International financial developments

Among the main developments

- *Market pessimism over US economic performance and consequent expectations of further easing of US monetary policy led to a resumption of the downward trend in the dollar, which fell by 7% in effective terms in the three months to August. Sterling was affected by oil price worries and depreciated sharply against the major currencies other than the dollar, particularly the deutschemark. The EMS was realigned in August, with the Irish pound devalued by 8%.*

- *In the international capital markets, uncertainty over interest rate trends was reflected in a sharp decline in activity in the fixed-rate bond sector in the three months to August and a resurgence of issues of floating-rate notes: financial institutions and sovereign borrowers accounted for virtually all FRN issues in the period.*

- *The first quarter of 1986 saw a sharp fall in both BIS-area banks' lending to, and deposits from, countries outside the reporting area; the largest reductions in claims were on oil exporting countries and Latin America. BIS-area banks' lending to non-bank final users in the (reporting) industrial countries, on the other hand, remained buoyant with the United States absorbing the bulk of these eurocurrency funds.*

- *London market data for the second quarter show only a modest resumption in UK banks' lending to 'outside-area' countries and a further drawdown of their deposits. Oil exporting countries and the Eastern bloc were the main takers of funds.*

Balance of payments positions

The combined current account deficit of the *major seven economies* appears to have declined during the second quarter of 1986. The decline largely reflects a further rise in the Japanese surplus, associated with the impact of further yen appreciation on Japanese import prices which offset shifts in trade volumes: in addition, Italy's current account is thought to have moved into surplus following favourable terms of trade shifts. In contrast, and despite the fall in oil prices, the current account deficit of the United States is estimated to have increased slightly during the second quarter, while the current account balances of the other four major OECD countries remained essentially unchanged.

A further deterioration in the *oil exporting countries'* combined current account balance is estimated to have occurred during the second quarter of 1986, following a very sharp decline in oil export earnings. Both Saudi Arabia and Oman have recently devalued their currencies explicitly in response to the slide in oil revenue, while other OPEC countries face further import retrenchment. These moves may eventually reverse a widening trend in the OPEC current account deficit.

The current account deficit of the *other developing economies* is estimated to have narrowed slightly during the first half of 1986 compared with the second half of last year. Within the slight improvement in the aggregate there was a substantial further rise in the Taiwanese surplus, while recent trade data indicate that the current account surpluses of Hong Kong and South Korea may also have risen.

Capital flows to the *other developing countries* are estimated to have declined in the first quarter of 1986 with a net flow of funds to banks. Of particular note is the

World current accounts(a)

$ billions; *seasonally adjusted*

	1984	1985(b)				1986(b)	
	Year	Year	Q2	Q3	Q4	Q1	Q2
OECD economies:							
Canada	3	—	—	- 1	—	- 2	- 2
France	- 1	1	1	—	1	1	1
Germany	7	14	3	4	5	8	8
Italy	- 3	- 4	- 3	—	—	- 1	2
Japan	35	49	12	13	15	15	22
United Kingdom	2	5	2	2	1	1	1
United States	-107	-118	-29	-28	-34	-34	-36
Major economies	- 64	- 53	-14	-10	-12	-12	- 4
Other OECD	- 2	- 3	- 1	—	- 1	- 1	- 1
Total OECD	- 66	- 56	-15	-10	-13	-13	- 5
OPEC economies	- 12	- 3	—	- 1	- 2	- 4	- 8
Other developing economies	- 13	- 28	- 6	- 7	- 8	- 8	- 5
Other economies(c)	5	5	—	3	4	—	- 1
World discrepancy(d)	- 86	- 82	-21	-15	-19	-25	-19

(a) Components may not add due to rounding.
(b) Includes Bank estimates/forecasts.
(c) South Africa and the centrally planned economies.
(d) Reflects errors and omissions arising from incomplete coverage, timing differences and other statistical deficiencies.

Non-OPEC developing countries' balance of payments

$ billions: *not seasonally adjusted*

	1984	1985(a)					1986(a)
	Year	Year	Q1	Q2	Q3	Q4	Q1
Current account	**-13**	**-28**	**-8**	**-6**	**-6**	**-8**	**-6**
Capital account	**25**	**24**	**-2**	**8**	**5**	**11**	**5**
of which:							
Concessionary and other official flows	27	18	4	4	5	5	6
Direct investment	8	8	2	2	2	2	3
Borrowing from banks(b)	11	11	-1	4	2	6	-6
Borrowing via bond issues (gross)	3	7	1	2	1	3	1
Other capital flows(c)	-22	-20	-8	-2	-5	-5	1
Official financing balance	**13**	**- 2**	**-6**	**2**	**-1**	**3**	**-1**
of which:							
Use of IMF credit	4	1	—	—	—	—	—
Liabilities to other CMIs	1	—	—	—	—	—	—
Reserves etc (increase -)	-18	3	6	-2	1	-3	1

(a) Includes Bank estimates.

(b) Adjusted to exclude valuation effects.

(c) Includes net errors and omissions.

reversal of previous net banking inflows to Mexico, Egypt and Yugoslavia. In addition, borrowing via bond issues was lower in the first quarter than in the last quarter of 1985; concessionary and other official flows are estimated to have remained essentially unchanged in aggregate.

Identified assets of oil exporting countries fell by $4.7 billion in the first quarter. Eurocurrency bank deposits were run down generally, but there was a modest increase in other investments. In dollar terms, the value of the overall stock of deployed assets rose by $30.7 billion over the twelve months to March 1986, most of which may, in very broad terms, be attributable to movements in exchange rates against the dollar. Provisional figures for the deployment of funds in the United Kingdom and the United States in the second quarter of 1986 indicate falls of $2.9 billion in bank deposits and $0.9 billion in other investments.

Identified deployment of oil exporters' funds[a]

$ billions

	Mar. 1985 levels	1985			1986	Mar. 1986 levels	1986
		Q2	Q3	Q4	Q1		Q2(b)
Industrial countries							
United Kingdom:							
Sterling bank deposits	4.9	0.1	0.1	0.4	0.1	6.7	-0.5
Eurocurrency bank deposits	41.2	2.3	-1.2	0.1	-2.0	42.2	-1.3
Government paper	2.2	0.3	-0.1	0.4	0.3	3.6	0.2
Other investments	5.6	0.1	-0.1	-0.2	—	8.3	—
	53.9	2.8	-1.3	0.7	-1.6	60.8	-1.6
Other EEC:(c)							
Domestic currency bank deposits	3.3	0.3	—	-0.3	0.3	4.6	..
Eurocurrency bank deposits	21.6	-0.4	0.2	1.5	-2.4	21.6	..
Other investments	32.9	—	-0.2	0.5	—	48.7	..
	57.8	-0.1	—	1.7	-2.1	74.9	..
United States:							
Bank deposits	21.1	-0.8	1.2	0.1	0.6	22.3	-1.1
Government paper	31.5	0.1	-2.2	0.1	—	29.5	-0.2
Other investments	30.4	-1.3	-0.7	-0.4	-0.2	27.8	-0.9
	83.0	-2.0	-1.7	-0.2	0.4	79.6	-2.2
Other:							
Domestic currency bank deposits	2.8	0.2	0.4	0.5	-0.3	4.9	..
Eurocurrency bank deposits	27.4	1.3	0.3	0.1	-1.8	27.7	..
Other investments	37.6	-0.2	—	-0.6	0.6(b)	43.9	..
	67.8	1.3	0.7	—	-1.5	76.5	..
Offshore centres:							
Bank deposits	42.7	-4.7	1.2	3.0	-0.3	41.9	..
Placements with ldcs	59.4	-0.2	—	—	—	59.1	..
OEC credit to non-banks	10.5	0.5	-0.1	—	0.2	11.1	..
IMF and IBRD(d)	33.7	0.1	0.7	0.2	0.2	35.6	—
Total identified additions(+)/reductions (-) in deployed assets	**408.8**	**-2.3**	**-0.5**	**5.4**	**-4.7**	**439.5**	..
Net funds available for deployment		-1.0	-1.2	2.3	-2.2		
of which:							
Net movements in external borrowing etc		*1.0*	*-1.2*	*-0.7*	*2.8*		
Current balance		*-2.0*	—	*3.0*	*-5.0*		

.. not available.

(a) The oil exporting countries covered are defined in the notes and definitions to Table 16 of the statistical annex in the March *Bulletin*.

(b) Provisional.

(c) Includes Spain and Portugal.

(d) Includes holdings of gold.

International capital markets

Activity in the international capital markets in the three months to August was marked by a decline in the fixed-rate bond sector and a resurgence of the floating-rate note market. Newly-announced euronote facilities declined slightly, with the proportion of non-underwritten facilities rising to 80%.

Fixed-rate bonds

There was a sharp fall in the volume of fixed-rate bond issues in the three months to August, from $52.5 billion in the preceding three months to $34.1 billion, which, after adjustment for a seasonal decline in new issues, represents a fall of 23%. Spreads between dollar eurobond and US Treasury bond yields widened, and US borrowers increasingly turned to their domestic bond market rather than the eurobond market.

The predominance of borrowers from developed countries in new fixed-rate bond issues was further accentuated in the three months to August, with borrowers from Western Europe, North America and Japan accounting for 96% of new issues. US borrowers raised only $5.8 billion, compared with $11.8 billion in the previous three months. There was a decline particularly in US energy sector borrowing, reflecting the impact of the fall in oil prices on the domestic energy industries. Borrowing by developing countries amounted to only $240 million, comprising issues for Israeli, South Korean, Colombian, Indian and Hong Kong borrowers.

The volume of fixed-rate bond issues denominated in dollars fell $18.7 billion to $15.5 billion (45% of the market, compared with 48% in the preceding three months). Among other currencies, the market share of the Swiss franc increased from 10% to 14%, the Canadian dollar's rose from 2% to 3% and the yen's share was unchanged at 12%; the deutschemark's share of the market fell from 11% to 8%, and sterling's from 6% to 3%.

Equity-related issues (convertible issues and issues with equity warrants) amounted to $6.7 billion, compared with $6.3 billion in the previous three months. Japanese borrowers display a clear preference for equity-related issues, and for warrants issues rather than convertibles. The appeal of equity warrants for Japanese borrowers reflects to some degree the greater ease with which swaps can be arranged and recent deregulatory measures which allow domestic investors to purchase equity warrants and bonds separately.

Dual-currency bond issues, where the issue price and coupon are calculated in one currency and the redemption price set in another at a predetermined exchange rate, fell to a low level in this period. There was only one yen dual-currency issue, and four Swiss franc issues.

Similarly, zero-coupon issues amounted to only $187 million. Hitherto, Japanese investors have appeared to be the principal source of demand for zero-coupon issues (Japanese tax regulations convey some advantages to debt securities that emphasise capital gain rather than a series of interest payments), but they were absent from the market in the three months to August.

Announced international bond issues[(a)]

$ billions; *percentages in italics*

	1984	1985		1986			
	Year	Year	Q4	Q1	Q2	July	Aug.
Fixed-rate bonds							
Borrower:							
Major OECD countries	46.8	70.5	20.1	31.2	34.5	8.3	8.2
of which:							
United States	20.0	30.2	9.0	11.0	10.4	1.4	2.2
Japan	14.4	19.0	4.1	5.7	8.5	3.0	2.3
Minor OECD countries	12.8	18.4	5.6	9.5	7.6	2.1	3.0
International institutions	12.4	15.7	4.1	5.3	3.5	1.5	0.8
Other	2.0	2.8	0.4	1.2	0.6	0.1	0.1
Total	**74.0**	**107.4**	**30.2**	**47.2**	**46.2**	**12.0**	**12.1**
Currency:							
US dollars	*50.1*	*46.8*	*44.9*	*46.9*	*50.3*	*43.3*	*47.3*
Swiss francs	*17.4*	*13.7*	*18.2*	*13.1*	*10.6*	*14.2*	*15.2*
Yen	*8.0*	*11.3*	*11.5*	*15.9*	*7.7*	*11.2*	*14.0*
Other	*24.5*	*28.2*	*25.4*	*24.1*	*31.4*	*31.3*	*23.5*
Floating-rate notes							
Borrower:							
Major OECD	21.6	38.6	11.5	5.4	7.0	3.8	3.8
Minor OECD	9.6	8.1	1.1	1.6	1.4	1.9	2.5
Other	2.8	8.6	1.8	1.4	0.9	—	—
Total	**34.0**	**55.3**	**14.4**	**8.4**	**9.3**	**5.7**	**6.3**

(a) Maturities of one year and over. The table includes euro and foreign issues and publicised private placements. It excludes Canadian borrowing in New York.

Floating-rate notes

The three months to August saw a resurgence in the FRN market, with announced issues totalling $16.8 billion, compared with $6.1 billion in the preceding three months. The marked decline in issuing activity earlier in the year was coupled with concern about a lack of secondary market liquidity. In the most recent period, the indifferent performance of the fixed-rate market made the floating-rate sector more attractive to investors after a long period of oversupply. Nonetheless, even after the recent increase in their popularity, FRN issues so far in 1986 still total only some 83% of the equivalent figure at the same time last year.

The proportion of sovereign borrowing and borrowing by financial institutions continued to be very high in the FRN market, with some 93% of new issues falling into these categories of borrower. Financial institutions in particular were active in the three months to August, raising $12.1 billion. There were some signs of a revival in FRN issues for banks, which accounted for 48% of the total (the same as their share of outstanding issues at the end of 1985); within total bank borrowing the share of European banks increased. UK banks were the largest issuers of FRNs within this total, with $1.2 billion of new issues, including perpetual FRNs for Lloyds Bank and Morgan Grenfell. UK building societies raised £1.5 billion ($2.2 billion). Sovereign borrowing amounted to $2.7 billion, consisting of issues for Belgium, the Republic of Ireland, New Zealand and Denmark. Denmark's issue, for $1 billion, was the largest for a sovereign borrower in the period.

Euronote facilities

This section covers facilities for the issue of short-term euronotes (including CD issuance facilities and eurocommercial paper) whether or not backed by bank commitments.

The total value of euronote facilities announced in the three months to August fell $5.4 billion from the previous three months' total to $13.2 billion. The proportion of facilities which were non-underwritten or uncommitted, including eurocommercial paper (ECP) programmes, was 80% (by value), a slightly higher proportion than in the previous three months and more than double the proportion in 1985. All but three facilities were denominated in US dollars. Two that were not are of some note, however: Metal Box arranged a £100 million ($153 million) programme allowing it to issue ECP in dollars or to tap the sterling CP market, and a CD issuance facility denominated in ECU was arranged for Mitsui Bank, the second such facility for a Japanese bank.

With only three exceptions, all borrowers were from OECD countries. Facilities for US borrowers remained high, at $4.3 billion, with sizable ECP programmes for BMX Holdings ($700 million) and Shearson Lehman ($500 million). The total for Japanese borrowers, which increased very rapidly in the first half of the year, fell sharply in the three months to August, to $0.4 billion. UK and Australian borrowers continued to be active in the market, with totals of $0.8 billion and $0.9 billion respectively. Following Electricité de France, Crédit Foncier became the second French state agency to achieve

Announced euronote facilities[(a)]

$ billions

	1984	1985			1986			
	Year	Year	Q3	Q4	Q1	Q2	July	Aug.
Committed(b)	18.20	33.14	5.01	8.50	3.41	6.11	1.27	0.32
Uncommitted	0.64	16.35	2.96	9.80	10.70	12.71	3.73	3.90
Total	**18.84**	**49.49**	**7.97**	**18.30**	**14.11**	**18.82**	**5.01**	**4.22**
of which:								
Major OECD	*6.40*	*29.26*	*4.22*	*10.66*	*8.08*	*12.21*	*4.00*	*2.08*
Minor OECD	*11.20*	*17.55*	*3.34*	*6.93*	*5.43*	*6.19*	*0.96*	*2.06*
Other	*1.24*	*2.68*	*0.41*	*0.71*	*0.60*	*0.42*	*0.05*	*0.08*
Selected nationalities of borrower								
United States	3.16	17.48	1.84	5.88	2.05	5.78	1.93	1.33
France	1.24	2.99	0.58	0.70	1.35	0.94	0.30	—
United Kingdom	0.72	3.82	1.00	1.92	1.48	1.58	0.40	0.20
Australia	2.72	7.90	1.68	3.96	1.17	1.90	—	0.20
Sweden	4.72	4.82	1.20	0.32	1.25	0.45	0.20	0.15

(a) Includes all facilities providing for the issue of euronotes (including note issuance facilities, revolving underwriting facilities, multiple component facilities which incorporate a note issuance option, and eurocommercial paper programmes).

(b) Underwritten or otherwise backed by bank commitments.

Announced eurocurrency syndicated credits
$ billions

	1984	1985			1986			
	Year	Year	Q3	Q4	Q1	Q2	July	Aug.
Major OECD	9.90	5.06	1.10	1.40	2.21	2.02	0.67	0.34
Minor OECD	6.16	4.40	0.86	0.49	1.16	0.90	1.31	0.37
Developing countries	7.17	3.92	1.29	0.08	1.25	0.68	0.17	0.48
Eastern bloc	2.19	3.55	0.71	0.46	0.50	0.88	—	0.05
Other	4.69	1.99	0.54	0.70	1.66	1.43	0.08	0.11
Total	**30.11**	**18.92**	**4.50**	**3.13**	**6.79**	**5.91**	**2.23**	**1.35**
of which, transferable	*1.49*	*5.77*	*1.62*	*1.55*	*1.75*	*1.05*	—	*0.03*

an underwriting fee of less than five basis points, on a $300 million deal.

Among borrowers from other OECD countries, the Central Bank of Turkey arranged a $125 million facility with an annual facility fee of 50 basis points, indicating an improvement in Turkey's credit rating, and Denmark launched a $1 billion ECP programme.

Eurocurrency syndicated lending
Borrowing in the syndicated credits market fell by $2 billion to $4.5 billion in the three months to August. Over 90% of the total was denominated in US dollars, with just a few loans denominated in sterling, deutschemarks, Luxembourg francs, Canadian dollars and ECU respectively. There were relatively few credits for non-OECD borrowers, and only one for an OPEC country.

Most borrowers have continued to achieve finer terms on syndicated credits. Among non-OECD countries, South Korean borrowers enjoyed favourable terms, with spreads of around ½% over Libor. Other developing countries to raise new market loans were India, Pakistan, Taiwan, Yemen, Barbados and Malaysia. The one loan for a Comecon borrower confirmed the trend of finer terms on Eastern bloc credits.

Among OECD borrowers, there were several small credits for Italian and French borrowers, amounting to $290 million and $540 million respectively. The largest single loan in the three months to August was a $700 million revolving/term loan for an Irish company, JSC/MS Holdings. Four credits for Greek borrowers, amounting to $333 million, all carried ¾% spreads.

Twelve credits out of fifty-four in the three months to August had maturities of ten years or more; this compares with an average maturity on all credits in the past year of seven years. The largest credit with a ten or more year maturity was for $250 million for the International Investment Bank, a lender inside Comecon.

International banking developments

This section concentrates on developments in the international business of banks in the BIS reporting area in the first quarter of 1986 and, separately, the business of banks in the London market in the second quarter of 1986. In addition, comment is made on two other sets of data: first, the BIS half-yearly statistics covering the maturity of banks' consolidated cross-border lending in the second half of 1985, and, second, the latest release issued jointly by the BIS and the OECD on bank and trade-related non-bank external claims.

Banks in the BIS reporting area (first quarter of 1986)
There was a sharp deceleration in the growth of BIS-area banks' cross-border lending in the first quarter of 1986, after the exceptional expansion in the final quarter of 1985. The growth in the twelve months to March was, however, still stronger than in the previous twelve months (9.3% compared with 6.7%). The principal factor accounting for the much slower growth in cross-border claims in the first quarter was a sharp cut-back in the expansion of business between reporting banks. Several factors help to explain this downturn. First, banks in Italy and France unwound their usual end-year interbank window-dressing positions. Second, banks in the United States reduced their external assets in the first quarter after considerable expansion in the previous three months. Banks in the 'offshore' centres, too, contributed to the slowdown; overall, they recorded no growth in the first quarter, following a sharp expansion in their cross-border lending in the fourth quarter of 1985. On the other hand, the external assets of banks in the United Kingdom and Switzerland expanded by more than in the fourth quarter.

In contrast to the lower growth in cross-border lending in the first quarter, there was a record rise in foreign currency lending to residents, mainly by banks in Japan, connected with their window-dressing operations.

With strong new issue volume in the bond markets, total international lending through banking and capital markets in the first quarter totalled $135 billion, 15% higher than the quarterly average for 1985 and more than twice the quarterly average for 1984. Bond issues continued to account for an increasing proportion of this aggregate, as the securitisation of lending continued apace.

After strong growth in the previous quarter, the rise in the BIS estimate of international bank lending to final users fell back in the first quarter of 1986 to below the average quarterly rise in 1985. The slowdown was the result of a fall in lending to countries outside the BIS reporting area, after the large rise in the fourth quarter. Lending to final users within the reporting area, on the other hand, remained buoyant. The United States absorbed the bulk of these funds, representing continued financing of the US current account deficit. On the sources side of the market, the main feature among reporting-area countries was a record increase in deposits from German non-banks. This exceptional rise appears to have been related to strong demand for deutschemark funds from outside Germany for investment in long-term German securities. These investments resulted in record long-term capital inflows into Germany during the first quarter.

The record fall in lending to outside-area countries was only partly explained by seasonal influences. There may also have been some, although probably not very significant, understatement of the figures for outside-area countries' borrowing from international markets, to the extent that some of these countries (such as Australia and Sweden) will have borrowed on the international bond markets and any take-up of these new issues by non-banks or by those BIS-area banks which still do not report securitised lending will have escaped the statistics. Although BIS-area banks' recorded claims on all groups of countries outside the reporting area fell, deposits by these countries contracted even more markedly so that outside-area countries were in aggregate still net users of funds in the first quarter.

The largest fall in claims was on the oil exporting countries. Far surpassing this, however, was a sharp reduction in these countries' deposits with BIS-area banks, with particularly large falls by Saudi Arabia, Kuwait and Venezuela. The oil exporting countries were in aggregate, therefore, significant net takers of funds from BIS-area banks, reflecting the impact of the collapse in oil prices on their current account positions. Claims on Latin America declined, having been raised by drawings of new 'package' money in the fourth quarter. The fall in claims was widely based but by far the largest decrease was in claims on Mexico. Latin American deposits with BIS-area banks rose a little, and overall the region was a net supplier of funds in the first quarter. Decreases in both borrowing and deposits by other developed countries, Eastern Europe and other non-oil developing countries were recorded in the first quarter.

Cross-border business of banks in the BIS reporting area

$ billions; changes exclude estimated exchange rate effects

	1984	1985			1986	Out-standing at end-March
	Year	Year	Q3	Q4	Q1	1986
Deposits from:						
BIS reporting area(a)	+ 94.1	+ 96.0	+42.6	+ 90.6	+38.6	1,677.9
'Offshore' banking centres(b)	+ 23.4	+134.0	+ 4.5	+ 27.8	+ 5.0	436.8
Sub-total	+117.6	+230.0	+47.1	+118.4	+43.5	2,114.7
Developed countries	+ 3.2	+ 3.2	+ 2.2	− 0.6	− 0.4	35.3
Eastern Europe	+ 4.3	+ 2.7	+ 1.7	+ 1.8	− 1.0	26.7
Oil exporting countries	+ 2.3	+ 7.3	+ 2.3	+ 5.5	− 7.0	155.4
Non-oil developing countries	+ 19.8	+ 5.3	+ 0.8	+ 4.7	− 2.2	179.3
of which, Latin America	*+ 10.3*	*+ 0.4*	*− 0.6*	*+ 0.6*	*+ 0.5*	*70.3*
Sub-total	+ 29.6	+ 18.5	+ 7.0	+ 11.4	−10.6	396.7
Unallocated	+ 0.3	+ 0.6	+ 5.3	− 2.6	+ 5.8	83.0
Total	**+147.5**	**+249.1**	**+59.4**	**+127.2**	**+38.8**	**2,594.4**
Lending to:						
BIS reporting area(a)	+ 87.4	+189.9	+33.3	+ 97.0	+36.9	1,554.8
'Offshore' banking centres(b)	+ 21.8	+ 23.3	+ 2.3	+ 15.7	− 0.8	404.8
Sub-total	+109.2	+213.2	+35.6	+112.7	+36.1	1,959.6
Developed countries	+ 5.7	+ 6.8	+ 1.4	+ 1.9	− 0.2	104.7
Eastern Europe	− 0.1	+ 5.6	+ 1.8	+ 1.4	− 0.2	62.7
Oil exporting countries	− 1.8	− 0.1	—	+ 1.6	− 3.2	110.1
Non-oil developing countries	+ 10.4	+ 11.3	+ 2.8	+ 5.8	− 5.2	352.9
of which, Latin America	*+ 5.7*	*+ 2.1*	*− 0.3*	*+ 1.9*	*− 2.7*	*218.0*
Sub-total	+ 14.2	+ 23.6	+ 6.0	+ 10.7	− 8.8	630.4
Unallocated	—	+ 3.9	—	+ 1.6	− 0.1	55.2
Total	**+123.4**	**+240.7**	**+41.6**	**+125.0**	**+27.2**	**2,645.4**

(a) Excluding 'offshore' reporters.
(b) Including BIS reporters and other 'offshore' centres.

There was again strong growth in cross-border lending denominated in currencies other than the dollar in the first quarter. The yen was the most popular currency for new lending, accounting for over one third of the quarter's growth. Sterling and ECU-denominated claims also made a significant contribution. There was a small reduction in dollar-denominated cross-border lending, although in stock terms the dollar's share is five times that of the deutschemark and nearly nine times that of the yen.

The latest half-yearly maturity analysis of the consolidated claims of banks in the BIS reporting area at end-December 1985 shows an increasing proportion of banks' claims with maturities of one year or less. These accounted for 43.7% of total outside-area claims compared with 41.7% at end-June 1985. Undisbursed credit commitments increased by $8.3 billion in the second half of 1985, with a particularly strong rise for East European countries.

A more comprehensive measure of external indebtedness, covering both bank and trade-related non-bank claims, is prepared jointly by the BIS and the OECD. This shows a rising proportion of banks' lending to debtor countries which has been officially guaranteed or insured. The proportion of external bank claims which are guaranteed rose from 10.1% at end-1983 to 10.2% at end-1984, and to 10.9% at end-1985. The second feature of these statistics is a quicker pace of growth in trade-related credit provided by non-banks in 1985 compared with 1984.

The London market (second quarter of 1986)

The cross-border lending of banks in the United Kingdom grew strongly for the fourth consecutive quarter. Lending to banks in other financial centres again accounted for most of the growth. There was a modest resumption in lending to countries outside the BIS reporting area after a fall in the first quarter.

Interbank flows between financial centres continued to dominate, with eurocurrency lending to banks in the 'offshore' centres, especially Singapore and Hong Kong, rising strongly. Lending to banks in the major industrial countries rose less rapidly than in the first quarter, although Japanese banks again lent heavily to their parents in Japan.

On the sources side of the market, interbank deposits from other financial centres, unusually, fell slightly, despite a substantial increase in deposits from banks in Japan. Non-banks in the BIS reporting area were the main suppliers of funds in the second quarter, particularly non-banks in the United States whose eurocurrency deposits with UK banks grew by nearly $8 billion.

The resumption of lending to countries outside the BIS reporting area was largely to the Soviet Union, East Germany, the Middle East oil exporters, and South Korea. Claims on Latin America fell in aggregate, but those on Argentina rose reflecting the further drawdown of new money provided under rescheduling agreements.

Cross-border business of banks in the United Kingdom

$ billions; changes exclude estimated exchange rate effects

	1984	1985			1986	
	Year	Year	Q3	Q4	Q1	Q2
Deposits from:						
BIS reporting area(a)	+25.3	+40.9	+13.2	+15.7	+12.4	+ 6.8
'Offshore' banking centres(b)	+ 6.8	+ 5.2	+ 1.1	+ 0.2	+ 1.6	+ 2.9
Sub-total	+32.1	+46.1	+14.3	+15.9	+14.0	+ 9.7
Developed countries	+ 1.4	+ 1.4	+ 1.2	− 0.6	− 0.3	+ 0.2
Eastern Europe	+ 0.9	+ 1.3	+ 0.7	+ 0.7	− 0.3	− 0.4
Oil exporting countries	− 1.2	+ 1.8	− 1.1	+ 0.5	− 1.9	− 1.8
Non-oil developing countries	+ 4.8	− 1.0	− 1.6	+ 1.1	− 1.0	+ 0.4
of which, Latin America	*+ 2.9*	*− 2.2*	*− 0.5*	*− 0.8*	*+ 0.6*	*− 0.8*
Sub-total	+ 5.9	+ 3.5	− 0.8	+ 1.7	− 3.5	− 1.6
Others	− 1.8	− 0.7	—	− 0.4	+ 0.6	− 0.9
Total	**+36.2**	**+48.9**	**+13.4**	**+17.1**	**+11.1**	**+ 7.3**
Lending(c) to:						
BIS reporting area(a)	+16.0	+30.1	+14.3	+11.0	+15.9	+ 4.4
'Offshore' banking centres(b)	+ 9.3	− 4.4	− 3.7	− 2.3	+ 0.4	+ 5.7
Sub-total	+25.3	+25.7	+10.6	+ 8.7	+16.2	+10.0
Developed countries	+ 1.2	+ 2.3	—	+ 1.4	+ 0.3	− 0.4
Eastern Europe	− 0.4	+ 3.3	+ 1.3	+ 1.0	+ 0.3	+ 1.1
Oil exporting countries	− 1.0	− 0.5	− 0.5	+ 0.2	− 0.7	+ 0.8
Non-oil developing countries	+ 1.1	+ 2.9	+ 1.9	+ 0.8	− 1.9	—
of which, Latin America	*+ 1.9*	*+ 1.5*	*+ 1.8*	*− 0.1*	*− 0.2*	*− 0.3*
Sub-total	+ 0.8	+ 8.0	+ 2.7	+ 3.4	− 1.9	+ 1.6
Others	− 0.8	− 1.1	—	− 1.2	+ 0.2	+ 0.1
Total	**+25.3**	**+32.6**	**+13.3**	**+10.9**	**+14.6**	**+11.7**

(a) Excluding 'offshore' reporters.
(b) Including BIS reporters and other 'offshore' centres.
(c) 'Securitised' lending is included only from the first quarter of 1986.

In net terms, countries outside the BIS area were takers of $3.2 billion from banks in the United Kingdom in the second quarter, borrowing $1.6 billion and reducing their deposits by the same amount. The oil exporting and Eastern European countries were the principal net takers. Taiwan, on the other hand, was a significant net depositor of funds with UK banks.

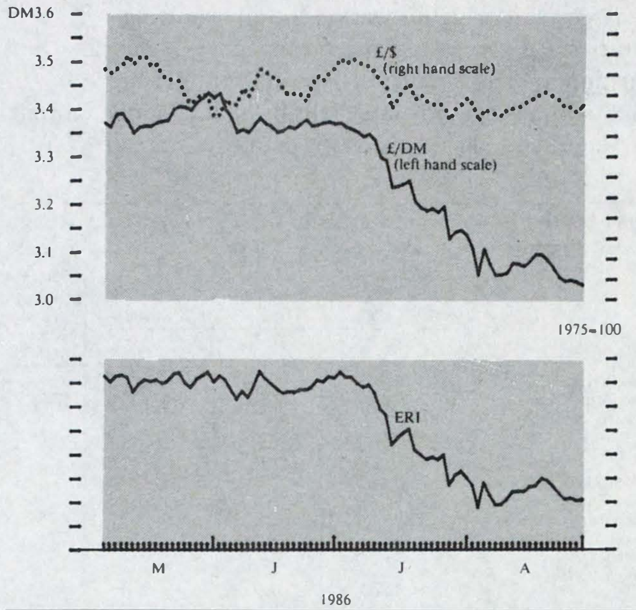
Dollar-denominated lending represented 70% of total cross-border lending in the quarter, compared with the unusually low share of only 3% in 1985. Deutschemark and Swiss franc claims fell, while lending in the traditionally less widely used European currencies rose sharply.

Foreign exchange and gold markets

This section reviews the three months to end-August.
During the period under review, the dollar re-established a downward trend and reached new lows against several major currencies as pessimism intensified over the performance of the US economy. The market took the view that, in the absence of action to promote stronger economic growth elsewhere, the US authorities would have no option but to relax monetary policy in order to stimulate domestic activity and, by encouraging further dollar depreciation, help reduce the trade deficit. Official US statements tended to reinforce these expectations, as did two unilateral cuts in the US discount rate. The rate of the dollar's fall, particularly against the yen, was at times tempered by reported central bank intervention, but underlying sentiment remained overwhelmingly bearish. Sterling came under bouts of pressure from early July as confidence was eroded by the expected impact of a further sharp fall in oil prices on the external position of the UK economy and on public finances. The pound failed to match the gains of other major currencies against the weaker dollar and reached new all-time lows against the deutschemark and the yen. Sterling was subsequently rallied by the unexpected agreement reached by OPEC and the sharp recovery in oil prices which followed. However, the pound quickly fell back as doubts emerged about how long this improvement would endure and concern persisted about the longer-term prospects for the UK economy. The European Monetary System (EMS) was realigned with effect from 4 August, with the Irish pound devalued by 8%.

Sterling exchange rates

At the close of business in London each day



Sterling

At the start of the period, on 2 June, the pound opened in London at ERI 76.1, $1.4660 and DM 3.4253. It eased slightly as the dollar reached the peak of a rally, but then rebounded to $1.4981 at best on 3 June. At this level, expectations emerged of an early cut in UK banks' base rates. The pound touched lows of ERI 75.1 and DM 3.3417 on 9 June, although it advanced against the weakening dollar and breached the $1.50 level the following day. However, interest rate expectations quickly faded with the announcement of a surge in money supply in May. The exchange rate was further buoyed by the Prime Minister's statement that sterling would not enter the EMS exchange rate mechanism at present. Sterling touched $1.5360 and DM 3.3891 on 11 June, before hopes of a cut in UK interest rates were rekindled when the release of the May retail price index (+ 2.8%) on 13 June focussed attention on the high level of UK rates in real terms. With the deutschemark also stronger following the success of the ruling Christian Democrat party in elections in Lower Saxony, the pound fell back to DM 3.3481 on 16 June. It also moved down against the dollar, to a trading range just above $1.50, from which level a dollar rally briefly forced the rate down to $1.4860 on 23 June. The OPEC meeting at Brioni in Yugoslavia which ended inconclusively on 30 June and the subsequent weakness in oil prices had little effect. Sterling finished the month quietly at ERI 76.2, \$1.5335 and DM 3.3680.

The pound's further indifference to oil price developments was short lived. Sterling advanced against the weaker dollar to a high of \$1.5505 on 7 July but thereafter began to slip back as oil prices continued to weaken, and fell below its previous all-time lows of DM 3.1825 and ¥ 247.72. As the price of North Sea Brent crude oil dipped to a record low of \$8.55 per barrel on 14 July, heavy outflows from sterling forced the rate down to \$1.4775. Nervousness towards sterling was exacerbated by a series of adverse press predictions for the exchange rate and for oil prices and, on 28 July, by a rumour in the Far East that the Prime Minister had resigned, following which a low of \$1.4635 was seen. At times, sterling rallied, most notably on 29 July following the publication of an encouraging opinion poll for the Government and a firming of oil prices reflecting Saudi moves to trim oil production. However, market sentiment remained bearish and DM 3.1196 and ¥ 229.92 were recorded on 31 July before the pound closed, to finish the month, at ERI 72.0, \$1.4920, and DM 3.1235.

Selling pressures on sterling continued at the start of August as deadlock in OPEC overshadowed the outlook for oil prices. New all-time lows of DM 3.0430 and ¥225.12 were recorded on 4 August. Early on 5 August, sterling fell to \$1.4615 before the unexpected agreement reached by OPEC and the subsequent sharp rise in oil prices triggered the closing out of short sterling positions, particularly against the deutschemark. In hectic trading, the pound advanced strongly to \$1.4910 and DM 3.1223, helped by reports of official intervention. However, underlying bearishness soon reasserted itself as doubts emerged over the effectiveness of the OPEC agreement, and the pound fell back to \$1.4760 and a new all-time low of DM 3.0316 on 11 August. A more sustained recovery followed a report that Kuwait planned to cease spot oil sales for two months and, on 12 August, news that Abu Dhabi was to cut oil output by 40%. Sterling moved up to DM 3.0957 on 15 August and, as the dollar eased, to \$1.5065 at best on 20 August. However, pessimism about economic trends in the United Kingdom depressed the pound again. As the dollar rallied, \$1.4770 and DM 3.0253 were recorded on 29 August before sterling recovered slightly to finish the period at ERI 71.1 ($-6\frac{1}{2}$% over the period), \$1.4875 (+ 1%) and DM3.0308 ($-11\frac{1}{2}$%).

Official reserves

Over the three months to end-August, there was an underlying increase in UK reserves of \$146 million. Net public sector repayments under the exchange cover scheme totalled \$184 million, while \$2 million was repaid in respect of long-term North American loans. There was a decrease of \$183 million on account of the valuation adjustment arising from the quarterly roll-over of the UK's ECU holding with the European Monetary Co-operation Fund. At the end of August, the reserves stood at \$18,924 million.

Changes in UK official reserves

\$ millions

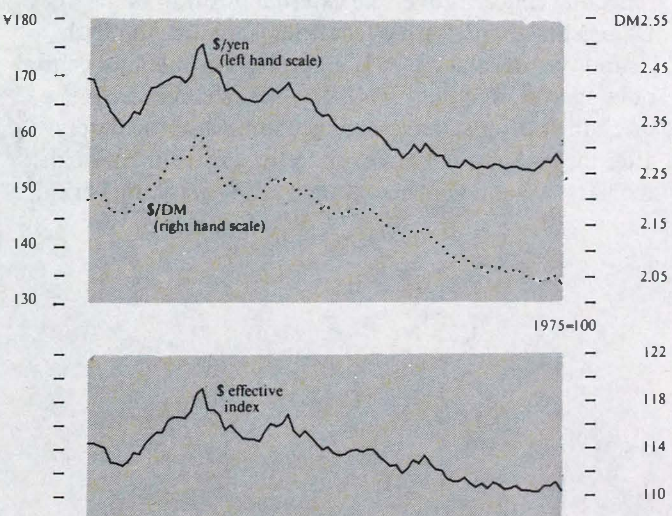
	1986 June	July	Aug.
Change in reserves	**+ 22**	**−105**	**−159**
of which:			
Net borrowing (+)/payment (−) of public debt	−269	+ 82	− 18
Valuation change on roll-over of EMCF swap	—	− 83	—
Underlying change in reserves	+291	− 4	−141
Level of reserves (end of period)	**19,188**	**19,083**	**18,924**

On 3 September, HM Treasury announced a \$3,000 million issue of 10-year floating-rate notes in the international capital markets. The issue was organised by the Bank of England on behalf of the Treasury and lead-managed by S G Warburg and Credit Suisse First Boston. It was the largest FRN to date and was priced on very fine terms. The good response from the market enabled the amount to be increased to \$4,000 million during the morning of the issue. The purpose of this borrowing, like the issue floated in September last year, was to supplement the official reserves.

US dollar

The dollar resumed a downward trend in June having achieved highs of DM 2.3412 and ¥ 176.45 on 2 June following reported central bank intervention against the yen in New York and firmer US interest rates. The principal factor behind the dollar's renewed fall was the widespread market expectation that, in order to reverse the slowdown in economic growth increasingly indicated by economic data, and to help correct the record trade deficit, the US authorities would act to reduce interest rates and encourage further depreciation of the dollar. Bearishness about US economic prospects was markedly intensified by the downward revision on 19 August to the figure for growth in US GNP in the second quarter from + 1.1% to + 0.6% and the record monthly trade deficit of US\$18 billion announced on 19 August. Concern over the health of a number of US financial institutions with large

Dollar exchange rates



exposures to the domestic energy and agricultural sectors and to developing country debtors was viewed as increasing the probability of easier monetary policy. Alternative hopes for action to stimulate more rapid growth in the rest of the world, particularly in Japan and Germany, which were the main beneficiaries of the US trade deficit, were seen as remote, particularly following statements from officials in these countries that their own monetary conditions were already sufficiently accommodative. An easier tendency in US interest rates and an accommodative stance in the domestic money markets by the Federal Reserve, including two $\frac{1}{2}$% cuts in the US discount rate on 11 July and 21 August (to a 9-year low of 5$\frac{1}{2}$%), appeared to confirm market beliefs, as did reports of statements by various US officials, notably one by Secretary of State Schultz on 30 July to the effect that there was scope for a further fall in the dollar. An all-time low of ¥ 152.80 was recorded on 4 August, and lows of DM 2.0340 and Sw.Fc. 1.6380 on 22 August.

The dollar's decline against the yen was at times constrained by reported Bank of Japan intervention and the market's predominantly bearish mood for the dollar was qualified by recurrent concern that central banks might initiate concerted intervention to stem the dollar's fall. Expectations also emerged, especially towards the end of the period, that central banks might co-ordinate interest rate reductions. Over the period, the dollar fell by 12$\frac{3}{8}$% against the deutschemark to DM 2.0375, 11$\frac{3}{8}$% against the yen to ¥ 154.70 and 7% on a Bank of England effective index to 110.4 (1975 = 100). From the close of business in New York just before the Group of Five meeting in September last year to the end of August, the dollar depreciated by 28$\frac{1}{4}$% against the deutschemark, 35$\frac{1}{8}$% against the yen and 20$\frac{7}{8}$% in effective terms.

EMS

Persistent pressures re-emerged within the narrow band of the EMS in the first half of the period and the system was frequently fully stretched between the French franc at the top and the Danish krone at the bottom, in part reflecting concerns over the external position of the Danish economy. With effect from 4 August, the Irish pound was devalued by 8% in terms of its bilateral central rates against other currencies in the exchange rate mechanism. Tensions re-emerged almost immediately after the realignment but eventually subsided, although the narrow band widened again by the end of the period, to finish 2$\frac{3}{16}$% wide between the deutschemark, which began to move up within the system in July and re-emerged at the top of the band towards the end of August, and the Danish krone, which was briefly dispaced by the Belgian franc in early August. The Italian lira finished 3$\frac{5}{8}$% above the bottom of the narrow band.

Other currencies

The yen appreciated by 11$\frac{3}{8}$% against the dollar over the period to finish at ¥154.70 and by 8% in effective terms to 216.4 (1975 = 100).

The Swiss franc remained strong largely reflecting a favourable conjuncture, the firmness of Swiss interest rates and expectations that, unlike the deutschemark, its appreciation would not be constrained by official action. Over the period, it appreciated by 14$\frac{3}{4}$% against the dollar to Sw.Fc. 1.6457 and by 8$\frac{7}{8}$% in effective terms to 169.2 (1975 = 100).

The Australian dollar came under pressure over the period as concern mounted over economic developments. A low of US$0.5720 was touched on 28 July. The Reserve Bank of Australia increased its discount rate in two stages to 18% from 14.6%, and a number of measures were introduced to stimulate foreign investment, including the reversal of an earlier decision to remove exemption from withholding tax on offshore securities. Further measures were announced in the Federal Budget presented on 19 August, following which the Australian dollar rallied to US$0.6420, before doubts emerged about the efficacy of the government's proposals. Over the period, the Australian dollar fell by 14$\frac{7}{8}$% against the US dollar to US$0.6091 and 19$\frac{3}{8}$% in effective terms to 50.3 (1975 = 100).

Gold

Gold advanced very strongly, though erratically, during the period, principally on the back of demand for platinum in the wake of the South African situation. It was helped at times by the weaker dollar but rallies were stemmed by selling from producer countries. Gold fixed in London at $394.50 on the morning of 11 August, its highest fixing since June 1984. It subsequently dipped to $367.00 in Hong Kong in nervous conditions on 19 August but, helped by a continued surge in platinum prices, recovered to $384.70 at the final fixing of the period in London, up $41.50 over the three months.

Prospects for a selection of developing economies

This note reports on the Bank's latest forecast of the economic prospects facing a number of developing countries. The forecast, completed in June 1986, considered the domestic, balance of payments and debt prospects of twenty-two developing countries[1] which together accounted, in 1985, for just over half of total developing countries' trade flows and around three quarters of their international debt.

The individual country forecasts were prepared with the aid of the Bank's developing country models. These allow a distinction to be made between countries where economic prospects are constrained by the capital flows which the international community is willing to provide and/or the country itself is willing to take up, and those countries that appear not to be so constrained—at least in the medium term. In addition to an examination of the balance of payments, each country forecast also considered domestic prospects.

Background to the forecast

Since the early 1980s the sample countries, in aggregate, have undergone considerable adjustment. Import cutbacks during 1982 and 1983 (non-oil import volumes declined by 7% over the two years taken together) combined with strong export volume growth during 1983 and 1984 (non-oil export volume increased by 12% and 13½% respectively) to turn the trade account round from a deficit of $8 billion in 1981 to a surplus of some $52 billion in 1984. Over the same period the current account moved from a deficit of $56 billion to a surplus of $4 billion. There was a small setback during 1985 as export volume growth slowed, import volume growth continued to recover and the terms of trade declined by almost 3%. Nonetheless the trade and current accounts—at a $40 billion surplus and a $7 billion deficit respectively—remained considerably stronger than a few years earlier. This improvement was achieved in part at the cost of restrained domestic absorption. Much of the GDP growth in 1982 and 1983 stemmed from the external sector; domestic demand was more subdued and actually fell during 1983, while GDP growth averaged little over 2% per annum between 1981 and 1983, recovering to more than 5% per annum during 1984 and 1985.

The background assumptions to the forecasts were taken from updated versions of the Bank's Spring World Economic Forecast (WEF), extrapolated to 1990.[2] In the *central* case it was assumed that, after a period of uncertainty in the world oil market, oil prices would rise to an average of $20 per barrel during the last quarter of 1986 as OPEC agreed to restrain production. This would represent a decline of 47% in the annual average real oil price between 1985 and 1986. Other real primary product prices were also assumed to remain weak. US 3-month CD rates were projected to rise at the end of this year to 7%, as a result of a shift in market sentiment against the dollar, but to drift down again after 1988 and to reach 6% by end-1990. The dollar was assumed to stabilise at an effective index of some 110 (1975 = 100) until the end of 1987, before resuming a modest decline over the next two years. Combined with the earlier substantial dollar depreciation, this contributed to a forecast of over 18% inflation of world manufactured export prices measured in dollar terms this year, slowing to an average 5% per annum over 1987–90. Interest rates measured against developing country export price inflation are expected to be fairly modest in the forecast period and considerably lower than in the recent past. Real GNP growth in the major seven industrial countries on average was forecast to be some 3% per annum over 1986–90, with growth slightly under 3% after 1987. Forecast import volumes in the OECD countries showed a similar profile, increasing by 6%–7% per annum over 1986–87, but slowing somewhat to an average of 4½% per annum in the later years of the decade.

In local currency terms inflation in the major economies was forecast to average under 3% per annum, reflecting depressed primary product prices and generally non-accommodating policies.

Given the importance of, and uncertainty surrounding, developments in the oil market, alternative forecasts were also prepared based on a *variant* of the Spring WEF which included, *inter alia*, a much lower oil price ($10 per barrel).

Summary of the forecast

Broadly speaking, in the central case the outlook for the sample economies in *aggregate* appears relatively little changed from the forecast of a year ago (see the September 1985 *Bulletin*, page 372). This is despite considerable changes in both the countries included in the sample[3]

(1) The sample consisted of nine net oil exporting countries—Algeria, China, Egypt, Indonesia, Malaysia, *Mexico, Nigeria, Peru* and *Venezuela*—and twelve net oil importing countries—*Brazil, Chile*, India, Israel, *Ivory Coast*, Kenya, South Korea, *Morocco, Philippines*, Taiwan, *Yugoslavia* and Zimbabwe—plus *Argentina*. (Countries included in the Baker initiative are shown in *italics*.)

(2) A summary of the original forecast is given in the June 1986 *Bulletin*, page 170. The main subsequent revisions were to oil prices and interest rates.

(3) Compared with last year's sample Algeria, China, Indonesia, Nigeria, Venezuela, Israel, Taiwan and Yugoslavia have been added while Colombia, Jamaica, Singapore, Sudan, Thailand and Zambia have been dropped.

Table A
Developing countries in the central forecast

	1985	1986	1987–90 (annual averages)
	Percentage changes		
Export markets	4.3	5.8	4.5
Non-oil export volume	4.9	5.4	5.3
Non-oil import volume	12.8	– 1.2	6.5
Terms of trade (change)	– 2.6	– 1.7	0.3
	$ billions		
Trade balance	39.5	38.8	50.8
Current account	– 7.0	0.1	2.9
Selected capital flows:			
Commercial borrowing	7.5	10.8	4.2
Official borrowing	9.9	12.8	15.7
Direct investment	6.6	6.3	8.5
Other capital flows	–12.6	–13.5	–11.6
Reserve change (increase –)	– 5.5	–11.1	–18.2
Use of IMF credit	1.1	– 0.7	– 3.6

and the assumptions—most notably a much lower oil price and lower eurodollar interest rates. These changes, however, have a marked effect on the *diversity* of prospects facing individual countries. Last year's forecast revealed a large degree of heterogeneity amongst countries; this year these differences are markedly greater. Table A gives a summary of the balance of payments prospects for the total sample in the central case.

Capital flows

Many countries' access to external commercial finance is expected to remain limited and this is an important factor in their overall prospects. The projections for net bank lending are lower than they were in last year's forecast—despite some assumed commercial lending associated with the Baker initiative. This reflects in part the impact of changes in sample coverage. Several countries are expected to reduce their outstanding stock of bank liabilities. The sample divides into two main groups: those which would like to borrow but to which the banks are unwilling to lend, and those countries which appear likely to be able to enjoy satisfactory rates of growth without further significant recourse to the banks. The commercial lending shown in Table A is equivalent to an average increase in banks' exposure to developing countries of around 1½% per annum, well within any global constraint on the availability of private funds, and is consistent with a continued shift away from exposure to developing countries and with a strengthening of banks' general capital/lending ratios. The increases in bank exposure that are expected to take place are mainly to Asian countries.

By contrast, official lending, especially from the development banks, is forecast to recover more strongly, associated in part with the Baker initiative. IBRD lending is expected to remain constrained more by the rate of disbursement, reflecting the need to identify and appraise relevant projects and, where necessary, to agree on policies of adjustment, than by the IBRD's capital base.

Only a modest increase in direct investment is forecast, because of expectations of low domestic activity in many countries and fears of increased protectionism and political instability. Nonetheless there is an upside risk to the forecast in this area; inflows of direct investment, particularly to the more dynamic Asian economies, could turn out to be significantly higher than forecast. The forecast also shows subdued growth of portfolio investment, with most of the expected borrowing being made by a small number of Asian countries. Fairly large net repayments to the Fund, as earlier large drawings are repurchased on schedule, are also forecast, as is a steady buildup of reserves—although the latter is almost entirely due to the results for Taiwan.

Current account

Non-oil export volume growth is expected to exceed export market growth marginally over the forecast period (see Table A) as adjustment measures are assumed to be implemented in many countries . Some countries may attempt to increase revenue from agricultural commodities but these additions to already abundant supplies of many commodities may lead to further downward pressure on agricultural prices.(1) Export growth may be hampered in a number of countries by lack of imported inputs, cuts in investment projects and other austerity measures. Other factors that could affect export performance are environmental problems and protectionism. The CAP is expected to restrain agricultural exports, particularly by the Mediterranean countries in the sample. Although no overall increase in protectionist measures is assumed, the expected gain in export market share in Korea and Taiwan is on the low side by historical standards even after allowing for some appreciation of their exchange rates during the forecast period.

The sample's surplus on oil trade is reduced sharply in the short run. Oil import costs are expected to fall by around a third between 1985 and 1986 with several countries—most notably Brazil and South Korea—making large terms of trade gains as a result. By 1990 the sample surplus on net oil revenue is forecast to return to the nominal level of 1985.

No significant reduction is envisaged in the real value of the deficit on invisibles. The combination of reduced Libor and only moderate increases in debt stabilises gross interest payments and the buildup in reserves allows some reduction in net interest outflows; as a proportion of exports of goods and services the latter declines from over 14% in 1985 to only 7% in 1990. This improvement, however, is offset by increasing insurance and freight payments as import values recover. The invisible deficit, which is projected to improve from $47 billion in 1985 to $40 billion this year, is forecast to deteriorate toward $50 billion in 1990.

In combination, the above factors constrain the volume of imports for the sample as a whole, and this year may be particularly difficult for some countries, with a slight fall

(1) See also 'Recent trends in primary product prices and developing countries' terms of trade' in the June 1986 *Bulletin*, page 172.

in aggregate non-oil import volumes in prospect. Thereafter non-oil import volume growth may average over 6% per annum across the sample of countries. This aggregate outturn conceals considerable variation between individual countries. Several countries may have insufficient imports to exploit export potential fully and in a number of cases the projected financial constraint seems consistent only with several further years of domestic austerity.

Domestic prospects
In the majority of sample countries GDP growth is expected to exceed the growth of domestic demand over the 1980s; the positive net external contribution to growth seen earlier in the 1980s is not expected to reverse during the forecast period. While in a few countries, most notably South Korea, the positive contribution is due to the inherent strength of the trade sector, in many more it reflects the adjustment measures necessitated by the need to continue servicing debts with only modest amounts of new finance.

The implications for income per person in the sample countries are much poorer. The combination of relatively subdued growth rates and strong population growth leads to a decline in per capita GDP and domestic demand over the entire decade for a number of countries. In some sample countries per capita GDP may be lower in 1990 than it was in 1970.

Debt implications
The forecast suggests that the external debt burden facing the sample countries will become less severe in aggregate. Gross external debt is projected to grow only moderately through the forecast period. With the value of exports continuing to increase, reflecting both export volume growth and dollar export price inflation, the ratio of the stock of debt to exports of goods and services is forecast to fall from an average of 2.1 over 1983–85 to 1.5 in 1990. The ratio of debt service to exports, which peaked at 37% in 1982, is expected to decline to 25% by the end of the decade.

Chart 1
Non-oil import volumes of selected sub-groups

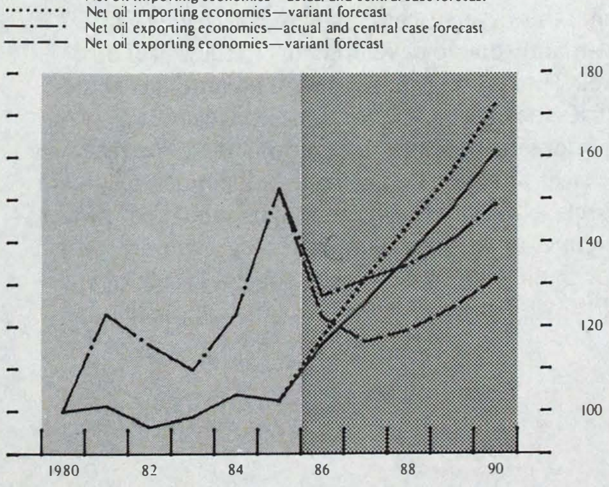
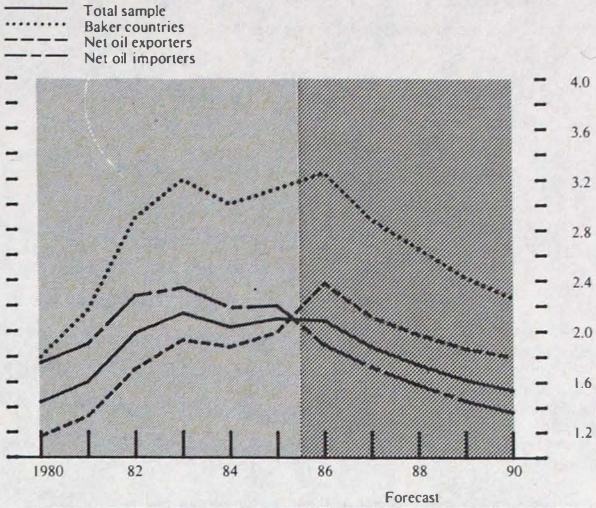


Chart 2
Selected debt to export ratios (central case)



Diversity
One of the main causes of the increased diversity of prospects compared with last year's forecast is the fall in the oil price. Even in the central case, with an oil price of $20 assumed, the difference in prospects between net oil exporting and net oil importing economies is marked. For example, between 1985 and 1990 non-oil import volume of the net oil importers may grow by more than 9% per annum on average while the net oil exporting group may face a slight fall (see Chart 1). Until recently the debt ratios of the net oil importing countries were higher than the sample average. This year this situation may be reversed as the net oil exporters record a sharp increase, more on account of the sharp decline in export revenues than because of a significant increase in indebtedness (Chart 2).

Prospects for Baker countries

Eleven of the fifteen severely indebted middle income countries covered by the 'Baker initiative' are included in the sample. According to the projections in the forecast, the Baker initiative may fail to realise the originally suggested volume of bank lending, although lending by the multilateral development banks is projected to be rather more buoyant than in the recent past. The various debt ratios move in the right direction, indeed at a somewhat faster pace than for the sample as a whole, though they remain at much higher levels than the sample average even by the end of the forecast period (Chart 2).

Growth in the Baker countries was weak during the first half of the decade. The wedge between GDP and domestic demand noted above is larger than for the total sample, indicating the large amount of domestic retrenchment that has taken place. Growth rates for these eleven countries in aggregate from here on may be similar to those in prospect for the total sample. However, much of this growth takes place in Brazil; excluding Brazil, aggregate GDP growth is expected to be only 2.3% per annum, implying little, if any, per capita increase.

Table B
Effect of variation in selected assumptions on the balance of payments

Figures show net first round effects in dollars for small changes from the central case

	Total sample	11 Baker countries	Net oil exporters	Net oil importers
Increase of 1% point in Libor: effect on the invisible account ($ billions)(a)				
1986	– 2.1	– 1.9	– 1.1	– 1.0
1990	– 1.7	– 1.9	– 1.5	– 0.3
Increase of $1 per barrel on the oil price: effect on the trade account ($ billions)(a)				
1986	1.9	1.1	2.7	– 0.8
1990	2.2	1.3	3.1	– 0.9
Increase of 1% point in the dollar price of selected groups of products: effect on the trade account ($ millions)				
Agricultural commodities	270	175	100	160
Metal ores and non-ferrous metals	80	85	60	20
Manufactured goods	–240	–295	–525	285

(a) Because the estimated impact can depend on when the change occurs, two years are shown for interest rates and the oil price.

Sensitivity to changes in starting assumptions

The forecast for each country is sensitive to changes in the world environment. Table B shows, for various groups of countries, the effects of small variations from the assumptions made in the central forecast. As both the total sample and the eleven Baker countries included in the sample are, in aggregate, net oil exporting, a fall in the oil price would be damaging to both groups. Not only would the benefits accruing to the net oil importing economies be less in aggregate than the negative effects on the oil exporters, but those benefits would be more thinly spread among the larger group of oil importers. An interesting result is that, due to the weight of South Korea, Taiwan and Brazil, the trade balance of the net oil importing group as a whole would benefit from an increase in the dollar export price of manufactured goods *vis-á-vis* that for other commodities. It should be noted that in this respect the net oil importing sample countries differ from the net oil importing developing countries taken as a whole.

$10 per barrel oil price variant (Table C)

The heterogeneity evident in the central forecast is intensified in the variant case. The *net oil importing* group is far better off in aggregate. Higher export market growth leads to higher export volume growth, oil import bills are reduced markedly, non-oil import volumes are higher and domestic growth prospects more buoyant. The buildup of reserves is greater and commercial borrowing lower; reserve cover is slightly higher and debt ratios somewhat lower. Nonetheless a few countries fail to gain significantly from the changes.

For the *net oil exporting* countries in aggregate prospects turn out to be perhaps less bleak than might have been expected. Greater reserve drawdown and commercial borrowing and increased use of Fund credit, compared to the central forecast, together with higher non-oil export volumes and lower import prices, imply that the required fall in non-oil import volumes is only 10 percentage points greater between 1986 and 1990 taken as a whole than in the central case. However, for the four worst affected countries, additional falls in import volumes of between 15 and 30 percentage points compared to the central case are forecast.

Table C
Developing countries in the variant forecast

	1985	1986	1987–90 (annual averages)
			Percentage changes
Export markets	4.3	6.0	4.9
Non-oil export volume	4.9	5.6	5.6
Non-oil import volume	12.8	– 1.3	6.7
Terms of trade (change)	– 2.6	– 0.3	– 0.2
			$ billions
Trade balance	39.5	37.2	42.6
Current account	– 7.0	—	0.2
Selected capital flows:			
Commercial borrowing	7.5	10.5	3.7
Official borrowing	9.9	13.0	15.8
Direct investment	6.6	6.5	8.5
Other capital flows	–12.6	–12.6	–11.0
Reserve change (increase–)	– 5.5	–12.1	–17.4
Use of IMF credit	1.1	– 0.7	– 2.0

One aspect of the divergence in the variant case between net oil importers and exporters is illustrated by Chart 1; the sharp fall in import volumes, in the short run, for the net oil exporters is not fully offset by extra growth in the oil importers as many of the latter are assumed to employ the windfall gain, at least in part, to repay extra debt, borrow less additional money or build up further reserves. In the short run, the impact of the lower oil price on domestic growth and import volumes of the sample is therefore likely to be adverse.

Conclusion

The forecast shows that an outcome consistent with continued progress for the developing countries considered in aggregate can nevertheless encompass a wide diversity of prospects between individual countries and that this diversity has increased over the last year—mainly due to developments in the world oil market. The central case suggests that, although some countries look set to face continued difficulties over the remainder of the decade, debt ratios should move slowly in the right direction and, despite only moderate growth prospects in the short run, economies should continue to restructure, improving medium-term growth prospects. However, the outlook is, as ever, subject to significant risks.