International financial developments

Among the main developments:

- *A new pattern of current account balances is emerging, in part reflecting changes in competitiveness: in particular, the positions of Japan and West Germany have improved sharply.*
- *Financing problems have been exacerbated by high US interest rates and the strong dollar. In many countries, short-term interest rates have been raised and reserves run down.*
- *There was some slowdown in international banking activity in the first quarter of the year, and information on the London market suggests that there was little growth also in the second quarter.*
- *The international bond market was buoyant in the second quarter. Despite high and volatile US interest rates, dollar-denominated issues have accounted for about half of the total.*
- *The foreign exchange markets have been very active with interest rate considerations still dominant. The dollar continued to strengthen, while sterling fell sharply in early June although it later stabilised in nervous markets.*

This section contains the regular coverage of the international banking and foreign exchange markets which was previously found in the financial review. It is preceded by an account of world payments balances and their financing, including the deployment of the surpluses of the oil exporters.

Balance of payments developments

The current account surplus of the oil exporters has continued to be the most important influence on the distribution of world payments balances. In the second half of 1980 the surplus declined from its earlier peak in the face of weak demand for oil and, at the end of the year, the net effect of the Iran-Iraq war. The main counterpart to this falling surplus was recorded in the current account positions of the major overseas economies[1] and the United Kingdom; the large deficits of the smaller OECD countries and the developing countries persisted.

World current account summary[a]

$ billions; *seasonally adjusted*

	1980			1981
	Year	H1	H2	H1[b]
Six major overseas economies	- 42	-28	-14	- 9
Other OECD	- 30	-19	-11	-13
Total OECD	- 72	-47	-25	-22
Oil-exporting countries	105	58	47	55
Other developing countries	- 66	-34	-32	-33

(a) The columns do not sum to zero because of incomplete country coverage, timing differences, and unrecorded invisibles transactions.
(b) Partly estimated.

At the beginning of 1981, the oil-exporters' surplus expanded once again, despite increased imports (which had been checked earlier by the Iran-Iraq war). Oil revenues rebounded as official prices were raised from 1 January and as production was partially resumed by Iran and Iraq and increased by Saudi Arabia. By the second quarter, however, market pressures were forcing cuts in oil production, but by then the oil exporters were beginning to benefit from terms of trade gains as the dollar appreciated; in addition, their receipts of investment income increased as international interest rates climbed. The current account position of the major overseas countries continued to improve, while preliminary data suggest that the smaller OECD and the developing countries remained in deep deficit.

Over the remainder of this year, the oil-exporters' surplus is likely to recede slowly. While there will be little scope for them to raise production above present low levels, the oil exporters will have continued to benefit from the recent strength of the dollar and high interest rates. Moreover, their import growth is likely to have settled down again to a more sustainable rate in the second half of the year. The combined current account position of the major overseas countries should improve further, but there seems little prospect of the smaller OECD countries and the developing countries being able to reduce their deficits significantly.

The fall in the combined current account deficit of the major six overseas economies in the second half of last year was accompanied by a marked redistribution of surpluses and deficits. The United States, Canada and Japan all recorded substantial improvements stemming mainly from

(1) United States, Canada, France, Italy, Japan and West Germany.

Major countries: current balances

$ billions; *seasonally adjusted*

	1980			1981	
	Year	Q3	Q4	Q1(a)	Q2(a)
United States	3.7	5.0	1.4	3.1	2.1
Canada	− 1.4	−0.1	0.4	−0.9	−1.5
France	− 7.4	−1.8	−1.7	−2.1	−0.5
Italy	− 9.9	−4.3	−2.2	−1.7	−1.8
Japan	−10.8	−1.6	−0.1	−1.0	2.2
West Germany	−15.9	−4.1	−4.6	−4.7	−2.3
Six major overseas countries	−41.7	−6.9	−6.8	−7.3	−1.8
United Kingdom	7.6	2.2	5.0	..	..

.. not available.

(a) Partly estimated.

falling import volumes, although in Japan exports were rising strongly also. In contrast, West Germany, and especially Italy, moved deeper into deficit. In the first two quarters of 1981, the combined deficit of the major six contracted further, but a new pattern of current balances has begun to emerge, in part reflecting the significant changes in competitive positions that have occurred in the past year or so. In Japan, for instance, the current account moved back into surplus for the first time since early 1979, while the very large West German deficit has fallen appreciably in recent months as the beneficial impact on trade volumes of a weak deutschemark has begun to outweigh its adverse terms of trade effect.

Financing of deficits

The high interest rates in the United States so far this year, and the consequent upward pressure on the dollar (see below), have exacerbated the external financing problems of both developed and developing deficit countries. To offset pressure on their exchange rates against the dollar, many countries have raised short-term interest rates (see below) as well as using reserves; there has also been continued compensatory borrowing, in particular by the West German authorities.

As the table shows, this differs from the experience of the second half of 1980 when deficit OECD countries were able to reconstitute some of the reserves lost in the early stages of the second oil shock. In spite of this emphasis on exchange rate support by other countries, the US dollar appreciated by nearly 13% in effective terms over the first six months of 1981. In aggregate, *ex post* capital inflows into OECD countries—apart from the United States—fell sharply in the first half of 1981, the fall being most marked in the major countries.

The developing countries' current account deficit (before seasonal adjustment) widened by $4 billion in the second half of last year but this was more than matched by an increase of $13 billion in their bank borrowing. Taken together with other capital account developments, this allowed their reserves to be rebuilt by $2 billion following a small run-down earlier in 1980. Provisional estimates suggest that their deficit narrowed slightly at the beginning of this year. The rate of their new bank borrowing fell sharply in the first quarter, but this is likely to pick up later

OECD balance of payments[a]

$ billions; *not seasonally adjusted*

	1979	1980			1981
	Year	Year	H1	H2	H1(b)
United States					
Current account	− 1	4	− 1	4	7
Capital account	18	1	9	− 7	—
of which, investment of OPEC and other developing countries' reserves	*7*	*16*	*8*	*7*	*7*
Official financing balance	18	5	8	− 3	7
of which,					
US reserves etc. (increase −)	*4*	*− 6*	*—*	*− 5*	*—*
Other industrial countries' dollar reserves in the US (increase +)	*−21*	*1*	*− 8*	*9*	*− 7*
Other OECD					
Current account	−33	−75	−46	−29	−24
Capital account	10	53	30	24	10
Official financing balance	−23	−22	−16	− 5	−14
of which,					
Reserves etc. (increase −)	*16*	*− 1*	*7*	*− 7*	*7*
Identified compensatory borrowing	*7*	*22*	*9*	*13*	*7*
Percentage change in dollar effective exchange rate during period	+1.0	+ 2.7	− 2.0	+ 4.8	+12.9
Ex post uncovered nominal interest rate differential between United States and other major countries(c)	+ 1½	− ¾	− 1	− ½	+ 2¾

(a) Components may not sum to totals due to rounding.

(b) Partly estimated.

(c) US three-month Treasury bill rate less GNP-weighted average of short-term interest rates in Canada, France, West Germany, Italy, Japan, Switzerland and the United Kingdom. Period averages.

in the year, reflecting seasonal factors as well as medium-term credit commitments which have already been arranged. Some developing countries have also participated in the second quarter surge of new bond issues noted below.

Deployment of oil money

The identified deployed cash surplus of the oil-exporting countries in the first quarter of 1981 was $19.1 billion, some $5 billion higher than in the previous quarter. The proportion of new funds placed in the United Kingdom and the United States rose to 54% of total identified placements, while new funds placed in other industrialised countries fell to 36% and were entirely in the form of longer-term investments, with bank deposits falling slightly.

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

$ billions

	1979	1980		1981	
	Year	Year	Q4	Q1	Q2
Exports	218	307	76	84	80
Imports	106	141	38	39	41
Merchandise trade	112	166	38	45	39
Net invisibles	− 46	− 61	−17	−15	−14
of which, official transfers	*− 3*	*− 4*	*− 1*	*− 1*	*− 2*
Current balance	**66**	**105**	**21**	**30**	**25**
Net external borrowing etc.(a)	11	5	4	− 5	..
Surplus available for investment	**77**	**110**	**25**	**25**	**..**

.. not available.

(a) For definitions, see footnote (a) to following table.

Identified deployment of oil exporters' surpluses(a)

$ billions

	1979	1980	1980	1981	1981
	Year	Year	Q4	Q1	Q2(b)
United Kingdom:					
Sterling bank deposits	1.4	1.4	– 0.1	0.3	0.3
Eurocurrency bank deposits	14.8	14.8	3.5	4.6	0.3
British government stocks	0.4	1.9	—	0.2	0.3
Treasury bills	—	– 0.1	– 0.1	0.2	—
Other sterling placements	0.4	0.1	—	—	—
Other foreign currency placements	0.2	– 0.5	– 0.2	– 0.1	– 0.4
	17.2	17.6	3.1	5.2	0.5
United States:					
Bank deposits	5.0	– 1.2	– 1.0	0.4	– 0.9
Treasury bonds and notes	– 1.1	8.3	2.2	3.0	2.5
Treasury bills	3.3	1.4	– 0.2	0.3	—
Other portfolio investment	1.0	4.6	1.0	1.4	1.2
Other	– 1.4	1.4	0.3	..	..
	6.8	14.5	2.3	5.1	2.8
Bank deposits in other industrialised countries	18.7	26.2	2.8	– 0.1	..
Other investment in other industrialised countries(c)	8.7	17.0	4.2	7.0	2.9
IMF and IBRD(d)	– 0.4	4.9	1.2	0.7	0.6
Loans to developing countries	9.6	6.7	0.9	1.2	1.3
Total identified deployed net cash surplus	**60.6**	**86.9**	**14.5**	**19.1**	..
Residual of unidentified items(e)	16.4	23.1	10.5	5.9	..
Total net cash surplus derived from current account (as shown in the previous table)	77.0	110.0	25.0	25.0	..

.. 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 previous table.

(b) Provisional.

(c) Mainly loans and holdings of equities.

(d) Includes holdings of gold.

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

The proportion of total new funds placed in bank deposits fell from 36% to 27%. About 76% were held in the form of eurocurrency deposits.

In the second quarter of 1981, oil-exporting countries' new placements in the United Kingdom were only $0.5 billion, as a result of a fall in the inflow to dollar-denominated bank deposits.(1)

The movement towards longer-term investments in the United States continued during the second quarter with new placements in the form of Treasury bonds and notes and other portfolio investment, while bank deposits fell by $0.9 billion.

Preliminary data indicate that new longer-term investment in industrialised countries other than the United Kingdom and the United States continued during the quarter.

International banking and eurocurrency markets

International developments (first quarter of 1981)

After the unusually rapid growth in the last quarter of 1980, there was a slowdown in the growth of international banking activity during the first quarter of 1981, as measured by BIS data.(2) The gross external claims of banks in the reporting area grew by some $25 billion to $1,347 billion. Excluding the effects of redepositing between reporting banks the growth was $10 billion. However, the appreciation of the dollar against other currencies in the quarter means that these figures understate the true growth of bank lending. After adjustment for this valuation effect, gross claims rose by $53 billion, or $30 billion net of redepositing, significantly less than the increases of $97 billion and $47 billion respectively in the fourth quarter. The slowdown was partly seasonal, but there does seem also to have been a drop in the underlying rate of growth, particularly in lending outside the reporting area.

Following the sharp increase of $77 billion (value adjusted) in the December quarter, the external assets of the banks in the reporting European countries grew by only $32 billion in the first quarter of this year. This slower growth was particularly evident in business denominated in dollars and in domestic currencies; there was also a marked slowing down in the growth of inter-bank transactions within the area, reflecting the unwinding of end-year window dressing. Official deposits with the reporting banks fell for the second successive quarter, probably reflecting drawings on reserves by non-OPEC countries to finance their deficits.

Banks in the United States were large net suppliers of funds to the market for the fourth consecutive quarter. Although this growth too was slower than of late, it was still sufficient to take the external net creditor position of these banks to over $50 billion, from $2 billion at end-March 1980.

A notable feature in the first quarter was the sharp slowdown in lending to countries outside the reporting area. Claims on non-oil-exporting developing countries grew by only $4.7 billion (value adjusted) compared with $13.1 billion in the last quarter of 1980, while claims on OPEC countries fell by $2.4 billion. Meanwhile deposits by OPEC countries rose by only $5.1 billion, continuing the declining growth rate shown in 1980, while deposits from other countries outside the reporting area fell by $4.8 billion. Thus the inflow of new funds from outside the area came almost to a halt.

Eurosterling

In the first quarter of 1981, as in the two previous quarters, the eurosterling market (as defined in the accompanying table) showed only modest growth in the three months ending in March 1981. This provided further evidence that the strong growth in the first half of 1980 was due primarily to the removal of UK exchange controls in October 1979 and the continued operation of the 'corset' until mid-June 1980. UK banks were the only suppliers of new funds (£0.4 billion) to the market in the first quarter, and they also showed by far the largest increase in borrowing (£0.3 billion). Overall, the excess of banks' eurosterling liabilities over their claims narrowed by £0.3 billion to £3.7 billion.

(1) See the following section.

(2) See Table 13 in the statistical annex.

Eurosterling market[a]
£ billions

	1979	1980				1981
	31 Dec.	31 Mar.	30 June(b)	30 Sept.	31 Dec.	31 Mar.
Deposits by:						
UK banks	0.7	1.0	1.7	2.1	2.6	3.0
UK non-banks	0.6	0.9	1.0	0.8	1.1	1.0
Other Western Europe	4.4	5.4	5.7	5.6	5.1	4.9
Oil-exporting countries	0.7	1.1	1.1	1.0	1.0	1.0
Other	1.4	1.6	1.6	1.5	1.5	1.5
Total	**7.8**	**10.0**	**11.1**	**11.0**	**11.3**	**11.4**
Of which, central monetary institutions	*0.7*	*1.0*	*1.0*	*0.8*	*0.9*	*0.8*
Claims on:						
UK banks	1.7	1.6	2.2	2.2	2.3	2.6
UK non-banks	0.9	0.8	0.8	0.6	0.7	0.7
Other Western Europe	3.2	3.8	3.8	4.0	3.7	3.7
Other	0.5	0.6	0.8	0.7	0.6	0.7
Total	**6.3**	**6.8**	**7.6**	**7.5**	**7.3**	**7.7**

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. Apart from this geographical limitation, full data on business with residents of the countries in which the reporting banks are situated are not available for all countries. The table therefore understates the size of the market.

(b) Expansion of coverage between March and June 1980 increased UK banks' deposits by £0.2 billion and UK non-banks' deposits, claims on UK banks and claims on UK non-banks each by £0.1 billion.

BIS half-yearly maturity analysis of country data (second half of 1980)

The analysis for end-December 1980 revealed that, except for credits to developed countries outside the BIS reporting area, a very large proportion of new lending by banks was short term; this trend was noted in the June *Bulletin* (page 183) when the UK contribution to the data was discussed.[1] Whereas from end-June 1979 to end-June 1980 claims with maturities of up to one year accounted for only about 40% of the overall increase, in the second half of 1980 they accounted for about 66%. This development reflects the lesser role played in 1980 by the syndicated loans market as a source of credit to developing countries. Apart from developed countries, most borrowers also experienced a sharp decline in recorded unutilised commitments available to them.

By contrast, most new lending to developed countries outside the BIS reporting area was for periods in excess of one year, probably reflecting bankers' perceptions that the majority of these countries are relatively good risks. In addition, this group of borrowers secured a further $3.2 billion in unused credit facilities, though most of this was accounted for by only two countries (Australia and Greece).

London market (second quarter of 1981)

After adjustment for the effects of exchange rate fluctuations, the London eurocurrency market—as measured by the gross foreign currency liabilities of UK banks—grew by $11.5 billion in the second quarter of 1981, compared with $36 billion in the previous three months. In unadjusted terms—the difference largely derived from the strength of the dollar—the market grew by only $1 billion. The (unadjusted) liabilities of the American and British banks each grew by about $4 billion, while the liabilities of Japanese banks fell by $6 billion; this fall is in marked contrast to the rapid growth of Japanese banks' business in recent quarters.

The geographical analysis of the market shows that the banks' liabilities to the United States and Switzerland each rose by $4 billion, while those to Japan, reflecting the fall in business of Japanese banks in London, fell by $3 billion.

The growth in foreign currency assets of the banks was widely spread, with Canada, Italy, and the Bahamas each increasing their borrowing by $2 billion. There was only a small rise in new borrowing by developing countries and a slight fall by Eastern bloc states, although a drawing down of deposits resulted in net flows of funds to both these areas.

The maturity analysis of the foreign currency positions of British banks at mid-May (see Table 14.2 in the statistical annex) shows that their short-term net liability position, measured as a proportion of their total assets, was very little

UK banks' liabilities and assets by customer[a]
$ billions

	1980			1981	
	30 June	30 Sept.	31 Dec.	31 Mar.	30 June
Foreign currency liabilities of UK banks to:					
Other UK banks	103.7	109.1	118.5	130.2	129.0
Other UK residents	13.5	13.5	13.9	17.0	16.6
Overseas central monetary institutions	61.4	62.8	58.6	58.1	54.3
Other banks overseas	198.6	201.0	222.8	233.3	238.6
Other non-residents	57.4	60.6	67.8	74.7	75.9
Other liabilities(b)	3.5	3.7	3.8	3.9	3.6
Total liabilities	**438.1**	**450.7**	**485.4**	**517.2**	**518.0**
Foreign currency assets of UK banks with:					
Other UK banks	99.4	106.4	116.4	129.0	127.1
Other UK residents	25.6	24.1	22.9	23.5	21.2
Banks overseas	227.1	228.9	249.1	263.0	264.1
Other non-residents	80.6	84.8	88.2	92.3	96.2
Other assets(b)	7.1	7.5	8.4	8.6	8.8
Total assets	**439.8**	**451.7**	**485.0**	**516.4**	**517.4**

(a) Figures differ from those in Table 6 in the statistical annex (see additional notes to Table 14.1).

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

UK banks' net liabilities and claims by country or area[a]
$ billions
Net source of funds to London – /net use of London funds +

	1980			1981	
	30 June	30 Sept.	31 Dec.	31 Mar.	30 June
BIS reporting area:					
European area	− 3.7	− 1.4	− 7.2	+ 1.4	—
Canada	− 0.5	− 0.3	+ 0.5	+ 1.8	+ 2.9
Japan	+16.0	+17.3	+17.9	+15.8	+14.7
United States	−18.7	−17.0	−20.3	−22.1	−26.3
Offshore banking centres	+12.5	+ 9.3	+ 7.6	+ 8.2	+12.2
Other Western Europe	+ 4.7	+ 5.3	+ 6.7	+ 8.4	+ 9.8
Australia, New Zealand and South Africa	+ 2.7	+ 3.0	+ 3.3	+ 3.6	+ 4.4
Eastern Europe	+10.7	+10.4	+10.6	+11.5	+11.6
Oil-exporting countries	−33.1	−37.4	−38.6	−43.9	−42.1
Non-oil developing countries	+ 8.4	+10.8	+13.5	+16.5	+18.5
Others(b)	−13.8	−13.1	− 6.9	−12.8	−14.0
Total	**−14.0**	**−13.1**	**−13.1**	**−11.6**	**− 8.3**

(a) The breakdown corresponds to that in Table 14.1 in the statistical annex.

(b) Includes international organisations and certain unallocated items.

(1) The major part of the UK contribution to the half-yearly analysis, which sets out by maturity the claims of banks in the Group of Ten countries, Austria, Denmark, the Republic of Ireland and Switzerland and of a number of their affiliates domiciled in other countries, is contained in Table 14.3 in the statistical annex.

changed in the period since mid-February, with a deterioration in positions of up to eight days' maturity being almost exactly matched by an improvement in the three to six-month maturity band. The slight change in the maturity profile was entirely due to activity in the inter-bank market.

Medium-term eurocurrency credits

The buoyancy in the opening months of the year was somewhat checked in the second quarter. The volume of announced credits, $17 billion, was 20% down on the first quarter, and the total in the first half of the year was only slightly higher (at an annual rate) than last year.

Announced new medium-term eurocurrency credits[(a)]

$ billions

	1979	1980	1981		
	Quarterly rate		Q1	Q2	July
Major OECD countries	3.2	4.8	4.8	4.6	42.9(c)
Minor OECD countries	3.6	4.7	4.0	3.5	0.4
Oil-exporting countries	1.9	1.8	1.4	0.7	0.5
Eastern Europe	1.0	0.6	0.9	0.1	—
Developing countries	7.5	6.2	10.4	8.0	2.4
of which:					
Net oil exporters	*2.3*	*1.6*	*3.7*	*2.3*	*0.8*
Newly industrialised countries	*2.6*	*2.5*	*3.1*	*3.7*	*0.9*
Other	0.8	0.1	0.1	0.2	—
Total(b)	18.1	18.3	21.6	17.1	46.3(c)

(a) Maturities of three years and over.
(b) Totals may not add because of rounding.
(c) See text.

The provisional total for July, $46 billion, represents an exceptional increase, but there were some special circumstances behind this: approximately $41 billion (88%) of the total relates to takeover activity in the United States, and it is expected that most of these facilities will never be drawn down. The total of the remaining loans announced in July was in line with the second quarter.

The pattern of spreads appears to have stabilised over recent months. In the June *Bulletin*, it was reported that average spreads for public sector borrowers from the major OECD countries had dipped below $\frac{1}{2}$%, but in the second quarter they rose slightly above $\frac{1}{2}$%. This reflects in part the type of borrower approaching the market—a factor that also lies behind the apparent shortening in maturities for the major OECD countries.

The mean spread for developing countries disguises three distinct tiers of borrowers. Countries seen as good risks by the banks because of their growth prospects, particularly in the exploitation of oil reserves (such as Mexico), or which are infrequent borrowers on the euromarkets, can obtain spreads similar to those available to major OECD countries. Countries seen as riskier prospects are required to pay around $1\frac{1}{8}$%–$1\frac{1}{4}$%, while Brazil—because it is a very heavy borrower—and those rescheduling debt pay about 2%.

International bonds and notes

After the erratic start to 1981, the second quarter was the most buoyant for a year, with bond issues reaching just over $10 billion. Most of the activity took place in June with dollar issues especially prominent. Bond issues in the first half of the year were thus running on average at the same rate as last year. In July, issues receded to $2.5 billion, much the same rate as in the first quarter.

The new issues market has undoubtedly been affected by the high level of, and volatility in, US interest rates. Nevertheless, dollar-denominated issues have accounted for about half the total, partly because any slight downward movement in rates has been construed by some investors as the arrival of the downturn and partly because of pent-up demand on the part of borrowers. There have been record coupons in all sectors.

Completed international bond issues[(a)]

$ billions

	1979	1980	1981		
	Quarterly rate		Q1	Q2	July
Total(b)	**8.4**	**8.9**	**7.9**	**10.2**	**2.6**
By currency:					
Dollars	3.2	3.7	3.6	5.6	1.4
Deutschemarks	1.8	1.9	0.3	0.5	0.1
Swiss francs	2.3	1.8	2.0	1.8	0.7
Sterling	0.1	0.3	0.3	0.7	0.1
Yen	0.4	0.4	0.6	1.0	0.3
Other	0.7	0.7	1.1	0.7	0.1
By borrower:					
OECD countries	6.2	6.6	6.5	6.9	2.0
International institutions	1.5	1.7	1.1	2.0	0.3
Developing countries	0.6	0.4	0.1	1.1	0.2
Other	0.2	0.1	0.2	0.1	—

(a) Euromarket and foreign issues, both fixed and floating rate, with original maturities of three years and over. Includes private placements, if publicised, but excluding Canadian borrowing in New York.
(b) Totals may not add because of rounding.

Floating-rate notes, usually denominated in dollars, have proved increasingly acceptable to many borrowers. In June a record amount of such paper was issued.

Although the moratorium on non-institutional borrowers in the deutschemark sector has now ended, few borrowers have been willing to pay the necessary coupons (which are the highest since the war). This has contributed, in part, to the success of the Swiss franc sector which has attracted a steady flow of both straight and convertible issues. Sterling and yen issues have also grown quite significantly.

The difficulty of placing bonds during a prolonged period of interest-rate uncertainty, and the unwillingness of borrowers to pay the high coupons necessary to ensure success, have led lead managers to devise a number of special deals over the last few months. One of the most interesting has been the introduction of deep discount nil-coupon bonds. These bonds carry no interest but are sold at a substantial discount, the return to investors being solely through capital gain.

Foreign exchange and gold markets

(Three months to end-July)

Summary

Exchange markets were very active throughout the period and continued to be dominated by high and volatile US interest rates. But other economic and political developments were also influential.

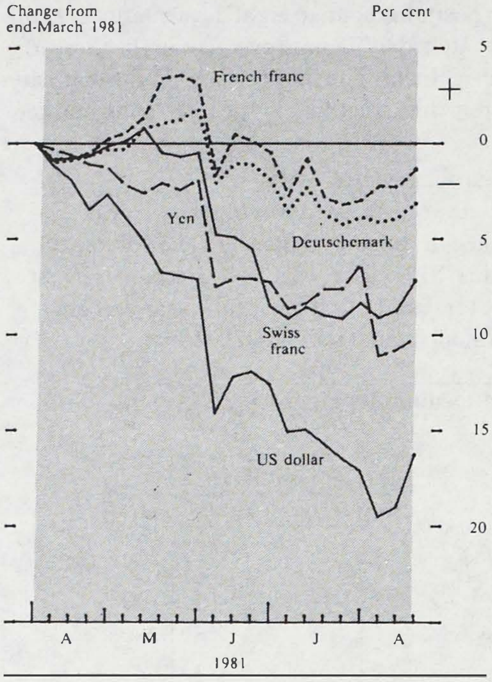
At the beginning of May US interest rates rose following an increase in the Federal Reserve discount rate, but growing signs of a slowdown in the economy and more moderate monetary growth led to some easing in June. Interest rates picked up again in July as the authorities re-emphasised their commitment to monetary restraint, and any hopes of an imminent cut in rates were dispelled at the end of July when the Administration's proposals for tax cuts were approved. Capital inflows, prompted by concern over political developments in Europe, also helped the dollar and it continued to strengthen.

Although weakening against the dollar, sterling rose against European currencies at first; but it fell sharply in early June following the cut in Mexican oil prices, which focused attention on the United Kingdom's balance of payments and the relatively low level of UK interest rates. The social unrest at the beginning of July added to the uncertainty, but increases in domestic interest rates helped to stabilise the sterling market by the end of the period under review.

In the European Monetary System (EMS) there was a brief spell of severe pressure when the French franc fell sharply after the second round of the Presidential election, and substantial support was required to keep it within its intervention limits against the deutschemark.

The pressures eased however after the introduction of a package of interest rate and exchange control measures and the Belgian franc then slipped to the bottom of the arrangement, although it required only occasional support. The differential between US and Japanese interest rates remained large and the yen fell sharply in July. The Canadian dollar also weakened considerably. After a firm beginning gold fell steadily in a generally quiet and featureless market.

Sterling against selected foreign currencies



Sterling

At the beginning of May sterling quickly dropped $4\frac{1}{2}$ cents to touch \$2.10 against a sharply stronger dollar. But it continued to strengthen against continental currencies and also recovered briefly against the dollar, reaching \$2.1275 as commercial buyers were encouraged by these lower levels. Thereafter the pound remained largely on the sidelines: it retreated before the strengthening dollar but improved against most European currencies. By mid-May it had fallen to \$2.0630; commercial demand then again became evident and the rate rose to \$2.1005 before falling back to \$2.0585. A temporary easing in US interest rates at the end of May enabled sterling to recover again and it closed the month at \$2.0705, DM $4.82\frac{1}{4}$ and Fr. Fcs $11.51\frac{1}{4}$. The effective index (ERI) was unchanged over the month at 98.9.

Sterling began June at \$2.08 in nervous conditions and persistent and heavy selling quickly developed. The reduction in Mexico's oil price announced on 3 June, with its implications for North Sea oil and the UK balance of payments, was the catalyst which brought out latent doubts about other aspects of the UK economy: an apparent increase in inflation, in the shorter term at least; the relatively low level of UK interest rates; a growing belief, in the absence of trade figures (because of the Civil Service dispute), that the current account had already deteriorated; and uncertainty over the interpretation of movements in the monetary aggregates (again because of the Civil Service action). Sterling's weakness was exacerbated by the continued stength of the dollar and by 5 June it had fallen 17 cents to \$1.91. It also weakened against European currencies, to DM $4.63\frac{3}{4}$ and Fr. Fcs $10.98\frac{1}{4}$, with the ERI showing a fall of 5.1 points in the first week of June to 93.8. The pound then staged a modest but nervous recovery, helped partly by a weakening in the dollar, and touched \$2.0125 by mid-June with the ERI at 95.7. Thereafter sterling was more stable but it came under heavy selling pressure again at the end of the month as oil prices eased further and US interest rates rose sharply. The pound closed at \$1.9384, DM $4.63\frac{1}{2}$, and Fr. Fcs $11.05\frac{1}{4}$, with the ERI at 94.1.

Selling pressure continued into July with sterling being sold particularly heavily against European currencies and on 2 July the rate touched \$1.8755 and DM $4.54\frac{1}{2}$. It began to recover after press reports that the Government intended to support the rate and was further boosted by a marked tightening in sterling deposit rates on 6 July. By 7 July it had recovered to \$1.9020 and DM 4.65 but soon came under selling pressure again as markets become concerned about the social unrest in the United Kingdom and fell to \$1.8555 on 14 July. A further tightening of domestic interest rates brought some relief but as the dollar strengthened the pound fell back to a three-year low of \$1.8385 on 21 July. Sterling subsequently recovered slightly to close at \$1.8480, DM 4.55½, Fr. Fcs 10.83¼, and 92.0 on the effective index.

The UK reserves fell by \$3,498 million to \$24,568 million in the three months to end-July (see table). During the period the whole of the \$2,500 million eurodollar loan raised in 1974 was repaid; this loan had originally been scheduled for repayment between 1981 and 1984. After allowing for this and also for a further repayment to the IMF under the oil facility, net repayments under the exchange cover scheme, and a valuation gain arising from the quarterly renewal of the EMCF swap, the underlying fall in the reserves was \$528 million.

Changes in UK official reserves

\$ millions

	1981		
	May	June	July
Change in reserves	**−1,579**	**−856**	**−1,063**
IMF oil facility repayment	—	—	− 76
Other HMG capital repayments	−1,700	−262	− 550
EMCF swap valuation gain	—	—	+ 61
Exchange cover scheme:			
Borrowing	+ 38	—	—
Repayments	− 195	−206	− 80
Underlying change in reserves	**+ 278**	**−388**	**− 418**
Level of reserves (end of period)	**26,487**	**25,631**	**24,568**

US dollar

Following large increases in the monetary aggregates throughout April, the Federal Reserve increased its discount rate to a record 14% on 5 May and raised the surcharge for large borrowers to 4%. Prime rates rose by 1% to 19% and the dollar made substantial gains, particularly against European currencies which were affected by political developments in France and Poland. US interest rates rose even higher after a large upward revision to first-quarter GNP data and most banks had raised their prime rates to 20½% by 22 May. After reaching DM 2.3470 on 27 May the dollar fell back as interest rates eased in the face of smaller increases in the money supply and indications that inflation was moderating. However, by 5 June Federal funds were again trading around 20% and the dollar rose to new recent peaks against European currencies. An easing in interest rates together with the threat of a possible oil embargo against the United States contributed to a slight weakening of the dollar in mid-June; but by early July it was once again surging ahead despite growing expectations of lower interest rates, prompted by further signs of a slowdown in the US economy, and reached DM 2.4755 on 8 July, its highest for almost five years.

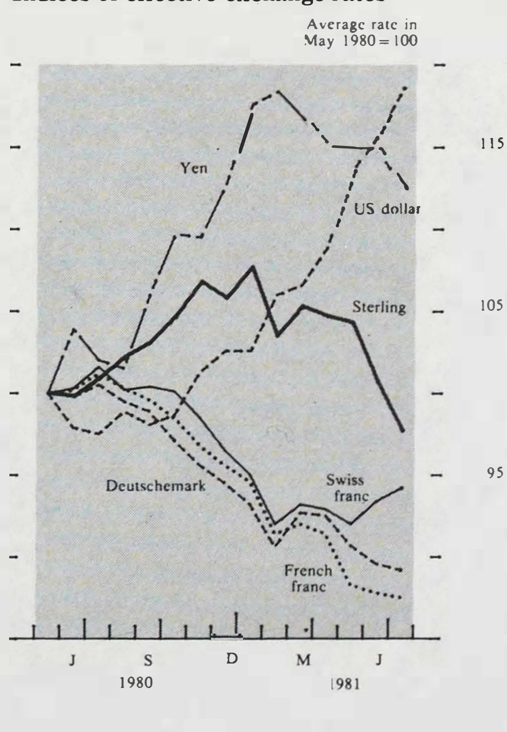
Thereafter the dollar eased back slightly as persistent declines in the monetary aggregates gave rise to hopes of lower interest rates, and the provisional GNP figure for the second quarter of 1981 confirmed the slowdown in the US economy. By the end of July, however, hopes of a reduction in interest rates had receded as the Federal Reserve reaffirmed its commitment to monetary restraint, and these hopes were further diminished after the approval of the Administration's tax cut proposals. The dollar ended very firm at DM 2.4652 and 112.8 in effective terms, a rise of 9.5 points in the effective index over the three-month period.

Other currencies

After a comfortable beginning the EMS came under considerable pressure in mid-May when the French franc weakened sharply following the second round of the Presidential election. Substantial support was required to keep the franc within its bilateral intervention limits against the deutschemark (which remained at the top of the grid throughout the period) and the French authorities introduced a number of exchange control measures and increased their money market intervention rate to a record 22%. Following these measures, pressures on the French franc eased and the Belgian franc slipped to the bottom of the system but it was under little pressure and the Belgian authorities were able to reduce Bank and Lombard rates by one percentage point on 28 May. By early July the French franc had risen to fourth position in the EMS and by the end of the month the money market intervention rate had been reduced in three stages to 18½%. The margin between the deutschemark and Belgian franc grew wider in July, occasionally reaching the permitted maximum, and the Belgian franc required some support. Although falling to a series of all-time lows against the US dollar the lira remained mostly in second position in the EMS, sustained by high domestic interest rates and helped also by deposit requirements on purchases of foreign exchange introduced at the end of May. The Dutch guilder and Danish krone remained comfortably in the middle of the band but the Irish pound required regular support as the balance of payments showed no sign of improvement and inflationary pressures increased.

Although falling to its lowest level for fifty years against the dollar at the end of July, the Swedish krona showed a smaller decline against the US currency than most as Sweden's external position continued to improve. The Swiss franc also held up well against the dollar, supported by higher interest rates and continued capital flows from

Indices of effective exchange rates



France, and improved to Sw. Fcs 0.86$\frac{3}{4}$ against the deutschemark. The Norwegian krone, however, came under some pressure after the reduction in oil prices and fell by over 2% in effective terms. The yen held up well against the dollar for most of the period, but with little prospect of a reduction in US interest rates it eventually fell away, to close at ¥239.67. The Canadian dollar was at first sustained by record interest rates but fell sharply in July to its lowest against the US dollar for fifty years as markets became concerned about the prospects for the capital account and the increasing differential between US and Canadian rates of inflation.

Interest rates and differentials

The three-month eurodollar rate was extremely volatile. It began the period at 17$\frac{9}{16}$% but quickly reached 20$\frac{1}{8}$% after the increase in the Federal Reserve discount rate. At the beginning of June the eurodollar rate fell back again to its opening levels, and then moved in the range 17$\frac{9}{16}$% to 19$\frac{3}{16}$% before closing at 18$\frac{3}{4}$%. Three-month inter-bank sterling opened at 12$\frac{3}{8}$% and having risen briefly to 13$\frac{3}{16}$% in early June eased back to trade steadily around 12$\frac{1}{2}$% until July, when it rose in two stages to close at 14$\frac{9}{16}$%. Three-month sterling traded consistently at a premium in forward markets, reaching a peak of 7$\frac{3}{4}$% on 14 May when eurodollar rates were at their highest, but fell back to close at 4$\frac{1}{8}$% as sterling interest rates firmed. The covered differential remained close to interest-rate parity throughout the period.

Gold

The impact of sharply higher US interest rates at the beginning of May was at first offset by tensions in the Middle East and concern about the result of the French Presidential election, and the gold price rose to fix at $501 on 11 May. Thereafter, however, gold drifted steadily downward in quiet and generally featureless markets. The decline accelerated at the end of June as the dollar continued to strengthen, and the price breached $400 to fix at 397\frac{3}{4}$ on 8 July. An easing in US interest rates and renewed hostilities in the Middle East combined to cause a slight recovery to 418\frac{1}{4}$ in more active markets in mid-July, but the recovery could not be sustained and gold closed at $406, a fall of 76\frac{3}{4}$ over the period.

UK and US three-month interest rates