.4	62.8
Other banks overseas	162.2	170.0	186.0	198.6	201.0
Other non-residents	46.6	51.0	55.2	57.4	60.6
Other liabilities(b)	2.7	3.3	3.1	3.5	3.7
Total liabilities	**358.3**	**384.7**	**410.2**	**438.1**	**450.7**
Foreign currency assets of UK banks with:					
Other UK banks	76.3	85.1	92.6	99.4	106.4
Other UK residents	22.1	22.1	22.6	25.6	24.1
Banks overseas	190.1	204.3	216.2	227.1	228.9
Other non-residents	64.3	68.1	73.2	80.6	84.8
Other assets(b)	5.5	5.8	5.9	7.1	7.5
Total assets	**358.3**	**385.4**	**410.5**	**439.8**	**451.7**

(a) Figures differ from those in Table 6 in the statistical annex (see additional notes to Tables 14 and 15).

(b) Mainly capital and other internal funds denominated in foreign currencies.

(1) As a percentage of total liabilities in non-domestic currencies of banks in the Group of Ten countries (except the United States), Austria, Denmark, the Republic of Ireland and Switzerland.

UK banks' net liabilities and claims by country or area[a]

$ billions
Net source of funds to London − /net use of London funds +

	1979	1980			
	28 Sept.	31 Dec.	31 Mar.	30 June	30 Sept.
BIS reporting area:					
European area	− 6.7	− 3.5	− 7.4	− 3.7	− 1.4
Canada	+ 0.4	+ 0.5	− 0.5	− 0.5	− 0.3
Japan	+11.8	+12.9	+13.5	+16.0	+17.3
United States	−18.9	−15.9	−13.9	−18.7	−17.0
Offshore banking centres	+15.9	+14.8	+14.5	+12.5	+ 9.3
Other Western Europe	− 0.1	+ 1.4	+ 4.0	+ 4.7	+ 5.3
Australia, New Zealand and South Africa	+ 2.5	+ 2.3	+ 2.1	+ 2.7	+ 3.0
Eastern Europe	+ 9.2	+ 8.6	+10.1	+10.7	+10.4
Oil-exporting countries	−24.9	−27.6	−31.2	−33.1	−37.4
Non-oil developing countries	+ 0.6	+ 2.4	+ 7.2	+ 8.4	+10.8
Other(b)	− 3.6	− 7.9	−11.7	−13.8	−13.1
Total	**−13.8**	**−12.0**	**−13.3**	**−14.0**	**−13.1**

(a) The breakdown corresponds to that in Table 14 in the statistical annex.
(b) Includes international organisations and certain unallocated items.

As for claims, lending to non-oil developing countries increased by some $2 billion, about half of which went to Brazil and Argentina. Lending to the smaller OECD countries also remained high, notably to Norway, Spain and Finland.

The maturity analysis of the foreign currency positions of British banks at mid-August[1] shows a further considerable improvement in their short-term net liability positions when viewed as a proportion of total claims. The sight to three-month band declined from just under 20% to less than 17%, with sight to six months dropping from 27% to 24%. This improvement was shared by all the other bank groups except the American banks, whose short-term mismatched positions deteriorated slightly.

UK contribution to BIS half-yearly survey of banks' external positions (first half of 1980)

The contribution of UK banks to the detailed half-yearly surveys of external positions undertaken by all central banks within the BIS reporting area,[2] are set out, for end-June 1980, in Table 16 of the statistical annex. If claims on the offshore banking centres (which include a large amount of short-term inter-bank business) are excluded, there was little change in the overall maturity structure of lending between end-December 1979 and end-June 1980. There was, however, some evidence that certain prime borrowers have been able to improve the maturity profile of their indebtedness; claims on Western Europe (excluding the BIS European reporting area) increased by some $1.2 billion in the over five-year band, and there was a corresponding fall in the shortest band. In contrast, the structure of claims on non-oil developing countries marginally shortened, possibly as banks' perceptions of country risk heightened. This was reflected in the higher cost of borrowing for these countries during the first half of 1980. As in the general maturity analysis referred to above, 'roll-over' loans[3] are classified according to their remaining period to maturity rather than to the next roll-over date.

Announced new medium-term euro-currency credits[a]

$ billions

	1979	1980			
	Quarterly average	Q1	Q2	Q3	Oct.
OECD countries	6.8	8.7	9.0	5.6	3.2
Eastern Europe	1.0	0.7	0.5	0.8	0.5
Oil-exporting countries	1.9	2.0	2.7	0.9	1.0
Developing countries	7.5	4.7	5.9	5.2	3.7
Other countries	0.9	—	—	0.5	—
Total	**18.1**	**16.1**	**18.0**	**13.0**	**8.4**

(a) Maturities of three years or over.

Medium-term euro-currency credit markets (third quarter of 1980)

New medium-term credits publicly announced in the third quarter totalled only $13 billion, the lowest quarterly figure for nearly three years. In real terms, this represented a fall of over 40% compared with the third quarter of 1979. Developing countries accounted for just over $5 billion—close to their rate of borrowing in the first half of this year, but significantly below that for 1979. Borrowing by the developing countries in this form thus remained low in relation to their financing requirements; however, the banking figures for the second quarter described above suggest that these requirements may have been met to a greater extent than usual by unpublicised borrowing from banks. In October, there was a sharp revival in the euro-credit markets, with publicised loans totalling over $8 billion, almost half of which were to developing countries.

The weighted average maturity of loans continued to fall: in October it stood at 7.5 years, compared with over 9 years in 1979. At the same time, the range of spreads paid by public sector borrowers in different country categories widened further, with the average for OECD countries diverging further from that for the developing countries.

(1) See Table 15 in the statistical annex.
(2) For this purpose, the Group of Ten countries, Austria, Denmark, the Republic of Ireland and Switzerland.
(3) These are loans made for, say, five years where the interest rate is fixed every three, six or nine months, depending on the agreement between the lender and the borrower.

Completed international bond issues[a]

$ billions

	1979	1980			
	Quarterly average	Q1	Q2	Q3	Oct.
Total issues	**8.4**	**6.3**	**11.5**	**8.3**	**4.3**
By currency:					
Dollars	3.2	1.3	6.5	2.9	2.1
Deutschemarks	1.8	2.3	1.8	2.1	0.9
Swiss francs	2.3	1.7	1.8	1.7	0.8
Sterling	0.1	0.2	0.3	0.4	0.1
Other	1.1	0.8	1.1	1.2	0.5
By borrower:					
OECD countries	6.2	5.0	8.4	5.8	3.3
International institutions	1.5	1.2	2.2	1.8	0.7
Developing countries(b)	0.6	0.1	0.6	0.6	0.2
Other	0.2	—	0.2	0.2	0.2

(a) Euro-market and foreign-market issues, both fixed and floating rate, with maturities of three years or over. Excludes Canadian borrowing in New York.

(b) Excluding oil-exporting countries.

Identified deployment of oil exporters' surpluses[a]

$ billions

	1979		1980		
	Year	Q4	Q1	Q2	Q3
United Kingdom:					
Sterling bank deposits	1.4	0.7	0.8	0.6	0.1
Euro-currency bank deposits	14.8	3.5	4.1	1.9	5.3
British government stocks	0.4	0.2	0.4	0.7	0.5
Treasury bills	—	−0.6	0.6	−0.4	−0.2
Other sterling placements	0.4	0.1	0.1	—	—
Other foreign currency placements	0.2	0.2	—	—	—
	17.2	4.1	6.0	2.8	5.7
United States:					
Bank deposits	5.0	3.7	−0.8	2.6	−2.0
Treasury bonds and notes	−1.1	0.4	2.1	2.4	1.6
Treasury bills	3.3	1.9	1.3	−0.4	0.7
Other portfolio investment	1.0	0.7	0.7	1.0	1.9
Other	−1.4	−0.3	−0.4	0.9	..
	6.8	6.4	2.9	6.5	2.2
Bank deposits in other industrial countries	18.7	6.7	8.3	8.2	..
Other investment in other industrial countries(b)	8.7	2.3	3.4	4.6	2.7(c)
IMF and IBRD(d)	−0.4	0.3	0.9	2.6	0.3(c)
Loans to developing countries	9.6	2.3	1.9	1.4	1.1(c)
Total identified deployed net cash surplus	**60.6**	**22.1**	**23.4**	**26.1**	..
Residual of unidentified items(e)	11.4	1.9	3.6	4.9	..
Total net cash surplus derived from current account (as shown in the following table)	**72.0**	**24.0**	**27.0**	**31.0**	..

.. not available.

(a) This table excludes liabilities arising from net borrowing and inward direct investment and also, on the assets side, changes in credit given for oil exports. These items are shown as net external borrowing etc. in the following table.

(b) Mainly loans and holdings of equities.

(c) Provisional.

(d) Includes holdings of gold.

(e) The residual may reflect errors in either the current or capital account.

International bond markets (third quarter of 1980)

Publicised completions in the third quarter of 1980 were $8.3 billion—similar to the average for 1979 but about 30% lower than in the previous quarter. The decline was largely the result of the climb in US interest rates after July, which brought an end to the upsurge in issues of dollar bonds; with short-term interest rates increasing faster than bond yields, the positive yield gap disappeared by the end of September.

Over the quarter as a whole, issues in most other currencies remained at about the same level as in previous quarters. But the sterling sector continued to grow; there were a further nine issues, bringing the total to seventeen so far this year, amounting to the equivalent of almost $1 billion.

Borrowing continued to be dominated by international institutions and OECD countries. Of the latter, UK entities raised $0.5 billion with nine issues, rather less than in the previous quarter. Developing countries also borrowed less, bringing the amount raised by them in the first three quarters of the year to $1.3 billion. Almost 60% of this sum was raised by Brazil, Mexico and Argentina.

In October, as with euro-currency credits, there was a sharp increase in issues, to $4.3 billion.

Deployment of oil money

In the second quarter, the identified cash surplus of the oil exporters was $26 billion, slightly higher than in the previous quarter. Some $13 billion was deposited with banks—split approximately equally between euro-currencies and domestic currencies—while there was net disinvestment of short-term government securities in both the United Kingdom and the United States.

In the first half of 1980, the amount of new funds placed in the United Kingdom and the United States fell to some 40% of total identified investments as more was placed in other industrial centres, notably West Germany, Japan, France, the Netherlands and Switzerland. Some $10 billion was placed in bank deposits in these countries and a further $7 billion in other assets, mostly in West Germany and Japan. Despite large increases in deutschemark, Swiss franc and Yen-denominated bank deposits, there was some recovery in the share of dollar-denominated bank deposits in the second quarter, and at end-June the dollar share of total foreign assets was probably just over 70%.

The current account surpluses of the oil exporters are estimated to have risen to some $65 billion in the first half of the year. Debt incurred in earlier years was repaid while trade credit extended was modest in relation to export revenue growth. Consequently, the disposable cash surplus for the first half year is estimated to be about $60 billion, still substantially greater than the deployed surplus of $50 billion identified so far.

In the third quarter, oil exporters' placements in the United Kingdom rose by $6 billion, mostly in dollar-denominated bank deposits. There was a further rundown of Treasury bill holdings, but continued purchases of gilt-edged stocks (holdings of which have risen by the equivalent of about $1.5 billion since the

Oil exporters' current account balance and cash surplus available for investment

$ billions

	1979		1980		
	Year	Q4	Q1	Q2	Q3
Merchandise trade	112	42	47	44	43
Net invisibles	– 45	–13	–14	–14	–15
of which, official transfers(a)	– *3*	– *1*	– *1*	– *1*	– *1*
Current balance	**67**	**29**	**33**	**30**	**28**
Net external borrowing etc.(b)	5	– 5	– 6	1	..
Surplus available for investment	**72**	**24**	**27**	**31**	..

(a) Provisional.

(b) For definitions see footnote (a) to previous table.

beginning of the year). Oil exporters' investments in the United States rose by $2 billion in the third quarter, with bank deposits falling by $2 billion. Partial figures for West Germany suggest that in the first two months of the third quarter placements rose by some $1.5 billion, including investments in the public sector.

The financing of North Sea oil

The following tables bring up to date the figures in Tables D and E in the article 'The financing of North Sea oil 1975–1980' in the March 1979 *Bulletin* (page 31), previously updated in the December 1979 *Bulletin*, page 390. They give details of the finance provided for North Sea oil development by banks in the United Kingdom as at 20 August 1980. The latest Bank estimate of the outstanding North Sea financing requirement is £8.7 billion for 1980 and £8.5 billion for 1981 (at current prices).

Loans and commitments by banks in the United Kingdom for North Sea oil development(a)

£ millions

	Loans outstanding			Additional firm commitments(b)		
	Sterling	Foreign currencies	Total	Sterling	Foreign currencies	Total
Sector						
London clearing bank groups:						
17 August 1977	243	230	473	95	123	218
16 August 1978	263	231	494	152	102	254
15 August 1979	348	225	573	113	139	252
20 August 1980	315	300	615	177	126	303
Scottish clearing bank groups:						
17 August 1977	24	52	76	15	28	43
16 August 1978	18	51	69	6	10	16
15 August 1979	15	46	61	24	31	55
20 August 1980	52	45	97	59	53	112
Accepting houses, other British banks and consortium banks (excluding clearing banks' subsidiaries):						
17 August 1977	41	67	108	25	24	49
16 August 1978	42	89	131	42	8	50
15 August 1979	56	109	165	7	66	73
20 August 1980	38	157	195	10	12	22
American banks:						
17 August 1977	229	409	638	32	215	247
16 August 1978	289	381	670	53	216	269
15 August 1979	305	353	658	94	216	310
20 August 1980	306	424	730	199	290	489
Other overseas banks:						
17 August 1977	83	271	354	40	111	151
16 August 1978	184	268	452	47	65	112
15 August 1979	169	208	377	41	26	67
20 August 1980	118	188	306	68	30	98
Total						
17 August 1977	620	1,031	1,651	207	500	707
16 August 1978	796	1,020	1,816	300	401	701
15 August 1979	893	941	1,834	279	478	757
20 August 1980	830	1,114	1,944	513	511	1,024

(a) Loans and commitments are included where lending is for an identifiable project or where it is reasonable to assume that the purpose of the borrower is to finance North Sea commitments. They include bill finance and loans to finance companies interposed between lenders and the ultimate borrowers.

(b) Firm commitments, in addition to actual loans outstanding, based on the existence of an agreed facility or of a loan not yet fully drawn down.

North Sea lending as a share of total advances to UK residents

£ millions; *percentage in italics*

	Banks in the United Kingdom					
	Total advances to UK residents as at 20 August 1980			North Sea lending as a proportion of total advances(a)		
	Sterling	Foreign currencies	Total	Sterling	Foreign currencies	Total
Sector						
London clearing bank groups	30,650	3,065	33,715	*1*	*10*	*2*
Scottish clearing bank groups	3,456	248	3,704			
Accepting houses etc.(b)	5,741	1,157	6,898	*1*	*13*	*3*
American banks	4,434	2,746	7,180	*7*	*15*	*10*
Other overseas banks	3,308	3,671	6,979	*4*	*5*	*4*
All banks	47,589	10,887	58,476	*2*	*10*	*3*

(a) Excluding bill finance and loans to non-resident finance companies.

(b) See table above for full description.

Commodity markets

Continuing world-wide recessionary pressures, and the effects of high interest rates and a further rise in sterling, restrained activity in the markets; speculative interest remained low.

Base metal prices eased further over the period, except for lead and zinc, which were influenced by producer price rises; but delays in settlement of the US copper workers' strike, together with movements in precious metal prices, accounted for some volatility. Silver prices continued to recover following the announcement of a rise in OPEC oil prices and the start of the Iran/Iraq war, but fell back in the second half of October.

Cocoa and, more particularly, coffee prices continued to fall during the period, despite attempts by the relevant international organisations to make price stabilisation policies more effective against a background of forecast surpluses. Sugar prices were again volatile, rising particularly sharply until mid-October as a result of widespread buying interest from abroad. Reports of an expected shortfall in Russian crops affected other markets as well as that for sugar; there was a surge of interest in the London soyabean meal futures contract.