Financial market developments

- *Confidence among investors and issuers appeared to recover quickly in the second quarter after the turbulent conditions earlier in the year, and risk premia fell on a range of higher-risk assets. Nevertheless, trading and issuing activity remained muted compared with early 1994.*

- *Activity in derivatives markets was subdued, in part reflecting the more stable conditions in underlying cash markets and in part end-users' continuing reaction to a number of highly visible losses in derivatives markets in recent quarters.*

- *Issue levels in both bond and equity markets remained low compared with early 1994; but early indications suggest that volumes have been rising—and maturities lengthening—since the start of the year.*

Overview

Overall, conditions in international markets were relatively stable in the second quarter, strengthening the view that market confidence had recovered fairly quickly from the uncertainty caused by the Mexican crisis and the currency turbulence earlier in the year. Prices rallied in most main financial-asset markets during the quarter. Yields in the major overseas sovereign debt markets continued to fall and spreads on a range of riskier assets—such as corporate debt, higher-yielding OECD sovereign debt and emerging-market debt—narrowed over comparable core assets, returning them to around the levels of late 1994. Prices in the main equity markets also rose, except in Japan and France.

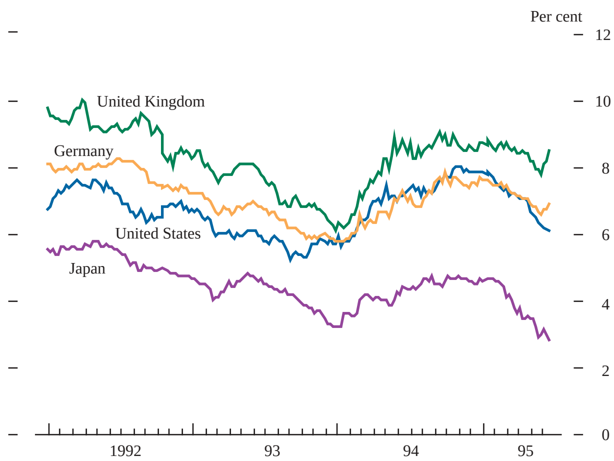
Trends in derivatives markets reflected the more stable conditions in the underlying markets: the volatilities implied by the prices of a number of exchange-traded options fell and turnover on the world's major derivatives exchanges was down on the record levels seen last year, reflecting lower demand for hedging and speculative purposes. A number of well-publicised losses in derivatives markets also continued to depress demand for derivatives products—particularly more complex over-the-counter (OTC) derivatives.

There was a modest increase in international primary bond issues compared with the first quarter of the year, but volumes in both bond and equity markets remained subdued compared with those in the first quarter of 1994. The average maturity of new bond issues also rose quite sharply compared with the first quarter of this year.

Bond and other debt markets

Yields in the main overseas bond markets fell over the quarter (see Chart 1). The yield on ten-year US Treasuries fell from 7.20% to 6.21%, and the dollar yield curve shifted downwards and flattened in maturities up to five years. This mainly reflected the growing view among investors that the outlook for US output was weaker than had previously been thought. Technical factors—such as the hedging of changes in the duration of pools of mortgages[(1)]—were also reported to have increased demand for longer-maturity Treasuries.

Chart 1
Ten-year government bond yields



Source: Bloomberg.

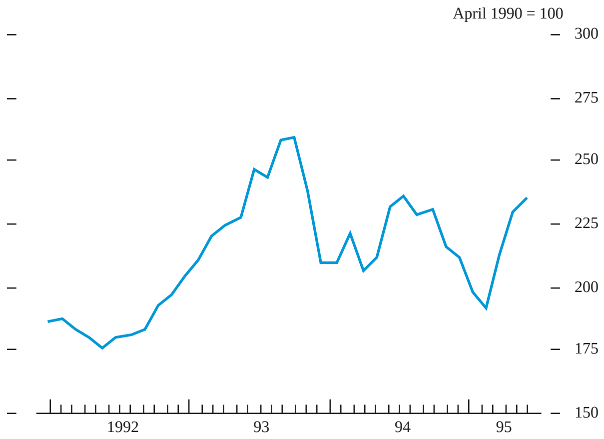
Price rises in the US Treasury market were mirrored in other major markets for much of the period: ten-year Japanese government bond yields fell to 2.74% at the end of June—some 190 basis points lower than at the start of January—and yields on ten-year German government bonds (Bunds) dropped from 7.19% at the end of March to 6.94% by the end of the quarter.

(1) Duration is defined as the average maturity of all future payments on a security, weighted according to the present value of each payment. US mortgage-holders often choose to prepay fixed-rate mortgages when interest rates fall, so that they can refinance their debt without penalty. As a result, the average maturity of pools of mortgages falls.

The yields on a number of other securities tightened relative to comparable major sovereign bond markets. First, the spreads between Bunds and several other European government bonds narrowed: differentials with Italian, Swedish and Spanish ten-year bonds tightened by 50, 30 and 30 basis points respectively, and yields spreads ended the period close to the levels seen in late 1994.

Second, the price of dollar-denominated emerging-market debt rose sharply, after reaching a trough in March, and returned to the levels prevailing before the Mexican crisis in December. The Salomon Brothers Brady Bond index rose by 22% over the period; by the end of June it was some 14% higher than a year earlier (see Chart 2). The rapid recovery

Chart 2
Recent Brady Bond performance



Source: Salomon Brothers Brady Bond index.

in these markets reflected the positive effect of lower US interest rates, the release of generally positive economic data for several of the major developing countries and the perceived resilience of other developing economies to events in Mexico. Brazilian Brady bonds, for example, rose by 24% in the year to end-June, whereas Mexican Brady bonds rose by only 2%. The success of the international support operation probably reduced the consequences of the crisis on Mexican debt.

Third, in a number of markets the spreads faced by corporate borrowers fell. In dollar bond markets, the spread between a basket of ten-year bonds issued by AAA-rated companies and a comparable US Treasury fell from some 40–45 basis points—a level similar to that seen for most of the second half of 1994—to just over 35 basis points by the end of June. The spread for a similar basket of lower-rated companies fell somewhat more, by about 15 basis points to around 75 basis points by the end of June. However, there was no equivalent reduction in the spreads on either euro-Deutsche Mark or euroyen issues over comparable German and Japanese government bonds; they remained at around 30 basis points and 20 basis points respectively for baskets of bonds issued by AAA-rated corporates. Market participants reported, however, that the very low nominal yields on Japanese government bonds appeared to be leading some Japanese investors to take on more credit risk in order to earn higher nominal returns.

International issues

Partly reflecting the improved trading conditions in secondary markets, the value of gross bond issues in the international markets recovered a little in the second quarter—rising by almost \$6 billion to \$104 billion. In spite of this, issues remained at relatively low levels compared with the first quarter of 1994 (see Table A). The upturn in the second quarter occurred despite only a small rise in the volume of fixed-rate issues, which rose 1% to \$82.7 billion. The increase in gross floating-rate issues was more significant: issues rose by 17% over the preceding quarter to \$16.6 billion. But, despite doubling to \$4.6 billion, equity-related issues remained low by historic standards, largely because of the subdued conditions on Japanese equity markets.

Table A
Total financing activity:(a) international markets by sector

\$ billions; by announcement date

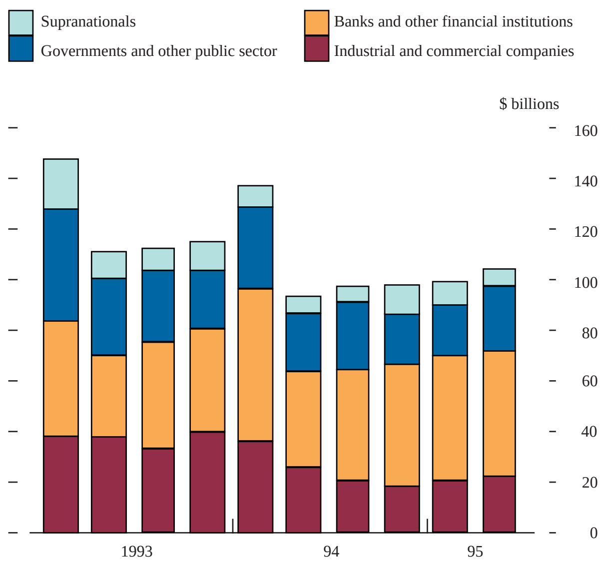
	1994 Q1	Q2	Q3	Q4	1995 Q1	Q2
International bond issues						
Straights	77.1	68.6	75.0	75.6	81.7	82.7
Equity-related	20.7	5.7	4.0	2.8	2.3	4.6
of which:						
Warrants	*8.2*	*0.8*	*0.7*	*1.1*	*0.9*	*0.5*
Convertibles	*12.5*	*4.9*	*3.3*	*1.7*	*1.4*	*4.1*
Floating-rate notes	38.7	17.8	17.9	18.3	14.2	16.6
Bonds with non-equity warrants	0.5	—	—	—	—	—
Total	**136.5**	**92.1**	**96.9**	**96.7**	**98.2**	**103.9**
Credit facilities (announcements)						
Euronote facilities	35.7	46.0	40.2	71.4	54.9	62.8
of which:						
CP	*3.9*	*15.4*	*10.9*	*6.2*	*6.8*	*8.9*
MTNs	*31.9*	*30.6*	*29.3*	*65.2*	*48.1*	*53.9*
NIFs/RUFs	—	—	—	—	—	—
Syndicated credits	53.8	64.5	59.3	72.8	101.6	74.9
Total	**89.5**	**110.5**	**99.9**	**145.8**	**156.5**	**137.7**
Memo: amounts outstanding						
All international						
Bonds (b)	1,888.4	1,947.7	2,020.8	2,041.8	2,188.5	2,232.8
Euronotes (c)	289.8	330.3	378.7	406.1	461.6	517.1
of which, EMTNs	*177.9*	*216.5*	*259.4*	*292.0*	*347.1*	*397.5*

(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) BIS-adjusted figures, including currency adjustment. Includes issues of fixed-rate bonds and floating-rate notes.
(c) Euroclear figures.

The average maturity of new bond issues rose for all currencies except the yen and Ecu, reflecting the relatively buoyant issuing conditions. The average maturity of dollar bonds rose to 8.4 years compared with 5.9 years in the first three months of 1995. The rise in the average maturities of Deutsche Mark bonds was more modest, from 5.4 to 6.2 years. The general fall in yields meant that the average duration of new issues increased still more.

Narrower yield spreads prompted fairly large increases in issues in some of the higher-risk markets: for example, the value of corporate bonds issued in international markets rose by 12% in the second quarter to $21.4 billion (see Chart 3), though they remained well below the $35 billion raised in the first quarter of 1994.

Chart 3
Borrowers in the international bond market



Source: Bank of England ICMS database.

Similarly, the rapid—if fragile—return of investor confidence in emerging markets permitted a rise in the volume of issues by Latin American and Caribbean borrowers, from $0.2 billion in the first quarter to $3.9 billion. The Brazilian government issued a yen eurobond worth ¥80 billion ($960 million) in late May, the first for some 15 years; and Bancomext, the state-owned Mexican foreign trade bank, issued a $300 million floating-rate note in the middle of June. Latin American borrowers were able to return to the capital markets relatively swiftly because the fall-out expected by investors in the immediate aftermath of the Mexico crisis did not materialise: other emerging nations were not forced by the crisis to change their own macroeconomic policies significantly, and the success of the international support operation reduced the immediate consequences of the crisis for Mexico itself.

Despite the gradual upturn in the value of bond issues, borrowing in other forms continued to grow in importance

Table B
Currency composition of international bond issues

$ billions

Currency denomination	1993	1994				1995	
	Year	Year	Q2	Q3	Q4	Q1	Q2
US dollar	175.6	147.3	26.2	30.6	37.3	30.6	32.8
Yen	58.7	77.8	20.7	23.9	22.1	13.6	25.4
Deutsche Mark	56.4	39.8	8.4	8.5	9.2	14.3	20.1
Sterling	42.6	29.5	6.6	5.3	4.1	6.5	4.5
French franc	42.3	28.7	8.5	3.1	3.5	4.8	3.2
Swiss franc	27.5	20.8	3.2	6.2	4.3	5.7	6.8
Italian lira	12.3	17.1	5.0	4.6	2.7	5.9	1.7
Ecu	11.4	7.6	1.8	1.5	0.9	2.9	0.2
Other	58.2	53.3	11.6	13.2	12.3	14.0	9.2
Total	**485.0**	**421.9**	**92.0**	**96.9**	**96.4**	**98.2**	**103.9**

Source: Bank of England ICMS database.

Table C
Value of gross bond issues in domestic markets

$ billions

	1994 Q1	Q2	Q3	Q4	1995 Q1	Q2
United States	339.0	297.1	279.3	234.6	323.2	. .
of which, private sector	*149.9*	*126.4*	*100.7*	*97.9*	*120.5*	. .
Japan	289.4	285.5	279.4	306.8	. .	. .
of which, private sector	*89.1*	*107.2*	*124.9*	*115.5*	. .	. .
Germany	94.5	73.0	98.2	119.1	104.6	. .
of which, private sector	*63.9*	*54.3*	*63.1*	*71.3*	*74.9*	. .
France	22.5	15.3	15.3	19.2	18.0	. .
of which, private sector	*6.8*	*4.6*	*3.2*	*5.3*	*5.4*	. .
United Kingdom (£ billions)	8.9	7.8	7.5	8.2	7.3	6.1
of which, private sector	*0.8*	*0.2*	*0.5*	*0.1*	*0.2*	*0.3*

. . not available.

Sources: Bank of England, OECD June 1995 *Financial Statistics Monthly* and IMF May 1995 *International Financial Statistics.*

during the second quarter. Gross issues of euromedium-term notes (EMTNs), for example, rose to $53.9 billion, some 76% up on a year earlier, continuing a general upward trend. Many eurobonds are now in effect issued as EMTNs—which are simply debt securities issued under a continuous programme, with maturities from under one year to over twenty. Once a borrower has set up a programme, issuing is simple and normally costs less than a bond. Similarly, the value of international syndicated credit lending announced in the second quarter remained high at $74.9 billion (some 16% higher than a year earlier) as continuing strong competition between banks in this sector ensured that spreads remained low and that issuers could raise funds more cheaply in that form.

Sterling issues

Announcements of new sterling bond issues totalled £3.3 billion ($5.4 billion) in the second quarter, a fall of £900 million from the first three months of the year. Some £650 million of these were floating-rate issues. £372 million of the total fixed-interest issues were domestic bonds, including a £73 million issue for seven local authorities, a £49 million convertible issue and a £100 million fixed-rate preference share issue. The rest were in eurosterling, taking sterling's share of international issues to 4.5%. £1.8 billion of the quarter's £2.4 billion fixed-rate eurosterling issues were by UK non-financial companies; a number of companies made issues to meet expected demand for bonds that could be included in corporate-bond personal equity plans (PEPs) after July (see below). Glaxo Wellcome launched a £500 million ten-year eurobond to refinance the bank borrowing taken on at the time of Glaxo's purchase of Wellcome. This and the European Investment Bank's £500 million issue in January were the largest sterling issues since February 1994. Outstanding sterling commercial paper rose to £6.1 billion over the quarter from £5.9 billion at the end of March. Outstanding sterling issues from MTN programmes also rose, to £14.0 billion from £12.8 billion at the end of the first quarter.

Two announcements by the Inland Revenue affected the sterling bond markets significantly during the quarter. On 31 March, the Revenue produced draft proposals for consultation on widening the range of instruments eligible in PEPs to include certain corporate bonds, preference shares and convertibles. These proposed that fixed-rate corporate bond issues by UK non-financial companies with a minimum term to redemption of five years at the time of acquisition would be eligible for both direct investment in PEPs and via qualifying unit and investment trusts. The proposal prompted a significant tightening of spreads in the corporate sector, beyond that which followed the initial announcement of the proposal in the Budget. Five to ten-year maturities tightened markedly, because managers of potential PEP trusts are likely to favour this sector in order to keep the duration of portfolios relatively low; high-yielding issues were also in demand, because these products are likely to be promoted on the basis of high income for retail investors. The tightening also spread to longer maturities given the potential extent of PEP demand.

The admission to PEPs of such instruments has two benefits: it will increase the availability and range of borrowing opportunities for UK companies, particularly those medium-sized companies which have traditionally relied on bank finance or development capital; and it will also increase the choice of tax-free instruments for investors.

In May, the Revenue produced a consultative document proposing changes to the taxation of gilts and other bonds. This suggested replacing the current distinction between income and capital gain with a unified treatment. Under the proposals, income and capital gains on gilts and bonds would be taxable or deductible from tax as income, removing the current exemption from tax of capital gains, but capital losses would be allowable against tax. Following the announcement of the proposals, yields on high and low-coupon gilts and other sterling bonds converged markedly. (In early July, following the consultation, the Revenue announced its decisions on the proposals: the box on page 228 gives details.)

The reforms will involve a major simplification of the tax code. They will also have a number of other advantages: they will facilitate innovation in the gilt and other bond markets (including gilt strips); they will make tax a more neutral factor in investment decisions and therefore increase market efficiency; in addition, by allowing the recognition of losses, they may make it cheaper for riskier ventures to raise loan finance.

In addition, some of the changes included in the current Pensions Bill are likely to have a structural impact on bond markets. The Bill builds on a number of the recommendations of the Pension Law Review Committee, chaired by Professor Goode, which was commissioned by the Secretary of State for Social Security in 1992 and reported in September 1993 on the regulation of occupational pension schemes. It includes a statutory Minimum Funding Requirement (MFR) for defined benefit occupational schemes and a requirement to increase future pensions in line with the lower of RPI and 5%, known as Limited Price Indexation (LPI). A number of commentators consider that the introduction of the MFR, particularly at a time when pension funds are becoming increasingly mature, will lead to an increase in the demand for gilts and, potentially, for non-government bonds.

Ecu issues

In the United Kingdom, there were regular monthly auctions of ECU 1 billion of Ecu Treasury bills during the second quarter, comprising ECU 200 million of one-month, ECU 500 million of three-month and ECU 300 million of six-month bills. The auctions continued to be oversubscribed, with issues being covered by an average of 2.3 times the amount on offer. Bids were accepted at yields up to 12 basis points below the Ecu Libid rate of the appropriate maturity, somewhat narrower than in the previous quarter but within the range achieved since the Ecu market disturbance in 1992. There are currently ECU 3.5 billion of Treasury bills outstanding. Secondary market turnover averaged ECU 2.2 billion a month, down from ECU 2.8 billion in the previous quarter, but close to the average for 1994.

The Bank reopened the Ecu Treasury note maturing in 1998, with a tender for ECU 500 million on 18 April, raising the amount outstanding to ECU 1,500 million. Cover at the tender was 3.6 times the amount on offer and bids were accepted in a range of 7.38%–7.42%. The total of notes outstanding under the UK note programme rose from ECU 5.5 billion to ECU 6 billion. Stimulated by the issue of the 1998 note, turnover in the notes was at record levels in the first half of 1995. The UK government's total outstanding Ecu debt rose from ECU 11.5 billion to ECU 12.0 billion over the quarter.

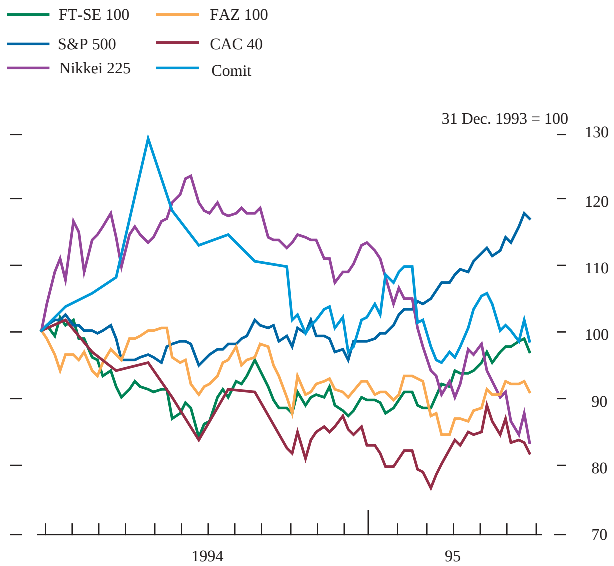
The French government issued ECU 700 million in bonds and notes during the quarter, taking its outstanding Ecu debt to ECU 23.9 billion. The Italian government issued ECU 1.0 billion of notes in May, but because of redemptions the total outstanding fell from ECU 25.6 billion to ECU 24.9 billion over the quarter. In addition, the amount of Italian government eurobonds outstanding remained at ECU 5.9 billion.

Equity markets

Equity prices in major international markets—with the exceptions of Japan and France—rose over the period (see Chart 4), driven largely by the same macroeconomic factors that affected bond markets. In the United States, equity prices continued the strong rise seen in the first quarter: the Standard and Poor's 500 index rose by 8.8% between April and June. Like bond markets, equity prices responded favourably to economic data indicating that the economy was slowing. Strong earnings figures from listed companies boosted prices further, although the persistent weakness of the dollar was interpreted as a negative factor.

The UK market also continued the rally begun earlier in the year, with the FT–SE 100 index rising by 5.6% in the second quarter. Despite the weakness of sterling, the market lowered its expectations of an early increase in base rates, following figures showing a slowdown in economic growth.

Chart 4
Equity indices(a)



(a) End-week prices.

Better-than-expected results from a wide cross-section of listed companies, combined with take-over announcements, also boosted equity market prices, despite uncertainty stemming from the political situation.

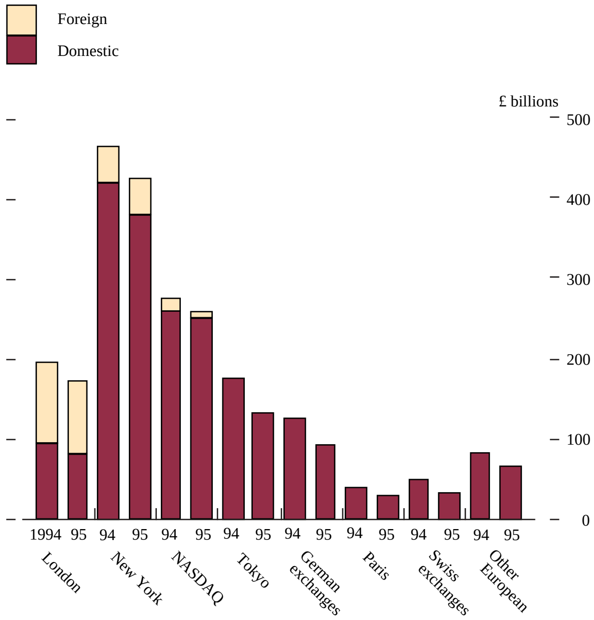
In Germany, the FAZ index rose strongly, by 7.6% during the quarter. This reflected an expected recovery in corporate profits and growing hopes of an early reduction in interest rates. In France, equity prices were buoyed by the end of the uncertainty associated with the presidential elections in May, but overall the CAC 40 index closed marginally down over the quarter. In Italy, the Comit index recorded a rise of 1.6%, as improved prospects for pension reform outweighed the effects of the rise in the discount rate announced on 26 May. In Sweden and Spain, equity markets also reflected the strong rally in domestic bond markets, rising by 12.6% and 9.2% respectively.

By contrast to the United States and Europe, Japanese equity prices fell sharply over the quarter, despite the continuing fall in longer-term Japanese interest rates. The Nikkei 225 index fell by 10% over the quarter. Equities were depressed by the poor outlook for future profits, in part because of the impact of the stronger yen and threats of trade sanctions from the United States. Prices were also affected by the perceptions of continuing fragility in the Japanese financial system, the level of bad debts held by banks and the reduction in the proportion of assets held by insurance companies in equities. The announcement in late June of a package designed to stimulate the market was unfavourably received, with the Nikkei 225 index falling 2.6% on the day.

Turnover

The most recent data show that equity market turnover in the first quarter was lower than a year earlier in all the major equity markets, reflecting the downturn in trading conditions in capital markets over the period (see Chart 5). On the New York Stock Exchange, turnover fell by 8% over the twelve months and on NASDAQ by 6%. The London Stock Exchange recorded a decline for both UK and foreign stocks, with total turnover down by 13% compared with the same period a year earlier. Volumes fell even more sharply in Germany, France and on several other European exchanges, suggesting that the recent reforms aimed at repatriating business have yet to have a significant effect. The weakness of Japanese equity prices continued to limit turnover on the

Chart 5
Turnover of domestic and foreign equities on major stock exchanges(a)



(a) Turnover in the first quarter of year indicated.

Tokyo Stock Exchange, which remained depressed compared with its levels in the late 1980s, though volumes were 30% higher in the first quarter than in the fourth quarter of 1994. In May, most of the top Japanese securities houses announced net losses in the year to end-March 1995, which were attributed mainly to low trading volumes. Data are not available for the second quarter of 1995, but are expected to show a pick-up in volumes in most markets as a result of improved trading conditions.

Equity issues

Like international bond markets, issues of international equities—offers of equities with an international tranche—remained subdued, at $6.9 billion in the first four months of 1995 compared with around $16.7 billion in the first four months of the previous year. This partly reflected the difficulty of bringing issues by companies from developing countries. There were only $1.3 billion of such issues in the first four months, compared with $3.2 billion for the same period last year. It also reflected a slowdown in the flow of privatisation stocks on to international equity markets. But the $1.6 billion privatisation of Repsol, the Spanish oil and gas company, was successfully completed at the beginning of the quarter, at a time when difficult market conditions resulted in other international offers being reduced in size and price. The Spanish government also sold a $130 million stake in Ence, the pulp and paper manufacturer.

Regulation of the UK equity markets

In June, the Securities and Investments Board (SIB) published a report on the structure of equity markets in the United Kingdom. The report was the culmination of a process started by the SIB's discussion paper, 'Regulation of the UK Equity Markets' (the so-called 'Agnew Report', issued in February 1994), and also gave the SIB's response to a report published in March 1995 by the Office of Fair Trading: 'Rules of the London Stock Exchange Relating to Market Makers'. It included a number of recommendations about how the regulation of UK equity markets might be amended to improve their integrity without impeding competition and innovation.

Transparency

The report recommended that information on equity trades should be published more rapidly. Agreement has recently been reached with the Stock Exchange that from January 1996 more trade information will be subject to immediate publication. Further improvements may be made after that, provided it is clear that they will not damage the overall liquidity of London's markets.

Trading between market-makers

It was suggested in the OFT's report that the exclusive access to quotes appearing on inter-dealer broker (IDB) screens at present enjoyed by market-makers distorts competition. The SIB recognised in its report that market-makers prefer to trade with each other indirectly and anonymously, and so did not suggest that access to IDB screens should be available more widely. However, agreement has been reached with the Stock Exchange that, from January 1996, details of all trades between market-makers will be published immediately.

Price display regime

Under the Stock Exchange's present rules, a market-maker is not allowed to quote a better price for a share on any other system than it quotes on the Stock Exchange's Automated Quotation system. The SIB could see no reason for retaining this rule on investor protection grounds for prices quoted on another Recognised Investment Exchange that was subject to transparency requirements.

Extension of stock borrowing

The SIB believed that an extension of the ability to borrow stock—currently restricted to market-makers—would be in line with market demands and would aid the efficient working of a more diverse marketplace. Should the Chancellor decide to extend access to stock borrowing, the SIB will take forward the necessary regulatory preparations.

Disclosure of corporate interest

The SIB supported the disclosure of material economic interests in company shares, particularly those arising from options, and announced it would issue a consultation paper on the subject.

Market-maker privileges and obligations

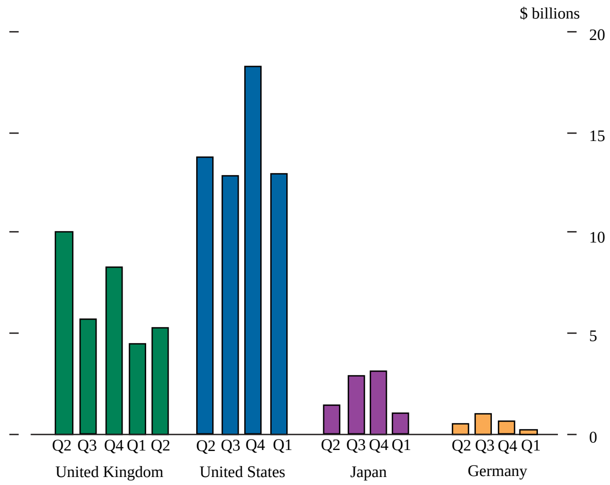
The SIB issued for consultation a draft standard on market-makers' privileges and obligations. It considered that these privileges should not extend further than is necessary to comply with market-makers' obligations.

These proposed changes are intended in part to accommodate a variety of trading platforms in the United Kingdom; the approval in June of Tradepoint Financial Networks plc as a Recognised Investment Exchange under the Financial Services Act will allow trading on a screen-based order-matching system of a selection of equities listed on the London Stock Exchange.

The most recent available data suggest that conditions in domestic equity markets were similar to those in international markets during early 1995 (see Chart 6). Issues on NASDAQ, the American Stock Exchange and the New York Stock Exchange, totalled some $13.5 billion in the first quarter, compared with $18.1 billion in the last quarter of 1994. In Japan, unfavourable secondary market conditions had a severe impact on the primary market, and the value of issues fell to just over $1 billion in the first quarter, compared with some $3.1 billion in the preceding period. Similarly, the value of issues on German exchanges slipped to around $179 million in the first quarter of 1995, compared with some $696 million in the preceding quarter.

In Germany, plans for a major overhaul of equity market structures over the next few years were announced in May. The three largest exchanges—in Frankfurt, Düsseldorf and Münich—plan to merge operations under a system that will

Chart 6
Equity capital raised in major stock exchanges



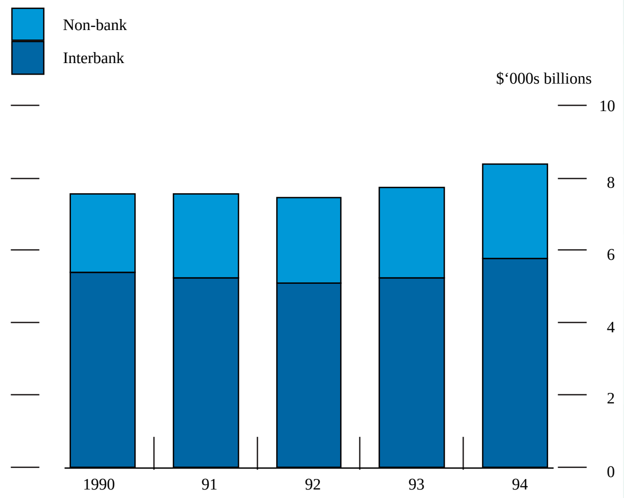
Developments in international banking in 1994

This box summarises developments in international banking in 1994: the first section looks at global trends, as revealed by quarterly statistics published by the Bank for International Settlements (BIS); the second focuses on developments in the London market, using the Bank's own data.

Banking business within the BIS reporting area(1)

International lending by banks in the BIS reporting area rose again in 1994, by $263 billion(2) (3%) to an outstanding stock of $8,373 billion(3) (see Chart A). Lending between banks accounted for $5,793 billion (69%), an increase of $289 billion (5%) compared with 1993. In contrast to the previous year's rise, lending to non-bank end-users fell by $26 billion (1%), which resulted in a small fall in its share 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 rose for the fourth consecutive year, and at a stronger rate than in 1993 (see Table 1). The developing economies of the Asian region were again the main recipients of the new lending. An increase of $50 billion to that region was dominated by increased lending to Thailand and South Korea, up $20.0 billion and $15.2 billion respectively. There were also large increases in lending to China ($7.8 billion) and Indonesia ($4.6 billion).

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

$ billions

	Exchange rate adjusted flows					Stocks at
	1990	1991	1992	1993	1994	end-1994
Total lending	**-12**	**7**	**66**	**11**	**39**	**880**
of which:						
Developed countries	6	—	7	5	-2	161
Eastern Europe	-10	-1	4	-4	-13	80
Latin America	-31	-1	15	2	4	232
Middle East	-1	-8	16	-5	3	80
Africa	-1	-4	-1	-2	-2	40
Asia	26	21	26	15	50	287
Total deposits	**92**	**-12**	**13**	**-18**	**75**	**794**
of which:						
Developed countries	8	-3	11	10	22	149
Eastern Europe	-6	1	10	3	2	36
Latin America	25	-2	-2	-7	22	159
Middle East	26	-12	-7	-20	3	195
Africa	4	—	3	—	3	41
Asia	35	4	-1	-4	24	214

Source: BIS.

Totals may not sum because of roundings.

Lending to Eastern Europe fell significantly (by $13 billion), largely because of falls in lending to Poland ($5.6 billion), Bulgaria ($3.7 billion) and Russia ($3.3 billion).

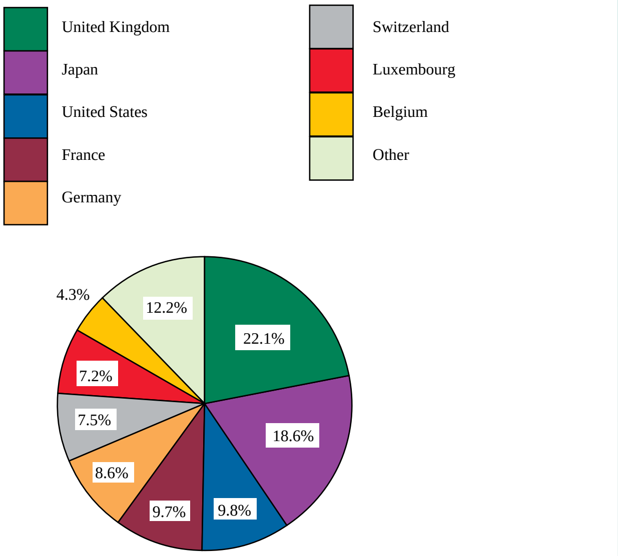
Deposits from countries outside the BIS reporting area also increased strongly during 1994, by $75 billion. The increased deposits were spread between Asia (up $24 billion), Latin America ($22 billion) and non BIS area developed countries ($22 billion). Within these regions, notable increases were reported by China ($10.3 billion), Brazil ($10.0 billion), Portugal ($7.1 billion), Greece ($5.5 billion) and South Korea ($4.9 billion). The largest fall in deposits was from Malaysia (down $9.5 billion), which had built up large increases during the previous two years. Saudi Arabia withdrew $3.9 billion of deposits, continuing its trend of recent years.

Analysis by centre and currency

The United Kingdom continued to increase its share of international lending (comprising foreign currency business within the United Kingdom as well as cross-border claims) during 1994. Outstanding cross-border loans by banks located within the BIS industrial area amounted to $5,425 billion at the end of 1994; as Chart B illustrates, 22% of this was lent by banks in the United Kingdom ($1,200 billion, up by 9% compared with 1993). The amount of foreign currency lending in the United Kingdom also increased, by $17 billion to $317 billion. Within the BIS industrial

(1) The BIS reporting area comprises: Austria, Belgium, Canada, Denmark, Finland, France, Germany, Ireland, Italy, Japan, Luxembourg, Netherlands, Norway, Spain, Sweden, Switzerland, the United Kingdom and the United States within the industrial area; and the Bahamas, Bahrain, Cayman Islands, Hong Kong, Singapore and Netherlands Antilles as offshore centres.
(2) Changes are adjusted so as to remove the effects of exchange rate movements on amounts outstanding. So changes are not simply the difference between the stock figures for two periods.
(3) Stock data are translated to dollars at 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 lending transacted by banks within the BIS industrial area(a)



Source: BIS.

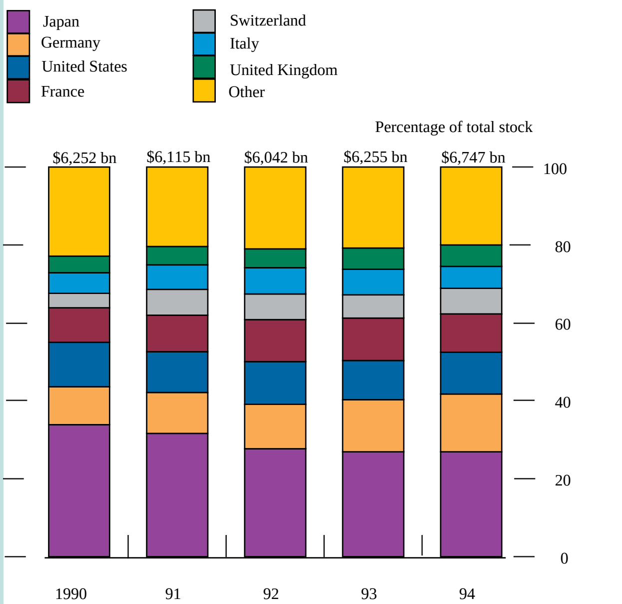
(a) BIS reporting countries other than offshore banking centres.

area, cross-border lending denominated in Japanese yen increased strongly (by $49 billion or 8%), following falls in recent years, while Deutsche Mark denominated cross-border lending fell (by $15 billion or 2%), following the previous year's strong increase. Cross-border lending in French francs also fell sharply (by $40 billion or 16%), as did lending in Ecu (by $20 billion or 8%).

Analysis by nationality of bank

Japanese banks remained the largest lenders of funds within the BIS reporting area, with 27.0% of international bank assets (see Chart C), virtually the same share as in 1993. German banks, the second largest group in terms of international business, again increased their share, to 14.8% from 13.2% in 1993. British-owned banks' share of business remained fairly constant at 5.4%.

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

Cross-border lending by banks in the United Kingdom increased by almost twice as much in 1994 as in the previous year (see Table 2). German-owned banks were particularly active (their business increased by $46 billion). American and Japanese-owned banks' business also increased, while British-owned banks' business fell for the first time in three years. Transactions in US dollars rose significantly (by $67 billion), increasing the dominance of the currency in this market.

Table 2
External lending of banks in the United Kingdom

$ billions

	Exchange rate adjusted flows 1990	1991	1992	1993	1994	Stocks at end-1994
By country						
BIS reporting area	90	-44	78	36	89	1,039
Outside reporting area:						
Developed countries	1	-1	3	1	—	35
Eastern Europe	-5	-3	-2	-1	-2	8
Latin America	-5	2	-1	3	-1	29
Middle East	—	-2	3	1	1	13
Africa	-1	-1	—	-1	-1	5
Asia	2	1	3	2	3	24
Other	6	3	-3	15	13	46
Total	**88**	**-45**	**81**	**56**	**102**	**1,200**
of which:						
By currency						
US Dollar	18	-52	38	-10	67	566
Deutsche Mark	18	-5	32	18	11	194
Sterling	8	-10	25	15	1	106
Yen	8	-30	-31	-12	8	79
Ecu 6	1	4	2	-9	38	
By nationality of bank (a)						
Japanese	-5	-57	-44	1	11	266
British	-1	-3	24	44	-2	209
German	28	5	33	23	46	202
American	10	2	4	7	27	129
Italian	20	2	4	-9	-1	71
French	5	2	13	-1	—	46

Totals may not sum because of roundings.

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

As in 1993, most of the new funds were lent to countries in the BIS reporting area (up $89 billion), and to the United States in particular (up $30 billion). Lending to Asian countries also increased ($3 billion), most notably to South Korea ($1.7 billion); lending to Eastern European countries continued to decline (by $2 billion).

Following the trend of previous years, lending by banks in the United Kingdom to other countries in the European Union continued to rise; it was up $49 billion or 13%. Deposits also rose (up by $26 billion or 6%), though more slowly than in 1993. These increases were largely attributable to business with Germany.

offer standardised price quotations for leading shares in all three exchanges. Less liquid shares will continue to be traded only in their local market. Plans were also announced for a strategy of computerisation and centralisation of German share trading.

It is not yet clear whether the changes in the structure of the sterling bond markets described above have had a significant impact on companies' choice between raising debt and equity issues. Overall, the reforms are expected to increase the relative attractiveness of issuing bonds, although industry sources vary markedly in their estimates of the likely impact. In the UK equity market, £1.2 billion ($1.9 billion) was raised from rights issues by UK and Irish companies during the second quarter of the year, compared with £1.4 billion raised in the first. 66 companies joined the Official List during the quarter; of these, 27 raised capital worth £1.1 billion in total, compared with £905 million in the preceding quarter. 32 companies from the Unlisted Securities Market (USM) transferred to the Official List during the second quarter of 1995, taking the total for the first half of 1995 to 56.

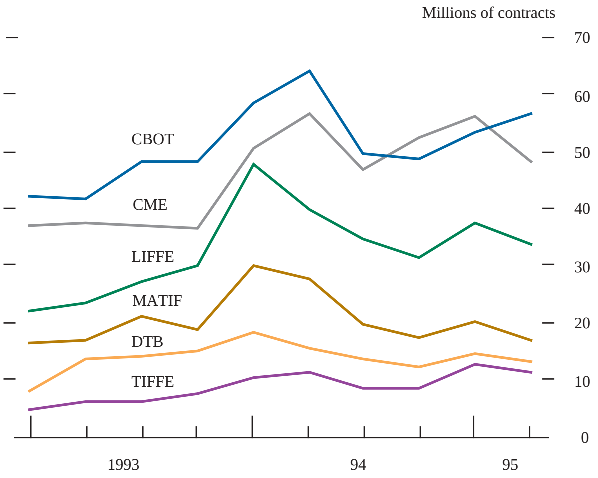
The Alternative Investment Market (AIM) was launched on 19 June replacing the USM; its inception brought to an end the transfer of companies to the Official List caused by the closure of the USM. There were 14 companies trading on AIM at the end of the quarter; the number is expected to increase when the transitional arrangements for Rule 4.2 companies end at the end of September.

In April, the Stock Exchange proposed a change to its listing rules to increase the minimum market capitalisation for the Official List; if approved, it will increase the differential between AIM and the Official List. In the same consultation, the Exchange is reviewing the rules for Initial Public Offers (IPOs), which require issues of more than £50 million to include an offer of shares to the general public. The review is aimed at addressing concerns that IPOs are more expensive than private placings. A further nine foreign companies were listed on the London Stock Exchange during the second quarter—bringing the total number of new overseas listings in 1995 to 16, compared with three for the same period in 1994.

Derivatives markets

On most major derivatives exchanges, the notional value of contracts traded was lower during the second quarter than during the preceding quarter, and well below the record levels set during the first half of 1994 (see Chart 7).(1) In part, this reflected lower volatility in some of the underlying markets, as shown by a steady reduction in at-the-money implied volatilities in a number of major financial option contracts over the period. In addition, the losses incurred by Barings—and other high-profile losses in OTC markets—continued to influence some users' willingness to engage in derivatives trading, leading them to reduce their level of activity.

Chart 7
Quarterly turnover on major derivatives exchanges



Of the world's major financial derivatives exchanges, the drop in turnover was most apparent in Europe. Volumes on the London International Financial Futures Exchange (LIFFE) were down 10% quarter on quarter and 15% year on year. This slowdown was also apparent on the DTB and MATIF—the main German and French derivatives exchanges—with volumes down 15% and 38% respectively compared with the second quarter of 1994. During the quarter, LIFFE's German Bund futures contract continued to challenge MATIF's *Notionnel* bond futures contract as Europe's most actively traded contract. The reduction in volumes on European exchanges trading by open outcry in particular have led some firms with large floor presences to reduce staffing levels.

Volumes on the Chicago Mercantile Exchange (CME) were also depressed; they were down 14% compared with the previous quarter. Turnover in the CME's eurodollar futures contract also fell by 14% quarter on quarter, though it remained the world's most actively traded major contract. By contrast, in May LIFFE announced that no further delivery months would be listed in its eurodollar futures contract, because of falling volumes—attributed to competition from the CME and the Singapore International Monetary Exchange (SIMEX), which effectively straddle the European time zone. The option on the future was delisted with immediate effect. In contrast to the CME, volumes on the Chicago Board of Trade (CBOT) increased by 7% on the previous quarter, though activity was still below the levels recorded in the second quarter of 1994. Turnover in its US Treasury Bond futures contract was down 22% on the second quarter of 1994.

By contrast with Europe and the United States, volumes in the Far East appeared to be relatively buoyant compared with the same period last year. Turnover on the Tokyo International Financial Futures Exchange (TIFFE), for example, was down 14% on the first quarter of 1995, but largely unchanged from the same period a year earlier.

(1) Worldwide, turnover data showed a rise in the number of exchange-traded derivatives contracts traded during the first half of 1995 from the levels seen in 1994, but this reflected strong turnover growth in emerging futures markets which tend to be characterised by smaller contract sizes.

In comparison with exchange-traded derivative markets, data on OTC markets are less comprehensive and available only after a delay. In its latest biannual survey of derivatives activity, the International Swaps and Derivatives Association (ISDA) reported that the value of interest rate swap transactions during the second half of 1994 amounted to a notional principal value of $3,058 billion, down only slightly on the first half of 1994.(1) The notional principal value of currency swap transactions was $198 billion, up nearly 10% on the previous period. However, activity in interest rate options—representing a notional principal value of $663 billion—fell 22% compared with the first half of 1994. The total value of transactions outstanding at the end of 1994 amounted to $11,303 billion, a rise of over 33% on end-1993. Overall activity in swaps and related derivative transactions reported by ISDA for the second half of 1994 was higher than expected.

Chart 8
Quarterly turnover of futures by type(a)

(a) The major futures contracts listed on the CME, CBOT, LIFFE, DTB, MATIF and TIFFE.

Disaggregated by currency, the data showed that at the end of 1994 US dollar interest rate swaps outstanding were 32% higher than at the end of 1993, and accounted for 37% of total activity. Transactions in yen and Deutsche Mark also grew rapidly, and were up 59% and 45% respectively. The yen accounted for 23% of interest rate swap activity during 1994 while the Deutsche Mark accounted for 10%.

Market participants report a slowdown in OTC turnover in the first half of 1995, though this broad trend masked a pick-up in March—as a result of turbulence in underlying currency markets—and more buoyant activity towards the end of the second quarter. Demand for complex, structured OTC derivatives has been particularly muted.

Exchange developments

During the quarter, the membership of CBOT approved the plan to develop an open outcry link with LIFFE enabling each exchange to trade the other's most liquid government debt contracts. The link—to be implemented in stages, beginning with the Bund and US Treasury Bond contracts—still requires regulatory approval. In addition, the International Petroleum Exchange's (IPE's) mutual offset agreement with SIMEX, allowing it to trade the IPE's Brent futures contract in the Asian time zone, came into operation in June.

At the end of June, LIFFE introduced a basis trading facility, initially on its Bund futures contract. This facility allows for the simultaneous purchase or sale of cash instruments and an offsetting purchase or sale in the futures market. If it is successful, the exchange is likely to introduce the facility on other contracts—in particular the long gilt futures contract—in the near future.

LIFFE also launched a flex option contract on the FT-SE 100 index in June. This allows participants to tailor the exercise price and expiry day of the option, subject to a maximum maturity of two years. The CME also listed dollar-denominated flex options on a range of world equity indices, including the FT-SE 100, S&P 500 and Nikkei 225 indices.

The DTB announced plans to launch a dollar-denominated dollar/Deutsche Mark currency option contract towards the end of the year. In a separate development, it delisted its extra-long German government bond futures contract (Buxl) a year after its launch. Turnover in the contract had been low; this was attributed to the low turnover in the underlying bond market.

The choice of the two MATIF contracts to be taken off its trading floor and listed on the Tradeus electronic link with the DTB was further delayed during the quarter. The DTB and MATIF announced that there were to be further negotiations, also involving the Paris Bourse and the Deutsche Börse, to discuss linking the two countries' stock exchanges in conjunction with their futures markets. Stage two of the link-up, in which two MATIF contracts are transferred to the system, is due to start by the end of the year.

(1) Data have been compiled from 88 international swap dealers.