Financial market developments

- *Government bond prices continued to fall during the second quarter, prompted mainly by growing concern about inflationary pressures and uncertainties over the future level of short-term interest rates. In many markets, prices returned to the levels prevailing before last year's strong rally.*

- *The volume of borrowing in the international bond markets was significantly lower than in the first quarter, reflecting borrowers' reluctance to issue and investors' unwillingness to commit funds while markets remained turbulent.*

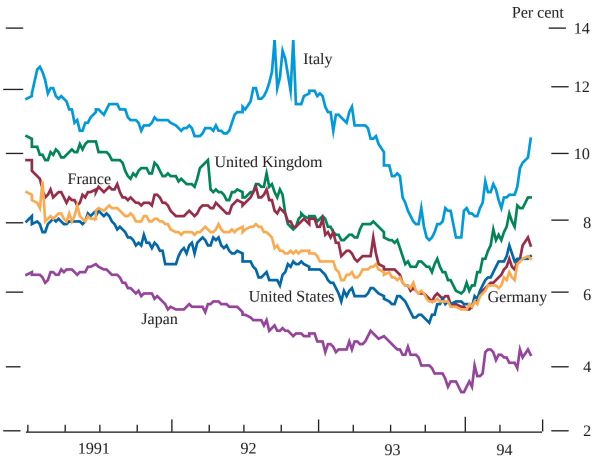
- *In the US, Japanese and most European markets, yield curves steepened as investors—taking a defensive view—shifted their interest away from long maturities. Most of the limited number of new bond issues were concentrated at maturities of five years or less.*

- *Rising real bond yields led to price falls in many equity markets. New equity issues were therefore more difficult, though this did not stop a large number of companies coming to the market in the United Kingdom.*

Overview

Bond prices continued to fall in volatile conditions during the second quarter. The falls were led by the US and German government bond markets, but the trend of rising yields was seen in all the major markets (see Chart 1). Growing concerns about inflation, particularly in the United States, contributed to the falls.

Chart 1
Ten-year government bond yields



Source: Bloomberg.

The prices of US Treasuries continued their decline; the yield on ten-year Treasury bonds rose by 47 basis points during the quarter. The Federal Reserve continued to tighten monetary policy, raising the target federal funds rate twice —by 25 basis points on 18 April and 50 basis points on 17 May (when the discount rate was raised by the same amount)—to a level of 4.25%. The second increase was initially perceived as a move towards a neutral monetary stance and provided a brief fillip to bond markets. With annual inflation of 2.3% at the end of the quarter, the 'real' federal funds rate was then 1.95%, close to its 2% average over the last 25 years. The markets nevertheless remained sensitive to any indicator suggesting higher future inflation, and the upward revision (to 3%) to the figure for first-quarter GDP growth ended the minor rally seen after 17 May.

In Europe, falling Bund prices and cuts in German short-term interest rates led to a significant steepening of the Deutsche Mark yield curve: the yield differential between ten-year and three-month rates, which had been negative in the fourth quarter of 1993, increased to 212 basis points by the end of June, influenced by rapid money supply growth, strengthening perceptions of recovery in Germany and diminishing expectations of further immediate cuts in short-term interest rates.

Japanese bond markets performed relatively strongly at the start of the quarter. Market sentiment was buoyed by relative currency stability in the first two months of the quarter as well as by perceptions that the government was continuing its accommodating stance on short-term interest rates. Lower interest rates, combined with renewed demand from institutional investors following the start of the new Japanese financial year, encouraged borrowing. After a brief sell-off in mid-June, however, prices of Japanese government bonds ended the period slightly lower than they began.

The general fall in bond prices in turbulent market conditions resulted, for most of the period, in a dearth of primary market issues. Borrowing in the international bond markets totalled only $91 billion in the second quarter, a third less than in the previous quarter (see Table A) and the lowest total since the fourth quarter of 1992. Most of the straight bonds issued were in currencies other than the dollar. The high volume of floating-rate notes (FRNs) issued in the first quarter ($39 billion) was not maintained in the second (only $17 billion), partly because underwriters had been left with FRNs on their books. The volume of equity-linked debt issues fell even more sharply; only $6 billion was raised from such issues, down from $21 billion in the first quarter.

Table A
Total financing activity:[a] international markets by sector

$ billions; by announcement date

	1992	1993				1994	
	Year	Year	Q2	Q3	Q4	Q1	Q2
International bond issues							
Straights	281.5	375.7	88.0	82.2	82.6	76.8	68.5
Equity-related	24.0	39.6	8.3	10.6	12.0	20.7	5.7
of which:							
Warrants	*18.3*	*20.8*	*3.7*	*5.5*	*5.3*	*8.2*	*0.8*
Convertibles	*5.7*	*18.8*	*4.6*	*5.1*	*6.8*	*12.5*	*4.8*
Floating-rate notes	43.2	68.5	13.6	19.0	20.3	38.7	16.7
Bonds with non-equity warrants (currency, gold, debt)	1.2	1.5	0.4	0.2	0.1	0.1	—
Total	**349.9**	**485.4**	**110.3**	**112.0**	**115.1**	**136.2**	**90.9**
Credit facilities (announcements)							
Euronote facilities	113.2	117.4	14.9	31.1	55.9	35.7	46.0 (b)
of which:							
ECP	*21.5*	*24.2*	*3.4*	*2.9*	*12.2*	*3.9*	*15.4* (b)
EMTNs	*90.8*	*92.7*	*11.2*	*28.1*	*43.6*	*31.9*	*30.6* (b)
NIFs/RUFs	*0.9*	*0.5*	*0.3*	*0.1*	*0.1*	—	—
Syndicated credits	221.4	221.2	69.4	54.7	55.0	52.0	64.5
Total	**334.6**	**338.6**	**84.3**	**85.8**	**110.9**	**87.7**	**110.5**
Memo: amounts outstanding							
All international							
Bonds (c)	1,686.4	1,847.9	1,774.9	1,843.6	1,847.9	1,980.8	. .
Euronotes (b)	173.1	255.8	199.3	234.6	255.8	289.8	330.3
of which, EMTNs	*61.4*	*146.6*	*94.8*	*124.6*	*146.6*	*177.9*	*216.5*

. . not available.

(a) Maturities of one year and over. The table includes euro and foreign issues and publicised placements. Issues which repackage existing bond issues are not included. Figures may not add to totals because of rounding. Bond total includes issues from MTN programmes.
(b) Euroclear figures.
(c) BIS-adjusted figures, including currency adjustment. Includes issues of fixed-rate bonds and floating-rate notes.

Among the issuers in the international market, sovereign borrowers remained prominent. Some domestic auctions by sovereign issuers were, however, cancelled in the face of adverse market conditions; but it is not clear how much this helped the markets, since cancellation may have heightened concerns about the scale of future borrowing. Re-assessment of risk by investors also led to lower levels of borrowing by emerging-market issuers who were, on the whole, unwilling to pay the higher premia. There was some recovery in fixed-rate borrowing towards the end of the quarter, and relatively strong borrowing in particular currencies: 28% of fixed-rate bonds were issued in yen (up from 8% in the previous quarter).

Investor interest shifted to shorter maturities in most currency sectors since, in an environment of rising yields (and falling prices), bonds of shorter duration[1] hold their value better than those with longer duration. This move was a reversal of the trend during 1993, when investors had bought longer-maturity instruments in order to maximise returns while yields were falling.

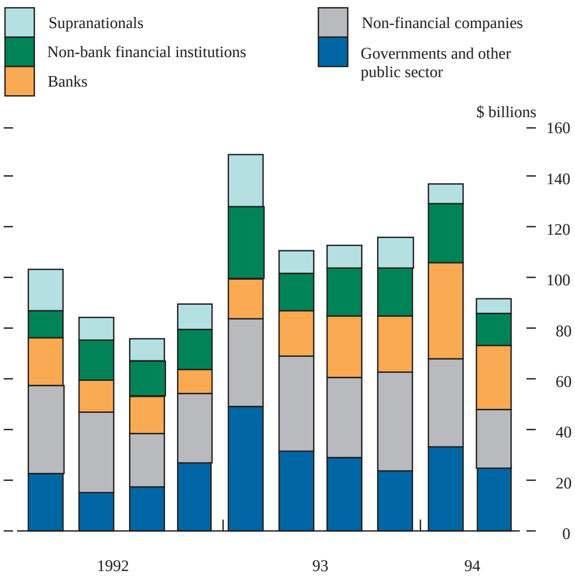
Short-term instruments such as eurocommercial paper (ECP) therefore became relatively attractive to investors: announcements of new ECP programmes rose strongly to $15.4 billion in the quarter and net borrowing rose to $4.8 billion. Announcements of new euromedium-term note (EMTN) programmes were at broadly similar levels to the first quarter and, with the investor preference for shorter maturities, issues from existing EMTN programmes rose to $38.6 billion. Despite the low levels of international bond issues, announcements of syndicated credits continued their recent strength, totalling $64 billion. Some of this was refinancing, but the attractiveness of floating-rate assets in the prevailing market conditions may also have boosted the volume of new loans.

Rising real yields in bond markets undermined prices in most equity markets, despite generally-improving economic conditions and a favourable outlook for corporate earnings. The general weakness of European equity markets led to a low level of equity-related bond issues. Another factor limiting volumes of these issues was a change in Japanese accounting rules, which deterred Japanese borrowers from issuing bonds with attached warrants.

International bond markets

Only $91 billion was raised through international bond issues in the second quarter of 1994. As a result of the fall in FRN issues and weakness in the equity-related bond sector, the share of the total formed by fixed-rate borrowing was higher than in the previous quarter. Overall, however,

Chart 2
Borrowers in the international bond market



Source: Bank of England ICMS database.

(1) *Duration* is defined as the average maturity of all future payments on a security (coupon and principal), weighted according to the discounted present value of each payment. For a given change in yield, a bond's price will move further the longer is its duration.

falling prices made borrowers reluctant to issue, and uncertainty about the timing of future interest rate moves (especially in Germany and the United States) and concerns over future inflation made investors unwilling to commit funds, particularly at long maturities.

Of those who did borrow, public sector issuers were prominent (see Chart 2): they raised $24 billion in total, including $14 billion of issues by central governments. Banks and financial institutions were also active, raising $38 billion in the quarter, almost half of which was accounted for by European banks.

Currency sectors

Dollar-denominated issues fell back markedly in the early part of the quarter. The weakness of the currency and rising short and long-term dollar interest rates meant that issuers preferred to postpone borrowing or issue in other currencies. There was, however, a recovery in the volume of dollar-denominated issues after the 50 basis-point rise in short-term US interest rates on 17 May; over the three months as a whole, dollar issues accounted for almost a quarter of all fixed-rate issues (see Table B).

Table B
Currency composition of fixed-rate bond issues(a)

Percentage of total issues announced

Currency denomination	1992 Year	1993 Year	1993 Q3	1993 Q4	1994 Q1	1994 Q2
US dollar	32	30	29	28	24	24
Deutsche Mark	11	13	13	16	13	4
French franc	8	11	8	12	13	12
Sterling	6	8	8	6	12	4
Yen	14	13	16	16	8	28
Italian lira	2	3	4	2	6	5
Canadian dollar	6	8	8	5	5	6
Ecu	7	3	2	2	4	3
Swiss franc	5	5	6	5	2	4
Other	9	6	6	8	13	10
Total	**100**	**100**	**100**	**100**	**100**	**100**

(a) Excluding equity-related issues.

In contrast, the low cost of funding and relative stability of the yen in the first two months of the quarter encouraged issues in that currency; 28% of total fixed-rate borrowing was in yen. There was renewed demand from Japanese institutional investors following the start of the new financial year, and issues were particularly strong after the Golden Week holiday at the beginning of May. Almost half of the euroyen borrowing was by Japanese companies that had been unwilling to issue before the financial year-end, but Scandinavian public sector institutions were also prominent.

The share of fixed-rate issues denominated in European currencies fell to 42%. This partly reflected the very low level of Deutsche Mark borrowing (only $3 billion) as rising long-term yields, concerns about inflationary pressures and uncertainty over the next move in German short-term interest rates deterred investors. Borrowing in Dutch guilders, often viewed as a close substitute for Deutsche Marks, was also lower than the previous quarter. In contrast, there was heavy borrowing in the French franc sector ($8 billion), boosted when two sovereign borrowers, the Kingdom of Spain and the Republic of Finland, took advantage of the low yield spread compared with German Bunds to issue deals of FFr 6 billion. The sector also saw its largest mortgage-backed deal to date, a FFr 2.5 billion two-tranche issue of securitised mortgages by Comptoir des Entrepreneurs.

Eurolira borrowing was also relatively strong (totalling $4 billion), helped by favourable swap rates and investor demand for higher coupons. Over 15% of the eurolira bonds issued in the first half of 1994 were in callable form (offering investors a yield premium in return for giving the borrower the right to redeem the bond early).

Volatility and sharply-rising yields in the gilt market meant that the volume of eurosterling fixed-rate borrowing was relatively low—only £1.9 billion over the quarter. Many issuers—particularly financial institutions—preferred to issue floating-rate notes. Activity overall remained subdued and issuers found it difficult to judge when best to come to the market and at what price. Investors, influenced by the persistence of the price falls, were reluctant to buy new debt and, with foreign investor interest in the eurosterling market at a low ebb, new issues were increasingly targeted at UK institutions. In the gilt market, the UK government's programme of regular monthly auctions was nevertheless successfully maintained, despite the market's turbulence; a flexible approach was adopted and a number of non-conventional instruments were brought to the market.

In the Ecu sector, $1.8 billion of fixed-rate bonds were issued; investors were attracted by widening spreads over German and French government bonds, and by arbitrage possibilities against Italian Ecu-denominated government bonds.

Volatility in currency and bond markets adversely affected the liquidity of the Ecu bond and money markets during the quarter. The Bank was nevertheless able to hold its regular monthly Ecu Treasury bill auctions. These were oversubscribed at all three maturities on offer, with overall cover at each auction of at least two times, at levels between Ecu Libid and 10 to 15 basis points below Ecu Libid at six months. ECU 200 million of one-month, ECU 500 million of three-month and ECU 300 million of six-month bills were on offer at each tender. There are now ECU 3.5 billion of Treasury bills outstanding across all maturities; monthly turnover averaged over ECU 2 billion during the quarter.

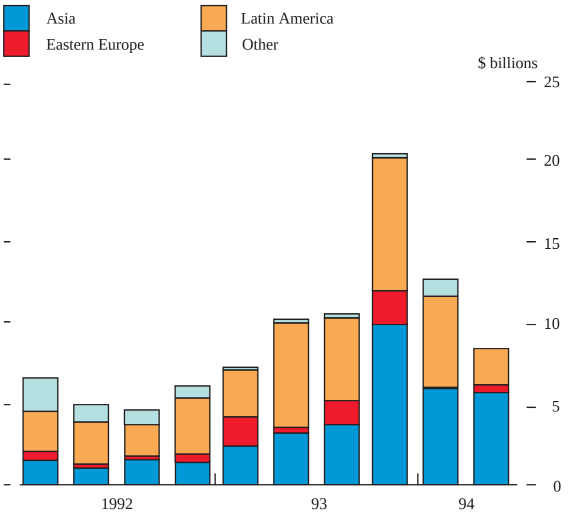
Despite the adverse market conditions, liquidity in all three of the outstanding Ecu Treasury notes (maturing in 1995, 1996 and 1997) was good, with turnover steady at around ECU 1 to 2 billion a month. These instruments benefited from investor demand for good quality short-term assets in the volatile market conditions.

Among the United Kingdom's other foreign currency debt, the DM 5.5 billion five-year and $3 billion ten-year bonds, launched in 1992 to complete HMG's ECU 10 billion currency borrowing programme have continued to trade well. Over the last quarter, they continued to be liquid and remained among the more actively traded eurobond issues settled through Euroclear and Cedel.

Emerging markets

Issues by emerging-market borrowers continued to be affected by events in the US bond market and investors' earlier re-assessment of risk (see Chart 3). Domestic difficulties in some countries (in particular, Venezuela) also influenced market sentiment. Many issuers therefore postponed borrowing, and those emerging-market borrowers that did come to the international markets were reliant on their lead managers to pre-place high proportions of their issues or indeed to be prepared to retain some of them. The secondary markets for Brady bonds and other less developed country (LDC) debt instruments steadied in April, and showed initial signs of recovery in May—but the Finacor 'LDCx' index of debt prices registered a 10% fall during June.

Chart 3
International bond issues by non-OECD borrowers



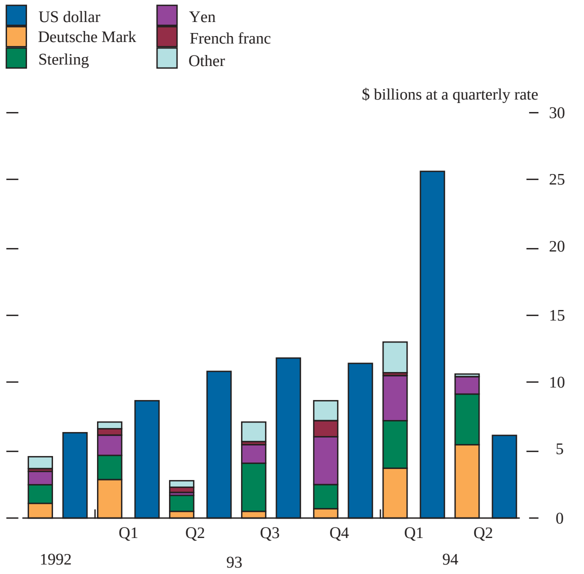
Source: Bank of England ICMS database.

Brazil agreed a Brady-style restructuring for $49 billion of its commercial debt; net debt reduction is estimated at 18%. Following four years of negotiation, Poland advanced towards the completion of its Brady deal to restructure $13 billion of commercial debt (an overall debt reduction of between 42% and 45%). The deal would be the first to give a reduction on short-term debt; this led some creditors to express reservations about its terms.

Floating-rate notes

Issues of FRNs in the international markets fell significantly from their levels in the first quarter (see Chart 4), despite their attractiveness to investors as defensive investments in an environment of rising short-term interest rates and steepening yield curves. At $17 billion, they represented only 18% of total bond borrowing, compared with 28% in the first quarter. The fall was perhaps in part a reaction to the high level of FRN issues in the first quarter, which saturated short-term demand for such assets and made further issues difficult while underwriters still held high levels of unsold inventory.

Chart 4
Currency composition of floating-rate issues



Source: Bank of England ICMS database.

Nevertheless a number of governments issued FRNs. The United Kingdom issued a floating-rate gilt and public sector borrowers were also prominent in issuing floating-rate debt in the international markets: the Republic of Finland, the Hellenic Republic (which had previously issued in the name of the Bank of Greece), the Province of Nova Scotia, the Kingdom of Sweden and the World Bank (with the first tranche of its global MTN programme) were among those to issue.

Several large asset-backed issues were launched in the sterling market during the quarter. The deals were reasonably well received—reflecting in part a shortage of such paper—and more are expected to follow. Two separate mortgage-backed deals totalling £590 million were brought by Barclays Bank, using a special-purpose vehicle. There were several other issues backed by residential mortgages, both performing and non-performing. And a special-purpose vehicle of First National Bank issued £75 million of securities backed by a variety of small-business loans, the first time such assets have been securitised in the United Kingdom.

A few borrowers responded to specific investor demand by offering short-maturity structured products. Several dollar-denominated hybrid FRNs were issued during the quarter. These offered investors a generous spread over Libor (normally 50 to 60 basis points) for the first two or three years, with fixed rates (normally above 8%) subsequently. The small size of the deals suggested that they were essentially private placements.

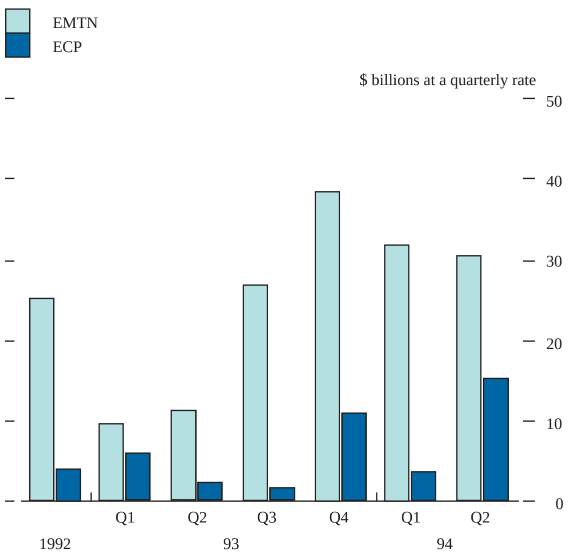
The illiquidity of many of the structured products that had been issued in recent quarters was, however, reflected in sharp falls in the prices of 'collared' and 'range' FRNs; and much of the $20 billion worth of these notes issued since 1992 traded at only 90% of face value. With US short-term interest rates rising, the value to investors of these products' floors was vastly reduced, and the caps applying on longer-maturity notes became an important potential constraint on yield. Even without any imminent impact of the caps (many of which are set at around 8%), the declining value of the options embedded in the bonds reduced their intrinsic value; at the extreme, where Libor had already moved outside the collar, some 'range' FRNs paid no interest at all. The falls in their prices are expected to lead to a repackaging of many collared FRNs, as well as deterring interest among investors for similar issues in the near future.

Structured issues were nevertheless popular in the sterling sector. Lloyds Bank and the Cheltenham and Gloucester Building Society both issued step-up FRNs; the Kingdom of Sweden and the Halifax Building Society issued collared FRNs (the latter to refinance maturing debt); and the Swedish Export Credit Corporation issued a small reverse FRN.

Euromedium-term notes and eurocommercial paper

Short-term dollar-denominated paper became relatively attractive to investors taking a defensive position in US bonds. As a result, net borrowing in eurocommercial paper

Chart 5
EMTN and ECP programme announcements



Source: Bank of England ICMS database; 1994 Q2 figures from Euroclear.

(ECP) totalled $4.8 billion, up from $1.4 billion in the first quarter, and the stock of ECP outstanding grew to $85.8 billion. There was a sharp rise in announcements of new ECP programmes; they totalled $15.4 billion in the quarter (see Chart 5).

Announcements of new euromedium-term note (EMTN) programmes were, at $30.6 billion, at broadly similar levels to the first quarter. Those borrowers who already had facilities were also active: net issues totalled $38.6 billion, up from $31.3 billion raised in the first quarter and more than double the same quarter last year. The stock of EMTN outstandings continued its upward trend to end the quarter at $216 billion.

Outstandings in the sterling MTN market continued to rise, reaching £10.2 billion at the end of May. The size of the sterling CP market increased to £6.1 billion by the end of May.

Equity-related bonds

Equity-related borrowing totalled $6 billion, only 28% of the first quarter's total and substantially less than 1993 levels. One reason for this fall was the almost total absence of bonds issued with attached warrants (they totalled only $0.8 billion). This was largely a result of changes in Japanese accounting regulations towards the end of their financial year. The new accounting rules, which came into effect on 1 April and brought Japanese practices into line with international ones, require straight-line amortisation of a bond's warrant position throughout the life of the instrument—previously only the warrant's coupon had to be included in the accounts. Amortising the warrant position increases the immediate accounting cost of the bond, with a potentially significant impact on a company's recorded profits. Although the permanent impact of the accounting changes should not be significant, it may be some time before issues return to recent levels; the share of equity-linked debt issued by Japanese borrowers fell to 20% from the 50% level in recent quarters.

This had a particular impact on the Swiss franc warrant market; the share of total equity-related bonds denominated in Swiss francs fell to only 10%. Such issues had been popular with Japanese corporates, who could easily swap the proceeds of ex-warrant bonds for yen to eliminate currency risk. Convertibles—where the options are not detachable—are less easily swapped. As an alternative to Swiss franc equity warrants, the Swiss National Bank subsequently announced that it would permit borrowers to launch yen-denominated convertibles ('Alpines') in Switzerland.

Volumes of equity-related bonds were further depressed by the general weakness of European equity markets; European issuers raised only $1.9 billion during the quarter, down from $6.8 billion in the previous quarter, with UK and French borrowers completely absent from the market.

Syndicated credits activity

The volume of syndicated credits was higher than in the previous three quarters, with a total of $64 billion announced in the second quarter. Non-financial borrowers accounted for the majority of this, and 23% of credits were explicit refinancings of existing loans. OECD borrowers were prominent, including Dutch and Portuguese entities, as well as more regular borrowers from the United States and United Kingdom. Asian borrowers, notably those from Hong Kong and Thailand, accounted for 16% of total borrowing, and a $100 million credit for the State Bank of Vietnam represented that country's first ever international financing. In currency terms, the dollar share of loans fell slightly to 75%, sterling's share increased to 14% and a number of borrowers moved into more unusual currencies, including the Norwegian krone, Malaysian ringgit and Thai baht.

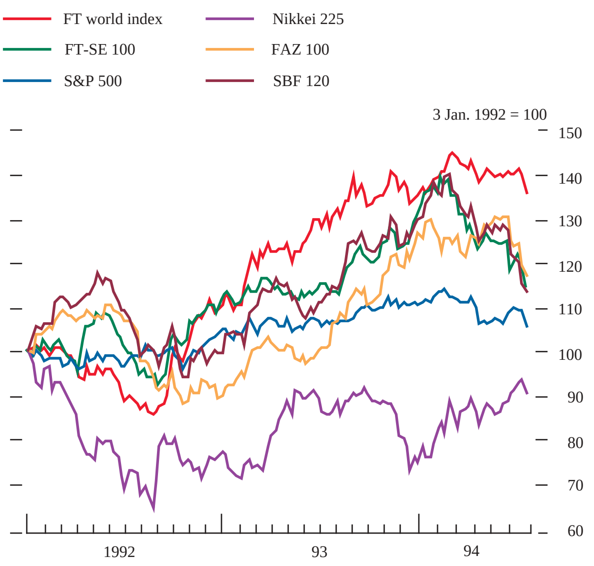
Settlement

On 1 June, the International Securities Markets Association (ISMA) Board announced that the euromarket's standard settlement period would be reduced from seven calendar days after the transaction date to three business days after with effect from 1 June 1995. The decision, approved at the ISMA annual general meeting, followed widespread consultation with international securities market participants and should reduce the level of market risk inherent in the settlement of euromarket transactions.

Equity markets

During the quarter as a whole, the FT-SE Actuaries world index fell by 1%, as price falls in Europe and the United States outweighed price increases elsewhere (see Chart 6). After prices of European equities had increased early in the quarter as German interest rates were lowered, price falls were subsequently triggered by rising bond yields, higher inflation expectations and perceptions that there was a reduced likelihood of significant reductions in interest rates in the near future (indeed that increases might be more likely). Over the quarter as a whole, the Paris SBF 250 fell by 10%, the Frankfurt FAZ 100 by 4.2% and the FT-SE 100 by 5.4%.

Chart 6
Equity indices(a)



(a) End-week prices.

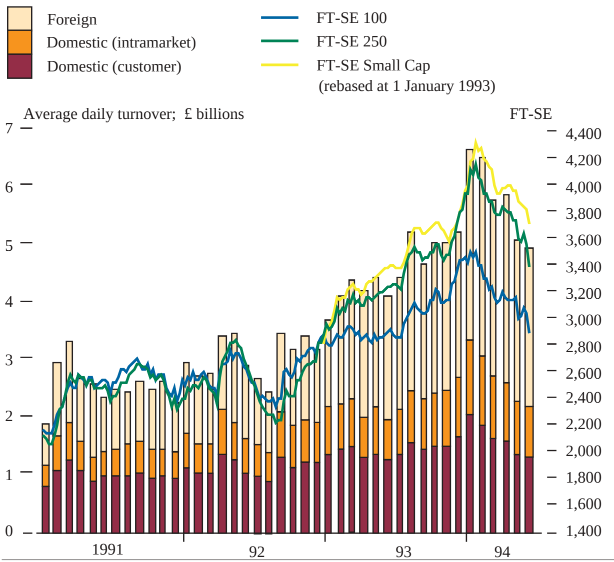
In the United States, weak equity prices were boosted by hopes that the 50 basis-point rise in interest rates on 17 May would lead to a period of stable interest rates. Towards the end of the quarter, however, prices fell sharply as expectations of rising short-term rates returned: the S&P 500 ended the quarter down 0.3%. In Japan, the Nikkei 225 index continued the upward trend which had begun at the start of the year; a series of well-received economic indicators and steady capital inflows from abroad helped the index to rise above 20,900—its highest for over a year—and the Nikkei 225 ended the quarter up 8%.

Despite the volatile and difficult conditions in the equity market, substantial amounts of new issue activity continued to take place in the United Kingdom: well over 100 issues were announced by companies seeking to raise a total of over £4.2 billion; this compares with £6.5 billion for the first quarter of the year. Over half of the equity was raised in rights issues, compared with only 15% in the first three months of the year. Much of this was, however, accounted for by the launch of the £858 million rights issue by Eurotunnel—the largest issue in the transport sector to date and one of the largest ever in the UK market.

A large number of new companies continued to come to the market. In all, 140 new companies were floated during the first half of 1994, compared with 63 in the first half of 1993. With the FT-SE 100 Index falling by almost 17% from its all-time high of 3,520 in February, however, new issues have become increasingly difficult and some may have been postponed or even cancelled.

Secondary market turnover in UK equities fell away steadily from the records set in the previous quarter to levels in line with the average last year (see Chart 7). Daily turnover on

Chart 7
Equity turnover and prices on the London Stock Exchange



SEAQ averaged £2.1 billion, of which customer business accounted for £1.2 billion. Turnover on SEAQI also declined from the previous quarter's record level, though it remained above 1993 levels at a daily average of £2.8 billion.

CREST project

The initial design phase of the CREST project ended in May as scheduled, with the publication by the Bank's project

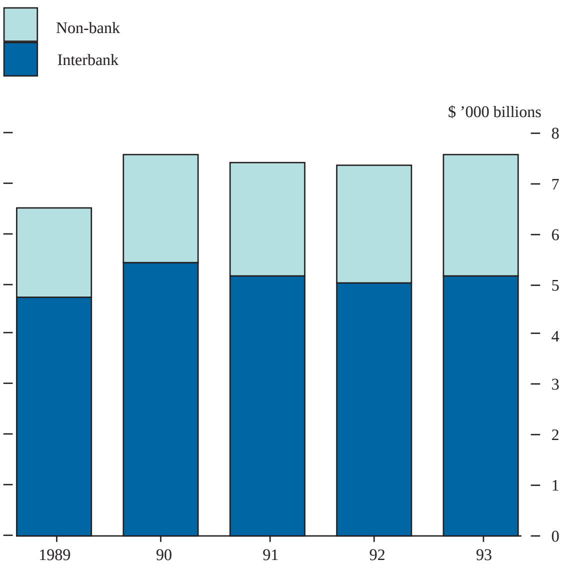
Developments in international banking in 1993

This box summarises developments in international banking in 1993: the first section looks at global trends, as revealed by quarterly statistics published by the BIS; the second section focuses on developments in the London market, using the Bank's own data.

Banking business within the BIS reporting area

International lending by banks in the BIS reporting area rose by $261 billion (4%) in 1993, to an outstanding stock of $7,592 billion(1) (see Chart A). Lending between banks accounted for $5,130 billion (68%) of this stock, an increase of $140 billion (3%) compared with 1992. The majority of this increase occurred during the second half of the year and was related to the turbulent conditions in foreign exchange markets. Lending to non-bank end-users increased by $122 billion (5%); it remained virtually unchanged as a proportion of the total stock of international bank lending.

Chart A
Stock of international bank lending



Source: BIS.

BIS-area banks' business with non-BIS reporting countries

Lending to countries outside the BIS reporting area continued to rise during 1993, but at a much slower pace than in 1992 (see Table 1). Once again, the developing economies of the Far East were the principal recipients of the new lending: the largest increases were to Thailand ($6.1 billion), China ($5.5 billion), Malaysia ($4.8 billion), South Korea ($2.9 billion) and Taiwan ($2.5 billion). Lending to Latin America also increased, with the total $6 billion rise more than accounted for by Mexico and Brazil, which received additional funds of $3.8 billion and $2.4 billion respectively.

Table 1
Lending to, and deposits from, countries outside the BIS reporting area

$ billions

	Exchange rate adjusted flows					Stocks at
	1989	1990	1991	1992	1993	end-1993
Total lending	**-2**	**-12**	**8**	**66**	**17**	**829**
of which:						
Developed countries	3	6	—	7	3	157
Eastern Europe	9	-10	-1	4	-4	88
Oil exporters	6	-2	-5	23	-4	151
Non-oil developing countries	-20	-6	14	33	22	434
of which:						
Latin America	*-17*	*-23*	—	*15*	*6*	*208*
Asia	—	*18*	*18*	*19*	*18*	*196*
Total deposits	**58**	**92**	**-12**	**14**	**-15**	**707**
of which:						
Developed countries	17	8	-3	11	7	118
Eastern Europe	—	-6	1	10	2	32
Oil exporters	14	25	-14	-9	-26	193
Non-oil developing countries	26	65	4	2	1	363
of which:						
Latin America	*5*	*19*	*-3*	*1*	*-2*	*113*
Asia	*16*	*35*	*2*	*-6*	*1*	*172*

Source: BIS.

Deposits from countries ouside the BIS reporting area fell by $15 billion. There were continuing widespread withdrawals by Middle Eastern oil-exporting countries, including the United Arab Emirates ($6.3 billion), Saudi Arabia ($4.2 billion), Kuwait ($3.2 billion) and Libya ($2.8 billion). Deposits from Taiwan also fell by $3.3 billion. Of those countries increasing their deposits, Malaysia ($6.9 billion) was prominent for the second successive year, along with Portugal ($5.0 billion) and the Former Soviet Union ($2.3 billion).

Analysis by centre and currency

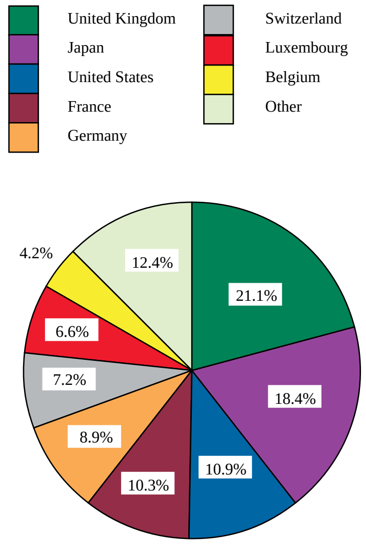
The United Kingdom increased its share of international lending (comprising foreign currency business within the United Kingdom as well as cross-border claims) during 1993, underlining London's position as the world's leading international banking centre. Outstanding cross-border loans by banks located within the BIS industrial area at the end of 1993 amounted to $4,997 billion; as Chart B shows, $1,053 billion (21%) of this was lent by banks in the United Kingdom, an increase of 5% compared with 1992. The amount of foreign currency lending in the United Kingdom also increased, by $24 billion to $287 billion. Within the BIS industrial area, cross-border lending denominated in Deutsche Marks increased strongly (by $112 billion), but the yen's share of cross-border lending continued to decline (falling $23 billion), as did lending in Swiss francs (down $18 billion) and US dollars (down $9 billion).

Analysis by nationality of bank

As a group, Japanese banks remained the largest lenders of funds within the BIS reporting area, with 26.9% of

(1) Stock data are converted to dollars at the prevailing end-year exchange rates; appreciation of a currency against the US dollar will therefore increase the value of foreign currency assets when converted into dollars.

Chart B
Cross-border business transacted by banks within the BIS industrial area(a)

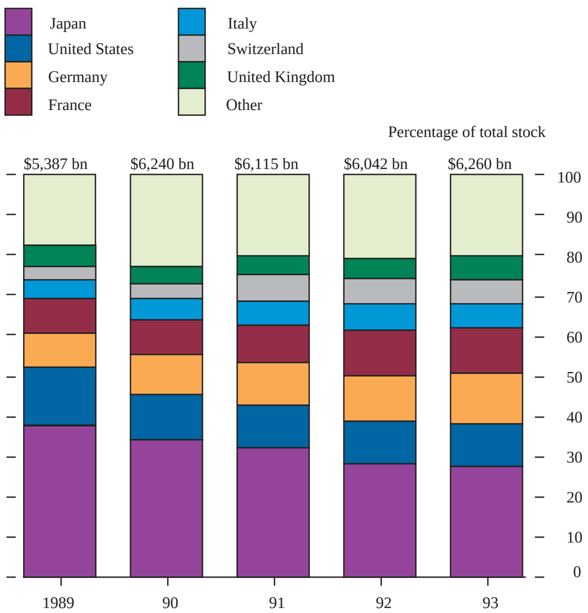


Source: BIS.

(a) BIS reporting countries other than offshore banking centres.

international bank assets (see Chart C), but their share has fallen for the last five years (from a high of 38.3% in 1988). Whereas the retrenchment of the previous two years reflected a genuine withdrawal from the international interbank market, in 1993 the fall was the result of reduced cross-border business with affiliated offices. German banks markedly increased their share of lending (from 11.3% to 12.6%), and British-owned banks' share of business rose from 4.9% to 5.3 %, the third consecutive annual increase.

Chart C
International bank assets by nationality of bank(a)



Source: BIS.

(a) Stocks at end-year, includes cross-border and domestic foreign currency lending.

Analysis of international banking business in London

There was a continued increase in cross-border lending by banks in the United Kingdom during 1993 (see Table 2). British and German-owned banks were particularly active in this market, with the Deutsche Mark and sterling both used increasingly as a currency of transaction.

Table 2
External lending of banks in the United Kingdom

$ billions

	Exchange rate adjusted flows					Stocks at
	1989	1990	1991	1992	1993	end-1993
By country						
BIS reporting area	57	86	-45	78	34	900
Outside reporting area:						
Developed countries	-2	1	-1	3	—	34
Eastern Europe	2	-2	-3	-2	-1	10
Oil exporters	-1	-5	-2	2	—	17
Non-oil developing countries	-4	-3	3	2	4	50
Other	3	9	5	-4	14	42
Total	**55**	**86**	**-44**	**79**	**51**	**1,053**
of which:						
By currency						
US dollar	1	18	-38	38	-12	496
Deutsche Mark	12	18	3	32	18	163
Sterling	5	8	-10	25	15	99
Yen	18	8	-28	-31	-12	63
Ecu	6	7	1	4	2	43
By nationality of bank (a)						
Japanese	3	-5	-57	-44	1	245
British	8	-1	-3	24	32	190
American	9	10	3	4	6	96
German	13	28	5	33	21	147
French	-1	5	2	14	-1	44
Italian	10	19	2	3	-9	69

(a) Nationality flows only relate to monthly reporting banks, whereas other figures include quarterly reporting banks and some other financial institutions.

Most of the new funds were lent to countries in the BIS reporting area (up $34 billion), and to Germany in particular (up $26 billion). There were also sizable increases in lending to Latin American countries (Brazil $1.1 billion, Argentina $0.9 billion and Mexico $0.8 billion) and to the Far East (Malaysia $0.9 billion and China $0.5 billion).

Lending by banks in the United Kingdom to other countries in the European Union continued to grow (up by $31 billion, or 8%), though more slowly than in 1992. Deposits from these countries also increased strongly (up $77 billion, or 20%). Almost half of this was from Germany (with German non-bank residents accounting for $10 billion of this rise).

The impact of the general increase in activity in global securities markets was seen in a number of ways. Greater recourse to the capital markets reduced banks' general lending opportunities; but banks faced an increased demand for funding from securities dealers, including bank subsidiaries (though there was evidence that some securities dealers looked to overseas banking markets for additional finance). Banks themselves also increased their holdings of securities, particularly those issued by European governments; during 1993, the stock of portfolio investments held by banks in the United Kingdom rose by 46% to $162 billion.

team of a concluding group of papers.(1) The business requirements were thus finalised, and an enlarged Bank team has begun to develop the fine detail of the system.

CREST will be owned and managed by CRESTCo. A further 25 firms have indicated their commitment in principle to subscribe capital for the development of CREST, bringing the total to 73. The Bank estimates that this group will be responsible for about three quarters of the activity in CREST. Individual subscriptions have been scaled down considerably, since the total commitments offered exceeded the £12 million sought by some 75%. Pen Kent, a director of the Bank and the chairman designate of CRESTCo, addressed a first meeting of representatives of the 73 committed firms in June; the company will be capitalised in October, subject to a satisfactory audit of the project's progress to be completed in the middle of that month.

The project team has now made an outline functional specification available to potential software developers: it describes the logical processes that will form the core of the CREST system. By making it available, the team hopes to help developers take forward their own business analysis; the documents that will enable them to begin programming will not be available until the late autumn.

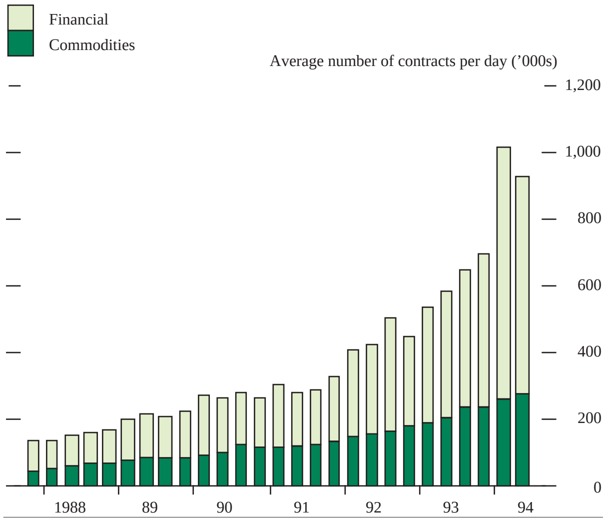
Potential network providers have given the Bank their proposals for developing a network to carry CREST messages. These were delivered by the beginning of August; the CREST team will use them to select up to four providers whose names will be announced on 1 October.

Derivative exchanges

Turnover on London's derivative exchanges remained high during the quarter: although 14% lower than in the first quarter, it was 70% higher than in the same period last year (see Chart 8). Trading on LIFFE was stimulated by the continuing volatility in the cash markets. The commodity exchanges also registered high turnover, because of fears of rising inflation and the sharp price rises of some commodities—notably oil, copper, aluminium and coffee.

LIFFE accounted for 73% of London's exchange-traded derivative business in the first half of 1994. Its volumes at the half-year stage were already 86% of its total turnover in

Chart 8
Turnover on London's derivative exchanges



1993. In the light of these high trading volumes, LIFFE has acted to remove one potential capacity constraint, related to the fact that the number of trading permits was fixed in proportion to firms' holdings of LIFFE shares. A one-for-four rights issue was agreed at an extraordinary general meeting on 26 May; this will increase the number of trading permits available, which should facilitate future growth and reduce the pressure on firms to concentrate their trading activities in the most liquid contracts.

There has been a major restructuring of GLOBEX during the quarter, with the Chicago exchange, CBOT—as expected —leaving the venture. CME and Reuters have been joined by the French exchange, MATIF, as a full partner. LIFFE declined the offer of a similar partnership but the DTB, the Frankfurt exchange, has agreed in principle to join the system.

In aggregate, turnover on the London commodity exchanges (the LME, the IPE and the LCE) increased by 6% in the quarter compared with the first three months of the year. One factor influencing the level of business was the increased presence of funds and other institutional investors in these markets. With the turbulence in bond markets, many funds turned to commodities in search of greater returns, encouraged by the fact that commodity prices tend to rise during periods of economic recovery.

(1) Summarised in the review of financial market developments in the May *Quarterly Bulletin*, pages 130–31.