International financial developments

This article covers developments in the international capital markets and the foreign exchange markets in the second quarter of 1990, and international banking developments in the first quarter.

International capital markets

Total borrowing activity in the international capital markets declined from $118.9 billion in the first quarter to $110.5 billion in the second. Issues of straight fixed-rate bonds were similar to the first quarter but there was a sharp decline in equity-related bond issues due to the suspension of issues by Japanese companies following the falls in the Japanese stock markets. The floating-rate note market continued its recovery, partly owing to the uncertainty over the direction of interest rates.

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

	1988	1989			1990	
	Year	Year	Q3	Q4	Q1	Q2
Fixed-rate bonds						
Straights	160.0	149.3	29.2	34.5	41.3	41.8
Equity-related	41.8	85.2	17.2	15.9	11.2	2.5
of which:						
Warrants	*29.7*	*69.6*	*13.7*	*13.2*	*7.1*	*0.7*
Convertibles	*12.1*	*15.6*	*3.5*	*2.7*	*4.0*	*1.8*
Bonds with non-equity warrants (currency, gold, debt)	1.2	0.5	0.2	—	—	0.1
Total	**203.0**	**235.0**	**46.6**	**50.4**	**52.4**	**44.3**
Floating-rate notes	23.5	24.2	7.2	6.3	9.7	11.0
Euronote facilities	81.2	66.8	13.9	19.8	17.0	17.0
Syndicated credits	99.8	151.7	35.6	51.0	39.7	38.2
Total	**407.5**	**477.7**	**103.3**	**127.5**	**118.9**	**110.5**

(a) Maturities of one year and over. The table includes euro and foreign issues and publicised private placements. Issues which repackage existing bond issues are not included. Figures may not add to totals because of rounding.

(i) Straight fixed-rate bonds

Issues of straight fixed-rate bonds were broadly unchanged in the second quarter, compared with the first, at $41.8 billion. The first half of the quarter saw relatively little activity as the markets continued to feel uncertain about the direction of interest rates and exchange rates. However, by mid-quarter, with the Japanese stock markets clearly stabilising, the decision on the conversion rate of the Ostmark for deutschemark having been taken and a rally in the US markets, there was a recovery which lasted until the end of the quarter.

Straight dollar issues, at $13.1 billion, were little changed from their first quarter rate. In April and early May rising US interest rates combined with poor swap rates caused a dearth of issues. By mid-May it had become apparent that a number of potential borrowers were wishing to tap the markets but were unwilling to lock themselves to the prevailing interest rates. A rally in the US bond market, following the release of economic data which removed fears that the Federal Reserve would tighten the stance of monetary policy, led to a surge of issues as some borrowers saw an opportunity to achieve their funding objectives. These issues were well received, indicating strong underlying demand, which was maintained to the end of the quarter. In addition, the rally in the markets together with the introduction in April of Rule 144a, which liberalised the rules relating to private placement in the United States, led to four issues being launched simultaneously in the eurobond and American markets. These so-called 'global bonds',[(1)] three of which were large issues backed by credit card receivables, capitalised on the demand from investors for good quality dollar paper. In June there was the second issue to use the auction method of syndication. The borrower, as with the first issue, was the Kingdom of Denmark ($800 million).

Issues of yen bonds in the second quarter at $5.4 billion were less than the $6.7 billion recorded in the first. The falls in the Japanese stock market and the currency weakness evident in the first quarter hampered primary activity early in the quarter. However, with evidence of continued European demand and with the currency and stock market both showing signs of recovery, primary issuance recovered, particularly in late May and early June.

There were $3.6 billion of Swiss franc straight issues in the second quarter, down from the abnormally high level of the previous quarter. Corporate issuance was weaker than in the first quarter but there was an unusually high level of supranational primary activity. The strength of the Swiss franc relative to the deutschemark and high interest rates ensured good investor demand, even during April, when issuance in other markets was low. While swap rates were, in general, unspectacular, many borrowers found it possible to lower their funding costs by swapping into floating-rate dollar funds.

The trend rise in ECU issues continued in the second quarter with a record $5.6 billion, following $4.9 billion in the first. Central government issues, particularly the Italian government's ECU 1 billion issue, were prominent, while a

(1) The US tranche of a 'global bond' may be issued on the public market (eg the first global bond issue by the IBRD in September 1989): in these cases Rule 144a is not involved.

reduction in private sector issuance was noticeable. Demand for ECU assets has been strong not only from European but also from Middle Eastern and Far Eastern investors.

Activity in the deutschemark sector was subdued, with issues of $1.9 billion. Uncertainty over the economic and financial impact of German monetary union inhibited deutschemark straight fixed-rate issues. The activity in this sector was concentrated in supranational issuers, and primarily the World Bank, which launched three deutschemark issues worth a total of DM 1.2 billions.

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

	Straight bonds			Equity-related bonds		
	1989	1990		1989	1990	
Currency denomination	Year	Q1	Q2	Year	Q1	Q2
US dollars	36	31	31	76	58	26
Swiss francs	4	11	9	16	30	6
Yen	15	16	13	—	—	—
Deutschemarks	6	6	5	5	6	—
Sterling	8	8	5	2	4	19
Australian dollars	5	4	4	—	—	—
Canadian dollars	7	2	4	—	—	—
ECU	8	12	13	—	—	—
French francs	3	2	5	—	2	36
Other	8	8	11	1	—	13

Issues in the sterling sector were £1.3 billion ($2.2 billion),[1] compared with £2 billion in the first quarter. The market was relatively quiet in April and May until speculation emerged in mid-May that the United Kingdom might shortly join the ERM. This led to increased investor interest in sterling from both Europe and the Far East, causing a rally in the bond markets and a number of new issues. Most of these issues were swapped into floating-rate sterling.

Issues in the French franc sector were a record $2.2 billion. There was a steady stream of issues throughout the quarter. International investors became more confident about the strength of the French franc and this was reflected in a narrowing of interest rate spreads between French franc and deutschemark bonds. The majority of bonds issued were by French companies but there were two Fr.Fc. 1 billion issues for the World Bank and the EIB which may act as benchmark issues.

There was an increase in the volume of primary activity in some smaller European currency sectors, most notably the Italian lira sector ($1.3 billion) and the recently opened Finnish markka sector ($0.9 billion). The Spanish peseta market was also active. Investors were attracted by high yielding coupons and/or a strengthening currency. Around half of the issues were swapped by the borrowers.

(ii) Equity-related bonds

The equity-related sector came to a relative standstill in the second quarter, with $2.5 billion of issues, the lowest total since 1984, following the decision by the Japanese securities houses in mid-March to suspend all new issues of equity-related bonds in the wake of the decline in Japanese equity prices. There were no equity-related issues by Japanese companies in the second quarter, against a quarterly average of $17 billion in 1989. The suspension of issues by Japanese companies was lifted in July and immediately a number of borrowers came to the market.

(iii) Floating-rate notes

Floating-rate note issues, at $11.0 billion, were higher than in the first quarter, which itself witnessed the highest volume since the end-1986 crisis in the perpetual sector of the market. However, unlike the first quarter, when the recovery was concentrated in the deutschemark sector, in the second quarter it was more broadly based in terms of currency. Issues tended to be concentrated among banks and financial institutions.

In the dollar sector, which had been exceptionally weak in the first quarter, the recovery was led by issues by banks, either raising capital classified as tier two under the BIS capital adequacy standards, or using asset-backed issues to reduce their capital requirements. The banks raised tier two capital via either step-up perpetuals (ie issues which have coupons which are increased periodically) or variable-rate notes (VRNs). The investors, who were faced with a relative dearth of paper in the dollar fixed-rate sector, were content to buy good quality bank paper. The asset backed issues included FRNs backed by leveraged buyout (LBO) loans and 'junk' bonds.

In the sterling FRN market there were £2.0 billion ($3.4 billion)[2] worth of issues, of which £1.1 billion ($1.8 billion) were issued by building societies. Asset-backed issues accounted for the remaining £0.9 billion ($1.6 billion). The latter included not only mortgage-backed issues, which recovered from their low in the first quarter, but also a £60 million ($100 million) issue backed by relocation loans and a £328 million ($571 million) issue backed by car loans.

In the deutschemark sector, issues were $1.7 billion following the exceptional $4.5 billion in the first quarter. The German government, early in the quarter, issued a 10-year FRN by means of a 'Dutch auction', marking a departure from the traditional distribution consortium. The yen sector was active, with issues of $1.2 billion. Most of these issues were privately placed. This activity, which was concentrated mainly in June, probably reflected uncertainty over the direction of Japanese interest rates.

Euronotes and other facilities

The second quarter volume of new euronote facilities (including eurocommercial paper and euro-medium-term notes), at $17 billion, was unchanged from the first quarter and close to the average for 1989. Within the total, announcements of new eurocommercial paper (ECP)

(1) These data are not strictly comparable with those in Table P on page 335, because they exclude equity-related issues.
(2) These data are not strictly comparable with those in Table P on page 335, because they only cover international issues.

facilities increased strongly, while arrangements of new euro-medium-term notes (EMTNs) at $3.2 billion fell back from the historically high volumes witnessed in the first quarter. Euroclear estimate that the stock of euronotes outstanding stood at $96.17 billion at the end of June, an increase of $7.5 billion during the quarter.

The ECP market continues to grow steadily, despite the difficulties it has faced in the last year with low dealer profitability and borrower defaults. At end-June outstanding ECP issuance stood at a record level ($69 billion). A contributory factor in this continued expansion is the current perception of the ECP market as an increasingly attractive funding alternative to its counterpart in the United States. Large borrowers can often now tap the ECP market for funds more cheaply than the US market, although the latter still retains the key advantages of depth and liquidity. Similarities between the two markets are increasing in other areas. There is a growing emphasis on credit ratings in the euromarket following recent defaults: dealers report that 90% of new programmes being established are now rated.

Announced euronote facilities[a]
$ billions

	1988	1989			1990	
	Year	Year	Q3	Q4	Q1	Q2
Committed(b)	3.7	2.9	1.3	0.2	0.1	—
Uncommitted	77.5	63.8	12.6	19.5	17.0	17.0
Total	**81.2**	**66.8**	**13.9**	**19.8**	**17.0**	**17.0**
of which:						
Major OECD	*45.1*	*36.6*	*9.8*	*8.6*	*11.6*	*6.6*
Minor OECD	*30.1*	*24.8*	*3.3*	*9.8*	*4.3*	*9.6*
Other	*6.1*	*5.4*	*0.8*	*1.4*	*1.2*	*0.8*
Selected nationalities of borrower						
United States	10.0	11.7	5.0	1.0	4.1	2.4
United Kingdom	11.4	5.8	1.3	1.3	0.6	2.9
Australia	6.6	10.6	0.7	3.9	2.8	4.1
Japan	6.8	8.0	1.2	2.5	3.1	0.6

(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 defaults in the market and the withdrawal of several market participants had sparked fears that lack of profitability might lead to the demise of the ECP market. Banks have been prompted to increase the commissions which they charge on deals and it has been reported that an 'informal charging system' has been established in the market. Some banks, however, are still prepared to cut margins in order to win market share.

Despite a decline in new facilities announced, Euroclear estimate that outstandings in the EMTN market increased very strongly during the quarter to reach a record level of $14.74 billion. This suggests that existing programmes have been activated. Actual issuance may be even higher as many of the notes are privately placed. The Kingdom of Spain, a major borrower in the market, recently indicated its confidence in EMTNs by doubling its existing $1 billion programme. The MTN market may benefit from the approval in the United States of Rule 144a (which relaxes the restriction on the resale of privately placed securities to qualified investors). It is now easier for non-US borrowers (whose primary investor market is in Europe) to establish EMTN programmes which contain a tranche which may be issued directly in the United States. In June, Abbey National became the first borrower to launch such a programme.

International syndicated credits

Announcements in the international syndicated credits market declined slightly to $38.2 billion in the second quarter from $39.7 billion in the first. The market has been dominated by a large number of medium-sized deals, with acquisition financings falling back to their lowest level since the third quarter of 1988, to stand at $5.4 billion.

The continued decline in merger and acquisition financings highlights the more cautious attitude towards highly leveraged transactions which banks have been exhibiting since the beginning of the year. Some lending to companies for acquisition purposes is continuing: however, such deals generally contain a larger proportion of equity finance than would have been usual in the recent past. Banks are now turning to project financing loans to provide them with sound investment opportunities. Some project financing loans have been heavily oversubscribed. Also there are signs of moves away from the transaction banking witnessed in recent years and a resurgence of relationship banking.

Announced eurocurrency syndicated credits[a]
$ billions

	1988	1989			1990	
	Year	Year	Q3	Q4	Q1	Q2
Major OECD	70.9	98.6	16.1	37.7	24.1	19.9
Minor OECD	18.3	25.7	9.7	7.1	9.0	6.5
Developing countries	9.3	25.1	9.4	5.2	6.4	8.3
Eastern bloc	1.2	2.2	0.3	0.8	—	3.6
Other	0.2	0.2	—	0.1	0.2	—
Total	**99.8**	**151.7**	**35.6**	**51.0**	**39.7**	**38.2**

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

In addition to project financing deals, the credits market has continued to be buoyed by exceptionally strong borrowing by Italian corporates. Sixty-two deals were syndicated in the past quarter, amounting to $5.9 billion. Since the start of the year Italian borrowers have raised $9.3 billion compared with $8.6 billion raised during the whole of 1989. The majority of the deals are for financial institutions involved in the property markets. Despite the high volumes, the deals have been well received by the market.

International syndicated credits arranged for the Soviet Union increased substantially during the quarter to $3.5 billion, of which $3 billion was in a single credit to Vnescheconombank from a syndicate of West German banks, 90% guaranteed by the West German government. Only one other credit was arranged for an Eastern European borrower during the period, highlighting the caution with which banks currently view lending to the USSR and Eastern Europe as a whole.

Lending to developing and other countries increased to $8.3 billion from $6.4 billion in the first quarter. This borrowing was largely concentrated in South East Asia and China. Borrowing by Indonesia was notably buoyant

($1.7 billion) with reports that many of the syndicated credits were oversubscribed.

International banking developments

The growth of cross-border business of banks in the BIS reporting area slowed sharply in the first quarter of 1990, with assets rising by $60.3 billion (or a little over 1%) and liabilities by $95.1 billion. This slowdown contrasts with the very rapid growth of over $200 billion on both sides of the balance sheet in the third and fourth quarters of 1989.

Reduced expansion of interbank business within the BIS reporting area accounted for most of the first quarter slowdown, and a sharp contraction in the outstanding positions of banks in the United States was the major factor behind this. Outstanding interbank claims between the United States and other inside-area countries except Japan contracted by $48 billion following an expansion of $61 billion in the previous quarter. Banks in Japan also reduced their interbank activity with other inside-area countries; the growth in claims fell from $61 billion in the fourth quarter of 1989 to $21 billion in the first quarter of 1990. This slowdown contrasts sharply with first quarter developments in previous years when the seasonal activities of Japanese banks at the end of their fiscal year tended to boost interbank business between the reporting banks. Interbank business between European centres, however, grew particularly strongly ($73.7 billion).

Cross-border business in Europe was buoyant during the first quarter with the liberalisation of exchange controls in several countries leading to increased financial intermediation.

Cross-border business of banks in the BIS reporting area

$ billions: changes exclude estimated exchange rate effects

	1988 Year	1989 Year	1989 Q1	1989 Q2	1989 Q3	1989 Q4	1990 Q1	Outstanding at end-Mar. 90
Liabilities vis-à-vis:								
BIS industrial area	347.5	515.6	212.8	30.4	136.4	136.0	81.1	3,602.9
'Offshore' centres	92.8	123.6	18.8	12.7	49.4	42.7	-3.2	909.3
Sub-total	440.3	639.2	231.6	43.1	185.8	178.7	77.9	4,512.2
Outside reporting area								
Developed countries	13.5	17.6	4.4	4.4	6.1	2.7	1.6	88.2
Eastern Europe	4.1	0.2	-0.1	1.3	-0.1	-0.9	-1.8	33.3
Oil exporters	11.7	14.3	3.1	9.4	-6.2	8.0	-1.2	190.1
Non-oil developing countries	12.6	26.1	5.1	-3.4	9.6	14.8	12.3	273.7
of which, Latin America	*3.4*	*4.7*	*1.7*	*-0.8*	*2.5*	*1.3*	*3.4*	*89.7*
Sub-total	41.9	58.2	12.5	11.7	9.4	24.6	10.9	585.3
Other (a)	33.4	41.7	5.0	5.7	11.2	19.8	6.3	272.7
Total	**515.6**	**739.1**	**249.1**	**60.5**	**206.4**	**223.1**	**95.1**	**5,370.2**
Assets vis-à-vis:								
BIS industrial area	365.3	524.9	195.0	13.4	160.8	155.7	72.2	3,464.5
'Offshore' centres	69.2	150.1	35.9	15.0	51.8	47.4	9.4	877.9
Sub-total	434.5	675.0	230.9	28.4	212.6	203.1	81.6	4,342.4
Outside reporting area								
Developed countries	2.4	3.2	0.7	-2.2	1.1	3.6	0.8	133.1
Eastern Europe	8.4	9.3	2.9	2.6	1.9	1.9	-0.1	97.8
Oil exporters	5.5	5.6	-2.9	2.0	0.6	5.9	-3.3	130.7
Non-oil developing countries	-2.0	-19.5	-3.0	-9.6	-2.1	-4.8	-20.0	339.3
of which, Latin America	*-4.9*	*-16.6*	*-4.4*	*-6.7*	*-2.3*	*-3.2*	*-18.6*	*185.6*
Sub-total	14.3	-1.4	-2.3	-7.2	1.5	6.6	-22.6	700.9
Unallocated and international institutions	1.3	14.1	2.8	2.7	1.7	6.9	1.3	127.8
Total	**450.1**	**687.7**	**231.4**	**23.9**	**215.8**	**216.6**	**60.3**	**5,171.1**

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

Growth in cross-border lending was strongest in the Netherlands ($20.3 billion), Luxembourg ($19.8 billion), the United Kingdom ($15.8 billion) and France ($14.4 billion). In contrast German banks' external claims rose by only $3.9 billion following growth of $32.7 billion in the previous quarter. Cross-border activity with the non-bank sector in Europe also remained buoyant on both sides of the balance sheet. Deposits from non-banks in Germany, France, Switzerland and the United Kingdom grew strongly. Elsewhere within the reporting area, non-bank deposits from Japan and the United States fell in the first quarter.

External lending to countries outside the BIS reporting area contracted in the first quarter by $22.6 billion (the largest quarterly decrease ever recorded), while deposits from these countries continued to increase ($10.9 billion). The $20 billion decline in banks' claims on non-OPEC developing countries was concentrated on Latin America. Such claims, which had contracted by $16.5 billion in the course of 1989, fell by a further $18.6 billion in the first quarter of 1990. By far the sharpest decline was recorded for Mexico ($14.2 billion or over 20%) following the implementation of the debt relief package; there were also falls in claims on Brazil ($2.7 billion) and Argentina ($1.2 billion).

In Eastern Europe total cross-border claims fell slightly ($0.1 billion) while liabilities contracted by $1.8 billion. The Soviet Union was the only major taker of new funds ($0.6 billion) in this group; decreases in claims were recorded for Hungary ($0.3 billion), the German Democratic Republic ($0.2 billion) and Bulgaria ($0.2 billion).

The London market

After slow growth in the final quarter of 1989, the external business of banks in the United Kingdom grew more rapidly *in the first quarter of 1990*. Cross-border lending increased by $17.6 billion and deposits rose by $20.8 billion, with both interbank and non-bank business buoyant. UK banks' external aggregates have in previous years recorded strong seasonal expansion in the first quarter associated with the window-dressing activities of Japanese banks; however, this feature was less apparent in the first quarter of 1990.

Business with countries in the BIS reporting area, and especially Western Europe, was a prominent feature of first quarter developments. Lending to the BIS industrial area grew moderately, by $12 billion, in the fourth quarter of 1989, but gained momentum in the first quarter of 1990, expanding by nearly $22 billion. Likewise, deposits from the BIS industrial area, which grew by $9 billion in the fourth quarter of 1989, rose by nearly $15 billion in the first quarter of 1990, notwithstanding a sizable reduction in deposits from the United States ($16.4 billion) and relatively subdued placings by banks in Japan.

Lending to banks in Japan, which was the largest single component of growth in total lending to the BIS industrial area in the first quarter of 1989, rose by less than $1 billion

Cross-border business of banks in the United Kingdom

$ billions: changes exclude estimated exchange rate effects

	1988 Year	1989 Year	1989 Q1	Q2	Q3	Q4	1990 Q1	Out-standing at end-Mar. 90
Liabilities vis-à-vis:								
BIS industrial area	41.2	58.7	37.4	-6.0	18.3	9.0	14.6	684.0
of which:								
United States	*7.7*	*-15.8*	*-0.6*	*-14.1*	*-2.6*	*1.5*	*-16.4*	*136.9*
Japan	*17.9*	*18.0*	*16.8*	*-8.6*	*13.5*	*-3.7*	*4.7*	*111.6*
'Offshore' banking centres	-2.4	6.6	4.8	2.3	0.3	-0.8	0.3	121.3
Sub-total	38.8	65.3	42.2	-3.7	18.6	8.2	15.0	805.3
Outside reporting area								
Developed countries	5.7	6.4	2.2	0.8	2.3	1.1	0.9	32.4
Eastern Europe	1.1	0.4	-1.0	0.8	0.6	—	-1.0	8.9
Oil exporters	6.8	3.5	2.1	3.5	-0.4	-1.7	0.7	56.4
Non-oil developing countries	-4.3	2.3	0.3	-1.1	2.3	0.8	0.4	49.4
of which, Latin America	*-1.1*	*-1.1*	*-0.6*	*-1.4*	*0.6*	*0.3*	*-0.1*	*5.6*
Sub-total	9.4	12.6	3.6	4.0	4.8	0.2	1.1	147.1
Other (a)	16.0	0.7	-5.2	-2.1	6.3	1.7	4.7	91.0
Total	**64.3**	**78.6**	**40.6**	**-1.8**	**29.7**	**10.1**	**20.8**	**1,043.4**
Assets (b) vis-à-vis:								
BIS industrial area	46.4	50.4	31.2	-8.1	15.7	11.6	21.9	685.9
of which:								
United States	*-10.8*	*1.3*	*3.8*	*-9.0*	*6.4*	*0.1*	*-1.1*	*128.5*
Japan	*42.5*	*9.9*	*9.6*	*-14.3*	*16.2*	*-1.6*	*0.6*	*205.9*
'Offshore' banking centres	-9.0	8.1	-5.0	8.4	3.0	1.7	0.3	118.6
Sub-total	37.4	58.5	26.2	0.3	18.7	13.3	22.2	804.5
Outside reporting area								
Developed countries	-1.9	-2.0	-1.6	-0.6	-0.5	0.7	-0.2	32.2
Eastern Europe	2.3	1.9	0.6	0.9	0.1	0.3	-0.9	23.8
Oil exporters	0.7	-1.4	—	-0.1	-0.8	-0.5	-0.2	18.8
Non-oil developing countries	-6.5	-3.4	-0.8	0.4	-0.9	-2.1	-2.8	42.5
of which, Latin America	*-3.9*	*-2.6*	*-0.4*	—	*-0.9*	*-1.3*	*-3.1*	*25.0*
Sub-total	-5.5	-4.9	-1.8	0.6	-2.0	-1.7	-4.2	117.3
Other (c)	3.9	2.7	1.6	-2.7	0.5	3.3	-0.4	10.8
Total	**35.8**	**56.3**	**26.1**	**-1.9**	**17.2**	**14.9**	**17.6**	**932.6**

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

in the first quarter of 1990, which may partly reflect caution in the wake of the fall in the Tokyo stock market.

Banks in the United Kingdom also reduced their activity with the United States on both sides of the balance sheet, but the relatively subdued activity with the United States and Japan was more than offset in the first quarter by buoyant cross-border business with European centres. Lending to West Germany accelerated rapidly by $4.2 billion after a small rise in the previous quarter, while lending to France ($4.8 billion) and Switzerland ($2.1 billion) continued to grow at much the same pace. These countries also placed sizable deposits with UK banks.

Overall, cross-border claims on countries outside the BIS reporting area continued to contract in the first quarter by $4.2 billion as lending to non-oil developing countries, and Latin America in particular (-$3.1 billion), continued to fall sharply. Within Latin America, claims on Mexico and Brazil fell by $1.7 billion and $0.8 billion respectively. Lending to Eastern Europe, which rose slightly during the fourth quarter of 1989, contracted markedly by $0.9 billion in the first quarter, with claims on the USSR falling by $0.6 billion.

Consistent with the unusually depressed levels of activity with banks in Japan was a fall in the share of branches of Japanese incorporated banks in total external lending by banks in the United Kingdom, by 2.3 percentage points during the first quarter of 1990 to 35.7%. British-owned banks accounted for 14.3% of external assets at end-March 1990, their share having dropped by 0.8 percentage points since end-December 1989. In contrast, the share of the 'other overseas banks' continued to increase significantly, by 2.4 percentage points, accounting for 34.2% of total external assets at end-March 1990, while the share of American banks edged upwards to stand at 14%. Within the 'other overseas banks' group, the assets of European Community banks, especially German banks, expanded most rapidly.

There was a further shift away from US dollar lending in the first quarter of 1990 in favour of the major European currencies and the yen. The dollar lost share by 3.2 percentage points, largely to the deutschemark, whose share of total external assets of UK banks rose by 1.3 percentage points to 13%. The share of sterling and ECU in external lending increased by about 0.3 percentage points each to 8.1% and 3.2% respectively, while the share of yen-denominated claims edged upward by 0.4 percentage points to account for 11.3% of the total at end-March 1990.

In the second quarter of 1990, UK banks' international business (including local foreign currency activity) fell on both sides of the balance sheet. International claims, which rose by $29 billion in the first quarter, fell by $10 billion in the second, while liabilities fell by $12 billion in the second quarter after a $35 billion rise in the first. On the liabilities side, the fall in cross-border deposits from banks overseas, other than own offices, was particularly sharp (-$13.4 billion), as was the fall in foreign currency deposits from banks in the United Kingdom. A reduction in cross-border claims on own offices overseas was the largest component of the fall in total international claims during the second quarter, but lending in foreign currencies between banks in the United Kingdom was also significantly reduced. The decline in interbank activity in the second quarter is broadly consistent with a more cautious approach to international interbank lending by banks in the United Kingdom.

The reduction in international activity of Japanese banks in the second quarter (claims down $13 billion, liabilities down $11 billion) was similar in magnitude to that recorded in the previous quarter and, together with the British banks, formed the largest component of the total decline in activity. Although the fall in lending by Japanese banks in the second quarter is as expected, the absence of a corresponding rise in the first quarter suggests that it may be less attributable to seasonal factors than usual.

The significant falls in second quarter international activity were offset to some extent by a continued rise in international business of the 'other overseas' bank group. Claims of the latter rose by $11.4 billion in the second quarter of 1990 bringing the growth in lending during the first half of this year to $44 billion compared with $20 billion in the first half of 1989.

Foreign exchange and gold markets

(This section reviews the three months to end-June)

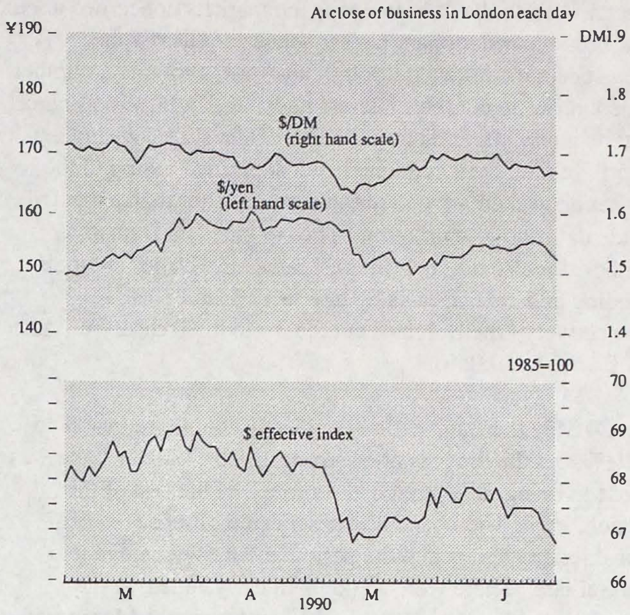
US dollar/deutschemark

The dollar opened on 2 April at DM 1.6975 and trading was initially restricted to a narrow range around DM 1.70 until the evening of 10 April when the US currency declined sharply to touch DM 1.6640 in the Far East. Changing sentiment about the likely inflationary consequences of German economic and monetary union (GEMU) and comments by German Economic Minister Haussmann, suggesting that reunification would lead to a stronger deutschemark, were the factors chiefly behind the dollar's fall. However, continued political tensions in the Soviet Union, and in particular over Lithuania, enabled the dollar to recover much of its lost ground, as the market regarded it as a safe haven at the time of international political uncertainties, while a bout of nervousness over the success of GEMU weakened the deutschemark so the dollar touched DM 1.70 again on 23 April. On 3 May the release of US employment data for April (up 64,000 against expectations of 383,000) dampened expectations of tightening by the US authorities and the dollar fell sharply against the deutschemark, touching DM 1.6265 (its lowest level since January 1988) on 11 May. However, election set-backs for Chancellor Kohl's CDU party over the weekend of 12–13 May softened the deutschemark, thus allowing the dollar to regain its lost ground. The market interpreted the actions of the Federal Reserve Bank of New York on 18 May to mean that there would be no early cut in interest rates, which helped the dollar maintain its firmer tone, and continued criticism by the West German opposition parties on 22 May of the terms of economic and monetary union further contributed to the deutschemark's softer tone. Although the dollar advanced steadily, it lost momentum again at DM 1.70 and steadied at around DM 1.69 in early June. However, from mid-June the market increasingly came to believe that the slower pace of the US economy left the US authorities scope to ease interest rates and the dollar then softened markedly. It fell further to DM 1.6597 on 27 June following President Bush's remarks that higher tax revenues would be needed to reduce the US fiscal deficit, as the market assumed that this would lead to a cut in interest rates. The deutschemark was the principal beneficiary of the dollar's fall and received further support from Bundesbank Council Member Tietmeyer's comments that higher German interest rates would be appropriate. The dollar ended the quarter at DM 1.6667 (down 1.6%).

US dollar/yen

Trading in the yen followed a broadly similar course to that of the deutschemark. The dollar opened on 2 April at ¥159.90 having reached ¥160.35 in the Far East earlier that morning (its highest levels since December 1986), reflecting the weakness of the Japanese equities market. Intervention by the Bank of Japan carried the dollar away from its highs and rumours that the G7 meeting in Paris on the weekend of 7–8 April might agree on measures to support the yen helped the dollar fall to ¥156.45 by 9 April. However, when it

Dollar exchange rate



become evident that no such agreement had been reached, the US currency recovered much of its lost ground, to touch ¥160.07 on 17 April before steadying at around ¥159. However, the release of the US employment figures on 4 May depressed the dollar and the yen was given an added impetus by the G7 communiqué issued after the meeting of 5–6 May. This restated the view that the prevailing low level of the yen might have undesirable consequences for the global adjustment process, and by 15 May the dollar had fallen to ¥150.55. Although the dollar firmed temporarily on 18 May on the belief that there would be no early cut in interest rates, comments by a US Treasury Assistant Secretary on 24 May that the US currency was undervalued except against the yen caused a further sharp fall in the dollar and the period low of ¥149.25 was reached on 25 May. These comments also served to add further downward pressure on the deutschemark/yen cross-rate, which fell to a low of ¥89.3 on 25 May. However, the dollar subsequently recovered, helped by its safe-haven status at a time of further tensions in Eastern Europe. The failure by the ruling Liberal Democratic Party to take control of the Upper House in Japan over the weekend 9–10 June gave the dollar a further impetus and it recovered to above ¥154. Remarks by US Treasury Under Secretary Mulford on 13 June that the yen was still too weak had only a temporary strengthening effect on the yen. On 25 June both the dollar and the deutschemark advanced on the yen which was unsettled by the US/Japan trade talks opening in Tokyo. However, the dollar fell sharply on 26 June following President Bush's remarks that higher tax revenue would be needed to reduce the US fiscal deficit —and ended the quarter at ¥152.15 (down 3.6%) and Sw.Fc. 1.4185 (down 5.4%). In effective terms, the dollar fell by 2.6% to 66.8 (1985 = 100).

EMS

The narrow band of the ERM began the period relatively quietly but polarised between the Italian lira at the top and the remaining currencies clustered together towards the bottom. With the foreign exchange markets concerned about the possible inflationary consequences of GEMU the deutschemark softened throughout April, allowing a number of countries to cut their interest rates: the Banque de France cut its intervention rate by 1% to 9½% in stages during April, but the franc remained well supported owing to the softer deutschemark and the release of better than expected trade data and low inflation. The Belgian and Danish authorities also cut their interest rates: the Danes cut their lending and deposit rates by ½% to 11% and 10% respectively; the Belgians cut the 3-month Treasury bill rate by 0.15% to 10.05%.

On 24 May the Bank of Italy cut its discount rate by 1% to 12½%, but the lira remained strong and the narrow band was close to being fully stretched for much of the rest of the period. In the wide band, the peseta strengthened considerably and ended the period about 5⅛% above its central rate. There were rumours in early June that the escudo would soon join the ERM, but Governor Moreira of the Bank of Portugal said that this was unlikely to happen before late 1991 or early 1992. On 26 June the Bank of Portugal announced a 90-day freeze on escudo swaps and forward operations with non-residents in an attempt to halt continuing upward pressure in that currency.

Gold

Having been fixed at $368.00 on the morning of 2 April gold rallied, after sales in the futures market towards the end of March had depressed prices, to touch a period high of $380.35 on the morning of 6 April. However, producer selling at these levels cut short the rally and thereafter gold traded narrowly in a quiet market. It fell further on 25 April on liquidation by US investment funds but temporarily consolidated to find a new trading range at around $371. Middle Eastern selling forced gold beneath $370 on 30 April and it was fixed at $367.75 on that afternoon. While gold edged modestly lower, any attempt to rally was cut short by producer selling. However, disturbances in the South African gold mines gave the metal the impetus needed to recover much of its lost ground; but, when it attempted to rally to $377.50 on 23 May, very heavy selling, particularly from the Middle East, caused the price to fall sharply to $363.25 in the morning fix.

Despite recovering from these levels, gold drifted lower in a bearish market and in the evening of 1 June fell beneath $360. A brief rally above this level once again met producer selling and the price drifted steadily lower. Renewed selling from the Middle East drove the price below $350 on 14 June and it touched $341 before steadying at around $345. Rumours of a strike in some South African mines caused gold to advance and this, together with comments by Governor Stals that the South African Reserve Bank might have been supporting the gold price, enabled gold to rally above $350. It ended the period at $352.20 in the afternoon fixing which represented a fall of $15.80 (4.3%) over the quarter.