

International financial developments

Among the main developments:

- The weakness of oil prices was reflected in a marked strengthening in the combined current account deficit of the major seven industrialised countries and a corresponding decline in the position of the OPEC economies during 1986. The surpluses of Japan and Germany rose very sharply in dollar terms, more than offsetting a further substantial increase in the US current deficit.
- Activity in the capital markets increased substantially in the first quarter of 1987, despite continuing weakness in the FRN sector. As a result in part of the dollar's weakness, issuance of non-dollar fixed-rate bonds rose very sharply, more than compensating for a decline in eurodollar issues.
- There was record growth in international banks' external assets in the fourth quarter of 1986. Activity was dominated by interbank business and was boosted by the opening of Tokyo's offshore market in December. The Japanese were significant net takers of banking funds. There was an upturn in lending by banks to developing countries.
- In the foreign exchange markets, the dollar fell back further, particularly against the yen and the deutschemark, on continuing concern about the US trade deficit and, towards the end of the period, worries about trade frictions. The EMS was realigned in January, with the deutschemark and the Netherlands guilder revalued by 3% and the Belgian franc by 2%.

Balance of payments positions

A marked strengthening in the combined current account position of the major seven industrialised countries and a corresponding deterioration in OPEC's current account were the major features of world current account developments in 1986. In dollar terms, imbalances of the three largest economies widened sharply last year (although latest estimates indicate that the German current account surplus declined in the final quarter). The US current account deficit rose from \$118 billion in 1985 to \$141 billion in 1986, while the Japanese surplus widened from \$49 billion to \$86 billion. Among the other major countries, both Italy and France recorded stronger external positions in 1986, reflecting to a large extent terms of trade gains brought about by the oil price fall. In contrast, the Canadian and UK current accounts deteriorated.

1986 was a difficult year for the OPEC economies. OPEC oil export prices were 45% lower on average than in 1985, although there was some recovery later in the year. Consequently, and despite significant import restraint by most countries and high export volume growth (21% for the OPEC countries as a group), the collective OPEC current account deficit is likely to have exceeded \$42 billion in 1986—compared with a surplus of \$6 billion in the previous year.

World current accounts^(a)

\$ billions; seasonally adjusted

	1985 Year	1986 Year	1985		1986(b)			
			Q3	Q4	Q1	Q2	Q3	Q4
OECD economies:								
Canada	—	-6	-1	-1	-2	-1	-1	-2
France	1	2	—	1	1	—	—	1
Germany	11	37	4	4	8	8	11	9
Italy	-4	5	—	-1	-2	1	4	2
Japan	49	86	12	16	15	22	23	25
United Kingdom	5	-1	2	1	1	1	-1	-1
United States	-118	-141	-29	-34	-34	-34	-35	-37
Major economies	-56	-18	-11	-13	-13	-4	1	-2
Other OECD	-1	4	2	-1	-3	2	2	3
Total OECD	-57	-14	-9	-14	-15	-2	3	1
OPEC economies	6	-42	2	-3	-7	-11	-13	-11
Non-OPEC developing economies	-21	-3	-5	-3	-4	-2	2	—
Other economies(c)	5	2	1	1	—	—	1	1
World discrepancy(d)	-67	-58	-12	-19	-26	-15	-7	-10

(a) Components may not add up due to rounding.

(b) Includes Bank estimates.

(c) The centrally planned economies and South Africa.

(d) Equals the overall identified balance. The negative sign implies that errors arising from incomplete coverage, timing differences and other statistical deficiencies are resulting in the omission of positive influences (eg unrecorded services and investment income).

The non-OPEC developing countries' estimated combined current account deficit fell to around \$3 billion in 1986 from \$21 billion in the previous year. This shift towards a balanced aggregate position reflected financing constraints in those countries predominantly dependent on oil and primary product exports and a further strengthening in manufactured export volumes of many industrialising developing countries.

Non-OPEC developing countries' balance of payments

\$ billions; not seasonally adjusted

	1984	1985(a)	1985(a)		1986(a)		
	Year	Year	Q3	Q4	Q1	Q2	Q3
Current account	-19	-21	-5	-6	-4	1	1
Capital account	39	22	7	10	1	3	5
<i>of which:</i>							
Concessionary and other official flows	23	21	5	5	5	5	5
Direct investment	9	10	2	3	3	2	2
Borrowing from banks(b)	11	11	2	6	-6	-	-
Borrowing via bond issues (gross)	3	7	1	3	1	1	1
Other capital flows(c)	-7	-27	-5	-7	-2	-5	-3
Official financing balance	20	1	-	4	-3	4	6
<i>of which:</i>							
Use of IMF credit	4	1	-	-	-	-1	-
Liabilities to other CMIs	1	-	-	-	-	-	-
Reserves etc (increase -)	-25	-2	-	-4	3	-3	-6

(a) Includes Bank estimates.

(b) Adjusted to exclude valuation effects.

(c) Unidentified items which may include net errors and omissions on both the current and capital accounts.

Although complete capital account estimates for 1986 are not yet available, the decline in the non-OPEC developing countries' current account deficit appears to have been reflected in a turnaround (to net repayments) in their borrowing from banks and in a sharp rise in reserves (though this was more than accounted for by Taiwan).

Identified deployment of oil exporters' funds^(a)

\$ billions

	Dec. 1985 levels	1986				Dec. 1986 levels ^(b)
		Q1	Q2	Q3	Q4 ^(b)	
Industrial countries						
United Kingdom:						
Sterling bank deposits	6.4	0.1	-0.5	-	-0.1	6.1
Eurocurrency bank deposits	43.7	-2.0	-1.3	-2.6	-1.7	37.9
Government paper	3.3	0.3	0.2	0.2	0.8	4.9
Other investments	7.0	-	-	-	0.2	8.0
	60.4	-1.6	-1.6	-2.4	-0.8	56.9
Other EEC: ^(c)						
Domestic currency bank deposits	4.1	0.3	0.1	0.4	-	5.8
Eurocurrency bank deposits	23.7	-2.4	-1.8	-1.0	-	19.3
Other investments	48.3	0.2	0.4	0.2	0.8	64.7
	76.1	-1.9	-1.3	-0.4	0.8	89.8
United States:						
Bank deposits	21.1	0.6	-1.0	1.0	-1.4	20.8
Government paper	29.5	-	-0.2	-2.0	-0.7	26.6
Other investments	28.0	-0.2	-1.0	-0.6	0.7	26.9
	78.6	0.4	-2.2	-1.6	-1.4	74.3
Other:						
Domestic currency bank deposits	4.6	-0.3	-0.6	0.2	-	5.2
Eurocurrency bank deposits	29.4	-1.8	-0.6	-1.3	-1.8	25.9
Other investments	41.0	0.6	5.5	-6.5	0.6	47.0
	75.0	-1.5	4.3	-7.6	-1.2	78.1
Offshore centres:						
Bank deposits	42.0	-0.3	-1.9	0.9	-	40.8
Placements with Idcs	59.4	-	0.1	-	-	59.5
OECD credit to non-banks	11.0	0.7	0.4	-	0.2	12.2
IMF and IBRD ^(d)	34.6	0.2	-	-0.1	-0.5	32.9
Total identified additions(+)/reductions (-) in deployed assets	437.1	-4.0	-2.2	-11.2	-2.9	444.5
Net funds available for deployment		-4.8	-9.6	-10.9	-11.0	
<i>of which:</i>						
Net movements in external borrowing etc		2.6	1.5	1.6	0.4	
Current balance		-7.4	-11.1	-12.5	-11.4	

(a) The oil exporting countries covered are defined in the notes and definitions to Table 16 of the statistical annex in the February 1987 Bulletin.

(b) Provisional.

(c) Includes Spain and Portugal.

(d) Includes holdings of gold.

Oil exporting countries as a group continued to run a large current account deficit in the fourth quarter, of \$11.4 billion, bringing the total for 1986 as a whole to \$42.4 billion. Only partial information is currently available on the deployment of oil exporters' funds at end-1986 and identified financial transactions explain only \$3.3 billion of the fourth quarter deficit at this stage. Available data on bank deposits for the fourth quarter suggest a continuing fall, of \$5.0 billion, for all BIS reporting countries, with the United States and the United Kingdom together accounting for \$3.2 billion. The withdrawal from US government paper continued in the fourth quarter but was matched by increased holdings of UK government paper.

International capital markets

Activity in the international capital markets increased substantially in the first quarter, despite a sharp drop in the issuance of FRNs and eurodollar bonds. Problems in the perpetual FRN sector continued and spread to the dated FRN sector. As a result of the dollar's weakness, the issuance of non-dollar fixed-rate bonds reached a record high, with particularly strong activity in sterling, yen and deutschemark. Syndicated credits increased, while the value of new euronote facilities declined.

Fixed-rate bonds

The volume of fixed-rate bond issues in the three months to March rose by \$17.2 billion from the previous quarter to a record of \$57.0 billion. Most of this increase was due to investors attempting to diversify their portfolios into non-dollar bonds combined with a shortage of non-dollar issues in the secondary markets. Non-dollar fixed-rate bonds increased by \$19.1 billion, with most activity centred on sterling, the yen and the deutschemark. Cuts in official interest rates in each of these three markets during the quarter spurred new issue activity. There was also strong demand for Australian dollar bonds (up \$2.3 billion) and ECU bonds (up \$2.1 billion).

Reflecting generally bullish equity markets in London, New York and Tokyo, equity-related bonds increased by \$900 million from their high fourth quarter level to \$7.9 billion.

Troubles in the FRN sector may also have contributed to increased fixed-rate issuance, as traditional FRN borrowers sought new markets. Fixed-rate issues of banks and financial institutions, traditional FRN borrowers, nearly doubled, rising from \$10.2 billion to \$19 billion. At least a quarter of these issues was swapped into floating-rate debt—almost twice the proportion swapped last year.

Issues for US borrowers rebounded from their low fourth quarter level to \$7.9 billion, in part owing to the belief that US interest rates may have bottomed out. The weak dollar pushed some US issuers into non-dollar currencies and a rising stock market contributed to a \$1.0 billion increase (to \$1.1 billion) in convertible issues.

Announced international bond issues^(a)

\$ billions: percentages in italics

	1985	1986					1987
	Year	Year	Q1	Q2	Q3	Q4	Q1
Fixed-rate bonds							
Borrower:							
Major OECD countries	70.6	115.5	31.0	34.6	26.1	23.8	35.1
of which:							
United States	29.8	31.1	10.8	10.3	6.5	3.4	7.9
Japan	19.2	31.4	5.8	8.6	8.3	8.6	8.9
Minor OECD countries	18.5	37.5	9.5	7.6	8.7	11.7	14.5
International institutions	15.8	17.1	5.5	3.5	3.9	4.2	6.2
Other	2.9	2.3	1.0	0.7	0.5	0.1	1.1
Total	107.8	172.4	47.0	46.4	39.2	39.8	57.0
Currency:							
US dollars	46.8	47.7	47.1	50.2	43.8	49.5	31.4
Swiss francs	13.7	13.4	13.1	10.6	15.5	15.0	10.7
Yen	11.3	12.8	16.2	7.8	15.0	12.3	15.9
Other	28.2	26.1	23.6	31.4	25.7	23.2	42.3
Floating-rate notes							
Borrower:							
Major OECD	39.1	34.0	5.4	7.1	15.0	6.6	2.3
Minor OECD	8.1	10.7	1.6	1.4	5.7	2.0	0.3
Other	8.7	3.1	1.5	0.8	0.1	1.7	0.1
Total	55.9	47.8	8.4	9.3	20.8	9.3	2.7

(a) Maturities of one year and over. The table includes euro and foreign issues and publicised private placements. Issues which repackage existing bond issues are not included.

Non-US issuers generally increased their fixed-rate borrowing, particularly in their own currencies, in order to take advantage of investor diversification out of the dollar. German borrowing rose by \$1.8 billion to \$4.2 billion — \$1.7 billion of which was denominated in deutschemarks. UK issuers increased their new fixed-rate issue activity by \$2.5 billion. UK building societies made their first non-sterling issues, taking advantage of new powers under the Building Societies Act that permit them to issue bonds in foreign currencies and swap the proceeds into sterling. French borrowing rose \$2.3 billion to \$4.1 billion, of which \$1.4 billion was denominated in yen and \$0.6 billion in ECU. Japanese borrowing increased slightly to \$8.9 billion, compared with \$8.6 billion in the fourth quarter.

The volume of issues denominated in dollars fell by \$1.9 billion to \$17.9 billion, or 31% of all fixed-rate bonds—the lowest market share for the dollar ever recorded. Demand for dollar-denominated bonds was depressed by the weak dollar, which fell to its lowest level against the yen since the Second World War. The volume of new euroyen issues increased by ¥612 billion (\$4.3 billion) to ¥1.4 trillion (\$9.2 billion), or 16% of the market, fueled in part by Japanese investors limiting their currency risk. The share of issues denominated in sterling increased from 1% of the market to 9%, with volume up £2.9 billion to about £3.2 billion, largely on expectations of a favourable UK budget and interest rate cuts. The volume of new deutschemark-denominated issues increased by DM 6.7 billion (\$4.0 billion) to DM 12.1 billion (\$6.6 billion), and the deutschemark's market share rose from 7% to 12%. The Swiss franc's share dropped from 15% to 11%, although the volume of issues in Swiss franc terms declined only slightly.

Floating-rate notes

Announcements of FRN issues dwindled to only \$2.7 billion during the first quarter as compared with

\$9.3 billion during the fourth quarter of 1986. (Issues which repackage existing bond issues with swaps are not included.) Limited liquidity, volatile prices and a weak dollar all contributed to the decline. Conventional FRN issues were very limited. Financial institutions, previously the heaviest issuers (with 63% of euromarket FRN issuance in 1986), issued only twice in the quarter and there were no sovereign borrowers.

Unconventionally-structured FRNs priced over Libor made up the bulk of issuance activity. There were \$840 million of mortgage-backed FRNs, which were first introduced to the euromarkets during the fourth quarter, two sterling mortgage pass-throughs worth \$390 million (the first in the euromarkets) and \$700 million of FRNs repackaging existing bond issues with currency or interest rate swaps. Given the current state of the market, the only FRN issues attracting significant retail demand (excluding high quality sovereign issues) are those that are priced at a spread over Libor. (All new FRNs issued during the quarter were priced over Libor.) Since many traditional issuers, such as banks and sovereigns, can achieve sub-Libor funding through swapping or activating euronote programmes, these unconventional Libor-priced FRNs tend to be the only FRNs that are feasible at present.

The perpetual FRN sector remained illiquid and, in the absence of any significant retail demand, continued to suffer from volatility. Several attempts were made to package perpetual FRNs with US government and agency zero-coupon bonds in order to provide a floor under the price of the perpetuials; however, the success of these efforts remains uncertain. The prices of perpetuials and other primary capital FRNs continue to be affected by the possibility that the Japanese authorities might impose rules on Japanese banks' capital holdings similar to those in effect in the United Kingdom. Those rules would require a bank investor to deduct holdings of the primary capital of other banks from its own primary capital base. Towards the end of the quarter, trading volatility temporarily spread into the dated FRN sector. The prices of US bank holding company FRNs were particularly hard hit following news of Brazil's suspension of its debt payments.

The proportion of FRNs denominated in dollars dipped sharply from 92% to 55%. There were three sterling FRNs worth \$545 million.

Eurocurrency syndicated lending

The total value of syndicated credits announced during the first quarter was \$17.4 billion—an increase of nearly \$7.2 billion over the previous three months. A large part of this increase was due to the announcement of a \$5 billion credit for British Petroleum (BP). Proceeds of the credit will provide the bulk of the finance for BP's offer for the 45% of Standard Oil shares it does not already own.

Announced eurocurrency syndicated credits

\$ billions

	1985		1986				1987
	Year	Year	Q1	Q2	Q3	Q4	Q1
Major OECD	5.06	11.61	2.21	2.02	2.02	5.36	9.09
Minor OECD	4.40	6.49	1.38	0.98	2.15	1.98	4.96
Developing countries	3.92	4.50	1.28	0.68	1.58	0.96	1.29
Eastern bloc	3.55	2.34	0.50	1.13	0.21	0.50	0.78
Other	1.99	4.81	1.64	1.19	0.61	1.37	1.24
Total	18.92	29.75	7.01	6.00	6.57	10.17	17.36
<i>of which, transferable</i>	5.77	3.34	1.75	1.05	0.10	0.44	0.38

OECD borrowers continued to achieve finer terms on credits. A \$1.4 billion refinancing for Sweden was announced carrying a spread of 4 basis points over Libor, to replace a more expensive multiple-component facility. However, towards the end of the quarter there was some discussion that the widening of spreads on FRNs could begin to place some upward pressure on the spreads on syndicated credits.

In contrast to the shift away from dollar-denominated securities, the proportion of credits denominated in dollars remained fairly constant at 85%, or \$14.8 billion.

Euronote and other facilities

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

The total value of euronote facilities announced in the first quarter of 1987 was \$16.0 billion, compared with a total of \$17.7 billion in the previous three months. Nearly all facilities were non-underwritten or uncommitted; the proportion of such facilities rose from 80% (by value) of the total in the previous quarter to 96%.

Borrowers from OECD countries continued to dominate the euronote market; only four facilities (including one, unusually, for an East European borrower) were for non-OECD borrowers. Facilities for US borrowers fell from \$5.7 billion to \$2.7 billion, while there was a substantial increase in facilities for UK borrowers, from \$0.5 billion in the previous quarter to \$4.2 billion (28% of the total). The UK total included the largest facility of the quarter, a \$1 billion eurocommercial paper programme for the Abbey National Building Society, again using new

International stock market performance

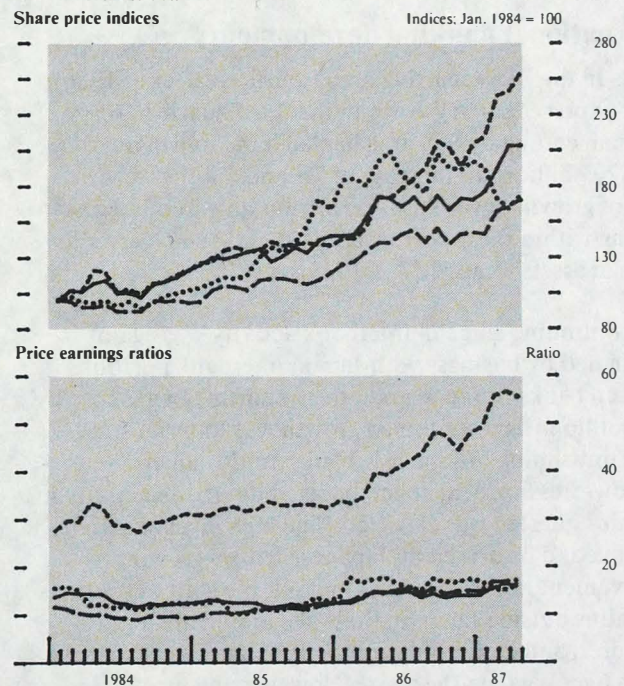
Share prices around the world resumed their upward trend in about 1982. The rate of increase was fairly consistent at about 15%–20% per annum in local currency terms in most major economies, with only the United States showing a lower rate of increase.

To a large extent these price rises reflected improved corporate profitability, although price-earnings ratios in the United Kingdom, the United States and Germany rose slightly over the period, suggesting that markets were expecting further improvements. Price-earnings ratios in Japan, already much higher than those in other countries, have also risen, and the rise has become much steeper in the past twelve months. The general rise in share prices may also be attributed to the effect of falling inflation rates and a shift in investors' preferences towards equities. An additional factor in the United States was the retirement of existing equity at the rate of about \$80 billion a year over the period 1984–86 as a result of take-overs and corporations buying back their own shares.

Towards the end of last year, share price performance became less consistent between countries. In both Germany and Japan, stock markets suffered steep falls at different times during 1986 on prospects for lower growth following the appreciation of their currencies. Share prices in Germany have fallen further this year, but in Japan they have rebounded from their fall and risen rapidly, taking price-earnings ratios to new high

Share prices and P/E ratios

--- Japan
 - - - United Kingdom
 Germany
 ——— United States



Source: Datastream Total Market Indices.

levels, as Japanese investors have preferred to avoid exposure to currency fluctuations by investing in their home market. In both the United Kingdom and the United States share prices rose rapidly in the first quarter, but faltered at the end of March on concern about increased international trade friction.

Announced euronote facilities^(a)

\$ billions

	1985		1986				1987
	Year	Year	Q1	Q2	Q3	Q4	Q1
Committed(b)	33.14	15.31	3.41	6.01	2.52	3.37	0.68
Uncommitted	16.35	54.28	10.72	14.39	14.81	14.36	15.33
Total	49.49	69.59	14.13	20.40	17.33	17.73	16.01
<i>of which:</i>							
Major OECD	29.26	43.46	8.10	13.06	11.71	10.59	9.90
Minor OECD	17.55	23.71	5.43	6.22	5.37	6.69	5.83
Other	2.68	2.42	0.60	1.12	0.25	0.45	0.28
Selected nationalities of borrower							
United States	17.48	18.40	2.08	5.98	5.19	5.15	2.69
France	2.99	4.52	1.25	0.94	1.40	0.93	0.69
United Kingdom	3.82	2.51	0.08	1.23	0.70	0.50	4.15
Australia	7.90	6.87	1.17	1.90	0.50	3.30	1.96
Sweden	4.82	4.35	1.25	0.75	1.00	1.35	0.60

(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.

powers under the Building Societies Act. Facilities for Australian borrowers remained at a high level, at \$2.0 billion.

Most facilities (\$10.9 billion) were denominated in dollars, but there was a significant fall in the dollar's market share, from 96% to 72%. The fledgling medium-term note (MTN) market continued to develop in the first quarter. One MTN programme was arranged, for \$200 million for the Franklin Savings Association of the United States, while seven facilities were arranged that included an option to issue medium-term notes.

International banking developments**Banks in the BIS reporting area (fourth quarter of 1986)**

After unprecedented growth in the third quarter, gross external lending by BIS-area banks in the fourth quarter was \$209 billion, an increase of 7% and another record level of growth. Over 90% was attributable to interbank lending within the reporting area. At end-1986, banks' external assets totalled \$3,221 billion.

The continuing surge in interbank activity was again dominated by business with Japan; interbank positions between banks in Japan and other reporting banks rose by \$124 billion. This continued growth was unusual since some unwinding of Japanese banks' mid-financial-year window-dressing, which had boosted interbank activity in the third quarter, was expected. The high level of activity continued to be driven by Japanese banks' growing involvement in the securities market, the shift of business to centres outside Japan in the wake of liberalising measures, and continuing competition between Japanese banks over balance-sheet size. However, the most significant influence was the opening on 1 December of Tokyo's 'offshore' banking market. Most of the offshore market's growth—its assets reached \$94 billion after one month—was due to the transfer to it of 'onshore' external business, but it also attracted business booked in financial centres outside Tokyo. Even though the market has generated genuine new business—particularly in the opportunities it offers smaller Japanese banking

institutions—the rebooking of external business in the Tokyo 'offshore' market significantly inflated the recorded level of interbank activity within the reporting area as a whole. External interbank business associated with the opening of the new market was largely between related offices of Japanese banks and particularly between banks in Japan and their branches in Hong Kong and Singapore. At end-December 1986, around 15% of the international assets of banks in Japan was booked 'offshore'.

In terms of the currency composition of new external lending, dollar-denominated lending fell back slightly to 64% of the total in the fourth quarter. The percentage of yen-denominated lending almost halved to 12% while deutschmark-denominated lending rose strongly to 10% of new lending. There was little movement in the currency composition of the stock of external assets, with the dollar retaining its 59% share, followed by the deutschmark (13%) and the yen (9%).

The BIS estimate that lending to final users, net of redepositing funds between the reporting banks (but allowing for banks' own use of external funds for domestic lending), was \$50 billion (3%) in the fourth quarter, similar to the increase in the previous quarter. While most of this lending (\$35 billion) was absorbed by reporting-area countries, the volume of lending to outside-area countries was higher than in the third quarter.

Among BIS reporting countries, Japan was by far the largest net taker of funds in the fourth quarter. External

Cross-border business of banks in the BIS reporting area

\$ billions; changes exclude estimated exchange rate effects

	1985		1986				Out-standing at end-1986
	Year	Year	Q1	Q2	Q3	Q4	
Liabilities vis-à-vis:							
BIS reporting area(a)	176.9	360.7	35.3	46.8	123.2	155.6	2,090.3
'Offshore' centres	43.8	127.4	5.6	16.9	54.5	50.4	567.5
Sub-total	220.8	488.1	40.9	63.6	177.7	206.0	2,657.8
Outside reporting area							
Developed countries	3.2	3.8	- 0.5	1.2	3.2	- 0.1	41.6
Eastern Europe	2.8	- 0.1	- 1.0	0.1	- 0.7	1.5	29.4
Oil exporters(b)	7.6	- 22.1	- 6.9	- 7.3	- 2.9	- 5.0	143.8
Non-oil developing countries	5.7	11.4	- 2.2	- 2.0	4.5	7.1	195.3
<i>of which, Latin America</i>	0.4	0.4	0.6	- 0.2	- 1.5	1.5	70.8
Sub-total	19.3	- 7.0	- 10.6	- 4.0	4.1	3.5	410.1
Unallocated(c)	2.5	28.6	6.2	4.7	10.1	7.6	111.5
Total	242.5	509.7	36.5	64.3	191.9	217.1	3,179.5
Assets vis-à-vis:							
BIS reporting area(a)	181.3	366.9	34.9	42.2	129.1	160.7	1,975.9
'Offshore' centres	24.3	91.5	- 1.1	22.3	37.7	32.6	507.0
Sub-total	205.5	458.4	33.8	64.5	166.8	193.3	2,482.9
Outside reporting area							
Developed countries	6.8	4.8	- 0.5	1.7	0.3	3.3	113.9
Eastern Europe	5.7	4.4	- 0.3	2.7	0.7	1.3	73.1
Oil exporters(b)	0.2	- 0.2	- 3.4	0.6	1.6	1.0	116.4
Non-oil developing countries	11.1	0.1	- 4.6	0.1	0.2	4.4	365.1
<i>of which, Latin America</i>	1.7	- 1.6	- 2.3	0.1	- 1.0	1.6	221.8
Sub-total	23.8	9.1	- 8.8	5.1	2.8	10.0	668.4
Unallocated(c)	4.2	9.1	1.6	1.7	0.3	5.5	69.7
Total	233.5	476.6	26.6	71.3	169.9	208.8	3,221.1

(a) Excluding 'offshore' centres.

(b) OPEC plus Oman, Brunei and Trinidad and Tobago.

(c) Includes international institutions.

assets and liabilities of banks in Japan rose by \$57.3 billion and \$78.1 billion respectively. Much of this expansion in the banks' net external borrowing was used to fund purchases of foreign currency bonds and securities by the Japanese non-bank sector. US banks were also net takers of funds (\$6.0 billion), which was to a large extent related to the buoyancy of domestic credit demand. Banks in the Federal Republic of Germany were the major net provider of funds, with external assets increasing by \$14.7 billion and deposits by only \$2.0 billion. There were the usual end-year window-dressing operations in a number of continental European centres, most pronounced for banks in France and Italy.

Lending to countries outside the reporting area experienced a seasonal upturn, rising 2%, compared with a negligible increase in the third quarter. In contrast to the previous quarter these countries were net takers of funds (\$6.5 billion). The largest increase in lending to outside-area countries was to developed countries; the \$3.3 billion of new lending was more than accounted for by Australia and New Zealand. Lending to Latin America was \$1.6 billion. But this was matched by an almost identical increase in deposits, more than accounted for by the \$1.8 billion increase in Mexico's deposits. Lending to Colombia of \$0.6 billion reflected the disbursement of the final tranche of a loan put together in December 1985. Claims on Eastern Europe rose by \$1.3 billion and deposits by \$1.5 billion; the USSR was both the largest borrower and the largest depositor.

There was a \$2.6 billion rise in lending to Asian developing countries. Particularly large increases were recorded for China and India (\$1.1 billion and \$0.7 billion respectively). Reporting banks' claims on South Korea fell by \$2.1 billion, reflecting the sharp improvement in the country's external current account. But the most notable feature within this group of countries was the continuing build-up of Taiwan's deposits, which rose by \$5.1 billion. Conversely, deposits of the oil producers recorded further declines; among the countries showing marked falls were Venezuela (-\$1.8 billion) and Indonesia (-\$1.6 billion).

The London market (fourth quarter of 1986 and first quarter of 1987)

During the fourth quarter, the rate of growth (2%) in the external claims of banks in the United Kingdom returned to levels recorded in the first half of the year, after the exceptional increase in claims of \$45 billion (7%) in the third quarter (during 1986, claims rose by 16%, to total \$715 billion). Growth in the fourth quarter was again dominated by interbank lending to banks in the BIS reporting area. The growth in UK banks' holdings of bonds and FRNs was the lowest quarterly increase during 1986.

Lending to banks in Japan again provided the main impetus for growth, accounting for around two thirds of the growth in UK banks' interbank claims on the BIS reporting area; over 40% of the growth in interbank

liabilities was also with Japan. During the fourth quarter, the Japanese non-bank sector was a net taker of \$1.3 billion from London.

Banks in Germany, in contrast to banks in Japan, were significant net providers of funds to banks in the United Kingdom, increasing their deposits by \$5.2 billion. The German non-bank sector was also the source of a net inflow of funds. There was little movement in deposits with and borrowing from banks in the United States. Business with the 'offshore' banking centres declined, with liabilities falling for the first time since the beginning of 1984.

In the fourth quarter, there was an upturn (2%) in lending to countries outside the BIS reporting area, after virtually no growth in the previous three months. This lending was spread between country groupings but the largest growth

Cross-border business of banks in the United Kingdom

\$ billions; changes exclude estimated exchange rate effects

	1985		1986				Out-standing at end-1986
	Year	Year	Q1	Q2	Q3	Q4	
Liabilities vis-à-vis:							
BIS reporting area(a)	40.9	70.8	12.4	6.8	37.9	13.7	489.0
'Offshore' centres	5.2	10.8	1.6	2.9	8.0	-1.8	107.4
Sub-total	46.1	81.6	14.0	9.8	46.0	11.9	596.4
Outside reporting area							
Developed countries	1.4	0.5	-0.3	0.2	1.4	-0.8	14.4
Eastern Europe	1.3	0.1	-0.3	-0.4	-0.1	0.9	8.1
Oil exporters(b)	1.8	-8.1	-1.9	-1.6	-2.8	-1.8	44.0
Non-oil developing countries	-1.0	2.2	-1.0	0.2	0.8	2.2	41.1
of which, Latin America	-2.2	-0.5	0.6	-0.8	-0.3	-0.1	5.3
Sub-total	3.4	-5.3	-3.5	-1.6	-0.7	0.4	107.6
Unallocated(c)	-0.7	-0.2	0.6	-0.9	-0.1	0.2	36.6
Total	48.9	76.1	11.1	7.3	45.2	12.5	740.5
Assets(d) vis-à-vis:							
BIS reporting area(a)	30.1	70.5	15.3	4.4	37.5	13.4	465.6
'Offshore' centres	-4.4	11.0	0.4	5.7	7.6	-2.6	104.7
Sub-total	25.7	81.6	15.6	10.0	45.1	10.8	570.2
Outside reporting area							
Developed countries	2.3	1.2	0.3	-0.3	-0.1	1.3	36.2
Eastern Europe	3.3	2.3	0.3	1.1	0.4	0.5	19.2
Oil exporters(b)	-0.4	0.3	-0.7	0.8	—	0.2	19.7
Non-oil developing countries	2.8	-0.8	-2.0	—	—	1.1	56.7
of which, Latin America	1.5	0.1	-0.2	-0.3	-0.1	0.7	36.4
Sub-total	8.0	3.0	-2.0	1.7	0.2	3.1	131.8
Unallocated(c)	-1.0	0.3	0.2	0.1	-0.5	0.5	12.5
Total	32.7	84.9	13.8	11.8	44.9	14.4	714.5

(a) Excluding 'offshore' centres.

(b) OPEC plus Oman, Brunei and Trinidad and Tobago.

(c) Includes international institutions.

(d) Securitised lending included only from the first quarter of 1986.

was to the developed countries (4%); Australia and New Zealand were the largest borrowers within the group in 1986 and borrowed \$1.2 billion and \$0.4 billion respectively. Lending to Mexico was \$0.5 billion but deposits also rose, by \$0.3 billion. In 1986, lending to countries outside the BIS reporting area grew by 2%, compared with 7% in 1985. The most active group of borrowers during 1986 was Eastern Europe, particularly the Soviet Union, which borrowed \$1.9 billion from UK banks. Claims on Latin America showed little increase in aggregate. Deposits of the oil exporters fell by \$8.1 billion (18%) over the year, but there was little new lending to these countries.

In the fourth quarter, dollar-denominated lending accounted for about half of total external lending. There was strong growth in both yen and sterling-denominated lending (24% and 19% of the total respectively). Deutschemark-denominated lending declined for the third consecutive quarter.

UK banks' holdings of overseas bonds and FRNs increased by \$1.2 billion in the fourth quarter, the lowest quarterly growth this year. During 1986, banks' holdings of securities rose by 29% from \$36.4 billion at end-1985

Holdings of investments^(a)

\$ billions

	1985		1986		
	Q4	Q1	Q2	Q3	Q4
Total holdings	36.4	38.2	41.9	45.9	47.1
of which issued by:					
BIS reporting area	29.6	30.5	33.6	37.4	38.4
'Offshore' banking centres	1.6	1.7	2.1	2.0	2.1
'Other' developed countries	2.2	2.6	2.7	3.2	3.4
Eastern Europe	0.1	0.2	0.1	0.2	0.1
Oil exporters	0.3	0.3	0.3	0.3	0.4
Non-oil developing countries	1.7	1.8	1.7	1.8	1.8
International organisations	1.0	1.1	1.3	0.9	1.0

(a) With a contractual repayment date.

to \$47.1 billion. Most of the increase in holdings during the year was in securities issued by institutions located in the BIS reporting area. At end-December 1986, 86% of the overseas bonds held by banks in the United Kingdom represented claims on residents of BIS reporting area countries and the 'offshore' centres. The bonds of non-oil developing countries represented only 4% of the total.

In the first quarter of 1987, international lending of UK banks rose by 3% to \$990 billion. Around half of this lending was in foreign currency to UK residents, notably to non-banks, whose borrowing increased by 15%. Lending to overseas residents was principally interbank. There was a slight decline in holdings of overseas bonds and FRNs, the first portfolio contraction in the last three years.

UK banks' international deposits grew by 3%. Around two thirds of funding came from overseas residents, mainly from unrelated banks; there was a decline in funding from banks' offices. Deposits from UK residents were predominantly interbank.

Around half the increase in international lending and deposits in the first quarter was accounted for by Japanese banks (although this represents a smaller share than in recent quarters); only a quarter of their lending was to offices in other financial centres (again a notably smaller share than in recent quarters). Their funding was largely achieved through the interbank market.

British banks' international lending increased by 3%, driven by the foreign currency borrowing requirements of UK non-banks; funding for this lending came from banks overseas. American banks' business, having contracted in the final quarter of last year, grew by around 1%.

Foreign exchange and gold markets

This section reviews the three months to end-March.

Over the period under review, the dollar fell back further to a 6½-year low against the deutschemark and a post-war low against the yen on continuing concern about the US trade deficit. It fluctuated nervously ahead of the meeting of Finance Ministers in Paris in February: the agreement reached at that meeting helped steady the dollar until late March, when it fell sharply against the yen on concerns about trade frictions. The realignment of the EMS on 12 January was initially greeted cautiously but the system subsequently remained quiet, with the Danish krone at the top and the Belgian franc mostly at the bottom.

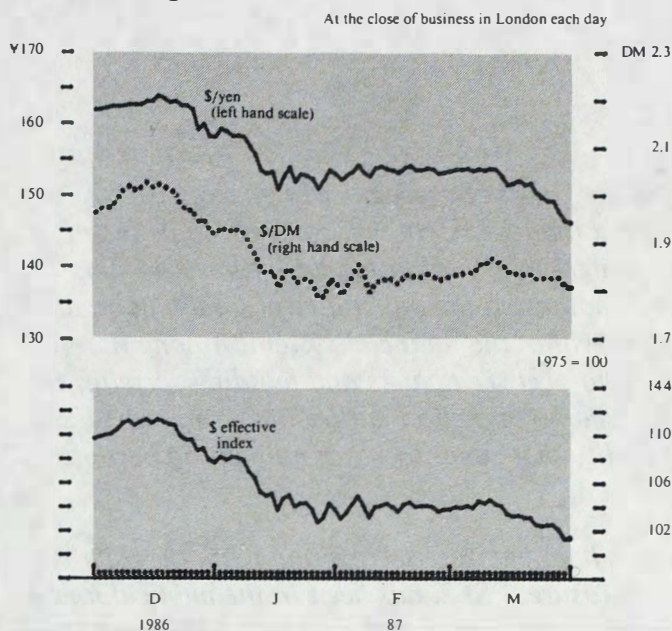
US dollar

The dollar fell to a 6-year low of DM1.9140 on 2 January in response to the very weak preliminary trade figures for November (a record \$19.2 billion deficit), released on New Year's Eve, which called into question hopes that the external imbalance had begun to improve and added to concerns about the US economy. Central bank support brought some stability ahead of the EMS realignment on the weekend of 11-12 January but the dollar then dropped sharply, to DM1.8032. This fall reflected disappointment that the expected reflux of funds from the deutschemark had not occurred and reports that the US authorities favoured lower levels for the dollar. However, the market became increasingly hopeful that intergovernmental agreement to stabilise the dollar would be reached: in particular, the dollar rallied briefly on hopes that the meeting on the evening of 21 January between US Secretary Baker and Japanese Finance Minister Miyazawa would build upon the agreement between Japanese and US officials of the previous autumn. The dollar then fell back on disappointment at the outcome of the meeting, touching DM1.7665 on 28 January, a 6½-year low.

Hopes of an early G5 meeting provided underpinning for the dollar from late January and it remained above its January lows throughout February. Improvements in economic and business statistics released in January and early February (notably those showing improvement in the trade deficit, industrial activity and employment) gradually reduced bearish sentiment, and the dollar was also helped by indications in early February that US officials agreed that it had fallen far enough.

The Louvre accord of 21-22 February between the Finance Ministers of the Group of Five countries and Canada brought agreement to co-operate closely to foster stability of exchange rates around current levels. Although the markets greeted the accord cautiously, they were reluctant to test the central banks' resolve and the dollar steadied after the meeting. Helped by more encouraging US statistics released in early March, the dollar strengthened to around DM1.87, which the markets saw as perhaps the upper limit of an agreed range. The dollar then eased on profit-taking; and when the US authorities again indicated that there was no precise exchange rate target the dollar fell back sharply against the yen and

Dollar exchange rates



eased against other currencies. This reflected market fears that the US authorities might allow a further depreciation in response to Congressional pressures for trade protection and growing concern that trade frictions between Japan and the United States could undermine the Louvre accord. The dollar fell to a post-war low of ¥144.70 on 30 March, but was supported by central bank intervention. The dollar finished March at 4 $\frac{3}{4}$ % below the rate prevailing against the yen in New York at the close of business on 20 February (just before the Louvre accord) and 3 $\frac{3}{4}$ % down against the deutschemark. Over the first quarter of the year, the dollar fell 6% against the deutschemark to DM1.8060, by 7 $\frac{1}{2}$ % against the yen to ¥146.17 and by 6% in effective terms to 101.4.

EMS

Tensions in the EMS evident in December intensified early in January as the deutschemark strengthened against the dollar and speculation about an imminent realignment increased, in part reflecting the diminished likelihood of an early reduction in German interest rates. The EMS narrow band remained fully stretched until the realignment of 12 January, despite heavy central bank support for weaker currencies and increases in interest rates in France, Belgium and Denmark.

The realignment involved a 3% revaluation of the deutschemark and the guilder and a 2% revaluation of the Belgian franc (these changes were relative to bilateral central rates against a selected EMS currency, in this case the lira). The realignment was initially regarded by the market as inadequate and the expected reflux of speculative funds out of the deutschemark did not immediately occur; indeed, funds continued to flow from the dollar to the deutschemark. The realigned narrow band quickly widened to over 1%, with the French franc at the top and the Irish pound (affected by concern over the

budget deficit) at the bottom. By late January the band had widened to nearly 2% and for the rest of the period it remained roughly 1 $\frac{1}{2}$ % to 2% wide, with the Danish krone at the top of the system, and the Irish pound and Belgian franc alternating at the bottom. Confidence in the realignment gradually increased and the system remained relatively quiet, helped by the periods of dollar stability. A reflux of funds out of the deutschemark occurred in February and March, notably into the lira and the French franc.

After the realignment, the deutschemark gradually moved to a position in the lower half of the new EMS band and in February and March stayed broadly in line with other EMS currencies. On 22 January, the Bundesbank announced reductions of $\frac{1}{2}$ % in both discount and Lombard rates but also took measures to absorb the increase in bank liquidity resulting from the earlier interventions within the EMS. The realignment allowed the French franc to establish itself in the upper part of the narrow band, aided by good foreign trade results and confirmation of a slowdown in inflation at the end of 1986. The lira benefited from reflows of funds after the realignment but, after a $\frac{1}{2}$ % reduction in the Banca d'Italia's discount rate and the introduction of a 25% reserve requirement on banks' foreign currency liabilities, eased in March to within the narrow band.

Other currencies

The yen strengthened against the dollar in early January and again in late March, but the dollar/yen rate remained relatively stable in the intervening period, influenced by the Baker/Miyazawa meeting on 21 January and the Louvre agreement. The yen eased in January against the strong deutschemark to a low of about 85 yen to the mark, which was close to the low for 1985-86, but then firmed slightly in February. The yen strengthened noticeably in March to finish at ¥80.9. The yen's effective rate rose over the first quarter of the year by 5% to 217.7, largely as a result of the rise of 7% against the dollar.

The Swiss franc improved by 2% in effective terms in January mainly reflecting the weakness of the dollar, which reached a 7-year low against the franc. The Swiss franc then steadied and finished March only slightly higher, at 3% above its value at end-December.

Gold

Gold rose strongly in January and early February under the influence of the weakening dollar to a peak of \$422.25 at the afternoon fixing on 19 January, but then eased as the dollar improved and some producer selling emerged. The gold price eased further in February on lower platinum prices and, as investment interest declined, fell to a low of \$390 on 18 February. It then recovered, initially partly reflecting concerns over Brazilian debt, and improved in March to a peak of \$424 on 30 March, partly helped by a rally on the silver market. Over the quarter, gold increased by \$30.10 to finish at \$421.