International financial developments

Among the main developments:

- *There were some signs of renewed adjustment of external imbalances among the major overseas economies in the second quarter, although the underlying degree of correction has been exaggerated by the initial effects of the strong dollar. In volume terms the improvement appears to have been concentrated in Japan and the United States, with a reduction in Germany's current account surplus being almost entirely due to weaker terms of trade.*
- *In the international capital markets, there was a marked decline in issues of fixed-rate bonds and in arrangements of new euronote programmes in the third quarter. The decline partly reflected seasonal factors, but was also the result of greater currency volatility and rising interest rates: activity in the syndicated credits market, however, remained buoyant.*
- *In the foreign exchange markets, the US dollar fluctuated fairly sharply in the third quarter, influenced in particular by shifting perceptions of the strength of the US economy and prospects for interest rates. Towards the end of the period, the dollar fell back following the renewed commitment of the G7 countries to preventing a further rise in its value, and reports of central bank sales, and ended the quarter 3½% down in effective terms.*

Balance of payments positions

Current accounts

In the latter part of 1988 and the early part of 1989 fears were expressed that the process of trade account adjustment in the major overseas economies was faltering. As statistics for the second quarter of 1989 become available, there are signs that the process may once more be under way. However, some of the adjustment has been due to the initial effects of the strength of the dollar since late 1988, with some of the adverse effects of changes in competitiveness still to come through. Also, the high level of oil and non-oil commodity prices relative to their levels in the past few years has been an important factor. Volume data, although difficult to interpret, indicate that any underlying adjustment in trade balances is concentrated in the United States and in Japan—though the most recent Japanese data suggest that this may not have been fully sustained. It is much less marked in Germany, where foreign demand for capital goods is still an important source of export growth.

World current accounts[(a)]

$ billions, *seasonally adjusted*

	1987	1988(b)				1989	
	Year	Year	Q2	Q3	Q4	Q1	Q2
OECD economies:							
United States	-144	-127	-33	-32	-29	-30	-31
Japan	87	80	17	18	21	22	13
Germany	46	49	15	12	11	16	14
France	- 4	- 4	—	—	-2	2	- 1
United Kingdom	- 5	- 26	-5	- 6	-10	- 8	- 8
Italy	- 2	- 5	1	—	- 1	..	..
Canada	- 7	- 8	-2	-2	- 3	-3	- 5
Major economies	- 29	- 41	- 7	-10	-13	..	..
Other OECD	- 10	- 14	-5	- 6	1	- 4	- 3
Total OECD	- 39	- 55	-12	-16	-12	..	..
OPEC economies	- 11	- 20	- 6	- 6	- 4	- 1	1
Non-OPEC developing economies	12	4	—	1	1	- 1	- 4
Other economies(c)	7	4	1	1	1	1	1
World discrepancy (d)	-31	-67	-17	-20	-14	..	..

.. not available.

(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 deficiencies are resulting in the omission of positive influences (eg unrecorded services and investment income).

The US current account deficit increased slightly to $31 billion in the second quarter of 1989: the first quarter's figure was revised to give a deficit of $30 billion. Although the deficit on merchandise trade narrowed to reach its lowest level since the first quarter of 1985, at a little below $28 billion, this was offset by an increase in the deficit on invisibles, mainly in the IPD balance (which showed a deficit of $5 billion). The invisibles deficit, at $3 billion, was a quarterly record. In volume terms, exports of goods continued to grow considerably more strongly than imports.

The Japanese current account surplus showed a remarkable fall from $22 billion in the first quarter of 1989 to $13 billion (1.9% of GNP) in the second, this being the smallest quarterly surplus recorded since 1985. Both visible and invisible trade contributed to the fall, with invisibles continuing the trend of increasing deficits exhibited since the beginning of 1988 with a record quarterly deficit of $6 billion in the second quarter as spending on tourism and other services continued to expand rapidly. The visible surplus declined substantially from $27 billion in the first quarter to $18 billion in the second. Data on imports, however, show volumes falling in the second quarter from the first, though slightly less quickly than exports.

Following a significant increase to $16 billion in the first quarter, the German current account surplus also fell, to $14 billion, in the second quarter; the visible trade surplus declined from $20 billion to $18 billion while the invisible deficit was little changed. The improvement was almost entirely due to weaker terms of trade; volume data were less encouraging than in Japan and the United States, with import and export volumes growing at about the same rate. In the second quarter the volume of goods exported was 8.2% up on the second quarter of 1988, with exports of consumer goods up 10.3% and those of capital goods up 9.6% (exports from the basic and producer goods sector rose by only 5.3%). However, the level of capital goods is four times higher than that of consumer goods, so that the former make a much greater contribution to total export growth. Despite some weakening in the most recent data, external orders for German goods remain strong, suggesting that little adjustment is likely in the volume position in the near future.

The United Kingdom's current account deficit remained at $8 billion in the second quarter, with a fall in the visible trade deficit (reflecting a small fall in the non-oil deficit and a small increase in the oil surplus) and an increase in the services surplus (following a reduced travel deficit and a recovery in insurance earnings) being offset by a fall in the IPD surplus to its lowest quarterly level since 1985, as earnings from banking and direct investment declined.

The French current account recorded a provisional $1 billion deficit in the second quarter, reversing a $2 billion surplus in the first. The deterioration resulted from a marked rise in the visible trade deficit and larger than usual transfers totalling $2 billion, only partially offset by a continuing invisibles surplus.

The improvement in the Canadian merchandise trade balance which occurred in the first quarter was more than reversed in the second, as imports rose sharply. This, coupled with an increase in the deficit on invisibles, resulted in an increase in the current account deficit from $3 billion in the first quarter to $5 billion in the second, this being a record seasonally adjusted quarterly deficit.

Capital accounts

Flows of capital to and from the major economies continue to show many of the features seen in recent quarters, with direct investment flows into the United States and outflows from Japan dominating the picture. Interpretation of the data is made more difficult than usual by the fact that three of the G7 countries (the United States, Japan and the United Kingdom) reported record balancing items in the second quarter.

External financing of the G7 countries

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

	1987	1988			1989	
	Year	Year	Q3	Q4	Q1	Q2
Identified current account						
United States (a)	-144	-127	-32	-29	-30	-31
Japan	87	80	19	24	16	14
Germany	46	49	9	16	16	14
France	-4	-4	—	-3	..	..
United Kingdom	-5	-26	-6	-8	-8	-9
Italy	-2	-5	—	-1	..	..
Canada	-7	-8	—	-3	-5	-5
Financed by:						
Portfolio investment						
United States (a)	74	82	6	22	20	-3
Assets	-5	-8	-2	-3	-3	-6
Liabilities	79	90	8	25	23	3
of which:						
From official sector	45	43	-3	13	5	-10
From private sector	35	46	11	12	17	12
Japan	-97	-65	-19	-14	7	-7
Germany	5	-37	-8	-9	-15	2
France	5	8	-1	3	..	..
United Kingdom	22	-9	5	-7	-12	-13
Italy	-4	—	-1	1	..	..
Canada	9	10	4	1	5	1
Direct investment						
United States (a)	2	41	7	14	14	10
Japan	-18	-35	-9	-10	-9	-12
Germany	-7	-9	-2	-1	-1	-2
France	-4	-6	-1	-3	..	..
United Kingdom	-17	-14	-4	-4	-2	2
Italy	2	1	2	—	..	..
Canada	-2	-2	—	-1	-1	—
Banking sector						
United States (a)	51	14	-1	—	-7	10
Japan	80	47	21	8	-15	8
Germany	-4	-5	-6	-2	13	-6
France	-5	3	2	-1	..	..
United Kingdom	4	26	1	11	14	-2
Italy	4	8	-1	5	..	..
Canada	2	2	4	—	-3	5
Other: (b)						
United States (a)	5	4	4	10	6	1
Japan	-8	-14	-4	-5	-2	-3
Germany	-16	-18	-3	-2	-14	-7
France	-2	-2	-1	2	..	..
United Kingdom	-1	6	1	1	5	7
Italy	-7	-6	-4	—	..	..
Canada	4	8	-5	5	4	-2
Official financing balance (-= increase in reserves)						
United States (a)	9	-4	-7	2	-4	-12
Japan	-39	-16	-4	-7	-2	10
Germany	-18	19	11	—	5	4
France	10	1	2	5	..	..
United Kingdom	-20	-5	-2	-1	1	4
Italy	-5	-7	-3	-3	..	..
Canada	-3	-8	2	-1	—	—
Memorandum: balancing item(b)						
United States (a)	2	-11	24	-19	2	27
Japan	-4	3	-5	3	4	-10
Germany	-4	2	—	-1	-3	-5
France	1	1	-1	-3	..	..
United Kingdom	19	22	5	9	2	11
Italy	-3	-2	-2	1	..	..
Canada	-2	-2	-4	—	1	—

.. not available.

(a) Seasonally adjusted.

(b) Reflects unidentified flows which may be associated with either the current or the capital account.

In the United States the current account deficit was matched by direct investment and banking inflows. Portfolio investment showed a small outflow, while reserves increased for the second quarter in succession reflecting intervention to hold down the dollar. The balancing item corresponded to an inflow of $27 billion.

The Japanese capital account in the second quarter displayed several changes from the first quarter. Portfolio investment returned to its established pattern with a net outflow of $7 billion, reversing an inflow of similar size in the first quarter, though this was still some way short of the levels recorded in 1987 and 1988. Bank borrowing also returned to its previous pattern with a net inflow of \$8 billion after a net outflow of \$15 billion in the first quarter, perhaps suggesting some additional hedging of foreign currency risk associated with portfolio purchases. However, the trend of increasing reserves was broken with a run-down of \$10 billion after a three-year sequence of increases which had seen reserves increase by \$73 billion. The fall followed action by the Japanese authorities to stem the weakness of the yen. The other noteworthy item was the large \$10 billion negative balancing item.

German reserves fell by \$4 billion in the second quarter, a similar magnitude to in the first, again reflecting the authorities' actions to counteract the weakness of the deutschemark. However, while in the first quarter there were considerable net outflows of portfolio investment, which were partially offset by banking inflows, in the second quarter the situation was reversed, with banking outflows being partially offset by a small net portfolio inflow, mainly as a consequence of renewed interest by investors in the German bond market following the withdrawal of the withholding tax announced in April and taking effect in July. Outflows of direct investment also increased.

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

	June 1988 levels	1988 Q3	1988 Q4	1989 Q1	1989 Q2	June 1989 levels
Industrial countries						
United Kingdom						
Sterling bank deposits	11.6	0.4	0.7	0.6	-1.0	11.1
Eurocurrency bank deposits	37.0	2.0	1.3	1.3	4.3	45.4
Government paper	5.4	-0.6	-0.3	—	—	4.1
Other investments	12.3	2.2	-0.1	-2.7	0.6	14.2
	66.3	4.0	1.6	-0.8	3.9	74.8
Other EEC: (b)						
Domestic currency bank deposits	6.8	-0.2	-0.3	-0.1	0.9	6.8
Eurocurrency bank deposits	20.3	0.3	-0.3	—	1.5	21.4
Other investments	66.2	-1.7	-1.2	-0.6	-0.9	59.4
	93.3	-1.6	-1.8	-0.7	1.5	87.6
United States:						
Bank deposits	17.4	2.9	-3.2	0.9	1.6	19.5
Government paper	18.4	0.3	2.6	5.8	-0.3	26.7
Other investments	20.9	-0.4	-0.6	0.7	0.5	21.1
	56.7	2.8	-1.2	7.4	1.8	67.3
Other:						
Domestic currency bank deposits	7.7	-1.2	-0.8	-1.4	0.9	4.9
Eurocurrency bank deposits	31.1	0.6	1.8	1.2	-0.2	34.4
Other investments	43.5	-1.7	-1.3	-1.7	-2.0	34.8
	82.3	-2.3	-0.3	-1.9	-1.3	74.1
Offshore centres:						
Bank deposits	50.0	1.4	0.5	0.8	0.9	53.6
Placements with ldcs	59.5	—	—	—	—	59.5
OEC credit to non-banks	12.9	—	—	—	—	13.0
IMF and IBRD(c)	39.0	—	—	-0.1	—	36.0
Total identified additions(+)/reductions (-) in deployed assets	**460.0**	**4.3**	**-1.2**	**4.7**	**6.8**	**465.9**
Net funds available for deployment		-2.2	-0.9	-5.2	2.4	
of which:						
Net movements in external borrowing etc		*3.3*	*2.9*	*-4.0*	*1.5*	
Current balance		*-5.5*	*-3.8*	*-1.2*	*0.9*	

(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.

In the fourth quarter of 1988 and the first quarter of 1989 the current account deficit in the United Kingdom was largely financed by banking flows, which also financed net outflows of direct and portfolio investment. In the second quarter this pattern changed. While the portfolio outflow continued at the high level of the first quarter (and amounted to \$25 billion in the first half of 1989), there was a small (\$2 billion) net inflow of direct investment and, in contrast to recent experience, a small outflow in the banking sector. The positive balancing item, at \$11 billion, was the highest quarterly figure ever recorded.

The Canadian current account deficit in the second quarter was essentially financed from banking inflows attracted by the historically high spread between Canadian and US assets.

Oil exporting countries interrupted a long-running trend by accumulating a surplus of \$0.9 billion in the second quarter. Identified movements in external assets for the second quarter consisted predominantly of increased bank deposits, the United Kingdom being the main recipient. Other types of investment showed a modest decrease.

International capital markets

Total borrowing activity in the international capital markets declined from \$117 billion in the second quarter of 1989 to \$101 billion in the third. There was a decline in issues of eurobonds as well as in the arrangement of new euronote programmes. In contrast, the value of newly-arranged international syndicated credits increased. Although the level of activity in the third quarter was below the levels observed in the first two quarters, the overall level of capital market activity so far in 1989 compares favourably with that recorded during the first three quarters of 1988.

Eurobond markets

(i) Fixed-rate bonds

Total issues of fixed-rate bonds declined from \$62.3 billion in the second quarter to \$47.1 billion in the third. The decline was partly attributable to the usual summer lull in international capital market activity, although it also reflected continuing concerns over

Total financing activity: by euromarket sector[a]
\$ billions, at quarterly rates, by announcement date

	1987 Year	1988 Year	1988 Q4	1989 Q1	1989 Q2	1989 Q3
Fixed-rate bonds						
Straights	117.2	160.0	34.5	51.2	34.6	29.8
Equity-related	43.2	42.0	4.8	24.6	27.5	17.1
of which:						
Warrants	*25.2*	*29.6*	*3.5*	*20.8*	*21.9*	*13.7*
Convertibles	*17.6*	*12.0*	*1.4*	*3.8*	*5.6*	*3.5*
Bonds with non-equity warrants (currency, gold, debt)	8.2	1.2	0.2	—	0.2	0.2
Total	**163.6**	**203.2**	**39.5**	**75.8**	**62.3**	**47.1**
Floating-rate notes	12.0	23.2	6.9	3.3	7.3	5.6
Euronote facilities	73.2	79.2	15.3	12.7	19.2	13.9
Syndicated credits	88.8	101.6	28.1	40.2	28.3	34.4
Total	**337.6**	**407.2**	**89.9**	**132.0**	**117.1**	**101.0**

(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.

Currency composition of fixed-rate bond issues
Percentage of total issues announced

	Straight bonds			Equity-related bonds		
	1988	1989		1988	1989	
Currency denomination	Year	Q2	Q3	Year	Q2	Q3
US dollars	30	40	34	69	78	72
Swiss francs	11	2	2	20	16	20
Yen	12	12	11	—	—	—
Deutschemarks	13	7	5	2	3	4
Sterling	7	8	11	5	1	2
Australian dollars	5	4	3	1	—	—
Canadian dollars	8	5	8	—	—	—
ECU	7	9	9	1	1	—
Other	8	13	17	2	1	2

currency volatility, rising interest rates and fears of oversupply in some markets; unease on the Tokyo stock market was also a factor. The decline in volume resulted mainly from a fall in equity-related issues from $27.5 billion to $17.1 billion. The launch of the World Bank's global bond helped the international institutions to maintain their position as the largest borrowers in the fixed-rate sector, raising funds worth $5.2 billion, compared with $4.5 billion in the previous quarter. UK institutions were also active, with funds raised increasing to $3.1 billion from $1.7 billion in the previous quarter. By contrast, borrowers from most other countries reduced their fixed-rate borrowing in the euromarkets. Japanese borrowers registered the largest decline, with issues falling from $29.6 billion to $19.3 billion. This decline almost wholly reflected a reduction in equity-warrant issues.

The volume of straight fixed-rate issues in the third quarter declined from $34.6 billion to $29.8 billion. This partly reflected a fall in dollar-denominated issues, with the currency accounting for only 34% of the total compared with 40% in the previous quarter. A flight to quality following a spate of defaults in the US junk bond market, and continuing fears over event risk, were among the reasons for this decline. Both factors tended to increase the cost of eurodollar funds for lower credit quality corporations or corporations which were thought to be potential takeover targets. However, these negative factors were tempered by a favourable sentiment towards the dollar for most of the quarter. In addition, for most of the quarter, dollar swap spreads over US Treasuries were favourable in relation to the spread of eurobonds against US Treasuries, making it attractive to obtain floating-rate funds by means of swaps. Turnover in the secondary market remained relatively strong. The quarter was particularly notable for the launch of the World Bank's $1.5 billion global bond issue. The deal, launched simultaneously in the euro and US domestic markets, represented the first truly successful attempt to overcome the fragmentation of the US dollar international bond market.

The volume of dollar-denominated equity-related deals totalled $12.3 billion compared with $21.5 billion in the second quarter. The decline in activity partly reflected fears of oversupply following the particularly high level of issuance in the first half of this year; other influences included unease in the Tokyo stock market, adverse interest rate movements, and the fact that many Japanese borrowers were reaching the permitted ceiling for issuance of overseas stock derivatives. In contrast to some predictions earlier in the year, there was little substitution of equity-related issues away from London to Tokyo. The quarter also saw the launch of the first shogun convertible (dollar-denominated) issue in Japan and the first US dollar equity-warrant eurobond issue in Singapore.

Primary activity in the sterling sector amounted to $3.6 billion, compared with $3.0 billion in the second quarter, reflecting continuing demand for funds by financial institutions, which accounted for 52% of the total. The high yield in the sterling market reportedly attracted strong demand from continental European investors, particularly at the shorter end of the yield curve.

Deutschemark-denominated issues declined from $3.5 billion to $2.1 billion, following concerns over rising interest rates. The volume of funds raised in the ECU also declined slightly in absolute terms, although primary activity in the unit still represented about 9% of the total, benefiting from the attractive swap spreads that were available for most of the quarter. These largely resulted from a tax arbitrage created by the launch of two domestic ECU 1 billion Treasury certificate issues by the Italian government. The setting of the unit's new currency amounts on 20 September was largely discounted by market participants, and therefore had little impact on the market.

In the euroyen market, issues declined from $4.1 billion to $3.3 billion, as political uncertainties, unattractive swap spreads and a trend towards higher interest rates deterred primary activity. Despite recent deregulation in the euroyen sector, liquidity was reported to remain fairly poor.

A high level of investor demand combined with wider swap spreads boosted issues in the Canadian dollar sector, with funds raised increasing from $1.5 billion to $2.5 billion. Despite concerns by some investors that the currency may be overvalued in relation to the US dollar, investor demand was stimulated by the attractive spread that Canadian government bonds offered over comparable US securities. In contrast, issues in the Australian dollar sector declined from $1.4 billion to $0.9 billion, owing to currency and interest rate concerns following the announcement of a number of poor economic indicators and the downgrading of some of the country's debt by one of the main rating agencies.

A number of deregulatory measures were initiated in the third quarter. In the Austrian schilling sector, the government removed restrictions preventing foreign issuers other than supranationals from tapping the market. The removal of restrictions in the Swedish krona market, which previously prevented the purchase of fixed-income securities in the currency by non-residents, also came into effect. In Japan, maximum maturity and size limits on non-Japanese issues were abolished.

(ii) Floating-rate notes

Issues of floating-rate notes declined from $7.3 billion in the second quarter to $5.6 billion in the third. The decline in issues was largely attributed to the reluctance of companies to borrow at floating rates in an environment of rising interest rates. The bulk of issues, as usual, came from financial institutions, which accounted for 92% of the total. The two most popular currencies of issue in the sector were the dollar and sterling, accounting for 35% and 31% of the total respectively.

(iii) Euronotes and other facilities

During the third quarter, primary activity in the euronote sector was relatively subdued. The total value of new euronote programmes announced fell from $19.2 billion in the second quarter to $13.9 billion in the third, while estimates by Euro-clear indicate that the value of outstanding notes amounted to $82.4 billion at the end of September, only $1.5 billion above the level at the end of the first quarter. The euronote sector has been adversely affected by high short-term interest rates in a number of major economies, which has encouraged borrowers to issue debt instruments with longer maturities. The value of new facilities for entities in major OECD countries increased from $8.5 billion to $9.8 billion, and borrowers in this category increased their share of all announcements from 44% to 71%. While non-OECD countries remained marginal participants in the market, a Brazilian company became one of the few borrowers from that country to obtain a euronote programme.

The euro-medium-term note (EMTN) market continued to grow steadily, with the value of outstanding notes increasing from $5.6 billion at the beginning of the year to $8.6 billion at the end of September. Market reports suggest that the average maturity of EMTNs has increased recently, reflecting the shape of the US dollar yield curve. There was also some evidence to suggest that the boundary between the eurobond and EMTN market is becoming less clear. For example, during the third quarter a number of borrowers in the eurobond market made tap issues, where additional tranches of bonds were to be fungible with earlier issues, while some EMTN issuers have sought in recent quarters to enhance the attractiveness of their notes by issuing them in larger tranches. The first Swedish krona ECP programme was launched in July, and in August the first deutschemark-denominated EMTN programme was arranged. Subsequently, the first EMTN programme denominated in yen was established in September.

Recently, investors have had to address the issue of default and assess the desirability of ratings in the eurocommercial paper market. Thus far, those defaults which have occurred have not caused any major dislocation to the sector, but it is felt that these events could result in a widening in the cost differential between prime-rated borrowers and those companies that have lower ratings or are unrated. Concern over defaults could strengthen the present trend for more borrowers in the ECP market to obtain credit ratings (as is common in the US CP market).

Announced euronote facilities[a]
$ billions

	1987	1988		1989		
	Year	Year	Q4	Q1	Q2	Q3
Committed(b)	3.9	3.7	0.1	0.6	0.8	1.3
Uncommitted	69.5	75.3	15.3	12.1	18.4	12.6
Total	**73.4**	**79.0**	**15.3**	**12.7**	**19.2**	**13.9**
of which:						
Major OECD	*47.6*	*44.9*	*7.9*	*9.5*	*8.5*	*9.8*
Minor OECD	*23.7*	*28.1*	*7.1*	*2.9*	*8.3*	*3.3*
Other	*2.1*	*6.1*	*0.3*	*0.3*	*2.4*	*0.8*
Selected nationalities of borrower						
United States	16.0	9.8	0.8	3.1	2.6	5.0
United Kingdom	10.0	11.4	1.8	0.4	2.7	1.3
Australia	8.5	6.0	1.0	1.5	4.4	0.7
Japan	10.0	6.8	2.2	2.1	2.1	1.2

(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.

International syndicated credits

Announcements of new international syndicated loans increased from $28.4 billion in the second quarter to $34.5 billion in the third, maintaining the strong underlying level of activity that the sector has experienced since the beginning of the year. While in previous quarters high volumes could be attributed to the trend among major OECD corporate borrowers to obtain multiple-option facilities and then later to the growth in acquisition-related lending, these two factors were of less significance in the third quarter. The value of all syndicated facilities arranged on behalf of institutions located in major OECD countries declined from $17.9 billion in the second quarter to $15.4 billion in the third. In contrast, credits for minor OECD borrowers and loans to entities in the less developed and newly industrialising countries increased.

One notable feature of the third quarter was the increase in announcements of new loan facilities on behalf of borrowers located in countries which have had limited involvement in the eurocurrency syndicated credit sector in recent years. For example, the Public Investment Fund of Saudi Arabia became the first central government agency from that country to raise funds in the market, while a loan to a Mexican mining company was the first eurocurrency syndicated loan on commercial terms for a borrower from Mexico since 1983. The deal was arranged using an innovative structure which included a commodity swap.

Announced eurocurrency syndicated credits[a]
$ billions

	1987	1988		1989		
	Year	Year	Q4	Q1	Q2	Q3
Major OECD	61.4	72.8	19.0	30.3	17.9	15.4
Minor OECD	14.9	18.3	5.1	3.7	5.1	9.5
Developing countries	9.6	9.3	3.6	5.8	4.7	9.2
Eastern bloc	1.9	1.2	0.3	0.3	0.7	0.3
Other	0.8	0.2	—	—	—	—
Total	**88.7**	**101.8**	**28.1**	**40.2**	**28.4**	**34.5**

(a) Includes those syndicated loan facilities which may allow a borrower to increase its liabilities partly or wholly in foreign currency (from the borrower's point of view) and/or involving an international capital flow.

The estimated volume of eurocurrency syndicated lending associated with merger and acquisition activity declined from $9.4 billion in the second quarter to $6.9 billion in the third, representing 20% of all credits announced. In recent quarters, a number of analysts have commented on the high returns that banks can earn by participating in acquisition-related financings, particularly in situations which involve a borrower assuming above average gearing ratios and where the bank can provide related services, such as the sale of interest rate hedging products. There now appears to be a tendency for the pricing on merger-related loans for major corporate borrowers with limited debt levels to move closer to the rates which such companies could obtain on facilities acquired to fund working capital.

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

	1987	1988			1989		Out-standing at end-June 1989
	Year	Year	Q3	Q4	Q1	Q2	
Liabilities vis-à-vis:							
BIS-reporting area	477.1	344.3	158.1	33.0	189.2	0.3	3,108.4
'Offshore' centres	125.9	94.4	48.8	6.3	9.6	11.8	817.1
Sub-total	603.0	438.8	206.9	39.3	198.8	12.1	3,925.5
Outside-reporting area							
Developed countries	6.3	12.7	2.7	4.5	3.5	3.0	71.0
Eastern Europe	-0.7	4.4	1.0	2.1	0.2	0.8	34.1
Oil exporters	19.2	11.0	6.3	-1.1	2.4	8.6	184.8
Non-oil developing countries	24.0	11.3	0.7	4.0	3.4	-4.5	230.2
of which, Latin America	*6.7*	*2.3*	*-2.0*	*0.2*	*0.3*	*-1.3*	*79.7*
Sub-total	48.8	39.5	10.7	9.5	9.5	7.9	520.1
Other(a)	34.5	32.5	2.1	16.0	4.6	9.3	222.4
Total	**686.2**	**510.7**	**219.7**	**64.8**	**212.9**	**29.3**	**4,668.0**
Assets vis-à-vis:							
BIS-reporting area	432.2	337.4	160.3	32.9	175.2	-16.0	2,924.3
'Offshore' centres	142.1	73.3	50.6	-3.4	33.7	12.2	775.3
Sub-total	574.3	410.8	210.9	29.5	208.9	-3.8	3,699.6
Outside-reporting area							
Developed countries	5.6	2.5	-3.1	2.5	1.0	-1.9	124.5
Eastern Europe	2.3	8.0	—	3.7	2.9	2.6	87.5
Oil exporters	2.0	5.6	2.9	1.4	-2.9	1.6	124.1
Non-oil developing countries	1.8	-8.9	-1.5	3.2	-1.4	-8.4	354.6
of which, Latin America	*-3.9*	*-10.8*	*-2.0*	*-2.7*	*-3.0*	*-5.3*	*202.2*
Sub-total	11.7	7.2	-1.7	10.8	-0.4	-6.1	690.7
Unallocated and international institutions	11.2	1.9	4.4	-3.0	3.4	2.4	101.4
Total	**597.3**	**419.7**	**213.6**	**37.3**	**211.9**	**-7.5**	**4,491.7**

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

International banking developments

Cross-border business of banks in the BIS reporting area slowed sharply in the second quarter of 1989, showing the first decline since the second quarter of 1985 (assets fell by $7.5 billion but liabilities rose by $29.3 billion). This slowdown contrasts with the very rapid growth of over $200 billion on both sides of the balance sheet during the previous quarter.

Interbank business within the BIS reporting area accounted for most of the second quarter slowdown, with the United Kingdom, Japan and the United States all reporting reductions in both assets and liabilities. Following the usual seasonal pattern, interbank business between banks in Japan and those in other centres fell by $54 billion. Deregulation in Japan was also an important influence.

International banking business in Europe continued to grow, although generally at a lower rate than in the first quarter of 1989. The main exception was Germany, where the announcement of the repeal of the withholding tax encouraged a reflux of deposits. The slowdown in the growth of net lending (the BIS's estimate of lending to final users) was much less pronounced. Within the reporting area, there was sizable borrowing by non-bank residents of France, the United Kingdom and Japan.

Overall growth in lending to countries outside the BIS reporting area fell by $6.1 billion during the second quarter of 1989. There were, however, further increases in cross-border claims of $2.6 billion on Eastern Europe ($1.7 billion being accounted for by growth in lending to the USSR), and $1.6 billion on the oil exporting countries. Recorded bank claims on non-oil developing countries showed a total fall of $8.4 billion, with the most significant reductions (as in the previous quarter) being in claims on Argentina ($1.6 billion) and Mexico ($1.3 billion). There was also a notable reduction in lending to Asian countries, particularly China ($1.2 billion) and Taiwan ($0.6 billion). Deposits by OPEC countries expanded by $8.6 billion during the second quarter, their largest quarterly increase since 1980. This expansion was almost fully accounted for by OPEC countries in the Middle East, especially Saudi Arabia ($3.3 billion) and Kuwait ($2.5 billion).

The London market

UK banks' external business contracted *in the second quarter of 1989*, partially reversing the strong recovery seen in the first quarter of the year. This period of recovery followed by a partial reversal repeats the pattern established in the half year to end-December 1988; the overall rate of growth during the two periods is also comparable (23.3% in the second half of 1988, 23.1% in 1989). Cross-border claims fell by $1.9 billion (0.2%) and deposits fell by $2.5 billion (0.3%). Interbank business accounted for all of the decrease, while business with non-banks maintained modest growth.

The fall in cross-border business was predominantly within the *BIS industrial area.* Following the recovery in the first quarter of 1989 ($31.2 billion), lending to the BIS industrial area fell by $8.9 billion (1.4%) in the second quarter. Deposits also fell, by $5.8 billion (0.9%), in sharp contrast to the rise of $37.4 billion in the previous quarter.

Within the reporting area, banks in Japan were again the largest net placers of funds with UK banks ($6.3 billion), despite a partly seasonal reduction in overall business. UK banks' lending to banks in Japan fell by $15.2 billion while deposits from banks in Japan placed with UK banks fell by only $8.9 billion. UK banks' business with the United States fell significantly, lending decreasing by $9.3 billion (7.0%) and deposits falling by $13.9 billion (8.3%).

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

	1987	1988			1989		Out-standing at end-June 89
	Year	Year	Q3	Q4	Q1	Q2	
Liabilities vis-à-vis:							
BIS industrial area	56.9	41.2	23.0	-10.2	37.4	- 5.8	617.4
of which:							
United States	*14.1*	*7.7*	*3.0*	*0.6*	*-0.6*	*-13.9*	*154.0*
Japan	*13.7*	*17.9*	*9.6*	*- 6.1*	*16.8*	*- 8.4*	*99.6*
'Offshore' banking centres	4.3	- 2.4	2.4	- 4.8	4.8	2.0	117.4
Sub-total	61.2	38.8	25.4	- 15.1	42.2	- 3.8	734.8
Outside reporting area							
Developed countries	3.0	5.7	3.4	- 0.2	2.2	0.8	25.6
Eastern Europe	- 0.1	1.1	0.3	1.4	- 1.0	0.8	8.7
Oil exporters	0.2	6.8	2.4	1.7	2.1	3.4	56.5
Non-oil developing countries	8.8	- 4.3	- 2.0	- 0.6	0.3	- 1.3	44.4
of which, Latin America	*3.0*	*-1.1*	*-1.5*	*0.7*	*0.6*	*- 1.3*	*4.6*
Sub-total	11.9	9.4	4.1	2.3	3.6	3.7	135.2
Other (a)	21.6	16.0	0.7	16.1	- 4.9	- 2.4	82.8
Total	**94.7**	**64.3**	**30.3**	**3.4**	**40.9**	**- 2.5**	**952.9**
Assets (b) vis-à-vis:							
BIS industrial area	80.6	46.5	27.0	1.3	31.2	- 8.9	615.6
of which:							
United States	*29.0*	*-10.8*	*0.1*	*- 2.1*	*3.8*	*- 9.3*	*121.8*
Japan	*38.5*	*42.5*	*20.8*	*- 0.2*	*9.5*	*-14.5*	*194.1*
'Offshore' banking centres	4.0	- 9.0	0.4	- 7.5	- 6.1	6.6	111.8
Sub-total	84.6	37.4	27.4	- 6.2	25.1	- 2.3	727.4
Outside reporting area							
Developed countries	- 1.5	- 1.9	-0.6	—	- 1.6	- 0.5	31.1
Eastern Europe	0.6	2.3	0.4	0.5	0.6	0.9	23.4
Oil exporters	- 0.4	0.7	0.1	0.4	—	- 0.1	19.8
Non-oil developing countries	- 2.4	- 6.5	-1.9	- 1.4	- 0.8	0.3	47.4
of which, Latin America	*-2.3*	*- 3.9*	*-1.6*	*- 1.1*	*-0.4*	*—*	*29.8*
Sub-total	- 3.7	- 5.5	-2.1	- 0.4	- 1.8	0.6	121.7
Other (c)	6.0	3.9	3.3	0.7	1.7	- 0.3	13.1
Total	**87.0**	**35.8**	**28.6**	**- 5.9**	**25.0**	**- 1.9**	**862.2**

(a) International organisations, unallocated and international issues of securities.
(b) Including securitised lending.
(c) International organisations and unallocated.

There was a marked increase in lending by UK banks to the *offshore centres* of $6.6 billion. This increase was due to rises in claims on Singapore ($4.0 billion) and Hong Kong ($2.5 billion), reversing the previous quarter's position. Deposits with UK banks by non-banks in Hong Kong fell by $1.2 billion.

Elsewhere there were no changes worthy of note, with the exception of the *oil exporting countries,* whose deposits with banks in the United Kingdom increased by $3.4 billion (2.9%).

The share of Japanese incorporated banks in all external lending by banks located in the United Kingdom fell further in the second quarter of 1989, by 1.3 percentage points to 37.7%, compared with 40.4% at end-September 1988. The share of British-owned banks fell marginally to 15.3%, while that of American banks rose by a further 0.4 of a percentage point to 14.0%. The 'other overseas' banks (including consortium banks) increased their share of external lending by 1.1 percentage points to 33%; this share has risen fairly steadily from 29% at end-September 1987.

During the second quarter the proportion of UK banks' external lending denominated in dollars fell from 58.1% to 55.6% of the outstanding total, a drop of $15.1 billion. Sterling lending rose by $5.1 billion, increasing its share by 0.4 of a percentage point to 8.2%. Lending denominated in deutschemarks rose by $3.4 billion, maintaining the previous quarter's share of total lending (11.8%). The Swiss franc's share also remained constant, at 3.8%.

The international business of banks in the United Kingdom rose gradually throughout *the third quarter of 1989.* Following a subdued second quarter, total claims rose by $26.5 billion (2.4%) while total liabilities increased by $38.8 billion (3.4%), over half of this increase being due to growth in liabilities to other banks overseas ($16.9 billion) and overseas non-banks ($8.6 billion). There was also a marked increase in foreign currency claims on non-banks in the United Kingdom ($6.5 billion).

Following their usual seasonal pattern Japanese banks increased their international business significiantly during September. After subdued activity in July and August, the large falls in business recorded in the second quarter were reversed in September (liabilities $16.1 billion, claims $17.0 billion). British-owned banks also stepped up deposit-taking ($16.8 billion) and lending ($9.0 billion) activity, primarily through business with non-connected banks overseas and CD issues. The international business of American banks (liabilities $1.0 billion, claims –$1.1 billion) and the other overseas banks sector (liabilities $4.8 billion, claims $1.7 billion) slowed during the third quarter.

Foreign exchange and gold markets

This section reviews the three months to end-September

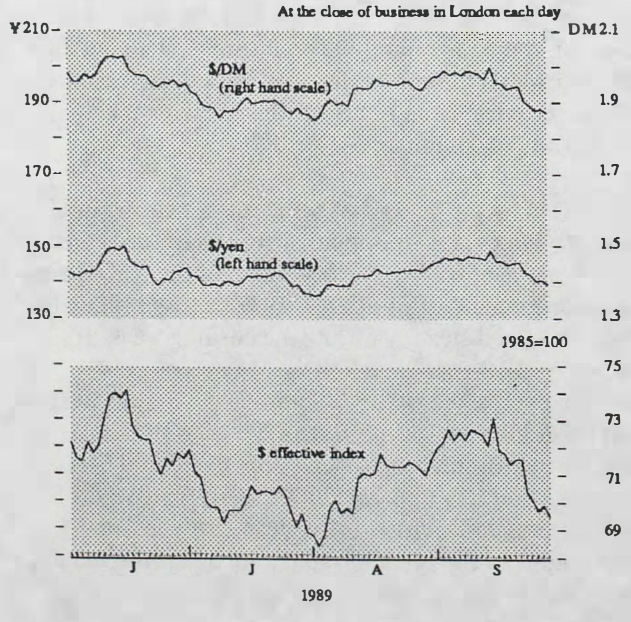
The dollar fell marginally on balance in the third quarter. After looking sluggish in July (when monetary conditions were indeed eased), the US economy subsequently seemed to be growing at a steady pace and the dollar forged ahead as funds were attracted by investment opportunities in the United States and by the prospect that US dollar interest rates would be kept around current levels. However, concerns about the US junk bond market sparked a steep fall in mid-September and the dollar surrendered further ground towards the end of the quarter in the wake of persistent central bank intervention following the G7 meeting of 23 September.

Encouraged by the belief that some further easing in US monetary policy was imminent, attitudes towards the dollar became bearish at the beginning of the period and, having opened on 3 July at DM 1.9375 and ¥142.50, the US currency fell steadily during the ensuing week. It touched ¥138.30 on 7 July following news of a lower-than-expected rise in US non-farm payrolls in June, and DM 1.8545 on 10 July when it became clear that monetary conditions had indeed been eased and Chase Manhattan cut its prime rate by ½% to 10½%. A vigorous short-covering rally ensued and, despite reports of intervention by the Bank of Japan, the dollar moved up briefly to DM 1.9245 and ¥142.75 on 18 July. However, underlying sentiment remained bearish and the US currency weakened sharply (to DM 1.8895 and ¥141.15 on 18–19 July) following the publication of worsening US trade figures. A brief technically-based rally saw the dollar reach ¥143.07 following the electoral defeat of Japan's ruling Liberal Democratic Party in Upper House elections, but this was short-lived. FRB Chairman Greenspan's Congressional testimony, which indicated that the balance of risk had shifted towards recession and away from inflation, was seen as confirmation that US interest rates were set to decline and, with weaker-than-expected data on US durable goods orders and on US GNP in the second quarter contributing to the lacklustre tone, the dollar fell steadily. It touched lows for the period of DM 1.8430 and ¥135.45 against the strengthening yen on 2 August after other leading US banks had followed Chase Manhattan's earlier lead in cutting their prime rates to $10\frac{1}{2}$%.

This marked a turning point for the dollar. Thereafter, the US real economy began to look considerably more buoyant than it had done a month earlier and the US currency benefited accordingly. It advanced strongly as data on US employment, retail sales and producer prices indicated that the Federal Reserve was not under any undue pressure to ease monetary conditions further; and, following publication of US trade figures showing a reduced deficit in June, the dollar advanced to DM 1.9725 and ¥144.00 on 17 August.

Fears of central bank intervention prevented the US currency mounting a serious challenge on DM 2 at this time and it reverted to technically-based range-trading during the latter part of August. Some nervousness about a possible increase in German interest rates sparked a fall to DM 1.9370 and ¥142.00 on 22 August, but the dollar rebounded to DM 1.9645 on 24 August and ¥144.30 on 29 August. A further steep fall occurred at the end of August when the release of strong US GNP figures for the second quarter encouraged profit-taking. Nevertheless, the dollar retained a bullish undertone, moving up smoothly to DM 2.0035 and ¥149.00 on 15 September—its highest levels since mid-June—as strong US employment data encouraged the view that US monetary policy would remain firm.

Dollar exchange rates



During the last fortnight of the quarter, however, sentiment changed markedly. Worries about the health of the US junk bond market were responsible for a steep fall in the dollar in New York on 15 September and the tone remained weak throughout the ensuing week as technical analysis pointed to a fall in the US currency and expectations of interest rate rises in Europe increased. When representatives of G7 countries meeting in Washington released a statement announcing their agreement 'that a rise of the dollar above current levels or an excessive decline could adversely affect prospects for the world economy', the US currency dipped sharply. The statement was followed by reports of persistent central bank sales which succeeded in moving the dollar down to DM 1.8625 and ¥138.90 on 29 September. It ended the quarter at DM 1.8710 (down 4.3%), ¥139.47 (down 3.2%), and Sw.Fc. 1.6205 (down 3.5%); in effective terms, it fell by 3.3% to 69.5 (1985=100).

EMS

Within the EMS, the width of the narrow band increased towards the end of the quarter as the deutschemark benefited from the dollar's sharp fall. The narrow band ended $2\frac{3}{16}$% wide between the mark at the top and the Danish krone. Until then, the system had enjoyed a particularly steady period during which interest had centred on the Spanish peseta and the Italian lira. Following its entry into the Exchange Rate Mechanism in June, the peseta stengthened and, at times, came very close to the upper limit of the 6% margin. For its part, the lira moved above the deutschemark towards the end of July and, throughout the ensuing month or so, there were reports of persistent intervention by the Bank of Italy amid rumours that the lira would soon formally enter the narrow band. However, upward pressure on both the peseta and the lira abated during the second half of September as funds moved out of the dollar and into the deutschemark; by the end of the quarter, the peseta was trading comfortably within its 6% margin and the lira was occupying a position just below the French franc at the centre of the narrow band. Treasury Minister Carli subsequently confirmed that Italy will aim to enter the narrow band of the Exchange Rate Mechanism within the next year.

Other currencies

The yen initially suffered from political uncertainty in Japan. Scandals involving ministers in the ruling Liberal Democratic Party (LDP) led to suggestions that the LDP would do badly in elections to the Japanese Upper House. As a result, the yen weakened from an opening level of ¥73.55 (=1 DM) on 3 July to ¥75.20 on 25 July (two days after the election, in which the LDP did indeed suffer losses). The sharp fall prompted dealers to unwind long deutschemark/short yen positions and the yen made a steady recovery, reaching ¥72.80 on 21 August. Thereafter, however, the Japanese currency slipped back again and, with the deutschemark benefiting more from the dollar's weakness in September, the yen ended the period on a soft note at ¥74.54 (=1 DM).

Gold

In relatively quiet trading, gold tended to track the dollar's movements. After being fixed at $375.40 on the morning of 3 July, gold edged up to a fixing high for the period of $385.50 on the afternoon of 6 July on heightened expectations of an easing in US monetary conditions. However, selling on the New York COMEX and weaker platinum prices sparked a fall to $368.80 on 20 July and the combined effect of a firmer dollar and steady producer selling caused gold to weaken further in early August. By 11 August, it had fallen to $361.90. A brief technically-based rally ensued, but, reflecting the dollar's advance, gold drifted lower during the first half of September, fixing at $355.75 on the afternoon of 15 September (its lowest fixing price since July 1986). With the dollar falling away during the ensuing fortnight, gold made a cautious recovery and it ended the quarter at $366.50 (down 1.7%).