Financial market developments

- *Prices in most major financial markets either showed little variation in the quarter, or inched upwards.*
- *US equity prices shrugged off speculation that they might fall sharply in the quarter.*
- *Over-the-counter (OTC) derivative volumes rose, in contrast to exchange-traded derivative volumes.*

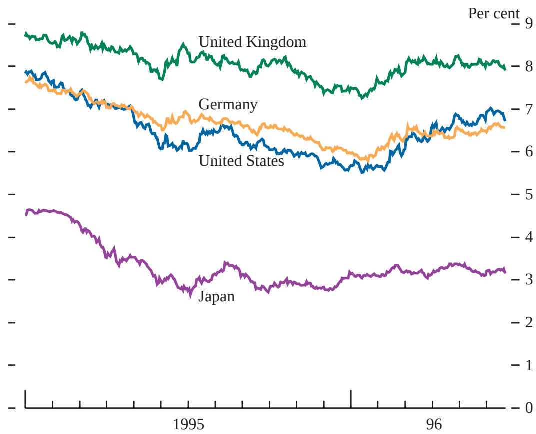
Background

Overall market conditions in the second quarter can be described as 'trading in a range'—in other words, there was no major turbulence or radical change in market expectations, and price movements were relatively limited. The foreign exchange markets were more settled than usual, although the Deutsche Mark weakened against the dollar. Price movements in bond markets were also relatively restrained, although market participants became concerned that the prospect of stronger growth in both the United States and Japan later in the year might lead to rises in official interest rates. There were also concerns about overvaluation of US equities but the widely anticipated falls did not occur until July. The S&P index rose by 4% over the quarter. In Japan, the Nikkei 225 rose by a similar amount but, in contrast, the FT-SE 100 lost early gains and ended flat over the period.

In the derivatives markets, the OTC segment seems to have grown far more rapidly than the exchange-traded derivatives markets through 1995 and in the first half of 1996. This may reflect changes in the underlying structure of participation in derivatives markets with firms active in OTC portfolios and so having less recourse to exchange-traded products.

The stability of the bond markets (see Chart 1) was, in part, a reflection of the stable macroeconomic environment: short-term official interest rates in two of the three major regions remained the same. The Federal Reserve did not change short rates during the quarter, but with the publication of data indicating stronger growth in the US economy, prices in the US Treasury market drifted lower. The economic data, particularly the increase in non-farm payrolls reported on 7 June, led market participants to expect a rise in short-term interest rates of 50 basis points (as priced into the implied forward curve) by the autumn. The 30-year long bond traded as high as 7.193% in mid-June, but ended the quarter at 6.872%. In Japan too, rates remained unchanged; but bond prices were sensitive to market interpretations of official signals about when the next interest rate rise might be. By contrast, in Germany the Bundesbank cut the discount and Lombard rates by 50 basis points on 18 April, which was followed by similar cuts in other countries including Belgium and Canada. Deutsche Mark weakness dampened investor sentiment toward the government debt of countries with currencies closely associated with the Deutsche Mark, but the high-yield group of European currencies benefited, with the Italian BTP/German bund spread on a downward trend over the period. The long end of the Italian curve has been the best performing bond sector in the world since the beginning of the year[1] as investors also reacted positively to the election of the new government. In the United Kingdom, the authorities surprised the markets with a cut of 25 basis points in official rates on 6 June.

Chart 1
Ten-year government bond yields



Source: Bloomberg.

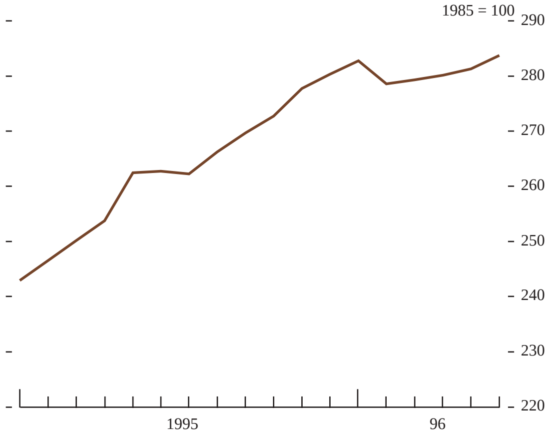
Emerging markets continued to be buoyant. The Salomon Brothers' Brady Bond index, which fell to 191 in March 1995 in the wake of the Mexico crisis, continued its steady rise and reached 312 in June, although there were some concerns in the market about credit risk after a state-owned Bulgarian bank defaulted.

Turnover was subdued in most of the bond markets, in part because of caution following losses sustained as a result of the bond market reversal in the first quarter. But the last

(1) Bloomberg EFFAS Italian 10+ years Total Return Index.

year has, overall, still been a good one for fixed-income investors (see Chart 2).

Chart 2
Salomon Brothers world government bond index



Source: Bloomberg.

Market participants report that far fewer investors are putting on ‘direction trades’—or positioning themselves for movements in interest rates generally—than in the past. Instead, many are becoming more focused in their risk taking. They eliminate much of the potential effect of rate changes on their portfolios by hedging, and concentrate instead on spread relationships or yield curve slopes, risks which they feel that they understand better.

Investors appeared increasingly to favour US dollar exposure in cash or bills over the quarter. Survey data(1) suggested that European investors increased the proportion of short-dated US debt in their portfolios during the period. The weakness of the Deutsche Mark may have been one reason, but professional investors may also have been reducing their US equity holdings, and substituting bonds and cash. Surveys of UK institutional investors and US mutual fund data suggest that institutional investors reduced their holdings of US equity—although retail inflows into equity mutual funds remained high. As the US equity market was seen as being fully valued, this may indicate that investors were positioning themselves for market falls.

Bonds

International issues

The second quarter saw strong gross issuance, whose patterns resembled the strong bull markets of last year—the higher-yielding issuers, particularly those from European and emerging markets, were well received by the markets. US and (particularly) Japanese official interest rates remain extremely low, so ‘search for yield’ remains a motivating factor for investors. The premium that must be paid by lower quality borrowers does not seem to move in line with the level of interest rates, so when rates are low the rates paid by such borrowers are more attractive to investors. There has been a sharp drop in the average maturity of international bond issues from the first to the second quarter for most categories of borrower, from 6.6 to 5.9 years (the average for the past ten quarters is 6.1 years). This may be a reflection of increased uncertainty about the future course of interest rates, as the prices of shorter maturity bonds are less sensitive to rate changes than those of longer-maturity bonds.

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

$ billions; by announcement date

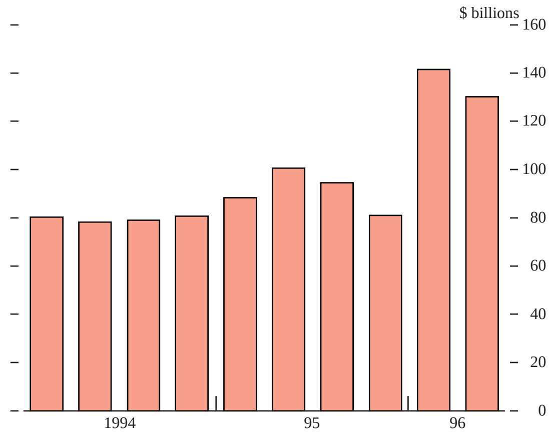
	1994 Year	1995 Year	1995 Q2	1995 Q3	1995 Q4	1996 Q1	1996 Q2
International bond issues							
Straights	320.2	378.4	91.9	100.2	97.7	146.7	124.6
Equity-related	35.4	24.1	7.6	7.7	5.8	12.2	15.1
of which:							
Warrants	*11.7*	*6.7*	*0.7*	*1.5*	*3.2*	*4.1*	*3.6*
Convertibles	*23.7*	*17.4*	*6.9*	*6.1*	*2.6*	*8.1*	*11.6*
Floating-rate notes	126.4	100.1	23.5	30.4	25.2	38.1	43.9
Total	**482.0**	**502.6**	**123.0**	**138.3**	**128.7**	**196.9**	**183.6**
Credit facilities (announcements)							
Euronote facilities	196.8	293.3	70.3	68.8	64.6	101.5	94.0
of which:							
CP (b)	*36.4*	*50.3*	*8.9*	*6.4*	*18.6*	*23.3*	*30.6*
MTNs	*160.4*	*243.0*	*61.4*	*62.4*	*46.0*	*78.2*	*63.4*
Syndicated credits	548.3	787.2	202.3	131.9	182.7	180.6	216.8
Total	**745.1**	**1,080.5**	**272.6**	**200.7**	**247.3**	**282.1**	**280.2**
Memo: amounts outstanding							
All international							
Bonds (c)	2,020.8	2,224.9	2,225.3	2,199.7	2,224.9	2,230.4	2,251.0
Euronotes (b)	378.7	595.2	517.1	555.8	595.2	647.5	710.9
of which, EMTNs	*259.4*	*461.0*	*397.5*	*426.4*	*461.0*	*504.6*	*555.0*

Sources: IFR, Euroclear, BIS.

(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.

Second quarter gross bond issuance was $183.6 billion (see Table A), only slightly less than the very high first quarter figure of $196.9 billion. Both of the first two quarters have a positive seasonal factor and on a seasonally adjusted basis they are even closer together at $178.5 billion for the first quarter, and $172.9 billion for the second. Part of the reason for this is that redemptions were unusually high during the first half of 1996 (see Chart 3), so refinancing accounts for some of the strength of issuance.

Chart 3
Redemptions of international bonds



Sources: IFR Omnibase; BIS.

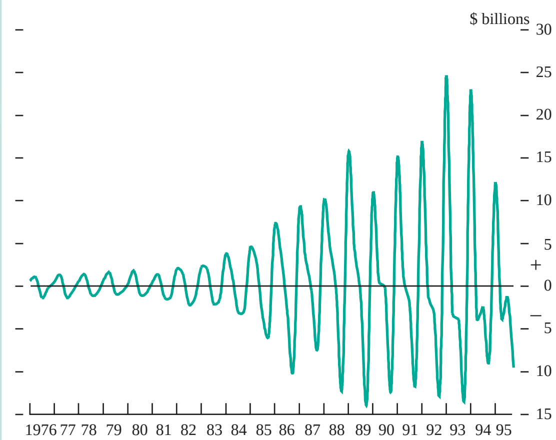
(1) Source: Merrill Lynch.

Seasonality in international bond and syndicated credit markets

It is widely recognised that prices and quantities in financial markets may be subject to seasonal fluctuations.(1) Although these effects vary in magnitude they are often a substantial proportion of the unadjusted flows in primary debt and credit markets each quarter. Clearly, in interpreting changes in bond issuance or bank credits, it will be important to adjust for these factors in order to get a better view of the underlying changes in market activity from quarter to quarter.

Preliminary research at the Bank has used standard econometric techniques to decompose time series on primary bond and credit issuance into trend, cycle, seasonal and erratic ('noise') components.(2) Chart A shows the absolute value of the estimated seasonal factors for international bond issuance based

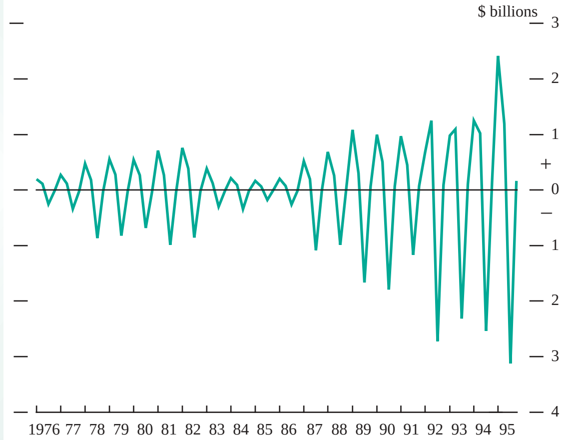
Chart A
Total international bond issuance: quarterly seasonal component



on a sample of quarterly data beginning in 1976. There have been some quite striking changes over time. Early in the sample—the mid to late 1970s—the seasonals were more evenly distributed between the first and second halves of the year—the former containing a seasonal boost to issuance and the latter a reduction. Over time, however, the effect seems to have become more concentrated in the first and final quarters of the year with much less seasonal effect in the second or third quarters. For example in the first quarter of 1995 an estimated 12% of the flow of international bond issues was seasonal while in the final quarter seasonal effects depressed issuance by around 8½%. So in broad terms the seasonal boost to issuance at the start of the year is roughly offset in the final quarter.

It is interesting to contrast these results with those for international syndicated credits, based on a sample of quarterly data beginning in 1976. Relatively speaking, the seasonal effects in credits have been much more stable and are substantially smaller in absolute terms over time. Although the unadjusted quarterly flows in credits are around half those in bonds, the average size of the quarterly seasonal component in syndicated credits is only $582 million, several times smaller than the comparable figure of $4,341 million in international bond issuance. The largest single effect in syndicated credits is a seasonal downturn in the third quarter which broadly offsets the combined upward effect in the first half (see Chart B).

Chart B
Total international syndicated credits: quarterly seasonal component

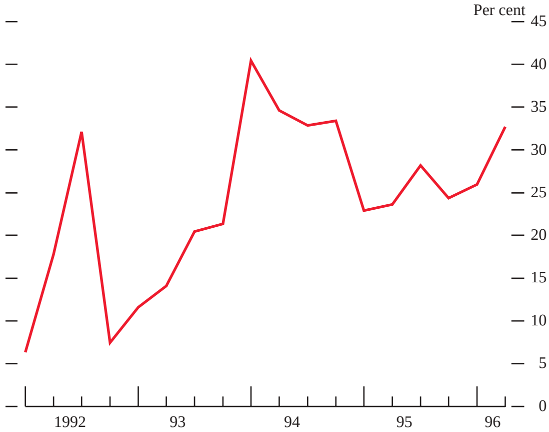


In both credit and bond markets the simplest intuitive explanation for these effects is a link to corporate (and possibly fiscal) accounting years. The start of the year usually appears to see a burst of activity with a decline towards the end of the year. Of course these results do not indicate which way causation goes. The beginning of the accounting year may see issuers' demand for finance rise with the supply of funds from investors adjusting passively to this. Equally, investors' willingness to supply finds may be actively managed through the year; in the second half of the year, for example, issuers might choose to delay an issue in the expectation that investor demand will rise in the first quarter. An interesting further source of seasonality may be financial intermediaries' willingness to take on business at different points of the year.

(1) See for example Fama, E (1991), 'Efficient capital markets: II', *Journal of Finance*, 46, pages 1,575–617.
(2) The results were estimated using a Kalman filter in the econometric package STAMP.

This quarter has seen a sharp rise (see Chart 4) in the proportion of international bond issues paying a floating-rate coupon (FRNs). Some borrowers wish to issue floating-rate debt because they need to finance floating-rate assets, and conversely some issuers like to buy FRNs because they have floating-rate liabilities. However, the size of these groups is unlikely to be much affected in the short term by market conditions. The current, rather unsettled markets are attractive for investors and issuers who take the view that the current yield curve and/or swap rates do not fully reflect their view of future interest rates. Such people can either issue or invest in FRNs if they take the view that future interest rate changes are not fully reflected in the price, or they can use the swap markets to acquire or dispose of floating-rate liabilities. As with all markets, the level of activity depends to some extent on different participants taking different views.

Chart 4
Ratio of floating-rate to fixed-rate eurobonds



Sources: Bank of England ICMS database; IFR Omnibase.

Asset-backed securities

There has been a record volume of international asset-backed security[(1)] (ABS) issues over the past year, which is a continuation of a longer-term trend. Gross issuance this quarter was $26.2 billion, compared with $32.6 billion in the whole of 1995.

It was not until the last quarter of 1994 that the number of issues in this market exceeded 15. This quarter, there were 43. There has been a superficial shift in the composition of issuers from financial institutions to corporates, but this does not reflect a change in the nature of the borrowing activity as industrial and commercial companies often issue through wholly-owned financing vehicles (which are nominally financial companies). In either case the real borrower is the originator of the underlying assets. It remains the case that international ABS is predominantly US borrower, US dollar-denominated paper. Market growth has been motivated by a growth in the corresponding domestic market in the United States and by an acceptance of the instrument by international investors (domestic ABS in Japan have only been authorised this year).

Currency of issuance

Among the G3 currencies, which always account for the majority of eurobond issues, the dollar appreciated against the Deutsche Mark, and traded in a range against the yen. The dollar's share of gross international issuance rose to 47% this quarter, up from 37% in the same quarter last year (see Table B). The yen's share fell over the same period, from 23% to 14%. Deutsche Mark-denominated bonds' share of issuance, which has fluctuated somewhat during the past year, fell sharply this quarter to 9%, from 16% last quarter. The French franc share continued to recover from its low of 1.7% in the third quarter of last year, when it reached 6.4% this quarter.

Table B
Currency composition of international bond issues

Per cent

	1994	1995				1996	
Currency denomination	Year	Year	Q2	Q3	Q4	Q1	Q2
US dollar	38.4	39.2	36.7	40.8	42.2	38.8	47.4
Yen	17.2	18.4	22.8	19.1	17.2	11.9	14.1
Deutsche Mark	10.9	13.9	16.4	11.7	15.0	16.0	9.2
Sterling	6.5	4.3	4.0	3.5	4.3	7.5	5.9
French franc	5.4	2.7	2.9	1.7	2.3	5.8	6.4
Swiss franc	4.5	6.1	5.8	6.8	5.3	4.5	3.3
Italian lira	3.6	2.4	1.6	1.5	1.7	2.8	4.4
Ecu	1.6	1.8	0.2	2.7	0.2	0.8	0.2
Other	11.9	11.2	9.6	12.2	11.8	11.9	9.1
Total (US$ billions)	**482.0**	**502.6**	**123.0**	**138.3**	**128.7**	**196.9**	**183.6**

Source: IFR Omnibase.

Sterling issues

Sterling's strength (even after the 25 basis point cut in UK official rates on 6 June) and attractive yield spreads over European bonds, notably against German short dates, led to increasing demand for sterling assets over the quarter. This encouraged further substantial issuance of sterling bonds, many of which were targeted at continental retail investors. Total fixed-rate issuance in the quarter was £4,833 million, of which £2,575 million was short-dated, £1,478 million was medium-dated, and £780 million was longer-dated, including two perpetual issues of £100 million each. Almost all of the fixed-rate issuance, totalling £4,753 million, was in Eurosterling form, with just one domestic debenture issue for £80 million.

There was a broad range of fixed-rate issuers, almost half of which were overseas. UK corporations raised £1,328 million in short and medium maturities, while issues of longer-term bonds were favoured by UK financial institutions, including 10 and 25-year issues for the Halifax and a 20-year issue for Commercial Union. Halifax's £300 million 25-year subordinated debt (ranking as Tier 2 capital) was particularly well received—the issue was oversubscribed and the spread over gilts narrowed sharply in secondary market trading—reflecting built-up demand from institutions for strongly rated issuers after a lull in supply of longer-dated paper. Overseas issuance was predominantly in short-dated paper for European banks but other issuers

(1) Asset-backed securities do not include mortgage-backed securities here.

included overseas sovereigns, corporates and other public sector bodies. Brazil's £100 million three-year bond was the first Latin American credit since Pemex in 1993.

With the uncertainty over the direction of UK and overseas interest rates continuing, floating-rate note issuance was also substantial in the second quarter at £2,359 million. FRN issuance is normally dominated by bank and building society names but, with spreads tightening on such paper, a wide range of issuers, both UK and overseas, was warmly welcomed by FRN buyers eager to pick up Libor-plus yields. Four of these issues were structured, giving the issuer a call or step-up option after a certain period, so as to allow a play on the steepness of the UK yield curve. FRN issues in the quarter also included £309 million of asset-backed securities, variously secured on mortgages, car and consumer loans. As with international issues (see above), sterling asset-backed securities have been growing owing to the tightening of credit spreads and increasing investor participation.

Despite the abundant supply of sterling issues, demand for sterling paper saw secondary market spreads over gilts narrow over the quarter, as narrower spreads in short-dated issues fed through to longer-dated paper. Indeed, certain sovereign issues have traded through gilts. Demand related to corporate bond PEPs continued through April but subsequently slowed. However, the market was also supported by bond buy-backs by SBC Warburg (of its 9% perpetual) and New Zealand (of its 2008 and 2014 bulldog issues).

Total outstanding sterling commercial paper fell to £6.7 billion by the end of the quarter, £555 million lower than the revised end-March level of £7.3 billion. Outstanding sterling medium-term notes rose by £765 million to stand at £17.9 billion at end June.

ECU issues

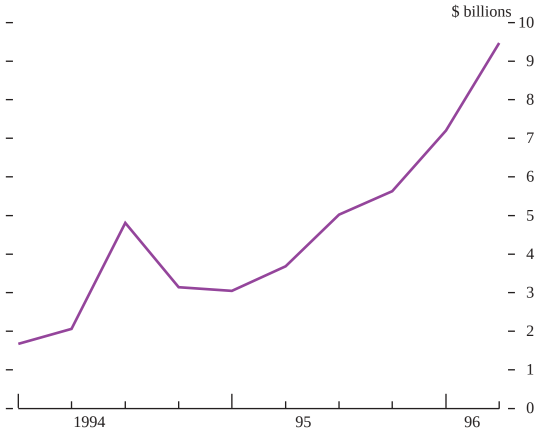
In the United Kingdom, regular monthly tenders of ECU 1 billion of Ecu Treasury bills continued during the second quarter of 1996, comprising ECU 200 million of one-month, ECU 500 million of three-month and ECU 300 million of six-month bills. The tenders continued to be strongly oversubscribed, with issues being covered by an average of 2.1 times the amount on offer, compared with an average of 2.4 times during 1995. Bids were accepted at average yields between 4 and 11 basis points below the Ecu Libid rate of the appropriate maturity. There are currently ECU 3.5 billion of Treasury bills outstanding which have been sold to the public. Secondary market turnover in the second quarter averaged ECU 2.1 billion per month, up from ECU 1.9 billion of average monthly turnover in the first quarter, but slightly lower than the ECU 2.2 billion average level in 1995.

On 16 April, the Bank of England reopened the Ecu Treasury note maturing in 1999 with a further tender for ECU 500 million, raising the amount outstanding with the public of this note to ECU 1.0 billion. There was strong cover at the auction of 3.4 times the amount on offer and accepted bids were in a range of 5.29%–5.33%. The total of notes outstanding with the public under the UK note programme thus rose from ECU 5.0 billion to ECU 5.5 billion.

Samurai market

Although it is still small in absolute terms compared with the whole market for international bonds, gross issuance in the Samurai market has been very strong, reaching US $9.5 billion this quarter. Chart 5 shows that this is double the level for the same quarter last year, and 2.5 times greater than the second quarter of 1994.

Chart 5
Gross Samurai issuance



Source: IFR Omnibase.

The Samurai market has been a microcosm of the international capital markets more generally over the last couple of years. The search for yield has been particularly strong from Japanese retail investors because absolute government bond yields have been lower there than in the other major economies. There has been strong demand for high yielding assets such as emerging market bonds (though surprisingly, emerging markets share of Samurai issuance has remained stable since the second quarter of 1994, at around 45%).

Note markets

EMTN markets continued to be active, with issuance of $63.4 billion. Commercial paper (CP) announcements have surged over the past three quarters, reaching $30.6 billion. This quarter saw some large CP issues from Cades, the French body set up to refinance social security debt. It issued CP in the French domestic market,(1) euromarkets, the US market and set up a global commercial paper programme—all of which totalled FFr101 billion.

Borrowers

While government bonds dominate domestic markets, banks and (non-financial) corporates are the biggest classes of

(1) The instruments issued in the domestic market were Billets de Trésorerie.

borrower in the international and eurobond markets. Banks are the biggest borrowers in the eurobond market—their share of gross eurobond issuance has risen this quarter to 41%, up from 33% a year ago—but corporates predominate in the foreign bond markets. Adding together eurobonds, global bonds and foreign bonds, banks accounted for 39% and corporates for 35% of issuance this quarter. German banks, which have been by the far the largest bank issuers for some time, made up 37% of gross eurobond bank issuance.

Emerging markets

Emerging market issuance was strong this quarter, as it has been since the middle of 1995. The resurgence of emerging market issuance so soon after the December 1994 Mexican Peso crisis surprised some. However, two factors explain the resurgence. First, with nominal yields so low in the major markets, the higher yields offered by emerging markets were attractive to investors, despite the higher risks that they entail. This effect will weaken if, as macroeconomic data suggest is likely, interest rates in the G3 rise. Second, there has been an increasing differentiation between emerging markets, with perhaps more attention paid to economic fundamentals. As with the euromarkets in general, an additional reason for high gross bond issuance in this sector in the first quarter is the high redemption levels of this year, when $12.4 billion of Latin American eurobonds alone will mature. The picture has not been uniformly rosy for emerging market issuers. The Mexican Brady bond swap was highly successful, but South African Rand-denominated assets did not perform as well as some others.

Central and eastern European countries continue to develop their access to the markets. The region issues far less debt than Latin America, and the series is volatile, varying (quarterly) between zero and 17% of emerging market issuance over the last three years. However, these countries are increasingly accessing international capital, for example Romania issued its first eurobond during the quarter. A number of corporates from the region are planning substantial equity issues in the second half of the year, and with the launch this year of several new equity funds dedicated to the region there is likely to be substantial demand for such issues. The performance of this region's debt has not been uniformly good though, reflecting the wider emerging market situation: for instance, an 80% state-owned Bulgarian bank defaulted on a Samurai issue. It may be some time before we can see how this will affect investor attitudes to other emerging market assets.

A number of structural and regulatory developments have accompanied the market development of central and eastern European assets. IBCA and S&P promoted Poland to investment grade this quarter. This follows recent upgrades for the Czech Republic and Slovenia. Also, the Czech authorities passed laws reforming the regulatory structure of their markets, with stricter rules on disclosure and greater protection for minority shareholders. International capital is needed in this region to supplement domestic capital in order to finance high growth, and so there is a strong incentive to liberalise capital markets along G7 models (the Czech Republic, Poland and Hungary all joined the OECD this quarter). Indeed, some countries have been so enthusiastic about setting up safe capital markets that they may have overregulated. The Warsaw stock exchange is one institution that is simplifying regulations, such as those governing disclosure.

Benchmarking in the global bond markets

Investors usually price bonds in reference to a baseline, or 'benchmark', because a relative price rather than an absolute one gives them the additional information they need, given their existing knowledge of what underlies the benchmark price. This is normally a bond issued by a high-quality borrower (ie with little or no credit risk), although an index of such bonds can serve the same purpose. One of the most commonly used is the US Treasury bond. So if a ten-year corporate Yankee yields 9% and a ten-year US Treasury bond yields 7%, the Yankee's yield is '200 basis points over Treasuries'. In this example, 200 basis points is a good proxy for the default risk of the corporate. 1996 has seen a number of new assets which will serve as benchmarks and facilitate the pricing of issues in their sector.

- The French Trésor has launched a constant maturity price index which will help all issuers price and issue mid-curve debt. The TEC10 index (Taux de L'Echeance Constante Dix Ans) gives the yield on a theoretical ten-year French Treasury Bond ('OAT'). There is a US equivalent—the Constant Maturity Treasury. The issuance of a floater paying the TEC10 earlier this quarter will reinforce the index as a benchmark.

- The US authorities plan to issue inflation index-linked bonds before the end of the year. These should provide a global benchmark for real interest rates.

- One effect of the German authorities' decision to increase issuance of short-term debt will be to deepen that part of the yield curve, making it a better reference rate (though there is currently a large amount of government debt outstanding with a short residual maturity).

- In August 1995, the Asian Development Bank issued a seven-year Taiwanese dollar bond, and were quite explicit in their motivation: 'There is no doubt we would like to develop a yield curve in the Taiwan dollar market'. This is an increasingly common strategy for emerging market authorities who want to facilitate borrowing in new markets or at longer maturities.

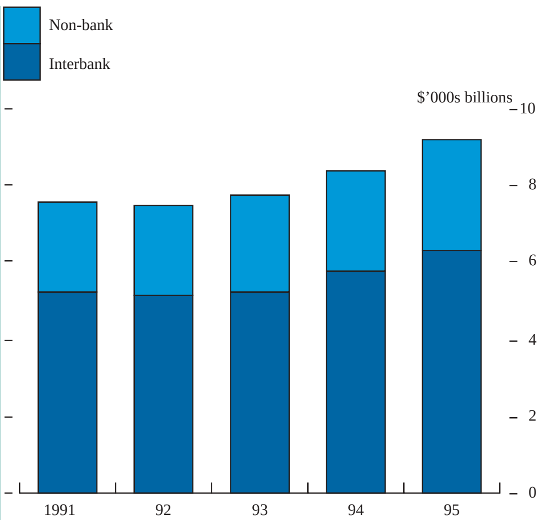
Developments in international banking in 1995

This box summarises developments in international banking in 1995: the first section looks at global trends, as revealed by quarterly statistics published by the Bank for International Settlements (BIS); the second section focuses on developments in the UK market, using the Bank's own data.

Banking business within the BIS reporting area(1)

International lending by banks in the BIS reporting area grew at a faster rate in 1995 than in the previous two years. It rose by $652 billion(2) (8%), to an outstanding stock of $9,224 billion(3) (see Chart A). Almost half of the increase in business occurred during the first quarter and was related to the turbulent condition in foreign exchange markets. Lending between banks accounted for $6,347 billion (69%), an increase of $405 billion (7%) compared with 1994. In contrast to the previous year's fall, lending to non-bank end-users increased by $247 billion (10%).

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 fifth consecutive year, and at a stronger rate than in previous years (see Table 1). The developing economies of the Asian region were again the main recipients of the new lending. An increase of $84 billion to that region was dominated by increased lending to Thailand and South Korea of $36 billion and $22 billion respectively. There were also large increases in lending to China ($10 billion) and Indonesia ($9 billion). Lending to non-BIS area developed countries also rose significantly (by $24 billion), with Portugal and Greece being the main recipients of this new lending ($8 billion and $5 billion respectively).

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

$ billions

	Exchange rate adjusted flows					Stocks at
	1991	1992	1993	1994	1995	end-1995
Total lending	**7**	**66**	**11**	**37**	**108**	**994**
of which:						
Developed countries	—	7	5	-1	24	189
Eastern Europe	-1	4	-4	-13	3	87
Latin America	-1	15	3	2	7	237
Middle East	-8	16	-5	3	-7	75
Africa	-4	-1	-2	-2	-3	38
Asia	21	26	15	48	84	368
Total deposits	**-12**	**13**	**-18**	**75**	**92**	**896**
of which:						
Developed countries	-3	11	10	22	23	177
Eastern Europe	1	10	3	2	9	47
Latin America	-2	-2	-7	21	35	194
Middle East	-12	-7	-20	3	9	204
Africa	—	3	—	3	-1	42
Asia	4	-1	-4	23	18	232

Source: BIS.

Totals may not sum due to roundings.

Deposits from countries outside the BIS reporting area also continued to increase strongly during 1995, by $92 billion. The increased deposits were mainly from Latin America ($35 billion), non-BIS area developed countries ($23 billion) and Asia ($18 billion). Within these regions notable increases were reported from Brazil ($22 billion), Portugal ($7 billion), Argentina ($5 billion), Mexico ($4 billion) and Thailand ($4 billion).

Analysis by nationality of bank

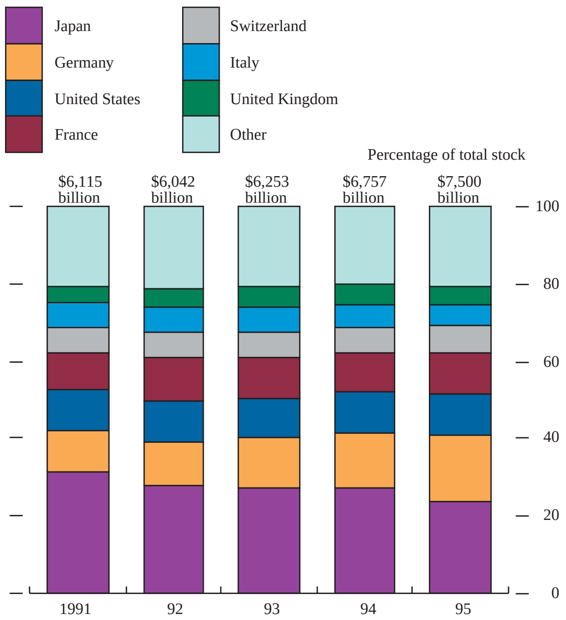
Although Japanese-owned banks remained the largest lenders of funds within the BIS reporting area, with 24% of international bank assets (see Chart B), their market share fell (from 27% in 1994). German-owned banks, the second largest group in terms of international business, increased their share to 17% from 15% in 1994. British-owned banks' share of business remained at 5%.

Analysis by centre and currency

The United Kingdom retained its position as the leading centre for international bank lending (comprising foreign currency business within the United Kingdom as well as cross-border claims) during 1995. Outstanding

(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 data 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
International bank assets by nationality of bank(a)

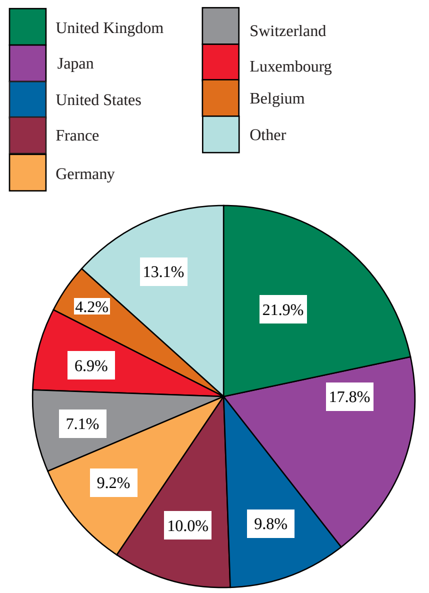


Source: BIS.

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

cross-border loans by banks located within the BIS industrial area amounted to $6,156 billion at the end of 1995; as Chart C illustrates 22% of this was lent by banks in the United Kingdom ($1,350 billion, up by 13% compared with 1994).

Chart C
Cross-border lending transacted by banks within the BIS industrial area(a)



Source: BIS.

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

The amount of foreign currency lending in the United Kingdom also increased, by $30 billion to $353 billion. Within the BIS industrial area, cross-border lending in Japanese yen increased strongly for the second consecutive year (by $158 billion or 21%). Cross-border lending in French francs and Deutsche Marks rose by $46 billion (19%) and $22 billion (3%) respectively, in each case following falls in the previous year. Lending in ECU continued to fall (by $14 billion or 9%).

Analysis of international business by banks in the United Kingdom

Cross-border lending by banks located in the United Kingdom rose for the fourth consecutive year but at a slower rate than in 1994 (see Table 2). German-owned banks remained the most active (their business increased by $40 billion). American and French-owned banks' business also increased while Japanese-owned banks' business fell for the first time in three years. British-owned banks' business increased slightly following the previous year's fall. Transactions in yen rose strongly (by $30 billion or 28%). Lending in Deutsche Marks also rose (by $19 billion or 8%). As in recent years most of the new funds were lent to countries in the BIS reporting area (up $74 billion), and to Germany in particular (up $31 billion) in 1995. Lending was comparatively strong to non-BIS area developed countries (up $11 billion), most notably to New Zealand ($2 billion), while lending to Asian countries continued to increase (up $4 billion). Banks in the United Kingdom continued to increase the amount of business they undertook with countries in the European Union in 1995. Lending to EU countries rose by $43 billion (9%), almost the same amount as in the previous year, and again mainly attributable to Germany, while deposits from EU countries rose by $13 billion (3%), only half the rate of the increase in 1994.

Table 2
External lending of banks in the United Kingdom

$ billions

	Exchange rate adjusted flows					Stocks at
	1991	1992	1993	1994	1995	end-1995
By country						
BIS reporting area	-44	78	36	89	74	1,143
Outside reporting area:						
Developed countries	-1	3	1	—	11	45
Eastern Europe	-3	-2	-1	-2	2	10
Latin America	2	-1	3	-1	-4	24
Middle East	-2	3	1	1	1	14
Africa	-1	—	-1	-1	—	4
Asia	1	3	2	3	4	26
Other	3	-3	15	13	-9	84
Total	**-45**	**81**	**56**	**102**	**79**	**1,350**
of which:						
By currency						
US dollar	-52	38	-10	67	7	572
Deutsche Mark	-5	32	18	11	19	228
Sterling	-10	25	15	1	7	112
Yen	-30	-31	-12	8	30	106
ECU	1	4	3	-9	-2	38
By nationality of bank (a)						
Japanese	-57	-44	1	11	-29	243
British	-3	24	44	-2	4	217
German	5	33	23	46	40	271
American	2	4	7	27	16	148
Italian	2	4	-9	-1	-1	72
French	2	13	-1	—	13	60

Totals may not sum due to roundings.

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

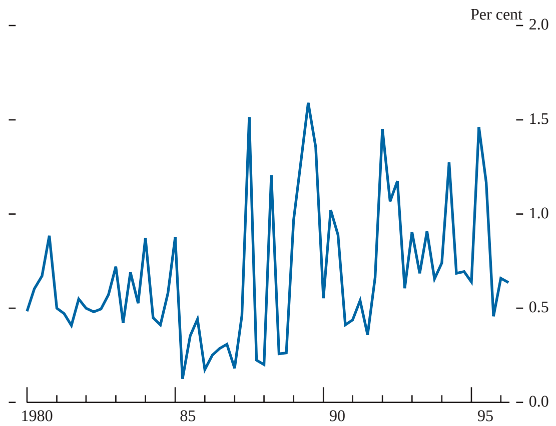
International syndicated credits

Syndicated credit announcements have risen and spreads are reported to have stopped falling. Announcements this quarter totalled $216 billion, up 20% on last quarter, but only 7% higher than for the same quarter last year. Syndicated credit announcements have also risen relative to bond issuance: loan announcements were 92% of bond issuance last quarter, but 118% this quarter. This has occurred despite issuers and investors substituting floating-rate bonds for syndicated credits (these loans are almost always priced on a floating-rate basis).

Of the syndicated credits announced this quarter, 64% were denominated in dollars, down from 84% in the second quarter of last year. Sterling and the French franc have gained ground, together making up 24% of this quarter's announcements, up from 6% in the same quarter last year. The change in currency composition was mirrored in changes in the nationality of borrowers. Over the past ten quarters, US borrowers have made up 55% of all borrowers, but only 40% this quarter. British and French borrowers have averaged 13% of borrowers over the same period, but almost doubled their representation to 24% this quarter. French borrowing was boosted by Cades' FFr40,000 million (US $7.8 billion) loan.

Chart 6 shows size-weighted spreads on syndicated loans to US borrowers. The picture is far from clear, but there is little evidence for a continuation of a downward trend. The general low level of spreads is indicative of the degree of competition in this market, and also of the fact that, for many banks, this business is to some extent a loss-leader which they attempt to use to gain more profitable business in other areas.

Chart 6
US borrowers' size-weighted spreads

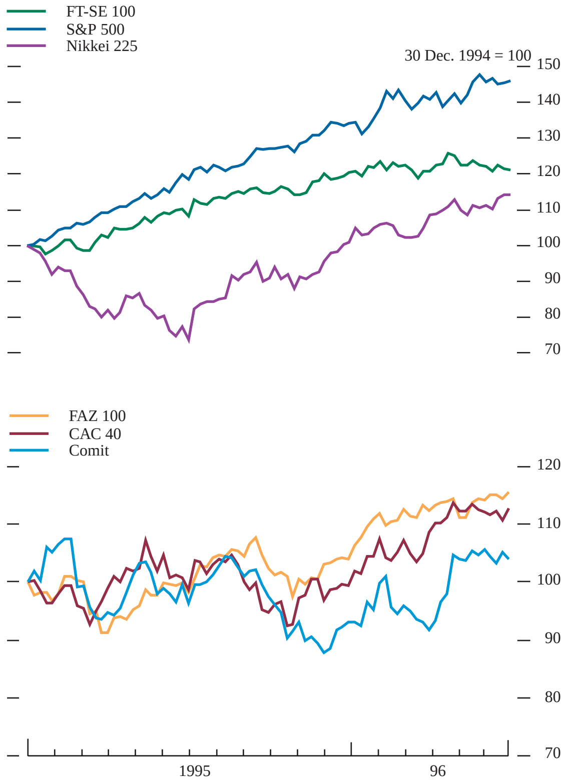


Equity markets

Prices

Despite widespread speculation that US equity markets were due for a correction, prices continued to rise during the second quarter. The Standard and Poor's 500 index rose by 3.9% (see Chart 7); technology stocks were particularly

Chart 7
Equity indices[a]



(a) End-week prices; data to 28 June 1996.

strong, as indicated by a rise of 7.6% in the NASDAQ composite index. Strong earnings reports, particularly from NASDAQ companies, underpinned prices. By the end of the second quarter, the S&P index had risen by nearly 9% after a rise of over 34% in 1995 but equity prices became increasingly vulnerable to increases in bond yields over the second quarter. Latin American equities, helped by the growing US market but further boosted by their own improving economic prospects, rose strongly over the quarter, the Brazilian equity market climbing by 22% and the Argentinian market by 19%.

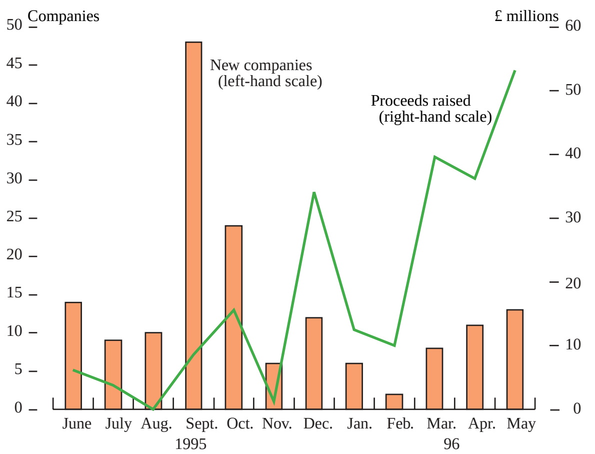
The Japanese equity market continued its upward momentum during the second quarter, to achieve levels last reached four years ago. The Nikkei index rose by 5.3% over the quarter. There was little evidence of sustained selling pressure despite continued concern over the state of the Japanese financial sector, and buying was fuelled later in the quarter by a strengthening in the dollar against the yen, with support from foreign investors evident. Taiwanese equity prices climbed nearly 30% during the quarter, with strong foreign demand a major contributing factor, and Indian equity prices rose by 13%; other Asian markets, however, were relatively subdued.

The UK equity market continued to be influenced by political uncertainties, the FT-SE 100 index rising only 0.3% between the end of March and the end of June. Takeover speculation, very much a feature of recent months, waned slightly in the spring; though utility stocks were in focus. Early in the quarter, as the New York equity market

The alternative investment market

In the twelve months since the alternative investment market (AIM) went live, on 19 June 1995, the number of companies traded has increased from 10 to 166 (see Chart A).

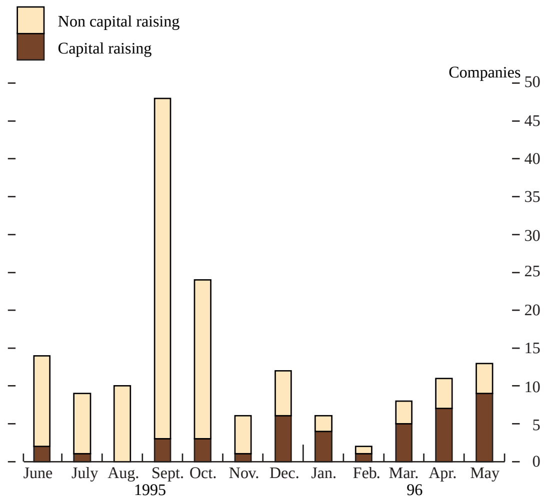
Chart A
New companies and capital raised on AIM



After just six months AIM had reached a critical mass of 121 companies; however, at least two thirds of these were previously traded on Rule 4.2—the Stock Exchange occasional deal facility—and were, therefore, non capital raising introductions. While only one in ten of the companies joining AIM in its first six months raised capital on admission, two thirds did so in the second six months (see Chart B). While the transfers from Rule 4.2 may have disguised the true level of activity on the market, it did give the market a valuable momentum which appears to have continued.

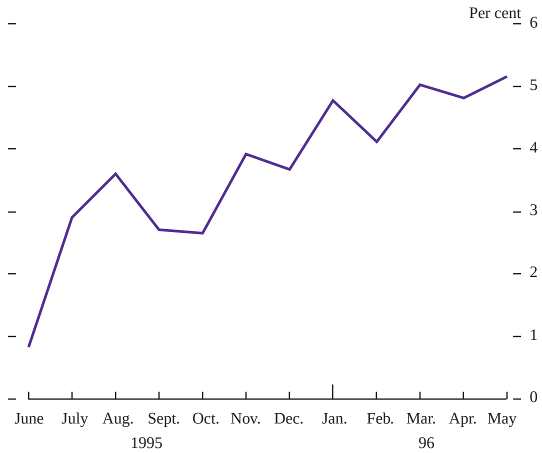
Not surprisingly, turnover on AIM has increased month on month as the number of companies trading has grown (see Chart C). However, turnover velocity (turnover as a percentage of market capitalisation) has increased over the last twelve months, indicating an increasingly liquid market. If turnover in May is annualised, annual velocity on AIM is 62%, which compares favourably with the USM where annual velocity in 1982 was 56% (turnover velocity peaked in 1987 at 80%). The increasing liquidity on the market has attracted more firms to make markets in AIM stocks.

Chart B
Admissions to AIM



The increasing number of firms willing to make markets in AIM stocks is encouraging for this market. From only three registered market-makers at its inception, there were eight by the end of May. 63% of AIM companies now have at least two market-makers quoting prices for their stocks.

Chart C
Turnover velocity on AIM



The increased capital-raising activity and liquidity levels on the market indicate the increasing maturity of AIM which has consolidated its strong start. While it is still too early to say with confidence that AIM could overcome a downturn in the market or economy, as it becomes more established it is in an increasingly strong position to overcome any such disturbances.

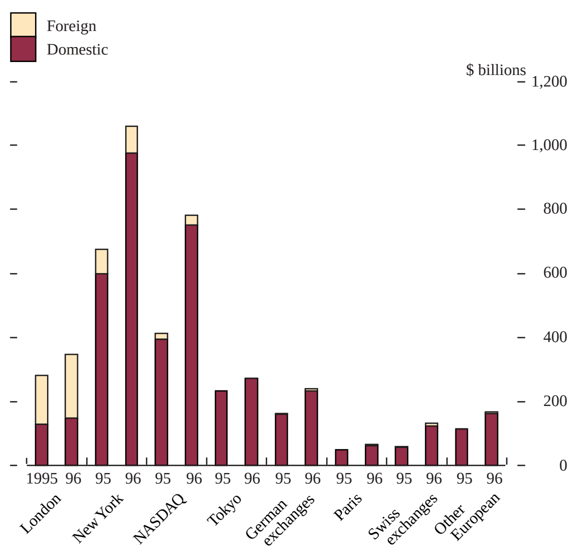
weakened, there was reported to be some switching of funds out of the United States and into the United Kingdom, helping to drive the FT-SE to a record high of 3857.1 on 19 April. But the cut in UK base rates on 6 June was not widely expected and equity prices responded in a muted manner, with traders worried that the move had been politically, rather than economically, motivated. Prices drifted lower toward the end of the quarter.

All of the other European equity markets, less restrained by political uncertainties and assuming a better chance of interest rate reductions, were stronger than the UK market. The Italian equity market showed particular strength, the Comit index rising by 13.2% over the quarter as a new government, in which the financial markets had confidence, was appointed. The German equity market rose 3% in low turnover, helped by a 50 basis point reduction in the discount and Lombard rates on 18 April, and with exporters boosted by a weakening in the Deutsche Mark against the dollar. The stronger dollar helped the French equity market too, the CAC 40 index rising by 3.9% over the quarter. The Netherlands market reached a series of record highs, rising by 5.4%. Scandinavian markets continued to show strong rises, underpinned by foreign investor interest.

Turnover

Equity market turnover, which has seen large increases in recent quarters, continued to rise worldwide in the first quarter of this year (see Chart 8). US turnover increased very sharply, with the value of equities transacted on NASDAQ nearly double that of the first quarter of 1995 and New York Stock Exchange turnover up by two thirds. Turnover of domestic equities on the London Stock Exchange in the first quarter was 20% higher than for the first quarter of 1995. Turnover of equities in Tokyo increased by 35%. Continental European equity markets continued to increase their volumes substantially, with Swiss turnover particularly striking, more than doubling between 1995 Q1 and 1996 Q1. But this does not appear to have been at the expense of London where foreign equity turnover rose by 40%.

Chart 8
Turnover of domestic and foreign equities on major stock exchanges(a)



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

Turnover of equities on Tradepoint totalled £64 million in the second quarter, compared to £86 million in the first. This represents only 0.1% of UK customer equity business.

Equity issuance

International

International equity issues increased in the second quarter of 1996, in contrast to the low level of issuance activity in 1995 and a relatively quiet beginning to the year; although at $11.9 billion in the first quarter of 1996, international equity issuance was more than double issuance in the corresponding quarter last year. High levels of institutional investor liquidity explain, in part, the oversubscribing of recent issues; and the full calendar in the first half of the year may be an attempt to tap that liquidity before it is absorbed by the Deutsche Telekom issue, scheduled for November this year. Almost all European governments are seeking to privatise state assets this year—including those that were withdrawn last year.

Latin American issuers appear to be taking advantage of the renewed investor confidence in emerging markets. However, there remains some evidence of caution on the part of issuers—offers have, for example, been quite heavily discounted—and investors, where interest appears to be coming from specialised Latin American funds.

United Kingdom

In the second quarter of the year, £2.2 billion was raised in further equity issues by UK companies, of which £1.6 billion was raised in rights issues.

Eighty companies joined the Official List this quarter, of which 67 raised capital totalling £4.3 billion. Commentators have suggested that issuers are trying to bring their companies to the market before speculation about the election unsettles the stock market.

Thirty-nine companies joined AIM this quarter raising a total of £181 million.

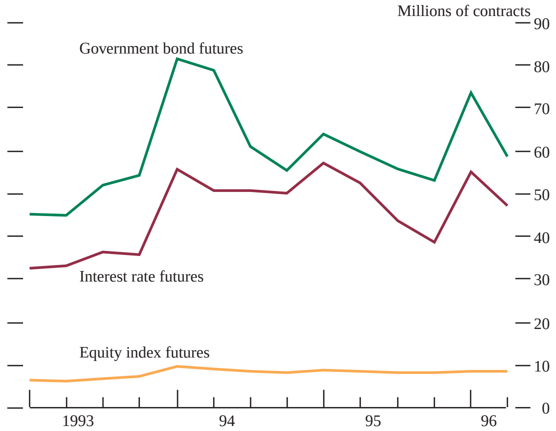
Other developments

On 29 May, the London Stock Exchange issued a further consultation document, 'New electronic trading services —proposal for the introduction of a public limit order book', setting out its plans for an electronic order book for FT-SE 100 stocks. The Exchange proposes the introduction of Registered Principal Traders which would, like the current market-makers, take on obligations designed to ensure liquidity in the market; and that these traders should be exempt from stamp duty on all their transactions in UK equities. The Treasury issued a press notice on 23 May in which the Chancellor indicated his support for the principle of such an exemption but asked the SIB to advise him on what obligations would be appropriate.

Derivatives markets

Turnover on the major derivatives exchanges in the second quarter of 1996 was generally lower than in the first quarter (see Chart 9). Rather than representing a downturn, however, this should be seen more as a reflection of the high level of exchange-traded activity in the first quarter of the year, which was associated with the short-term turbulence in the bond markets. Volumes on several exchanges in the second quarter showed some growth over the equivalent period in 1995.

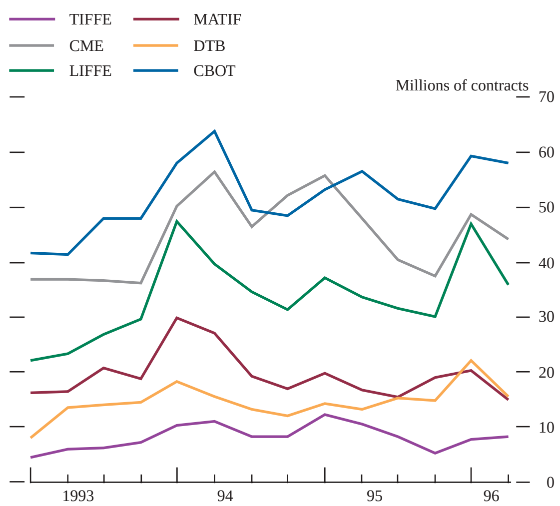
Chart 9
Quarterly turnover on futures by type[(a)]



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

Total volumes on the London International Financial Futures and Options Exchange (LIFFE) fell by 23% from the first quarter to the second, with declines evident in most contracts (see Chart 10). This was particularly apparent in the case of LIFFE's Bund contract, which saw a 31% fall, although it remained Europe's most actively traded bond contract. Volumes in the short-sterling and long-gilt futures contracts both declined by over 25%. However, open interest on LIFFE fell by only 2%, and increased on both the long-gilt and short-sterling contracts.

Chart 10
Quarterly turnover on major derivatives exchanges



Turnover on the Deutsche Terminborse (DTB) fell by 29% from the first quarter to the second, whilst volumes on the Marché à Terme International de France (MATIF) fell by 25%. The DTB remains Europe's second largest derivatives exchange. Increasing numbers of firms have now installed remote DTB terminals.

In the United States, volumes on the Chicago Mercantile Exchange (CME) fell by 9%, while those on the Chicago Board of Trade (CBOT) fell by only 2%. The CBOT's small overall decline was in part attributable to the strong performance of its agricultural contracts during a period of irregular weather conditions, in particular during April.

In East Asia, turnover on TIFFE increased by a moderate 8%, although it was still over 20% lower than a year earlier.

The London Metal Exchange's (LME) copper market experienced great volatility in the latter part of the quarter, which was associated with the departure of Sumitomo Corporation's chief copper trader, Yasuo Hamanaka, and the announcement on 13 June of losses of $1.8 billion—which Sumitomo attributed to unauthorised trading by Hamanaka. The sizable cash price premium over the three-month price (backwardation) led to suggestions that Hamanaka may have been attempting to manipulate the market. The three-month price of copper fell by 25%, between early May and early June. At the LME's request, the SIB has instituted a review of its markets and their regulation; investigations into Sumitomo's losses are also in train.

A number of Japanese exchanges, notably TIFFE, have now added their names to the Memorandum of Understanding, designed to promote improved information sharing, which 49 other exchanges and regulators had signed at the international regulators' conference at Boca Raton, Florida, in March.

As a move towards a full merger, shareholders of the London Commodity Exchange (LCE) voted unanimously to amend the exchange's constitution to allow LIFFE to purchase all LCE's shares; LIFFE also changed its Articles of Association at its AGM to allow the merger to proceed and a prospectus has now been issued.

The London Clearing House has also unveiled its restructuring plan in which ownership will transfer from six UK clearing banks to the clearing house's clearing members and the four exchanges for which it clears. The proposals will increase backing for the clearing house. Share capital will be increased from £15 million to £50 million; the £150 million back-up provided by the shareholder banks will be replaced by a £150 million Member Default Fund and an insurance tranche for £100 million, which is in place for three years initially. It is hoped that the new arrangements will be in place by October.

OTC derivatives markets

Indications are that volumes in the OTC markets in the first half of 1996 were high when compared with 1995. This reportedly reflects a growth in activity by end-users—whose confidence in their understanding of these markets is gradually being restored—and favourable market conditions. There is said to have been a change in end-users' use of derivatives, from liability management to asset management. One factor behind this could be the low and stable interest rate and inflation environment.

The latest International Swaps and Derivatives Association (ISDA) survey suggested that the OTC derivatives market grew substantially in 1995. Notional amounts outstanding in interest rate swaps, interest rate options and currency swaps stood at $17.7 trillion at end 1995, up 56.7% on the end 1994 figure. Turnover in these instruments also increased, totalling $11.2 trillion in 1995, up 37.3% on the 1994 figure.(1) As a comparison to the growth in the OTC markets suggested by the ISDA survey, open interest in thirteen major futures contracts grew by 4.4% year on year to $4.7 trillion at end 1995.

Most volume is still in plain vanilla products. The more complex 'structured products', which bore the brunt of end-user concerns about these markets, are increasingly tailored to the economic needs of the end-users rather than being standardised, and the core firms have increasingly sought to offer end-users advice and assistance in managing the financial risks inherent in their balance sheets rather than merely selling 'off the peg' solutions. Newer products —such as credit derivatives and insurance derivatives—are still uncommon.

Indications are that bid/offer spreads in the OTC derivatives markets remain very tight on plain vanilla products and are tightening on structured products. Despite the tightness of spreads—which partly reflects the entry to the market of several new firms—profitability is reportedly higher, reflecting the higher volumes. However, market entry and tighter spreads has reportedly meant that brokers are being increasingly squeezed out of the market. Attention continues to be given to bilateral credit exposures with the consequence that firms are increasingly using collateral in derivatives transactions.

As mentioned above, OTC volumes have reportedly been high throughout the first half of 1996 but exchange-traded volumes have decreased in the second quarter. There are several possible hypotheses concerning these developments: end-users may be switching to using OTC derivatives because they increasingly want tailored rather than standard products to match exactly assets and liabilities; the type of OTC products which have seen substantial growth (such as those enabling agents to take views on EMU) may be better hedged in the cash market rather than in the exchange traded derivatives market; and market participants may be increasingly comfortable with the level of risk in the OTC market because of, for example, the increased use of collateral and therefore are switching away from exchange-traded derivatives to take advantage of the flexibility offered by the OTC market where spreads are lower than they were previously. However, it is too early to say whether any longer-term change in trends may be emerging in terms of the relative size of OTC and exchange-traded business.

(1) These data are not directly comparable with the results of the 1995 central bank survey of OTC derivatives markets which covered a wider range of instruments and market participants and included arms-length internal transactions. See 'The over-the-counter derivatives markets in the United Kingdom', *Bank of England Quarterly Bulletin*, February 1996.