International financial developments

Among the main developments:

- *The adjustment in the external imbalances of the United States, Japan and Germany evident earlier in 1988 appears to have stalled in the fourth quarter. Although the US current account deficit improved in nominal terms in the second half of the year, export volume growth slowed while import volumes picked up: and the latest monthly data for Japan and Germany suggest that their trade surpluses are rising again.*
- *On capital account, there was a substantial rise in direct investment flows to the United States in 1988, while there were sizable outflows from Japan, Germany and the United Kingdom among others. Increased acquisition and merger activity, prompted in part by the desire to reduce costs and exchange risks by locating some production abroad and by a wish to surmount potential trade barriers, is seen as the principal motive behind the increased direct investment flows.*
- *Activity in the international capital markets was sharply higher in the first quarter, with a substantial increase in issuance of equity-related bonds by Japanese borrowers the most important contributory factor: by contrast, announcements of new euronote facilities fell for the second consecutive quarter.*
- *In the foreign exchange markets, the dollar improved steadily throughout the first quarter of 1989 as economic statistics continued to indicate that the US economy was growing strongly; over the period as a whole, the dollar appreciated by more than 5% in effective terms.*

Balance of payment positions

Current accounts

The *US* current account deficit was little changed in the fourth quarter at $32 billion but this masked a larger trade deficit, offset by a shift in service transactions from net payments of $0.2 billion in the third quarter to net receipts of $4.5 billion in the fourth. The shift was due to a surge in receipts of income on US direct investment abroad, reflecting both higher operating earnings and the valuation effect associated with a decline in the value of the dollar at the end of the year. This suggests that adjustment in the US current imbalance may have stalled. The merchandise trade deficit increased to $32 billion in the fourth quarter from $29 billion in the third and $30 billion in the second. The growth in export volumes continues to slow and import volume growth increased in the second half of the year.

Japan's current account surplus rose to $21 billion in the fourth quarter ($18 billion in the third): for the year as a whole the current surplus fell to $78 billion (from $87 billion in 1987). The trade balance has begun to rise again in recent months, although from lower levels than in the previous year. The surge in the current balance in the fourth quarter was due to a slowing in imports, which grew 16.4% in the year to the fourth quarter (27.2% in the year to the third) while exports grew 14% (against 16.8%).

World current accounts[(a)]

$ billions; *seasonally adjusted*

	1987 Year	1988(b) Year	Q1	Q2	Q3	Q4
OECD economies:						
United States	–154	–136	–37	–34	–33	–32
Japan	87	78	22	17	18	21
Germany	45	48	9	16	12	11
France	– 4	– 4	1	—	– 1	– 4
United Kingdom	– 5	– 25	– 5	– 5	– 6	– 9
Italy	– 1	– 7	– 5	1	—	– 3
Canada	– 8	– 9	– 1	– 2	– 2	– 4
Major economies	– 40	– 55	–16	– 7	–12	–20
Other OECD	– 16	– 22	– 6	– 8	– 7	– 2
Total OECD	– 57	– 77	–22	–15	–19	–22
OPEC economies	– 10	– 22	– 4	– 6	– 6	– 6
Non-OPEC developing economies	12	4	3	—	—	1
Other economies(c)	8	8	2	2	2	3
World discrepancy(d)	– 46	– 87	–21	–19	–22	–24

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

(b) Includes Bank estimates.

(c) The centrally planned economies.

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

The invisibles deficit was slightly lower in the fourth quarter compared with the previous three months. The latest monthly data so far this year suggest that both the invisibles deficit and the merchandise trade surplus rose again in the first quarter and the current account surplus in February was $9 billion—among the highest monthly surpluses yet recorded.

Germany's current surplus fell to $11 billion in the fourth quarter of 1988, from $12 billion in the previous three months and a record $16 billion in the second quarter. However, the trade surplus also continued to be strong in January, reaching $7 billion—the second largest monthly surplus ever recorded. In volume terms, both exports and imports have been rising rapidly, with import growth exceeding export growth since the second quarter.

France recorded a current account deficit of $4 billion in the fourth quarter, from $1 billion in the third: the change was mainly the result of a large annual contribution to the EC which is not fully captured by seasonal adjustment. Revised figures for 1988 as a whole show a current account deficit of $4 billion, little changed from the previous year.

The current account deficit in the *United Kingdom* in the fourth quarter was $9 billion ($6 billion in the third). The visible trade deficit continued to rise and there was a large deficit in transfers.

Canada's current account deficit was $9 billion in 1988 ($8 billion in 1987). The merchandise trade surplus was unchanged at $8 billion but the deficit on non-merchandise transactions increased by $1 billion to $17 billion. The deficit on net investment income was $15 billion, up from $13 billion in 1987, mainly because of higher interest payments on banking operations and money-market borrowing.

The *Italian* current account deficit, as measured on a transactions basis, was $4 billion for the first half of 1988, compared with $1 billion for the whole of 1987. The deterioration was due in part to a much weaker visible trade performance and slightly lower tourism receipts. Monthly merchandise trade data suggest a further weakening in later months and the deficit of $3 billion in January was the highest-ever recorded monthly trade deficit.

Capital accounts

There was a marked shift in the composition of capital flows into the *United States* in 1988 as compared with the previous year. In 1987, capital flows were largely associated with the purchase of US securities and bank borrowing while direct investment recorded a small net outflow. In 1988, direct investment moved to a net inflow of $22 billion with a particularly large inflow in the second quarter. A favourable exchange rate, strong growth in the domestic economy and attempts to surmount potential trade barriers may have been the main explanations. Portfolio investment inflows picked up toward the end of the year with a resurgence in foreign official inflows indicating to some extent central bank intervention in the fourth quarter to stabilise the declining dollar. Private capital inflows were also strong during 1988, being attracted by high interest rates and expectations of a recovery in the exchange rate. Net banking inflows amounted to $21 billion in 1988, against $51 billion in 1987, with the largest inflow ($19 billion) occurring in the second quarter, helped by a narrowing in the interest differential between US domestic and euromarket rates.

Japan's capital account in 1988 showed the usual pattern of large longer-term net outflows and short-term net inflows. Net direct investment outflows were $35 billion ($18 billion in 1987) with a surge towards the end of the year. Net portfolio investment outflows were $65 billion in 1988, down from $97 billion in 1987—largely a reflection of more favourable sentiment towards the Japanese stock market by both foreign and domestic investors. Foreigners' purchases of Japanese securities rose in the fourth quarter while domestic purchases of foreign securities declined a little. Net short-term bank borrowing grew less strongly than in the previous year (by $62 billion compared with $96 billion). The latest Basle

External financing of the G7 countries, 1987–88 Q4

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

	1987	1988				
	Year	Year	Q1	Q2	Q3	Q4
Identified current account						
United States(a)	–154	–136	–37	–34	–33	–32
Japan	87	78	18	19	19	23
Germany	45	48	9	15	9	16
France	– 4	– 4	– 1	—	—	– 3
United Kingdom	– 5	– 25	– 6	– 6	– 6	– 8
Italy	– 1	– 7	– 5	1	—	– 3
Canada	– 8	– 9	– 4	– 1	—	– 4
Financed by:						
Portfolio investment						
United States(a)	75	82	32	23	7	21
Assets	– 5	– 8	– 5	2	– 2	– 3
Liabilities	80	90	37	21	8	24
of which:						
From official sector	45	43	28	6	– 3	13
From private sector	35	47	9	15	11	11
Japan	– 97	– 65	– 6	–25	–19	–14
Germany	5	– 36	– 9	–11	– 8	– 8
France	5	..	– 1	1	– 1	..
United Kingdom	28	– 12	– 5	– 7	4	– 5
Italy	– 4	..	..	..	..	..
Canada	9	10	2	3	4	1
Direct investment						
United States(a)	– 3	22	1	14	3	4
Japan	– 18	– 35	– 8	– 8	– 9	–10
Germany	– 7	– 9	– 2	– 4	– 2	– 1
France	– 4	..	– 1	– 1	– 1	..
United Kingdom	– 15	– 14	—	– 6	– 4	– 4
Italy	2	..	1	..	..	..
Canada	– 1	– 2	—	– 2	—	– 1
Banking sector						
United States(a)	51	21	– 2	19	3	2
Japan	80	47	– 6	23	21	9
Germany	– 4	– 4	8	– 3	– 6	– 2
France	– 11	..	4	– 4	2	..
United Kingdom	4	26	5	10	—	11
Italy	4	..	..	..	..	..
Canada	2	2	1	– 3	4	—
Other(b)						
United States(a)	21	14	4	–21	27	3
Japan	– 12	– 11	5	– 5	– 9	– 2
Germany	– 21	– 17	– 7	– 2	– 3	– 5
France	14	..	2	—	..	..
United Kingdom	7	31	7	10	8	7
Italy	2	..	..	..	..	..
Canada	2	7	5	6	– 9	4
Official financing balance (– = increase in reserves)						
United States(a)	9	– 4	2	—	– 7	2
Japan	– 39	– 16	– 3	– 3	– 4	– 7
Germany	– 18	18	2	5	11	—
France	—	..	– 4	2	..	..
United Kingdom	– 20	– 5	– 1	– 1	– 2	– 1
Italy	– 5	..	..	..		
Canada	– 3	– 8	– 4	– 4	2	– 1

.. not available.

(a) Seasonally adjusted.

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

convergence agreement may have prompted banks to restrain lending while firms have been easily able to raise capital using alternative financial instruments or retained earnings. Another notable feature in the fourth quarter was the large increase in official reserves, as the Bank of Japan intervened heavily in the currency markets to stabilise the yen exchange rate.

The most notable feature of *Germany's* private capital flows was a net outflow of portfolio investment, which amounted to $36 billion in 1988 (from a net inflow of $5 billion in 1987)—mainly in bonds, partly in reaction to the announcement of a withholding tax to be introduced at the start of 1989 but also attracted by higher yields in other financial centres. In addition, net direct investment outflows amounted to $9 billion in 1988 ($7 billion in 1987) and net outflows from the banking sector were recorded in the last nine months of the year, following a large inflow in the first quarter. Overall, the deficit on these elements of the capital account exceeded the record surplus on current account and reserves fell by $18 billion in 1988 (after having risen by the same amount in 1987), with the largest declines occurring in the third quarter as a result of intervention to support the deutschemark.

In *France,* a net outflow of long-term capital of $1.6 billion in the third quarter was followed by a further provisional outflow of $2.8 billion in the fourth (largely a result of increased French direct investment abroad). However, after a surplus of $4 billion in the first half of 1988 due to non-resident purchases of French securities, the long-term capital account showed a surplus of $0.6 billion in 1988 as a whole, following a surplus of $3.0 billion in 1987.

Capital inflows into *Italy* totalled $2 billion in the first half of 1988—as much as in the whole of 1987. This reflected high foreign investment inflows which more than offset residents' outflows.

In *Canada,* non-resident investment in Canadian securities grew strongly, with a record inflow into short-term securities. Net portfolio investment inflows amounted to $10 billion in 1988 ($9 billion in 1987). There was a record increase in Canadian direct investment abroad, causing the outflow on net direct investment to increase from $1 billion in 1987 to $2 billion in 1988. Canada's international reserves at year-end were nearly double their end-1987 level largely arising out of Bank of Canada intervention associated with the strength of the Canadian dollar.

The *United Kingdom's* identified capital account in the fourth quarter, as in the year as a whole, was dominated by net outflows on direct and portfolio accounts met by heavy net short-term inflows via the banking system, both in foreign currency and in sterling. While the size of the balancing item—a record $27 billion in 1988—greatly hinders interpretation of the accounts, the pattern has been one of a large structural deficit (current balance plus direct investment) being financed by liquid funds. 1988 saw a continuation of the recent trend of net outward direct investment ($14 billion), with substantial gross flows in both directions, particularly in the fourth quarter. Both inward and outward investment continued to be boosted by cross-border takeover and merger activity, with acquisitions in the United States and pre-1992 restructuring being major underlying factors. Recorded portfolio investment also showed a net outflow, of $12 billion—it is, however, believed that the recording of the gross inflows is particularly weak. Recorded inflows in the fourth quarter were boosted by the overseas take-up of British Steel shares, but this was to a degree offset by the redemption of HMG's $2.5 billion floating-rate note issue. On outward portfolio investment, revised data show that disinvestment from overseas securities in the aftermath of the October 1987 crash has now been fully reversed. The heavy net inflows through the banking system in 1988 reflected the financing of the non-bank private sector balance of payments deficit, and the fact that two thirds of these net flows were in sterling reflects the large interest differential in favour of the United Kingdom. Public sector net external assets continued to rise in the fourth quarter as in 1988 as a whole—mainly reflecting the growth in official reserves.

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

$ billions

	Dec. 1987 levels	1988 Q1	Q2	Q3	Q4	Dec. 1988 levels
Industrial countries						
United Kingdom:						
Sterling bank deposits	10.5	—	2.2	0.4	0.7	13.5
Eurocurrency bank deposits	37.4	−1.1	1.5	1.9	1.4	40.6
Government paper	6.9	0.3	−1.2	−0.6	−0.3	4.9
Other investments	12.4	0.6	0.1	0.1	−0.1	13.1
	67.2	−0.2	2.6	1.8	1.7	72.1
Other EEC:(b)						
Domestic currency bank deposits	7.3	0.4	0.2	−0.2	−0.3	6.5
Eurocurrency bank deposits	22.4	−0.8	−0.7	0.3	−0.3	20.4
Other investments	68.2	−3.1	−0.6	−1.7	−1.2	64.0
	97.9	−3.5	−1.1	−1.6	−1.8	90.9
United States:						
Bank deposits	19.1	−0.6	−1.1	2.9	−3.2	17.1
Government paper	20.0	−0.4	−1.1	0.3	2.5	21.3
Other investments	22.6	−1.1	−0.6	−0.4	−0.6	19.9
	61.7	−2.1	−2.8	2.8	−1.3	58.3
Other:						
Domestic currency bank deposits	6.6	−0.5	2.3	−1.2	−0.8	6.0
Eurocurrency bank deposits	31.5	1.4	−1.6	0.6	1.8	33.6
Other investments	47.9	−0.4	−1.4	−1.7	−1.3	41.3
	86.0	0.5	−0.7	−2.3	−0.3	80.9
Offshore centres:						
Bank deposits	47.0	1.3	1.7	1.3	0.5	51.9
Placements with ldcs	59.5	—	—	—	—	59.5
OEC credit to non-banks	12.7	0.1	0.1	—	0.1	13.0
IMF and IBRD(c)	40.9	0.2	—	—	—	37.9
Total identified additions(+)/reductions (−) in deployed assets	**472.9**	**−3.7**	**−0.2**	**2.0**	**−1.1**	**464.5**
Net funds available for deployment		−4.1	−4.1	−3.3	−2.9	
of which:						
Net movements in external borrowing etc		*0.3*	*1.9*	*3.1*	*2.6*	
Current balance		*−4.4*	*−6.0*	*−6.4*	*−5.5*	

(a) The oil exporting countries covered are defined in the notes and definitions to Table 16 of the statistical annex in the February 1989 Bulletin.

(b) Includes Spain and Portugal.

(c) Includes holdings of gold.

Oil exporting countries continued to run a current account deficit ($5.5 billion) in the fourth quarter, bringing the total for 1988 as a whole to $22.3 billion. Within the identified movements in external assets in the fourth quarter was continuing net investment in the United Kingdom ($1.7 billion) contrasting with withdrawal from elsewhere in Europe ($1.8 billion) and the United States ($1.3 billion).

International capital markets

Overall activity in the international capital markets increased sharply from $92 billion in the fourth quarter of 1988 to $131 billion in the first quarter of 1989. The increase was largely due to a sharp rise in issuance of fixed-rate bonds with equity warrants attached, although issuance of straight international bonds and syndicated credit facilities were also strong. By contrast, issuance of floating-rate notes and announcements of new euronote facilities declined.

Fixed-rate bonds

There was a substantial increase in issuance of fixed-rate bonds, from $39.8 billion in the fourth quarter to a record $75.8 billion in the first quarter, largely reflecting a sharp increase in issuance of equity-related bonds by Japanese borrowers. Issuance of straight fixed-rate eurobonds also increased despite higher interest rates in most of the major bond markets and, in many cases, widening new issue spreads relative to domestic bonds. Of the total, $5.5 billion was identified as being privately placed, compared with $4.4 billion in the previous quarter. Japanese borrowers issued bonds totalling $27.6 billion, bringing their share of total fixed-rate funding to 37%. Supranational institutions were also active, raising $8 billion or 11% of total funds. Borrowers from the United Kingdom more than doubled the volume of their international financing, raising $6.7 billion and accounting for 9% of the total. Borrowers from Canada, the United States and France also sharply increased their borrowing. However, borrowing by German entities declined from $3 billion to $1.3 billion. Turnover in the primary eurobond market stood at a record level of $117 billion, almost double the previous quarter's total of $63 billion, largely reflecting the heavy volume of bond issues with equity warrants attached. However, turnover on the secondary market remained very low, particularly in dollar bonds. Competition remained intense, and further redundancies were announced by intermediaries in several centres. In addition, many of the leading eurobond market firms decided to end the traditional practice of price stabilisation of new eurobond issues.

(i) Equity-linked bonds

The surge in equity-related issues, from $5.1 billion in the fourth quarter to $24.6 billion in the first, was largely the result of exceptionally strong issuance of bonds with equity warrants attached. This compares with a volume of $42.0 billion for 1988 as a whole. Borrowers from Japan brought to market over 90% of new equity-related issues.

Announced international bond issues[a]

$ billions

	1986	1987	1988				1989
	Year	Year	Year	Q2	Q3	Q4	Q1
Fixed-rate bonds							
Straights	144.8	117.0	159.9	41.0	35.5	34.5	51.2
Equity-related	26.7	43.3	42.0	14.9	14.1	5.1	24.6
of which:							
Warrants	*19.2*	*25.7*	*29.9*	*10.8*	*9.9*	*3.8*	*20.8*
Convertibles	*7.5*	*17.6*	*12.1*	*4.1*	*4.3*	*1.4*	*3.8*
Bonds with non-equity warrants (currency, gold, debt)	2.2	3.3	1.2	0.7	0.1	0.2	—
Total	**173.7**	**163.6**	**203.1**	**56.6**	**49.7**	**39.8**	**75.8**
Floating-rate notes	**47.8**	**12.0**	**23.2**	**6.1**	**7.0**	**6.9**	**3.4**

(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.

Borrowers from the United States also increased their activity with issues totalling $1.1 billion, after having been virtually absent from the equity-linked market since the stock market crash.The rebound in the issuance of equity-warrant bonds by Japanese borrowers from the fourth quarter level, itself affected by an over-supply of paper, partly reflected the bullish stance of Japanese financial intermediaries towards the domestic equity market. In addition, investors demonstrated a preference for large issues, which encouraged underwriters to bring to market very large deals; for example, there were five issues worth $1 billion or over. As a result, the average size of issues doubled to $263 million (the highest recorded) compared with the previous quarter. Several factors relating to the secondary market in detached warrants were also thought to have encouraged primary market issuance. Notably, recently announced fiscal and accounting changes affecting Japanese banks and life insurance companies are expected to increase the attraction of capital gains as opposed to coupon and dividend income for these institutions.

(ii) Straight fixed-rate bonds

The volume of straight fixed-rate issues in the first quarter increased from $34.5 billion to $51.2 billion. The proportion of dollar-denominated international bonds rose from 24% to 38%, reflecting the stability of the US dollar in foreign exchange markets. The widening of new issue spreads over US Treasuries was offset by the widening of swap spreads in the two and three year area, which created favourable swap opportunities for issuers of short-dated bonds. These swap opportunities were also evident in the yankee market, and contributed to an increase in new issues to $4.3 billion, compared with $2.8 billion in the previous quarter. The dollar market also saw the introduction of a number of 10-year issues by commercial and investment banks which had call options after three years. A significant proportion of these issues was reported to have been sold to Far Eastern investors seeking high yields.

In spite of investors' concerns about yen interest rates, the market for yen-denominated issues was the second most active sector, accounting for a dollar equivalent of $6 billion (12% of new issues). Most of the issues were for supranational entities, foreign governments and financial

Currency composition of fixed-rate bond issues

Percentages of total issues

	Straight bonds			Equity-related bonds		
	1988		1989	1988		1989
Currency denomination	Year	Q4	Q1	Year	Q4	Q1
US dollars	30	24	38	69	66	82
Swiss francs	11	10	5	20	21	13
Yen	12	11	12	—	—	—
Deutschemarks	13	13	9	2	5	2
Sterling	7	7	9	5	2	2
Australian dollars	5	7	7	1	—	—
Canadian dollars	8	8	10	—	—	—
ECU	7	11	5	1	2	—
Other	8	9	6	2	4	2

firms, and many were specially-tailored deals aimed at particular investor groups. Several sovereign issuers and a few foreign banks also issued in the samurai market where funds were reportedly available in longer maturities than in the euromarkets. Additionally, the shelf registration system introduced last year was reported to have improved access to the samurai market to some extent. In contrast, issuance of deutschemark bonds was flat, leading to a decline in the currency's market share, but the market was characterised by a number of issues which were large by historical standards—such as a DM 750 million deal for the Soviet trade bank, Vnesheconombank. A similar trend was evident in the Swiss franc foreign bond market, with issuance declining by almost 30% to its lowest quarterly level since the third quarter of 1985.

The sterling market was used extensively by foreign sovereign borrowers, supranational institutions, and private corporations, with issues totalling $5.9 billion. Although sterling interest rates rose for much of the quarter, purchases of long-dated gilts by the Bank of England were considered to have provided support to the market. Several sterling issues were made with maturities of over 20 years, and many deals introduced by private sector firms included covenants to protect investors from leveraged buyouts. The liberalisation of sterling capital markets announced in the Budget is expected to provide a further boost to sterling issuance.

The Canadian dollar eurobond market, where issues totalled $5 billion, in several cases offered cheaper financing to Canadian borrowers than was available in the domestic market. The Province of Alberta took advantage of these opportunities to introduce the largest-ever Canadian dollar issue (C$650 million). In the Australian dollar sector a notable feature was the introduction of several short-dated high-coupon issues which gave borrowers the option to redeem the issues in either US dollars or Australian dollars at a predetermined exchange rate. The options sold by borrowers to investors were then on-sold to lead managers who used them to offer above-market swap rates and, therefore, floating-rate funds at below market rates. One such issue from the Swedish Export Credit Corporation carried a coupon of 30%, the highest ever in the euromarket. Finally, the ECU market was somewhat unsettled by the impending recomposition of the unit and the currency's share fell from 11% to 5%.

Floating-rate notes

The volume of floating-rate note issues introduced in the first quarter fell by 50% to $3.4 billion. In spite of continued investor demand for floating-rate assets, borrowers were reluctant to increase floating-rate exposure given the upward trend in interest rates. The issuance of dollar-denominated FRNs fell from $3.8 billion to $1.5 billion (45% of total issues) and sterling issues declined from a dollar equivalent of $1.6 billion to $1.1 billion. UK building societies were the most active issuers in the sterling sector, raising $820 million. In contrast, there was only one sterling mortgage-backed issue, worth £150 million, reflecting the slowdown in the pace of new UK mortgage commitments (see the note on page 260). Innovations during the quarter included an issue collateralised on a portfolio of high-yielding bonds as well as the first-ever issue to be based exclusively on the Paris interbank offer rate (Pibor).

Euronotes and other facilities

The volume of announcements in the euronotes market declined for the second quarter running, to $11.0 billion, in the first quarter. The reduction was largely the result of a decline in the volume of new eurocommercial paper (ECP) programmes to $7.5 billion, which represented 68% of total euronote facilities, as against $12.5 billion (85%) in the previous quarter, and a further fall in the value of new short-term committed and tender panel facilities (NIFs and RUFs). The decline in ECP was slightly offset by a doubling in the volume of MTN programmes announced to $2.0 billion. The general reduction in new announcements can largely be attributed to two factors; first, the majority of large borrowers requiring funding already have programmes in place; and second, many borrowers, on balance, can reportedly obtain cheaper finance in the more developed US CP and MTN markets (although the stricter requirements for issuing paper in the US market can make it less accessible to lower-quality corporations).

In contrast to the fall in announcements during the first quarter, estimates by Euroclear indicate that the level of euronotes outstanding increased from $72.6 billion to

Announced euronote facilities[a]

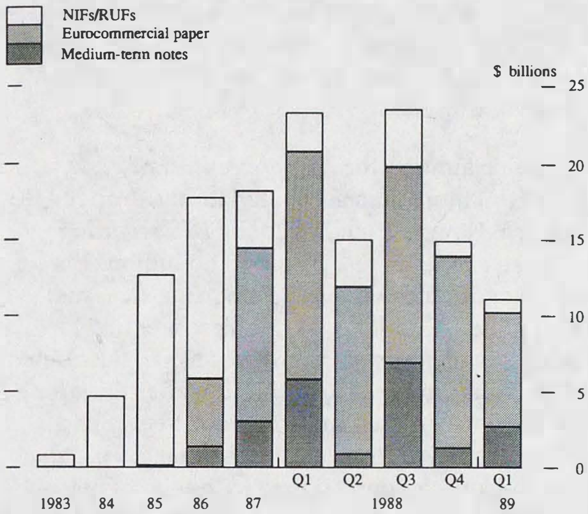
$ billions

	1987	1988				1989
	Year	Year	Q2	Q3	Q4	Q1
Committed(b)	3.9	3.7	1.0	1.6	0.1	0.4
Uncommitted	69.0	73.4	14.2	22.0	14.8	10.6
Total	**72.9**	**77.1**	**15.2**	**23.6**	**14.8**	**11.0**
of which:						
Major OECD	*47.4*	*43.8*	*6.8*	*14.7*	*7.9*	*8.1*
Minor OECD	*23.4*	*27.2*	*7.2*	*5.3*	*6.6*	*2.7*
Other	*2.1*	*6.1*	*1.2*	*3.6*	*0.3*	*0.2*
Selected nationalities of borrower						
United States	16.0	9.8	1.1	3.7	0.8	2.1
United Kingdom	9.8	10.9	2.2	2.8	1.8	0.4
Australia	8.5	6.0	1.6	1.7	1.0	1.3
Japan	10.0	6.5	2.3	2.0	2.2	2.0

(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.

Announced euronote facilities (a)



Source :Bank of England ICMS database.

(a) Full years shown as quarterly averages.

$80.9 billion. This was composed of a 12% increase in ECP outstanding to $59.9 billion and a 13% rise in the level of outstandings for medium-term notes to $14.6 billion. The level of short-term committed facilities outstanding remained little changed at $14.6 billion. The level of euronotes outstanding is a better indication of flows of funds in the euronotes market, for it shows the degree to which facilities have been utilised.

International syndicated credits

There was a sharp increase in the level of activity in the international syndicated credits market in the first quarter, with announcements amounting to $40.2 billion compared with $30.2 billion in the fourth quarter of 1988. The rise can largely be attributed to the buoyant level of merger and acquisition related financing which accounted for 41% of all new credits announced, as opposed to 30% for 1988 as a whole. The high proportion of merger and acquisition activity was accounted for by the largest-ever syndicated loan ($13.6 billion) on behalf of Kohlberg Kravis Roberts for the proposed leveraged buyout of RJR Nabisco. Excluding this loan, the volume of syndicated credits would have declined marginally over the quarter. Borrowing by sovereign entities more than doubled to $2 billion—the majority on behalf of middle-income countries which, apart from benefiting from the implicit gains accruing from the development of banking relationships, were reportedly able to obtain funds at a lower cost than in the eurobond market: at the same time, the banks obtained larger margins than on OECD credits.

Announced eurocurrency syndicated credits

$ billions

	1987	1988				1989
	Year	Year	Q2	Q3	Q4	Q1
Major OECD	61.4	72.8	15.7	21.3	19.0	30.6
Minor OECD	14.9	18.3	4.9	3.1	7.2	3.7
Developing countries	9.6	9.3	1.4	2.0	3.6	5.7
Eastern bloc	1.9	1.2	0.5	0.1	0.3	0.3
Other	0.8	0.2	0.1	—	—	—
Total	**88.7**	**101.7**	**22.6**	**26.5**	**30.2**	**40.2**
of which, transferable	*2.7*	*2.3*	*0.2*	*0.4*	*1.1*	*0.2*

The majority (84%) of new loans continued to be denominated in dollars, partly reflecting the concentration of merger and acquisition activity in the United States. The volume of new facilities denominated in ECU rose to the equivalent of $1.5 billion—3.7% of the total during the quarter. This was partly the result of the largest-ever ECU denominated facility (ECU 600 million) on behalf of CMB Packaging, a company set up as a result of the proposed merger between Carnaud and Metal Box. There was also a spate of ECU facilities arranged on behalf of Italian corporations, most of which were believed to be motivated by the stability of the ECU.

A number of novel structures were developed in the syndicated credits market, aimed at providing banking syndicates with greater flexibility. One such structure includes an option for the participating banks to swap their credit obligation into euronotes at predetermined monthly intervals in the future. To encourage banks to retain their credit obligations, the spread on the credit is revised upwards the longer the loan is held.

International banking developments

In the fourth quarter of 1988 cross-border lending by BIS reporting area banks slowed sharply to only $35 billion, by far the smallest growth since the first quarter of 1986. This contrasts with the very rapid acceleration to over $212 billion in the previous quarter and reflects the unwinding of positions built up then. Over the year as a whole, cross-border lending slowed from $597 billion in 1987 to $419 billion in 1988, the first fall in the rate of growth for five years.

Interbank business within the reporting area accounted for the whole of the fourth quarter slowdown. Banks in Japan reduced their interbank business to $28.8 billion, about one fifth of the previous period's level. This reflects not only the unwinding of seasonal window-dressing positions but also a change in domestic monetary conditions which has encouraged the repatriation of much of the business which had been switched to the offshore and euro-markets. In particular, Japanese banks reduced their cross-border yen funding by $41 billion after a $64.8 billion rise the previous quarter, although this was counterbalanced by a strong increase in foreign currency borrowing.

Business between banks in Europe contracted by $10 billion while lending between banks in the United States and other reporting area countries except Japan also slowed somewhat to $14.4 billion from $25.9 billion the previous quarter. In addition, local foreign currency lending practically stopped ($2.6 billion) following rapid growth in the third quarter.

In contrast to interbank business, non-banks within the reporting area continued both to borrow and to lend. Non-banks in the United States were substantial net providers of funds of $8.9 billion. Non-banks in Japan continued to borrow, but less strongly than in the previous

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

	1987 Year	1988 Year	1988 Q1	1988 Q2	1988 Q3	1988 Q4	Outstanding at end-Dec. 1988
Liabilities vis-à-vis:							
BIS-reporting area	477.1	344.3	53.5	101.4	148.6	40.9	3,067.4
'Offshore' centres	125.9	94.4	14.9	25.1	48.3	6.1	818.2
Sub-total	603.0	438.8	68.4	126.5	196.3	47.0	3,885.5
Outside reporting area							
Developed countries	6.3	12.7	0.6	4.9	2.7	4.6	68.3
Eastern Europe	- 0.7	4.4	0.5	0.8	1.1	2.0	34.7
Oil exporters	19.2	11.0	0.4	5.4	6.3	- 1.1	178.5
Non-oil developing countries	24.0	11.3	3.4	3.5	0.7	3.7	236.9
of which, Latin America	*6.7*	*2.3*	*3.3*	*1.1*	*- 2.0*	*- 0.1*	*80.7*
Sub-total	48.8	39.5	4.8	14.6	10.8	9.2	518.3
Other(a)	34.5	32.5	12.7	2.8	8.6	8.4	216.6
Total	**686.2**	**510.7**	**85.9**	**144.0**	**216.3**	**64.5**	**4,620.5**
Assets vis-à-vis:							
BIS-reporting area	432.2	337.4	61.9	84.2	159.6	31.8	2,906.8
'Offshore' centres	142.1	73.3	18.1	8.5	50.5	- 3.9	756.2
Sub-total	574.3	410.8	80.1	92.8	210.0	27.9	3,663.0
Outside reporting area							
Developed countries	5.6	2.5	- 0.7	3.9	- 3.5	2.8	130.2
Eastern Europe	2.3	8.0	3.0	1.3	0.3	3.5	87.0
Oil exporters	2.0	5.2	- 1.1	2.4	2.7	1.3	129.0
Non-oil developing countries	1.8	- 8.9	- 4.3	- 6.2	- 1.5	3.0	373.7
of which, Latin America	*- 3.9*	*-10.8*	*- 2.5*	*- 4.0*	*- 1.8*	*- 2.5*	*214.9*
Sub-total	11.2	6.8	- 3.1	1.3	- 2.0	10.6	719.9
Unallocated and international institutions	11.7	1.9	- 0.2	0.8	4.4	- 3.1	102.4
Total	**597.3**	**419.4**	**76.7**	**94.9**	**212.4**	**35.3**	**4,485.3**

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

quarter as they switched from cross-border yen borrowing to foreign currency. In Europe non-bank business on both sides of the balance sheet recovered from a relatively low level in the previous quarter.

Lending to countries outside the reporting area also picked up, to $10.6 billion, after the small repayment recorded in the third quarter, although on a net basis there was only a small outflow of funds. Thus final lending, which is calculated by the BIS as all lending to non-banks and outside area countries and a part of interbank lending, slowed much less sharply (to $50 billion) than total external lending. The major areas of growth in lending to outside-area countries were Eastern Europe ($3.5 billion) and the non-oil developing countries ($3 billion). Lending to the Soviet Union in particular increased to $2.6 billion and there was a notable increase in lending to Asian countries, particularly Taiwan ($3 billion) and China ($1.6 billion). Recorded claims on Latin American countries, particularly Mexico (-$1.9 billion), continued to fall.

The London market

In common with experience in other centres, external lending by banks in the United Kingdom fell by $5.2 billion (0.6%) *in the fourth quarter of 1988* after strong growth in the third. Over the year as a whole, claims rose by only $35.8 billion in comparison with the increases of about $85 billion seen in each of the two preceding years. The slowdown in lending was entirely in the interbank market; lending to non-banks increased more rapidly over the year, by $6.0 billion compared with $3.6 billion in 1987. Deposits with banks in the United Kingdom increased by $2.5 billion (0.3%) in the fourth quarter, far more slowly than earlier in the year. In total, banks in the United Kingdom were net takers of $25.2 billion during 1988.

A reduction in claims on the *offshore centres* of $7.4 billion (1%) more than accounted for the drop in UK banks' lending. However, lending to the *BIS reporting area* industrial countries rose by only $1.5 billion. The major net taker of funds within the reporting area was Japan ($5.9 billion), but this was due almost entirely to a very sharp fall in deposits placed with banks in the United Kingdom by banks in Japan ($6.1 billion) after the strong rise in the previous quarter; these movements are partly seasonal but also reflect domestic policy changes in Japan. Japanese non-banks accounted for $1.1 billion of net borrowing. Other large net borrowers in the reporting area were Switzerland ($2.1 billion), the Netherlands ($3.3 billion) and the Cayman Islands ($3.4 billion).

The major net providers of funds within the reporting area were Belgium ($3.5 billion), the United States ($2.5 billion), Germany ($1.5 billion) and Luxembourg ($1.7 billion). With the exception of Germany and Luxembourg, this represented reductions in borrowing by these countries rather than increases in lending. Of the

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

	1986 Year	1987 Year	1988 Q1	1988 Q2	1988 Q3	1988 Q4	Outstanding at end-Dec. 1988
Liabilities vis-à-vis:							
BIS-reporting area	69.6	56.6	10.8	17.3	23.3	-7.6	621.7
of which:							
United States	*12.4*	*14.1*	*- 1.4*	*5.6*	*3.1*	*0.3*	*170.3*
Japan	*28.4*	*13.7*	*8.8*	*5.7*	*9.6*	*- 6.0*	*98.7*
'Offshore' banking centres	10.1	4.5	- 4.1	5.2	2.5	- 4.7	115.7
Sub-total	79.6	61.2	6.7	22.4	25.9	-12.4	737.5
Outside reporting area							
Developed countries	0.2	3.1	0.6	2.3	3.4	- 0.2	24.9
Eastern Europe	—	- 0.2	- 0.7	0.1	0.3	0.9	8.9
Oil exporters	- 8.5	0.2	- 0.9	4.1	2.5	1.9	54.1
Non-oil developing countries	2.1	8.6	- 1.5	0.1	- 2.0	- 0.7	48.4
of which, Latin America	*- 0.5*	*3.0*	*- 0.3*	*—*	*- 1.5*	*0.7*	*6.9*
Sub-total	- 6.2	11.8	- 2.6	6.6	4.2	1.9	136.3
Other(a)	19.6	14.9	- 0.6	- 3.7	- 0.5	13.0	88.3
Total	**93.0**	**87.7**	**3.5**	**25.3**	**29.6**	**2.5**	**962.0**
Assets(b) vis-à-vis:							
BIS-reporting area	69.0	80.6	4.0	15.5	27.0	1.5	627.1
of which:							
United States	*14.3*	*29.1*	*-13.7*	*5.0*	*0.2*	*- 2.1*	*129.3*
Japan	*50.0*	*42.8*	*12.6*	*9.4*	*20.8*	*- 0.1*	*212.3*
'Offshore' banking centres	7.5	5.3	- 3.0	2.0	0.8	- 7.4	112.8
Sub-total	76.5	86.0	1.0	17.4	27.7	- 5.8	739.9
Outside reporting area							
Developed countries	1.0	- 1.4	- 1.6	0.4	- 0.6	0.3	34.8
Eastern Europe	2.4	0.6	0.9	0.5	0.4	0.5	23.1
Oil exporters	0.1	- 0.6	- 0.5	0.8	0.1	0.4	20.8
Non-oil developing countries	- 0.9	—	- 1.3	- 1.9	- 1.9	- 1.4	49.6
of which, Latin America	*—*	*- 2.3*	*- 0.7*	*- 0.4*	*- 1.7*	*- 1.0*	*31.1*
Sub-total	2.5	- 3.8	- 2.5	- 0.2	- 2.1	- 0.3	128.3
Other(c)	7.2	4.8	- 2.4	- 0.9	- 3.0	0.8	15.5
Total	**86.2**	**87.1**	**- 3.9**	**16.3**	**28.6**	**- 5.2**	**883.6**

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

offshore centres, and indeed in overall terms, Hong Kong was the largest net supplier of funds ($5.4 billion).

Countries outside the BIS reporting area increased their deposits with UK banks by $1.9 billion following growth of $4.2 billion in the previous quarter. Borrowing from the United Kingdom by these countries fell by $0.3 billion. The oil exporting countries were again the major net placers of funds, with an increase of $1.5 billion.The recorded debt of Brazil and Mexico together was reduced by $0.8 billion.

Japanese-owned banks' share of external lending by banks in the United Kingdom dropped back to the level of the first quarter of 1988 (39.9%), following an increase of one percentage point in the previous quarter. The market share of the British banks also fell, by just over one percentage point to 14.8%, the first significant reduction since the second quarter of 1987. Following a succession of modest falls, the share of the American banks strengthened by just under a percentage point to 13.3%. The 'other overseas' banks' share of business rose to the highest level for several years (31.9%).

Lending in the US dollar and the deutschemark was more significant in the fourth quarter of 1988 than in the third, rising by $12.7 billion and $7.7 billion respectively. Despite this, the US dollar's share of the outstanding lending remained stable at around 57.8%, while the deutschemark's share increased slightly. Yen lending fell by $3.5 billion in the fourth quarter, following a strong rise of $12.5 billion in the previous quarter. With interest rates high, sterling lending fell by $0.7 billion, so that growth over the year was only $1.5 billion.

International business of banks in the United Kingdom increased significantly on both sides of the balance sheet *in the first quarter of 1989.* Following a fall of $2.9 billion (0.3%) in the fourth quarter of 1988, international claims grew by $42.1 billion (3.7%); almost half of this increase ($20.1 billion) was due to growth in lending to other banks overseas. There was also a marked increase in claims on non-banks in the United Kingdom ($11.3 billion). International liabilities increased by $45.5 billion (3.9%) in the first quarter of 1989. Again this was largely accounted for by other banks overseas whose deposits grew by $18.1 billion, offsetting the large fall ($21.8 billion) seen in the fourth quarter of 1988. There was also marked growth in deposits from own offices and non-banks overseas.

There was a significant increase in British banks' international business of $14.9 billion (7.7%) in the first quarter of 1989, in sharp contrast to the fall shown in the last quarter of 1988 and modest rises before that; this was due to an increase of $10.1 billion in their overseas activities. The American banks' international business continued to grow relatively strongly; lending increased by $8.1 billion (5.6%) in the first quarter of 1989, owing largely to a rise of $4.5 billion in claims on own offices.

Following the fall in the Japanese banks' international business in the last quarter of 1988, there was a modest overall increase in claims of $6.7 billion (1.7%) in the first quarter of 1989; however, this disguises falls in January and February and a sharp rise in March. Increases in lending of $8.6 billion to unrelated banks overseas and $5.0 billion to UK non-banks more than offset a fall of $6.3 billion in claims on own offices. This fall contrasts sharply with their former pattern of increased lending to own offices in the first and third quarters. Deposits from own offices increased by $12.6 billion so that they continued to be net takers from this source, and certificates of deposits fell by $5.7 billion, resulting in an overall increase in liabilities of $7.6 billion (2.0%) in the first quarter of 1989.

The marked decrease in external sterling lending seen at the end of 1988 ($5.7 billion) continued in the first quarter of 1989 when it fell by a further $2.5 billion (4.0%). However, external sterling deposits recovered again, increasing by $5.8 billion (5.5%), resulting in a net sterling inflow of $8.3 billion.

Foreign exchange and gold markets

This section reviews the three months to end-March. Despite persistent reports of concerted central bank intervention, the dollar improved steadily throughout the quarter as economic statistics continued to indicate that the US economy was growing strongly. Increases in official interest rates in some European countries were largely offset by increases in US rates and the dollar ended the quarter close to its highs.

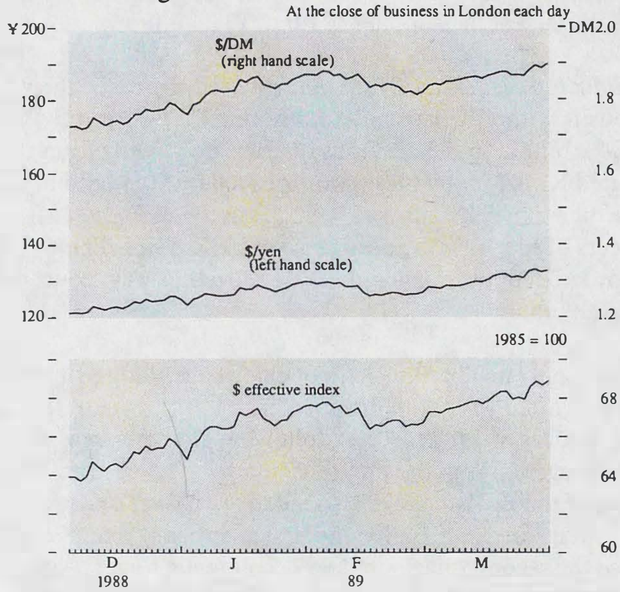
Although it had weakened sharply at the turn of the year when Bundesbank Vice-President Schlesinger stressed the Bundesbank's concern at its strength, the dollar opened solidly on 3 January at DM 1.7595 and ¥123.55. It was underpinned by expectations that US employment data for December would be strong and that US interest rates would therefore remain high; a rise in the Federal Reserve's discount rate was still expected in some quarters. Precautionary demand arising from an increase in tension between the United States and Libya also helped the dollar, which rose above DM 1.80 and ¥126 on 6 January.

In the event, the employment data was not as strong as expected, but a further statement from Schlesinger, that he did not foresee it weakening soon, boosted the dollar and it touched DM 1.8337 and ¥126.77 on 9 January. Rounds of concerted central bank sales subsequently restricted the US currency, but the firmness of US short-term interest rates continued to underpin the dollar and it edged up cautiously. News of an unexpectedly large US trade deficit in November and renewed central bank intervention caused the dollar to dip on 18 January, but it quickly recovered to reach DM 1.8765 and ¥129.70 the following day. Its bullish mood subsequently encountered resistance in the form of ½% rises in interest rates in Germany, Switzerland, Austria and France, and when tentative rallies were met by further concerted central bank intervention, the dollar gave ground rapidly, touching DM 1.8200 and ¥126.35 on 24 January following Bundesbank Director Gleske's statement that the Bundesbank would prefer to see it below DM 1.80. However, Federal Reserve Chairman Greenspan's testimony before the House Banking Committee (which reflected his concern about inflation and was interpreted as an indication that monetary policy should err on the side of restrictiveness) re-established a bullish tone and the dollar advanced steadily, a strong rise in US orders for durable goods in December providing further support.

Although dealers were nervous of intervention around DM 1.85, they tested the central banks' resolve on 27 January, prompting a round of co-ordinated sales which was initially successful in holding the dollar back. However, it moved above DM 1.86 in New York that night and strengthened further in the ensuing week when helped by the Bundesbank Council's decision not to raise German interest rates, by expectations that the G7 Ministers would accept the current pattern of exchange rates and by strong US labour market data for January. After the US currency had touched highs of ¥130.40 and DM 1.8885 on 1 and 3 February respectively, a further round of concerted official sales helped limit the dollar's rise and it slipped back further in the Far East on 10 February as dealers expressed disappointment that there was nothing fundamentally new in President Bush's budget proposals. However, after touching DM 1.8375 and ¥126.95, the dollar made a swift recovery following publication of a larger-than-forecast rise in US wholesale prices and a ½% increase in US prime rates (to 11%). It touched DM 1.8740 and ¥128.75 on 13 February, but sentiment turned against the US currency when news of a 1.7% rise in German wholesale prices pointed towards a further tightening of monetary policy in Europe and generated demand for the deutschemark. As dealers began to anticipate a rise in German interest rates, the dollar fell sharply, touching DM 1.8285 and ¥125.55 on 15 February.

In the event, the Bundesbank Council did not raise German interest rates on 16 February, but the dollar remained soft in the wake of the US trade figures for December as dealers focused on the fast growth in US imports during 1988. Amid renewed expectations of a rise in German interest rates, the US currency fell below a key support point of DM 1.83 on 23 February, triggering a wave of technically-based sales. In spite of an unexpected tightening of monetary conditions by the Federal Reserve which led to a ½% rise—to 11½%—in US prime rates on 23 February and was followed by a ½% rise—to 7%—in US discount rate the following day, the dollar was subdued by expectations of similar action in Germany. It touched a low of DM 1.8095 on 27 February before embarking upon a steady recovery as the likelihood of a rise in German interest rates began to fade. In the wake of news that the Bundesbank was supplying liquidity to the market at a lower rate than previously—which was taken to imply that an early increase in interest rates was unlikely—the dollar edged up to DM 1.8665 in the Far East on 9 March despite reports of dollar sales by the Federal Reserve. At the same time, the US currency, which had remained within a narrow trading range against the yen throughout the latter half of February, rose to ¥129.40, encouraged by a statement from a Japanese Finance Ministry official that it had reached a low point.

Dollar exchange rates



Although the dollar subsequently became unsettled by fears of co-ordinated intervention and by conflicting reports as to whether or not President Bush would agree to higher taxes to cut the fiscal deficit, it recovered its losses in the wake of a surprise 0.3% fall in US unemployment in February, opening in London on 13 March at DM 1.8640 and ¥129.70. An improvement in the US trade figures for January, published on 15 March, was in line with market forecasts, but the removal of uncertainty provided a further boost for the dollar, and the underlying tone became bullish as dealers perceived that both the Germans and the Japanese were reluctant to raise interest rates. Rounds of concerted intervention on 16 and 17 March had only a cautionary effect on the US currency, which gained further ground on news of a 1% rise in US producer prices for the second successive month, touching DM 1.8800 and ¥132.25 on 20 March in the wake of a warning from FRB Governor Angell on the dangers of rising inflation from a weaker dollar. However, the US currency fell back before Easter as fears of a further increase in US interest rates were reduced by a modest increase in US consumer prices and a sharp fall in US durable goods orders in February. Comments by Chairman Greenspan, which were interpreted as implying that the Federal Reserve would not raise interest rates in the short term, contributed to the softer tone and the dollar touched DM 1.8622 and ¥130.65 on 23 March. However, with both the yen and the deutschemark suffering from political uncertainties, there was no counter-attraction to the dollar. Following an upward revision to US GNP for the fourth quarter (from 2% to 2.4%), the US currency advanced to DM 1.8860 and ¥133.00 in thin New York markets on Easter Monday and forged ahead again after the holiday. In spite of further concerted intervention, it touched highs for the period of DM 1.9035 and ¥133.50 in New York on 30 March. There were reports of sales by the Federal Reserve, but the dollar's bullish tone remained intact and it closed the quarter at DM 1.8990 (up 7.1%), ¥132.75 (up 6.2%) and Sw.Fc. 1.6640 (up 10.8%); in effective terms, it rose by 5.3% to 68.8 (1985 = 100).

EMS

The EMS began the period comfortably. However, the Danish krone replaced the French franc at the foot of the narrow band on 19 January when Denmark did not match the interest rate increases elsewhere in Europe and, with the deutschemark strengthening against the dollar towards the end of February, the system was stretched almost to its 2¼% limit. Pressure eased as the likelihood of a further increase in German interest rates faded, but resurfaced shortly before Easter when the deutschemark benefited from reports of concerted intervention to restrain the dollar. However, the continuing strength of the US currency helped ease tensions after the holiday and, with the krone itself rising a little following a cut in financial institutions' borrowing ceiling with the central bank, the system ended the quarter 2% wide.

The deutschemark and the Dutch guilder were comfortably placed as the two strongest currencies, although the guilder had softened a little in January and, in addition to raising its key interest rates along with other European countries on 19 January, the Nederlandsche Bank increased its money-market intervention rate from 6% to 6¼% on 7 February. The Italian lira, which had used its freedom to fall below the 2¼% band on 23 February, moved back above the Danish krone at the beginning of March. This followed a 1% increase (to 13½%) in Italian discount rate—Italy's response to, among other factors, a record Lit 4.3 trillion trade deficit in January. Italian banks' prime rates were also increased by 1%—to 14%. The French franc firmed steadily throughout the quarter, helped by a claim from French Finance Minister Beregovoy that any deutschemark revaluation within the EMS would be matched by a revaluation in the franc; sentiment was also boosted by the removal of all remaining exchange controls for companies in France.

Other currencies

The yen initially withstood the dollar's rise better than most currencies. The Emperor's death prompted the covering of short positions taken out in anticipation of the event and there were also signs of a slight tightening of monetary policy by the Bank of Japan. Following a Japanese news agency report (which was later denied in Washington) that the US Senate Banking Committee was in favour of the dollar falling to ¥120, the yen continued to strengthen against most currencies, reaching a record Tokyo closing high of ¥68.29 (=1DM) on 14 February. However, amid growing expectations of a rise in German interest rates, the yen weakened because it was not expected that Japanese interest rates would follow suit. Suggestions in some quarters that the ruling Liberal Democratic Party could be forced to call an early general election over a political scandal also undermined confidence in the yen, which weakened steadily throughout March. As interest rate differentials were thought likely to move against Tokyo, and oil, a significant Japanese import, became more expensive, the reported absence of the Bank of Japan from co-ordinated central bank intervention encouraged buying of the dollar against the yen, which ended the quarter at its lows.

Elsewhere, a sharp fall in the Australian dollar triggered weakness in some other high-yielding currencies, notably the Canadian dollar, which softened again in early March in the wake of press reports that the IMF had warned of the need to reduce Canada's budget deficit. There was also some turbulence in the Spanish peseta following the Bank of Spain's attempts to curb rapid private sector credit growth. With effect from 1 February, it imposed a 30% zero rate deposit requirement for all foreign exchange credits and increased the amount of reserves that institutions were required to deposit with the central bank from 16½% to 18%. The peseta weakened sharply, but steadied in the wake of reported intervention and rising interest rates.

Gold

With the dollar enjoying a period of strength, sentiment towards gold remained bearish throughout the quarter. Having fixed at $413.60 on the morning of 3 January, gold fell back to $401.50 on 16 January, reflecting the dollar's advance. Although it recovered to $408.30 by 24 January when the dollar eased in the wake of European interest rate increases, gold weakened again as the US currency resumed its upward movement and stock markets firmed in response to temporarily diminishing inflation fears. It fell below $400 on 27 January and slumped to $378.95 on 17 February under the weight of selling by Australian producers. This represented its lowest fixing since August 1986. In the ensuing weeks, however, the steadier Australian dollar reduced the incentive for producers to sell the metal and gold made a cautious recovery. It touched $390.75 on 27 February and, although renewed producer selling and a rally in the dollar caused the price to fall back to $383.90 on 2 March, gold recovered well as it benefited from short-covering and from reports that a cut in USSR oil exports would add to global inflationary pressures. Rising platinum prices contributed to the firmer tone and, by 10 March, gold had advanced to $397.00. It was restricted to a narrow range during the pre-Easter period, falling to $389.25 on 17 March but recovering in the wake of a sharp rise in US producer prices. After the holiday, however, the strength of the dollar caused gold to fall sharply and the final fixing of $383.20 represented a loss of 6.6% over the quarter.