International financial developments

Among the main developments:

- *Trade imbalances among the major industrial countries were little changed in the third quarter, although the US current account deficit narrowed fairly sharply as exchange rate valuation effects boosted investment income.*
- *Overall activity in the international capital markets rose in the fourth quarter, reflecting continuing strength in the syndicated credits market and some recovery in issues of fixed-rate bonds and arrangements of euronote facilities after a weak third quarter.*
- *Developments in the foreign exchange markets in the fourth quarter were strongly influenced by events in Eastern Europe—which were seen as highly favourable to West Germany's economic prospects, so stimulating inflows of funds into the deutschemark, which rose by 9½% against the dollar and by almost 5% in effective terms over the period.*

Balance of payments positions

Current accounts *(seasonally adjusted)*
The most notable changes in the balance of payments positions of the major industrial economies between the second and third quarters occurred on the invisibles and capital accounts: visible trade imbalances were, in comparison, little changed.

By far the largest change in the current account was in the United States, where it improved from a revised second quarter deficit of $32 billion to a third quarter deficit of $23 billion, with all the improvement accounted for by a swing in the services balance from a $2 billion deficit to a $9 billion surplus. Chief contributors to this improvement were increased receipts on US direct investment abroad (up $8 billion) and an increase in other service receipts of $1 billion. The shift in direct investment earnings was a result of a move from currency translation losses on foreign currency flows in the early part of the year to gains in the third quarter as the dollar's value peaked in June. The merchandise trade deficit was virtually unchanged at $28 billion, with exports and imports both showing a marginal rise.

The Japanese current account surplus in the third quarter was little changed from the second, at $14 billion, still well below the levels of the recent past. Within the total, the visible surplus fell slightly, while the invisibles deficit reversed the trend of the past year and a half and narrowed from $6 billion to $5 billion, as higher investment income more than offset higher payments on travel.

Although the German current account fluctuated considerably in the first half of 1989 owing to strong first quarter export performance and a sharp increase in investment income from abroad, the current account surplus in the third quarter was little changed from the second, at $14 billion. The visible surplus increased from $17 billion to $19 billion, close to the average level for 1988, while the invisibles deficit widened slightly though remaining well below the levels recorded in 1988. Although a further small surplus on services was recorded, there was a further increase in net transfers abroad: unadjusted data show increased transfers to the EC and further growth in net investment income.

World current accounts[(a)]
$ billions, *seasonally adjusted*

	1987	1988(b)			1989(b)		
	Year	Year	Q3	Q4	Q1	Q2	Q3
OECD economies:							
United States	-144	-127	-32	-29	-30	-32	-23
Japan	87	80	18	21	22	13	14
Germany	46	49	12	13	16	13	14
France	-4	-4	-1	-3	2	-1	-1
United Kingdom	-6	-26	-6	-10	-8	-8	-9
Italy	-2	-5	—	-1	..	..	..
Canada	-7	-8	-2	-3	-3	-5	-4
Major economies	-30	-41	-11	-12	..	..	..
Other OECD	-10	-14	-6	1	-4	-3	-5
Total OECD	-40	-55	-17	-11	..	..	..
OPEC economies	-11	-20	-6	-4	-1	1	2
Non-OPEC developing economies	12	4	1	1	-1	-4	-4
Other economies(c)	7	4	1	1	1	1	—
World discrepancy(d)	-32	-67	-21	-13	..	..	..

.. 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 result in the omission of positive influences (eg unrecorded services and investment income).

The third quarter French current account was unchanged from the second quarter, recording a deficit of $1 billion. The visible trade deficit narrowed from a revised $2 billion in the second quarter to $1 billion, while the surplus on invisibles decreased slightly. Increased transfers to the EC were an important factor in the invisibles account, as they were in the third quarter of 1988.

The United Kingdom's current account deficit widened from $8 billion in the second quarter to $9 billion in the third. The visible trade deficit increased from $10 billion to $11 billion, largely accounted for by a possibly erratic surge in manufactured imports (motor vehicles in particular); the oil surplus was almost unchanged. In volume terms, non-oil exports and imports grew by 3.6 per cent and 4.6 per cent respectively.

The main factors behind the fall of $1 billion from the second quarter in the UK invisibles surplus to near balance were an increase in the deficit on transfers from $1 billion to $2 billion, reflecting in the main a one-off fall in receipts from the European Community, and a fall in the services surplus, to which all the main components contributed. These offset a slight increase in the surplus on IPD, which at $1 billion in the third quarter nevertheless remains well below the levels reached in 1988 and the first quarter of 1989. Within IPD, net earnings by banks were little altered from the second quarter, with a recovery in spread earnings (due to a recovery in foreign currency spreads) offset by an increase in the cost of servicing the United Kingdom's net monetary liabilities as a result of strong sterling inflows and high UK interest rates. Net direct investment earnings were little changed, while net portfolio earnings increased somewhat as outward portfolio investment took place and earnings on official reserves fell as the level of reserves declined.

Canada's current account deficit narrowed from $5 billion in the second quarter to $4 billion in the third, as a result of a slight increase in the visible surplus from its very low second quarter level (though it remains well below the levels of the recent past), and an improvement in the invisibles deficit (mainly because of a higher surplus on unilateral transfers).

Capital accounts *(not seasonally adjusted except United States)*

In the US capital account, the switch from currency translation losses to gains mentioned above was the main factor behind the fall in net direct investment inflows from $7 billion in the second quarter to near balance in the third: gross outflows were $11 billion, the increase from $6 billion being more than accounted for by a rise in reinvested earnings. On the inflow side, takeover activity was an important factor. The portfolio investment inflow was dominated by foreign purchases of US Treasury securities, up from $2 billion to $13 billion. Japanese purchases accounted for almost all of the total.

Outflows of direct and portfolio investment more than offset the Japanese current account surplus in the third quarter, giving an apparent net outflow to be financed by other means of $8 billion. For the second quarter in succession, a record balancing item, corresponding to an

External financing of the G7 countries
$ billions, *not seasonally adjusted*

(Inflow+/Outflow-)

	1987	1988		1989		
	Year	Year	Q4	Q1	Q2	Q3
Identified current account						
United States (a)	-144	-127	-29	-30	-32	-23
Japan	87	80	24	16	14	15
Germany	46	49	16	16	14	10
France	-4	-4	-2	—	-1	—
United Kingdom	-6	-26	-8	-8	-10	-11
Italy	-2	-5	-1	..	..	..
Canada	-7	-8	-3	-5	-5	-2
Financed by:						
Portfolio investment						
United States (a)	74	82	22	20	-4	26
Assets	-5	-8	-3	-3	-6	-10
Liabilities	79	90	25	23	2	36
of which:						
From official sector	45	43	13	5	-10	12
From private sector	35	47	12	17	12	24
Japan	-97	-65	-14	7	-7	-12
Germany	5	-37	-9	-15	2	—
France	5	8	3	1	6	10
United Kingdom	24	-5	-5	-12	-11	-12
Italy	-7	—	1	..	..	..
Canada	9	10	1	5	1	3
Direct investment						
United States (a)	2	41	14	14	7	—
Japan	-18	-35	-10	-9	-12	-11
Germany	-7	-9	-1	-1	-2	-2
France	-4	-6	-3	-1	-4	-2
United Kingdom	-17	-14	-4	-1	2	-5
Italy	2	1	—	..	..	..
Canada	-2	-2	-1	-1	—	—
Banking sector						
United States (a)	51	14	—	-7	9	4
Japan	80	47	8	-15	8	20
Germany	-4	-5	-2	13	-6	-8
France	-5	2	-1	4	6	-2
United Kingdom	4	26	11	14	-2	15
Italy	4	8	5	..	..	..
Canada	2	2	—	-3	5	-3
Other						
United States (a)	5	4	10	6	-3	1
Japan	-8	-14	-5	-2	-4	-4
Germany	-16	-18	-2	-14	-8	1
France	—	-2	—	-2	-4	-7
United Kingdom	-1	5	—	5	3	7
Italy	11	5	-2	..	..	..
Canada	4	8	5	4	-1	1
Official financing balance (- = increase in reserves)						
United States (a)	9	-4	2	-4	-12	-6
Japan	-40	-16	-7	-2	10	3
Germany	-18	19	—	5	4	2
France	8	1	5	-1	-2	1
United Kingdom	-20	-5	-1	1	3	1
Italy	-9	-5	-6	..	..	..
Canada	-3	-8	-1	—	—	1
Memorandum: balancing item (b)						
United States (a)	2	-11	-19	2	34	-3
Japan	-4	3	3	4	-9	-11
Germany	-4	2	-1	-3	-4	-3
France	1	1	-2	—	—	1
United Kingdom	16	19	6	2	14	3
Italy	-3	-1	1	..	..	..
Canada	-2	-2	—	-1	—	-1

.. not available.

(a) Seasonally adjusted.

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

outflow of $11 billion compared with $9 billion in the second quarter, complicates interpretation of the data.

In terms of changes from the previous quarter, the Japanese figures were dominated by a portfolio outflow of $12 billion, which is largely the counterpart to the US portfolio inflow resulting from the large-scale Japanese purchases of US Treasury securities, and the identified banking inflow, which rose from $8 billion in the second quarter to $20 billion in the third, was mainly accounted for by a large increase in long-term and net short-term borrowing.

The German current account surplus was partly financed by banking outflows, with a fall in the long-term inflow and an increase in the short-term outflow, while portfolio investment was virtually in balance despite a sharp increase in investment into Germany from abroad, especially into shares. Inward portfolio investment recorded its highest level since early 1987. Net outflows of direct investment accounted for the remainder. Reserves fell by $2 billion, about half the fall recorded in the preceding two quarters.

The French capital account in the third quarter showed a net portfolio investment inflow of $10 billion, matched by a banking sector outflow of $2 billion, a direct investment outflow of $2 billion (rather smaller than in the second quarter) and 'other' outflows of $7 billion.

In the third quarter, the United Kingdom's capital account once more took on the overall pattern seen since the larger current account deficit emerged, with the current deficit and outflows of portfolio and direct investment financed by inflows through the banking sector. The total amount apparently required to finance the current account deficit and portfolio and direct investment outflows in the third quarter was some $27 billion. The balancing item, $3 billion in the third quarter, was considerably smaller than the erratically large figure recorded in the second.

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

	Sept. 1988 levels	1988 Q4	1989 Q1	Q2	Q3	Sept. 1989 levels
Industrial countries						
United Kingdom						
Sterling bank deposits	11.9	0.7	0.6	-1.0	- 0.3	11.3
Eurocurrency bank deposits	38.7	1.3	1.3	4.3	- 0.1	45.6
Government paper	4.8	-0.3	—	—	0.9	5.2
Other investments	14.2	-0.1	-3.0	0.6	- 0.1	17.3
	69.6	1.7	-1.2	3.8	0.4	79.4
Other EEC: (b)						
Domestic currency bank deposits	6.4	-0.3	-0.1	0.9	-0.8	6.2
Eurocurrency bank deposits	20.5	-0.3	—	1.5	-1.1	20.5
Other investments	64.2	-1.2	-0.6	-0.8	—	66.8
	91.1	-1.8	-0.7	1.5	-1.9	93.5
United States:						
Bank deposits	20.2	-3.2	0.9	1.6	- 0.8	18.7
Government paper	18.7	2.6	5.8	-0.3	5.1	31.8
Other investments	20.5	-0.6	0.7	0.5	1.0	22.0
	59.5	-1.1	7.3	1.7	5.2	72.6
Other:						
Domestic currency bank deposits	6.4	-0.8	-1.4	0.9	-0.6	4.4
Eurocurrency bank deposits	31.7	1.8	1.2	-0.2	1.4	35.9
Other investments	41.3	-1.3	-1.7	-2.0	-0.3	35.0
	79.4	-0.3	-1.9	-1.3	0.5	75.3
Offshore centres:						
Bank deposits	51.4	0.5	0.9	0.9	-2.4	51.3
Placements with ldcs	59.5	—	—	—	—	59.5
OEC credit to non-banks	12.9	—	—	—	—	13.0
IMF and IBRD (c)	37.2	—	-0.1	—	—	35.9
Total identified additions(+)/reductions (-) in deployed assets	**460.6**	**-1.0**	**4.3**	**6.6**	**1.9**	**480.5**
Net funds available for deployment		-0.9	-5.2	2.4	2.4	
of which:						
Net movements in external borrowing etc		*2.9*	*-4.0*	*1.5*	*0.4*	
Current balance		*-3.8*	*-1.2*	*0.9*	*2.0*	

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

(b) Includes Spain and Portugal.

(c) Includes holdings of gold.

Direct investment showed a net outflow of $5 billion, compared with a net inflow in the second quarter: the main reason for the change appears to be a fall in gross inflows. A record gross outflow contributed to a strong net portfolio investment outflow of $12 billion. A significant factor was strong investment by other financial institutions in overseas equities, although securities dealers participated only modestly. The final call on the British Steel privatisation was a factor in inward portfolio investment. The overseas sector was a net purchaser of gilts for the first time since 1988.

A record net inflow of $15 billion on banking transactions provided most of the identified finance of the current deficit and direct/portfolio outflows. The overseas sector appears to have been the counterparty (through deposits with UK banks) to a financial deficit on the part of UK industrial and commercial companies, with high levels of spending on merger and acquisition activity being an important source of demand for funds.

Oil exporting countries accumulated a surplus of $2.4 billion in the third quarter. Identified movements in external assets in the period included a decrease in bank deposits and an increase in other types of investment, predominantly US government paper.

International capital markets

Overall activity in the international capital markets rose from $103.4 billion in the third quarter to $121.8 billion in the fourth. The increase was largely due to a rise in announcements of euronote facilities and syndicated credits and in the volume of straight fixed-rate bonds. The increase in the latter was more than sufficient to offset a small decline in equity-related bond issues. Despite the increase in fixed-rate bonds over the quarter, overall issuance was below levels recorded in the first half of the year. This in part reflects a continuing slowdown in the volume of dollar-denominated equity-related bonds, which reached a peak in the second quarter of the year.

Activity (as measured by gross flows) for the year as a whole rose from $405 billion in 1988 to $472 billion. This reflected both the strength of equity-related bond issues, and a further increase in the announcement of international syndicated credits which, at over $148 billion, was the highest level of announcements recorded during the decade.

Bond markets

(i) Straight fixed-rate bonds

Straight fixed-rate issues rose to $34.5 billion in the fourth quarter from $29.6 billion in the third. Although there were reports that investors were preferring to remain in money-market instruments, expectations of higher interest rates in several major OECD countries encouraged borrowers to seek fixed-rate funds. In some

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

	1988 Year	1989 Year	Q1	Q2	Q3	Q4
Fixed-rate bonds						
Straights	160.0	149.9	51.2	34.6	29.6	34.5
Equity-related	41.8	85.2	24.6	27.5	17.2	15.9
of which:						
Warrants	*29.7*	*69.6*	*20.8*	*21.9*	*13.7*	*13.2*
Convertibles	*12.1*	*15.6*	*3.8*	*5.6*	*3.5*	*2.7*
Bonds with non-equity warrants (currency, gold, debt)	1.2	0.4	—	0.2	0.2	—
Total	**202.9**	**235.5**	**75.8**	**62.3**	**47.0**	**50.4**
Floating-rate notes	23.5	23.4	3.4	7.5	7.0	5.5
Euronote facilities	79.1	64.5	12.7	19.2	13.9	18.7
Syndicated credits	99.4	148.4	40.2	25.4	35.6	47.2
Total	**405.0**	**471.7**	**132.1**	**114.5**	**103.4**	**121.8**

(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.

sectors, unattractive swap spreads, which were not compensated for by a reduction in the spreads on new issues, deterred borrowing.

In the eurodollar sector, primary issuance in the fourth quarter increased from $9.8 billion to $11.2 billion, the dollar's share of total issues remaining at one third. Sentiment towards dollar assets was positive at the beginning of the quarter. However, the narrowing of the dollar's favourable interest rate differential reduced the attractiveness to investors of dollar fixed-income securities. Towards the end of the quarter, some evidence suggesting that the US economy was more resilient than expected and heightened concern about inflation caused investors to reassess the attraction of dollar bonds. The volume of issues, however, was maintained—in part owing to the announcement of a number of large deals for sovereign borrowers, including a $1.5 billion issue on behalf of Italy—the largest straight transaction so far launched in the euromarkets. The issue employed US-style syndication techniques, which have been used successfully in a number of large deals in the eurodollar market in both the third and fourth quarters.

Expectations of higher inflation combined with tight monetary policies in several of the countries whose currencies comprise the ECU failed to deter issues in the ECU in the fourth quarter. Strong purchases from retail investors seeking favourable nominal yields relative to the dollar, combined with attractive swap rates resulting from tax arbitrages created by a domestic ECU 1 billion issue of Treasury certificates by the Italian Government, encouraged borrowers to tap the ECU market. As a result of these factors issues rose from $2.7 billion to $3.0 billion. By contrast, issues in deutschemarks declined slightly to $1.1 billion mainly because potential borrowers remained reluctant to issue in the market as poor swap rates failed to compensate for the historically high cost of fixed-rate funds.

The deutschemark's strength contributed to a fall in sterling's effective exchange rate. This fall, and a further rise in interest rates, led to a sharp decline in the volume of international fixed-rate borrowing in the currency from $3.3 billion to $1.4 billion. Favourable swap spreads encouraged swap-related deals, although activity was generally thin, partly because of a High Court ruling that the swap transactions of Hammersmith and Fulham local authority were *ultra vires*. This caused banks to take a more cautious approach to sterling swap-related activity

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

	Straight bonds 1989			Equity-related bonds 1989		
Currency denomination	Year	Q3	Q4	Year	Q3	Q4
US dollars	36	34	32	76	72	70
Swiss francs	4	2	4	16	20	17
Yen	15	11	26	—	—	—
Deutschemarks	6	5	3	5	4	12
Sterling	8	11	4	1	2	—
Australian dollars	5	3	4	—	—	—
Canadian dollars	7	8	6	—	—	—
ECU	8	9	9	1	—	—
Other	11	17	11	1	2	1

as they reassessed their ability to engage in swaps with non-corporate counterparties.

Among the other high-yield currencies, the volume of Australian dollar issues almost doubled over the quarter to $1.6 billion. The belief that the Australian economy would slow down and that interest rates would fall in the near future enhanced demand in the sector, particularly from German and Benelux investors attracted by the higher yields. In the Canadian dollar sector issues fell to $2.0 billion.

In the euroyen sector, issues increased substantially in the fourth quarter, from $3.3 billion to $8.9 billion. Domestic inflationary pressures combined with fears of imported inflation owing to the strength of the dollar led the Bank of Japan to increase the discount rate by ½% in October and again in December. This initially discouraged issuance in the euroyen market. In December, however, anticipation of further increases in interest rates and attractive swap opportunities led borrowers to launch fixed-rate issues. Financial institutions remained the most active borrowers in the market, accounting for 70% of the quarterly figure.

A number of important developments occurred in the smaller eurocurrency markets. The first foreign bond issues were announced in the Norwegian krone and Danish krone sectors following a relaxation of restrictions by the Norwegian and Danish authorities. In France, minimum maturity restrictions on French franc eurobonds were relaxed. The quarter also saw the first straight eurobond issue by a Malaysian borrower, and the first eurobond issue for a Mexican private sector company since the debt crisis of 1982.

(ii) Equity-related bonds
The volume of equity-linked issues declined slightly to $15.9 billion in the fourth quarter, although the volume was substantially above the total of $5 billion for the corresponding quarter in 1988. The continued strength of the Japanese stock markets allowed for a reduction in coupons on bonds with warrants attached, in some

cases to less than 3%. The volume of issues denominated in dollars declined slightly during the quarter to $11.2 billion, in part a reflection of adverse dollar-yen swap rates which reportedly caused the all-in cost of yen funds to rise to 2½%, appreciably above the costs incurred in earlier quarters. Issues denominated in Swiss francs, most of which were convertibles, also registered a decline. These falls were partly offset by an increase in the volume of deutschemark-denominated issues from $0.8 billion to $1.9 billion. The majority of these were launched towards the end of the quarter, reflecting the strength of the deutschemark against the dollar. However, the development of this market is thought to be hindered by the lack of an active secondary market for deutschemark equity-warrant bonds.

One of the main developments during the fourth quarter was the announcement by the Japanese Ministry of Finance (MoF) that it was examining ways to improve price transparency in the secondary market for detached warrants in Tokyo. Although most of the bonds with equity warrants are issued and traded in London, secondary market trading in detached warrants in Tokyo has expanded substantially in recent quarters. In addition, a fall in issuing costs for domestic yen-denominated equity warrant issues provided a stimulus for an increase in the number of such issues in Japan during the quarter.

(iii) Floating-rate notes

Issues of floating-rate notes (FRNs) registered a further decline to $5.5 billion in the fourth quarter. There was a sharp decline in the volume of issues on behalf of financial institutions which was partly offset by a marked increase in issues by the company sector. The largest issue over the quarter was a $400 million FRN for the Kingdom of Belgium. The issue contained special conversion features which reportedly enabled Belgium to obtain funds at lower rates than if it had issued a fixed-rate bond and swapped the proceeds into floating-rate funds. More generally, however, FRNs remain unattractive to issuers in the current high interest rate environment, while investors' interest is limited by the lack of liquidity in the market. National Westminster Bank launched the first issue of undated sterling variable-rate notes, which will count as Upper Case Tier Two capital under the Basle convergence agreement.

Euronotes and other facilities

The volume of announcements of new euronote programmes increased from $13.9 billion in the third quarter to $18.7 billion in the fourth. Borrowers from the smaller OECD countries, especially Sweden and Australia, accounted for much of the growth in the fourth quarter. Their share of new programmes increased from 24% to 49%, largely at the expense of the share of the major OECD countries. There was a seasonal decline (from $82.4 billion to $79.2 billion) in the value of euronotes outstanding during the quarter.

Announced euronote facilities[(a)]

$ billions

	1988	1989				
	Year	Year	Q1	Q2	Q3	Q4
Committed(b)	3.7	2.8	0.6	0.8	1.3	0.1
Uncommitted	75.3	61.7	12.1	18.4	12.6	18.6
Total	79.0	64.4	12.7	19.2	13.9	18.7
of which:						
Major OECD	*44.9*	*35.9*	*9.5*	*8.5*	*9.8*	*8.1*
Minor OECD	*28.1*	*23.8*	*2.9*	*8.3*	*3.3*	*9.2*
Other	*6.1*	*4.8*	*0.3*	*2.4*	*0.8*	*1.4*
Selected nationalities of borrower						
United States	9.8	11.7	3.1	2.6	5.0	1.0
United Kingdom	11.4	5.8	0.4	2.7	1.3	1.3
Australia	6.0	10.4	1.5	4.4	0.7	3.8
Japan	6.8	7.3	2.1	2.1	1.2	2.0

(a) Include 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.

The principal currency in which announced euronote programmes were denominated was the dollar (88% by value), although over 60% of the programmes had multiple currency options. The value of programmes denominated in deutschemarks increased, reflecting the announcement of three new programmes, each of DM500 million ($262 million) in the recently established deutschemark euro-medium-term note (EMTN) sector. These included the first programme to be listed on the regulated section of the Frankfurt Stock Exchange, enabling the notes to be purchased by institutional investors and fund managers, thus expanding the potential investor base. The fourth quarter also witnessed the first ever eurolira certificate of deposit and EMTN programmes.

The eurocommercial paper (ECP) market was marked by further retrenchment and the withdrawal of some dealers, the result of low profitability owing to intense competition. Whether the departure of dealers results in any improvement in the returns for those that remain partly depends on whether issuers, who have been used to low costs, accept a higher level of commissions.

International syndicated credits

The value of new international syndicated credits announced increased substantially to $47.2 billion in the fourth quarter from $35.6 billion in the third. The high volume of credits was again partly fuelled by merger and acquisition activity by borrowers from the major OECD countries. (The total value of new facilities for these borrowers rose to $36.9 billion while the value of credits announced which were associated with merger and

Announced eurocurrency syndicated credits[(a)]

$ billions

	1988	1989				
	Year	Year	Q1	Q2	Q3	Q4
Major OECD	70.5	98.1	30.3	14.9	16.1	36.9
Minor OECD	18.3	23.9	3.7	5.1	9.7	5.4
Developing countries	9.3	24.0	5.9	4.7	9.4	4.0
Eastern Europe	1.2	2.2	0.3	0.7	0.3	0.8
Other	0.2	0.2	—	—	—	0.1
Total	**99.4**	**148.4**	**40.3**	**25.4**	**35.6**	**47.2**

(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.

acquisition rose from $8.1 billion to $21.3 billion.) Lending to East European borrowers increased by $0.5 billion to $0.8 billion, although many bankers are reportedly cautious given the uncertain political situation.

New syndicated credits for developing country borrowers fell to $4 billion. One innovative facility announced in the fourth quarter was an oil-indexed loan facility for Sonatrach of Algeria that enables lenders to obtain a higher return if oil prices deviate substantially from an agreed reference price. Such a structure is consistent with the IBRD's policy of encouraging developing country borrowers to use their commodity risk profile to their advantage.

The market for leveraged buyout (LBO) finance was turbulent in the fourth quarter, mainly because of the collapse of the bid for United Airlines in October. The collapse contributed to a reassessment of the risks of LBOs, with lenders seeking higher returns to compensate them for the perceived higher risk. During the quarter there was a new type of securitised euro-issue backed by LBO loans. Under the new issue, the cash flows from the loans were restructured to create four separate tranches of different credit quality and spreads. The largest part of the issue had a triple-A rating which was achieved by the pooling of a diversified basket of LBO loans together with an insurance guarantee. The large size of the deal, $625 million, is thought by some analysts to indicate the potential for future development of this market.

International banking developments

The second quarter deceleration in cross-border business of banks in the BIS-reporting area was reversed during the third quarter of 1989 as banks' total external assets and liabilities grew strongly (by $203 billion and $184 billion respectively). The majority of growth in business was attributable to the activities of Japanese banks, but there were also notable rises in lending and deposit taking activity of banks in the United Kingdom and the United States.

Business in Europe overall was buoyant. Cross-border lending by banks in the Netherlands accelerated, rising by $11.3 billion, compared with a modest $4.9 billion rise in the second quarter of 1989. UK banks stepped up external lending and deposit taking, recording a net intake of deposits of $15.0 billion. Similarly, US banks ended the quarter taking net deposits from the BIS-area of $6.7 billion, as business on both sides of the balance sheet recovered after the falls in the previous quarter. In the reporting off-shore centres, business with Hong Kong and Singapore rose sharply, reflecting their close association with cross-border activities of Japanese banks.

Interbank lending activity of reporting banks was buoyant. Both sides of the balance sheet were closely matched, with a resulting net asset position of $9.2 billion. The well-established pattern of Japanese banks' seasonal operations was especially apparent. Interbank business

Cross-border business of banks in the BIS reporting area

$ billions: changes exclude estimated exchange rate effects

	1987	1988		1989			Out-standing at end-Sept. 1989
	Year	Year	Q4	Q1	Q2	Q3	
Liabilities vis-à-vis:							
BIS-industrial area	477.1	344.3	33.0	189.1	0.6	113.9	3,278.1
'Offshore' centres	125.9	94.4	6.3	9.6	12.4	50.2	875.1
Sub-total	603.0	438.8	39.3	198.7	13.0	164.1	4,153.2
Outside-reporting area							
Developed countries	6.3	12.7	4.5	3.5	3.5	5.0	78.9
Eastern Europe	-0.7	4.4	2.1	0.2	0.7	- 0.3	34.1
Oil exporters	19.2	11.0	-1.1	2.4	8.7	- 6.9	179.6
Non-oil developing countries	24.0	11.3	4.0	3.4	- 4.4	9.9	242.3
of which, Latin America	*6.7*	*2.3*	*0.2*	*0.3*	*- 1.3*	*2.7*	*82.4*
Sub-total	48.8	39.5	9.5	9.5	8.5	7.7	534.9
Other (a)	34.5	32.5	16.0	4.6	4.8	12.4	236.1
Total	**686.2**	**510.7**	**64.8**	**212.8**	**26.3**	**184.2**	**4,924.2**
Assets vis-à-vis:							
BIS-industrial area	432.2	337.4	32.9	175.2	-14.8	148.8	3,126.0
'Offshore' centres	142.1	73.3	-3.4	33.7	13.1	53.2	837.4
Sub-total	574.3	410.8	29.5	208.9	- 1.7	202.0	3,963.4
Outside-reporting area							
Developed countries	5.6	2.5	2.5	1.0	- 1.6	0.4	128.0
Eastern Europe	2.3	8.0	3.7	2.9	2.6	1.9	91.8
Oil exporters	2.0	5.6	1.4	- 2.9	1.7	—	126.1
Non-oil developing countries	1.8	- 8.9	3.2	- 1.4	- 8.3	- 1.7	358.7
of which, Latin America	*-3.9*	*-10.8*	*-2.7*	*- 3.0*	*- 5.4*	*- 2.2*	*283.0*
Sub-total	11.7	7.2	10.8	- 0.4	- 5.6	0.6	704.6
Unallocated and international institutions	11.2	1.9	-3.0	3.4	1.3	0.4	101.8
Total	**597.3**	**419.7**	**37.3**	**211.9**	**- 6.0**	**203.0**	**4,769.9**

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

with Japanese banks rose by $146.4 billion, accounting for 87% of the growth in interbank lending within the reporting area. Business between banks in Europe showed weak growth in the third quarter when compared with the surges of the previous two quarters.

A key feature of third quarter developments was the unusually large rise in cross-border claims on non-banks. Lending to non-banks rose by an unprecedented $35.3 billion, of which $17.8 billion was absorbed by the Japanese non-bank sector.

Markedly high levels of lending to Japanese non-banks, mostly denominated in yen, are consistent with the underlying strength of the Japanese economy during the third quarter. A tightening of 'window guidance' rules in Japan is likely to have encouraged lending through overseas branches of Japanese banks. Claims on non-bank sectors of European countries also recorded sturdy growth in the third quarter. Italian non-banks continued to receive substantial funds from the BIS-reporting area, as did non-banks in countries comprising the Benelux group. After slow second quarter growth, the German non-bank sector borrowed strongly in the third quarter of 1989.

Outside the reporting area, cross-border lending edged upwards by $0.6 billion following a sharp contraction in the previous quarter. Latin America and China significantly ran down borrowing from BIS-reporting banks as did New Zealand, facing economic recession, during the third quarter. Claims on the USSR continued to grow strongly, forming the major component of the modest growth in lending to Eastern Europe. Growth of deposit taking activity in previous quarters was repeated in the third quarter, helped substantially by rises in deposits of $9.9 billion from the non-oil developing countries. In this context, a $4.0 billion rise in deposits from Taiwan is notable. A decline in deposits from Saudi Arabia of $3.9 billion largely accounted for the recorded reduction in deposits taken from oil exporting countries.

The London market

UK banks' external business grew during *the third quarter of 1989*. Cross-border claims increased by $17.5 billion (2.0%) in contrast to the small fall seen the previous quarter, and deposits rose by $30.8 billion (3.2%). Growth in interbank business accounted for much of this increase but business with non-banks, particularly within the BIS area, continued to increase. The overall rate of growth in UK banks' external lending during the first three quarters of 1989 is roughly comparable to the same period of 1988; however it is evident that a slowing in interbank business has been offset by an acceleration in non-bank business.

The increase in cross-border business was predominantly within the *BIS industrial area*. Following the fall recorded in the second quarter of 1989 ($8.1 billion), lending to the BIS industrial area rose by $15.4 billion (2.5%) in the third quarter; deposits also increased, by $19.4 billion (3.1%).

Within the reporting area external business continued to be dominated by the seasonal activity of Japanese banks. UK banks' lending to banks in Japan rose by $12.3 billion as Japanese banks stepped up their asset accumulation; lending to Japanese non-banks also increased, by $3.9 billion.

UK banks' lending to the United States increased by $6.4 billion (5.2%) and deposits fell by $1.9 billion (1.2%) making the United States the largest net taker of funds within the reporting area ($8.3 billion); non-banks in the United States accounted for $6.8 billion of this net flow.

Elsewhere, there was a marked growth in deposits with UK banks by the non-oil developing countries ($2.5 billion, or 5.6%) and by the developed countries ($2.3 billion, or 9.0%).

For the first time since the third quarter of 1988 Japanese incorporated banks increased their share in all external lending by banks located in the United Kingdom. A rise of 0.8 of a percentage point during the third quarter of 1989 increased Japanese banks' share of the market to 38.4%, (2% below the all time high reached in the third quarter of 1988). British-owned banks marginally increased their share of lending to 15.4% while the American banks' share fell from 14.0% to 13.4%. The 'other overseas' banks' (including consortium banks) share also fell during the third quarter, from 33.0% to 32.8%.

To reflect the increasing importance of the United Kingdom's involvement in ECU business (London

Cross-border business in the United Kingdom

$ billions: changes exclude estimated exchange rate effects

	1987 Year	1988 Year	1988 Q4	1989 Q1	1989 Q2	1989 Q3	Out-standing at end-Sept.89
Liabilities vis-à-vis:							
BIS industrial area	56.9	41.2	-10.2	37.4	- 6.0	19.4	649.1
of which:							
United States	*14.1*	*7.7*	*0.6*	*-0.6*	*-13.9*	*-1.9*	*152.4*
Japan	*13.7*	*17.9*	*- 6.1*	*16.8*	*- 8.4*	*13.6*	*115.1*
'Offshore' banking centres	4.3	- 2.4	- 4.8	4.8	2.3	0.3	119.6
Sub-total	61.2	38.8	- 15.1	42.2	- 3.7	19.7	768.7
Outside reporting area							
Developed countries	3.0	5.7	- 0.2	2.2	0.8	2.3	28.8
Eastern Europe	- 0.1	1.1	1.4	- 1.0	0.8	0.6	9.5
Oil exporters	0.2	6.8	1.7	2.1	3.5	- 0.4	56.9
Non-oil developing countries	8.8	- 4.3	- 0.6	0.3	- 1.1	2.5	48.0
of which, Latin America	*3.0*	*-1.1*	*0.7*	*-0.6*	*- 1.4*	*0.6*	*5.3*
Sub-total	11.9	9.4	2.3	3.6	4.0	5.0	143.2
Other (a)	21.6	16.0	16.2	- 5.0	- 2.8	6.1	88.3
Total	**94.7**	**64.3**	**3.5**	**40.8**	**- 2.5**	**30.8**	**1000.2**
Assets (b) vis-à-vis:							
BIS industrial area	80.6	46.5	1.3	31.2	- 8.1	15.4	643.6
of which:							
United States	*29.0*	*-10.8*	*- 2.1*	*3.8*	*- 9.3*	*6.4*	*129.2*
Japan	*38.5*	*42.5*	*- 0.2*	*9.5*	*-14.5*	*16.2*	*214.0*
'Offshore' banking centres	4.0	- 9.0	- 7.5	- 6.1	7.1	1.8	116.8
Sub-total	84.6	37.4	- 6.2	25.1	- 1.0	17.2	760.4
Outside reporting area							
Developed countries	- 1.5	- 1.9	—	- 1.6	- 0.6	-0.5	30.9
Eastern Europe	0.6	2.3	0.5	0.6	0.9	0.1	23.9
Oil exporters	- 0.4	0.7	0.4	—	- 0.1	-0.8	19.3
Non-oil developing countries	- 2.4	- 6.5	- 1.4	- 0.8	0.4	-0.9	47.0
of which, Latin America	*-2.3*	*- 3.9*	*- 1.1*	*-0.4*	—	*-0.9*	*29.2*
Sub-total	- 3.7	- 5.5	- 0.4	- 1.8	0.6	-2.1	121.1
Other (c)	6.0	3.9	0.7	1.8	- 1.5	2.4	12.3
Total	**87.0**	**35.8**	**- 5.9**	**25.1**	**- 1.9**	**17.5**	**893.8**

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

accounted for 29% of international ECU activity at March 1989) the third quarter currency figures have been adjusted to reveal the ECU within the currency breakdown. The following table shows the currency composition of UK banks' external lending as at end-September 1989:

US dollar	54.5%
Japanese yen	11.9%
Deutschemark	11.0%
Sterling	7.8%
Swiss franc	3.8%
ECU	2.8%

UK banks' international business contracted slightly on both sides of the balance sheet during *the fourth quarter of 1989*, in contrast to the moderate growth seen in the previous quarter. Claims fell by $2.8 billion (0.2%) while liabilities decreased by $5.7 billion (0.5%), interbank lending being almost entirely responsible for the slowdown in the growth of total international bank lending. During 1989 as a whole international claims rose by nearly 6%, compared with 4½% in 1988, 9% in 1988 and 14% in 1986.

The largest increase in international business during the fourth quarter was reported by the 'other overseas' banks sector (liabilities $9.8 billion or 2.3%, claims $10.3 billion or 2.6%). A rise in claims on unrelated banks ($4.4 billion) and a growth in liabilities to own offices overseas ($4.8 billlion) were the main factors. The American banks also stepped up their international activities during the fourth quarter with increased claims of $7.0 billion (4.3%).

In contrast, British and Japanese banks' international business contracted over this period. The partly seasonal decrease in Japanese banks' activities, which did not reverse the sharp increase of the previous quarter, was due to a reduction in the interbank market both in the United Kingdom and overseas. Similarly the contraction in lending by British banks of $19.0 billion was more than accounted for by reduced interbank activities.

Since the end of 1987 American banks in the United Kingdom have broadly maintained their share of international business at around 13%; at end December 1989 this had risen to 13.6%. Japanese and British banks have reduced their share to 35% and 16.5% respectively, while the share of the 'other overseas' group has continued to increase marginally to 34.5%.

Foreign exchange and gold markets

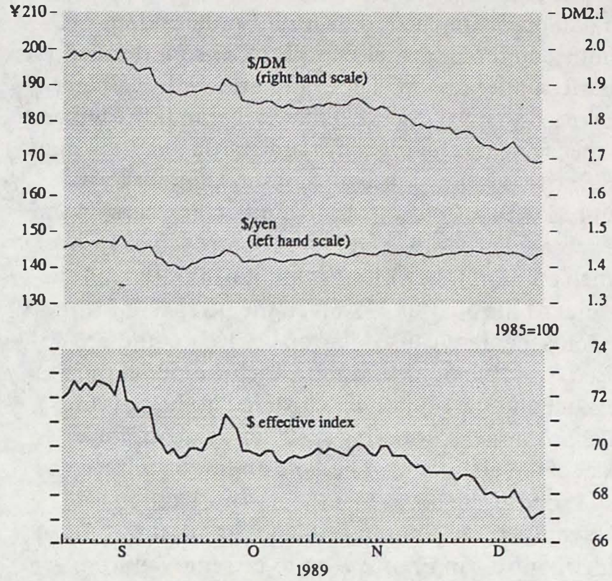
(This section reviews the three months to end-December)
Trading on the foreign exchanges during the final quarter of 1989 was heavily influenced by developments in Eastern Europe. As dealers took an increasingly optimistic view of prospects for the West German economy, in the light of events in Eastern European countries, funds flowed into the deutschemark and significant gains were recorded against all currencies.

US dollar
Underlying sentiment towards the dollar was positive at the beginning of the period. Reports of concerted intervention succeeded in reminding the market of central banks' concern, but the US currency traded comfortably against the deutschemark and improved steadily against the soft yen. Increases of 1% in most European interest rates on 5 October failed to dent the market's enthusiasm for the dollar, which moved up from an opening level of DM 1.8752 on 2 October to $1.9220 on 11 October when the market interpreted comments by Federal Reserve Chairman Greenspan to mean that attempts at short-run exchange stabilisation were considered counterproductive. However, as concerns about the prospects for the US economy resurfaced, an abrupt fall on Wall Street on 13 October caused the dollar to plummet and it remained soft following the publication of worsening US trade figures. A lower-than-expected rise in US consumer prices sparked a brief recovery, but news of a sharp fall in US durable goods orders (excluding defence) in September undermined confidence and another sudden collapse on Wall Street on 24 October put the dollar under renewed pressure.

Having touched DM 1.8265 on 30 October, however, the dollar stabilised during the first half of November despite

Dollar exchange rates

At the close of business in London each day



the fact that German interest rates firmed and US equity prices suffered a further sharp fall. In fact, with the initial uncertainties of the German political situation briefly attracting funds back to the dollar, it touched DM 1.8665 on 13 November. However, bearish tendencies resurfaced as dealers became optimistic about the outlook for the West German economy and, helped by the additional prospect of a further reduction in the dollar's favourable interest rate differential, the deutschemark strengthened sharply against both the yen and the dollar, the latter dipping briefly to DM 1.7690 on 28 November.

The dollar continued to depreciate against the deutschemark during December, but it remained within a narrow range against the yen. Comments by US Treasury Under-Secretary Mulford that its fall against the deutschemark was not alarming triggered further sales and the US currency dipped to DM 1.7625 on 6 December. Although the dollar recovered to DM 1.7772 on 8 December and touched ¥144.75 on 11 December, demand for deutschemarks in a thin market caused it to fall to DM 1.70 on 13 December and it remained soft following the announcement of a worse-than-expected US trade deficit in October. Profit-taking sales of deutschemarks provided some respite, but the US currency subsequently encountered renewed downward pressure on both political and interest rate considerations. Bullish sentiments about prospects for the West German economy were encouraged by the political developments in Eastern Europe, including the collapse of the regime in Romania and, with the Federal Reserve signalling an easing of monetary policy on 20 December and the Japanese raising their discount rate by $\frac{1}{2}$% to $4\frac{1}{4}$% on Christmas Day, the dollar fell to ¥141.75 on 27 December and DM 1.6747 on 28 December (its lowest level against the deutschemark since April 1988). It ended the quarter at DM 1.6915 (down 9.6%), ¥143.80 (up 3.1%) and Sw.Fc. 1.5422 (down 4.8%); in effective terms, it fell by 3.2% to 67.3 (1985 = 100).

EMS

As a result of the deutschemark's strength, the EMS, which had been stretched to its limits at the end of September, endured further periods of tension throughout the quarter under review. The Danmarks Nationalbank was reported to have intervened heavily in mid-October when the krone reached its limit against the deutschemark and a 1% rise in official interest rates in Denmark was announced with effect from 1 November. Pressure on the krone subsequently subsided and the narrow band remained comfortably within its margins throughout the remainder of the quarter. However, the persistent firmness of the deutschemark caused currencies to become polarised, with the mark and the Dutch guilder at the top of the band and the remainder clustered at the bottom, and this prompted simmering speculation about the prospect of a realignment. The Belgian franc replaced the Danish krone at the bottom of the narrow band in mid-November. The announcement that existing exchange controls in France were to be removed from 1 January 1990 had little effect on the franc, which itself occupied the lowest position in the narrow band for a short time in early December. At the end of the quarter, however, the band was $2\frac{1}{16}$% wide between the deutschemark and the Danish krone.

As for the wide band currencies, the peseta and lira were soft during the first half of October. The lira fell from a position above the deutschemark at the top of the narrow band in September to a point just outside the foot of the band. Both the peseta and the lira recovered during the latter part of October and early November, the peseta strengthening markedly following Senor Gonzalez' election victory and the lira benefiting from its favourable interest rate differential. However, the relentless advance of the deutschemark subsequently caused the peseta and lira to fall sharply and, by the end of the quarter, the peseta was only just above the top of the narrow band while the lira was some 2% below the weakest currency in the band.

Japanese yen

Although the yen traded within a reasonably narrow range against the dollar, it weakened steadily against the deutschemark throughout the period as, initially, interest rate differentials and, later, developments in Eastern Europe lured Japanese investment to West Germany.

Coming in the wake of a 1% rise in German and most European interest rates, an unexpected 0.5% increase in Japan's official discount rate on 11 October was too small to reverse the yen's decline from an opening level of ¥74.26 (= 1 DM) on 2 October to ¥77.87 on 3 November, although it succeeded in boosting the Japanese currency's rate against the dollar after a low for the period of ¥145.15 had been seen. Speculation about a further discount rate rise sparked a brief recovery against the deutschemark, but, when this did not materialise, the yen's cross-rate fell steadily. A further 0.5% rise in Japanese discount rate was eventually announced on Christmas Day, but the yen continued to lose ground to the deutschemark while remaining in a narrow range against the dollar. By the end of the quarter, its cross-rate against the deutschemark had fallen to ¥85.01 (down 14%).

Gold

After being fixed on the morning of 2 October at $366.45, gold initially traded quietly, falling back to a fixing low for the quarter of $360.40 on 11 October. Later in the month, however, the price was boosted by news that Japanese non-life insurance companies had been permitted to invest in gold and, with the political uncertainty in Eastern Europe from November, gold advanced further. It reached a fixing high of $417.15 on 27 November (its highest fixing since December 1988) and remained in demand following the coup attempt in the Philippines. However, gold's sharp rise encouraged a wave of profit-taking which caused the price to fall steadily during the latter part of December. Nevertheless, the final fixing of $401.00 represented a rise of $34.50 during the quarter.