International financial developments

- *Following a further weakening in demand for oil and continued rapid growth of their imports, the oil exporters' surplus has shrunk considerably; the main counterpart has been a reduction in the combined deficit of major OECD countries.*
- *Oil importing developed and developing countries alike made greater use of reserves in financing current account deficits in the first three quarters of 1981.*
- *Partly reflecting this pattern of deficit financing, there was a continued slowdown in the underlying growth of international bank credit in the third quarter of the year.*
- *Exchange markets were both nervous and volatile from August. Important factors were interest rate developments, the OPEC oil price discussions and the realignment of currencies within the European Monetary System.*
- *Sterling fell sharply early in September but recovered after the authorities had moved to raise short-term interest rates.*

This review covers world payments balances and their financing, the deployment of the surpluses of the oil exporters, international banking, and the foreign exchange markets.

Balance of payments developments

The current account surplus of the oil exporters declined in the first half of this year. Demand for oil weakened and import volume increased; but much of the effect was offset by terms of trade gains as a result of the dollar's appreciation and increased receipts of investment income reflecting higher international interest rates. Since mid-year, a further weakening in the demand for oil and continued rapid import growth have sharply reduced the oil exporters' surplus. In the second half of 1981 it may have been running at less than half the peak rate recorded in early 1980.

The main counterpart to this diminishing surplus during 1981 has been the declining deficit of the major overseas countries. These have benefited from falling imports (especially of oil) and relatively strong export growth, not only to the oil producers, but also to the developing countries and Eastern Europe. Smaller OECD countries have also improved their external positions in 1981, largely through severe domestic restraint. In the case of the developing countries, import growth has been held down during 1981, but with their terms of trade worsening further and interest payments mounting, their current account deficit for the year as a whole may be somewhat larger than in 1980.

Current account summary(a)

$ billions; *seasonally adjusted*

	1980	1981			1982
	Year	Year	H1	H2(b)	Year(b)
Major overseas countries(c)	− 42	− 18	−13	− 5	− 6
Other OECD(d)	− 37	− 24	−13	−11	−15
Total OECD(d)	− 79	− 42	−26	−16	−21
Oil exporting countries	117	77	49	28	52
Other developing countries	− 66	− 73	−37	−36	−68

(a) The columns do not sum to zero because of incomplete country coverage (including the United Kingdom), timing differences, and unrecorded invisibles transactions.

(b) Bank estimates/forecasts.

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

(d) Excluding United Kingdom.

Present trends in the distribution of surpluses and deficits amongst the main country groupings are likely to continue next year, though at a slower rate than in 1981. Allowing for some further weakening in the real price of oil, the oil exporters' surplus may fall to around $50 billion. But there could be deficits in a number of high absorbing countries, whose import growth is likely to be reined back. The combined deficit of the OECD area should continue to narrow until about the middle of next year when activity may begin to pick up. There seems little prospect of the developing countries achieving much reduction in their deficit in 1982.

Major OECD current balances

As noted in the September *Bulletin*, a new pattern of current account surpluses and deficits among the major overseas countries emerged in the first half of 1981. Data for the third quarter confirm this shift (see table), which has resulted in large part from the substantial changes in competitive positions following the appreciation of the US dollar since mid-1980. Japan, for instance, has now returned to comfortable surplus, while the West German deficit has been halved from its peak. In both cases these improvements have been led by buoyant exports while import volume has remained flat or fallen. Both of these

Major countries: current balances

$ billions; *seasonally adjusted*

	1980	1981		
	Year	Q1	Q2	Q3(a)
United States	3.7	3.3	1.1	1.6
Canada	- 1.4	-0.9	-1.5	-2.3
France	- 7.4	-2.1	-0.4	-1.8
Italy(a)	- 9.8	-4.5	-1.8	-0.6
Japan	-10.8	-1.0	2.2	2.4
West Germany	-16.4	-4.7	-2.3	-2.5
Six major overseas countries	-42.2	-9.9	-2.7	-3.2

(a) Includes Bank estimates.

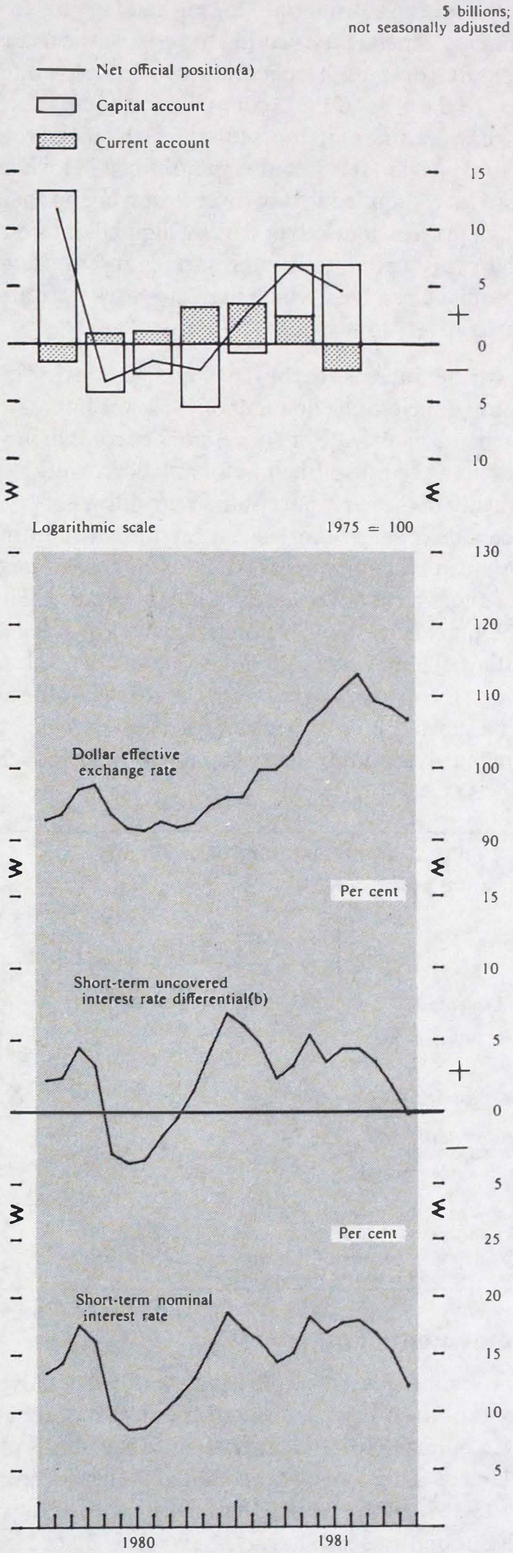
countries remain highly competitive in export markets. In contrast, the current account surplus of the United States has diminished, in spite of the weakness of the US economy; export volume has contracted over the past year, while import volume has held up.

Capital accounts and external financing

The pattern of exchange market pressures between the major countries altered during 1981, reflecting both the changing distribution of current balances described above and the greater willingness of authorities outside the United States to align domestic short-term interest rates more closely with US rates (see chart). None the less, the dollar continued to appreciate strongly until August. Upward pressure on the dollar seems to have continued unabated, even in the spring when short-term uncovered interest differentials in favour of the United States narrowed. In April, it was announced that the US authorities would only intervene on their own account in exceptional circumstances, and any subsequent intervention was undertaken by the monetary authorities of other industrial countries, who ran down their reserves in the United States (see chart). But, set beside the strength of the upward pressure on the dollar during the first eight months of 1981, the extent of such intervention was not great. Since the summer, some of these exchange rate pressures have been reversed (see below, page 486).

In the other major countries, balance of payments and exchange market developments this year have varied considerably. Despite the continued move into current account surplus, there appears to have been little pressure for further changes in the yen effective exchange rate after the rapid appreciation and rebuilding of reserves in the twelve months to March this year. In addition to the widening gap between shorter-term Japanese and foreign interest rates, this reflects the impact of the lifting of earlier restrictions on capital outflows, and together these have contributed to a resumption in substantial long-term lending abroad and outflows of both portfolio and direct investment capital. In West Germany, by contrast, the deutschemark remained weak until September, despite the sharply reduced gap between domestic and foreign interest rates. Notwithstanding continued heavy direct borrowing from oil exporting countries, the West German foreign exchange reserves were further depleted during the second and third quarters. In France, the balance of payments was dominated in the spring and summer by market expectations that the franc would be devalued following the

Interest rates, the dollar and the US balance of payments



(a) Changes in US net official position reflect movements in US reserves etc. and in other industrial countries' dollar reserves held in the United States. 1981 Q3 data are partly estimated.

(b) The three-month CD rate *less* a GNP-weighted average of short-term interest rates in Canada, France, Italy, Japan, Switzerland, West Germany and the United Kingdom. Monthly averages; November 1981 data partly estimated.

change in policies heralded by the election of the new government. In the second quarter, when it seems that there may have been substantial 'leading and lagging' in foreign payments, official intervention to support the franc was substantial despite sharp increases in domestic interest rates. In the other OECD countries (excluding the United Kingdom), earlier attempts to replenish official reserves were reversed in the first nine months of 1981 when many countries responded to downward pressure on their exchange rates, induced in part by high US interest rates, both by raising domestic interest rates and by drawing on their official reserves, which in many cases were already comparatively low.

The further increase in the developing countries' current account deficit in the first half of 1981 was not matched by movements in private or concessionary capital; in particular, the rate of their new bank borrowing slowed markedly in the early part of the year. Flows of concessionary and other official capital have continued to grow steadily, but it appears that by the second quarter other short-term flows were broadly in balance. These developments left the developing countries with a substantial financing need in the first half of 1981; part of this was met by borrowing from the IMF, but the bulk came from a substantial run-down of reserves (reducing them in aggregate to the equivalent of less than three months' imports).

Developing countries balance of payments(a)

$ billions; *not seasonally adjusted*

	1980			1981	
	Year	Q3	Q4	Q1	Q2(b)
Current balance	-66	-18	-18	-18	-19
Capital balance	64	20	16	15	15
of which:					
Direct investment(b)	*8*	*2*	*2*	*2*	*2*
Capital market finance(c)	*40*	*13*	*13*	*5*	*10*
Other(d)	*16*	*5*	*1*	*8*	*3*
Official financing balance	– 2	2	– 2	– 3	– 4
of which:					
Borrowing from IMF	*3*	*2*	—	—	*2*
SDR allocations	*1*	—	—	*1*	—
Reserves (increase –)(c)	*– 2*	*– 4*	*2*	*2*	*2*

(a) Excluding oil exporting countries.
(b) Bank estimates/forecasts.
(c) Adjusted to exclude valuation changes.
(d) Includes official flows, trade credits, errors and omissions.

Deployment of oil money

In the second quarter of 1981 the identified deployed cash surplus of the oil exporting countries was more than halved at $8.5 billion. With the proportion of new funds placed in the United Kingdom and the United States declining from 53% to 38% of the reduced cash surplus, the flow of funds to these countries fell sharply. New funds placed in other industrialised countries rose to about 47% of the cash surplus and were again invested entirely in longer-term investments. New loans to developing countries were only slightly higher, but as a proportion of new placements rose from 6% in the first quarter of 1981 to 20% in the second quarter.

In the first half of the year, the total identified cash surplus was $27.6 billion, compared with $45 billion for the same period in 1980. Despite this, the amount placed in

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

$ billions

	1979	1980	1981		
	Year	Year	Q1	Q2	Q3
Exports	223	317	79	72	66
Imports	109	143	37	38	39
Merchandise trade	114	174	42	34	27
Net invisibles	– 54	– 57	–14	–13	–13
of which, official transfers	*– 3*	*– 4*	*– 1*	*– 2*	*– 2*
Current balance	**60**	**117**	**28**	**21**	**14**
Net external borrowing etc.(a)	3	9	– 4	8	..
Surplus available for investment	**63**	**126**	**24**	**13**	**..**

.. not available.

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

Identified deployment of oil exporters' surpluses(a)(b)

$ billions

	1979	1980	1981		
	Year	Year	Q1	Q2	Q3(c)
United Kingdom:					
Sterling bank deposits	1.4	1.4	0.3	0.3	– 0.1
Eurocurrency bank deposits	14.8	14.8	4.6	0.3	3.4
British government stocks	0.4	1.9	0.2	0.4	0.1
Treasury bills	—	– 0.1	0.2	—	—
Other sterling placements	0.4	0.1	—	—	—
Other foreign currency placements	0.2	– 0.5	– 0.1	– 0.4	– 0.1
	17.2	17.6	5.2	0.6	3.3
United States:					
Bank deposits	5.1	– 1.2	0.5	– 0.9	– 2.0
Treasury bonds and notes	– 1.1	8.2	3.0	2.5	3.1
Treasury bills	3.3	1.4	0.3	– 0.1	– 0.6
Other portfolio investment	1.1	4.7	1.4	1.3	1.8
Other	– 1.2	0.9	– 0.2	– 0.2	..
	7.2	14.0	5.0	2.6	2.3
Bank deposits in other industrialised countries	18.7	26.2	– 0.1	– 1.0	..
Other investment in other industrialised countries(d)	8.7	17.0	7.1	4.0	2.5
IMF and IBRD(e)	– 0.4	4.9	0.7	0.6	0.5
Loans to developing countries	9.6	6.7	1.2	1.7	1.4
Total identified deployed net cash surplus	**61.0**	**86.4**	**19.1**	**8.5**	**..**
Residual of unidentified items(f)	2.0	39.6	4.9	4.5	..
Total net cash surplus derived from current account (as shown in the previous table)	**63.0**	**126.0**	**24.0**	**13.0**	**..**

.. 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) See the additional notes to Table 16.1 in the statistical annex for list of oil exporting countries.
(c) Provisional.
(d) Mainly loans and holdings of equities.
(e) Includes holdings of gold.
(f) The residual may reflect errors in either the current or capital account.

longer-term investments rose to $19 billion in the first half of 1981 compared with $16 billion for the same period in 1980. The proportion of the identified cash surplus deposited with banks in the first six months of 1981 fell to 14% (in 1979 and 1980 such deposits amounted to 65% and 47% respectively).

In the third quarter, oil exporting countries' new placements in the United Kingdom were $3.3 billion, predominantly in dollar-denominated bank deposits. In the

United States the movement towards longer-term investments was maintained during the quarter with continued inflows into other portfolio investment and Treasury bonds and notes. Bank deposits fell by $2 billion.

International banking and eurocurrency markets[1]

International developments (second quarter of 1981)

The more moderate growth of international banking activity in the first quarter of 1981 continued into the second quarter. Gross external claims of banks in the BIS reporting area[2] grew by $40 billion in the June quarter compared with $53 billion in the March quarter. The underlying growth of international bank credit in the first half of 1981 (excluding the redepositing of funds between the banks) is estimated at $65 billion, compared with $80 billion in each half of 1980.

The gross supply of funds from outside the reporting area fell in the second quarter to only $1 billion, the major factor being a sharply lower inflow from the oil exporters. New borrowing by oil exporting countries ($1.5 billion) was equal to their new lending and hence they ceased to be a net supplier of funds to the reporting area. From within the area, net new funds were provided by banks in the United States ($7.6 billion) and the European area ($8.5 billion): banks in the United States have been net suppliers of funds since March 1980 and injected $56 billion in the period to end-June 1981; banks in the United Kingdom accounted for the majority of the growth in the European reporting area in the second quarter, on both sides of the balance sheet. On the other hand, banks in Canada and Japan were large net importers of funds with increased net external deposits of $6.5 billion and $3.7 billion respectively.

Non-oil exporting countries outside the area continued to be net takers of funds, with the developing countries increasing their net indebtedness by $7.2 billion, higher than the $6.1 billion in the previous quarter, but still below the 1980 average. Net new borrowing by countries in Eastern Europe declined from $4.5 billion to $3.1 billion, while net borrowing by developed countries outside the reporting area increased to $4.9 billion.

Eurosterling

In the second quarter of 1981, eurosterling liabilities of the reporting banks (as defined in the accompanying table) contracted by £0.3 billion, leaving the size of the market unchanged over the past year. The banks' assets grew by £0.9 billion, to £8.6 billion, and the extent to which they were switched out of sterling therefore narrowed.

UK non-banks' eurosterling deposits (not included in sterling M_3, which is restricted to UK residents' sterling deposits with the domestic banking system) remained unchanged over the second quarter at £1 billion. The growth of UK banks' lending to the market moderated somewhat, whereas their borrowing grew more rapidly.

Eurosterling market[a]

£ billions

	1980				1981	
	31 Mar.	30 June[b]	30 Sept.	31 Dec.	31 Mar.	30 June
Deposits by:						
UK banks	1.0	1.7	2.1	2.6	3.0	3.2
UK non-banks	0.9	1.0	0.8	1.1	1.0	1.0
Other Western Europe	5.4	5.7	5.6	5.1	4.9	4.6
Oil exporting countries	1.1	1.1	1.0	1.0	1.0	0.9
Other	1.6	1.6	1.5	1.5	1.5	1.4
Total	**10.0**	**11.1**	**11.0**	**11.3**	**11.4**	**11.1**
Of which, central monetary institutions	*1.0*	*1.0*	*0.8*	*0.9*	*0.8*	*0.7*
Claims on:						
UK banks	1.6	2.2	2.2	2.3	2.6	3.0
UK non-banks	0.8	0.8	0.6	0.7	0.7	0.6
Other Western Europe	3.8	3.8	4.0	3.7	3.7	4.1
Other	0.6	0.8	0.7	0.6	0.7	0.9
Total	**6.8**	**7.6**	**7.5**	**7.3**	**7.7**	**8.6**

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. 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.

UK banks' positions *vis-à-vis* countries outside the BIS reporting area (end-June 1981)

UK banks' positions *vis-à-vis* countries outside the BIS reporting area, as notified to the BIS for the purpose of its latest half-yearly survey,[3] are set out in Table 14.3 of the statistical annex.

Although there continues to be a shortening in the overall maturity structure of external bank lending, this trend lost impetus during the first half of 1981, essentially because of a lengthening of the profile of lending to the Latin American countries, in particular Brazil. None the less, the proportion of claims on the Middle Eastern, African and Asian developing countries with remaining maturities of less than six months has continued to increase markedly.

In the first half of 1981 there was also a reduction of $1 billion, to $30 billion, in unused external commitments recorded by banks. The largest falls were recorded against Greece ($0.6 billion) and Yugoslavia ($0.4 billion).

London market (third quarter of 1981)

The London eurocurrency market, as measured by the gross foreign currency liabilities of UK banks, grew by $32 billion in the third quarter compared with $11.5 billion in the previous quarter. The Japanese banks, whose fast growth of business had been less evident in the previous quarter, accounted for just over half this rise, and at end-September held 23% of all foreign currency deposits in London, rather more than British banks but slightly less than the American banks. The other bank groups all showed small rises, with the exception of the consortium banks whose total foreign currency liabilities fell by $4 billion; as with the rise of the Japanese banks' business, these movements were most evident in the UK inter-bank sector.

(1) All transactions data in this passage exclude the estimated effects of exchange rate fluctuations and hence may not correspond with the differences between amounts outstanding.

(2) As defined in Table 13 in the statistical annex.

(3) Undertaken by all central banks within the area.

New deposits in London from overseas during the third quarter were provided mainly by other countries in the BIS reporting area; the United States placed almost $10 billion —seemingly a continuation of the trend commented upon in the section on international developments. The other sources of credit to London were the oil exporters, who provided new deposits of $3.6 billion, thus resuming their supply of funds after a pause in the second quarter. On the assets side, other BIS area countries accounted for a large share of the increase in borrowing from the United Kingdom, although overall they were net suppliers to the London market of nearly $3 billion. Borrowing by Eastern Europe remained flat during the quarter, but increased deposits—after the sizable draw-down in the first half of the year—resulted in a small reduction in the area's net indebtedness to UK banks, the first since the third quarter of last year. The steady growth in lending to non-oil developing countries continued in the third quarter with a net increase of $3 billion.

The maturity analysis of the foreign currency positions of British banks at mid-August shows that their short-term (less than six months) net liability position, expressed as a percentage of total claims, improved from 27.8% at mid-May to 26.5% at mid-August. During the same period, there was a slight deterioration in the short-term maturity profile of all the other bank groups. (For the reasons mentioned in the additional notes to Table 14.2 in the statistical annex, the figures for foreign banks may be unrepresentative of their operations world-wide.) The major factor behind the British banks' improvement was a reduction of $1.8 billion in net liabilities with a remaining maturity of less than eight days.

UK banks' liabilities and assets by customer[(a)]

$ billions

	1980		1981		
	30 Sept.	31 Dec.	31 Mar.	30 June	30 Sept.
Foreign currency liabilities of UK banks to:					
Other UK banks	109.1	118.5	130.2	129.0	139.4
Other UK residents	13.5	13.9	17.0	16.6	19.8
Overseas central monetary institutions	62.8	58.6	58.1	54.3	53.0
Other banks overseas	201.0	222.8	233.3	238.6	249.8
Other non-residents	60.6	67.8	74.7	75.9	86.2
Other liabilities(b)	3.7	3.8	3.9	3.6	3.9
Total liabilities	**450.7**	**485.4**	**517.2**	**518.0**	**552.1**
Foreign currency assets of UK banks with:					
Other UK banks	106.4	116.4	129.0	127.1	137.5
Other UK residents	24.1	22.9	23.5	21.2	22.8
Banks overseas	228.9	249.1	263.0	264.1	277.4
Other non-residents	84.8	88.2	92.3	96.2	105.3
Other assets(b)	7.5	8.4	8.6	8.8	9.6
Total assets	**451.7**	**485.0**	**516.4**	**517.4**	**552.6**

(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 Sept.	31 Dec.	31 Mar.	30 June	30 Sept.
BIS reporting area:					
European area	− 1.4	− 3.3	+ 1.4	—	+ 3.2
Canada	− 0.3	+ 0.5	+ 1.8	+ 2.9	+ 3.0
Japan	+17.3	+17.9	+15.8	+14.7	+15.2
United States	−17.0	−20.4	−22.2	−26.2	−32.9
Offshore banking centres	+ 9.3	+ 7.6	+ 8.2	+12.2	+12.2
Other Western Europe	+ 5.3	+ 6.7	+ 8.3	+ 9.8	+10.1
Australia, New Zealand and South Africa	+ 3.0	+ 3.3	+ 3.6	+ 4.4	+ 5.6
Eastern Europe	+10.4	+10.5	+11.3	+11.6	+11.2
Oil exporting countries	−37.4	−38.5	−43.9	−42.1	−44.2
Non-oil developing countries	+10.8	+13.5	+16.5	+18.5	+21.5
Others(b)	−13.1	−10.9	−12.4	−14.1	−12.6
Total	**−13.1**	**−13.1**	**−11.6**	**−8.3**	**− 7.7**

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

(b) Includes international organisations and certain unallocated items.

Medium-term eurocurrency credits

In the third quarter, credits totalling nearly $60 billion were announced, but $41 billion related to takeover activity in the United States and only a small proportion of this is likely to be drawn down.

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

$ billions

	1979	1980	1981			
	Quarterly rate		Q1	Q2	Q3	Oct.
Major OECD countries	3.2	4.8	4.8	4.8	49.8(c)	2.0
Minor OECD countries	3.6	4.7	4.0	3.5	1.6	1.9
Oil exporting countries	1.9	1.8	1.4	0.8	1.4	1.9
Eastern Europe	1.0	0.6	0.9	0.1	0.1	—
Developing countries	7.5	6.2	10.4	8.0	6.6	3.1
of which:						
Net oil exporters	*2.3*	*1.6*	*3.7*	*2.3*	*1.5*	*0.8*
Newly industrialised countries	*2.6*	*2.5*	*3.1*	*3.7*	*3.4*	*1.7*
Other	0.8	0.1	0.1	0.2	0.1	—
Total(b)	18.1	18.3	21.6	17.4	59.5(c)	8.8

(a) Maturities of three years and over.

(b) Totals may not add because of rounding.

(c) See text.

The average spreads for public sector borrowers from the major OECD countries dipped below ½% again in the third quarter, having risen to just above ½% in the previous quarter. These small changes were due primarily to the type of borrower active in the market. In October, though, there were signs that the continuing fine spreads were being obtained at the expense of increased fees.

Spreads on credits to developing countries since July provide further evidence of the distinct tiers of borrowers described in the September *Bulletin* (page 343). One aspect of this was the deterioration in terms for some Latin American borrowers, while Asian borrowers have obtained improved terms. Borrowers (either sovereign or state guaranteed) from Malaysia, Indonesia and Taiwan obtained ⅜% spreads for part or the whole of the life of their loans.

International bonds and notes

Bond issues in the third quarter fell back to under $9 billion compared with $10.2 billion in the second quarter. Activity in the market recovered in October when bond completions reached $4.9 billion.

Dollar issues have continued to dominate the market, with their share rising from half the total in the second quarter to close to 60% in the third quarter. A large number of

Japanese entities issued dollar-denominated convertible bonds early in the third quarter, but a subsequent fall in Japanese share prices led to some proposed issues being reduced in size or postponed, and since then there have been only a few further issues. Floating-rate notes have continued to be in demand by borrowers; over $1.3 billion of such paper was issued in October.

Completed international bond issues[a]

$ billions

	1979	1980	1981			
	Quarterly rate		Q1	Q2	Q3	Oct.
Total(b)	**8.4**	**8.9**	**7.9**	**10.2**	**8.9**	**4.9**
By currency:						
Dollars	3.2	3.7	3.6	5.6	5.2	3.2
Deutschemarks	1.8	1.9	0.3	0.5	0.5	0.3
Swiss francs	2.3	1.8	2.0	1.8	1.9	0.8
Sterling	0.1	0.3	0.3	0.7	0.3	0.1
Yen	0.4	0.4	0.6	1.0	0.7	0.3
Other	0.7	0.7	1.1	0.7	0.5	0.3
By borrower:						
OECD countries	6.2	6.6	6.5	6.9	6.7	4.0
International institutions	1.5	1.7	1.1	2.0	1.6	0.7
Developing countries	0.6	0.4	0.1	1.1	0.7	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.

There were also an exceptional number of Swiss franc convertible issues by Japanese entities during July and August. In September, the pace slackened considerably, so that the total of Swiss franc-denominated bonds over the three months was little different from earlier quarters. It appears that activity has returned to more normal levels in this sector since then. There was a resumption of deutschemark issues, despite continued high coupons.

There was an increase in activity among the minor currencies, particularly towards the end of the quarter. The French franc, Canadian dollar and Kuwaiti dinar sectors reopened after closures of several months, but it has been necessary to pay record coupons in each of them, as elsewhere in the market.

The composite currency sector was quiet, with only three issues completed in the third quarter and two in October. None of these was denominated in the simplified SDR.

Bonds issued by borrowers from OECD countries accounted for about three quarters of the third quarter total, a return to more usual levels after a relatively low share in the second quarter. The World Bank was the most active borrower of the international institutions. Borrowers from only a few developing countries raised funds in the bond market; they mostly issued floating-rate notes.

Foreign exchange and gold markets

(Three months to end-October)

Exchange markets were exceptionally nervous and volatile during the period. Interest rates, particularly the course and likely future trend of US interest rates, continued to be the main determinant of movements on the exchanges, but they were at times overshadowed by other factors. Speculation about the outcome of the OPEC oil price discussions and the timing and content of the expected realignment within the European Monetary System (EMS) was also influential, while events in Poland and the Middle East caused sharp fluctuations at times.

After reaching its highest level for over five years against most European currencies in August, the dollar fell sharply but erratically in September and early October as short-term interest rates eased markedly. It recovered briefly when concern over the size of the budget deficit in the context of a still growing economy gave rise to a temporary reversal in interest rates, but eased back again at the end of the period as it became increasingly clear that the US economy had entered a recession.

The failure of the OPEC price unification meeting at the end of August and the ensuing cuts in some oil prices heightened concern about the prospects for the UK balance of payments. Moreover, the high level of US interest rates relative to those in the United Kingdom also helped to weaken sterling, which fell sharply in the first two weeks of September. Following action by the authorities to raise short-term interest rates and two increases in clearing banks' base rates, the pound recovered somewhat, but nevertheless ended the period weaker overall.

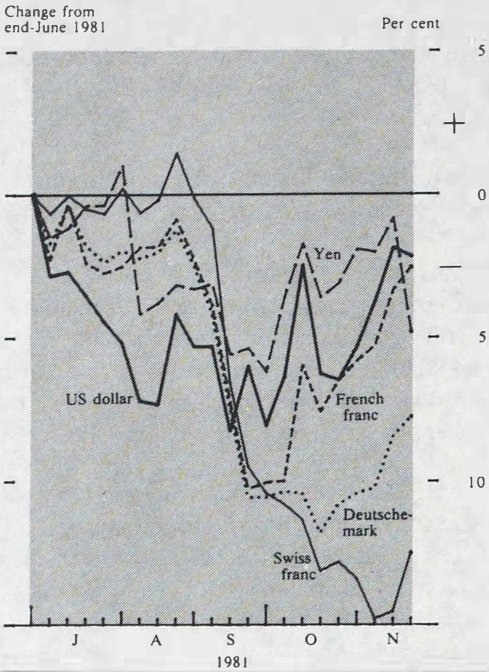
Pressures within the EMS grew throughout September, and a general realignment took place in early October involving a revaluation of the deutschemark and the Dutch guilder and a devaluation of the French franc and the lira. The Swedish krona was devalued in September but the Swiss franc strengthened sharply against most currencies. The yen remained depressed by relatively low interest rates, while the gold price remained steady, largely reflecting movements in individual currencies. It closed slightly higher in terms of the dollar and sterling but lower against other currencies.

Sterling

After opening August at $1.8235, DM 4.54½, and 91.6 in effective terms, sterling retreated before the strengthening dollar to touch a four-year low of $1.7565 on 10 August, when the dollar reached new recent peaks against most currencies. Following heavy selling of the dollar on 12 August, the pound recovered quickly and continued to strengthen thereafter, supported both by purchases by the oil companies in advance of petroleum revenue tax payments and the prospect of an increase in the official Saudi oil price. The rate reached $1.8790, DM 4.60½, and 92.4 in effective terms on 24 August before weakening again on heavy selling following the breakdown of the OPEC oil price discussions and the announcement of a discount on Nigerian oil prices. Sterling closed the month at $1.8455, DM 4.52⅞, with the ERI at 91.3.

The downward pressures on sterling intensified in September, and by 14 September the rate had fallen to $1.7671 (against a weaker dollar), DM 4.21½, and 86.6 in effective terms as repeated forecasts of further reductions in oil prices along with continuing concern over the prospects

Sterling against selected foreign currencies



for the UK economy persuaded the markets that the pound was overvalued, particularly against European currencies. The decline was temporarily arrested following the Bank of England's action on 14 September to raise short-term money market rates and the subsequent increase in clearing banks' base rates to 14% on 16 September; but although the pound made some gains against a weaker dollar, it continued to decline against European currencies, falling to DM 4.08¾ on 21 September, and 85.7 in effective terms on 24 September (the lowest since March 1979). A further sharp increase in sterling inter-bank rates towards the end of the month in the wake of higher US interest rates helped the pound to recover, and it closed at $1.8105, DM 4.19⅞, and 87.4 in effective terms.

The increase in clearing banks' base rates to 16% on 1 October prompted widespread demand for sterling; this continued into the following week as both eurodollar rates and, later, West German interest rates fell by around one percentage point. The pound reached $1.9187 and 90 in effective terms on 9 October before an easing in sterling inter-bank rates, which enabled clearing banks to reduce their base rates to 15½%, together with unfounded rumours of a reimposition of exchange controls, depressed the rate. The vote in favour of industrial action at BL added to the pressure, and the pound fell to $1.8245 and DM 4.07½ on 20 October as markets nervously awaited the first set of trade figures to be published since February. These had little effect on the pound which quickly recovered as firmer sterling inter-bank rates gave rise to expectations of an imminent increase in base rates. Inter-bank rates subsequently eased in the wake of the sharp fall in US interest rates and the pound ended the month fairly steady, with the prospect of an increase in North Sea oil prices following the OPEC oil price agreement largely offsetting concern over the threatened strike at BL. Sterling closed at $1.8455, DM 4.1616, and with the ERI at 88.7.

Official reserves

The UK reserves fell by $1,252 million to $23,316 million in the three months to end-October (see table). After allowing for net repayments under the exchange cover scheme, a further repayment to the IMF under the oil facility, and a valuation loss arising from the quarterly renewal of the EMCF swap, the underlying fall in the reserves was $931 million.

Changes in UK official reserves

$ millions

	1981		
	August	September	October
Change in reserves	**−57**	**−815**	**−380**
IMF oil facility repayment	—	—	− 76
EMCF swap valuation change	—	—	−174
Exchange cover scheme:			
Borrowing	—	+ 48	+148
Repayments	−28	−186	− 53
Underlying change in reserves	**−29**	**−677**	**−225**
Level of reserves (end of period)	**24,511**	**23,696**	**23,316**

US dollar

The dollar strengthened further in early August, supported by continuing high US interest rates and renewed tensions in Poland, and rose to its highest point for five years or more against most European currencies on 10 August (DM 2.5785 and 115.4 in effective terms). A fraction of these gains was quickly lost in very heavy selling on 12 August, triggered in part by a strong belief that interest rates had reached their peak. The dollar subsequently recovered some of its losses when unexpected increases in the monetary aggregates at the end of August and the publication of a 1.2% increase in the consumer price index for July suggested that expectations of lower interest rates might have been premature, but interest rates soon resumed their downward trend. A fall-off in credit demand and an increase in the provision of reserves to the banking system combined to push the Federal funds rate down to 14%, while prime rates were reduced in two stages to 19½%, and the dollar weakened. Speculation about an imminent revaluation of the deutschemark in the EMS added to the downward pressure and the dollar fell sharply to touch DM 2.2260 on 21 September, a fall of 14% from the August peak.

In response to the decline in short-term interest rates, the Federal Reserve reduced its surcharge on the discount rate for large borrowers from 4% to 3% on 22 September, but the market had already discounted a larger reduction; at the same time growing scepticism about the Administration's ability to cut the budget deficit and an ensuing rise in long-term interest rates were seen as limiting the scope for short-term interest rates to drop in the United States. This factor, combined with an official statement denying any intention of revaluing the deutschemark within the EMS, helped to push the dollar up to DM 2.3405 by 28 September. However, short-term interest rates eased further in October and the surcharge on the discount rate was cut to 2% on 9 October while prime rates were gradually reduced to 18%. Affected also by a large trade deficit for August, the dollar fell to DM 2.1612 and 106.2 in effective terms on 12 October. Forecasts of record interest rates yet to come, along with the publication of a 1.2% increase in consumer prices in September and renewed tensions in Poland and the Middle East, helped the dollar to recover to DM 2.3085 by 26 October, but it fell back again after the announcement of a substantial fall in the index of leading indicators for September (– 2.7%) confirmed other indications that the US economy was turning down for the second time in two years. The dollar closed in London at DM 2.2550 and 108.8 in effective terms. After European markets had closed on 30 October the Federal Reserve cut its discount rate to 13%, though the surcharge was kept until 16 November when it was removed completely.

Other currencies

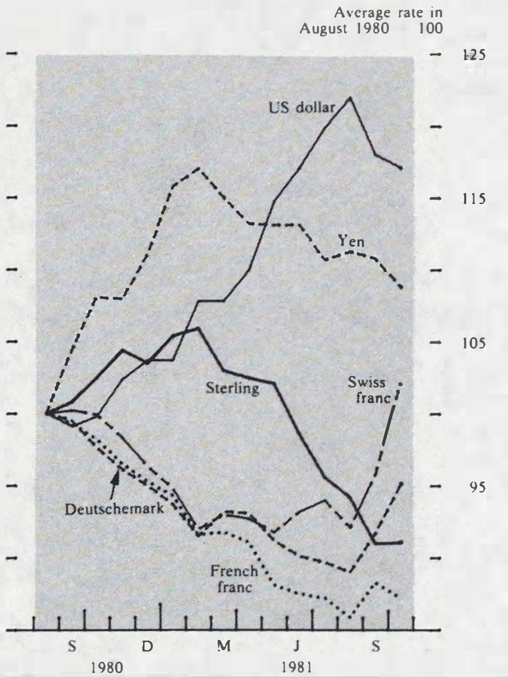
Although EMS currencies weakened sharply against the dollar in August, there were few tensions in the system. However, in September the EMS became subject to increasingly severe bouts of pre-weekend pressures as the strength of the deutschemark, buoyed up by a much improved current account, led to growing speculation about an imminent realignment. The French authorities increased their money market intervention rate to $19\frac{1}{2}$% and introduced further exchange control measures on 23 September to ease pressures on the French franc. Concern about economic developments and the uncertain political situation continued to depress the Belgian franc and it was generally the weakest currency in the $2\frac{1}{4}$% band, while the Irish pound also remained weak.

The long-expected realignment took place on 4 October. The deutschemark and the Dutch guilder were each revalued by 5.5%, while the French franc and the lira were devalued by 3%. Following the realignment, the French franc rose to the top of the EMS and the Dutch guilder fell to the bottom, although it was soon replaced by the deutschemark. Both the French and West German authorities allowed interest rates to ease following the realignment and the sharp fall in US interest rates. In France the money market intervention rate was cut to $17\frac{1}{2}$% and in West Germany the special Lombard rate to 11%—the first change since its introduction in February. The band remained almost fully stretched throughout October and the Danish krone occasionally replaced the French franc at the top of the system as Danish interest rates remained firm. The lira weakened following the realignment but remained comfortably within the $2\frac{1}{4}$% band.

The Swedish krona came under severe pressure in August as markets became increasingly concerned about the level of public expenditure and the current account deficit, and was devalued by 10% against a basket of currencies on 14 September. It stabilised at this lower level and was largely unaffected by the cut in discount rate, from 12% to 11%, on 15 October. The Norwegian krone improved slightly against the dollar, but showed little movement in effective terms. After falling sharply against all currencies in August, the Swiss franc recovered strongly, helped by an increase in discount and Lombard rates to 6% and 7% respectively on 2 September, the revaluation of the deutschemark in the EMS, and a growing belief that the authorities had abandoned their ceiling on the Swiss franc/deutschemark rate. The franc strengthened to close at Sw. Fcs $0.82\frac{1}{8}$ against the deutschemark.

The yen made a strong recovery in August, assisted by the prospect of lower oil prices enhancing a current account that was already in surplus, but the gains were later largely reversed as the relatively low level of Japanese interest rates once again outweighed positive signs in the real economy, and the rate closed at ¥233.00 against the dollar. The Canadian dollar fell to its lowest against the US dollar for fifty years in early August (US $$0.80\frac{1}{2}$), but recovered sharply following an oil pricing agreement between the Federal Government and the Province of Alberta. Thereafter, it remained stable both in effective terms and against the dollar, sustained by high interest rates and sizable conversions of external borrowings.

Indices of effective exchange rates



Interest rates and differentials

The three-month eurodollar rate fell sharply but erratically while the three-month inter-bank sterling rate rose, so that forward sterling was trading at a discount by the end of the period. After reaching $19\frac{7}{16}$% at the beginning of August, the three-month eurodollar rate fell to $18\frac{3}{4}$% before rising again to $19\frac{1}{2}$% at the end of the month; it fell again to $16\frac{7}{8}$% in September, but recovered briefly to $17\frac{13}{16}$% at the beginning of October before falling back once more to close at $15\frac{5}{8}$%. Three-month sterling inter-bank eased back in August and traded in the range $13\frac{3}{4}$% to $14\frac{1}{8}$% until mid-September when the authorities took action to raise short-term money market rates; it rose steadily to a peak of $16\frac{15}{16}$% at the beginning of October before easing back to close at $16\frac{5}{16}$%. Three-month sterling reached a premium of $5\frac{1}{2}$% on 25 August, but fell back steadily thereafter as the interest-rate differential narrowed, and closed at a discount of $\frac{3}{8}$%. The covered differential remained close to interest-rate parity throughout the period.

Gold

High US interest rates and the strength of the dollar depressed the gold price in early August and it breached \$400 to fix at \$391.25 on 4 August—the lowest in dollar terms for twenty months. Despite heavy producer selling it recovered as the dollar weakened, reaching \$463½ on 21 September; thereafter it traded quietly in the range \$425 to \$450, showing only small movements in response to events in the Middle East and Poland. It closed at \$427, a net rise of \$21 over the period. The gold price also showed a small rise in sterling terms, but in terms of the Swiss franc and deutschemark it fell over the period.