International financial developments

Among the main developments:

- *Both the US current account deficit and the Japanese surplus fell in the second quarter to their lowest levels for two years: latest monthly data suggest, however, that the pace of adjustment has slowed. The German current account surplus rose sharply in the second quarter.*
- *Activity in the international capital markets remained buoyant in the third quarter, with issuer and investor confidence continuing to improve, helped by greater stability in foreign exchange markets. There was a marked recovery in the euronote sector, offsetting a decline in fixed-rate bond issuance.*
- *In the foreign exchange market, the US dollar remained in strong demand throughout July and early August and, although weakening somewhat thereafter in generally quiet market conditions, ended the quarter on a steadier note, having risen 2% in effective terms over the period.*

Balance of payments positions

Current accounts

Although the US current account deficit rose in the first quarter, a downward trend in both the US and Japanese external imbalances was evident in the first half of the year. In the second quarter, both the US deficit and the Japanese surplus fell to their lowest levels in two years. However, monthly data at the end of that period and into the third quarter suggest that the pace of adjustment in both these countries has slowed. In addition, the German current account surplus, which fell in the first quarter, rose sharply in the second to 5% of GNP, a similar level to the peak figure reached about two years earlier.

The US current account deficit fell to $33 billion in the second quarter from $37 billion in the first, reflecting a continued strong improvement in the merchandise trade deficit which outweighed the deterioration in the invisibles component. Export volumes in the second quarter were some 25% higher than a year earlier while import volumes rose by only 4.8% over the same period, and indeed fell between the first and second quarters, the first decline since early 1985. However, the latest monthly trade data indicate that the decline in the trade deficit may have stabilised. In August it rose to $12.2 billion from $9.5 billion in July.

The Japanese current account surplus declined in the second quarter to $17 billion from $23 billion in the previous three months, largely as a result of the continued strong growth in imports, while export volumes remained resilient. More recently, however, imports have fallen back. Despite the continuing increase in external assets, the invisibles deficit, which rose to over $3 billion in the second quarter, has continued to assist external adjustment.

World current accounts[(a)]

$ billions; *seasonally adjusted*

	1986	1987					1988	
	Year	Year	Q1	Q2	Q3	Q4	Q1	Q2
OECD economies:								
United States	−139	−154	−38	−41	−42	−34	−37	−33
Japan	86	87	25	21	20	20	23	17
Germany	39	45	12	12	11	10	9	15
France	3	− 4	—	− 1	− 1	− 2	1	—
United Kingdom	—	− 4	1	—	− 1	− 2	− 5	−5
Italy	3	− 1	1	1	− 1	− 1	− 3	..
Canada	− 8	− 8	− 1	− 2	− 2	− 3	− 1	− 2
Major economies	− 17	− 38	− 1	−10	−17	−12	−13	..
Other OECD	− 3	− 6	− 1	− 1	− 1	− 3	..	..
Total OECD	− 20	− 44	− 2	−11	−18	−15	..	..
OPEC economies	− 31	− 11	− 5	− 3	− 1	− 1	..	..
Non-OPEC developing economies	− 13	10	—	3	4	3	..	..
Other economies(b)	2	5	1	1	1	1	..	..
World discrepancy(c)	− 62	− 39	− 5	−10	−14	−12	..	..

(a) Partly estimated: components may not add exactly to totals because of rounding.

(b) The centrally planned economies.

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

The German surplus rose to $15 billion in the second quarter after falling to $9 billion in the first. This increase partly reflects the continued improvement in competitiveness against some countries, but it is also related to the worldwide buoyancy of investment demand and the comparative advantage of the German economy in the supply of capital goods. The trade surplus fell back to $6.7 billion in July from $8.1 billion in June. Second quarter figures for the French current account show a slight deficit of $0.3 billion after a surplus of about $1 billion in the first quarter, and trade data for July and August indicate a further deterioration. The UK current account deficit widened to $5.4 billion in the second quarter, owing to strong demand for imports.

The current account positions of Taiwan and Korea continue to be strong. Although the Taiwanese surplus fell in the first half of the year, this was largely because of official purchases of gold, which totalled some $3 billion in the first seven months of the year. In Korea, the current account surplus has continued to rise and at $8 billion in the first eight months of the year was substantially higher than in the same period of 1987.

Among the non-OPEC developing economies there appears to have been some further improvement in the current account position during the first half of 1988. Rising non-oil commodity prices have contributed to stronger terms of trade, although this may be temporary, as spot prices have in general fallen since the end of the second quarter. Current account deficits in Argentina and Brazil declined during the first half of the year, although the Mexican surplus fell in response to weakening oil prices and a sharp rise in imports.

Capital accounts

Capital account data for the United States in the first half of the year show a strengthening of private sector net capital inflows into the country. Rising short-term interest rate differentials and reduced concern about exchange rate risk have been important factors underlying this change from last year. Private sector net inflows of portfolio investment rose to $14 billion in the second quarter, up from $9 billion in the first, compared with net outflows in the last three months of 1987. There was a net direct investment inflow of $13 billion in the second quarter, a substantial rise from $1 billion in the first. This was partly accounted for by a reduction in new finance for US foreign affiliates and by a substantial increase in net loans to US affiliates of foreign firms. Also there was a sharp net inflow of banking assets caused partly by heavy US loan demand. Conversely, foreign official sector purchases of US Treasury securities declined from $28 billion in the first quarter of the year to $6 billion in the second.

Following the relatively low figure in the first quarter, there was a further large net outflow of portfolio investment from Japan in the second quarter of $26 billion. Japanese investment in foreign securities more than doubled in the second quarter, rising to $28 billion, while foreigners' investment in Japanese securities declined from $11 billion in the first quarter to $2.5 billion in the second, although net of external bonds there was a net outflow of $5 billion in the second quarter. These net outflows were associated with the weakening of the yen against the dollar as interest differentials moved against Japanese assets, and with a less rapid rate of increase in prices on the Tokyo Stock Exchange. There was a large net inflow of $23 billion through the banking system in the second quarter, contrasting with the slight outflow in the first quarter.

The latest data on the German capital account indicate that there was an outflow of portfolio investment in the second quarter of the year of $11 billion. This was slightly higher than the level in the first quarter, and very much larger than the average quarterly inflow in 1987. The uncertainty surrounding the forthcoming withholding tax

External financing of the G7 countries, 1986–88 Q1

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

	1986	1987					1988	
		Year	Q1	Q2	Q3	Q4	Q1	Q2
Identified current account								
United States(a)	-139	-154	-38	-41	-42	-34	-37	-33
Japan	86	87	21	23	21	22	18	19
Germany	39	45	11	11	8	15	9	16
France	3	-4	-2	—	-1	-1	-1	—
United Kingdom	—	-4	1	-1	-2	-2	-6	-6
Italy	3	-1	-2	1	2	-2	-5	
Canada	-8	-8	-3	-2	-1	-3	-4	-1
Financed by:								
Portfolio investment								
United States(a)	104	75	26	25	11	14	32	22
Assets	-4	-5	-2	—	-1	-2	-5	2
Liabilities	108	80	28	25	12	15	37	20
of which:								
From official sector	*33*	*45*	*12*	*11*	*2*	*20*	*28*	*6*
From private sector	*75*	*35*	*16*	*14*	*10*	*-5*	*9*	*14*
Japan	-105	-97	-25	-39	-10	-23	-6	-26
Germany	24	5	10	4	-5	-5	-9	-11
France	2	5	1	1	1	2	..	..
United Kingdom	-25	28	1	3	7	19	-4	-6
Italy	-2	-4	-1	-1	-2	—	..	..
Canada	16	9	4	2	4	-1	2	3
Direct investment								
United States(a)	6	-3	-3	1	7	-8	1	13
Japan	-14	-18	-3	-4	-5	-6	-8	-8
Germany	-8	-7	-1	-2	-1	-3	-2	-4
France	-3	-4	-1	-1	-1	-2	..	..
United Kingdom	-11	-15	-2	-8	-6	—	-2	-6
Italy	-3	2	1	—	—	1	1	..
Canada	-2	-1	1	-1	—	-1	—	-1
Banking sector								
United States(a)	21	51	19	-4	30	6	-2	16
Japan	55	80	20	31	—	30	-6	23
Germany	-23	-4	-4	-6	4	3	8	-3
France	4	-11	-1	-3	-1	-6	..	..
United Kingdom	14	4	6	9	-6	-5	5	11
Italy	3	4	3	1	-2	2	..	..
Canada	-4	2	—	—	1	1	1	-3
Other(b)								
United States	8	21	-7	16	-5	18	4	-18
Japan	-6	-12	4	1	-3	-13	5	-7
Germany	-31	-21	-8	-4	-6	-2	-7	-3
France	-5	14	3	1	3	7	..	..
United Kingdom	26	7	-3	4	8	-3	8	9
Italy	-5	2	4	-4	-1	4	..	..
Canada	-2	2	2	-1	-2	3	5	6
Official financing balance (– = increase in reserves)								
United States(a)	—	9	2	3	—	4	2	—
Japan	-16	-39	-16	-11	-3	-9	-3	-3
Germany	-1	-18	-8	-3	1	-8	2	5
France	-1	—	-1	2	-1	1	..	..
United Kingdom	-4	-20	-2	-7	—	-10	-1	-1
Italy	-1	-5	-4	2	2	-5	..	..
Canada	-1	-3	-4	2	-1	—	-4	-4

(a) Seasonally adjusted.
(b) Includes balancing item reflecting unidentified net flows which may be associated with either the current or the capital account.

on interest payments is still believed to be discouraging foreigners from holding certain German securities. There was a net inflow of around $7 billion into Germany in the first half of the year associated with a fall in German official holdings of foreign assets.

Net direct investment outflows from the United Kingdom rose to $5.5 billion in the second quarter as the strength of sterling made takeovers of foreign companies particularly attractive. Meanwhile, the net inflow to the banking sector (a record in sterling terms) was stimulated by strong private sector demand for credit together with interest differentials favourable to the United Kingdom, both of which enhanced the attractiveness of sterling.

In Canada, there was a net outflow of some $8 billion in the first half of the year owing to an increase in official purchases of foreign assets. Slight net outflows associated with both direct investment and the banking sector components were more than offset by net inflows of portfolio investment, and heavy purchases of government paper.

International capital markets

Overall activity in the international capital markets in the third quarter continued at the brisk pace recorded in the first half of the year, suggesting that 1988 may witness a record volume of primary market activity. In spite of concerns over inflation in major OECD countries, which were reflected in monetary tightening and rising interest rates, issuer and investor confidence continued to improve, helped by greater stability in foreign exchange markets.

The credit and euronote markets were more buoyant than the bond market over the quarter. Announcements of euronote facilities were substantially higher than in the second quarter, while announcements of syndicated credits also rose. There was, however, a decline in issuance of straight (ie non-equity-related) fixed-rate bonds, and, to a lesser extent, in issues of equity-related bonds. The markets for equity-related bonds were weakened by frequent bouts of oversupply and by falls in the Japanese equity markets.

Some commentators have suggested that the volume of financial activity has been underestimated because of an increasing volume of specially-tailored private placements targeted at specific group of investors in Far Eastern countries (mainly Japan). This suggests that, in spite of low secondary market turnover in euro-securities and tight margins on many instruments, the buoyancy of certain sectors may be helping to offset poor profitability in several main areas of activity.

Fixed-rate bonds

The volume of fixed-rate bonds issued in the third quarter was $49.6 billion, $7 billion lower than in the second quarter. Most of the decline occurred in the straight sector of the market—the volume of straight international fixed-rate bonds declined from $41.0 billion in the second quarter to $35.3 billion in the third, reflecting higher interest rates in the earlier part of the quarter and the seasonally low volume of issuance in August. There was a sharp rise in dollar-denominated issues, so that they represented 48% of total straight fixed-rate bond issues, the highest proportion since the fourth quarter of 1986. The international dollar bond market's fortunes were aided by the recovery in the US dollar, which caused eurodollar spreads against US Treasuries to narrow, and by the improvement in investors' confidence in dollar-denominated assets. This improvement in confidence resulted in an extension of average eurodollar bond maturities to between five and seven years.

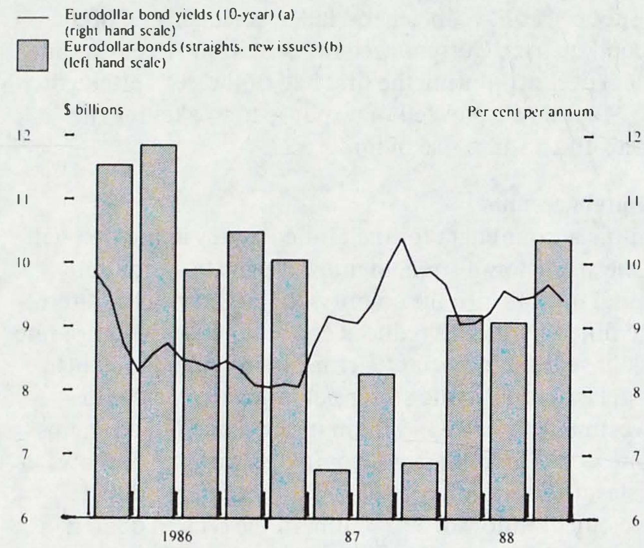
Announced international bond issues[a]

$ billions

	1986	1987	1988		
	Year	Year	Q1	Q2	Q3
Fixed-rate bonds					
Straights	144.4	116.9	48.7	41.0	35.3
Equity-related bonds	27.5	43.3	8.0	14.9	14.2
of which:					
Warrants	*19.7*	*25.6*	*5.5*	*10.8*	*9.9*
Convertibles	*7.8*	*17.7*	*2.5*	*4.1*	*4.3*
Bonds with non-equity warrants (currency, gold, debt)	3.7	3.4	0.2	0.7	0.1
Total	**175.6**	**163.6**	**56.8**	**56.6**	**49.6**
Floating-rate notes	**47.8**	**12.0**	**3.1**	**6.0**	**6.9**
Total gross new issues	**223.4**	**175.6**	**59.9**	**62.6**	**56.5**
Repayments	59.2	41.0	21.0	18.2	17.0
Total net new issues	**164.2**	**134.6**	**38.9**	**44.4**	**39.5**

(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.

Eurodollar yields and eurodollar bond issuance

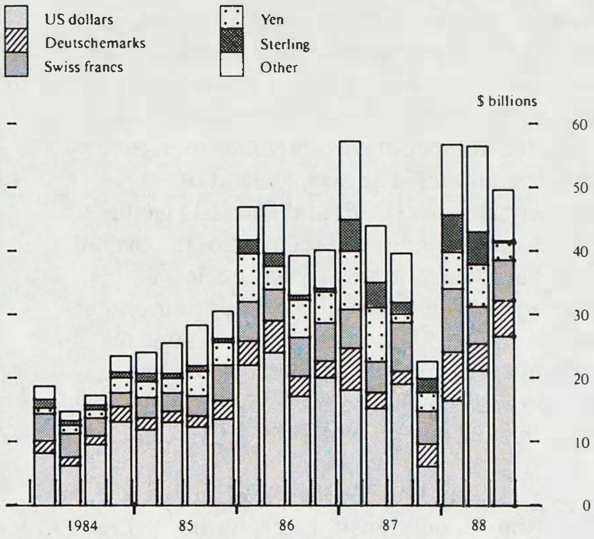


(a) Source: OECD.
(b) Source: Bank of England ICMS Database.

The international dollar market was boosted by several very large issues for sovereign borrowers, including five-year and seven-year $1 billion deals for the Republic of Italy and two $600 million deals for the Kingdom of Denmark and the Province of Alberta. Except for the Alberta offering, all three were driven by complex swap structures. Several highly rated US corporates also tapped the market for funds in Europe, partly as a result of the narrowing of eurodollar spreads against domestic corporate bonds. Issues in the Yankee market also proved popular, accounting for 23% of total international dollar issues. Banks from Australia, Japan and Canada were the most important fund raisers in this market.

Issues in the foreign deutschemark market amounted to a dollar equivalent of $5.1 billion (14% of total straight issues) compared with $4.0 billion (10%) in the previous quarter. There was particularly strong demand for deutschemark foreign bonds towards the end of the quarter, as the exchange rate and interest rates appeared to have stabilised. A variety of European banks as well as several subsidiaries of German banks and supranational entities were the principal issuers.

Total fixed-rate bonds by selected currencies



Source: Bank of England ICMS Database.

The value of new issues in the euroyen sector was $2.8 billion in the third quarter, a sharp decline from the $6.7 billion recorded in the second. Restricted swap opportunities and international investors' perception that the yen had peaked against other leading currencies contributed to the decline. The most notable feature of the fixed-rate euroyen market since the beginning of the year has been the virtual disappearance of 'plain vanilla' (ie straight fixed-rate) bonds. These issues have been replaced by specially-tailored issues designed to meet the demands of specific investors. The principal repayment on many of these bonds is tied to changes in a financial market index such as that of the stock market or the Japanese government bond futures market. Index-linked bonds generally carry higher coupons to induce investors to take the risk inherent in the structures.

The volume of issues denominated in Swiss francs declined for the third consecutive quarter, to $2.6 billion, representing 8% of total straight issues. This is in marked contrast to the levels of activity recorded in the second half of 1987, and especially the first quarter of 1988 (when issues amounted to $8 billion, or 16% of total volume). The decline partly reflected the smaller increases in Swiss interest rates compared with those in other countries.

Of the high-yielding currencies, issuance in Australian dollars fell in the third quarter (after a rebound in the second) because of unattractive swap rates, saturation of continental European portfolios with high-yielding assets and profit-taking as the Australian dollar remained strong relative to the US dollar. Funding opportunities through the Canadian dollar eurobond market remained attractive, because of the continued favourable position of the currency relative to the US dollar, and its attractiveness as a high-yielding substitute for US dollar assets. Despite a decline in the third quarter, the Canadian dollar eurobond market has nevertheless registered a record volume of issuance so far this year at $10.3 billion, compared with $5.9 billion for the whole of 1987. After a very robust pace of activity in the first half of the year, fixed-rate eurosterling issues slowed in the third quarter, mainly reflecting higher domestic interest rates in the wake of concerns about inflation and a deterioration in the trade balance.

The Japanese were the most active borrowers in the straight fixed-rate sector with 15% of the total, followed by US borrowers (12%), supranationals (12%) and Canadian borrowers (9%). Across business sectors, banks have consistently increased their share of the total this year from 24% in the first quarter to 30% in the third.

Equity-related issues

New issues of equity-related fixed-rate bonds fell only slightly, from $14.9 billion to $14.2 billion, despite persistent problems of oversupply in the Japanese equity-warrant bond market which were exacerbated by several downward corrections in the Japanese stock market. As in previous quarters, about 70% of issues comprised bonds with equity warrants attached, virtually all of which were issued by Japanese corporates in US dollars (although slightly higher volumes of equity warrant bonds were issued in deutschemarks and Swiss francs than in the second quarter). The issuance of bonds convertible into equity (at $4.3 billion) accounted for the remaining 30%.

With the Japanese stock market rising strongly at the beginning of the quarter, there was a surge of new issues in the equity-warrant bond market. Because of the earlier strength of the stock market, coupons on equity-warrant bond issues failed to increase in line with yields on alternative dollar-denominated instruments, such as US Treasuries and straight eurodollar bonds, resulting in widening yield differentials between these instruments. A subsequent decline in the Japanese stockmarket in mid-July resulted in a sharp fall in the prices of new bonds with equity warrants, accentuating the problems of oversupply.

In response to these developments, the major Japanese securities houses agreed on a temporary moratorium on new equity-warrant bond issues. To make the bonds more attractive to investors, coupons on new issues were progressively raised, maturities were generally shortened and underwriters informally agreed to set coupons on new issues according to credit quality and the size of issue. The higher coupons meant that proceeds obtained through swapping such issues from dollars into yen became only marginally more attractive than issuing in yen directly. Although issuance was lower in August and September than in July, secondary market prices improved towards the end of the quarter.

Floating-rate notes

The quarterly volume of floating-rate note (FRN) issues rose further in the third quarter. The volume of new issues, at $6.9 billion, was the highest quarterly level since 1986. Sterling was the dominant currency (46%) followed by the French franc (14%) and the US dollar (11%). During the quarter, secondary market prices firmed, reflecting higher interest rates (as some investors switched away from fixed-rate bonds) and the call of over $6 billion of mainly sovereign outstanding FRN issues. Although these developments provided a favourable background for the issuance of floating-rate debt, the issuer constituency remained limited.

The rise in activity does not necessarily mean that the FRN market will soon experience a generalised recovery, because other instruments such as swaps and money-market paper, including ECP, continue to provide very competitive financing. Several issues illustrated the advantages of swapping fixed-rate dollar bonds rather than seeking funding in the FRN market, allowing borrowers to obtain floating-rate funding at several basis points cheaper than in the conventional FRN market.

Sterling FRNs were supported over the quarter by higher domestic interest rates and a downward-sloping yield curve. Most sterling FRNs have been related to UK mortgage financing in the form of mortgage-backed issues for specialist mortgage lenders (£1 billion, or $1.9 billion, in the third quarter) and issues by UK building societies (£0.6 billion, or $1.1 billion). The Trustee Savings Bank (TSB) was also the first UK clearing bank to issue a mortgage-backed issue, with a £135 million offering. Sterling mortgage-backed bonds have been particularly attractive because of the relatively high margins over Libor. In addition, these bonds have exhibited less price volatility than dollar FRNs, mainly because the coupons are usually reset more frequently—every quarter as opposed to once every six months.

The market for variable-rate notes (VRNs) continued to expand in the third quarter, following two introductory issues in the first half of the year. There were three sterling issues worth £400 million, for two UK building societies and the TSB, and a $200 million issue for the National Westminster Bank. VRNs function on the same principle as FRNs but have the added feature that a new spread over Libor is negotiated at each quarterly coupon reset period. The coupon reset process also includes a mechanism for note holders to trade out of their positions if they so wish.

Announced euronote facilities[(a)]

$ billions

	1986 Year	1987 Year	1988 Q1	1988 Q2	1988 Q3
Committed(b)	15.2	3.9	1.0	1.0	1.6
Uncommitted	55.4	67.2	22.4	13.7	19.7
Total	**70.6**	**71.2**	**23.4**	**14.7**	**21.3**
of which:					
Major OECD	*44.6*	*46.4*	*14.4*	*6.3*	*12.4*
Minor OECD	*23.4*	*22.8*	*8.0*	*7.2*	*5.3*
Other	*2.7*	*2.0*	*1.0*	*1.2*	*3.6*
Selected nationalities of borrower					
United States	19.0	15.0	4.1	1.1	3.7
United Kingdom	2.6	9.8	4.1	2.2	2.8
Australia	6.4	8.1	1.7	1.6	1.7
Japan	10.4	10.0	—	1.8	1.0

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

(b) Underwritten or otherwise backed by bank commitments.

Euronotes and other facilities

There was a recovery in activity in the euronote sector during the third quarter as borrowers announced they had obtained new facilities worth $21.3 billion, compared with $14.7 billion in the second, mainly resulting from an increase in the number of euro-medium-term note (EMTN) programmes. The arrangement of eurocommercial paper (ECP) and euro-CD facilities remained the most significant segment of the overall market and accounted for nearly half of new announcements. The stock of outstanding euronotes increased from $66.5 billion at the end of June to $73.1 billion at the end of September, according to estimates provided by Euroclear. Most of this expansion represented the further growth of the ECP sector.

The stock of outstanding EMTNs is estimated to have increased from $2.8 billion at the beginning of 1988 to $4.3 billion at the end of the third quarter. These amounts are, however, comparatively small when compared with the total value of all EMTN facilities announced in recent years, or with the value of outstanding notes in either the domestic US-MTN or the ECP market. This sector may develop further in view of the recent interest in this instrument shown by a number of prominent euromarket borrowers.

A number of innovations took place in the ECP market during the first half of this year, such as the introduction of asset-backed ECP and also the introduction of an ECP programme where the return on paper issued is linked to the price of a futures contract. This trend continued in the third quarter when one borrower announced the establishment of an ECP facility backed by trade receivables; although new to the euromarkets, such facilities have existed for some time in the United States. In addition, there is some evidence that the ECP and US-CP markets are becoming more integrated. A number of major borrowers possess both US-CP and ECP facilities and will raise funds in the market which offers the most competitive funding at any particular moment. Towards the end of the third quarter, dollar ECP rates briefly fell below US-CP rates.

As in the first and second quarters, dollar-denominated facilities accounted for over three quarters of all announcements; sterling programmes, with a 10% share, were the only other currency group to achieve a market share in excess of 5%. Announcements on behalf of industrial companies grew significantly, from 39% of all programmes in the second quarter to 48% in the third; in contrast, the share of activity by non-bank financial institutions fell from 20% to 7%.

Syndicated credits

The value of newly announced syndicated loans increased from $22.5 billion in the second quarter to $25.9 billion in the third. The volume of new business remained very high by historic standards and was only $1 billion below the peak achieved in the fourth quarter of 1987. The market continued to be driven by the arrangement of large loan

Announced eurocurrency syndicated credits
$ billions

	1986	1987	1988		
	Year	Year	Q1	Q2	Q3
Major OECD	11.6	61.3	16.8	15.6	20.8
Minor OECD	6.5	14.9	5.3	4.7	3.0
Developing countries	8.3	9.1	2.3	1.5	2.0
Eastern bloc	2.3	1.9	0.2	0.5	0.1
Other	1.1	1.4	—	0.2	—
Total	**29.8**	**88.6**	**24.6**	**22.5**	**25.9**
of which, transferable	*3.3*	*2.5*	*0.6*	*0.2*	*0.4*

facilities on behalf of corporates in the major industrial countries, especially for those engaged in merger activity.

Borrowers are generally able to obtain larger sums through syndicated loans than they could raise through the issue of eurobonds over the short term. Participation in merger-related business is attractive to banks because the margins attached to these loans are reported to be generally higher than those associated with drawings on standby loan arrangements such as multiple-option facilities. Some of the acquisition-related loans announced during the year have subsequently been cancelled, usually because the particular company has not, in the event, proceeded with the takeover.

UK corporates continued to restructure their existing lines of credit by obtaining multiple-option facilities. The pace of activity slowed when compared with earlier quarters, partly because many large UK and French companies have already obtained such programmes. It is likely, though, that these arrangements will continue to filter down to second-tier corporates. Pricing in the loan market remained very competitive. Concerns about future capital adequacy requirements did, however, lead some banks to charge higher margins for some borrowers.

Borrowers in major OECD countries reinforced their dominant position in the euroloan sector, accounting for 80% of all new credits compared with 70% in the second quarter, while the share of minor OECD borrowers fell from 21% to 12%. The US dollar remained the most important currency, accounting for 54% of new facilities, while sterling and French franc denominated facilities accounted for 30% and 7% respectively.

International banking developments

This section covers developments in the London market in the second and third quarters of 1988: the BIS international banking figures for the second quarter were not available at the time of publication.

The London market

In the second quarter of 1988, the external assets of banks in the United Kingdom increased by $15.6 billion (1.8%), more than reversing the previous quarter's fall. Deposit growth was at its strongest since the second quarter of 1987, with the result that banks in the United Kingdom were net takers of $9.3 billion ($16.5 billion during the first half of 1988). The feature of the quarter was the strong increase in sterling-denominated business. This reflected in part the interest rate differential between the United Kingdom and overseas which helped to create exceptional investor demand for sterling. Sterling deposits increased by a record £8.8 billion (17%). Most of the increase was from private holders of sterling, principally from within the European Community and offshore banking centres.

The *BIS reporting area* and *offshore centres* more than accounted for the overall increase in lending and accounted for most of the $24.9 billion increase in deposits. Banks in Japan were net takers of $3.9 billion. There was an unusually low level of activity with the non-bank sector in Japan; for the first time since the first quarter of 1986 non-banks in Japan were net providers of funds and they reduced their borrowing from banks in the United Kingdom for the first time since the second quarter of 1985. Strong loan demand in the United States contributed to banks in the United States being net takers of $2.2 billion, although this was offset by non-banks there increasing their net deposits by $3.5 billion, contrasting with the (unusual) first quarter position when London was a net taker of funds from banks in the United States but a net lender to the US non-bank sector. Other than Japan, the major net takers of funds were Italy ($1.8 billion) and

Cross-border business of banks in the United Kingdom
$ billions: changes exclude estimated exchange rate effects

	1986	1987				1988		Out-standing at end-June
	Year	Year	Q2	Q3	Q4	Q1	Q2	1988
Liabilities vis-à-vis:								
BIS-reporting area	69.6	56.6	23.3	16.1	6.0	10.8	17.3	593.5
of which:								
United States	*12.4*	*14.1*	*10.5*	*8.9*	*- 6.6*	*- 1.4*	*5.5*	*166.1*
Japan	*28.4*	*13.7*	*4.5*	*9.7*	*- 2.8*	*8.8*	*5.7*	*91.9*
'Offshore' banking centres	10.1	4.5	2.4	3.1	0.4	- 4.1	5.1	116.0
Sub-total	79.6	61.2	25.7	19.2	6.5	6.7	22.4	709.4
Outside reporting area								
Developed countries	0.2	3.1	1.8	1.3	-0.8	0.6	2.3	21.6
Eastern Europe	—	- 0.2	0.1	0.3	0.5	- 0.7	0.1	7.6
Oil exporters	- 8.5	0.2	2.2	—	0.6	- 0.9	4.1	48.6
Non-oil developing countries	2.1	8.6	5.9	0.4	0.6	- 1.5	0.1	49.7
of which, Latin America	*- 0.5*	*3.0*	*3.0*	*0.5*	*- 0.7*	*- 0.3*	*—*	*7.6*
Sub-total	- 6.2	11.8	10.0	2.1	0.9	- 2.6	6.6	127.5
Other(a)	19.6	14.8	- 1.1	0.8	6.8	- 0.4	- 4.2	73.3
Total	**93.0**	**87.7**	**34.6**	**22.0**	**14.2**	**3.6**	**24.9**	**910.1**
Assets(b) vis-à-vis:								
BIS-reporting area	69.0	80.6	20.2	26.2	22.1	4.0	15.0	585.3
of which:								
United States	*14.3*	*29.1*	*7.4*	*15.2*	*1.3*	*-13.7*	*4.9*	*130.5*
Japan	*50.0*	*42.8*	*14.4*	*7.6*	*8.2*	*12.6*	*9.4*	*185.3*
'Offshore' banking centres	7.5	5.3	4.2	3.1	- 2.2	- 3.0	2.0	115.7
Sub-total	76.5	86.0	24.4	29.3	19.9	1.0	17.0	701.0
Outside reporting area								
Developed countries	1.0	- 1.4	- 0.1	- 1.0	0.2	- 1.6	0.4	34.7
Eastern Europe	2.4	0.6	0.6	0.9	- 0.5	0.9	0.5	21.9
Oil exporters	0.1	- 0.6	0.3	- 0.4	- 0.3	- 0.5	0.7	20.0
Non-oil developing countries	- 0.9	- 2.4	- 0.5	- 1.2	- 0.7	- 1.2	- 1.9	52.1
of which, Latin America	*—*	*- 2.3*	*- 0.2*	*- 0.5*	*- 1.1*	*- 0.7*	*- 0.4*	*33.6*
Sub-total	2.5	- 3.8	0.3	- 1.7	- 1.3	- 2.4	- 0.3	128.7
Other(c)	7.2	4.5	- 1.1	0.9	3.2	- 2.2	- 1.1	14.2
Total	**86.2**	**86.7**	**23.6**	**28.5**	**21.9**	**- 3.6**	**15.6**	**844.0**

(a) International organisations, unallocated and international issues of securities.
(b) Including securitised lending from the first quarter of 1986.
(c) International organisations and unallocated.

Switzerland ($0.9 billion). In both these countries, substantial interbank borrowing was partially offset by repayments by non-banks.

On the sources side of the balance sheet, banks in France placed $2.5 billion with banks in the United Kingdom and non-banks in France a further $0.9 billion. Around one third of these deposits were in sterling. Luxembourg and Canada were also substantial net providers, of $1.6 billion and $1.1 billion respectively. Among the offshore centres, there were inflows from the Cayman Islands ($1.5 billion) and Hong Kong ($1.0 billion). Continuing political uncertainties led to a further contraction of business with Panama, although on a less marked scale than in the first quarter.

Lending rose marginally to all country groups *outside the BIS-reporting area* with the exception of the non-oil developing countries. Within the 'other developed' country group, both Greece and South Africa were, unusually, net providers (of $0.5 billion and $0.9 billion, respectively). The increase in deposits from South Africa during the second quarter totalled an exceptional $0.6 billion. The rise in lending to Eastern Europe ($0.5 billion) was entirely accounted for by the Soviet Union, which also drew down its deposits by $0.3 billion. So far this year, the USSR has been a net taker of $1.8 billion as its hard currency trade balance has worsened owing to weak oil prices and strong import growth. Elsewhere, there was a continuing reduction ($0.5 billion) in the recorded bank debt of Brazil; claims on Brazil have fallen by $1.2 billion over the past year, probably because of debt transfers, debt sales and debt/equity swaps. The continued strength of South Korea's external position was reflected in a further build-up in deposits and repayment of debt; so far this year it has been a net provider of $0.6 billion. China's deposits have increased by $1.8 billion (78%) over the first half of this year; this seems to be due to a depositing of funds raised from banks outside the United Kingdom. Despite persisting current account deficits among oil exporters, these countries' deposits increased by $4.1 billion (9%) in the second quarter.

In the second quarter, Japanese banks maintained their market share of external lending from the United Kingdom at just below 40%, although they were no longer expanding their London-based fund-raising operations. British-owned banks' market share remained just under 16%. The market share of US-owned banks, which had stabilised at 13.5% during 1987 (after falling from over 17% during 1986), fell again to 12.9% during the first half of 1988. Other overseas banks increased their share of business to just under 30%.

In the third quarter of 1988, UK banks' international assets grew very sharply, by $45.4 billion (4.3%), in contrast to a modest rise of $1.7 billion (0.2%) in the second quarter. However, the total rise in lending over the first nine months of 1988 amounted to 5.2%, compared with 9% over the same period in 1987. As usual, growth on both sides of the balance sheet was largely accounted for by increased external activity, mostly foreign currency business with unrelated banks overseas; as in the first half of the year, there was a net inflow of funds through the banking system. Foreign currency business in the UK interbank market increased sharply after falls or modest rises in recent quarters. The strong increase in sterling activity overseas seen in the second quarter was not maintained, this business returning to the level of earlier periods.

Nearly two thirds of the growth of international claims was accounted for by a strong seasonal increase in the activity of Japanese banks related to the presentation of their half-yearly accounts at end-September. The greatest part of their lending activities was in the interbank market both overseas ($20.0 billion) and in London ($7.9 billion). Despite this rise, Japanese banks have still reduced their participation in foreign currency business in the London interbank market over the past year. Unusually for a 'window-dressing' quarter, Japanese banks in the United Kingdom were net takers of funds from own offices overseas; a similar phenomenon occurred in the same quarter of 1987.

British banks' total claims again rose more strongly than in earlier quarters, by $5.8 billion, which was due entirely to an increase in lending to other banks overseas ($6.2 billion); external lending to own offices fell away by $0.8 billion following the modest growth seen in the second quarter ($2.7 billion). The activity of American banks remained subdued, while the claims of other overseas banks rose by $7.7 billion, particularly in the overseas interbank market; this activity tends to be stronger in the second and fourth quarters.

Foreign exchange and gold markets

This section reviews the three months to end-September.

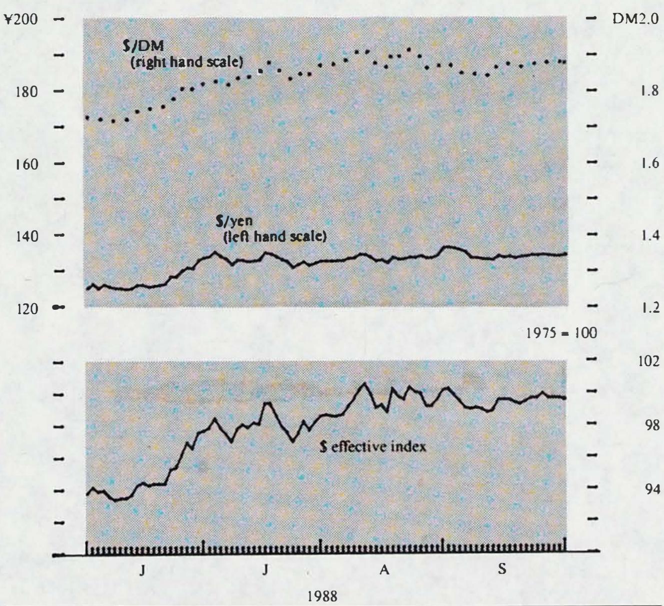
Boosted by the prospect of rising interest rates in the United States to offset inflationary pressures, the dollar enjoyed periods of strong demand throughout July and most of August. Sentiment turned less bullish in September as the markets became more cautious in the face of reports of concerted central bank dollar sales, and as economic data pointed to a slowing of the US economy, but underlying support was provided by a sharp decline in the US trade deficit and the dollar ended the quarter on a steady note.

Increased tension in the Middle East saw the dollar open strongly in London on 1 July at DM 1.8225 and ¥134.50. It rose to DM 1.8310 and ¥135.45 on Independence Day, but subsequently surrendered some of its gains as reports of persistent intervention by the Bundesbank began to have an effect and investors became wary of the risk of pushing the dollar too high in advance of the US trade figures for May. Having fallen to DM 1.8135 and ¥131.35 on 7 July, however, the dollar was boosted by stronger-than-expected US employment data and, although the announcement on 15 July of a $10.9 billion trade deficit was in line with expectations, the removal of uncertainty provided a renewed incentive to buy the US currency. Despite widespread reports of central bank sales, the dollar rose to ¥135.45 and DM 1.8925 on 15 and 18 July respectively, only to fall steeply thereafter following a rise in Japanese domestic interest rates and reports of further central bank intervention. After touching lows of DM 1.8205 and ¥130.15 on 25 July, the dollar rallied on hopes that second quarter US GNP figures would reveal strong economic growth, but, in the event, the figures (+3.1%) were not as strong as expected and, having reached DM 1.8735 and ¥133.25 on 27 July, the dollar fell away sharply following their announcement.

However, after falling to DM 1.8410 and ¥131.20, the US currency recovered its bullish tone. In the wake of Federal Reserve Chairman Greenspan's expression of concern at the rise in US inflation during the second quarter and the publication of strong US employment data for July on 5 August, the dollar was buoyed by the prospect of rising interest rates in the United States. Non-farm payroll jobs rose slightly more than expected, but the major boost came from a revision to the June figure (+532,000 compared with +346,000 previously reported). A ½% increase in the Federal Reserve's discount rate on 9 August provided further impetus and, following a period of hectic trading, the US currency reached DM 1.9250 (its highest level since January 1987) and ¥135.10 on 10 August. However, a warning from West German Finance Minister Stoltenberg of the problems for the trade deficit of a higher dollar, together with increasing nervousness about the US trade figures for June, subsequently caused the dollar to fall, a ½% rise (to 10%) in US prime rates having no effect. In the event, the June deficit ($12.5 billion) exceeded most expectations and the dollar dropped abruptly to DM 1.8600 and ¥131.50 on release of the figures on 16 August. However, a strong recovery ensued as further assessment focused on the underlying strength of the US economy, and the dollar reached DM 1.9215 on 22 August despite reports of renewed central bank intervention.

Dollar exchange rates

At the close of business in London each day



Further reports of persistent central bank sales caused the dollar to drift lower following interest rate increases in Europe. However, it advanced strongly against the yen when the Bank of Japan stated that it would not be raising its discount rate, reaching a high for the quarter of ¥137.20 on 2 September before falling sharply against all currencies on weaker-than-expected US labour market figures for August (unemployment up 0.2% to 5.6%). It dipped to DM 1.8395 and ¥132.90 in quiet conditions on 7 and 9 September, but rebounded strongly in the wake of better-than-expected US trade figures for July ($9.5 billion from a revised $13.7 billion in June), reaching ¥134.85 and DM 1.8790 on 14 and 15 September respectively. Thereafter, the exchanges became quiet, the dollar's bullish undertone tending to be subdued by fears of central bank intervention should the dollar return to its August highs. Data on consumer prices (+0.4% in August), housing starts (−3.3%) and personal income (+0.2%) indicated a slowing in the economy, which contributed to the dollar's easier tone, while the contradictory 6% rise in US durable goods orders was shrugged aside by the market. A final rally to DM 1.8910 and ¥135.02 on 26 September occurred on hopes that the Group of Seven Ministers had acquiesced to a firmer dollar, but when this was met by a further round of concerted central bank sales the dollar eased to close the quarter quietly at DM 1.8797 (up 3¼%), Sw. Fc. 1.5905 (up 5¼%) and ¥ 34.57 (up ⅝%); in effective terms it rose by 2% to 99.6 (1975=100).

EMS

The exchange rate mechanism remained free from pressure during July and early August, the Danish krone and Irish punt vying for the position of strongest currency while the Belgian franc remained at the bottom in spite of increases in Belgian discount rate. However, during the quarter, the Bundesbank (shadowed by the Nederlandsche Bank) embarked upon a series of interest rate increases designed to protect the deutschemark and curb inflation and, with the deutschemark also benefiting from periods of weakness in sterling and the Japanese yen, the mark replaced the Irish punt at the top of the narrow band on 25 August. Amid reports that the French, Italians and Belgians were intervening to protect their cross-rates against the deutschemark, expectations of an early realignment formed in mid-September. However, with the currency markets becoming quieter at the end of the quarter, the punt regained the highest position and the tensions subsided. Nevertheless, the French franc remained close to the bottom of the narrow band, which ended the quarter 1⅝% wide between the Irish punt and the Belgian franc.

Gold

Sentiment towards gold was bearish throughout the quarter and, in late-September, the gold price fell to its lowest level since December 1986.

Having opened on 1 July at $436.50, gold was relatively unmoved by increased tension in the Middle East, but it advanced reflecting the rise in oil prices which followed the Piper Alpha disaster, rising to $440.90 on 7 July. It briefly suffered from a combination of the dollar's strength, a decline in US agricultural futures and a renewed fall in oil prices, but news of strikes in Peruvian mines boosted silver prices and, on the back of this, gold rose to a high for the quarter of $445.00 on 20 July. In the ensuing weeks, silver continued to influence gold prices which fell, sharply at times, to $425.80 on 9 August on reports of an end to the strike in Peru. Although gold was subsequently helped by news of a 0.5% increase in US producer prices in July, bearish tendencies continued to prevail and, as inflation expectations were lowered in response to weaker-than-expected US economic data and a continuing decline in oil prices, gold fell sharply. Reports of selling by some producers into this falling market added to gold's decline and it fell to a fixing low of $389.05 on 26 September. It subsequently staged a nervous recovery, the final fixing of $396.70 representing a loss of $39.85 over the quarter.