

International financial developments

Among the main developments

- There were signs of some improvement in the US current account deficit, which fell by \$4 billion to \$39 billion in the fourth quarter: nonetheless, the deficit for the year as a whole rose to \$160 billion, after \$141 billion in 1986. Against a background of a depreciating dollar, net private sector capital inflows to the United States fell back sharply in the fourth quarter and official purchases of dollars by foreign monetary authorities assumed the major share of financing the US deficit.
- Borrowing activity in the international capital markets recovered in the first quarter from the depressed levels at the end of last year following the stock market crash: issues of straight fixed-rate bonds, in particular, were sharply higher.
- The growth of BIS reporting banks' external business slowed in the fourth quarter of 1987, owing to a slowdown in interbank business, but lending to non-banks remained buoyant.
- In the foreign exchange markets, the dollar recovered strongly at the beginning of the year, helped by reports of concerted central bank intervention and publication of improved trade figures, but fell back thereafter, to end the first quarter 1.9% up in effective terms.

Balance of payments positions

Current accounts

There was a marked shift in the pattern of global current account positions in 1987. The combined current account position of the OECD economies, which had improved by about \$30 billion in 1986, deteriorated by a similar amount last year. By contrast, OPEC's current account strengthened by about \$20 billion in 1987, although remaining in deficit, and the position of non-OPEC developing countries continued to improve. Their combined current account has strengthened by about \$35 billion in the past two years. However, the improvement has been concentrated among a relatively small number of countries, including China, Mexico and the newly-industrialising countries of Asia (see the note on page 14 of the February 1988 *Bulletin*).

The current account imbalances in nominal dollar terms between the three major overseas economies increased in 1987. The US deficit widened to \$160 billion from \$141 billion in 1986, while the German surplus rose to \$44 billion from \$39 billion: the Japanese surplus was broadly stable at \$87 billion. The trend in trade volumes has tended to restrain the rise in the imbalances, reflecting the changes in competitiveness brought about in part by exchange rate movements, but there have been offsetting movements in the terms of trade. Nevertheless, there are indications that the scale of the imbalances is beginning to fall. The US current account deficit declined by \$4 billion to \$39 billion in the fourth quarter, having risen in the two previous quarters. In Japan, the current account surplus

World current accounts^(a)

\$ billions; seasonally adjusted

	1985	1986	1987(b)				
	Year	Year	Year	Q1	Q2	Q3	Q4
OECD economies:							
United States	-116	-141	-160	-37	-41	-43	-39
Japan	49	86	87	25	21	20	21
Germany	17	39	44	12	11	11	10
France	1	3	-5	-	-1	-1	-3
United Kingdom	4	-	-3	1	-1	-1	-2
Italy	-4	1	-	-	-1	1	-
Canada	-1	-7	-10	-2	-2	-2	-5
Major economies	-49	-19	-47	-2	-13	-15	-18
Other OECD	-4	-3	-6	-1	-1	-1	-3
Total OECD	-53	-22	-53	-3	-14	-16	-21
OPEC economies	6	-31	-11	-5	-3	-1	-1
Non-OPEC developing economies	-24	-13	10	-	3	4	3
Other economies(c)	3	2	5	1	1	1	1
World discrepancy(d)	-67	-65	-49	-7	-13	-12	-18

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

(b) Includes bank estimates.

(c) The centrally planned economies.

(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).

declined in 1987 to about 3½% of GNP, from about 4½% of GNP in 1986. However, relatively weak domestic demand growth in Germany has meant that volume trends have made a smaller contribution to a reduction in the current account surplus, despite the deterioration in competitiveness.

Continued import volume growth and stagnant export volumes contributed to the emergence of a current account deficit in France in 1987, while in Italy a deterioration in the terms of trade and a strong rise in domestic demand pushed the current account from

small surplus to balance. A weakening in competitiveness and rapid import growth, reflecting buoyant domestic demand growth, was largely responsible for the deterioration in the UK current account, and a sharp rise in imports in the second half of the year contributed to a widening in the Canadian current account deficit to about \$10 billion for 1987 as a whole. Among the smaller OECD countries, there were significant reductions in the current account surpluses of the Netherlands, Portugal and Spain. Overall, the smaller countries' deficit rose from about \$3 billion in 1986 to \$6 billion in 1987.

Capital accounts

Capital account flows in the three major economies in the fourth quarter of 1987 continued to reflect volatile exchange rate movements and substantial official exchange market intervention. Private sector financing accounted for less than half of total net capital flows to the United States, and the rise in official reserves in Japan and Germany was comparable to the quarterly rate in the first half of 1987. In the aftermath of October's sharp fall in equity prices, foreign investors in all the three major economies were net sellers of stocks.

Net private sector inflows to the United States fell from \$43 billion in the third quarter to \$14 billion in the fourth. Outflows from Japan and Germany fell from \$30 billion to \$19 billion over the same period, a movement consistent with the overall decline during 1987 as a whole. In the fourth quarter, according to US capital account data, private overseas capital flows assumed a smaller share of financing of the US current account deficit, accounting for only 37% of net inflows (compared with 65% in 1987 as a whole). This coincided with a fall in the exchange value of the dollar, which, during the fourth quarter, depreciated around 6% in effective terms. Foreign official assets in the United States increased by \$20 billion in the fourth quarter as foreign monetary authorities purchased dollars in the exchange markets. US official reserves fell by \$4 billion, compared with almost no change in the third quarter. Reserves in Japan and Germany rose by a total of \$17 billion in the fourth quarter, a rate of increase comparable to that in the first half of 1987. The measured increase in US liabilities to the authorities of other countries may, however, understate the degree of intervention to support the exchange value of the dollar as, for example, the US reporting system, like other national arrangements, excludes foreign central bank holdings of eurodollars.

Net inflows of capital through banks in the United States during the fourth quarter were lower than in the third; liabilities to private foreigners reported by US banks rose by \$32 billion, compared with \$44 billion in the third quarter. On the portfolio account, in the aftermath of October's sharp fall in equity prices, attention focused on stock transactions. There was a net outflow of funds from the United States in the fourth quarter, and this was mainly accounted for by sales of US equities by foreigners which totalled a record \$8 billion. Both Japan and

Capital accounts of the G7 countries, 1985-87

\$ billions, not seasonally adjusted
(Inflow+/Outflow-)

	1985	1986	1987	1987			
				Q1	Q2	Q3	Q4
Capital account balance(a)							
United States(b)	120	105	103	13	33	43	14
Japan	- 48	- 55	- 48	- 5	-12	-18	-13
Germany(b)	- 17	- 37	- 26	- 1	- 7	-12	- 6
Portfolio investment							
United States	64	76	33	16	14	9	- 6
Japan	- 53	-115	- 90	-24	-36	- 7	-28
Germany	2	24	- 2	10	3	- 7	- 8
Monetary sector							
United States	40	18	44	12	- 1	24	9
Japan	3	56	44	15	22	-14	21
Germany	- 11	- 26	- 6	- 5	- 6	3	2
Direct investment							
United States	2	- 3	2	- 3	3	6	- 4
Japan	- 7	-15	-18	- 3	- 4	- 5	- 6
Germany	- 6	- 8	- 7	- 2	- 2	- 1	- 2
Other							
United States	14	14	24	-12	17	4	15
Japan	9	19	16	7	6	8	- 5
Germany	- 2	- 27	- 11	- 4	- 2	- 7	2
Official financing balance							
United States	2	- 33	- 57	-17	-15	- 1	-24
Japan	1	31	39	16	11	3	9
Germany	-	2	18	8	3	- 1	8
Change in reserves (c) (increase +)							
United States	4	-	- 9	- 2	- 3	-	- 4

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

(b) Quarterly totals exclude the current account seasonal adjustment discrepancy.

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

Germany also saw strong net sales of domestic equities by non-resident investors. However, evidence from Japan covering the first two months of 1988 suggests that foreign investors were net purchasers of Japanese equities, reversing some of the net sales of the previous quarter.

During 1987 as a whole, net foreign purchases in the United States of securities other than Treasury securities totalled \$42 billion, compared with \$71 billion in 1986. Much of this reduction reflected a decline in net foreign purchases of eurobonds issued abroad by US corporations. New issues of fixed-rate eurobonds and floating-rate notes by US borrowers fell to \$22 billion in 1987, compared with \$41 billion in 1986.

Japanese capital flows during the fourth quarter reverted to the pattern seen in 1986 and the first half of 1987, characterised by a net outflow of long-term funds and a net inflow of short-term liabilities through the banking system. In the third quarter of 1987, long-term capital outflows from Japan fell substantially and the banking sector switched to being a net exporter of capital. In contrast, net inflows through the banking sector totalled \$21 billion in the fourth quarter while, on the portfolio account, Japanese residents made net overseas purchases totalling \$23 billion, a level comparable to the quarterly rate recorded in the first half of 1987.

The third quarter saw a similar reversal of an established pattern in German capital flows, which had previously been characterised by a net inflow on the portfolio account and short-term outflows via the banking sector. This reversal continued in the fourth quarter and net

World Bank general capital increase

On 19 February 1988, the World Bank Board of Directors agreed a general capital increase (GCI) of \$74.8 billion, which, together with \$1.7 billion shares reserved for subscription by potential new members of the Bank, will increase its capital to \$171.4 billion. Under the new GCI, 3% of the subscription price will be paid in, with the rest remaining on call. As a result of the United Kingdom's contribution to the GCI, its voting power will be 4.78% of the total. The GCI was necessary in order to allow the Bank to fulfil its lending plans for the next five to six years, without breaching its statutory one-to-one gearing ratio. This requires that the level of loans and guarantees not be increased beyond the IBRD's capital base.

The World Bank's commitments in its last financial year reached \$14.2 billion, but the expanded capital base will

IBRD lending

Calendar year	1980	1981	1982	1983	1984	1985	1986
Commitments	8.0	9.7	10.0	12.0	9.3	11.7	14.6
Disbursements	4.6	5.7	6.7	7.9	8.7	8.5	10.2
Principal repayments	1.1	1.3	1.8	2.2	2.8	3.4	4.0
Net disbursements	3.5	4.3	4.9	5.7	5.8	5.1	6.2
Net transfers(a)	1.7	2.4	2.7	3.0	2.7	1.6	1.0

(a) Net disbursements *minus* interest payments (or disbursements *minus* total debt-service payments).

provide it with the capacity to increase its lending steadily over the next five years to commitments of over \$20 billion per year in the early 1990s.

The Bank's lending plans should be put in context. Over the past five years there has been a marked slowdown in net financial flows to developing countries, due largely to a sharp fall in private bank lending. Since 1982 almost all new private

Net disbursements to developing countries^(a)

Calendar year	1980	1981	1982	1983	1984	1985	1986
Official creditors							
Multilateral	9.5	9.9	11.9	11.1	12.2	11.6	14.3
of which, IBRD	3.5	4.3	4.9	5.7	5.8	5.1	6.2
Bilateral	11.6	14.6	10.8	10.7	9.4	4.9	5.2
Total official	21.1	24.4	22.7	21.8	21.6	16.5	19.5
Private creditors(b)							
Total	31.1	32.0	36.1	29.4	20.7	16.6	7.5
Total	52.1	56.5	58.7	51.2	42.3	33.1	27.0

Source: IBRD's World Debt Tables (1987-88).

Note: Discrepancies in table are due to rounding.

(a) Public and publicly-guaranteed long-term debt.

(b) Includes officially-guaranteed bank credits, and hence understates the decline in private bank lending from creditor countries.

lending to middle-income debtors has been involuntary. Throughout this period, official flows have changed little (in dollar terms). Although the share of official flows doubled to 72% of all net flows in 1986, this was due only to the significant decline in private flows (see the table).

Prior to approval of the GCI, there were discussions on the role that the Bank should play in the years ahead. It was agreed that its traditional activities—project lending and institutional reform to promote economic development and to assist in the alleviation of poverty—should remain the mainstay of its operations.

In addition to these activities, it was agreed that the Bank will continue to give priority to the new policy emphases which have emerged over the past few years.

The most important of these new emphases is its policy lending, which supports developing countries' own programmes for growth-oriented structural adjustment. The Bank's policy lending accounted for 24.6% of all new lending in its 1987 financial year (beginning 1 July 1986). Policy lending is carried out in close co-ordination with the IMF, and takes two main forms: structural adjustment loans, which cover reform of national institutions and macroeconomic policies; and sectoral adjustment loans, which concentrate on the institutions and policies governing individual sectors of the economy. The latter account for the major part of policy lending, running to 19.5% of total IBRD lending in its 1987 fiscal year.

The IBRD lends to developing countries at market-related rates, but has a soft loan arm, the International Development Association (IDA), which lends to countries which have a GNP below \$835 per capita, though the majority goes to countries with a GNP per capita below \$425. IDA charges only nominal commitment and service charges and lends at very long maturities (40 years repayment period for the poorest borrowers, 35 years for the rest, with a 10-year grace period for all borrowers). In December 1986 the eighth replenishment of IDA was agreed, raising \$12.4 billion for commitment from mid-1987 to mid-1990.

Special attention will continue to be paid to two country groupings, the highly indebted middle-income countries and the low-income debt-distressed countries of sub-Saharan Africa. The latter are mostly covered by IDA. For both, the Bank will continue to assist in the design of growth-oriented structural adjustment programmes, and has already reoriented its lending to provide quick-disbursing aid in support of these programmes.

For the highly-indebted middle-income countries, the IBRD has been the largest single source of new money since 1982, and lending to these countries will continue to account for a significant portion of all IBRD lending. For these countries the Bank seeks a return to steady non-inflationary growth, and in the longer term a return to full creditworthiness in the international capital markets. In addition to its other activities in the highly-indebted middle-income countries, the Bank seeks to play an enhanced catalytic role both in restructuring debt and in stimulating other financial flows. Its co-financing programme is an important element in this.

For the low-income debt-distressed countries of sub-Saharan Africa, mainly covered by IDA, the Bank will continue to support efforts to promote growth high enough to restore consumption to acceptable minimum levels, while also increasing savings and investment. Such support will come from its own lending and also from that of others. The latest and most important example of the latter was agreed in December 1987, when bilateral donors and international aid organisations pledged \$6.4 billion adjustment financing for low-income African countries with severe debt problems, to be used in close co-operation with World Bank programmes.

inflows through the banking sector totalled \$2 billion. Net outflows on the portfolio account were in large part a reflection of net sales of equities by non-residents, which totalled \$4 billion.

The UK capital account looks likely to show a small net inflow (\$1.3 billion) in 1987 as a whole, the first year in which this has occurred for a decade. In the fourth quarter very large net portfolio inflows (\$22 billion) were no doubt associated with the crash on world stock markets, with UK financial institutions liquidating their holding of foreign securities, particularly equities, on a large scale. These capital inflows were partly offset by heavy official intervention, reserves rising by \$10 billion. There were also continued, though reduced, net outflows on direct investment (\$2½ billion) and banking transactions (\$5½ billion).

Turbulent financial markets and exchange rate movements affected the deployment of oil exporters' funds in the fourth quarter. Net investment in the United Kingdom over the quarter (\$2.3 billion) included an exceptionally sharp rise in sterling bank deposits, probably responding to sterling's strength and dollar weakness; the sharp rise in other investments was largely attributable to the Kuwait Investment Office's well

publicised acquisition of shares in BP. The decline in assets in the United States may also reflect the decline in the dollar. Exchange rate movements have tended to raise generally the levels of non dollar denominated assets, measured in dollar terms (these exchange rate movements being excluded from the estimated flows).

International capital markets

International borrowing activity recovered in the first quarter from the depressed levels that had been recorded in the last quarter of 1987 following the stock market crash. Total activity was equivalent to \$105 billion, over 50% higher than in the fourth quarter and 26% above the quarterly average for 1987. Within the total, fixed-rate bond issues rose sharply, and announcements of euronotes more modestly: announcements of new syndicated credits, however, fell slightly. Issuance of floating-rate notes declined after the minor recovery experienced by the market in the fourth quarter of 1987. UK entities emerged as the largest borrowers overall, taking \$19.6 billion or nearly 20% of the various markets. By contrast, the share of US and Japanese institutions in total activity fell to around 10% each, compared with an average of 16% each in 1987.

Fixed-rate bonds

Issues of fixed-rate bonds rose from \$22.6 billion in the fourth quarter of 1987 to \$56.8 billion in the first quarter of 1988, the highest level since the first quarter of 1987. Within this total, straight fixed-rate bonds rose from \$19.8 billion to \$48.7 billion, while issues of equity-linked bonds rose from \$2.9 billion to \$8.0 billion as the Japanese equity market quickly recovered from the October crash.

(i) Straight fixed-rate issues

The recovery of straight fixed-rate issuance can be attributed to such factors as the continuing buoyant level of economic activity in a number of OECD countries, relative stability of the major currencies, a favourable interest rate climate in most markets and gradual diminution of the uncertainty that had been generated by the equity market crash. In addition, there were reports of continuing portfolio adjustments from equities to bonds in many countries. Dollar issuance was initially aided by the need for reinvestment of dollar portfolios after the dearth of issues in the fourth quarter and the belief among investors that the currency had reached its floor level; however, issuance began to decline towards the end of the quarter as the dollar came under pressure. The share of issuance in dollars declined slightly from 25% in the fourth quarter to 23% in the first. The dollar share thus remains far below historic levels. Maturities of dollar eurobonds increased to ten years or more in mid-quarter before retreating to two years at the end. Some very long-term debt (40–50 years) was issued in the Yankee market.

Among non-dollar currencies, issuance grew strongly in high-yielding currencies such as sterling and the Canadian

Identified deployment of oil exporters' funds^(a)

\$ billions

	Dec. 1986 levels	1986				Dec. 1987 levels
		Q1	Q2	Q3	Q4	
Industrial countries						
United Kingdom:						
Sterling bank deposits	6.1	0.3	-0.1	0.4	2.0	10.5
Eurocurrency bank deposits	37.8	-2.6	2.3	-0.4	-0.9	37.4
Government paper	4.9	0.5	-0.4	1.1	-0.7	7.0
Other investments	8.0	0.2	0.1	0.2	1.9	12.8
	56.8	-1.6	1.9	1.3	2.3	67.7
Other EEC:(b)						
Domestic currency bank deposits	6.0	—	0.2	0.2	-0.4	6.9
Eurocurrency bank deposits	17.8	0.8	1.4	-0.2	1.4	20.3
Other investments	64.9	0.6	0.7	-0.2	-2.2	67.2
	88.7	1.4	2.3	-0.2	-1.2	94.4
United States:						
Bank deposits	20.7	-0.7	0.7	2.5	-0.7	22.5
Government paper	24.5	-2.3	-0.8	0.3	-1.7	20.0
Other investments	25.0	-0.3	-0.8	-1.3	—	22.6
	70.2	-3.3	-0.9	1.5	-2.4	65.1
Other:						
Domestic currency bank deposits	4.4	0.3	-1.4	-0.3	2.2	6.6
Eurocurrency bank deposits	24.7	2.6	1.3	0.7	2.0	31.5
Other investments	47.0	-0.7	-1.7	-7.5	5.1	47.9
	76.1	2.2	-1.8	-7.1	9.3	86.0
Offshore centres:						
Bank deposits	41.8	1.5	2.6	-0.7	1.6	46.9
Placements with Idcs	59.5	—	—	—	—	59.5
OEC credit to non-banks	12.2	0.2	0.3	—	—	12.7
IMF and IBRD(c)	37.1	0.7	-0.8	-0.2	-0.2	40.9
Total identified additions(+)/reductions (-) in deployed assets	442.4	1.1	3.6	-5.4	9.4	473.2
Net funds available for deployment		-4.1	-1.3	-2.7	-1.0	
of which:						
Net movements in external borrowing etc		1.0	1.4	-1.4	0.4	
Current balance		-5.1	-2.7	-1.3	-1.4	

(a) The oil exporting countries covered are defined in the notes and definitions to Table 16 of the statistical annex in the February 1988 *Bulletin*.

(b) Includes Spain and Portugal.

(c) Includes holdings of gold.

Announced international bond issues^(a)

\$ billions

	1985	1986	1987	1988			
	Year	Year	Year	Q2	Q3	Q4	Q1
Fixed-rate bonds							
Straights	96.6	146.0	117.0	26.9	22.0	19.8	48.7
Equity-related bonds	11.6	26.7	46.7	17.1	17.6	2.9	8.0
of which:							
Warrants	4.3	19.2	29.0	11.6	11.0	1.5	5.5
Convertibles	7.3	7.5	17.7	5.4	6.7	1.4	2.5
Total	107.8	172.4	163.7	44.0	39.6	22.6	56.8
Floating-rate notes	55.9	47.8	12.0	1.7	2.5	5.0	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. Figures may not add to totals because of rounding

dollar, and in the deutschemark and Swiss franc sectors. The eurosterling sector was notable for a level of new issues exceeding that of gilts for the first time as the latter declined with the PSBR. The Canadian dollar sector featured strongly, raising its share to 6% of total issues from 1% in the fourth quarter. Appreciation of the currency against the US dollar and attractive swap rates spurred activity in this sector. By contrast, issues in yen fell from 20% of the total to 9%, as swap rates were unattractive for most of the quarter.

Currency composition of fixed-rate bond issues

Percentages of total issues

Currency denomination	Straight bonds		Equity-related bonds	
	1987 Year	1988 Q1	1987 Year	1988 Q1
US dollars	25	23	67	67
Swiss francs	14	16	17	25
Yen	19	12	—	—
Sterling	8	11	9	6
Australian dollars	7	3	1	—
Canadian dollars	5	8	—	—
Other	22	27	6	2

All sectors increased their level of eurobond issuance, including industrial corporations (which also increased their share) as many firms returned to the market after the interruption of the stock market crash. The principal exceptions were firms from the United States. Banks, some of whose issues were in the form of subordinated debt, were also attracted to the market. Under the new guidelines for capital convergence, eurobond issues in the form of subordinated notes count as supplementary capital rather than core capital.

Activity in the euromarkets, by sector: first quarter 1988

\$ billions

	Fixed-rate bonds	Floating-rate bonds	Syndicated credits	Euronotes
Industrial sector	22.6	0.1	21.1	6.2
Financial sector	17.8	2.3	1.9	9.3
of which, Banks	12.4	0.5	—	3.2
Government sector	9.9	0.3	0.8	6.5
International institutions	6.4	0.1	0.0	0.2
Total	56.7	2.7	23.8	22.2

There were some indications in the first quarter that the eurobond market is attempting to overcome some of the problems evident in recent years. For example, partly in response to investor dissatisfaction with illiquid secondary markets, borrowers generally avoided many of

the unconventional structures common in the past two years. In addition, liquidity was enhanced by larger issues, such as the \$500 million issues for Sweden and for Ferrovie Dello Stato and ¥50 billion (\$400 million) for Norway. The shake-out of eurobond intermediaries continued, and this, together with higher volume, may have contributed to a slight improvement in market returns for remaining participants. There was reported to be less willingness on the part of participants to take part in deals merely for relationship reasons. For example, there was some evidence of more realistic pricing of bonds, while more of the new issues are now reportedly placed directly with final investors rather than being kept on underwriters' books.

(ii) Equity-linked bonds

Issuance of equity-related bonds recovered from the depressed levels observed in the fourth quarter after the stock market crash. The total of \$8.0 billion compared favourably with the level of \$2.9 billion in the fourth quarter, although it was far below the levels seen in the second and third quarters of 1987. Coupons were significantly higher in the first quarter than in mid-1987. The principal users of the equity-linked sector, as in 1987, were Japanese corporations issuing bonds with equity warrants attached. Convertible issues, though higher than in the fourth quarter, were a much lower proportion of total issuance. The continuing rise in the Tokyo stock market made equity-related issues attractive to investors, thought to be mainly Japanese. The majority (67%) of such issues continued to be denominated in US dollars, though issuance in Swiss francs also proved attractive, accounting for 25% of the total. Virtually all Swiss franc issues featured put options to protect investors in the event of further market declines.

Floating-rate notes

The tentative recovery in the FRN sector apparent in the fourth quarter of 1987 faded in the first quarter of 1988, as issuance halved from \$5 billion to \$2.6 billion. The market was adversely affected by withdrawals of market makers from the bank subordinated segment and by concomitant price declines. The majority of FRNs (83%) were issued by financial institutions, notably UK building societies and specialist mortgage lenders. Partly reflecting this, the currency of denomination of new FRNs was predominantly sterling (57%), representing a shift from a traditionally dollar-denominated market. The FRN market witnessed an innovation aimed at improving liquidity in the form of variable rate notes (VRNs), in which lenders will participate in a quarterly auction to reset the coupon on the notes.

Euronotes and other facilities

Announcements of new euronote facilities rose from \$16.1 billion in the fourth quarter of 1987 to \$22.2 billion, the highest level yet recorded. The stock of euronotes outstanding, which had declined during the fourth quarter, recovered strongly to reach \$62.1 billion. Eurocommercial paper (ECP) and eurocertificates of deposit continued to account for the majority of announcements (67%) (see the

Eurocommercial paper

Eurocommercial paper programmes are facilities for the issuance of short-term promissory notes, usually with fixed maturities ranging between 7 and 365 days, issued in bearer form and on a discount basis. The eurocommercial paper (ECP) market has undergone substantial growth over the last two years, with the announcement of over \$90 billion of facilities since the start of 1986. Outstanding notes issued under activated programmes have risen from \$4.5 billion at the end of the first quarter of 1986 to over \$40 billion at the end of the first quarter of 1988.

Eurocommercial paper

\$ billions

Amount of ECP notes outstanding (a) (end-quarter)		Nominal value of ECP programmes announced (b) (quarterly)	
1986	Q1	4.5	6.5(c)
	Q2	7.2	9.6(c)
	Q3	12.4	8.4
	Q4	13.9	8.5
1987	Q1	20.4	11.0
	Q2	25.9	12.4
	Q3	33.6	9.3
	Q4	32.9	12.2
1988	Q1	43.0	14.2

(a) Source: Euro-clear. (b) Source: ICMS Database. (c) Estimated.

The ECP market is an offshoot of the underwritten euronote market which itself developed as an alternative to the syndicated credits market in the early 1980s.⁽¹⁾ Euronote facilities were initially structured as syndicated underwritten medium-term arrangements, enabling borrowers to issue a stream of short-term bearer notes on a roll-over basis, usually for maturities of 1, 3 or 6 months. Euronote facilities were usually distributed by way of a tender panel, and were called on by issuers when funds were required. The first ECP programmes were arranged in the early 1970s but did not prove very popular at the time. Renewed interest emerged in late 1984. These programmes differed from previous euronote facilities in two respects; first, they were not underwritten and, second, borrowers used a small group of appointed banks and dealers as placing agents to distribute paper on a 'best efforts' basis. The paper generally had more flexible maturities and could be issued on a continuous basis.

Although the major features of the instrument are similar to US CP, there are two important differences. First, in the United States, most programmes are backed by firm bank credit lines and receive a credit rating from one of the major agencies. By contrast, most ECP is not yet backed by explicit bank lines and fewer programmes have credit ratings, although the practice is spreading. Second, in the US CP market, maturities are on average less than thirty days, whereas ECP maturities are thought to be about 90 days on average. The majority of ECP programmes announced so far have been denominated in US dollars although, following authorisation by national authorities, an

increasing number of programmes have been announced in other currencies. Many programmes now include multi-currency options.

The increased use of ECP reflects several factors underlying the growing securitisation of international financing in the early 1980s. In particular, many top quality borrowers realised they could obtain financing more cheaply in their own names than through the intermediation of banks. Because of the existence of legal and fiscal restrictions on the issuance of short-term notes in various national markets, many quality issuers arranged facilities to issue in the US CP market and/or arranged euronote facilities.⁽²⁾ It has been suggested that a difference in the credit risk attached to issuers by investors in the US CP market and the euromarket was instrumental in the development of the euronote market.⁽³⁾ In the US CP market investors have generally required a premium over domestic issues from foreign borrowers, whereas, in the euromarket, investors have made no systematic distinction according to the borrowers' nationality. Partly as a result, many non-US issuers have found the issuance of euronotes increasingly cost-effective. At the same time, some US issuers which were well known in Europe but were regarded as of less than top quality in the domestic market have also found it helpful to issue ECP.

Several other factors have contributed to the dominance of ECP over underwritten euronotes. Quality issuers soon realised that they could forego altogether the support provided by committed facilities, and thereby save on the banks' underwriting fees. ECP placed through agents was shown to provide simpler distribution and quicker access to funds compared with tender panels used in underwritten facilities. Placing of ECP also benefited from lower start-up costs and the very strong competition which exists amongst ECP dealers for mandates and placement of the paper. Wider name recognition, the freeing up of bank credit lines and the widening of issuers' investor base have also been reported to be favourable factors.

More recently, the collapse of the FRN market has provided ECP with new opportunities as a substitute for floating-rate financing for both issuers and investors. In addition, the trend for interest rates to rise for most of 1987 led to increased investor interest in short-dated instruments on which there was a smaller risk of capital losses. The stock market crash of October 1987 also reportedly led investors to express greater interest for short-term instruments such as ECP, although most of this interest was apparently for sovereign or sovereign-backed paper. Finally, the proposed capital weighting by bank regulators of the G10 countries for underwritten euronote facilities has made them somewhat less attractive to bank arrangers, thus encouraging non-underwritten forms of issuance such as ECP.

(1) For a more detailed treatment of the development of the euronote market see: N F E Ramsden, 'The international market for floating-rate instruments', in the September 1984 *Bulletin*, pages 337-45, and 'Developments in international banking and capital markets in 1985', in the March 1986 *Bulletin*, pages 58-70.

(2) See S L Topping, 'Commercial paper markets', in the February 1987 *Bulletin*, pages 46-53.

(3) For a recent survey of the differences between US CP and ECP see: R N McCauley and L A Hargraves, 'Eurocommercial paper and US commercial paper: converging money markets?', *FRBNY Quarterly Review*, Autumn 1987, pages 24-35.

Announced euronote facilities^(a)

\$ billions

	1985	1986	1987				1988
	Year	Year	Year	Q2	Q3	Q4	Q1
Committed(b)	33.4	15.2	3.6	0.4	1.0	1.5	1.0
Uncommitted	17.0	55.9	66.6	20.7	16.3	14.5	21.2
Total	50.3	71.1	70.2	21.0	17.3	16.1	22.2
<i>of which:</i>							
Major OECD	29.5	44.6	45.7	15.5	10.0	10.6	13.3
Minor OECD	18.1	23.8	22.7	5.2	6.5	5.0	7.9
Other	2.7	2.8	1.8	0.3	0.8	0.5	1.0
Selected nationalities of borrower							
United States	16.5	18.9	15.0	7.6	4.3	0.8	4.1
United Kingdom	3.6	2.6	9.1	1.3	1.5	2.1	4.1
Australia	7.8	6.4	8.0	1.9	2.5	1.2	1.7
Japan	0.5	10.4	10.0	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.

note on page 203). Some 5% of new announced facilities were underwritten euronotes and 22% were medium-term note (MTN) programmes.

Most new euronote programmes continued to be introduced by borrowers from major OECD countries, though minor OECD countries increased their share to 36%—largely as a result of the confirmation of a \$3 billion programme by Sweden (which had previously been for an unspecified amount). Facilities announced were, as usual, largely denominated in US dollars, but there was a significant increase in new sterling programmes.

A breakdown of new euronote programmes by business type reveals an increase in the proportion of facilities announced by governments and state agencies. Non-bank financial institutions also raised their share with a significant amount being announced, largely in dollars, on behalf of UK building societies, which are increasingly turning to the euro-CD market as an additional source of wholesale funds. By contrast, announcements by banks and non-financial corporations declined. These patterns partly reflect the increased discrimination by investors regarding credit quality that was first evident after the stock market crash. Nevertheless, strong competition among intermediaries has ensured that pricing remains tight on note drawdowns.

In the euro-medium-term note (EMTN) market, Belgium announced a \$2 billion programme, which is one of the largest to date. Although many issues of EMTNs have taken the form of private placements, the development of a secondary market has been somewhat hindered by a perceived lack of liquidity. The EMTN market is dwarfed by the domestic US market, where over \$50 billion are outstanding. Credit National de France was the first sovereign-guaranteed borrower from that country to announce a programme in the US MTN market.

Syndicated credits

The growth in syndicated lending that occurred in the second half of 1987 abated a little as newly announced credits fell from \$26.2 billion in the fourth quarter to \$23.8 billion in the first quarter of 1988. This may be

compared with *annual* rates of \$19 billion and \$29.8 billion in 1985 and 1986 respectively. Borrowing continued to be dominated by institutions from OECD countries, which accounted for 90% of the total, similar to their share in 1987. Ldc and Eastern bloc borrowers were again marginal participants, although Soviet borrowers returned to the market after an absence in the fourth quarter. The dominance of the credits market by non-financial corporations intensified as higher quality borrowers returned to the eurobond market; 89% of borrowing was by non-financial corporations.

Trends in borrowing observable in 1987 continued in the first quarter. For example, some large credits associated with mergers and acquisitions were announced, thereby dispelling expectations that the stock market crash would weaken lending associated with such activity, although two large credits were cancelled as a result of the failure of takeover bids. BAT industries mandated their bankers to arrange a takeover financing credit for \$3.2 billion, showing the strength of the credits market as a means for raising large sums quickly. The competitiveness of the market ensured that the credit was priced at a very low margin, despite its being takeover-related. The tendency of European corporates to re-arrange existing lines of credit into multiple-option facilities also continued in the first quarter, notably among French corporations. In addition, the credits market continued to feature strong competition for mandates, as had occurred in the fourth quarter. Indeed, the availability of low-cost credit helps to explain the popularity of the market with corporate borrowers. In the view of some commentators, margins frequently remained too low to produce an adequate return.

Announced eurocurrency syndicated credits

\$ billions

	1985	1986	1987				1988
	Year	Year	Year	Q2	Q3	Q4	Q1
Major OECD	5.1	11.6	60.6	8.8	22.4	19.4	16.1
Minor OECD	4.4	6.5	14.9	3.6	1.9	4.5	5.3
Developing countries	5.7	8.3	9.1	2.7	2.6	2.2	2.2
Eastern bloc	3.6	2.3	1.9	1.1	0.1	—	0.2
Other	0.2	1.1	1.4	0.6	—	0.1	—
Total	19.0	29.8	87.9	16.8	27.0	26.2	23.8
<i>of which, transferable</i>	<i>3.9</i>	<i>3.3</i>	<i>2.5</i>	<i>0.8</i>	<i>0.5</i>	<i>0.9</i>	<i>0.6</i>

Borrowers from major OECD countries continued to be dominant in the syndicated loans market, accounting for 68% of activity. Borrowers from the United Kingdom, the United States and France were the most significant participants. Minor OECD countries increased their activity from \$4.5 billion to \$5.3 billion while ldc borrowers raised announced facilities worth \$2.2 billion, the same amount as in the fourth quarter of 1987.

The US dollar increased its share of the market, accounting for 65% of all credits compared with 55% in the fourth quarter. The share of sterling fell to 18%, continuing the decline from the third quarter of 1987 when, partly because of the Eurotunnel issue, it had accounted for 47% of total syndicated credits announced.

International banking developments

Banks in the BIS reporting area (fourth quarter of 1987)

In the fourth quarter of 1987, the growth of cross-border business slowed to 3.7% (\$142 billion), compared with 5.2% in the preceeding quarter. The slowdown was entirely attributable to slower growth of interbank business within the BIS reporting area; new lending to final users remained buoyant, at \$75 billion.

The United States, Japan and Germany were all major borrowers in the fourth quarter. Of these, *Japan* was the largest net borrower (of \$35 billion)—a return to the position in the first half of the year after net lending in the third quarter. Around a third of the fourth quarter's inflow was provided by banks in the United Kingdom. Banks in Japan were largely responsible for this turnaround, as the growth in their cross-border lending slowed to \$17 billion (the lowest quarterly increase since the second quarter of 1986). The \$11 billion increase in the Japan Offshore Market's assets was the smallest since the market was set up in December 1986. The slow growth in the fourth quarter meant that while the growth of cross-border assets of banks in Japan for the whole of 1987 remained high at 48%, it was below that of 1986 (65%). There was also a slowing in the growth of foreign currency lending to Japanese non-bank residents, although this was less marked than in banks' cross-border lending (it fell from \$14 billion in the third quarter to \$9 billion). However, cross-border borrowing by non-banks in Japan grew by a record \$11 billion, (34%). Over the year as a whole, the cross-border borrowing of non-banks in Japan totalled \$27 billion (an increase of 190%).

In the fourth quarter, banks in the *United States* remained net borrowers of funds—\$13 billion, compared with \$23 billion in the third quarter. Banks in *Germany* were also net borrowers (of \$3 billion), as they had been in the third quarter, although in recent years they have been important providers of funds to international banking markets.

Within the BIS reporting area, there was a record increase in borrowing by non-banks in the fourth quarter (\$22 billion). In addition, non-banks drew down their deposits by \$3.5 billion, the first fall in these deposits since the second quarter of 1985. The phenomenon of increased borrowing and a drawdown in deposits was most marked in Japan (where it was predominantly in foreign currencies) and Germany (where it was almost entirely deutschemark denominated).

The fourth quarter saw a resurgence in cross-border dollar-denominated lending, which accounted for 63% of new lending by the industrial countries, compared with 43% in the previous quarter. This was largely due to a slowing in the growth of yen-denominated lending, which accounted for 15% of new lending (compared with 42% in the third quarter).

The \$6 billion increase in recorded lending to *countries outside the BIS reporting area* (these countries made

Cross-border business of banks in the BIS reporting area

\$ billions; changes exclude estimated exchange rate effects

	1985		1986		1987				Out-standing at end-Dec. 1987
	Year	Year	Q4	Year	Q1	Q2	Q3	Q4	
Liabilities vis-à-vis:									
BIS-reporting area	176.9	384.9	161.8	455.4	69.3	149.0	128.0	109.0	2,792.0
'Offshore' centres	43.8	128.7	51.0	124.6	8.9	20.1	59.6	36.0	730.4
Sub-total	220.8	513.6	212.8	579.9	78.1	169.2	187.6	145.1	3,522.4
Outside-reporting area									
Developed countries	3.2	7.2	0.6	8.0	3.2	1.1	3.4	0.3	58.6
Eastern Europe	2.8	- 0.1	1.5	- 0.7	- 2.2	0.2	0.9	0.2	31.9
Oil exporters	7.6	-22.0	- 5.0	18.9	1.1	7.3	2.2	8.4	169.6
Non-oil developing countries	5.7	12.8	6.7	24.4	4.5	14.4	- 1.5	7.1	229.8
of which, Latin America	0.4	0.8	1.5	7.4	- 0.8	5.5	0.5	2.1	79.8
Sub-total	19.3	- 2.1	3.9	50.6	6.6	23.0	5.0	16.1	490.0
Unallocated	2.5	31.0	9.7	32.4	17.8	- 2.4	9.0	8.0	189.0
Total	242.5	542.5	226.4	663.0	102.6	189.8	201.5	169.1	4,201.4
Assets vis-à-vis:									
BIS-reporting area	181.3	394.8	169.1	409.3	47.0	130.7	128.5	103.0	2,634.3
'Offshore' centres	24.3	96.0	33.9	138.3	16.3	32.0	57.4	32.6	688.1
Sub-total	205.5	490.7	203.0	547.6	63.3	162.7	185.9	135.6	3,322.4
Outside-reporting area									
Developed countries	6.8	6.7	3.9	4.6	1.1	1.3	0.5	1.7	129.8
Eastern Europe	5.7	3.4	0.5	1.7	- 0.7	1.3	1.3	- 0.2	84.0
Oil exporters	0.2	0.4	1.1	2.3	0.8	2.5	- 0.9	- 0.1	127.4
Non-oil developing countries	11.1	3.1	5.1	- 1.2	0.1	1.1	- 7.5	5.1	384.9
of which, Latin America	1.7	1.6	2.3	- 7.1	0.4	1.4	- 4.7	- 3.4	225.7
Sub-total	23.8	13.5	10.6	7.4	1.3	6.2	- 6.6	6.4	726.1
Unallocated	4.2	13.0	7.2	12.8	5.6	0.7	6.5	—	108.7
Total	233.5	517.3	220.8	567.8	70.3	169.6	185.9	142.0	4,157.2

repayments of \$7 billion in the third quarter), was concentrated on Taiwan and, to a lesser extent, on developed economies. There was another surge in outside-area countries' deposits with BIS reporting banks which rose by \$16 billion, around half of which was accounted for by OPEC countries.

The London market

UK banks' external assets increased by \$22 billion (3%) in the fourth quarter, accounting for around 17% of the increase among all BIS reporting banks. Over the year as a whole, lending increased by 12% compared with 15% in 1986. In the fourth quarter, as in the third, UK banks were net suppliers of funds to non-residents (\$8 billion) but over the year they were net takers (\$1.7 billion).

As usual, most lending during the fourth quarter was to countries within the BIS reporting area. In contrast to the third quarter, *Japan* reverted to its position of being a net taker of funds from the United Kingdom (\$11.0 billion), with interbank borrowing of \$7.5 billion and some drawing down of deposits. This is a reflection of the sharp reduction in the growth of external claims of banks in Japan during the fourth quarter. The surge in borrowing by non-banks in Japan was not focused on London where they borrowed less than \$1 billion (net) compared with nearly \$3 billion during the third quarter. However, during 1987 as a whole, UK banks provided Japan with around half its net cross-border banking flows. The *United States* was the other major net taker of funds in the quarter (\$4 billion compared with \$12 billion in the third quarter)

Cross-border business of banks in the United Kingdom

\$ billions; changes exclude estimated exchange rate effects

	1985	1986	1987				Out-standing at end-Sept. 1987	
	Year	Year	Q4	Q1	Q2	Q3		Q4
Liabilities vis-à-vis:								
BIS reporting area	39.2	67.4	12.3	14.5	29.0	13.3	4.6	603.2
of which:								
United States	11.1	10.1	- 2.7	3.5	16.3	3.1	- 6.6	164.2
Japan	8.2	28.4	4.9	2.3	4.5	9.7	- 2.8	82.4
'Offshore' banking centres	6.2	10.4	- 2.7	- 0.1	2.5	1.9	- 0.3	120.2
Sub-total	45.3	77.9	9.5	14.5	31.5	15.2	4.3	723.4
Outside reporting area								
Developed countries	1.2	0.2	- 0.8	0.3	1.2	1.5	- 0.3	19.9
Eastern Europe	1.2	—	0.9	- 1.1	0.1	0.3	0.5	8.8
Oil exporters	- 0.4	- 8.9	- 0.9	- 4.0	2.1	1.2	1.3	47.9
Non-oil developing countries	- 1.2	2.1	2.1	1.7	5.9	0.5	0.6	54.0
of which, Latin America	- 2.2	- 0.5	- 0.1	0.2	3.0	0.5	- 0.7	8.3
Sub-total	0.9	- 6.6	1.3	- 3.1	9.4	3.5	2.2	130.6
Unallocated	- 5.8	21.8	4.7	6.5	- 6.6	3.3	7.4	53.8
Total	40.4	93.1	15.6	17.9	34.2	21.9	13.9	907.7
Assets(a) vis-à-vis:								
BIS reporting area	29.0	69.0	13.5	12.1	20.2	26.1	22.2	602.0
of which:								
United States	15.1	14.3	- 1.1	5.2	7.4	15.2	1.3	141.7
Japan	16.9	50.0	9.9	8.3	14.4	7.6	8.2	173.7
'Offshore' banking centres	- 5.0	9.0	- 2.9	1.7	3.1	3.1	- 3.1	120.2
Sub-total	24.1	78.0	10.6	13.8	23.3	29.2	19.1	722.2
Outside reporting area								
Developed countries	2.2	1.0	1.3	- 0.5	- 0.2	- 0.9	0.2	37.4
Eastern Europe	3.3	2.4	0.6	- 0.4	0.6	0.9	- 0.5	21.8
Oil exporters	- 2.2	- 0.4	—	- 1.5	1.6	- 0.4	0.9	20.6
Non-oil developing countries	2.7	- 0.9	1.0	—	- 0.5	- 1.2	- 0.8	56.2
of which, Latin America	1.4	—	0.7	- 0.5	- 0.2	- 0.5	- 1.1	35.3
Sub-total	6.1	2.0	2.9	- 2.4	1.5	- 1.4	0.2	136.1
Unallocated	- 0.3	6.6	1.3	1.1	- 1.3	0.5	3.0	17.3
Total	29.8	86.6	14.7	12.5	23.5	28.3	21.9	875.6

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

but, with substantial net placements in the second quarter, took only \$13 billion in the year as a whole. Banks in the United States ran down their deposits with banks in the United Kingdom by an exceptional \$11.0 billion in the fourth quarter, whereas non-banks continued to build up their balances.

Other significant net takers of funds were Italy (\$2.8 billion), Canada (\$2.2 billion) and Germany (\$2.2 billion). London experienced the same phenomenon as other centres, with non-banks in Germany increasing their borrowing and banks in Germany curtailing their external lending. Over the year, banks in Germany made net placements of only \$0.5 billion (compared with \$10.4 billion during 1986); net lending of over \$2.8 billion during the first six months was subsequently reversed, largely in the third quarter.

The Swiss were the largest net lenders in the London market during the fourth quarter with banks increasing their deposits by \$6.8 billion. Banks in Belgium have been active borrowers and depositors (\$2.9 billion and \$3.9 billion) but over the year as a whole their activity has largely netted out. Banks in France have continued to expand their business with banks in the United Kingdom, borrowing \$1.8 billion and depositing \$2.3 billion in the

latest quarter. Among the *offshore centres*, Hong Kong and Panama placed \$2.8 billion and \$2.0 billion respectively, largely repayments of interbank borrowing. The Cayman Islands, however, were net borrowers of \$4.7 billion.

Countries outside the BIS reporting area made net placements of \$2 billion with banks in the United Kingdom during the fourth quarter; during 1987 as a whole, they provided \$14.1 billion, in contrast to the previous two years when they were net borrowers. The 'other developed' countries were small net takers (\$0.5 billion) in the fourth quarter, reducing deposits and increasing borrowing for the first time since the fourth quarter of 1986. Eastern Europe was a small net taker during 1987 (\$0.8 billion), although of less than in 1986 or 1985. There was no net change in the *oil exporting countries'* position over the year, but they have been building up their deposits from the second quarter onwards, having reduced them for the previous seven quarters. The oil exporters and Eastern Europe were the only regions to increase their borrowing from banks in the United Kingdom over the year.

Non-oil developing countries have been building up their deposits with UK banks since 1986 and their outstanding borrowing has fallen for the past three quarters. This latter phenomenon was probably caused in part by the various debt securitisation initiatives, which have reduced the figures for outstanding bank claims on developing countries. Figures for Latin America follow these trends except for the fourth quarter when deposits fell as Mexico withdrew \$1.0 billion from the London interbank market, the first drawdown since the third quarter of 1986. Some of these funds were moved to other centres.

Japanese banks' share of outstanding cross-border lending, which had been rising for more than a decade and showed particularly strong growth during 1986, stabilised at 40% during 1987. *US banks'* market share also stabilised (13%) after declining from 35% over the same period. *British banks'* share of the London market continued to drift downwards, from 16.5% at end-1986 to 15.9% at end-June 1987, at which level it remained for the rest of the year. The share of the 'other overseas' bank group fluctuated just below 30% throughout 1987.

In common with the developments in the BIS reporting area as a whole, a higher proportion (79%) of new lending was denominated in dollars during the fourth quarter than during the third (49%). Yen lending declined sharply to only 4% of new lending, compared with 29% in the third quarter. For three quarters running there have been net repayments of lending in Swiss francs.

In the first quarter of 1988, UK banks' international assets rose by less than 1%, making the second quarter of slow growth. This growth came almost entirely from foreign currency lending to UK residents, both bank and non-bank; external lending was virtually unchanged overall, though external liabilities rose by \$7.5 billion.

Among the different nationality groups, the Japanese provided most of the growth, with a small increase (after falls for three quarters) in lending to other banks in the United Kingdom and of over \$8 billion in lending to their own offices overseas. Even this latter figure was largely offset by increased deposits from own offices, leaving the net position almost flat. British and US banks reduced their business on both sides of the balance sheet. In the case of American banks, the major fall was in lending to own offices, partly offset by a rise in lending to banks in the United Kingdom. Other overseas banks expanded their business, increasing their holdings of investments (including FRNs) during the quarter.

Foreign exchange and gold markets

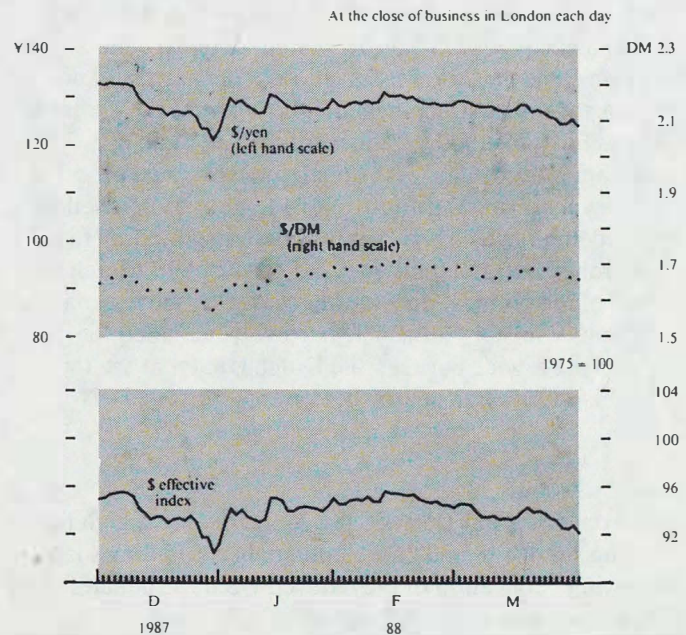
This section reviews the three months to end-March

In a volatile beginning to the quarter, the dollar made a strong recovery from record lows as a result of reported central bank intervention. Further rises secured in the immediate aftermath of successive improvements in the US trade deficit were subsequently surrendered and the dollar ended the period close to the levels attained in mid-January.

The dollar opened the quarter by attaining new record lows of ¥ 120.25 and DM 1.5620 in Sydney and the Far East on 4 January. However, reports of concerted central bank intervention proved sufficient to impress the market of the G7's commitment to stable exchange rates, causing the dollar to rise steeply. It gained 4 pfennigs and nearly 4 yen on 5 January and soared to DM 1.6710 and ¥ 131.87 the following day upon reports that the G3 countries had secretly agreed intervention points for the dollar at just above ¥ 130 and just below ¥ 140 and had set aside \$5 billion for that purpose. The dollar subsequently surrendered some of its gains on concerns about falling share prices, rumours that the US budget deficit had been underestimated and a statement from Japanese Finance Minister Miyazawa that there was no target range for the dollar. It dipped to DM 1.6255 and ¥ 125.50 on 13 January, but, within a week, had risen to DM 1.6920 and ¥ 131.12 in the wake of a significantly improved trade deficit (from \$17.6 billion in October to \$13.2 billion in November).

Thereafter, the markets quietened, with the dollar fluctuating within a relatively narrow range until the next set of US trade figures. It gave up some of its gains when Japanese trade figures showed an increased surplus with the United States, and Mr Clayton Yeutter, US trade representative, claimed that a major drop in the US trade deficit was unlikely before the latter half of the year. A $\frac{1}{4}$ % cut in US prime rates (to 8 $\frac{1}{2}$ %) and renewed speculation that the US economy was heading for recession (when the US leading indicators index for December confirmed the slower growth in consumption indicated by US GNP figures for the fourth quarter) were other factors contributing to the softer tone.

Dollar exchange rates



However, another contraction in the US trade deficit (to \$12.2 billion in December) provided the springboard for a further strengthening of the dollar. In the immediate aftermath of this news, a flurry of activity carried the dollar up to highs of DM 1.7250 and ¥ 132.00 on 12 February, but trading then became subdued until Swiss National Bank Chairman, Mr Languetin, was misreported as forecasting that the dollar could come under renewed pressure because of trade imbalances. This triggered a brisk bout of profit-taking sales of dollars and, following a smaller-than-expected upward revision to the US GNP figure for the fourth quarter (from 4.2% to 4.5%), principally because of a rise in imports, the dollar drifted down to DM 1.6855 and ¥ 128.10 on 29 February. It rallied briefly on Japanese press reports that the US authorities would tolerate a substantial rise in the dollar, and that the Bank of Japan would permit the dollar to rise to ¥ 140, but subsequently weakened as a result of the flow of funds into sterling when the pound rose above DM 3. The dollar eased further as a cautious mood set in ahead of the publication of US trade figures for January, touching DM 1.6545 and ¥ 126.52 on 14 March. Although some comfort was provided by news of a better-than-forecast \$12.4 billion deficit, the strong US personal income and consumer spending figure implied that there was little scope for more improvement in the US trade situation and caused the dollar to soften again despite further concerted intervention. Amid concerns that Japanese insurance companies would be heavy sellers of dollars in April (ie after the end of their financial year), the yen was particularly strong and the dollar ended the quarter nervously at DM 1.6592 (up 5.7%), Sw.Fc. 1.3660 (up 7.6%) and ¥ 124.12 (up 2.6%); in effective terms, it rose by 1.9% to 92.2.

EMS

The EMS remained free from tension, although there was some movement within the exchange rate mechanism

during March. In the early part of the month the French franc began to ease against the deutschemark, drifting to Fr.Fc. 3.4063 (= 1 DM) on 10 March, to replace the Belgian franc in the lowest position in the narrow band, but, as the dollar strengthened in the wake of the US trade figures for January, the franc recovered and talk of a realignment subsided. The Italian lira weakened in January following the removal of a temporary restriction on trade financing imposed by the Italian government in September, and suffered again in February and March as a result of the political uncertainty caused by the resignation of Prime Minister Gorla. The narrow band ended the quarter 1.8% wide between the Dutch guilder at the top and the Belgian franc at the bottom.

Gold

Gold opened the period at \$484.10. It touched a high for the quarter of \$485.30 on 11 January before falling sharply following publication of the reduced US trade deficit for November, and weakened again on 26 January in the wake of reports that the US company, Newmont Mining,

was arranging to borrow 1 million troy ounces of gold, more than twice the size of any previous gold loan. Gold subsequently met substantial producer selling which forced the price below \$450 for the first time since July 1987 and, although a 0.4% increase in US producer prices sparked a brief rally, reassurances from Federal Reserve Chairman Greenspan about the Federal Reserve's commitment to fighting inflation in an election year prompted further heavy sales, taking gold down to \$423.75 on 29 February (its lowest fixing since 9 April 1987).

The subsequent publication of Shearson Lehman's review of the World Gold Industry, which maintained that the worst was over for the price of gold and suggested an average price of \$450 for 1988, tended to stabilise the market and a cautious recovery ensued. Benefiting from higher oil, silver and platinum prices, renewed demand from the Far East and fears of further declines in world stock markets, gold advanced steadily, reaching a high of \$458.00 at the morning fixing on 31 March and ending the quarter with a final fixing at \$456.95 (down 6.1%).