International financial developments

In the first three quarters of 1987, there was little evidence of any substantial correction in current account imbalances between the three major industrial countries in dollar terms, despite improvements in volume trends in response to exchange rate adjustments. Capital account flows were increasingly concentrated among the major industrial countries, and were characterised by increased volatility of private capital flows, associated with fluctuations in exchange and interest rates and periods of substantial official exchange market intervention.

In October, market reactions to poor US trade figures triggered heavy falls in equity prices on world markets and a further sharp fall in the dollar. Under the influence of the stock market crash and the ensuing uncertainty, activity in the international capital markets was sharply lower in the fourth quarter. Issues of equity-related bonds, in particular, were reduced to very low levels, while increased tiering of rates and greater emphasis on credit quality were apparent in other market sectors. Conditions in the foreign exchange markets were at times highly volatile, influenced by perceptions of progress towards reducing the US fiscal deficit. Between end-September and end-December, the dollar fell by 17¼% against the yen and 14⅝% against the deutschemark, and by 11⅜% in effective terms.

Balance of payments positions

Current account imbalances within the three major economies remained high in dollar terms over the first three quarters of 1987, and showed little sign of any substantial correction. The US deficit rose from $38 billion in the fourth quarter of 1986 to $43 billion in the third quarter of 1987. Over the same period, the Japanese surplus fell from $24 billion to $20 billion, but the German surplus rose very slightly from $10 billion to $11 billion. Trends in trade volumes, in part reflecting changes in competitiveness due to exchange rate movements, have tended to narrow these imbalances, but have been offset by associated changes in the terms of trade. A deterioration in the terms of trade over the first three quarters of last year contributed to the emergence of deficits in Italy and France, although in Italy strong import volume growth was a further relevant factor. Rapid growth in imports was also responsible for the move into deficit of the UK current account over this period. In Canada, the deficit in 1987 is estimated to have been broadly the same as in 1986. The smaller European countries in aggregate also look set to report a deficit for last year. Surpluses of the newly industrialising countries in Asia, particularly Taiwan and South Korea, continued to increase in 1987.

The marked strengthening in the combined current account position of the OECD countries that occurred in 1986, and the corresponding deterioration in OPEC's current account, were partially reversed in the first nine months of 1987. Continued import restraint by most OPEC countries, in conjunction with a recovery in the oil price, has brought about a significant reduction in the aggregate OPEC deficit.

World current accounts[a]
$ billions; *seasonally adjusted*

	1985	1986(b)			1987(b)		
	Year	Year	Q3	Q4	Q1	Q2	Q3
OECD economies:							
Canada	- 1	- 7	- 2	- 2	- 2	- 2	- 2
France	—	3	1	1	—	- 1	- 1
Germany	16	38	12	10	11	11	11
Italy	- 4	4	3	2	—	- 1	—
Japan	49	86	24	24	25	21	20
United Kingdom	4	- 1	- 1	- 1	1	—	- 2
United States	-118	-141	-37	-38	-37	-41	-43
Major economies	- 53	- 19	—	- 5	- 2	-13	-18
Other OECD	—	- 3	—	—	- 1	- 1	- 2
Total OECD	- 53	- 22	—	- 5	- 3	-14	-20
OPEC economies	4	- 34	-10	- 9	- 8	- 6	- 4
Non-OPEC developing economies	- 21	- 4	1	2	- 1	1	—
Other economies(c)	3	2	1	2	1	1	1
World discrepancy(d)	- 66	- 59	- 8	-10	-11	-19	-23

(a) Components may not add to totals because of 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).

In the first half of 1987, the current account of the non-OPEC developing countries improved by $8 billion compared with the first half of 1986. However, most of this strengthening occurred in the second half of 1986, and on a seasonally-adjusted basis there may have been no improvement in the first half of 1987, when these countries' current account was in balance overall. The improvement (compared with a year earlier) is more than explained by the strength of the trade accounts of China, Mexico and the newly industrialised countries in Asia. The terms of trade for the group as a whole improved marginally over this period, with the gains explained largely by an improvement in export volumes, which showed a rise of 8% in the second quarter while import volumes stagnated (compared with a year earlier). Net capital inflows reached $18 billion in the first half of the year, driven largely by concessionary and official flows; commercial borrowing remained subdued. Reserves increased by some $20 billion in the first six months of 1987, compared with a reduction of $1 billion over the same period in 1986. But Taiwan's reserves rose by about $14 billion in the first half of 1987, implying that, overall, the remaining countries in the group increased their foreign reserves by $6 billion. In the third quarter of 1987, non-OPEC developing countries' foreign exchange reserves increased by just $4 billion—the lowest increase for over a year, partly a reflection of debt prepayments by South Korea and Malaysia.

Non-OPEC developing countries' balance of payments

$ billions; *not seasonally adjusted*

	1985	1986(a)				1987(a)	
	Year	Year	Q2	Q3	Q4	Q1	Q2
Current account	**-21**	**- 4**	**- 1**	**1**	**—**	**-2**	**5**
Capital account	**23**	**19**	**4**	**4**	**10**	**8**	**9**
of which:							
Concessionary and other official flows	21	20	5	5	5	6	6
Direct investment	10	10	2	2	3	4	4
Borrowing from banks(b)	11	1	—	—	6	—	1
Borrowing via bond issues (gross)	7	3	1	1	—	1	—
Other capital flows(c)	-26	-15	-4	-4	- 4	-3	- 2
Official financing balance	**1**	**16**	**4**	**5**	**10**	**7**	**14**
of which:							
Use of IMF credit	1	- 1	-1	—	—	-1	—
Liabilities to other CMIs	—	—	—	—	—	—	—
Reserves etc (increase -)	- 2	-15	-3	-5	-10	-6	-14

(a) Data include Bank estimates.

(b) Net: adjusted to exclude valuation effects.

(c) Including trade credit extended by developing countries and net errors and omissions.

Oil exporting countries continued to run a current account deficit ($4.1 billion) in the third quarter, bringing the total for the first three quarters of 1987 to $18.3 billion. Information about the movement of these countries' assets is at present only partially identifiable by host country, but it appears that there was net investment in the United Kingdom over the quarter ($1.4 billion, largely government paper) and in the United States ($1.5 billion, largely bank deposits). Partial information suggests a sharp fall in investment in other industrial countries.

Identified deployment of oil exporters' funds(a)

$ billions

	Sept. 1986 levels	1986 Q4	1987 Q1	1987 Q2	1987 Q3(b)	Sept. 1987 levels(b)
Industrial countries						
United Kingdom:						
Sterling bank deposits	6.1	-0.1	0.3	-0.1	0.4	7.2
Eurocurrency bank deposits	39.4	-1.7	-2.6	2.3	-0.4	37.4
Government paper	4.0	0.8	0.5	-0.4	1.2	6.8
Other investments	7.3	0.2	0.2	0.1	0.2	11.7
	56.8	-0.8	-1.6	1.9	1.4	63.1
Other EEC:(c)						
Domestic currency bank deposits	5.8	-0.1	—	0.2	..	..
Eurocurrency bank deposits	19.3	-1.6	0.8	1.4	..	..
Other investments	60.9	0.8	0.6	0.6	-0.2	70.7
	86.0	-0.9	1.4	2.2	-0.2	70.7
United States:						
Bank deposits	22.1	-1.4	-0.7	0.7	2.5	23.4
Government paper	26.8	-2.2	-2.3	-0.9	0.3	21.7
Other investments	25.8	-0.8	-0.3	-0.8	-1.3	22.6
	74.7	-4.4	-3.3	-1.0	1.5	67.7
Other:						
Domestic currency bank deposits	5.2	-0.7	0.3	-1.4	..	..
Eurocurrency bank deposits	25.9	-1.3	2.6	1.3	..	..
Other investments	47.0	0.6	-0.7	-1.7	-7.5	38.1
	78.1	-1.4	2.2	-1.8	-7.5	38.1
Offshore centres:						
Bank deposits	40.8	0.8	1.7	2.8	..	..
Placements with ldcs	59.5	—	—	—	—	59.5
OEC credit to non-banks	12.0	0.2	0.2	0.3	—	12.7
IMF and IBRD(d)	39.0	-0.4	0.7	-0.8	-0.2	39.9
Total identified additions(+)/reductions (-) in deployed assets	**446.9**	**-6.9**	**1.3**	**3.6**	**-5.0**	..
Net funds available for deployment		-8.7	-7.4	-4.5	..	
of which:						
Net movements in external borrowing etc		*0.5*	*0.6*	*1.7*	..	
Current balance		*-9.2*	*-8.0*	*-6.2*	-4.1	

.. not available.

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

(b) Provisional.

(c) Includes Spain and Portugal.

(d) Includes holdings of gold.

Capital accounts

This section reviews capital account developments in the three largest industrial economies in the third quarter of 1987.

During the course of 1987, capital account flows were increasingly concentrated among the major developed countries. This was accompanied by an increase in the volatility of private capital flows which was in turn associated with fluctuations in exchange and interest rates and periods of substantial official exchange market intervention.

Attention focused on the size and composition of the funding of the US current account deficit and the balance between private and official flows. The net surplus on the US capital account rose from $34 billion in the second quarter to $43 billion in the third. The counterpart to this increase was a rise in total net capital outflows from Japan and, to a lesser extent, Germany. In addition to an increase in the net imbalance on capital accounts within these countries, the third quarter witnessed a change in the composition of funding of the US deficit and in the mix of capital flows from Japan and Germany.

During the first half of 1987, private sector financing accounted for around 60% of net capital flows to the United States (compared with 75% in 1986); private overseas investors were net sellers of US Treasury securities. US liabilities to the authorities of other countries are estimated to have increased by around $20 billion over this period. This may, however, understate the degree of intervention to support the exchange value of the dollar as, for example, the US reporting system excludes foreign central bank holdings of eurodollars. The official reserves of the other G7 countries rose by $49.4 billion; Japan accounted for a little over half of this increase.

Capital accounts of the G7 countries, 1985–87Q3

$ billions, *not seasonally adjusted*
(Inflow+/Outflow−)

	1985	1986	1987 Q1	Q2	Q3
Capital account balance(a)					
United States	120	112	14	34	43
Japan	−49	− 71	− 5	−12	−18
Germany	−15	− 36	− 2	− 8	− 8
France	2	− 2	1	− 2	..
United Kingdom	− 2	6	2	9	2
Italy	− 3	− 3	5	− 1	..
Canada	5	10	3	2	2
Portfolio investment					
United States	64	75	16	14	9
Japan	−43	−102	−23	−37	− 8
Germany	2	25	10	4	− 4
Monetary sector					
United States	40	18	12	− 1	28
Japan	− 4	46	17	26	−11
Germany	− 9	− 27	− 6	− 7	3
Direct investment					
United States	2	− 3	− 2	4	2
Japan	− 6	− 14	− 3	− 4	− 5
Germany	− 4	− 8	− 3	− 2	− 1
Other					
United States	14	22	−12	17	4
Japan	4	− 1	4	3	6
Germany	− 4	− 26	− 3	− 3	− 6
Official financing balance					
United States	2	29	−19	− 7	2
Japan	—	15	16	11	3
Germany	—	2	8	3	− 1
France	2	1	− 1	− 2	..
United Kingdom	2	4	2	7	—
Italy	− 7	1	4	− 2	..
Canada	− 4	− 3	—	− 1	2
Change in reserves(b) (increase +)					
United States	4	—	− 2	− 3	—
Italy	− 7	2	4	− 2	− 2
Canada	—	1	4	− 2	1
US liabilities to the authorities of industrial countries (increase +)	*2*	*29*	*17*	*4*	*− 2*

.. not available.

(a) Includes estimates. Capital account balances include balancing items and unclassifiable transactions.

(b) Where not the reverse of the official financing balance.

In the third quarter, private overseas capital flows assumed a larger share of financing of the US current account deficit. This coincided with increases in the exchange value of the dollar during July and in long-term interest differentials between the United States and Germany and between the United States and Japan. Official intervention was modest compared with earlier quarters, despite a weakening of the dollar during August. US liabilities to the authorities of industrial countries declined by $2.4 billion. The counterpart to this was a rise of only $0.9 billion in the reserves of the other G7 countries.

Net inflows of capital through banks in the United States fell sharply during 1986 and the first half of 1987. During the second quarter of 1987 there was a small net outflow caused by a rise in US lending to overseas interbank markets, which was associated with a more rapid increase in short-term eurodollar interest rates than in domestic interest rates. During the third quarter this interest rate differential was reversed and net inflows to banks in the United States resumed. Liabilities to private foreigners and international financial institutions rose by $49 billion, compared with $15 billion in the second quarter.

On the portfolio account during the third quarter there were net sales of US stocks by foreigners and of foreign stocks by US residents. Overall, the net portfolio inflow fell by $5 billion to $9 billion. New bond issues overseas by US borrowers increased by $1 billion to $6.4 billion, but remained well below the quarterly average for 1986 ($10.25 billion).

During the third quarter, there was a significant change in the pattern of Japanese and German capital flows. In 1986 and the first half of 1987, the Japanese capital account was characterised by a net outflow of long-term funds and a net inflow of short-term liabilities, which typically took the form of dollar bond holdings funded from the short-term eurodollar market. In Germany, by contrast, there was a large net long-term inflow and short-term outflows via the banking system.

In the third quarter, long-term capital outflows from Japan fell to the lowest level since the first quarter of 1986. Portfolio account outflows totalled $8.4 billion compared with $36.5 billion in the second quarter. In contrast, the banking sector switched from being a net importer of capital to a net exporter, with an outflow of $11 billion. Germany, by contrast, became a net exporter of long-term capital during the third quarter. This was presaged during the second quarter, when long-term net capital inflows fell to under $0.2 billion from a quarterly average of $4 billion in 1986. This fall was mostly accounted for by overseas investors: foreign investment in German securities fell to its lowest level for more than three years, with net sales of German bonds for the first time since the abolition of coupon tax in 1984, although non-resident investors continued to be net purchasers of German stocks during the third quarter. The banking sector had a net capital inflow totalling $3.1 billion, the first such inflow for two years.

At this stage it is difficult to assess the impact of events during the fourth quarter on capital account balances. Three developments seem likely to emerge. First, the fourth quarter witnessed a large scale resumption of official intervention in the exchange markets (Japanese reserves rose by $9.7 billion in the fourth quarter). Second, the fall in the exchange value of the dollar was accompanied by a steepening of the yield curve in the United States. Third, the fall in world stock market prices was accompanied by a withdrawal of foreign funds from equity markets. In Japan, foreign disinvestment in Japanese equities totalled $21 billion in October and November, compared with $9.6 billion in the third quarter as a whole.

International capital markets

Under the influence of the stock market crash, new international borrowing activity in the fourth quarter was sharply lower than in the third. Demand for funds among corporate borrowers declined, as economic uncertainty dampened investment financing. In addition, there was some evidence of a shift in borrowing back to domestic markets. There was also a marked change in the pattern of financing. Issues of equity-linked bonds fell to insignificant levels following 19 October, while straight bond issues declined to levels not observed since 1984. By contrast, arrangement of syndicated credits and announcements of new euronote facilities remained steady. Issuance of floating-rate notes increased, though remaining at a relatively low level.

During the first three quarters of 1987, the rate of growth of intermediation through securities markets was already declining. The contraction of the eurobond market in 1987 has been linked to several developments, notably the collapse of the FRN market at the end of 1986, the rise in long-term interest rates in the second and third quarters of 1987 and the equity market crisis of October 1987. These developments weakened successively the floating-rate note, straight fixed-rate and equity-linked sectors of the eurobond market. In the immediate aftermath of the crash, the uncertainty created by the volatility in equity markets spread to the eurobond market. There was a decline in secondary market liquidity and a virtual cessation of new issue activity. Concerns about prospects for corporate borrowers led to an increase in tiering of yields according to credit quality. Investors too were discouraged by the decline in liquidity in eurobonds and there were signs of a shift to more liquid assets, particularly domestic government bonds and bank deposits. As a result, the volume of financing in the fixed-rate bond sector remained at low levels despite the fall in long-term interest rates.

The revival of syndicated credits during 1987, although partly associated with a reassessment of risks by investors in the eurobond market, has also been linked to developments in the credits market itself. In particular, the development of syndicated multiple-option facilities has offered borrowers a larger number of options for drawing funds, ranging from bank loans to money-market instruments. The return to syndicated lending does not, therefore, necessarily entail a resurgence of traditional bank lending.

Fixed-rate bonds

Issues of fixed-rate bonds fell from $39.7 billion in the third quarter to $21.7 billion in the fourth, the lowest level since 1984. Issues of equity-linked bonds—previously the most buoyant sector of the eurobond market—virtually ceased after 19 October, while straight fixed-rate bond issuance fell from $22.5 billion to $19.1 billion.

(i) Straight fixed-rate issues

The decline in issuance of straight fixed-rate bonds, already apparent in the first three quarters of 1987, continued in the fourth. After 19 October, the increased tiering of bond yields which had become apparent discouraged issuance by lower-quality borrowers. Borrowing by industrial and commercial companies declined by around 40% to $4.4 billion. By contrast, public sector borrowers from a number of more highly rated OECD countries benefited from the decline in

Announced international bond issues[(a)]

$ billions

	1985	1986	1987 Year	Q1	Q2	Q3	Q4
Fixed-rate bonds							
Straights	96.6	146.0	119.3	49.4	28.3	22.5	19.1
Equity-related bonds	11.6	26.7	43.3	7.8	15.7	17.2	2.6
of which:							
Warrants	*4.3*	*19.2*	*25.6*	*3.7*	*10.2*	*10.5*	*1.2*
Convertibles	*7.3*	*7.5*	*17.7*	*4.1*	*5.5*	*6.7*	*1.4*
Total	**107.8**	**172.4**	**162.6**	**57.2**	**44.0**	**39.7**	**21.7**
Floating-rate notes	**55.9**	**47.8**	**12.0**	**2.7**	**1.7**	**2.5**	**5.1**

(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.

long-term interest rates, increasing their activity by around 20% to $4.5 billion. Issues by these public sector borrowers are longer and generally more liquid.

Under the influence of exchange rate volatility, the share of dollar-denominated issues continued to decline, reaching 21%, compared with 35% in the third quarter. Even more precipitous declines were observed in the high-coupon Australian dollar sector and the Canadian dollar market. By contrast, the deutschemark, Swiss franc and sterling sectors showed buoyancy, investors being attracted by expectations of currency appreciation and falling interest rates.

(ii) Equity-related issues

New issues in the equity-linked sector fell sharply from $17.2 billion to $2.6 billion. The stock market collapse rendered these issues unattractive to investors, and as a result, prices fell sharply. Indeed, for a few days following 19 October, the secondary market for equity-linked issues came to a virtual standstill as the market was

Announced fixed-rate bond issues: fourth quarter 1987

$ billions; *percentages in italics*

	Straight	Equity related
Borrower:		
Major OECD countries	10.2	2.5
of which:		
United States	0.6	0.2
Japan	2.1	1.7
Minor OECD	5.1	0.1
International institutions	3.3	—
Other	0.5	—
Total	**19.1**	**2.6**
Currency:		
US dollars	*20.6*	*50.3*
Swiss francs	*22.4*	*32.7*
Yen	*15.3*	—
Sterling	*9.9*	*10.1*
Australian dollars	*0.7*	—
Other	*31.1*	*6.9*

overwhelmed by sell orders and many of the underlying stocks were not trading actively on the Tokyo Stock Exchange. Most issues that had been planned for the period following the crisis were withdrawn. Although there was some recovery in prices in the Japanese equity warrant market late in the year, no revival in issuance occurred—no warrant issues and only one convertible issue were recorded between 19 October and the end of the year.

Floating-rate notes

Issuance of floating-rate notes (FRNs) rose in the fourth quarter from $2.5 billion to $5.1 billion, the highest level observed since the crisis in the perpetual FRN market at the end of 1986. The higher level of activity was largely accounted for by increased borrowing by central governments and industrial firms, the latter having switched some of their demand for funds out of the fixed-rate market. Provided that borrowers were of sufficiently high credit quality, FRNs were seen as attractive to lenders in the context of interest rate uncertainty prevailing in the fourth quarter.

Euronotes and other facilities

New announcements of euronote facilities totalled $16 billion in the fourth quarter. This represented a decline from the peak observed in the second quarter, though activity remained relatively buoyant compared with the fixed-rate eurobond market. Some deceleration in announcements was to be expected as the market matured. In addition, some borrowers have been attracted to syndicated multiple-option facilities. Figures from Euro-Clear suggest that the stock of notes outstanding also declined slightly in the fourth quarter to $53 billion at end-December, after a peak of $56 billion at end-October.

Announced euronote facilities[a]

$ billions

	1985	1986	1987				
	Year	Year	Year	Q1	Q2	Q3	Q4
Committed(b)	33.3	15.2	3.6	0.7	0.4	1.0	1.5
Uncommitted	17.0	55.6	66.5	15.0	20.6	16.4	14.5
Total	**50.3**	**70.8**	**70.1**	**15.7**	**21.0**	**17.4**	**16.0**
of which:							
Major OECD	*29.5*	*44.0*	*45.6*	*9.6*	*15.5*	*10.0*	*10.5*
Minor OECD	*18.1*	*24.0*	*22.6*	*5.9*	*5.2*	*6.5*	*5.0*
Other	*2.7*	*2.8*	*1.9*	*0.2*	*0.3*	*0.9*	*0.5*
Selected nationalities of borrower							
United States	16.5	18.5	15.0	2.3	7.6	4.3	0.8
United Kingdom	3.6	2.6	9.1	4.2	1.3	1.5	2.1
Australia	7.9	6.9	7.9	2.3	1.9	2.5	1.2
Japan	0.5	10.4	10.0	0.7	4.4	2.3	2.6

(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, eurocommercial paper programmes and medium-term note programmes).

(b) Underwritten or otherwise backed by bank commitments.

Eurocommercial paper (ECP) continued to be the dominant instrument, and there were few announcements of euro medium-term note (EMTN) programmes. Most facilities were still denominated in dollars (77%) though many incorporated multiple-currency options. Non-financial corporations made increased use of the market compared with the third quarter, while announcements by banks fell sharply. Banks, together with sovereign borrowers, were among the first borrowers to enter the market, and the decline in bank announcements may thus partly have reflected the maturing of the market.

Syndicated credits

Arrangement of syndicated credits in the fourth quarter ($25.9 billion) remained at the high level observed in the third, despite the economic uncertainty caused by the equity market crisis and the absence of individual credits comparable in size to the £5 billion facility arranged for Eurotunnel. This performance confirmed the resurgence of this market from the low levels observed after the onset of the LDC debt crisis. The fourth quarter was characterised by a large number of small to medium-sized deals, indicating that the sector's recovery was broadly based. Aided by the flow of funds to the banking sector, the market continued to be characterised by intense competition. This enabled some borrowers to obtain funds as cheaply as Libor.

Announced eurocurrency syndicated credits

$ billions

	1985	1986	1987				
	Year	Year	Year	Q1	Q2	Q3	Q4
Major OECD	5.1	11.6	59.9	9.5	8.6	22.6	19.2
Minor OECD	4.4	6.5	14.9	5.0	3.6	1.9	4.4
Developing countries	5.6	7.8	7.5	1.6	1.5	2.4	2.0
Eastern bloc	3.6	2.3	1.9	0.8	1.0	0.1	—
Other	0.3	1.5	3.2	0.8	1.8	0.3	0.3
Total	**19.0**	**29.7**	**87.4**	**17.7**	**16.5**	**27.3**	**25.9**
of which, transferable	*3.9*	*3.3*	*2.6*	*0.4*	*0.8*	*0.5*	*0.9*

Non-financial firms from OECD countries, notably those from the United Kingdom, the United States and France, continued to be the largest borrowers. Credits for highly rated non-financial firms were often oversubscribed. This led in some cases to increases in the size of loans during syndication. The geographical distribution of borrowers in the fourth quarter can partly be attributed to the underlying economic growth in North America and the United Kingdom, together with the restructuring of traditional lines of bank finance into multiple-option facilities which took place in France. Minor OECD countries doubled their borrowing from $1.9 billion to $4.4 billion in the fourth quarter, Turkish and Swedish borrowers were particularly active. NICs, the Eastern bloc and LDCs were marginal participants in the market.

The US dollar returned in the fourth quarter to being the most widely-used currency for syndicated lending, with 56% of loans, followed by sterling (25%). Yen credits remained insignificant (0.7%).

International banking developments

This section covers developments in the London markets in the third and fourth quarters of 1987; the BIS international banking figures for the third quarter were not available at the time of publication.

The London market

During the third quarter of 1987, UK banks' external claims rose by $28.3 billion (4%); although this was more rapid than in the previous quarter, growth in the first three quarters of 1987 remained below that of the same period in 1986. With UK residents repaying foreign currency borrowing, external liabilities rose less rapidly than assets, so that banks in the United Kingdom were net suppliers of funds overall; however, the pattern of recent quarters continued, with banks in the United Kingdom being net lenders to banks abroad while drawing on non-banks for funding.

In line with the aggregate flows, banks in Japan were net suppliers of funds, but this was as much a result of a lower rate of borrowing from the banks in the United Kingdom as of increased deposits with them. The borrowing was largely in yen, there being some repayment of dollar borrowing; deposits from banks in Japan were much more evenly split between dollars and yen. Non-banks in Japan continued to borrow heavily ($2.9 billion, again largely in yen) but this was not sufficient to offset the banks' position, so that overall there were net outflows from Japan to the United Kingdom through the banking system, for the first time since the second quarter of 1986.

With US domestic interest rates higher than eurodollar rates, banks in the United Kingdom substantially increased their lending to banks in the United States ($14.3 billion); liabilities rose by only $2.0 billion, so that banks in the United States were net takers of $12.4 billion from banks in the United Kingdom, compared with only $1 billion in the previous quarter. Non-banks in the United States, on the other hand, continued to be net suppliers of funds to the London market, but at a lower rate than in the second quarter, so that in aggregate there were net inflows to the United States through the banking system in the third quarter.

There was also a change in the direction of flows with German residents. German banks' deposits with UK banks actually fell, this being more than accounted for by deposits in deutschemarks. Although there was a sharp increase in deposits from non-banks, German residents in aggregate were net takers of funds, a reversal of the pattern which had been established from end-1984.

Lending to countries outside the reporting area fell in the third quarter, though much of this was accounted for by the developed countries, with Australia prominent. However, the only increase in claims was to Eastern European countries; they were the only group to borrow in the first three quarters of 1987, much of the lending going to the USSR. Outside-area countries' deposits increased by $2.3 billion in the third quarter, much less than the sharp rise in the second, but they remained net providers of funds. In the first nine months of 1987 they were net suppliers of $13.6 billion, whereas in 1986 as a whole they were net takers of $8.7 billion. Oil exporters' deposits rose more slowly than in some recent quarters. Recorded lending to the non-oil developing countries continued to fall, the drop in the third quarter being fairly well spread.

Almost all the increase in new lending by banks in the United Kingdom in the second quarter had been dollar-denominated, but such lending dropped back sharply in the third quarter. There was some revival in deutschemark and sterling lending, but nearly a third of new lending was in yen. At end-September, yen-denominated lending accounted for 10% of the total outstanding, its share having doubled since the end of 1985. About two thirds of this lending is to Japanese residents; other notable recipients are the offshore centres, especially Hong Kong and Singapore.

Cross-border business of banks in the United Kingdom

$ billions: changes exclude estimated exchange rate effects

	1985	1986		1987			Outstanding at end-Sept. 1987
	Year	Year	Q4	Q1	Q2	Q3	
Liabilities vis-à-vis:							
BIS reporting area	39.2	67.4	12.2	14.5	28.9	17.3	560.9
'Offshore' banking centres	4.5	10.1	- 1.9	- 1.4	2.4	3.0	113.5
of which:							
United States	*11.1*	*10.1*	*- 2.7*	*3.4*	*16.2*	*7.4*	*172.1*
Japan	*8.2*	*28.4*	*4.9*	*2.3*	*4.5*	*9.7*	*77.4*
Sub-total	43.7	77.4	10.3	13.0	31.3	20.3	674.4
Outside reporting area							
Developed countries	1.2	0.2	- 1.0	0.8	1.8	1.4	18.9
Eastern Europe	1.2	—	0.9	- 1.1	0.1	0.3	7.6
Oil exporters	1.3	- 8.5	- 1.8	- 2.6	2.2	—	44.7
Non-oil developing countries	- 1.2	2.1	2.1	1.7	5.9	0.5	49.9
of which, Latin America	*- 2.2*	*- 0.5*	*- 0.1*	*0.2*	*3.0*	*0.5*	*8.6*
Sub-total	2.5	- 6.2	0.3	- 1.2	10.1	2.3	121.1
Unallocated	- 5.7	21.7	5.0	6.1	- 7.1	- 0.7	40.3
Total	**40.5**	**93.0**	**15.6**	**17.9**	**34.2**	**21.9**	**835.8**
Assets(a) vis-à-vis:							
BIS reporting area	29.0	69.0	13.5	12.1	20.5	25.7	537.6
'Offshore' banking centres	- 8.1	7.5	- 3.2	0.2	4.0	3.4	116.2
of which:							
United States	*15.1*	*14.3*	*- 1.1*	*5.2*	*7.7*	*14.9*	*138.0*
Japan	*16.9*	*50.0*	*9.9*	*8.3*	*14.4*	*7.6*	*150.0*
Sub-total	20.9	76.5	10.3	12.4	24.5	29.1	653.7
Outside reporting area							
Developed countries	2.2	1.0	1.3	- 0.5	- 0.1	-1.0	35.4
Eastern Europe	3.3	2.4	0.6	- 0.4	0.6	0.9	20.8
Oil exporters	- 0.5	0.1	0.1	- 0.2	0.3	- 0.4	19.8
Non-oil developing countries	2.7	- 0.9	1.0	—	- 0.5	- 1.2	55.1
of which, Latin America	*1.4*	*—*	*0.7*	*- 0.5*	*- 0.2*	*- 0.5*	*35.6*
Sub-total	7.7	2.5	2.9	- 1.1	0.3	- 1.6	131.1
Unallocated	1.5	7.7	1.5	1.2	- 1.0	0.8	15.0
Total	**30.1**	**86.7**	**14.8**	**12.5**	**23.8**	**28.3**	**799.7**

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

In the fourth quarter of 1987, UK banks' international lending rose by only about 1%, the smallest increase since the second quarter of 1985. Most of the slowdown was attributable to repayment of borrowing by UK residents, notably by the banks themselves; the repayment of loans by non-banks—which occurred in the latter part of the quarter—may have been partly a result of the stock market crash, which would have reduced the value of loans needed for hedging. However, external lending also rose less rapidly than in the previous two quarters; here it was lending to own offices which rose only slightly. On the liabilities side, the increase in deposits came mainly from non-banks, both in the United Kingdom and overseas.

Over the year as a whole, UK banks' international lending rose by around 9% compared with 15% in 1986; their foreign currency lending to other banks in the United Kingdom actually fell over the year as a whole and lending to own offices overseas increased at a much more moderate rate than in 1986. Apart from the Japanese banks, other banks in the United Kingdom reduced their holdings of investments (which include FRNs).

Japanese banks reduced their business on both sides of the balance sheet in the fourth quarter of 1987; this will be partly seasonal. There was a further reduction in both their lending to and borrowing from the UK interbank market—perhaps evidence of a wish to cut back on this business, where margins are fine. However, there was only a very slight increase in their external lending, with a fall in lending to (and deposits from) overseas offices. In 1987 as a whole, Japanese banks' international lending grew by only 8% compared with 15% in 1986 and nearly 20% in 1985. Their share of total claims has therefore fallen slightly from the peak of 37% reached in the first quarter of 1987.

American banks' international business fell back slightly in the fourth quarter after the sharp rise in the third, with their lending to own offices the only item to show any growth. It was therefore the other overseas banks which provided virtually all the increase in lending in the quarter, most of which went to unrelated banks overseas.

Foreign exchange and gold markets

This section reviews the three months to end-December.

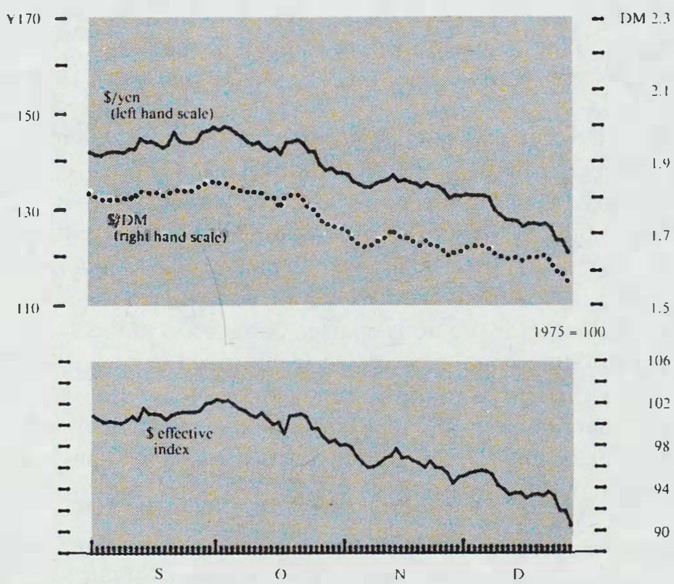
In a volatile quarter on the foreign exchanges, the uncertainties encountered in reducing America's fiscal deficit dominated developments, causing the dollar to fall steeply.

Having opened in London on 1 October at DM 1.8440 and ¥146.75, the dollar continued to show the slightly firmer tendency which had been evident since the September meeting of G7 Finance Ministers in Washington, moving up to highs of DM 1.8482 and ¥147.28 on 5 October. Thereafter, however, a bearish mood resurfaced, and the dollar fell sharply after the announcement of a larger-than-expected $15.7 billion trade deficit for August. It breached DM 1.80 on 23 October as rumours circulated that G7 Ministers were about to hold an emergency meeting with a view to attaching a lower range to the dollar. Although no such meeting was held, the dollar continued to weaken amid growing concern about the US budget and trade deficits following news of a sharp rise in Germany's trade surplus (from DM 6.5 billion in August to DM 11.5 billion in September). Bouts of concerted intervention steadied the fall, but sentiment towards the dollar remained gloomy and the decline gathered pace, on fears that the US Administration was prepared to acquiesce in a lower dollar and reports that negotiations to cut the US budget deficit were unlikely to achieve agreement on any cuts over and above the Gramm-Rudman requirement. New post-war lows of DM 1.6485 and ¥133.20 were attained on 10 November.

Although some respite was provided by a slightly better than expected trade deficit for September of $14.1 billion and from the announcement on 20 November of a package of proposals to cut the US budget deficit, on reflection the markets were disappointed with the package, and worries persisted over ratification of the agreement and about prospects for a new understanding on exchange rates. Accordingly, the dollar continued to decline and although a series of European interest rate reductions and further central bank intervention provided some temporary relief, much worse than expected trade figures for October (a deficit of $17.6 billion) triggered a further sharp fall. Subsequently, the package of proposals to cut the US budget deficit was agreed by Congress, and a G7 communiqué reaffirming the Louvre Accord was released on 23 December. However, comments by a US official cast uncertainties over the US authorities' commitment to stabilising the exchange rate and the dollar plummeted to new record lows in thin but volatile trading when European and North American centres reopened after the Christmas holiday, ending the quarter very close to its worst levels at DM1.5690 (down 14⅝%), Sw.Fc. 1.2695 (down 17%) and ¥121.00 (down 17¼%); in effective terms, it fell by 11⅜% to 90.5.

Dollar exchange rates

At the close of business in London each day



EMS

The dollar's weakness at the end of October caused the tensions which had been evident within the EMS in September to re-emerge. As the deutschemark benefited from the dollar's decline, the French franc suffered more than other currencies, falling from the highest position within the narrow band to the lowest position in the course of a week, despite substantial intervention by the Bank of France. However, a cut in German interest rates at the beginning of November and simultaneous increases in the Bank of France's money-market intervention and seven-day repurchase rates took some of the pressure off the franc. The continued weakness of the dollar led to a round of concerted interest rate cuts towards the end of the month (in which, *inter alia,* the Bundesbank cut its discount rate by ½% to 2½%—the lowest since the war—while the Bank of France cut its key rates by ¼%). The narrow band ended the quarter 1¾% wide between the Netherlands guilder at the top and the Belgian franc at the bottom.

Gold

Gold opened the period sharply lower at $454.10 following a fall in platinum prices, but nervousness arising from the stock market falls which occurred in the wake of the announcement of the US trade deficit for August enabled it to recover its losses. Interest in gold increased considerably as concerns grew about the impact on US inflation levels of the dollar's depreciation and the consequences of the provision of liquidity to the US money market. As a result, gold moved up to $502.75 on 14 December—its highest fixing since February 1983—but profit-taking and selling inspired by a fall in oil prices subsequently caused a decline and it closed the quarter with a fixing of $486.50.