International financial developments

Among the main developments:

- *Signs of further progress in adjustment of the external imbalances of the major economies have been mixed. The US current account deficit narrowed further in the third quarter, but latest monthly data suggest it may have widened again in the fourth: and, although Germany's current account surplus fell back in the third quarter from its high second quarter level, Japan's surplus widened, and may have strengthened further in the fourth quarter.*
- *Activity in the international capital markets declined in the fourth quarter, reflecting lower issuance of equity-related bonds and a fall in announcements of new euronote programmes. For the year as a whole, however, there was a record level of activity (totalling over $400 billion). Rapid growth of world output and investment, together with industrial restructuring, were key factors underlying borrowing activity during the year.*
- *In the foreign exchange market, the US dollar fell back in the fourth quarter, with sentiment affected by disappointing economic indicators and doubts about the prospect for action to reduce the US trade and fiscal deficits; and despite strengthening in December, the dollar fell by over 5% in effective terms over the quarter.*

World current accounts[a]

$ billions; *seasonally adjusted*

	1986	1987			1988		
	Year	Year	Q3	Q4	Q1	Q2	Q3
OECD economies:							
United States	-139	-154	-42	-34	-37	-34	-31
Japan	86	87	20	21	23	17	18
Germany	40	45	11	10	9	16	12
France	3	- 4	- 1	- 1	1	- 1	- 1
United Kingdom	—	- 5	- 2	- 4	- 5	- 5	- 6
Italy	3	- 1	2	- 2	- 1	- 1	- 1
Canada	- 8	- 8	- 2	- 3	- 1	- 2	- 2
Major economies	- 15	- 40	-15	-11	-11	-10	-10
Other OECD	- 4	- 9	- 1	- 2	- 2	- 3	- 3
Total OECD	- 19	- 49	-16	-13	-13	-13	-13
OPEC economies	- 27	- 9	- 1	- 1	- 3	- 5	- 6
Non-OPEC developing economies	- 17	5	1	2	3	3	2
Other economies(b)	2	5	1	2	2	1	1
World discrepancy(c)	- 61	- 48	-15	-10	-11	-14	-16

(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).

Balance of payments positions

Current accounts

The *United States'* current account deficit fell to $31 billion in the third quarter, down from $33¾ billion in the second. This was the lowest figure for almost three years, and some $7½ billion below the quarterly average in 1987. The decline was fully accounted for by a lower trade deficit, and in particular the strong growth in the value of merchandise exports. These rose by 26% in the year to the third quarter, although on a quarterly basis the increase slowed significantly in the second and third quarters. Export volumes rose by almost 20% over the same period. Merchandise imports too have been reasonably buoyant, rising by 6% in value terms in the year to the third quarter and by 5% in volume. However, much of this increase occurred at the end of 1987, and in the third quarter imports were only 1½% higher in value terms than at the end of the previous year. The deficit in the same period on the invisibles account of some $2 billion was much the same as a year earlier. The trade deficit was $10½ billion (fas-cif) in October, much the same as the monthly average in the previous quarter, but it rose to $12½ billion in November.

Japan's current account surplus rose slightly to $17¾ billion in the third quarter from $16¾ billion in the second, but it remained below the $23 billion surplus in the first quarter and the quarterly average of $21¾ billion in 1987. The trade surplus has remained relatively stable over the past year as a whole, with the figure of $22½ billion in the third quarter much the same as the average for the four previous quarters. Exports rose by 17% in the year to the third quarter and imports by 27%. However, the higher initial level of exports meant that their slower percentage increase led to a very similar rise in absolute terms to the increase in imports. In the face of this relative stability in the trade position, it has been the Japanese invisibles deficit, which rose by some $2¼ billion in the year to the third quarter, which has accounted for virtually all of the fall in the current account surplus over that period. Expenditure on tourism and other services grew particularly strongly and outweighed the improvement in IPD earnings. Data covering October and November suggest that the current account surplus rose again in the fourth quarter. The invisibles deficit fell in these two months together from the third quarter, while exports rose strongly and imports were little changed.

The *German* current account surplus fell in the third quarter to \$12½ billion from \$15½ billion in the previous three months. This latest figure was, however, still higher than at the start of 1988 and also higher than the average quarterly surplus of \$11¼ billion in 1987. The trade surplus reached \$7 billion in November, the second-highest monthly figure (the June total was \$8 billion). Both import and export values have risen strongly in dollar terms, with imports 7% higher in the three months to November than in the same period of the previous year and exports 6% higher. The dollar value of the surplus rose, as in Japan, because the initial value of exports was higher than the initial value of imports. The deficit on the invisibles account was around \$½ billion higher in the third quarter than a year earlier, but much the same as the quarterly average over the intervening period.

In *France*, a current account surplus of \$¾ billion was recorded in the first half of 1988, following a deficit of \$4 billion in 1987. There was a surplus of some \$1¼ billion in the first quarter but this was followed by a deficit of \$½ billion in the second: a deficit of a similar size was reported for the third quarter.

In the *United Kingdom*, the current account deficit in the first three quarters of the year was over \$16¼ billion, compared with a deficit of under \$4¾ billion in 1987. The deterioration mainly reflects a sharp rise in imports.

The *Canadian* current account deficit in the first three quarters of 1988 was \$4¾ billion, and the outturn for the year as a whole is likely to be below the deficit of \$8 billion reported for 1987. The merchandise trade balance has benefited from a sharp increase in export prices, which has partially offset lower volumes, and a significant decline in the value of imports.

In *Italy*, the current account deficit in the first half of 1988 may have been around \$1½ billion, compared with a deficit in 1987 as a whole of some \$1 billion.

The combined current account deficit of the OECD area (including the countries outside the major seven) in 1988 is likely to have been around the \$50 billion figure reported for 1987, or perhaps slightly more. However, the OPEC countries will probably have seen a deterioration of over \$10 billion in their external position owing to the weakness in oil prices. With the developing economies in South-East Asia likely to report a slightly lower surplus in aggregate, it is the other non-oil developing countries which are likely to be the only major group of countries to report an improved external position. This reflects improved terms of trade and generally restrained domestic policies, though the aggregate figure disguises a varied performance across different countries. Moreover, this improvement in the non-oil developing country bloc is unlikely to offset the wider current account deficits or lower surpluses reported elsewhere. It appears probable that the world current account discrepancy, which reflects the under-reporting of net external receipts by some countries, will have widened slightly last year.

Capital accounts

There was a marked shift in the composition of capital flows into the *United States* in the second and third quarters of last year compared with the previous year or so. In 1987, private capital inflows were subdued and official purchases of dollar assets by financial authorities in the United States and elsewhere accounted for a substantial element of total capital flows into the United States. Such support continued into the first quarter of 1988 (particularly the first few weeks), when the official inflow was larger, as a proportion of the current account deficit, than it had been in 1987. However, while in 1987

External financing of the G7 countries, 1986–88 Q3

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

	1986	1987			1988		
		Year	Q3	Q4	Q1	Q2	Q3
Identified current account							
United States(a)	–139	–154	–42	–34	–37	–34	–31
Japan	86	87	21	22	18	19	19
Germany	40	45	8	15	9	15	9
France	3	– 4	– 1	– 1	– 1	—	..
United Kingdom	—	– 5	– 2	– 2	– 6	– 6	– 6
Italy	3	– 1	2	– 2	– 5	..	..
Canada	– 8	– 8	– 1	– 3	– 4	– 1	– 1
Financed by:							
Portfolio investment							
United States(a)	109	75	11	14	32	22	8
Japan	–105	– 97	–10	–23	– 6	–25	–19
Germany	24	5	– 5	– 5	– 9	–11	– 8
France	2	4	—	2	—	3	..
United Kingdom	– 25	28	6	19	– 6	– 6	2
Italy	– 2	– 4	– 2	—	..	..	..
Canada	16	9	4	– 1	2	3	3
Direct investment							
United States(a)	– 1	– 4	7	– 8	1	11	3
Japan	– 14	– 18	– 5	– 6	– 8	– 8	– 9
Germany	– 8	– 7	– 1	– 3	– 2	– 4	– 2
France	– 3	– 4	– 1	– 2	– 1	– 2	..
United Kingdom	– 11	– 15	– 6	—	– 2	– 6	– 4
Italy	– 3	2	—	1	1	..	..
Canada	– 2	– 1	—	– 1	—	– 2	—
Banking sector							
United States(a)	19	51	30	6	– 1	16	5
Japan	55	80	—	30	– 6	23	22
Germany	– 23	– 4	4	3	8	– 3	– 6
France	4	– 9	—	– 6	2	– 2	..
United Kingdom	14	4	– 6	– 5	5	10	2
Italy	3	4	– 2	2	..	..	..
Canada	– 4	2	1	1	1	– 3	4
Other(b)							
United States(a)	16	21	– 5	18	3	–15	23
Japan	– 6	– 12	– 3	–13	5	– 5	– 9
Germany	– 31	– 22	– 6	– 2	– 7	– 4	– 3
France	– 5	4	3	– 1	6	3	..
United Kingdom	26	8	8	– 2	10	9	8
Italy	—	2	– 1	4	..	..	..
Canada	– 2	2	– 2	3	5	6	– 8
Official financing balance (– = increase in reserves)							
United States(a)	—	9	—	4	2	–	– 7
Japan	– 16	– 39	– 3	– 9	– 3	– 3	– 4
Germany	– 1	– 18	1	– 8	2	5	11
France	– 1	10	– 1	9	– 4	2	..
United Kingdom	– 4	– 20	—	–10	– 1	– 1	– 2
Italy	– 1	– 5	2	– 5	..	..	..
Canada	– 1	– 3	– 1	—	– 4	– 4	2

(a) Seasonally adjusted.

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

the official financing of the US deficit probably reflected to a great extent the activities of central banks in the G10 countries, in the first six months of 1988 it may, at least after January, have been more the result of the accumulation of official dollar reserves by a number of non-G10 countries. Moreover, US balance of payments data, which in 1987 understated the degree of official financing, may have overstated it in the first half of last year, as some official dollar balances previously invested in the eurodollar market may have been shifted to the United States. In the second and third quarters there was a resurgence of private capital inflows into the United States. Indeed, in the third quarter, a period of dollar strength, the current account deficit was more than financed by such flows—the United States increased its foreign exchange reserves and there were net sales of US securities by foreign official authorities. The large balancing item in the third quarter implies that it is not possible fully to identify the components of private capital inflows. However, it appears that both direct and portfolio investment rose in the first three quarters of 1988 compared with the second half of 1987; and the net inflow through the banking system fell back, while remaining positive.

The usual pattern of *Japanese* private capital movements, with large longer-term net outflows and shorter-term net inflows, was again evident in the first three quarters of 1988 taken together. Within the longer-term component there was an increase in net direct investment outflows and a decline in net outward portfolio investment. The latter is, however, still by far the larger outflow. Portfolio investment increased in the middle of the year compared with the relatively small figure in the first quarter and remained strong thereafter. Purchases of foreign securities by Japanese residents were, however, more moderate in 1988 than in the previous two years. The rise in direct investment outflows is in part related to the relocation of some Japanese companies in other countries, in order to maintain a competitive price in world markets following the yen's appreciation and to overcome trade restrictions. There was a net outflow of short-term funds through the banking system in the first quarter, but this was followed by substantial net inflows in the next six months. Official capital outflows associated with an increase in foreign official assets amounted to some $10 billion in the first three quarters of last year, well below the total figure of $40 billion in 1987.

The most notable feature of *German* private capital flows in the first three quarters of 1988 was the outflow of portfolio investment. In 1987, there had been a net inflow of $5 billion associated with this component, although there had been net outflows in the second half of the year. In the first nine months of last year, however, there was a net outflow of almost $30 billion, mainly reflecting increased purchases of foreign securities by German residents. This net outflow may partly reflect the higher nominal interest rates prevailing in some other financial centres and the announcement of the introduction, in 1989, of a withholding tax on interest earnings on German securities. The modest net outflow of direct investment continued in 1988 and, although there were net outflows through the banking system in the second and third quarters, this followed a large inflow in the first quarter. The major counterpart to the larger outflow of portfolio investment has been the turnaround in the official financing balance. German foreign exchange reserves rose by $18 billion in 1987, reflecting intervention to support the dollar. By contrast, the weakness of the deutschemark against the dollar through to last autumn led to intervention by the Bundesbank to support the German currency, particularly in the third quarter.

In *France*, there was a small net outflow of long-term capital in the first half of 1988, with inflows of portfolio investment, particularly in the second quarter, being offset by outflows of direct investment. There was a net inflow of around $1 billion associated with the shorter-term components, and a net outflow due to an increase in foreign official assets.

Interpretation of recent *UK* figures is hindered by the particularly large balancing item, which probably reflects to a great extent unrecorded capital inflows. The balancing item for 1988 as a whole could be greater than the year's recorded deficit on current account and, in absolute terms, may exceed the record $21½ billion in 1986. Of the identified flows, there was a net inflow of portfolio investment in the third quarter for the first time last year. Following three quarters of disinvestment abroad in 1987, OFIs returned to net investment in overseas securities in each of the first three quarters of 1988, though on a more modest scale than in 1986. In the first half of last year, much of the new investment was concentrated in overseas bond markets. In the third quarter, however, there was modest disinvestment in bonds and, although total acquisitions of equities rose, the net outflow fell back. UK banks were net sellers of overseas securities in the third quarter, while there were large purchases of UK ordinary shares by overseas investors, the dominant influence being the first call on the BP privatisation issue. There was a net sterling capital inflow through the banking system in the third quarter, probably reflecting the continued attraction of high UK interest differentials against other major economies. The inflow was, however, smaller than in the preceding two quarters.

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, but a net inflow of $2 billion associated with the same component in the third. There was a net inflow of portfolio investment of $8 billion in the first three quarters and a small net outflow on direct investment. In the third quarter, the net inflow through the banking system was $4 billion, compared with an outflow of $2 billion in the first half of the year.

Figures for the identified deployment of oil exporters' funds are available in full detail only to the second quarter of 1988. In the second quarter, the oil exporters continued to disinvest in securities but built up their bank deposits (particularly in the United Kingdom). Their current

Identified deployment of oil exporters' funds[(a)]
$ billions

	June 1987 levels	1987 Q3	1987 Q4	1988 Q1	1988 Q2	June 1988 levels
Industrial countries						
United Kingdom:						
Sterling bank deposits	6.8	0.4	2.0	—	2.2	11.6
Eurocurrency bank deposits	37.8	-0.4	-0.9	-1.1	1.5	37.0
Government paper	5.3	1.2	-0.7	0.3	-1.2	5.4
Other investments	11.0	0.2	1.6	0.6	0.1	12.5
	60.9	1.4	2.0	-0.2	2.6	66.5
Other EEC:(b)						
Domestic currency bank deposits	6.4	0.2	-0.4	0.4	0.2	6.8
Eurocurrency bank deposits	20.3	-0.2	1.7	-0.8	-0.7	20.3
Other investments	72.0	-0.2	-1.9	-3.1	-0.6	64.1
	98.7	-0.2	-0.6	-3.5	-1.1	91.2
United States:						
Bank deposits	18.9	2.5	-0.7	-0.6	-1.1	19.0
Government paper	21.4	0.3	-1.7	-0.4	-1.1	18.4
Other investments	23.9	-1.3	—	-1.1	-0.6	20.9
	64.2	1.5	-2.4	-2.1	-2.8	58.3
Other:						
Domestic currency bank deposits	3.7	-0.3	2.2	-0.5	2.3	7.7
Eurocurrency bank deposits	28.6	0.7	2.0	1.4	-1.6	31.1
Other investments	46.4	-7.5	5.1	-0.4	-1.4	43.5
	78.7	-7.1	9.3	0.5	-0.7	82.3
Offshore centres:						
Bank deposits	46.1	-1.0	1.9	1.3	1.7	50.0
Placements with ldcs	59.5	—	—	—	—	59.5
OEC credit to non-banks	12.7	—	—	0.1	0.1	12.9
IMF and IBRD(c)	39.6	-0.2	-0.2	0.2	—	34.8
Total identified additions(+)/reductions (–) in deployed assets	**460.4**	**-5.6**	**10.0**	**-3.7**	**-0.2**	**455.5**
Net funds available for deployment		-2.4	-1.3	-2.4	-2.9	
of which:						
Net movements in external borrowing etc		*-1.3*	*0.2*	*0.6*	*1.7*	
Current balance		*-1.1*	*-1.5*	*-3.0*	*-4.6*	

(a) The oil exporting countries covered are defined in the notes and definitions to Table 16 of the statistical annex.
(b) Includes Spain and Portugal.
(c) Includes holdings of gold.

account deficit has continued to increase—from an estimated $4.6 billion in the second quarter of 1988 to about $6 billion in the third.

International capital markets

Overall activity in the international capital markets declined from $106.6 billion in the third quarter of 1988 to $89.0 billion in the fourth. For the year as a whole, however, there was a record volume of activity, totalling just over $400 billion compared with $337 billion in 1987, thus confounding predictions made immediately after the stock market crash of a sharp decline in international borrowing. Rapid growth of world output and investment and corporate restructuring activity were key factors underlying borrowing activity during the year.

The markets for straight fixed-rate bonds and syndicated credits maintained a level of activity in the fourth quarter similar to that in the third, while the issuance of equity-related bonds and announcements of new euronote programmes declined. The lower volume of issuance in the market for equity-related bonds reflected the problems of oversupply apparent earlier in the year which disrupted the calendar of issuance. As well as seasonal factors, the decline in announcements of euronote programmes may reflect the maturity of the market (as most borrowers desiring programmes have now instituted them) and the flatness of the yield curve.

Announced international bond issues[(a)]
$ billions

	1987	1988 Year	1988 Q1	1988 Q2	1988 Q3	1988 Q4
Fixed-rate bonds						
Straights	117.0	159.2	48.7	41.0	35.3	34.1
Equity-related bonds	43.3	42.0	7.9	14.9	14.1	5.1
of which:						
Warrants	*25.6*	*30.0*	*5.5*	*10.8*	*9.9*	*3.8*
Convertibles	*17.6*	*12.0*	*2.5*	*4.1*	*4.3*	*1.3*
Bonds with non-equity warrants (currency, gold, debt)	3.3	1.2	0.2	0.7	0.1	0.2
Total	**163.6**	**202.4**	**56.9**	**56.6**	**49.6**	**39.5**
Floating-rate notes	**12.0**	**23.1**	**3.2**	**6.0**	**6.9**	**7.0**
Total gross new issues	**175.6**	**225.5**	**60.1**	**62.6**	**56.5**	**46.5**
Repayments	71.0	77.8	21.0	18.2	16.6	23.0
Total net new issues	**104.6**	**147.7**	**39.1**	**44.4**	**39.9**	**23.5**

(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.

Fixed-rate bonds

Total issuance of fixed-rate bonds declined from $49.6 billion in the third quarter to $39.5 billion in the fourth, largely reflecting a sharp fall in issuance of equity-related bonds. Japanese borrowers accounted for the bulk of the fall, as their fixed-rate issuance fell from $17.5 billion to $8.2 billion, although activity by US borrowers also declined, from $4.5 billion to $2.7 billion, and reductions were also recorded by French and German issuers. Borrowing by UK entities increased from $1.6 billion to $3.2 billion. In spite of the relatively buoyant level of issuance, secondary market turnover for eurobonds remained depressed, prompting a further round of retrenchment by intermediaries.

The volume of straight fixed-rate bonds in the fourth quarter was marginally lower than in the third, at $34.1 billion. There was a decline in issuance of dollar-denominated bonds, offset by increases in most other currencies, notably sterling and the ECU. Renewed weakness of the dollar and upward pressures on US interest rates were the principal factors underlying the fall in dollar-denominated issues. Issuance by US corporations was subdued, following heightened concerns by bond investors over the risk of sudden price falls associated with reductions in credit quality following the spate of leveraged buyouts of large US corporations. Foreign borrowers in the New York market took advantage of this to step up issuance of 'Yankee' bonds. The ECU sector benefited from good swap opportunities and increased popularity following the successful UK

Currency composition of fixed-rate bond issues
Percentages of total issues

Currency denomination	Straight bonds 1988 Year	Straight bonds 1988 Q3	Straight bonds 1988 Q4	Equity-related bonds 1988 Year	Equity-related bonds 1988 Q3	Equity-related bonds 1988 Q4
US dollars	29.4	48.2	23.8	68.0	67.3	65.6
Swiss francs	11.2	7.5	9.7	20.7	26.5	20.7
Yen	11.9	7.8	11.2	—	—	—
Deutschemarks	13.1	14.4	13.1	2.8	3.9	4.9
Sterling	7.3	0.7	6.9	4.3	—	2.1
Australian dollars	4.6	2.7	6.6	0.6	1.0	—
Canadian dollars	8.2	6.9	8.2	—	—	—
ECU	6.6	4.6	11.3	1.2	—	2.3
Other	7.7	7.2	9.2	2.4	1.3	4.4

auctions of Treasury bills denominated in ECU, while the reduction in net issuance of gilts increased funding opportunities in the eurosterling sector. High-coupon currencies such as the Canadian dollar and the Australian dollar again proved popular with continental European investors. Activity in deutschemarks was initially affected by continuing uncertainty over the withholding tax, although confidence eventually returned and there was a recovery in issuance in December.

Equity-related issues declined sharply from $14.1 billion to $5.1 billion. The proportions of total equity-related bonds in dollars and Swiss francs were similar to those in the third quarter. Most of the decline in total issuance was accounted for by Japanese borrowers.

Floating-rate notes

The volume of floating-rate notes issued in the fourth quarter was similar (at $7.0 billion) to that in the third, and remained well above the quarterly average for 1987. At $23.1 billion, issuance in 1988 was almost double that in 1987. There was a strong revival in issuance in dollars in the fourth quarter, aided by innovations such as instantly repackaged perpetuals and perpetual variable-rate notes, though the market also continued to feature sterling mortgage-related FRNs, in the form of either mortgage-backed issues by specialist lenders or issues by building societies. A number of sovereign borrowers took advantage of the dearth of sovereign paper (for example, Portugal with a $700 million issue of 5-year FRNs). The National Westminster Bank launched the first perpetual floating-rate bonds since 1986 using the variable-rate note structure (whereby both the Libor reference rate and the spread above it are reset periodically). Four borrowers (of which two were banks) used the technique of instantly repackaged perpetuals to obtain $1.4 billion in subordinated funds. These instruments aim to benefit from fiscal advantages to raise primary capital by using complex repackagings of subordinated perpetual FRNs into dated FRNs through the purchase of zero-coupon US Treasury bonds.

Euronotes and other facilities

Announcements of new euronote programmes, after reaching a peak of $23.6 billion in the third quarter, fell to $14.1 billion in the fourth. However, overall activity in the second half of 1988, as measured by new announcements, was similar to that achieved in the first half, and the total value of new announcements for 1988, at $76.4 billion, was above the equivalent annual figures for 1986 and 1987. According to estimates by Euroclear, the value of all euronotes outstanding decreased marginally from $73.1 billion at the end of the third quarter to $72.6 billion at the end of December. This decline was largely seasonal. The value of outstanding eurocommercial paper (ECP) fell from $54.6 billion at the end of September to $53.4 billion at the end of December.

The majority (83%) of new euronote facilities announced continued to be denominated in dollars. The most significant borrowers were from a wide variety of OECD countries, notably Australia, New Zealand, Japan, Sweden and the United Kingdom. New Zealand arranged a $500 million ECP programme in December to complement its existing US-CP programme. US activity was relatively minor, as borrowers in that country turned to the well-established domestic CP market. The Soviet Vnesheconombank became the first Soviet institution to obtain an ECP programme, with a $250 million programme announced in the fourth quarter.

Announced euronote facilities[a]

$ billions

	1986	1987	1988				
	Year	Year	Year	Q1	Q2	Q3	Q4
Committed(b)	15.0	3.9	3.7	1.0	1.0	1.6	0.1
Uncommitted	55.9	69.0	72.2	22.4	13.7	21.9	14.2
Total	**70.8**	**72.9**	**76.4**	**23.4**	**15.2**	**23.6**	**14.1**
of which:							
Major OECD	*44.8*	*47.4*	*43.8*	*14.4*	*6.8*	*14.7*	*7.9*
Minor OECD	*23.4*	*23.3*	*26.6*	*8.0*	*7.2*	*5.3*	*6.0*
Other	*2.7*	*2.1*	*6.0*	*1.0*	*1.2*	*3.6*	*0.3*
Selected nationalities of borrower							
United States	19.0	16.0	9.8	4.1	1.1	3.7	0.8
United Kingdom	2.6	9.8	10.9	4.1	2.2	2.8	1.8
Australia	6.4	8.5	6.0	1.7	1.6	1.7	0.9
Japan	10.4	10.0	5.9	—	1.8	2.0	2.1

(a) Includes all facilities providing for the use 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.

Innovations introduced in previous quarters in the ECP market continued to develop. One of the major Japanese securities houses announced that it had established another ECP programme where the return on paper issued is linked to a Japanese government bond futures contract. Such arrangements can appeal to distinct groups of investors each with different perceptions of how the futures market will perform. These programmes offer purchasers the opportunity of acquiring notes that belong to one of three categories referred to as bull, bear and neutral paper. Holders of bull paper benefit most if the value of the futures contract rises, while those who hold bear paper will benefit if it falls.

A new financing mechanism referred to as a continuously-offered payments right programme (COPS) has been developed in order to enable investors to purchase short-term Swiss franc denominated investments without incurring Swiss stamp duty. (Because of the existence of a Swiss stamp duty on securities transactions, borrowers have not been able to develop a commercial paper market in Switzerland.) Under these schemes, claims are offered continuously, as is the case with commercial paper, but, as no security is issued (they are recorded in book-entry form), they are not subject to the stamp duty. During the second half of 1988, three new COPS programmes were announced. In general, these programmes have been targeted at retail investors.

Syndicated credits

International syndicated credits maintained a high level of activity in the fourth quarter, with new announcements amounting to $28.4 billion compared with $26.5 billion in the third. As in the third quarter, the demand for new

Announced eurocurrency syndicated credits
$ billions

	1986	1987	1988				
	Year	Year	Year	Q1	Q2	Q3	Q4
Major OECD	11.6	61.4	71.1	16.9	15.7	21.3	17.3
Minor OECD	6.6	14.9	20.3	5.2	4.9	3.1	7.1
Developing countries	8.7	9.6	9.3	2.3	1.4	2.0	3.5
Eastern bloc	2.0	1.9	1.2	0.2	0.5	0.1	0.3
Other	1.0	0.8	0.1	—	0.1	—	—
Total	**29.9**	**88.7**	**102.0**	**24.6**	**22.6**	**26.5**	**28.4**
of which, transferable	*3.3*	*2.7*	*2.3*	*0.6*	*0.2*	*0.4*	*1.1*

credit facilities came increasingly from companies which needed credits in order to finance takeovers or refinance debt incurred in previous acquisitions. UK companies continued to account for a large proportion of merger-related credits; for example, major credit facilties were arranged on behalf of Grand Metropolitan Finance plc ($6 billion) and Beazer plc ($2.3 billion). Most merger-related loans were denominated in dollars, reflecting the intended or past acquisition of US-based corporations. For the year as a whole, the value of announced syndicated credits associated with merger activity is estimated at $30.3 billion (out of a total of $101 billion).

Merger-related loans are attractive to lenders because the margins are often high when compared with the spreads that are charged to corporate borrowers who draw upon other standby credits such as multiple-option facilities. This partly reflects the greater credit risk posed by highly geared companies. (This has led some banks to set margins which are contingent upon some performance criterion such as the borrower's gearing or interest cover ratio.) More recently there has been some evidence to suggest that margins associated with this type of lending have declined, mainly as a result of increased competition, although the greater emphasis that many banks placed on this type of activity during the course of 1988 suggests that it is regarded as a profitable source of business.

In contrast with the growth of merger-related loans, the arrangement of multiple-option facilities for major industrial companies has become a less prominent part of the euroloan market since the first half of 1988. There is, however, a steady demand for medium-term loans from lower-rated corporate borrowers who are unable to utilise the eurobond market or who may prefer the stability and implicit insurance offered by banking relationships.

International banking developments

Cross-border lending by BIS reporting area banks increased by 2% ($93 billion) in the second quarter of 1988 but growth remained below the high rate recorded throughout most of 1987. The increase was largely attributable to a strong recovery in external claims of banks in the United States, mostly *vis-à-vis* other reporting area banks. Cross-border lending by banks in Europe also picked up. In contrast, the growth rate of external claims by banks in Japan slowed sharply, partly perhaps for seasonal reasons, although Japan continues to dominate cross-border banking business. Net inflows from countries outside the reporting area increased, largely owing to a continued fall in recorded claims on Latin America (thought to have been due in large part to debt sales and conversions) and an increase in deposits from outside-area developed countries and from OPEC.

The BIS international banking figures for the third quarter were not available in time for publication, but on the basis of partial data for some countries, the indications are that cross-border banking business accelerated strongly. Capital account figures published by the Bank of Japan show that short-term cross-border bank lending increased by $63.8 billion in the third quarter while cross-border borrowing increased by $84.2 billion. This represents a rapid acceleration in the rate of growth of the external business of banks in Japan compared with the second quarter and is consistent with third quarter figures from the United Kingdom showing very strong growth in lending to Japanese banks (+$19.3 billion). This may have been partly seasonal, with mid-year window-dressing operations by the Japanese banks, but banks may also have been taking advantage of the differential between domestic and euroyen rates which existed in that quarter. Hong Kong figures also indicate a substantial resumption of interbank business with Japan. Overall external lending by banks in the United Kingdom grew by $28.4 billion, the strongest growth since the corresponding period of the previous year. In the United States, Department of Commerce figures show the rate of growth of external bank lending to have doubled to $27 billion in the third quarter from $13 billion in the second while the growth of

Cross-border business of banks in the BIS-reporting area
$ billions; changes exclude estimated exchange rate effects

	1986	1987			1988		Out-standing at end-Sept. 1988
	Year	Year	Q3	Q4	Q1	Q2	
Liabilities vis-à-vis:							
BIS-reporting area	384.5	495.9	147.1	118.3	53.0	102.1	2,841.9
'Offshore' centres	128.8	126.3	58.6	37.7	14.7	23.7	751.5
Sub-total	513.3	622.2	205.7	156.0	67.7	125.8	3,593.4
Outside reporting area							
Developed countries	7.2	5.9	3.2	−0.7	1.0	7.5	62.5
Eastern Europe	− 0.1	0.8	0.8	0.3	0.4	1.0	31.2
Oil exporters	−22.0	19.4	2.3	8.5	0.5	5.1	171.4
Non-oil developing countries	12.8	23.9	−1.2	5.9	2.9	3.0	229.4
of which, Latin America	*0.8*	*6.7*	*0.8*	*0.9*	*2.8*	*0.7*	*81.7*
Sub-total	− 2.1	48.5	5.0	14.1	4.8	16.5	494.5
Other(a)	31.1	34.8	6.5	6.9	11.4	2.9	196.5
Total	**542.3**	**705.6**	**217.2**	**177.1**	**83.9**	**145.5**	**4,284.5**
Assets vis-à-vis:							
BIS-reporting area	394.8	454.8	138.5	114.4	58.5	80.2	2,675.1
'Offshore' centres	96.0	140.5	57.2	33.3	15.2	9.1	694.7
Sub-total	490.7	595.3	195.7	147.7	73.7	89.3	3,369.8
Outside reporting area							
Developed countries	6.7	5.1	0.7	1.9	−0.9	3.9	129.4
Eastern Europe	3.4	2.3	1.5	—	2.9	1.3	82.1
Oil exporters	0.4	2.0	−0.9	−0.2	−0.9	2.2	123.9
Non-oil developing countries	3.0	1.7	−6.2	6.2	−5.3	−4.8	369.4
of which, Latin America	*1.6*	*3.9*	*−3.2*	*−2.2*	*−3.4*	*−2.6*	*218.4*
Sub-total	13.5	11.1	−4.9	7.9	−4.1	2.6	704.8
Unallocated and international institutions	13.1	11.4	6.2	−1.1	−1.2	1.3	98.1
Total	**517.3**	**617.8**	**197.0**	**154.5**	**68.5**	**93.2**	**4,172.5**

(a) Includes international institutions, unallocated and issues of securities.

cross-border deposits with US banks was little changed at $30 billion. Since these three countries account for about half of total international bank assets booked in the BIS-reporting area, the BIS third quarter figures are expected to show a substantial increase in overall cross-border business.

The London market

In the third quarter of 1988, lending by banks in the United Kingdom increased by $28.4 billion (3.4%). Deposits grew by $30.2 billion (3.3%) with the result that UK banks were net takers of $1.8 billion.

The *BIS-reporting area and offshore centres* accounted for almost all of the increase in lending (claims on the BIS area increased $28.0 billion) and over half ($18.8 billion) of the increase in deposits. Japan was by far the largest net taker of funds ($11.2 billion). Business was again concentrated on the interbank market, which accounted for $9.9 billion—probably at least partly seasonal. Non-banks in Japan accounted for the remaining $1.3 billion, returning to a position of net takers (after being in the unusual position of net providers in the previous quarter). The United States remained the second largest net taker of funds ($4.6 billion). While American banks were again small net providers ($1.0 billion), this was more than offset by a substantial decrease ($5.5 billion) in deposits placed by US non-banks, in contrast to the increase ($3.5 billion) in the previous quarter.

The Cayman Islands were the largest net placers ($3.5 billion) reflecting a larger than normal increase in deposits, ($3.0 billion compared with $0.4 billion in the second quarter and a decrease in the first) together with a small decrease in claims ($0.5 billion). This business was centred on the banking sector. The second most significant net provider of funds was Germany, with placements of $3.1 billion; the most striking feature here was the substantial rise in interbank deposits of $3.3 billion, which follows the fall shown over the previous four quarters. The Netherlands ($2.9 billion), Belgium ($1.8 billion) and Canada ($1.0 billion) were also substantial net providers.

Apart from Japan and the United States, the major net taker of funds this quarter was France ($2.4 billion), which was largely attributable to an increase of $2.7 billion in lending to French banks. This is in sharp contrast to their second quarter position as the largest net placer of funds. Switzerland ($1.8 billion), the Bahamas ($1.5 billion), Singapore ($1.4 billion) and Denmark ($0.1 billion) were also substantial net takers of funds, all showing increases in interbank borrowing. Business with Hong Kong contracted slightly on both sides of the balance sheet, resulting in a shift in position from that of a major net placer in the second quarter to one of small net taker of $0.3 billion in the third.

Deposits placed with UK banks by *all countries outside the BIS-reporting area* increased by $4.2 billion, while their debts to UK banks fell by a total of $2.2 billion. The oil exporting countries were major net placers of funds of $2.4 billion.

Cross-border business of banks in the United Kingdom

$ billions; changes exclude estimated exchange rate effects

	1986	1987		1988			Outstanding at end-Sept. 1988
	Year	Year	Q4	Q1	Q2	Q3	
Liabilities vis-à-vis:							
BIS-reporting area	69.6	56.6	6.0	10.8	17.3	16.2	604.0
of which:							
United States	*12.4*	*14.1*	*- 6.6*	*- 1.4*	*5.6*	*- 4.4*	*161.4*
Japan	*28.4*	*13.7*	*- 2.8*	*8.8*	*5.7*	*9.6*	*101.0*
'Offshore' banking centres	10.1	4.5	0.4	- 4.1	5.1	2.6	117.7
Sub-total	79.6	61.2	6.5	6.7	22.4	18.8	721.7
Outside reporting area							
Developed countries	0.2	3.1	- 0.8	0.6	2.3	3.4	24.0
Eastern Europe	—	- 0.2	0.5	- 0.7	0.1	0.3	7.8
Oil exporters	- 8.5	0.2	0.6	- 0.9	4.1	2.5	50.6
Non-oil developing countries	2.1	8.6	0.6	- 1.5	0.2	- 2.0	47.3
of which, Latin America	*- 0.5*	*3.0*	*- 0.7*	*- 0.3*	—	*- 1.5*	*6.1*
Sub-total	- 6.2	11.8	0.9	- 2.6	6.7	4.2	129.7
Other(a)	19.6	14.8	6.8	- 0.4	- 3.8	7.2	79.9
Total	**93.0**	**87.7**	**14.2**	**3.6**	**25.3**	**30.2**	**931.4**
Assets(b) vis-à-vis:							
BIS-reporting area	69.0	80.6	22.1	4.0	15.5	27.3	606.8
of which:							
United States	*14.3*	*29.1*	*1.3*	*-13.7*	*5.0*	*0.2*	*130.4*
Japan	*50.0*	*42.8*	*8.2*	*12.6*	*9.4*	*20.9*	*204.8*
'Offshore' banking centres	7.5	5.3	- 2.2	- 3.0	2.0	0.7	116.7
Sub-total	76.5	86.0	19.9	1.0	17.5	28.0	723.5
Outside reporting area							
Developed countries	1.0	- 1.4	0.2	- 1.6	0.4	- 0.9	33.5
Eastern Europe	2.4	0.6	- 0.5	0.9	0.5	0.4	22.0
Oil exporters	0.1	- 0.6	- 0.3	- 0.5	0.8	0.1	20.0
Non-oil developing countries	- 0.9	- 2.4	- 0.7	- 1.2	- 1.9	- 1.8	50.2
of which, Latin America	—	*- 2.3*	*- 1.1*	*- 0.7*	*- 0.4*	*- 1.6*	*31.8*
Sub-total	2.5	- 3.8	- 1.3	- 2.4	- 0.3	- 2.2	125.7
Other(a)	7.2	4.5	3.4	- 2.3	- 0.7	2.6	14.6
Total	**86.2**	**86.7**	**22.0**	**- 3.7**	**16.5**	**28.4**	**863.7**

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

The largest net provider of funds within the 'other developed' country group was Greece ($1.4 billion), which for the second consecutive quarter significantly increased deposits with UK banks. Australia and Portugal were also net placers ($0.8 billion each), Australia because of debt repayment ($0.9 billion) and Portugal because of an increase in deposits ($0.6 billion). Lending to Eastern European countries increased by $0.4 billion, largely reflecting a rise of $0.3 billion in borrowing by East Germany which was only partially offset by a $0.2 billion increase in deposits, and a placement of $0.2 billion with the USSR. Brazil's recorded debt fell by a further $1.5 billion. Lending to Mexico remained fairly static, but they drew down $1.2 billion of their London deposits.

Following a fall in the second quarter, the Japanese banks' share of the external lending market increased again, by one percentage point, to reach an all-time high of 40.4%. British banks have maintained their market share of just under 16% since the second quarter of 1987 (when it fell from 16.4%). The market share of US-owned banks continued to fall, (by 0.5%) to 12.4%. After an increase in the second quarter 'other overseas' banks' share of business fell back to 29.2%.

The strongest rise in lending in the third quarter was in yen ($14.7 billion), so that the yen's share of total lending rose by 1% to 12%. Dollar lending increased by $3.3 billion but fell as a share of total lending from 54% to 53%. Deutschemark and Swiss franc denominated lending both showed more moderate increases. Demand for sterling lending was low, probably because of high interest rates, growing by $1.1 billion in the third quarter compared with $12.9 billion in the first half of the year.

In the fourth quarter of 1988, international assets of banks in the United Kingdom fell back by $2.9 billion (0.3%) following the strong growth of the third quarter ($45.4 billion). Over the year as a whole, international claims rose by only some 4½%, compared with 9% in 1987 and 15% in 1986. The fall-off in international claims in the fourth quarter was spread across lending to other banks both within the United Kingdom and overseas; lending to non-banks in the United Kingdom and overseas increased by $5.6 billion and $5.9 billion respectively. Similarly, in the whole of 1988 it was interbank lending which was almost entirely responsible for the slowdown in the growth of total international bank lending.

The American banks significantly stepped up their international activities in the fourth quarter with an increase in claims of $6.6 billion (4.8%). Similarly 'other overseas' banks' lending activities rose by $9.3 billion (2.5%) in the fourth quarter, the most significant growth seen since the same quarter of the previous year. In both cases much of this growth was accounted for by an increase in claims on non-banks and, in the case of the American banks, an increase in lending to own offices overseas ($6.5 billion).

In contrast, British and Japanese banks' lending contracted over this period, by $9.8 billion and $8.9 billion respectively. The decrease in the Japanese banks' claims, which did not reverse the sharp increase in the previous quarter, was due to the unwinding of business with own offices overseas ($13.3 billion) and a simultaneous increase in lending in the interbank market overseas ($6.9 billion). The British banks, on the other hand, reduced their lending in the overseas interbank market by $9.3 billion, more than reversing the marked increase during the third quarter.

The growth in external sterling business, which peaked in the second quarter, was partially reversed by a fall in assets of the equivalent of $5.7 billion; deposits also fell (by $1.4 billion), making a net inflow of sterling ($4.3 billion).

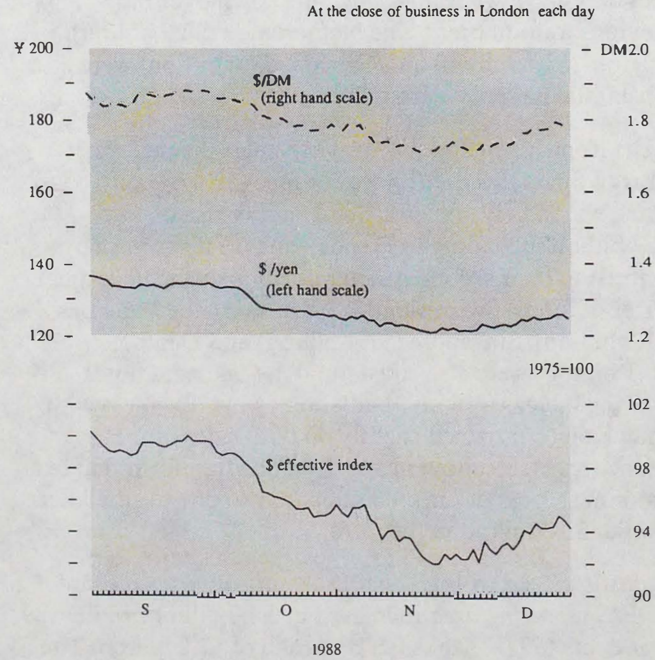
Since the end of 1987, American and Japanese banks in the United Kingdom have broadly maintained their share of international business, at around 13% and 36% respectively. The share of the 'other overseas' group has slightly increased to 33½%, offset by a fall in that of British banks to 17%.

Foreign exchange and gold markets

This section reviews the three months to end-December.
Sentiment towards the dollar turned bearish in October following disappointing trade data and other economic statistics which suggested that the pace of growth in the United States was slowing. The US currency fell sharply after the Presidential election as dealers became pessimistic about the prospect of action to reduce the US fiscal and balance of payments deficits, but in December an increasingly firmer tone in US interest rates and book-squaring demand underpinned the dollar and it began a recovery.

Having opened on 3 October at DM 1.8685 and ¥133.90, the dollar initially softened (to DM 1.8572 and ¥133.00 on 4 October) in the wake of a sharp fall in oil prices—on fears of Saudi overproduction—which lowered inflation expectations in the United States and thus forecasts of future US interest rates. Weaker-than-expected employment data for September, published on 7 October, turned sentiment against the dollar. Although unemployment fell to 5.4% from 5.6%, the growth in non-farm payrolls was not as strong as expected, suggesting that the Federal Reserve was unlikely to have to tighten monetary policy; this prompted heavy sales of dollars. When an increased US trade deficit for August was announced on 13 October, the dollar fell sharply and, with no encouragement being provided by sluggish data for US industrial production and retail sales, touched DM 1.7950 and ¥126.00 in the Far East on 17 October. The Bank of Japan's indication of its readiness to support the dollar subsequently sparked a recovery, but weak figures for US durable goods orders in September and for third quarter US GNP re-established a bearish tone, causing the dollar to fall to ¥124.55 and a low for the period of DM 1.7645 on 31 October.

Dollar exchange rates



The dollar was subsequently helped by reported intervention by the Bank of Japan and the Federal Reserve and, as the US election drew near, firmed in anticipation of a Republican victory, touching highs of DM 1.8035 and ¥126.00 in the Far East on 9 November as the result became clear. However, a wave of profit-taking sales (when it became clear that President-elect Bush would be confronted by a Democrat-controlled Congress) caused the dollar to fall sharply and, following statements by foreign monetary officials warning about the consequences of the US budget and trade deficits and comments from Feldstein (a former chairman of the Council of Economic Advisers) that the dollar needed to fall to DM 1.45 and ¥100 within three years, it touched DM 1.7645 and ¥124.20.

The dollar subsequently drew some support from unexpectedly good figures for US wholesale prices, but selling pressure intensified in thin markets on Remembrance Day and the US currency touched DM 1.7347 and ¥122.55, largely unaffected by reports of intervention by the Bank of Japan and European central banks. The dollar steadied at around DM 1.7450 and ¥123.50 before the publication of the US trade figures, but the deficit in September was no better than expected and the underlying bearish mood resurfaced. The dollar encountered heavy selling in New York and the Far East on 16/17 November, falling to a ten-month low against the yen. Reports of concerted central bank support for the dollar were offset by US Treasury Secretary Brady's comments that he was not worried by the dollar's weakness and saw no signs that US interest rates would rise.

Underlying sentiment remained bearish and when, on 21 November, President-elect Bush again ruled out tax increases as a means of reducing the fiscal deficit, a further wave of dollar selling was triggered. Reports of renewed intervention from the Federal Reserve and the Bank of Japan had little effect and, with news of a fall in US durable goods orders (excluding defence) during October providing a further reason for selling, the dollar touched lows for the period of DM 1.7100 and ¥120.75 in the Far East on 28 November. A brisk technical rally ensued as short-covering was spurred by expectations of an early rise in the Federal Reserve's discount rate (expectations which were reinforced by the ½% rise—to 10½%—in US prime rates) and the dollar reached DM 1.7427 and ¥122.00 on 2 December in the wake of much stronger than forecast non-farm payroll data for November. However, heavy selling emerged at the higher levels on disappointment that there was not an immediate ½% rise in the Federal Reserve's discount rate and, as a result, the US currency fell back sharply to DM 1.7212 and ¥121.15.

A resurgence of speculation about an increase in the discount rate sparked a further rally and the dollar advanced strongly in the Far East on 7 December on reports that the Russians were to announce defence cuts which, if matched by the Americans, would result in a cut in the US fiscal deficit. President Gorbachev's confirmation of such cuts in his speech to the United Nations triggered a hectic period of trading during which the dollar touched highs of DM 1.7725 and ¥124.15.

However, as dealers reappraised the significance of President Gorbachev's speech and noted a statement by German Economics Minister Haussman implying the need for higher deutschemark interest rates, the dollar suffered a bout of profit-taking and bearish sentiment again predominated following publication of US trade figures for October. The dollar fell back to DM 1.7340 and ¥122.80 on 14 December, but end-year demand subsequently led to a recovery and, with firmer US interest rates prompting renewed speculation about an increase in the Federal Reserve's discount rate, the dollar moved up gradually in quiet markets. It reached DM 1.7980 and ¥126.25 on 28 and 29 December before ending the year at DM 1.7725 (down 5.7% over the quarter), ¥124.95 (down 7.1%) and Sw.Fc.1.5020 (down 5.6%); in effective terms it fell by 5.4% to 94.2 (1975=100).

EMS

As sentiment towards the dollar turned bearish, tensions emerged within the ERM in early October, with the deutschemark replacing the Irish punt at the top of the narrow band and the French franc replacing the Belgian franc at the bottom. The Banque de France were reported to have intervened to support their currency, which also benefited from a rise in domestic interest rates on 18 October and from news that the French trade balance had moved from a sizable deficit in August to a small surplus in September. Although October's French trade figures were worse than expected, the French franc was underpinned during November and early December by comments from Finance Minister Beregovoy ruling out acceptance of a realignment of the franc; the effects of public sector strikes in France were brushed aside. Pressure re-emerged in mid-December amid speculation about the increase in German interest rates. The deutschemark rose to a record high against the French franc on 15 December but, with French interest rates moving higher in reponse to the ½% rise in German Lombard rate and the dollar itself gathering strength, the pressure within the EMS soon dissipated. The narrow band ended the period 1$\frac{13}{16}$% wide between the deutschemark and the French franc, while the Italian lira remained strong throughout the period, rising to narrow band level, despite a significant liberalisation of exchange controls on 1 October.

Gold

Although gold recovered from the year's lows seen in September, sentiment remained bearish. Having opened on 3 October at $394.20, gold benefited from a rise in oil prices, reaching $413.05 on 18 October. Although OPEC's failure to agree on a new oil production-sharing formula caused the gold price to fall back to $405.50 on 24 October, it was helped by rumours that Syrian troops were gathering on the Lebanese border and rose sharply (to $423.40 on 3 November) on the back of demand for platinum and silver. Gold subsequently drifted to $415.95 on 21 November on pessimism about the outcome of the OPEC meeting in Vienna, but made a swift recovery when an OPEC agreement was announced, and advanced strongly in New York on 2 December as a surge in US non-farm payrolls raised fears of higher inflation. However, after a fixing high for the period of $430.40 on 5 December, gold retreated as the dollar strengthened. A further setback came in the shape of Ford's announcement of a reduction in demand for platinum for car exhausts. The price of platinum fell sharply and gold was pulled lower in its wake. Gold fell to $411.75 on 16 December before rallying on the back of steadier platinum prices. By 23 December, it had edged up to $417.55, but fell back again in relatively active trading after Christmas: the final fixing of $410.15 represented a gain of $13.45 over the quarter.