BANK FOR INTERNATIONAL SETTLEMENTS

62nd ANNUAL REPORT

1st APRIL 1991–31st MARCH 1992

BASLE, 15th JUNE 1992

Bank for International Settlements

62nd Annual Report

1st April 1991–31st March 1992   Basle, 15th June 1992

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62nd Annual Report

submitted to the Annual General Meeting of the Bank for International Settlements held in Basle on 15th June 1992

Ladies and Gentlemen,

I have the honour to submit herewith the sixty-second Annual Report of the Bank for International Settlements for the financial year which began on 1st April 1991 and ended on 31st March 1992.

The net profit for the year amounted to 119,460,160 gold francs, after transfer of 3,650,285 gold francs to the Provision for Exceptional Costs of Administration and 11,000,000 gold francs to the Provision for Modernisation of Premises and Renewal of Equipment. This compares with a net profit for the preceding year of 114,892,783 gold francs.

The Board of Directors recommends that, in application of Article 51 of the Bank's Statutes, the present General Meeting should apply the sum of 32,460,160 gold francs in payment of a dividend of 200 Swiss francs per share.

The Board further recommends that 26,100,000 gold francs be transferred to the General Reserve Fund, 3,000,000 gold francs to the Special Dividend Reserve Fund and the remainder of 57,900,000 gold francs to the Free Reserve Fund.

If these proposals are approved, the Bank's dividend for the financial year 1991–92 will be payable to shareholders on 1st July 1992.

I. Weaker growth than widely expected

The economic downturn, which has lasted longer than was foreseen a year ago, spread to more countries in the course of 1991 as activity weakened in Japan and Germany – the two industrial economies which were still growing strongly early last year. With overall output growth of less than 1% (see the table on page 5) 1991 saw the weakest economic expansion in the industrial countries since 1982 and for the first time in eight years the unemployment rate rose, reaching 7½% by the end of the year. Chapter II of this Report examines a number of special factors that may help to explain why most assessments of near-term economic prospects in the industrial countries had been too optimistic. Private sector debt burdens, aggravated by sharp declines in real asset prices, seem to have played the biggest role. In addition, household and business confidence failed to sustain the recovery that set in after the cessation of hostilities in the Gulf and fell to new lows during the second half of 1991. At the same time, the earlier onset of recession in countries with large current account deficits tended to reduce international imbalances last year. One notable exception to this improvement, discussed in Chapter IV, was the sharp rise in the Japanese surplus.

The sluggishness of activity led to an easing of macroeconomic policies in a number of countries, most notably the United States, Australia and later Japan. Elsewhere, however, as described in Chapter V, monetary policy was not directed towards achieving counter-cyclical goals, even when the unexpected weakness of demand became apparent. Germany, Italy and some other European countries experienced strong inflationary pressures that ruled out any relaxation of monetary policies. Other monetary authorities gave priority to their exchange rate objectives even though this meant accepting tighter policies than were considered desirable on domestic grounds. On the fiscal side, even automatic stabilisers were only allowed to operate sparingly, lest financial markets should deduce that fiscal consolidation no longer figured as prominently on the supply-side agenda. As elections approached, however, this resolve weakened a little more recently in some countries.

The lack of major macroeconomic policy reactions in many countries no doubt reflects the widespread loss of belief in short-term stimulation as being either effective or worthwhile, considering the harm it can do to medium-term objectives. It may also reflect a basic confidence that the downside risks are limited and that the danger of an imminent worldwide depression is slim. This confidence rests on fairly solid ground: recent structural improvements have not been reversed; profitability in manufacturing has not dipped too sharply from the healthier levels attained in the second half of the 1980s. Some cyclical decline in demand, even if closely synchronised across countries, must be regarded as normal, particularly after such a long, strong and equally synchronised upswing between 1983 and 1990.

A positive aspect of the current situation is the way in which inflation in a number of countries has responded to reduced demand pressure. In the United States the rate of consumer price inflation has recently been the lowest since 1986, the best year after 1965; in Canada one has to go back three decades to find a level similar to the present one. In the United Kingdom and Sweden the current rates of price increase over the last twelve months have been less than half those of only two years ago. In Australia and New Zealand prices scarcely rose at all last year. The "odd man out" is Germany, with the highest inflation rate among the Group of Seven countries after Italy. All these rates are in part distorted by tax measures, changes in mortgage rates or energy prices, but they do suggest that "stagflation", the unresponsiveness of inflationary pressure to weakness in economic activity, is in most countries not a serious threat at present, although inflexibility in many labour markets remains a problem.

Another feature of economic events in the period under review provides some further comfort against the background of mainly bad news. Most encouraging is the recovery in those Latin American countries which in recent years have adopted firm anti-inflation policies and structural reforms. Such policies have long been in place in many Asian countries where real growth remained high last year despite the recession in the industrial countries. At the same time, real per capita income continued to fall in Sub-Saharan Africa and, as a consequence of the war in the Gulf, real output growth weakened considerably in the Middle East.

There can, however, be little doubt that the present slowdown in the industrial world has compounded the difficulties faced by those countries in the process of transition from centrally administered to market economies. The violent break-up of Yugoslavia and the disintegration of the Soviet Union have added a further turn to this most dramatic story, in which the good news at the core, of freedom and economic initiative regained, is constantly in danger of being overwhelmed by a multitude of problems that demand urgent solutions. Chapter III describes the difficulties encountered by the eastern European countries, with real output falling even further and unemployment rising steeply.

The economics of the transition is difficult enough in itself. Structural reform is almost by definition a slow process, even more so when no stone can be left unturned. The most important domestic issue examined in Chapter III is the fiscal situation, which is in danger of getting out of hand in almost all of these countries, with revenue and expenditure following their own sharply divergent trajectories. Macroeconomic policy is severely hampered by having to work with newly adopted instruments which cannot function properly in underdeveloped markets. At the same time, policymakers cannot fall back on the old policy mechanisms if they want to create room for markets to develop further. This often amounts to trying

World output growth[1]							
Country groups and regions	1984–86 GDP	1981–86 average	1987	1988	1989	1990	1991
	as % of total	percentage changes in real GDP					
Seven major countries	59.0	2.7	3.3	4.5	3.3	2.5	1.0
Other industrial countries[2]	12.7	2.3	3.2	3.5	3.6	2.7	0.5
Developing countries	18.5	3.4	4.0	4.3	3.4	3.4	3.5
Major oil producers[3]	6.4	0.6	0.5	1.7	3.0	4.4	2.3
Other developing countries	12.1	5.1	6.0	5.7	3.6	2.8	4.1
Africa and Middle East	1.8	3.2	3.4	4.5	1.0	3.0	3.1
Asia	6.6	7.0	8.1	9.2	5.4	5.2	5.4
of which: NIEs[4]	1.6	7.5	12.1	9.5	6.3	6.7	7.2
Latin America	3.7	2.5	3.3	0.1	1.6	−1.4	2.2
Eastern Europe[5]	9.8	3.0	1.8	3.7	1.7	−4.1	−16.8
World	100.0	2.8	3.3	4.3	3.2	2.1	− 0.4
Memorandum item:							
World, excl. eastern Europe		*2.8*	*3.4*	*4.4*	*3.4*	*2.7*	*1.4*

[1] Average growth rates for the seven major and other industrial countries are calculated using 1989 GDP weights and exchange rates and other averages using 1984–86 GDP weights and exchange rates, including all countries with 1989 GDP of at least US$0.1 billion. [2] Including the countries listed in the table on page 29, Iceland, Luxembourg and Malta. [3] OPEC members, Mexico and Trinidad and Tobago. [4] The newly industrialised economies: Hong Kong, Singapore, South Korea and Taiwan. [5] National output figures converted at non-commercial exchange rates.

Sources: IMF World Economic Outlook, OECD National Accounts, UN Yearbook, World Bank Atlas and World Debt Tables, national data and BIS estimates.

to square the circle. Opening domestic markets to international competition and giving local entrepreneurs the chance to exploit the opportunities offered by world markets is an essential element in this process. The steps being taken towards trade policy reform and currency convertibility in the former communist countries, as well as in China, are discussed in Chapter IV.

But even a sound economic strategy may not be enough. The political process of transition requires broad popular support because the reforms in eastern Europe are of a democratic nature. People in these countries do not, and in fact cannot, compare their present experience with what might have happened had the old regimes managed to retain power; they tend to compare it with some earlier period before the utter failure of socialism was so starkly exposed. This distorted perception brings mounting difficulties on the political front the longer it takes for economic growth to be resumed. Outside financial assistance may be required in substantial quantities just to provide the glimmer of hope needed to sustain the political momentum.

In these circumstances, however, important lessons may be drawn from the simultaneous transition under way in eastern Germany, where, almost as if under conditions of a controlled experiment, outside help is available in abundance on all levels – financial, managerial, technical and administrative – where there are no language barriers, where a sound new legal framework and a sound currency are in place, and where experienced macroeconomic policy-makers are at work – and yet the transition process is running far from smoothly. It is true that one has to set against all these unquestionable advantages the not inconsiderable disadvantages largely absent in the other former socialist countries. Perhaps the greatest of these, apart from the huge revaluation implied in the move to monetary union, is the explosion in expectations as a consequence of political union. What the frustrations of the transition process in Germany reveal, however, is that outside help, no matter how abundant, offers no panacea for rapidly overcoming the legacies of socialism: state ownership of the means of production; technological backwardness in all but a few areas; the decay of the infrastructure, industrial equipment and the housing stock; the complete neglect of the environment; the seriously distorted price structure; and the total lack of marketing skills. All these are formidable obstacles to an early resumption of growth under conditions of a market economy, to which outside assistance, of whatever kind, cannot provide a quick solution.

The form of assistance which can contribute most to the transition process and to stimulating economic growth in the eastern European countries is the offer of unimpeded access to western markets. Most industrial countries have in recent years strayed further from the free trade ideals they profess to uphold while many developing countries have taken decisive measures to open their economies. The Uruguay Round has been the most drawn-out of any GATT trade negotiations. Resistance to further reciprocal concessions seems to be stiffening all the time. Regional trading arrangements, which have become an important feature in world trade relationships, distract attention from the global scene. This issue is discussed in some detail in Chapter IV and is taken up again in the Conclusion. It is of the utmost importance, not only for the countries in transition but for the economic prosperity of the world as a whole. In this respect not just the former socialist countries but *all* countries should embark on a transition to free and more open market economies. Market distortions and barriers to competition are as harmful in the international context as they are on a national level.

Can we assume that what applies to goods markets applies equally to financial markets, or do questions of financial stability and/or the efficacy of monetary policy suggest the need for special regulation? This is an issue to which special attention is devoted in this Report – in Chapter V with regard to the monetary policy transmission mechanism, more broadly in Chapter VIII, which addresses certain aspects of structural changes in financial markets in a longer-term perspective, and finally in the Conclusion. There can be no unequivocal answer: there clearly is a role for regulators and supervisors, and not just in the narrowly defined banking sector but also in other sectors of the financial services industry. The question is where to draw the boundaries between government intervention and market forces, and it is one to which different countries have traditionally given somewhat different answers. Yet increasingly globalised financial markets have made it imperative to coordinate national efforts in this area. The Basle capital ratios are a result of such coordination. They have attracted some criticism, but few would argue that it would be safe to let banks operate with much less capital than these ratios require. Of course any regulatory framework has to be adapted to new market developments; having first focused exclusively on credit risks, the Basle ratios will in time have to be modified to incorporate market risks of various kinds, which technically is not an easy task.

1991 saw an absolute decline in the international banking aggregates, for the first time since these data have been available. This, however, is not a reflection of a "credit crunch" in international lending. It largely concerns the interbank business of Japanese banks and more generally suggests a shift in banks' strategies away from "expansion at any price" to a rebuilding of profit margins. Bond yields showed a high degree of independence from domestic short-term interest rates but considerable interdependence across national borders. The result – depending on the stance of monetary policy – was very steep or sharply inverted yield curves (see Chapters V and VI). There is no doubt that domestic inflation expectations have a major influence on national bond yields, but they should not always be assumed to be the dominant force when short and long-term rates diverge. The puzzle of high "real" interest rates is addressed in Chapter II, although it has to be admitted that experience in 1991 did not allow much analytical progress to be made in this area. Equity markets, which in 1987 and to a lesser extent in 1989 had exhibited close interlinkage, very much followed their own courses in 1991 after their synchronised rise at the end of the Gulf war. Links with the cyclical situation in the countries concerned – and in particular with corporate profit positions and prospects – can only be detected if allowance is made for fairly long lags, of several years in fact (see Chapter VI).

Real estate prices have been under unusually severe downward pressure in a number of countries, adding a new page to the history of asset price inflation and how it relates to inflation in general, to speculative bubbles and to the overall economic situation. Real estate price deflation, if that is what it should be called, might be considered to be a new phenomenon in the post-war economic history of the industrial countries, although declines in commercial property prices following the inflationary excesses of the 1970s were in some countries also on a major scale. No doubt it required a large dent in the inflation trend for asset price deflation to become a possibility. If not contained, it could not only have further repercussions on financial institutions in the countries concerned but also affect the prospects for full economic recovery. Given the lack of relevant past experience, it is difficult to assess the potential danger of a vicious circle of declines feeding on declines. But it should be remembered that the industrial economies have not ceased to be more inflation than deflation-prone, and that earlier fears of deflationary spirals invariably proved to be unfounded.

There has been no notable trend in major exchange rate relationships over the period under review as a whole. This is perhaps surprising given the marked divergence of monetary policies. Within the period, however, the US dollar did undergo a relatively large cycle of appreciation and decline. Intervention was undertaken towards the peak of this cycle and again early this year as the dollar rose once more. Although they showed significant growth, capital flows were not of a nature to plunge the exchange markets into turmoil. Within the EMS no realignments occurred and periods of pressure due to speculation on parity changes were relatively brief. The Maastricht Summit had only short-term effects on financial markets. It seemed that they decided not to jump to conclusions but to take their time in assessing the implications for the EMS in the intermediate stage. This impression may not be in line with widely accepted hypotheses about adjustment speeds in financial markets. The Treaty provisions on monetary union are, however, more than simply an item of news which the markets can quickly digest. They comprise a very complicated set of possible courses of action dependent on a number of conditions, and at this stage it is very difficult to say which countries will be able to meet these conditions or how strictly they will be applied.

The Treaty represents agreement on the bare bones of economic and monetary union and many important matters have yet to be decided. Strangely, the fact of having reached this basic consensus does not seem to have made it any easier to resolve the remaining issues. Those governments that were committed to achieving agreement on the principle were not unhappy about the lack of public debate in their countries prior to the Maastricht Summit and did little or nothing to stimulate it. Having managed to spring the programme on a largely unprepared public they are now faced with debate and dissension very late in the day. This has cast some doubt on the prospects for implementation, although parliamentary opposition to ratification of the Treaty has not lined up in force in any member country. As is explained in some detail in Chapter V, a monetary union between economies as divergent in certain respects as those of the EC member countries, even if the convergence criteria are strictly applied, is an undertaking attended by many uncertainties which may well give rise to different views once a debate focusing on the concrete implications gathers momentum.

The structure of the Report has been modified somewhat compared with that of recent years. The following three chapters discuss economic developments in different groups of countries and balance-of-payments developments as before. The next chapter examines monetary policy from both a national and an international perspective. There then follows a chapter dealing with financial markets in all their aspects, including the exchange markets, and summarising developments in real estate markets. As in the past, the international financial markets as covered by BIS statistics are discussed in a separate chapter. Finally, this year a special chapter looks at structural changes in financial markets and their implications.

II. Developments in the industrial countries

Highlights

The economic downturn that began in 1990 continued throughout last year and widened to include virtually the entire industrial world. Nearly one-third of the countries remained in recession, the rapid expansions in Germany and Japan came to an end, and there were slowdowns in several European countries whose performance in 1990 had been comparatively favourable. Overall, the downturn has been more moderate than those of the early 1980s and mid-1970s, in large part because domestic inflation pressures as well as the preceding rise in oil prices were less severe. However, inflation has become a serious concern in Germany and remains a concern in several other major European countries. Efforts to contain inflation, together with the constraints on interest rates arising from the EMS exchange rate regime, played a role in keeping real interest rates throughout Europe at high levels. Furthermore, financial strains and imbalances largely accumulated during the previous expansion have been unusually prominent in this cycle, and continuing widespread public sector budget problems have limited the scope for fiscal stimulus. Together these factors suggest that the forces restraining demand, while less severe than in past cycles, have nonetheless been stronger, more persistent and more widespread than foreseen a year ago.

Business cycle developments

Weak growth in 1991

Real growth in the industrial countries as a whole averaged only 0.9% in 1991, its weakest overall pace since 1982, and in nearly all countries was considerably slower than in 1990. Last year was also marked by an end to the booms in business investment in Europe and Japan, rising unemployment and serious constraints on macroeconomic policies in many countries.

Output continued to decline during all or most of 1991 in the United Kingdom, Australia, Sweden, Finland and New Zealand. And while the recessions in the United States, Canada and Switzerland appeared to have ended, there was little or no growth over the four quarters of the year. With the exception of the United States, the downturns in these countries were largely the product of previous over-expansion and resulting inflationary pressures that had forced the authorities to impose stringent monetary restraint. The downturns typically began several quarters before the Gulf conflict and in Australia and Finland have equalled or exceeded those of earlier post-war cycles in severity. The downturn in the United States has been comparatively mild but the weakness in activity has lasted longer than expected. Activity did begin to recover in the spring of last year both in the United States and in Canada but subsequently faltered, in part because consumption revived less than had been anticipated.

Japan's rapid expansion ends

Important new sources of weakness emerged last year as the rapid expansions in Japan and Germany came to an end. Japan's aggregate output growth decelerated sharply throughout 1991 and came to a halt in the last quarter, while activity in western Germany fell over the second half of the year. The slowdown in Japan primarily reflected the deceleration of business and housing investment from the exceptionally rapid pace of the preceding five years. Personal income growth, employment, interest rates and other fundamental demand determinants were more favourable than in most other countries. However, the continuing weakness of real estate and stock prices and the sharp fall in business confidence beginning in late 1991 heightened concern as to how serious the slowdown in activity might become.

Led by Germany ...

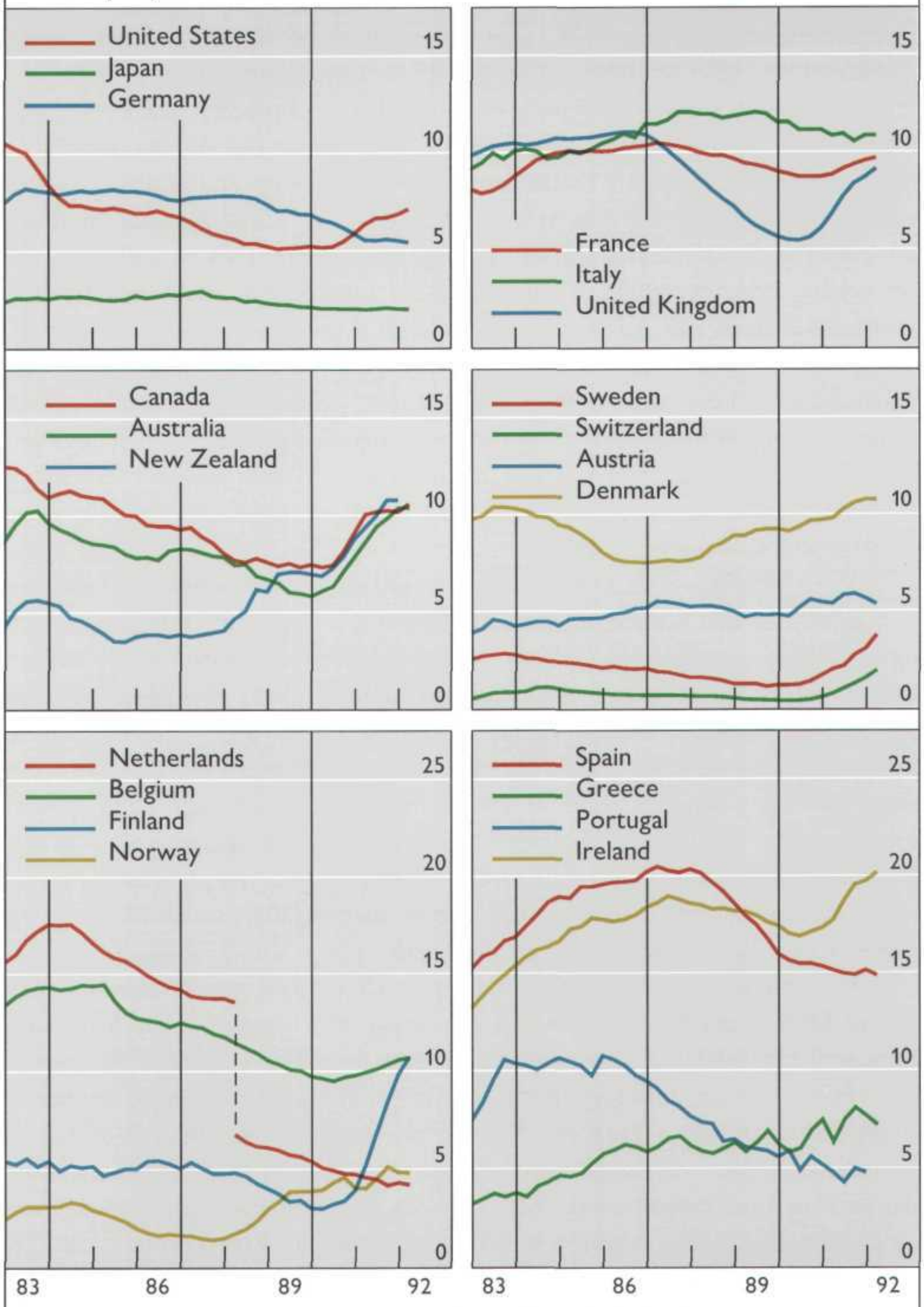
The downturn in western Germany, while somewhat accentuated by mid-year tax increases, also reflected a significant reduction in underlying demand strength. In particular, demand from the new Länder, which was a major contributor to growth in 1990 and early 1991, decelerated considerably as the boom in household accumulation of consumer durables cooled and as the public outlays that have been the primary support to regional spending began to slow. The slowdown in government expenditure reflected temporary supply constraints on infrastructure investments, and probably to some degree the stabilisation of eastern Länder output beginning around mid-1991. Slowdowns in the growth of business investment in the second half of 1991, and of exports in the last quarter, contributed further to the deceleration in aggregate German demand.

The change in Germany's growth trend has potentially important implications for other European countries. During 1990 and until around mid-1991, much of the rapid growth in spending in Germany was diverted to its European partners as capacity constraints in the western Länder became increasingly stringent. In large part as a result, the exports of other European countries grew quite rapidly and provided a substantial boost to overall demand growth. This support was a significant factor in the comparatively favourable growth performances during 1990 of Belgium, Austria and the Netherlands, whose exports to Germany amount to at least one-tenth of their total output. In most European countries, the stimulus from exports to Germany seems to have outweighed the effects of rising interest rates during this period.

... growth in continental Europe slows

During 1991, growth slowed considerably in Austria, Belgium and the Netherlands, declined further in Spain and Portugal and remained quite sluggish in France and Italy. Much of the slowdown was attributable to decelerating investment, as exports in most cases continued to increase fairly strongly through the first half of the year. However, export growth began to slow noticeably in the second half of the year, in large part as a result of a sharp deceleration in Germany's imports. Thus the growth stimulus provided by Germany to the rest of Europe appears to have progressively weakened during 1991.

Unemployment rates*



* In percentages. National data and definitions; for the Netherlands, break in series.

The continued and spreading weakness of economic activity in the industrial countries led to a marked deterioration in labour market conditions last year, which probably contributed to the widespread decline in consumer confidence. With the important exception of Japan, total employment in most countries either stopped growing or declined. The average unemployment rate of the industrial countries increased, by nearly 1 percentage point, for the first time since 1983. In general, unemployment rates have risen by less than during the downturn of the early 1980s and

Rising unemployment rates

remain below the peaks reached at that time. However, quite substantial increases have occurred in a number of countries, particularly those still in recession, and unemployment rates in Ireland, Australia and several Nordic countries are now at their highest levels in over three decades.

Some progress on inflation

Largely as a result of falling oil and other commodity prices, average inflation for the industrial countries fell to 4.1% over the twelve months of 1991, compared with 5.7% the previous year. There was little change in core inflation for the group as a whole, however. Nonetheless, a number of individual countries did achieve substantial reductions in inflation and underlying cost pressures from previously high levels, most notably the United Kingdom and Australia, where wage increases were nearly halved, as well as Canada, Sweden, Finland and Iceland. Core inflation rates also stabilised or fell modestly in the United States, Japan and a number of other countries, but in most cases they remained significantly above their average of 1986–88. However, underlying inflation pressures in western Germany strengthened further in 1991, largely as a result of the marked acceleration in wage increases since 1989.

Lower interest rates in North America and Japan ...

With inflation pressures easing or contained at moderate levels, the authorities in the United States and Japan took explicit steps to reduce interest rates substantially in 1991. Nominal short-term rates in the United States fell by more than 2½ percentage points during the year, to their lowest level in nearly twenty years, while short-term rates in Japan declined by nearly 2 percentage points. By the end of 1991 real long-term interest rates in both countries were at their lowest point since the early 1980s. Interest rates also fell significantly in Canada and Australia as well as in the United Kingdom in the first half of 1991. Signs of a revival in housing investment in Canada and in the United States suggested that the lower rates were beginning to stimulate aggregate activity.

... but little change in continental Europe

In continental Europe interest rates declined by considerably less than in the United States or Japan and real long-term rates remained high by historical standards. In Germany short-term interest rates rose further as efforts to contain inflation continued. In most other European countries short-term interest rates, which generally were fairly close to those in Germany, either remained unchanged or fell only slightly. Substantial declines to levels significantly below those in Germany would have been inconsistent with the maintenance of the exchange rate configuration to which nearly all the European countries are now formally or informally committed. Reductions in central bank lending rates in France and Sweden later had to be partly reversed, and cuts in the base lending rate in the United Kingdom were halted, largely because of such considerations. In effect, nominal interest rates have become closely synchronised in the European countries, so that France and some other countries with comparatively low inflation now have higher real interest rates than Germany.

Limited budget flexibility

There have also been significant constraints on the budget policies of many of the industrial countries. The average general government budget deficit of the group reached nearly 2.5% of GDP in 1991, roughly ¾ of a percentage point greater than in the previous year and almost 1.5

Consumer price inflation							
Countries	1981–85	1986–89	1990	1991			1992
			Dec.	June	Sept.	Dec.	March
	annual averages		percentage changes over previous year[1]				
United States	5.5	3.6	6.1	4.7	3.4	3.1	3.2
Japan	2.8	0.9	3.8	3.4	2.7	2.7	2.0
Germany	3.9	1.0	2.8	3.5	3.9	4.2	4.8
France	9.6	3.0	3.4	3.3	2.6	3.1	3.2
Italy	13.9	5.6	6.4	6.9	6.2	6.0	5.5
United Kingdom	7.2	5.1	9.3	5.8	4.1	4.5	4.0
Canada	7.4	4.4	5.0	6.3	5.4	3.8	1.6
Australia	8.3	8.1	6.9	3.4	3.3	1.5	1.7
Austria	4.9	1.9	3.5	3.8	3.2	3.1	4.1
Belgium	7.0	1.8	3.5	3.6	2.5	2.8	2.7
Denmark	7.9	4.3	1.9	2.9	1.8	2.3	2.6
Finland	8.5	4.7	4.9	4.2	3.3	3.9	2.8
Greece	20.7	16.6	22.9	18.9	18.2	18.0	18.3
Ireland	12.3	3.3	2.7	3.1	3.5	3.6	3.7
Israel	195.4	25.5	17.6	19.3	20.9	18.0	17.3
Netherlands	4.2	0.3	2.6	3.3	4.4	4.9	4.2
New Zealand	12.0	10.2	4.9	2.8	2.2	1.0	0.8
Norway	9.0	6.8	4.4	3.5	3.3	2.9	2.5
Portugal	23.2	10.8	13.7	12.6	10.2	9.6	8.5
South Africa	14.0	15.5	14.6	15.2	15.4	16.2	15.8
Spain	12.2	6.4	6.5	6.2	5.7	5.5	6.9
Sweden	9.0	5.2	10.9	10.3	8.3	8.1	2.6
Switzerland	4.3	1.8	5.3	6.6	5.7	5.2	4.9
Turkey	38.3	53.6	60.4	64.9	66.9	71.1	78.7
Average[2]	7.0	3.7	5.7	5.0	4.2	4.1	3.9

[1] Quarterly figures for Australia, Ireland and New Zealand. [2] Calculated using 1989 GDP weights and exchange rates.

Source: National data.

percentage points higher than in 1989. The deterioration resulted largely from the weakness of economic activity. Except in Germany, budgets generally provided only very modest stimulus or, as in France, Canada and a number of other countries, restrained activity by partially offsetting automatic stabilisers with spending limitations or tax increases. Furthermore, current budget plans suggest that, except in the United Kingdom and to a lesser extent France and Italy, budget policies will be somewhat more restrictive in 1992 than in 1991, as longer-term fiscal consolidation programmes now planned in the United States, Canada and a number of other countries are implemented.

The present cycle in comparison with earlier downturns

Last year marked the third general downturn in economic activity in the industrial countries since the 1960s. Comparison with the past confirms that the present slowdown has generally been milder than those of the mid-1970s and early 1980s, in large part because the factors, particularly inflation, that led to the earlier downturns have been more favourable in the present cycle. Nonetheless, the slowdown has lasted longer than expected in some countries and the overall constraints on demand now appear to be somewhat greater than had been anticipated. Two factors appear to be primarily responsible. First, structural adjustments to private sector financial burdens and imbalances in the United States, the United Kingdom and several other countries have restrained demand more than in earlier cycles. Second, inflation in Europe, while much improved on average in comparison with the last two decades, remains or has become an important concern in several key countries, most notably Germany. This situation, along with the constraints imposed by the EMS, has kept European real interest rates at high levels, despite the weakness in activity.

Prolonged weakness in the early 1980s

The previous two business cycles, beginning in 1974 and 1980 respectively, were both initiated by sharp increases in oil prices, but the downturns that followed were quite different in character. The first, following the nearly fourfold rise in oil prices in 1973, led within several quarters to a sharp decline in output in virtually all the industrial countries except Canada, which in most cases as well as overall was the most severe of the post-war era. However, the downturn was generally followed within roughly a year by fairly robust recovery. In contrast, the economic downturns in 1980 and 1981 following the tripling of oil prices in 1979–80 were typically milder, but activity, and especially domestic demand, remained weak for much longer. Growth during 1980–82 was the weakest of any comparable post-war period. Domestic demand growth in the industrial countries averaged less than 0.3% annually in the three years after 1979, compared with an average of 1.3% in the three years following the first oil shock. The weakness was especially protracted in Europe, most notably in Germany, where domestic demand remained below its 1979 peak until 1985.

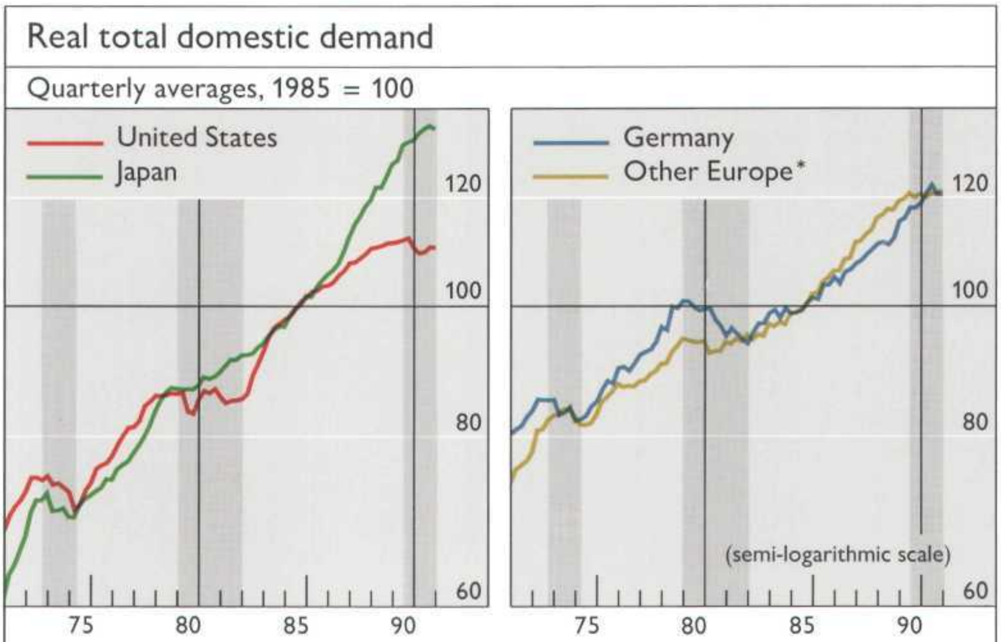
A milder downturn than in earlier recessions ...

By comparison with the two earlier periods, the present economic downturn has so far been moderate in most respects. Output in the industrial countries as a whole rose in 1991, whereas it fell in 1975 and 1982. The recessions in the United States and Canada have been about half as deep as in 1980–82, although those in Australia and Finland have been exceptionally severe.

The downturns in the major demand components have also generally been noticeably milder than previously. In particular, business investment and consumption remained stronger through 1991, both on average and in most individual cases, than in the two earlier cycles; with some important exceptions, the same observation applies to housing investment. Furthermore, the slowdown in business investment follows an exceptionally strong boom in Europe and Japan over the latter half of the 1980s. Investment spending during this period, which increased by nearly half in Europe and by almost two-thirds in Japan, was much stronger than in the expansions preceding the 1974–75 and 1980–82 recessions.

... but with important exceptions

There are some important exceptions, however. In the United Kingdom, the United States and France consumption has been somewhat



Note: The shaded areas represent periods of slowdown in activity in the Group of Seven countries (1973 QIV–1975 QI, 1980 QI–1982 QIV and 1990 QIII–1991 QIV).

* OECD Europe, excluding Germany. Calculated using 1989 GDP weights and exchange rates; figures for 1991 are partly estimated.

Sources: OECD Economic Outlook and national data.

weaker in relation to aggregate activity than in past cycles. Automobile sales in the United States, many European countries and Japan have been stagnant or in decline for as much as two years. Housing in the United Kingdom and several Nordic countries has been exceptionally depressed, as has commercial real estate investment in the United States, the United Kingdom, Australia and Norway.

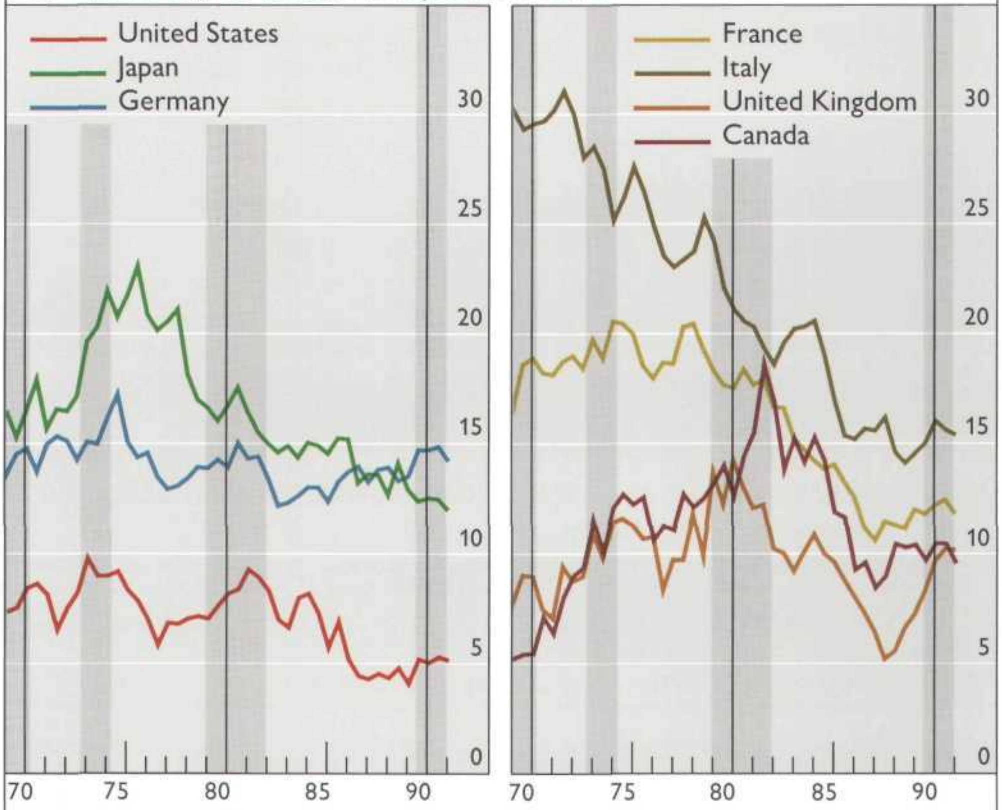
Less fluctuation in inventories and personal saving

Two other differences compared with the earlier cycles help somewhat in explaining why the pronounced rebound seen after 1975, and briefly in 1980, has not occurred in the present instance. Fluctuations in inventory investment, which often in the past significantly affected the timing and strength of the turnround in activity, generally have been less pronounced, particularly in the United States but also to a considerable degree in the other larger countries. The reduction in volatility in this demand component is substantially a reflection of tighter inventory management arising in part from relatively high real interest rates. Moreover, personal saving rates have generally been less variable in recent years than in previous cycles. In contrast, saving rates generally rose prior to the cyclical peaks preceding the 1974 and 1981–82 recessions, but then began falling several quarters after the downturn began, providing an impetus to consumption that was largely absent in 1991. The United Kingdom is an important exception, however. The household saving rate there has nearly doubled since 1988, after falling by more than one-half over the preceding seven years. Largely as a result, consumption has been particularly weak.

The relative mildness of the present downturn mainly reflects the fact that the rise in oil prices and domestic cost pressures that were the key factors shaping the previous recessions have been less severe, at least in

Net household saving*

As a percentage of household disposable income



Note: The shaded areas represent periods of slowdown in activity in the Group of Seven countries (1969 QIV–1971 Q1, 1973 QIV–1975 QI, 1980 QI–1982 QIV and 1990 QIII–1991 QIV). Figures for 1991 are partly estimated.

* Seasonally adjusted semi-annual data. For France, Italy and the United Kingdom, gross saving.

Sources: OECD Economic Outlook and national data.

overall terms. In particular, the increase in oil prices in 1990 was substantially smaller than in 1973 and 1979 and was quickly reversed; thus the impact on real incomes was very slight and only temporary. Prices of other basic commodities have also not risen as they did earlier, and in some cases have fallen considerably.

Even more important is the comparative moderation, with important exceptions, of underlying inflationary pressures before the current downturn. Prior to both the 1974 and 1980–82 recessions, there was a marked build-up in domestic cost pressures that led to monetary restraint and sharp increases in interest rates, greatly aggravating the downturn. Cost pressures were particularly severe in Japan prior to the first oil shock, and that country's downturn was the worst in its post-war history. However, policy began to ease in most countries fairly soon after the 1974 downturn and the recovery was later further reinforced by major fiscal expansions in Europe and Japan. By the late 1970s underlying domestic cost pressures in the largest industrial countries, except Japan, were as great as or greater than in the early 1970s and more entrenched. In response, monetary policy in the United States and most major European countries continued to restrain activity for much longer than in the previous cycle. In Japan, and somewhat later in Europe, demand was further weakened by extensive fiscal consolidation to reduce the budget deficits and curb the rapid growth of public debt.

Overall, inflation pressures have been less severe ...

In general, the inflation pressures that were a key factor in the prolonged weakness of the early 1980s are now considerably less severe. Core inflation rates and underlying cost pressures before the present downturn were significantly lower on average in most individual countries. Largely as a result, monetary restraint and interest rate increases were less pronounced, and the authorities in the United States and to some extent in Japan have been able to take steps to lower interest rates somewhat sooner than in the previous cycle. Furthermore, as in the past, the downturn has typically been particularly severe in those countries with the most serious inflation problems.

... but private financial imbalances have been greater

Two aspects of the present situation are potentially more problematic however. First, financial strains and imbalances arising from high debt burdens, deteriorating asset quality and falling asset prices have been considerably more prominent in the present slowdown than in earlier cycles. The analysis at the end of this chapter suggests that, except to some degree in the United States, credit supply constraints have not as yet had a noticeable impact on aggregate spending. Particularly in Japan, however, credit constraints could become a more serious impediment to activity should falling asset prices lead to a substantial further deterioration in financial institutions' balance sheets. The analysis also suggests that relatively high private debt burdens, especially in the household sector, along with falling real estate and stock prices, have added to and prolonged the weakness in demand in several major countries. In particular, the rise in the saving rate and the exceptional weakness of consumption and the housing market in the United Kingdom appear to derive in part from efforts by households to reduce their debt to more manageable levels. Similar, if somewhat less severe, balance-sheet adjustments have been occurring in the United States, as well as in Norway and Sweden. There is considerable uncertainty in all these countries as to how far the adjustments will go. Furthermore, the exceptional weakness in the commercial real estate sector in the United States, Australia, Norway and, to some degree, the United Kingdom is substantially the result of a build-up of excess capacity fuelled by the relatively abundant availability of credit during the earlier expansion.

Rising inflation in Germany ...

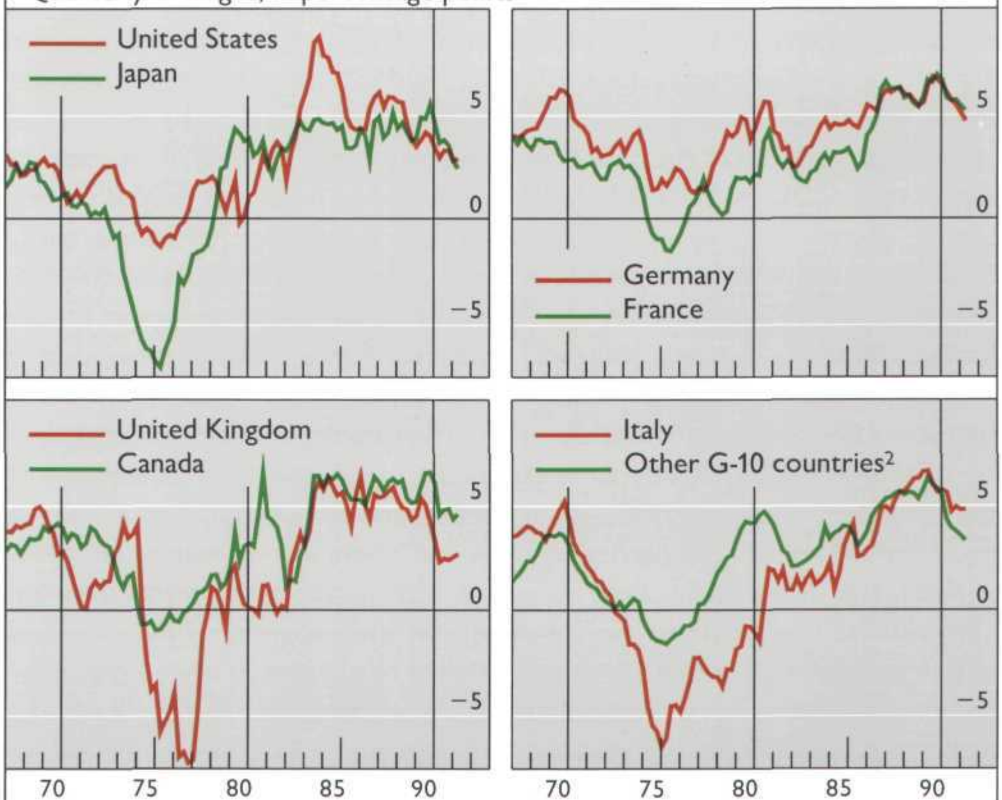
Second, inflation has become a more serious overall cause of concern in Europe than is suggested by the aggregate performance, largely because of the problems in Germany. In particular, wage and labour compensation increases in Germany during 1991 were nearly as high as the peak reached in the early 1980s. The historical record, based on the experiences of numerous industrial countries, indicates that substantial reductions in underlying wage and cost pressures have nearly always been accompanied by significant and prolonged slowdowns in real output growth. Moreover, inflation in Germany has been less responsive to slowdowns in growth than in other major industrial countries. Admittedly, conditions now may be more conducive to restraining wage pressures than in the past. In particular, inflation and cost pressures in Germany are more recent and probably less entrenched. Nonetheless, historical experience would suggest that several years of growth well below potential could be required to bring wage inflation back to the levels prevailing during the second half of the 1980s.

... has kept interest rates high throughout Europe

The monetary restraint prompted by the build-up of inflation pressures has led to a considerable rise in nominal interest rates in Germany over the last few years and to parallel increases in France, Italy and other countries participating in the narrow band of the EMS exchange rate mechanism. Nominal interest rates in Europe are much more closely linked than in earlier cycles as a result of the broadening of the EMS and the greater mobility of financial flows among its members. As is shown in the graph below, real interest rates have also risen appreciably. Admittedly, real interest rates are difficult to measure precisely, and their true level was almost certainly higher during the 1970s and the early 1980s than is indicated in the graph because much of the acceleration in inflation in those periods was unanticipated. Nonetheless, the current level of real interest rates in Germany and most other continental European countries, especially those with the lowest inflation, does appear to be noticeably high by historical standards, and significantly higher than during the downturns of 1980–82. Real rates in these countries are also higher than in the United States and Japan, and the gap has widened in the last twelve months.

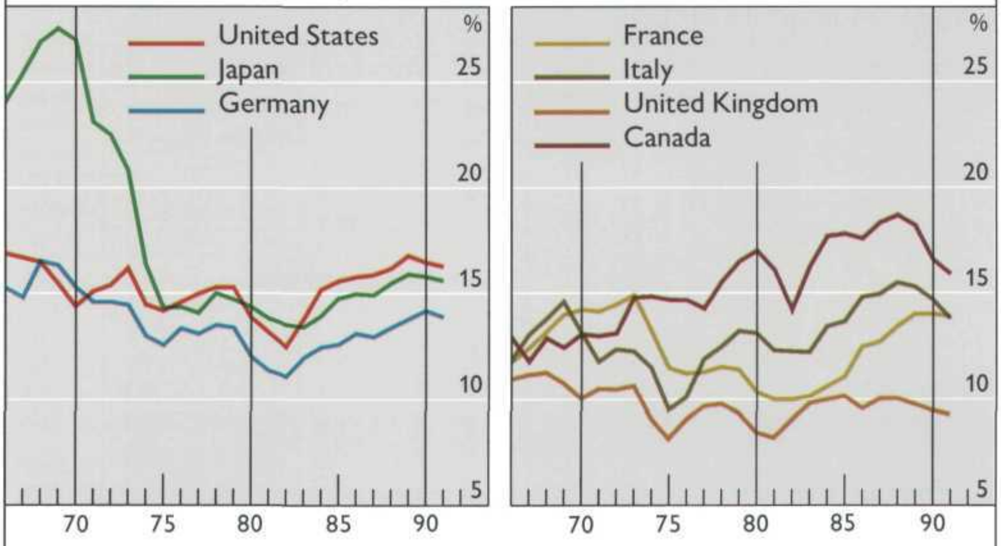
Real long-term interest rates[1]

Quarterly averages, in percentage points



[1] Representative government bond yields less annualised changes in consumer prices over the previous three years. [2] Belgium, the Netherlands, Sweden and Switzerland (arithmetic average).

Rates of return on capital in the business sector*



* Gross operating surplus (value added less employee compensation) divided by the capital stock.
Source: OECD Economic Outlook (figures for 1990 and 1991 are partly estimated).

Uncertain impact on spending

The effects of real interest rates on spending are difficult to assess. Real interest rates were persistently high during the 1980s in comparison with both the 1970s and, in most countries, the 1960s. Nonetheless, as noted earlier, the second part of the decade saw the strongest and most extended boom in business fixed investment in both Europe and Japan since the 1960s. The coincidence of strong investment and high real interest rates is probably attributable in part to the significant rise in profit rates during the 1980s shown in the graph above. Particularly in Europe and Japan investment during the 1980s was also stimulated by efforts to save labour and otherwise reduce costs in order to maintain international competitiveness as exchange rates appreciated. Investment in Europe was further boosted by business preparations for the development of the single market.

Nonetheless, the weakening of investment in most European countries, which in many cases preceded the slowdown in activity in Germany, suggests that real interest rates may now be exerting a greater restraint on spending than during much of the latter half of the 1980s. Several factors that traditionally have been important in investment decisions, in particular profit rates and business confidence, have deteriorated noticeably in the last year, although in most cases they remain more favourable than in the last downturn. The resilience of investment, given these conditions and the persistence of high real interest rates, is a key factor in the medium-term outlook for the European economies.

Developments in individual countries

The three largest economies

US recovery falters

The recession in the *United States* apparently ended in early 1991 but there was no genuine recovery. Growth, led by consumption, briefly rebounded in the spring but stalled later in the year as consumption weakened again.

Developments in real GNP/GDP and demand components: major industrial countries

Countries and periods	GNP/ GDP[1]	Total domestic demand	Demand components					Memo: Private non-residential fixed investment[3]
			Personal consumption	Public spending[2,3]	Total private fixed investment[3]	Stock changes[4]	Net exports[4]	
	percentage changes							
United States								
1982–89 average	3.7	3.9	3.7	3.2	4.4	0.2	−0.3	3.2
1989	2.5	1.9	1.9	1.5	0.4	0.3	0.6	2.2
1990	1.0	0.5	1.2	3.2	−1.6	−0.7	0.6	1.2
1991	−0.7	−1.3	−0.1	0.9	−7.6	−0.3	0.7	−6.7
1991 Q IV[5]	0.4	0.1	0.5	−1.6	−5.7	0.9	0.3	−7.1
Japan								
1982–89 average	4.3	4.5	3.8	1.4	8.4	0.1	−0.2	9.6
1989	4.8	5.8	4.3	0.1	12.5	0.2	−0.9	16.5
1990	5.3	5.5	4.3	3.3	10.7	−0.2	−0.3	12.4
1991	4.4	3.0	2.6	3.7	3.3	0.1	1.4	6.2
1991 Q IV[5]	3.2	1.9	3.0	4.2	−1.8	0.1	1.3	1.5
Germany								
1982–89 average	2.5	2.5	2.2	1.2	3.4	0.3	0.2	4.7
1989	3.9	2.7	2.1	−1.1	7.4	0.4	1.2	8.5
1990	4.7	4.7	4.6	2.5	9.7	−0.3	0.1	10.5
1991	3.2	3.0	2.5	0.9	7.4	−0.1	0.3	8.6
1991 Q IV[5]	0.9	1.6	1.0	3.4	2.8	−0.3	−0.6	0.2
France								
1982–89 average	2.5	2.6	2.5	2.3	3.0	0.0	−0.2	3.9
1989	4.1	3.7	3.3	0.8	7.6	0.2	0.3	7.8
1990	2.2	2.6	2.9	2.2	2.7	−0.1	−0.4	4.3
1991	1.1	0.9	1.4	4.2	−2.1	−0.5	0.2	−2.1
1991 Q IV[5]	1.8	0.9	2.1	3.1	−1.7	−0.7	0.9	−3.9

For footnotes and sources see the table opposite.

Business investment declined in 1991, although exports continued to grow and housing activity began to revive in the second quarter.

Structural adjustments continue

The continued sluggishness of the US economy largely reflects adjustments that began well before the 1990 downturn. Consumer spending, particularly on housing, automobiles and other durables, has been restrained by efforts to reduce debt burdens accumulated during the prior expansion. Corporate reorganisation and other structural factors have led to proportionately greater and more widespread permanent job losses in the present cycle, particularly in services – a development which has probably contributed to the surprisingly low level of consumer confidence. Similarly, much of the stagnation in business investment over the last twelve months reflects the protracted decline in spending on business structures that began in 1985. The weakness in this demand component is primarily attributable to substantial overbuilding earlier in the decade; investment

Developments in real GNP/GDP and demand components: major industrial countries (continued)

Countries and periods	GNP/GDP[1]	Total domestic demand	Demand components					Memo: Private non-residential fixed investment[3]
			Personal consumption	Public spending[2,3]	Total private fixed investment[3]	Stock changes[4]	Net exports[4]	
	percentage changes							
Italy[6]								
1982–89 average	2.8	3.3	3.0	2.7	3.2	0.0	−0.3	n.a.
1989	3.0	3.0	3.6	0.9	4.6	−0.3	−0.1	5.2
1990	2.2	2.4	2.8	1.3	3.3	−0.2	−0.3	3.1
1991	1.4	2.3	2.8	1.7	0.9	0.1	−0.9	0.7
1991 Q IV[5]	1.5	2.8	2.7	1.4	3.8	0.1	−1.3	6.3
United Kingdom								
1982–89 average	3.5	4.4	4.6	1.0	8.6	0.2	−1.1	9.8
1989	2.3	3.3	3.5	3.0	5.0	−0.3	−1.2	8.1
1990	1.1	−0.1	0.8	3.5	− 3.9	−0.7	1.1	− 1.1
1991	−2.3	−3.1	−1.7	0.9	−10.7	−0.6	1.2	−11.9
1991 Q IV[5]	−1.5	−1.6	−1.3	0.4	− 8.6	0.4	0.6	−10.4
Canada								
1982–89 average	4.1	4.7	4.2	2.4	6.5	0.4	−0.7	5.5
1989	2.5	3.8	3.2	3.6	5.2	0.1	−1.3	6.0
1990	0.5	−0.2	1.3	3.6	− 4.6	−0.9	0.8	− 3.2
1991	−1.5	−0.5	−1.1	2.2	− 3.9	0.4	−0.5	− 1.9
1991 Q IV[5]	−0.2	1.4	−0.8	1.0	4.1	0.9	−1.4	3.2
Average[7]								
1982–89 average	3.6	3.8	3.5	2.4	5.8	0.2	−0.3	6.1
1989	3.3	3.3	2.8	1.2	6.5	0.2	0.0	8.8
1990	2.5	2.3	2.4	3.0	4.0	−0.5	0.3	5.9
1991	1.0	0.5	0.9	1.5	− 1.6	−0.1	0.6	− 0.2
1991 Q IV[5]	1.1	0.9	1.2	0.5	− 2.5	0.4	0.3	− 2.2

[1] GNP for Japan and Germany. [2] Public consumption and public fixed investment. [3] For Germany (1991 Q IV) and Italy (all years), public spending comprises public consumption only, total private fixed investment includes public investment and private non-residential fixed investment comprises machinery and equipment only. [4] Percentage point contribution to GNP/GDP growth. [5] Change over four quarters. [6] Average for 1982–89 based on accounts at 1980 prices. Individual years 1989 to 1991 based on 1985 prices. [7] Weights proportional to GDP and demand components in 1989.

Sources: OECD and national data.

in business structures could remain depressed for some time further since commercial vacancy rates are still high by historical standards.

Strength in exports

Exports, which increased by nearly 7% in real terms over the four quarters of 1991, were an important exception to the overall weakness of demand. Their strength reflects significant market share gains in the industrial countries, owing in large part to the relatively favourable competitive position of US export industries and to a pick-up in imports of Latin American countries.

Apart from exports, prospects for recovery depend largely on a revival in household spending spurred by lower interest rates. Continued signs that core inflation was declining and ongoing weakness in the economy prompted a considerable relaxation of monetary policy in 1991. Market interest rates eased substantially, and by the end of 1991 longer-term interest rates, including mortgage rates, were at their lowest levels in nearly five years. The decline in interest rates reduced household debt service burdens and allowed a greater proportion of applicants to qualify for housing loans. Partly as a result of the lower servicing burdens, households and businesses were able to lower their debt levels somewhat in 1991.

Lower interest rates ...

The scope for budgetary stimulus to the economy has been quite severely limited by the high federal budget deficit, which reached 4.8% of GDP in fiscal 1991, close to the peak of 5.2% recorded in fiscal 1986. Apart from payments to replenish the bank deposit insurance fund, the increase over fiscal 1990 was primarily attributable to the weakness of economic activity, and the deficit is expected to rise substantially in fiscal 1992 for the same reason. The contribution to economic activity in 1991 provided by the federal budget was somewhat less than in the aftermath of earlier downturns. Further budget consolidation over the next few years is mandated by the terms of the 1990 budget agreement. Moreover, federal budget restraint has been significantly reinforced by tax increases and spending reductions in many states, whose fiscal positions are considerably worse than in past cycles.

... but high budget deficits

Economic activity in *Japan* slowed progressively and more abruptly than expected during 1991, to its slowest pace since 1986. Net external demand accounted for more than one-third of the increase in aggregate output; domestic demand growth over the four quarters of 1991 was the lowest since 1983. The slowdown largely reflects the inevitable cooling of the exceptionally strong investment boom mentioned earlier. Housing investment began to decline from exceptionally high levels in 1990 and its continued fall in 1991 reduced aggregate output growth by nearly ¾ percentage point. Business investment, which grew at an average annual rate of more than 10% from 1988 to 1990, decelerated sharply in 1991. The weakness in demand became more widespread later in the year as consumption as well as exports slowed noticeably and the accumulation of inventories, which had risen markedly in relation to sales, began to decelerate. Significant inventory reductions are expected to depress aggregate spending for much of 1992.

Abrupt slowdown in Japan

Nonetheless, many of the fundamental conditions underlying demand continue to be relatively favourable. There has been very little slowdown in either employment or household income growth. Corporate profits have fallen, but from previously quite high levels. More importantly, the inflation and budget situations are significantly better than in most of the other industrial countries. Consumer prices rose by less than 3% in 1991, and wage increases continued to be moderate even though labour market conditions remained tight by historical standards. Wage settlements negotiated in the spring of 1992 were somewhat lower on average than in the previous year. With inflation apparently contained, the authorities were

Inflation and interest rates comparatively favourable

able to reduce interest rates considerably. Long-term interest rates fell below 5.5% in early 1992, lower than in any other major industrial country and the lowest in real terms since the early 1980s. The scope for fiscal support to activity has also been somewhat greater than elsewhere. The general government budget remained in surplus and the central government deficit, while higher in fiscal 1991 than originally projected owing to the slowdown in activity, was nonetheless comparatively modest. The general government budget contributed a moderate net stimulus to growth in 1991; however, the proposed budget for fiscal 1992 provides little or no further discretionary economic stimulus, despite a substantial increase in public works spending concentrated in the first half of the year.

The greatest uncertainties concerning Japanese economic prospects are the financial situation and the extent of the deceleration in investment. Aggregate spending in 1991 does not appear to have been significantly affected by the sharp slowdown in bank lending, mainly because alternative funds available to larger corporations remained ample. However, there is a risk that activity could be more seriously affected if substantial further declines in real estate or equity prices were to lead to a more serious credit constraint. How much further the adjustment in capital investment will proceed is particularly difficult to gauge. Housing investment has been declining faster than during the more protracted downturn in the early 1980s, but remains well above its historical trend. Enterprise surveys conducted in early 1992 project a significant decline in investment, particularly in manufacturing, for the 1992 fiscal year. However, surveys taken the year before understated the strength of business investment and past experience suggests that outlays could be stronger were the overall economic outlook to improve.

Potential risks from falling asset prices

In *western Germany* the slowdown in growth, while amplified by the effects of income and excise taxes imposed at mid-year, nonetheless reflects a genuine weakening of underlying demand. In particular, industrial production fell during 1991 and employment stopped growing. As already noted, the deceleration in growth was essentially due to changing conditions in the eastern Länder and their consequences for fiscal policy, as well as to the inflation situation. Up to about the middle of last year, rising public expenditure on the new Länder fuelled a spending boom that was largely directed to western German and other European producers. This stimulus receded in the course of 1991, and demand was further weakened by slowdowns in exports to other countries and in business investment.

Germany's expansion halts as fiscal stimulus ebbs ...

Primarily as a result of the stabilisation of output in the new Länder and the tax increases, the general government budget deficit rose less in 1991 than in 1990. Nonetheless, the general government deficit was 3.1% of western German GDP in 1991, nearly as high as the ratios recorded by western Germany in the early 1980s. Moreover, interest rates remained high, and short-term rates increased during 1991, as monetary policy was progressively tightened in the effort to contain inflation. By the end of 1991 long-term interest rates appeared to be almost as high in real terms as in the early 1980s. The degree to which the rise in interest rates dampened

... but interest rates stay high ...

activity is somewhat unclear. Total investment rose by 2.8% during the four quarters of 1991, but the pace was considerably slower than in the previous two years. Furthermore, virtually all of the increase occurred in the first quarter, as capital spending fell over the remainder of 1991.

The prospects for interest rates, and to a large degree for the overall economy, have come to depend critically on wage developments. Wage rate increases averaged nearly 7% last year, close to the peak reached in 1980–81. Productivity growth in the western German economy has averaged slightly less than 2% over the last decade, so that continued wage growth at last year's pace would imply an underlying inflation rate somewhat higher than the 4% recorded last year. Settlements negotiated at the end of last year and in early 1992, notably in the steel industry, suggest that the acceleration in wage growth may be coming to an end. However, the settlements also do not represent any significant moderation from the current trend in average wages, and the extent of wage restraint in future agreements remains highly uncertain. Capacity utilisation rates in 1991 remained above the previous peak in 1979 as well as the level at which wage inflation began to decline in the early 1980s.

... and inflation concerns intensify

The situation in eastern Germany. Almost one year following unification, industrial activity in the eastern Länder levelled off at about two-thirds of its 1990 average and then apparently began to improve somewhat in the latter half of the year. There was a noticeable increase in manufacturing orders and a revival in construction orders as well as activity. Employment, however, continued to decline, and recent business surveys suggest that further declines are likely. The officially recorded unemployment rate rose to nearly one-sixth of the labour force in early 1992 as a number of employment subsidy schemes came to an end.

Output stops falling in eastern Germany

The end of the decline in activity effectively meant that production had fallen to the level supported by the very large transfer payments from the Federal Government. The net payments amounted to more than one-half of the total GNP of the eastern Länder. Subsidised government credits were chiefly responsible for the rise in foreign orders received by eastern German manufacturers, and public infrastructure investment was the main source of the pick-up in construction.

Despite some encouraging progress, output in eastern Germany remains depressed because its formerly state-run enterprises are generally not competitive in an international environment. Genuine recovery will depend on large and sustained improvements in productivity and product quality in the core industries. This process will entail massive investment over many years before the gap in productivity vis-à-vis western Germany can be closed.

Productivity increases needed to catch up with the west

Significant, if somewhat uneven, progress has been made over the last year in establishing the institutional basis for development of the eastern Länder. The new legal framework governing private property and commercial activities is now in place, although the provisions governing the restitution of property remain a source of uncertainty in some areas. Nearly 1,300 of the more than 5,000 industrial firms originally held by the Treu-

Selected economic indicators of Germany's new Länder

Items	1990	1991		1992
	H II	Year	H II	Q I
	percentage changes over preceding year			
Industrial output	−19.5[1]	−36.4	−35.1	..
Gross fixed investment	n.a.	n.a.	37.0	..
Cost of living	1.9[2]	21.3[3]	21.4	15.1[4]
Wages/worker in industry	n.a.	61.0[5]	40.7[6]	..
Wages/hours worked in industry	n.a.	87.9[5]	71.5[6]	..
	levels			
Gross fixed investment/GNP (%)	22.6	33.5	34.6	..
GNP/domestic demand (%)	n.a.	55.0	..	..
Total employment (millions)	8.5	7.5	7.3	..
of which: Short-time workers[7] (%)	*20.0*	*21.3*	*17.8*	..
Unemployment rate (%)	6.3[8]	10.4	11.7	15.5[4]
Memorandum items:	as a percentage of western Germany's GNP			
GNP	*7.8*	*7.4*	*8.5*	..
GNP/employee	*n.a.*	*30.0*	*n.a.*	..

[1] December relative to the third quarter of 1990. [2] December relative to 1989. [3] December to December. [4] March. [5] January to December 1991 at annual rate. [6] June to December 1991 at an annual rate. [7] As a percentage of total employment. [8] Fourth quarter.

Source: National data.

handanstalt have been transferred to the private sector. However, the majority are relatively small and most of the difficult task of restructuring and privatising the major industrial enterprises remains.

Growing investment

There has been a large and growing amount of capital investment, corresponding over the last twelve months to more than 30% of the region's GNP. A significant start was made on infrastructure investment, as the public authorities spent DM 45 billion on transport, communications and related facilities in the new Länder in 1991. These infrastructure outlays represented nearly 60% of total capital spending in the new Länder for that year. Private investment, supported by substantial government subsidies, has also increased markedly. Recent surveys indicate that as much as one-sixth of total private investment in the Federal Republic could go to projects in the eastern part of the country in 1992.

Despite the encouraging response to date, the incentives to invest in the eastern Länder are limited by a number of factors and in one important respect probably have deteriorated. Ambiguities regarding the restitution of property to former owners and enterprises' liability for existing pollution remain sources of uncertainty for prospective investors. The privatisation agreements in many cases restrict firms' latitude to reduce the workforce in the course of restructuring, which to some degree limits the return on investment, at least initially.

Increasing gap between wages and productivity

A potentially more serious problem is presented by the sharp increases in wages over the last year. Preliminary figures indicate that wages per worker in industry rose by roughly 60% during the year. To some extent, the rising wages reflect attempts to offset consumer price increases, which exceeded 20% in 1991, owing mainly to the curtailment of rent and other subsidies to the personal sector. However, agreements have been negotiated in the banking industry and a number of other sectors to achieve parity or near-parity with western German wages within a few years.

The gap between wage scales and productivity in the core industries has thus almost certainly widened. This trend could become an increasingly serious impediment to sustained investment in the eastern Länder, particularly as wages are significantly lower in several other member countries of the European Community. Furthermore, the greater imbalance between wages and industrial productivity also implies that the public outlays required to support industry and employment at any given level and to maintain investment incentives have increased.

Other large industrial economies

Both the *United Kingdom* and *Canada* made significant progress in 1991 in reducing the inflation pressures that were the primary causes of their recessions, but neither was able to generate any sustained recovery. Growth resumed in both *France* and *Italy* but became increasingly sluggish, due in part to the continuing restraint from high real interest rates and the slowdown in Germany.

UK recession continues

Major private sector financial adjustments considerably deepened and prolonged the recession in the *United Kingdom*, which has been the longest of its post-war history. The reversal of the boom in real estate prices and exceptionally high household debt burdens were important factors behind the severe and protracted weakness of personal consumption and housing investment. Likewise, corporate financial burdens, aggravated by excess capacity in certain areas, have been major contributors to the severe contraction in commercial real estate investment.

Inflation falls markedly

There was, however, marked progress in establishing the fundamental conditions necessary for recovery. While the decline in consumer price inflation last year was somewhat overstated as a result of falling oil prices and interest rates, there was nonetheless a substantial underlying improvement. By the end of 1991, negotiated wage increases were generally in the 4–5% range, about half the average of the previous year. With the moderation of inflation, the authorities were able to lower short-term interest rates by nearly 3 percentage points in the first half of 1991, and long-term rates came down by more than 1 percentage point. The differential between interest rates in the United Kingdom and Germany had been all but closed by the end of last year. Despite an increase in the central government deficit to over 1% of aggregate output, the budget provided essentially no discretionary stimulus to the economy last year. However, the proposed budget for fiscal 1992 contains a significant amount of stimulus and is expected to further increase the deficit.

The favourable effects of the decline in interest rates were most evident in the business sector, where financial deficits fell and the liquidity

Some improvement in private financial positions

of manufacturing enterprises improved somewhat. There was a significant rebound in business confidence in 1991 and surveys taken later in the year suggested that business investment might begin to revive in 1992. However, while the financial position of households has also improved, how much further their balance-sheet adjustments will go is uncertain.

There was some recovery in domestic demand in *Canada* beginning in the spring of 1991. Housing revived and there was a modest pick-up in business investment. However, consumption remained sluggish and external demand declined as the US recovery stalled. Consequently, there was virtually no growth in output after the second quarter.

Private sector financial imbalances have had only a modest impact on the recession, particularly in comparison with the 1981–82 downturn, when excess capacity in the energy sector was a serious problem. The reduction of inflation and continued budget consolidation have been the key preconditions for sustained recovery and considerable progress was made in both areas in 1991. Average wage increases began to decelerate markedly. Consumer prices excluding food, energy and indirect tax increases rose noticeably less in 1991 than in the previous year and were within the range implied by the Bank of Canada's longer-term inflation objectives. Partly as a result, interest rates fell substantially, in real as well as nominal terms, and the differential vis-à-vis rates in the United States narrowed appreciably. Furthermore, the central and general government budget deficits, although higher in 1991 than the preceding year due to the economic downturn, nonetheless improved significantly on a cyclically adjusted basis. Considerable further budget consolidation is planned for fiscal 1992. Thus the domestic foundations for a recovery have been substantially established, but the prospects hinge to a large degree on a revival of growth in the United States.

Progress on inflation in Canada ...

... but recovery is dependent on the United States

In *France* and *Italy* private debt burdens and related problems seem to have been relatively moderate. Activity was increasingly affected during 1991 by high real interest rates and, later in the year, by the slowdown in Germany. Growth in France was positive in 1991 but relatively sluggish. Consumption growth was somewhat faster than in most of the other major countries, although slower than in the previous two years. Activity was also supported by a fairly strong expansion in exports for much of the year. Underlying conditions for growth remained comparatively favourable. In particular, inflation pressures were quite subdued and core inflation remained among the lowest in the industrial world. Although the general government budget deficit rose to 1.9% of GDP in 1991, largely as a result of the weakness of activity, it was still significantly lower than the industrial country average. The budget was moderately contractionary in 1991 but is expected to be somewhat stimulative in 1992.

Sluggish growth in France

Nonetheless, demand conditions worsened as the year progressed. Exports decelerated considerably in the final months of 1991. Consumer confidence, which was already quite low prior to the current downturn and had been in decline for a number years, fell further to its lowest level since the early 1980s. The unemployment rate rose in 1991 for the first time in nearly five years, to just below 10%, although employment did increase moderately.

The decline in business and housing investment that began in 1990 also continued throughout last year, although there was some revival of housing activity in the second half. While the weakness of investment in part reflects the slowdown in overall activity, the exceptionally high level of real interest rates may have been an important factor. With nominal long-term interest rates nearly 6 percentage points above the underlying rate of inflation, real long-term interest rates are now at their highest for over twenty years, and higher than in any of the other major industrial countries.

High interest rates despite low inflation

Aggregate output in *Italy* grew by 1.4% in 1991, although this outcome is somewhat deceptive as industrial production has declined fairly continuously since 1990. Nonetheless, consumption growth was nearly as strong as before the Gulf war and business equipment investment also increased substantially during the year.

The inflation and government budget situations remain quite serious and together with the slowdown in Germany raise some doubt as to whether growth can be sustained for much longer. Inflation, although down substantially from the peaks reached earlier in the 1980s, has changed little since 1989 and has been significantly above the rates of most of Italy's main trading partners. Wage increases, particularly in the public sector, accelerated appreciably in 1991. The combination of relatively high inflation and a stable nominal exchange rate in the EMS has led to a considerable decline in the country's industrial competitiveness. The deterioration was largely responsible for the marked slowdown in exports that began in 1990, and whose effects are manifest in the fall in industrial production.

Serious inflation and budget problems in Italy

Furthermore, while the budget's net impact on activity has been restrictive, consolidation has proved quite difficult. The Government's target for deficit reduction in 1991 was not achieved, despite tax increases and other corrective measures taken at mid-year. Current plans for balancing the primary budget, excluding interest payments, in fiscal 1992 are based on a significant recovery in activity. In any case, additional and intensified monetary and budgetary restraint will be needed for some time if the criteria for participation in European monetary union are to be met.

Other industrial countries

The overall performance of the smaller industrial economies in 1991 was in many respects similar to that of the larger seven. Growth slowed and averaged about 0.5%. The downturn in investment was particularly marked but consumption was also weak in many countries. As in the larger economies, performances were shaped to varying degrees by efforts to reduce inflation, high real interest rates, budget consolidation, adjustments of private financial imbalances and, in Europe, growth in Germany.

Sweden, Finland, Switzerland, Australia and New Zealand remained in recession last year but made significant progress in reducing inflationary pressures. The downturn in Finland, which has been much more severe than in any other industrial country, was considerably aggravated by falling

Continued recession but lower inflation

Changes in real GDP and fixed investment in other industrial countries

Countries	1989 GDP in billions of US dollars	Real GDP[1] 1980–88	Real GDP[1] 1989	Real GDP[1] 1990	Real GDP[1] 1991[2]	Real gross fixed investment 1980–88	Real gross fixed investment 1989	Real gross fixed investment 1990	Real gross fixed investment 1991[2]
		percentage changes							
Australia	284	3.3	4.1	1.2	−2.1	3.3	10.3	− 7.1	−11.5
Austria	126	1.7	3.7	4.6	3.0	1.1	5.4	6.5	5.0
Belgium	153	1.6	3.8	3.7	1.4	0.4	14.6	7.4	1.7
Denmark	106	2.3	0.8	1.7	1.0	2.1	−0.6	− 0.5	− 2.1
Finland	116	3.3	5.4	0.4	−6.2	3.4	14.1	− 4.9	−17.0
Greece	54	1.5	3.5	−0.1	1.2	−1.9	10.0	4.8	− 2.1
Ireland	34	2.7	6.4	7.1	2.1	−2.1	15.8	9.5	− 4.7
Israel	44	3.3	1.6	5.1	5.2	1.3	−4.8	17.1	45.0
Netherlands	224	1.3	4.2	3.9	2.1	1.9	4.6	4.2	− 0.4
New Zealand	42	2.3	0.4	1.4	−2.2	5.5	9.3	1.3	−17.0
Norway	90	2.8	0.6	1.8	1.9	3.4	−3.9	−26.6	1.0
Portugal	45	2.2	5.5	4.2	2.0	2.0	8.3	7.3	2.8
South Africa	89	1.5	2.3	−0.5	−0.6	−2.8	5.1	− 1.7	− 8.4
Spain	380	2.6	4.8	3.6	2.4	3.6	13.8	6.9	1.6
Sweden	190	2.1	2.4	0.4	−1.1	2.8	11.8	− 0.9	− 7.3
Switzerland	177	1.8	3.9	2.2	−0.5	4.4	5.8	2.2	− 2.8
Turkey	79	5.3	1.9	9.2	1.5	4.9	−1.0	14.1	− 1.0
Average[3]	–	2.4	3.6	2.7	0.5	2.5	8.3	1.5	− 2.5

[1] For Turkey, real GNP. [2] Preliminary. [3] Calculated using 1989 GDP weights and exchange rates.
Sources: OECD and national data.

commodity export prices and especially by the contraction of 65% in trade with the former Soviet Union; this contraction alone accounted for more than one-quarter of the 6% drop in Finland's output in 1991. There was substantial progress in reducing wage pressures, particularly in Australia, Finland, New Zealand and Sweden, where a wage restraint agreement between government and industry had considerable success. Growth in Ireland, where inflation has been fairly modest, fell markedly in 1991 as demand from the United Kingdom declined sharply. Largely as a result, the unemployment rate rose considerably and along with that of Spain remained the highest in the industrial world.

Slowdowns in Germany's closest trading partners

Growth in Austria, Belgium, the Netherlands and Norway was higher than the industrial country average in 1991. However, a marked deceleration in fixed investment in Belgium and the Netherlands, and in inventory accumulation in Austria, led to a significant slowdown in aggregate output growth from 1990. External demand accounted for nearly all the growth in Denmark and Norway, although domestic demand in Denmark continued to recover modestly from earlier downturns. Net external demand also contributed somewhat to growth in the Netherlands but fell slightly in Austria and Belgium. Demand in these three countries, and to a lesser extent in Denmark and Norway, is relatively dependent on exports to Germany and thus potentially vulnerable if the slowdown there should persist. Real interest rates in these countries are also fairly high and constrained by exchange rate objectives. Inflation in most cases has remained quite moderate. Denmark's membership of the EMS and structural reforms over the last few years seem to have significantly affected wage behaviour, as wage pressures have continued to ease. However, wages have accelerated markedly over the last two years in the Netherlands, and consumer price inflation during 1991 rose to nearly 5%, although partly as a result of increases in fuel taxes and in ceilings on medical charges and rents. Moreover, wages in Austria have also accelerated noticeably.

Continued deceleration in Spain's growth

Growth in Spain and Portugal was also higher than the industrial country average in 1991, although slower than in 1990. Business investment decelerated sharply in Spain and consumption growth slowed somewhat. Activity has been decelerating gradually since 1988 as the stimulus to housing and consumer spending provided by the extensive financial deregulation of the late 1980s has abated. Furthermore, monetary policy has been tightened since 1990 in an effort to reduce inflation. Structural improvements, particularly in labour mobility and wage flexibility, remain a key to a sustained reduction in inflation pressures as well as the full realisation of Spain's relatively high growth potential. In Portugal, domestic demand continued to be relatively robust in 1991. However, persistent high inflation has seriously eroded the country's competitiveness, leading to a sharp fall in export growth.

Financial strains in several Nordic countries

Problems in the banking sector and other financial strains similar in certain respects to those in the United States and the United Kingdom have also arisen in a number of the smaller economies. Large losses by major banks in the Nordic countries led to a state takeover of the second and third-largest institutions in Norway, and government intervention in a major bank in both Sweden and Finland. The financial problems do not seem to have seriously affected spending, probably because loan demand was already weak, particularly in Sweden and Finland. Investment demand in Norway, and to some degree in Sweden, has also been substantially weakened by excess supply and falling prices in the commercial and residential real estate sectors. Similar problems have arisen from the interaction of financial liberalisation and high inflation in Australia during much of the 1980s. As in the United Kingdom, adjustments to these imbalances have been an important factor in aggravating and prolonging the recession.

Widespread budget consolidation efforts

Many smaller countries either continued or began budget consolidation efforts in 1991, with significant restraint on aggregate demand in several cases. In Greece, the general government deficit fell but remained nearly one-sixth of GNP. Output recovered somewhat but there was virtually no progress in reducing the country's exceptionally high inflation. Budget retrenchment in the Netherlands, where the general government deficit fell by nearly 1 percentage point of aggregate output, was a significant factor in the slowdown in real growth. Further but somewhat milder restraint is planned for the 1992 fiscal year as part of a long-term effort to reduce the high public debt ratio, which now amounts to almost 80% of GDP. A long-term budget consolidation process also continued in Belgium, where public debt exceeds national output and interest payments amount to nearly one-fifth of total government spending. In Sweden the central government budget deficit increased sharply in 1991 and the general government budget, which recorded a surplus of 3.9% of GDP for the previous year, fell into deficit for the first time since 1986. However, the new Government introduced spending cuts amounting to about 1% of total expenditure, although the savings in the first year were substantially offset by a temporary increase in funds for employment programmes and by the abolition or reduction of several taxes.

Financial constraints on real activity

Financial strains have been unusually prominent in the present cycle and there has been concern that two problems in particular may be significantly restraining activity in a number of countries. One concern is that credit supply constraints, prompted by a severe deterioration in asset quality and low profitability in the banking sector, have been limiting spending enough to add substantially to the overall weakness of activity. Among the countries in which bank balance sheets have been weak are the United States, Japan, the United Kingdom, Australia, Finland, Norway and Sweden. A second concern is that increased debt service burdens in the private sector, aggravated in some cases by a decline in asset prices, may have initiated a process of balance-sheet restructuring that has restrained expenditure. Important definitional and statistical questions are involved in determining to what degree a true "credit crunch", a situation in which banks or other lenders refuse loans or financing at their current lending rates to even creditworthy customers with sound projects, is seriously holding back growth in some countries. On balance, the available evidence suggests that a reduction of the supply of credit appears to have played a comparatively minor role in shaping economic developments during the last year, although a restriction of the availability of credit remains a potential risk to growth in some countries. There is more evidence that high debt burdens, particularly in the household sector, have contributed to weakness, at least in the United States, the United Kingdom and several Nordic countries.

High debt burdens more significant than credit problems

Credit supply constraints

Bank credit growth remains weak

The growth of bank credit to the private sector in many industrialised countries (including the United States, Canada, Japan and much of northern Europe), which had already fallen sharply prior to 1991, either declined further or remained subdued last year. Much of the slowdown can be attributed to the overall weakness of aggregate demand. However, in a number of countries declining bank profitability and a deterioration in balance-sheet positions have raised concerns that banks may have been much more cautious in extending credit and that the resulting stringency has added significantly to the weakness of activity.

In certain respects the potential vulnerability of economic activity to credit supply restrictions is considerably less than in the past. Previous sharp contractions in credit growth typically arose as a result of a rapid process of disintermediation. For example, monetary policy tightening in the United States in the 1960s led to a sharp reduction in bank deposits because of the existence of Regulation Q ceilings on deposit interest rates, which restricted the ability of banks to undertake lending activity. Financial liberalisation has removed these regulations and promoted competition amongst financial institutions as well as the development of new financial instruments. This, together with a major expansion of the commercial paper and bond markets, has led to a corresponding reduction in the dependence of some, particularly large, companies on the banking sector. However, there is some evidence that alternative sources of finance have not expanded as much for small to medium-sized enterprises. They are, therefore, likely to be more vulnerable to restrictions on credit supply.

Dependence on the banking sector has diminished

Despite the overall improvement in financial flexibility, a number of factors suggest that bank credit restrictions in the United States and some other countries may have become a serious constraint on certain key spending components. As noted earlier, the markets for consumer durables, housing and commercial real estate have been unusually weak in a number of countries. Bank loan spreads over costs have widened, although this is not untypical during periods of recession when the creditworthiness of borrowers may deteriorate. In the United States, bank loan survey data suggest that bank credit availability has been reduced as non-price lending terms and conditions have tightened.

Lending standards have been tightened

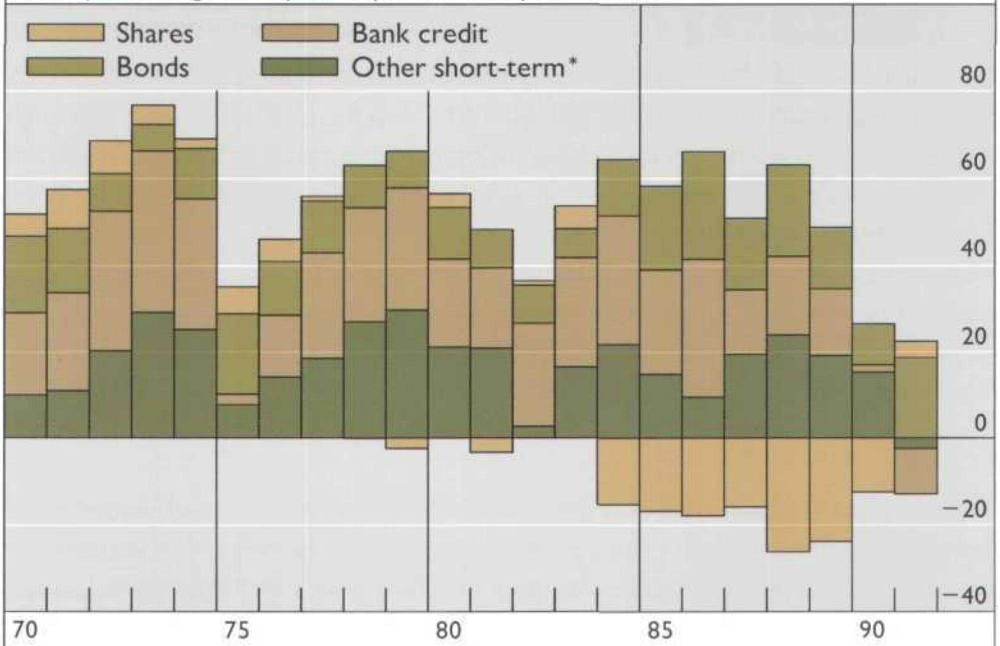
But even in the United States credit stringencies, while possibly important in certain regions and sectors, seem to have had only a moderate overall impact on activity. In particular, the weakness in the commercial real estate sector appears to be directly attributable to excess capacity, reduced demand arising from the overall weakness of activity and high debt burdens. This view is further borne out by an analysis of external enterprise financing in the United States.

External enterprise financing in the United States

External sources of finance, which in the United States contributed around 50% of total investment expenditure in the first half of the 1980s, and around 30% in the second half, fell sharply in 1990 and again in 1991. Much of this decline was due to a contraction in bank borrowing. However, this is consistent with both a fall in investment demand and a reduction in the supply of credit. Some indication of the relative importance of these two factors may be derived from an examination of the recourse made by enterprises to external sources of finance that are alternatives to bank borrowing. In contrast to previous cycles, other short-term sources of finance, including commercial paper issues, also appear weak, suggesting that demand-side influences are very significant. Moreover, during the 1980s internal and external funds were more than sufficient to finance corporate investment expenditure and stocks of liquid assets rose substantially. These liquid assets provide a buffer in the event of a restricted availability of bank loans. Despite the slowdown in credit growth the net acquisition of liquid assets has remained positive. There has been a trend reversal in share issuance – with positive net share issues in 1991 for the first time since 1983 – and a higher percentage of investment

External financing of the US non-financial business sector

As a percentage of capital expenditures by the sector



* Other loans, commercial paper and trade credit received.
Source: National data.

financed by bonds. Both developments are consistent with a restructuring of corporate balance sheets as is discussed below.

Little evidence of a "credit crunch" in the United Kingdom or Japan

Similar considerations suggest that credit supply constraints have not been a significant influence in either the United Kingdom or Japan. In the United Kingdom banking sector problems have not been so severe as to have been a likely impediment to lending growth. Although there is some evidence that banks have tightened their lending criteria, there is little to suggest that they have done so more than would be warranted in the light of the position and prospects of the corporate sector. In Japan, where bank lending has traditionally been an important source of external funds for the corporate sector, financial deregulation over the past few years has increased the range of instruments available, both domestically and in foreign capital markets, reducing the dependence on banks. For example, the commercial paper market established in 1987 has expanded rapidly. The slowdown in credit growth has not led to unusual weakness in corporate expenditure in either the United Kingdom or Japan, except in the real estate sector. In Japan a ceiling was applied from the spring of 1990 until the end of 1991 to the growth of lending to the real estate industry but this is likely to have speeded up the adjustment already taking place rather than caused the weakness in this sector.

Banking problems are a greater concern in several Nordic countries ...

Banking problems have been more severe in several Nordic countries. The impact of a sharp contraction in bank credit growth has nonetheless been cushioned by several factors. The most important have been large companies' ready access to foreign sources of finance and the willingness of governments to intervene to ensure the continued supply of credit. In

Norway, for example, state funds have been used to strengthen bank capital. In May 1992 Sweden's Government announced plans to acquire the remaining privately-owned shares of the country's second-largest, state-controlled bank.

On balance, the widespread reduction in credit growth appears to have been more a demand than a credit supply phenomenon. Although there has been some credit supply influence on real activity in the United States, it has not been significant in aggregate terms. Rather, credit demand has generally been weak. Nevertheless, credit supply constraints could represent a potential risk to activity in some countries, most notably Japan and some Nordic countries, should investment demand prove to be stronger than is currently anticipated or should asset prices continue to fall, weakening the banking sector further.

... and remain a potential risk to activity in some countries

Private sector debt burdens

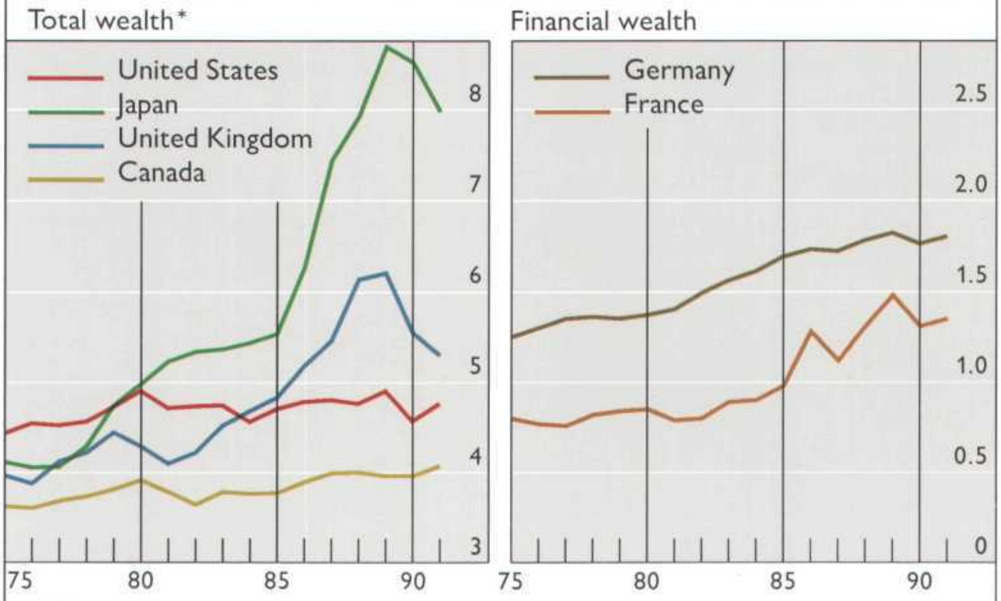
High private sector debt burdens were a more serious and widespread constraint on real activity during 1991. One aspect of this is the increase in liquidity problems which has accompanied the growth of liabilities, in particular where income flows have been reduced by a slowdown in economic activity, real interest payments have risen sharply and a fall in asset values has caused a significant decline in net wealth. In some countries these problems have led to a process of balance-sheet restructuring and to a period of subdued expenditure. In some instances there has also been an increase in saving rates. Debt levels rose substantially in a number of industrialised countries in the 1980s, but the adverse impact of higher debt burdens has been particularly apparent in the United States, the United Kingdom, Australia and several Nordic countries. Financial consolidation has taken place in both the household and corporate sectors, but the main influence on real activity appears to have derived from household sector adjustments. Private sector debt also rose sharply in Japan but there is no evidence that this has so far been an impediment to economic growth.

Expenditure subdued while balance-sheet imbalances are corrected

The household sector has been most affected in those countries, such as the United States and the United Kingdom, where interest payments (or income gearing) have risen substantially and where net wealth has either not risen or has declined. In much of continental Europe and Japan there has been less of an impact on expenditure either because interest payments have been lower or levels of net wealth have been higher. Rapid growth in purchases of consumer durables and housing was widespread during the 1980s, financed to a large degree by borrowing. The interaction of an easing of constraints on housing finance and favourable tax treatment of interest payments stimulated a rapid expansion in mortgage debt in a number of countries. However, increases in asset values – notably equity prices and residential property prices – in general more than kept pace with the increase in liabilities. In consequence, net wealth/income ratios tended to rise in the major industrialised countries, with the exception of the United States and Canada. This rise in net wealth relative to income was strongest in Japan, but a more modest increase was also recorded in the

Household net wealth

Household net wealth: ratio to disposable income



* Tangible and net financial wealth.
Sources: National data and BIS estimates.

United Kingdom, France and Germany. More recently, the ratio of net wealth to income has fallen back from the levels reached towards the end of the 1980s but the decline has not reversed the increase of earlier years. Consumers' expenditure has been more subdued in the United Kingdom, where net wealth has declined sharply, and in North America, where net wealth/income ratios remained broadly constant throughout the decade.

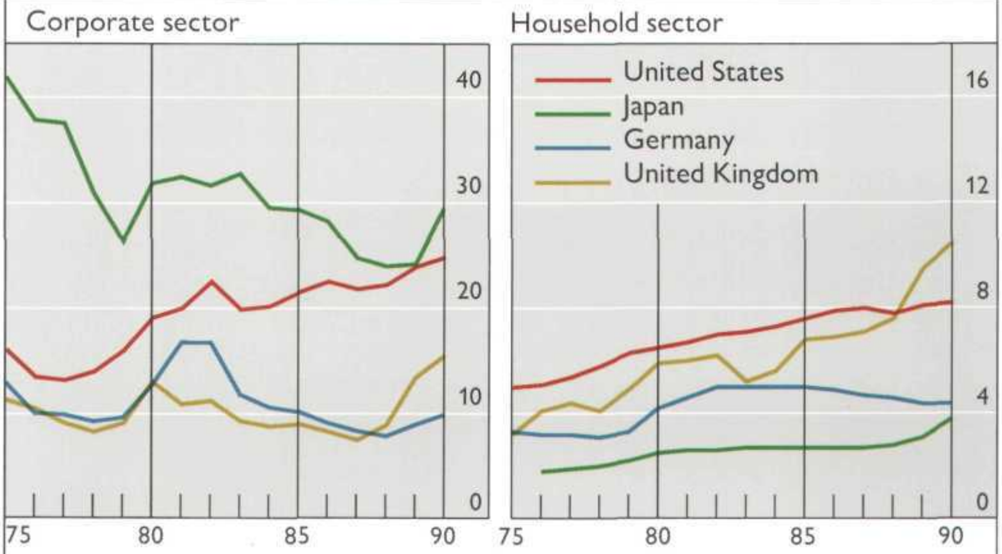
The debt servicing burden has eased

Changes in household sector income gearing, measured by gross interest payments as a proportion of disposable income, have underpinned the desire to restructure balance sheets. Following financial deregulation there was a trend increase in gearing, accentuated by a tightening of monetary policy in some countries in response to growing inflationary pressures in the late 1980s. Household income gearing reached particularly high levels in the United States and the United Kingdom. Reductions in interest rates since 1990 have begun to ease the debt service burden, as has the repayment of consumer debt. In the United Kingdom the saving ratio, which declined markedly between 1985 and 1988, has since recovered sharply, as it has in Sweden. In Norway the household saving rate turned positive in 1989 for the first time since the abolition of quantitative credit controls for private banks in 1984.

Corporate restructuring most apparent in the United States

There have been similar developments in the corporate sectors of these countries. A number of arguments have been advanced to suggest that the corporate sector may have been more willing to take on debt because of tax legislation, improved risk management or the prospect of increases in economic efficiency. The effects of higher leverage also depend in part on whether the changes have occurred in industries which are more vulnerable to a downturn in economic activity or in non-cyclical industries. The significance of higher debt levels for the corporate sector may be

Income gearing



Note: Corporate sector income gearing is defined as net interest payments as a percentage of pre-tax income, taken as an indicator of corporate cash flow. Mainly for distributional reasons, household sector income gearing and the associated burden are measured by gross interest payments as a percentage of household disposable income.

Source: National data.

illustrated by reference to the ratio of net interest payments to pre-tax income. In Canada, the United States and the United Kingdom income gearing has risen. Higher debt levels have meant that interest payments in relation to income have been higher than in previous cycles. Corporate restructuring has been particularly apparent in the United States, facilitated by lower corporate bond rates and a buoyant stock market, which has supported a resurgence of share issues. In contrast, corporate income gearing declined in Japan and Germany in the course of the 1980s, although there has been some modest increase since 1988.

Financial factors have increased uncertainty

In conclusion, in most countries the credit slowdown appears to have reflected more a decline in the demand for borrowing than an inordinate reluctance of banks to grant new credits. The more dominant financial influence on real activity has been high private sector debt levels. In 1991 the process of restructuring balance sheets contributed to lower household and enterprise expenditure. It is unclear to what extent financial deregulation and innovations in financial instruments and technology during the past ten years may permanently support higher debt levels. There is, therefore, considerable uncertainty as to the cyclical impact that higher private debt levels might have on economic recovery and its timing. There also remains some risk that credit conditions could become a more serious constraint on economic activity in certain countries should investment demand prove stronger than is currently anticipated prior to any significant improvement in their banking sectors.

III. Developments in other countries

Highlights

Real output performance in the developing countries and the NIEs last year was marked by very large differences, reflecting the influence of slow growth in the industrial countries as well as the effect of domestic developments and policies. The Asian countries, being only marginally affected by weaker world trade, recorded rapid output growth and in Latin America domestic demand recovered strongly. By contrast, the Middle Eastern countries were adversely affected by the Gulf war and in Sub-Saharan Africa real per capita income declined for the third consecutive year.

The impression of large regional or country differences also extends to developments in inflation, foreign trade, balances of payments and external debt. The rate of inflation declined dramatically in Latin America while in other developing countries it remained mostly high or even accelerated somewhat. Overall, the current account deficit of the developing countries widened sharply as the result of large transfer payments from Middle Eastern oil producers, strong import growth in Latin America and a general weakening of export demand and the terms of trade. At the same time, financing conditions eased significantly and a number of the most heavily indebted countries made progress in reducing the burden of excessive external debt.

1991 was a difficult year in eastern Europe as the fall in real output accelerated and rates of unemployment rose steeply in the course of the year. One reason for the disappointing outcome was the large and unexpected decline in exports to the former Soviet Union, which exacerbated the effects of the dismantling of the CMEA trading system. In several countries output and demand were also adversely affected by the disintegration of production and distribution systems and to reduce the risk of excess demand pressures fiscal and monetary policies were kept restrictive.

While near-term prospects for a return to positive growth are generally poor, progress has been made in some areas. Despite large once-for-all price increases following price reforms and the abolition of subsidies as well as clear signs of cost-push pressures, most countries managed to reduce the rate of inflation in the course of last year. Moreover, to be discussed in greater detail in Chapter IV, current account imbalances were generally smaller than predicted, partly because of significant increases in exports to western countries. However, to sustain the progress made budgetary reforms are urgently needed as widening fiscal imbalances pose a serious risk to monetary stability and the long-run rate of inflation.

Real output, inflation and trade in the developing countries and the NIEs

Unchanged output growth with large regional variations

Despite the recession in the industrialised countries and the slowdown in world trade, real output growth in the developing countries and the newly industrialised economies (NIEs) was largely unchanged last year. There were, however, major regional differences in average growth performance and in underlying causes and problems (see the table opposite). The most pronounced improvement was registered in Latin America as several countries, having been through a period of reducing budget imbalances and inflation, experienced a marked strengthening of domestic demand. The Asian countries once again outperformed those of other regions, but there were larger differences within the region than in earlier years with some countries having entered the early phase of a cyclical upswing while others experienced slower growth because of anti-inflation policies or weaker exports. In Africa the pattern of low growth and stagnating or falling per capita incomes continued, whereas many countries in the Middle East faced unusually difficult problems due to the effects of the war in the Gulf, changes in oil prices and various financial shocks.

Marked decline in inflation

Coinciding with steady overall real growth there was a marked decline in the average rate of inflation. However, this was entirely due to developments in Latin America. In Asia average inflation increased slightly as a number of countries encountered capacity bottlenecks and tight labour markets. Inflation also rose in Africa and the Middle East, reflecting the effects of lax fiscal policies and higher import prices.

Adverse external influences...

A number of factors played an important role in shaping trade and current account developments in the NIEs and the developing countries last year. The two most basic ones – export markets and commodity prices – were largely adverse. *Export markets* weakened sharply as real import growth in the industrial countries slipped to less than half the average rate of the preceding ten years (5¾%). Falling output in eastern Europe and the former Soviet Union was a further unfavourable influence. While domestic demand picked up somewhat in the developing countries, its effect on export growth was too limited to compensate for the slack in the industrial countries. *Export prices* (in US dollars) of the developing countries declined once again. Following a drop of nearly 7½% in 1990, non-fuel commodity prices fell by 3½% in 1991, with a particularly sharp decline in prices of cyclically sensitive commodities. The end of the Gulf crisis also brought a rapid downward correction of oil prices, only briefly interrupted in late 1991, taking the level almost back to that just prior to the Gulf conflict.

... but also favourable factors

There were, however, other and more favourable factors. Perhaps the most important of these was the *greater ease of financing* current account transactions. A number of Latin American countries in particular benefited from larger inflows of capital which enabled them to increase imports and reduce interest arrears. The inflows included foreign direct investment, short-term capital, repatriation of flight capital and some modest return to the international capital markets. In addition, the signifi-

GDP growth in developing countries and the NIEs								
Countries and country groups	1984–86 GDP in billions of US$	1981–86 average	1987	1988	1989	1990	1991	Per capita 1981–91 average
		percentage changes						
Africa	250	2.2	1.6	3.7	3.5	1.9	2.5	−0.6
Nigeria	62	0.2	1.8	9.8	6.1	5.2	4.2	−0.7
Sub-Saharan countries	109	1.6	2.0	2.7	2.2	1.2	0.8	−1.5
Middle East	488	0.5	−0.2	0.7	2.5	4.5	0.4	−2.1
Egypt[1]	55	7.1	6.4	4.0	3.0	2.6	2.3	3.0
Iran[2]	173	4.5	−1.1	−6.5	4.3	10.1	9.5	0.2
Asia	950	6.6	7.8	8.9	5.5	5.4	5.5	5.0
China	237	10.5	10.2	11.1	3.8	4.8	7.0	7.3
India[1]	216	5.2	4.5	9.4	5.0	4.0	2.0	3.0
Indonesia	82	4.3	4.9	5.8	7.5	7.4	6.4	3.3
Malaysia	31	3.9	5.3	9.1	8.6	9.8	8.8	3.4
Philippines	32	−1.3	4.8	6.2	5.9	2.4	−1.0	−0.9
Thailand	40	5.4	9.5	13.2	12.0	10.0	7.9	5.7
NIEs	208	7.5	12.1	9.5	6.3	6.7	7.2	6.6
Latin America	732	1.4	2.8	1.0	1.2	0.6	3.1	−0.8
Brazil	236	3.7	3.6	−0.0	3.3	−4.0	1.2	−0.6
Mexico	163	−0.7	1.7	1.4	3.4	4.4	3.6	−0.5
Argentina	74	0.2	2.5	−2.7	− 4.4	0.4	4.5	−2.0
Chile	17	−0.4	5.7	7.4	10.0	2.1	5.0	1.6
Peru	22	0.5	8.3	−8.3	−11.9	−4.6	2.0	−2.9
Venezuela	58	0.2	4.5	6.3	− 7.8	5.3	9.2	−1.7
All countries[3]	2,420	3.4	4.0	4.3	3.4	3.4	3.5	1.2

[1] Fiscal year. [2] Year beginning 21st March. [3] Calculated using 1984–86 GDP weights and exchange rates.

Sources: IMF World Economic Outlook, UN Commission for Latin America and the Caribbean and national data.

cant *decline in world interest rates,* especially short-term rates in the United States, reduced interest payments of developing countries by more than $5 billion. Since interest rates in many developing countries rose, capital inflows were further spurred and exchange rates came under upward pressure, leading in a number of instances to a decline in competitiveness. Finally, economic reforms, including trade liberalisation, privatisation and deregulation, produced *greater openness to foreign trade and investment.* In the short run trade balances have deteriorated because the measures mainly favoured imports. However, in the longer term these reforms are likely to prove beneficial and raise investment incentives and export potential.

Developments in the NIEs

Recovery in Taiwan and Hong Kong ...

Last year the four NIEs went through different phases of the business cycle. South Korea and Singapore recorded slower growth due to consolidation policies and weakening exports respectively, while Taiwan and Hong

Kong were in the early phase of an upswing. The main impetus in *Taiwan* stemmed from a turnround in business fixed investment and stronger exports, reflecting lower nominal wage increases, the effects of earlier direct investment in ASEAN countries and buoyant activity in Southern China. This last factor was even more important in *Hong Kong*, with manufacturing firms employing around 3 million workers in Southern China, compared with less than 0.7 million in Hong Kong. As a result, the annual growth of real GNP may have exceeded that of real GDP by about 2 percentage points over the last two years.

... but slower growth in South Korea ...

In *South Korea* a shift in policy priorities in favour of reducing inflation and strengthening the external position was instrumental in significantly reducing the growth of business fixed investment as monetary policy was tightened and construction permits made subject to stricter controls. Helped by a depreciation of the nominal exchange rate and falling unit labour costs, real export growth rose slightly. However, because of a slow deceleration in the growth of domestic demand, the contribution of net exports to GDP was again negative and the current account deficit rose to almost 3½% of GDP. In *Singapore* demand management policies changed little since the rate of inflation remained stable at a low level and the surplus on the external current account rose. Output slowed because of weaker demand in major export markets, which in turn reduced business fixed investment. Moreover, a contraction in offshore banking activities and reduced turnover in the foreign exchange market, following very high rates of expansion during the previous five years, caused a setback in the financial services industry.

... and Singapore

Real output and inflation in the developing countries

Recovery and lower inflation in Latin America ...

Despite lower export demand and a terms-of-trade deterioration of more than 5%, real output growth in *Latin America* rose to 3% last year. For the first time since 1987 per capita income did not decline. The average rate of inflation fell significantly from nearly 1,600 to less than 200% (see the table opposite). Several countries, which in 1990 had experienced inflation rates of 1,000% or more, managed to suppress or eliminate the main sources of inflation. The rate of price increase also declined significantly in those countries which in 1990 had recorded inflation rates in the 25–30% range.

... owing to reforms and tighter policies

This favourable outcome was due in large measure to the policies pursued during the previous three years, when a number of countries adopted reform measures aimed at creating more favourable conditions for sustainable growth. Throughout the region monetary and fiscal policies were tightened and steps were taken to scale back the role of the public sector by privatising state enterprises and reducing government regulation. Financial sectors were liberalised, interest subsidies were cut or eliminated and in most countries real interest rates are now positive. Finally, there was a general move towards promoting export-led growth, including the adoption of more competitive exchange rate policies and the partial removal of export taxes and import restrictions.

Inflation in developing countries and the NIEs							
Countries and country groups	1980–85 average	1986	1987	1988	1989	1990	1991
	percentage changes in consumer prices						
Africa and Middle East	11.5	11.5	16.5	19.0	17.5	14.0	18.5
Egypt	14.0	23.9	19.7	17.6	21.3	16.8	19.8
Nigeria	18.7	5.4	10.2	38.3	51.0	7.1	15.0[1]
Asia	7.5	12.4	12.5	18.5	13.5	9.0	9.5
China	4.1	7.0	8.8	20.7	16.3	2.1	3.4
India	9.3	8.7	8.8	9.4	6.2	9.0	12.0[1]
Indonesia	9.7	5.9	9.2	8.0	6.4	7.5	9.5
Philippines	20.5	0.8	3.8	8.8	10.5	12.7	18.0
South Korea	7.1	2.8	3.0	7.1	5.8	8.6	9.5
Thailand	4.9	1.8	2.5	3.9	5.4	5.9	6.0
Latin America	128.5	91.5	130.0	292.0	910.5	1,568	193.0
Argentina	322.5	90.0	131.5	343.0	3,080	2,314	172.0
Brazil	149.0	150.0	219.0	582.0	1,325	3,118	428.0
Mexico	60.5	86.2	131.8	114.2	20.0	26.7	22.7
Peru	102.0	77.9	85.8	667.0	3,399	7,482	410.0
All countries[2]	45.0	35.5	49.5	101.0	286.0	482.0	67.5

[1] Estimated. [2] Calculated using 1984–86 GDP weights and exchange rates.
Sources: IMF International Financial Statistics and World Economic Outlook and national data.

High initial costs ...

Initially, the reorientation of policies entailed high economic and social costs, with per capita incomes declining by a cumulative 3½% during 1988–90 and unemployment increasing throughout the region. Gradually, however, the new policies appear to have strengthened confidence among international and domestic economic agents. Net capital inflows nearly doubled last year and for the first time since 1981 there was a net transfer of resources to the Latin American region. In addition, the recovery of domestic demand was led by business fixed investment, in part financed by capital inflows. Finally, signs of lower risk premia on financial assets and a reduced need for massive changes in policy instruments to signal policy intentions became noticeable.

... but increased confidence

These positive signs were particularly evident in *Mexico* and *Chile,* which have pursued policies of consolidation and restructuring for several years. In Mexico a combination of incomes policies and a tight fiscal policy has contributed to reducing inflation and raising the growth of business fixed investment. Even excluding privatisation revenues, the public sector deficit declined last year, implying that the rise in the external deficit reflected a growing saving shortfall in the private sector. In Chile the growth of real GDP recovered last year as policies were gradually relaxed in response to lower inflation. Despite a budget surplus, the now independent Central Bank faced considerable problems in restraining money supply growth and finally resorted to a revaluation of the peso to stem the inflow of foreign capital. Real GDP accelerated even more sharply in *Venezuela,* reflecting an expansionary fiscal policy and large-scale investment in the oil sector. *Argentina* recorded the highest growth rate since 1986, as the

Favourable outcome in Mexico ...

... Chile ...

... and other countries ...

abolition of wage indexation combined with the introduction of currency convertibility and fiscal and monetary reforms helped to dampen inflation expectations. *Peru* relied on strict monetary and fiscal policies and structural reforms in bringing hyperinflation under control.

In *Brazil* it is still unclear whether the tenth major reform since 1979 will have lasting success in reducing inflation and reversing the fall in output. Real GDP growth amounted to only 1.2% in 1991 and the rate of expansion declined in the course of the year. The public sector financial surplus (operational concept) appears to have been maintained last year, but the fiscal target was overshot because of excessive state and local government spending. A process of deregulation and opening the economy to foreign competition has also started, but the influence of the public sector is still large and several privatisation projects have failed. Finally, while the rate of inflation fell significantly compared with 1990, monthly price increases accelerated during the second half of 1991 and averaged 25% in the first quarter of this year. All in all, it appears that the authorities have succeeded in gradually tightening fiscal and monetary policies. However, in the absence of a political consensus in favour of structural reforms and of a clear "break" in inflation expectations, the initial effects of these policies have mainly been to reduce real output and employment.

... but not yet in Brazil

Overall, the macroeconomic performance of the Latin American countries last year was a significant change from years of high inflation and low or negative output growth. Nonetheless, recent achievements should not be extrapolated mechanically. A number of previous reforms were successful in their initial phase but later aborted because fundamental imbalances had not been removed. The lower inflation observed last year was also influenced by temporary measures and/or an appreciating currency, and the return to positive growth partly reflected once-for-all effects of lower prices. Consequently, near-term growth prospects depend on consolidating the inflation gains through more comprehensive stabilisation measures. Secondly, in many cases the policy reforms and the reduction in inflation have been accompanied by a marked decline in the income share of wage earners. In fact, the extent of the distributional changes has been such that a resurgence of real wage claims cannot be excluded. In Mexico real wages have fallen by over 20% since 1980 compared with a 5% decline in per capita real income. In Peru the redistribution effects have been even more pronounced, with the erosion of real wages, at 60% since 1980, more than twice the fall in per capita income. Finally, even where policies appear to have been most successful, the costs have been high, creating a risk of "reform fatigue" before the gains have been consolidated. In Chile the 1981 level of per capita real income was not regained until 1989 and in Bolivia per capita real income is still more than 20% below the level of 1980.

Near-term prospects still uncertain

In the *Middle East* 1991 was a year marked by significant differences in terms of macroeconomic developments, principally because of the effects of the Gulf war. *Iran* has experienced a strong recovery over the last two years, partly reflecting higher oil revenue but also as the result of disman-

Developments in the Middle East affected by the war ...

tling a previously centralised system. Output growth was also strong in *Saudi Arabia,* even though war-related costs may have been as high as 40% of GDP, of which less than half was compensated by additional oil revenues. One problem with considerable repercussions in the *Gulf states* was the closure of the Bank of Credit and Commerce International (BCCI). In other countries large demographic changes during and after the hostilities caused serious adjustment problems. In *Jordan* and *Yemen* the return of migrant workers swelled the rate of unemployment to over 25%. In addition to the social costs involved, losses of workers' remittances will pose serious medium-term problems, although in the short run domestic demand and output were probably boosted. *Egypt* may have gained most from the war economically, even though returning migrant workers added further to an already high number of unemployed and the loss of workers' remittances exacerbated the decline in real household income. Transfers from the Gulf states, combined with a substantial easing of the foreign debt burden (see page 49 below) helped to improve the external balance and reduce the budget deficit. Moreover, the rate of inflation was held below 20% owing to a marked tightening of credit policy. Steps were also taken last year to strengthen the financial sector, including the removal of interest rate ceilings and the abolition of the dual exchange rate system, the introduction of Treasury bill auctions and stricter guidelines for evaluating loans.

... demographic changes ...

... and reforms

Several countries in *Africa* were also adversely affected by the war in the Gulf and by the closure of BCCI. In addition, social and political unrest was widespread across the continent, severely affecting output and foreign trade. These disturbances should be seen against the background of a decade of falling per capita incomes (more than half of the population in Sub-Saharan Africa is now living in "absolute poverty"), rising unemployment, low and falling investment and a growing debt burden. The problems facing African countries are numerous but four principal obstacles to faster growth stand out: a lack of export diversification and high sensitivity to terms-of-trade changes; population growth of nearly 3% per year and an even faster expansion of the labour force; low domestic saving; and inadequate structural and demand management policies. These problems are most evident in low-income countries relying on non-oil commodity exports, but are also illustrated by developments in *Nigeria,* where oil accounts for more than 95% of total export revenue. During 1980–87 per capita real income fell by over 25% and a large budget surplus turned into a deficit. Last year, following the decline in the price of oil, GDP growth weakened and a rising budget deficit was largely financed by bank credits, causing the credit target to be widely exceeded. Influenced also by higher domestic energy prices, the rate of inflation more than doubled, with a further acceleration early this year.

Unresolved problems in Africa

High output growth led by domestic demand and foreign direct investment has characterised recent developments in several *ASEAN* countries. Last year, however, saw some modifications to this pattern, as rising external deficits, shortages of skilled labour, infrastructure bottlenecks and

Restrictive policies in ASEAN countries

inflationary pressures forced some countries to take restrictive measures. In *Indonesia* a tighter monetary policy (including stricter limits on offshore borrowing and real interest rates of over 15%) dampened the growth of domestic demand and contained the rate of inflation and the external deficit. In *Malaysia,* too, a more restrictive monetary policy helped to dampen the acceleration of inflation despite a tighter labour market. Nonetheless, fixed capital spending again rose sharply and has now added almost 25% to real GDP over the last three years. At the same time, reflecting growing financial imbalances in both the private and the public sector, the external deficit rose to 10% of GDP. Low domestic saving is also a problem in *Thailand* and the same is true of the *Philippines,* where a national saving rate of only 16% is much too low to finance the investments required to absorb the rapidly growing labour force. Last year the Philippines registered a fall in real output, partly owing to a series of natural disasters but also as a result of tighter fiscal and monetary policies. These policies were instrumental in reducing the budget and external deficits, whereas the rate of inflation only started to decline towards the end of the year.

Strong output performance in China and structural reforms in India

The two largest countries in Asia recorded major differences in economic performance and some of their long-run problems remained unresolved. In *China* GDP growth accelerated, spurred by a robust expansion in industrial output and all domestic demand components. In *India,* by contrast, GDP growth fell to only 2%, reflecting stagnation in the industrial sector and a more restrictive fiscal policy. Another element of strength in China was its export performance (see Chapter IV), whereas in India a progressively widening trade deficit and falling foreign currency reserves induced the Government to devalue the currency in July and to introduce partial convertibility early this year. These measures formed part of two policy packages aimed at opening up the economy to foreign competition and deregulating and privatising the domestic economy. So far, however, the reforms have done little to reduce the weight of the public sector. This is also the case in China, where loss-making state enterprises have been a major cause of budget overruns. However, unlike in India, where private saving has been stagnating and a major part of the budget deficit is financed by bank credits, the budget deficit in China has not posed a major risk to inflation or to the external balance as personal saving has increased to over 10% of GDP.

Trade and current account developments in the developing countries

The overall current account deficit of the developing countries (other than the NIEs) widened sharply in 1991 (see the table opposite). The largest deteriorations were in the trade account and in the traditionally large surplus on unrequited transfers, which shrank by almost $17 billion.

Massive deterioration in the Middle East…

To a large extent, these overall developments can be explained by a massive deterioration in the *Middle East*. This was directly related to the aftermath of the Gulf conflict, which in addition to lower fuel prices left the region with disrupted trade relationships, extensive damage and, since

Current account balances of developing countries[1]									
Country groups	Current account balance			of which					
				Trade balance			Interest payments		
	1989	1990	1991	1989	1990	1991	1989	1990	1991
	in billions of US dollars								
Developing countries	−45.9	−23.5	−90.8	21.0	51.4	9.3	79.6	80.9	75.2
Africa	− 8.7	− 4.4	− 8.6	− 2.3	2.9	− 0.9	11.5	12.4	12.4
Asia	−23.9	−17.0	−17.1	−18.9	−12.9	−11.3	16.3	17.1	17.3
Middle East	− 7.2	2.1	−45.7	12.9	31.6	9.7	12.1	12.6	9.9
Latin America	− 6.1	− 4.2	−19.4	29.3	29.8	11.8	39.7	38.8	35.6
Memorandum items:									
Fuel-exporting developing countries[2]	*−11.2*	*4.6*	*−59.7*	*49.0*	*78.9*	*41.9*	*29.4*	*29.3*	*25.6*
Non-fuel-exporting developing countries	*−34.9*	*−28.2*	*−31.0*	*−28.0*	*−27.5*	*−32.5*	*50.1*	*51.7*	*49.7*
NIEs	*24.1*	*14.5*	*9.9*	*19.3*	*7.5*	*2.8*	*5.7*	*4.8*	*5.0*

[1] Other than the NIEs. [2] Countries whose exports of fuel accounted in 1984–86 for over 50% of their exports of goods and services.

Sources: IMF World Economic Outlook and national data.

these countries did not benefit from the financial contributions of Germany and Japan, the costs of financing the war. Increased oil shipments, mainly from Saudi Arabia and Iran, did not suffice to compensate for these losses, and export growth in other countries remained depressed. In addition, reconstruction required a rise in imports, while war-related payments inflated the deficit on unrequited transfers to almost $30 billion. In Saudi Arabia alone, the precipitous rise in imports and transfer payments is estimated to have widened the current account deficit from just over $4 billion in 1990 to more than $20 billion last year.

... and adverse factors in Africa

Although the Gulf conflict also affected the external accounts of a number of countries in *Africa,* their position was mostly determined by adverse market developments. Dependent on cyclically sensitive commodity exports, many African countries saw export growth slow and their terms of trade deteriorate significantly (see the table overleaf).

Also deterioration in Latin America ...

In *Latin America* the combined current account deficit widened substantially to over $19 billion last year, entirely as a result of a lower trade surplus. By contrast, the decline in world interest rates provided significant relief. Interest payments in relation to exports of goods and services fell to just over 21%, compared with about one-third in the early 1980s.

... despite trade-promoting policies

Weakened by currency overvaluation and the unsustained implementation of stabilisation policies, export growth in Latin America was subdued throughout the 1980s, while imports gradually recovered from their dramatic fall in the early part of the decade. Nevertheless, many Latin American countries did take measures to strengthen export performance and increase the efficiency of their economies. Policies included a move to more competitive exchange rates, the dismantling of protective trade

Indicators of foreign trade of developing countries[1]				
Country groups	Periods	Export volumes	Import volumes	Terms of trade
		percentage changes, annual averages		
Developing countries	1985–89	8.6	0.7	− 7.4
	1990	5.3	3.8	4.7
	1991	3.9	8.0	− 5.3
Africa	1985–89	3.6	0.9	−15.3
	1990	5.5	4.4	7.2
	1991	4.0	1.2	− 9.2
Asia	1985–89	11.1	1.4	− 4.1
	1990	11.0	4.2	− 1.2
	1991	11.3	8.5	− 0.1
Middle East	1985–89	10.6	−3.8	−13.4
	1990	−0.5	1.1	16.3
	1991	−3.8	2.5	−10.0
Latin America	1985–89	5.0	3.8	− 4.2
	1990	4.6	6.0	− 1.1
	1991	3.2	15.6	− 5.2
Memorandum items:				
Fuel-exporting developing countries[2]	*1985–89*	*9.0*	*−2.9*	*−13.7*
	1990	*3.1*	*6.4*	*15.8*
	1991	*0.8*	*9.7*	*−10.8*
Non-fuel-exporting developing countries	*1985–89*	*8.2*	*3.2*	*− 3.4*
	1990	*6.9*	*1.9*	*− 3.2*
	1991	*6.2*	*6.7*	*− 1.2*
NIEs	*1985–89*	*15.5*	*18.0*	*2.2*
	1990	*6.2*	*10.5*	*− 1.3*
	1991	*13.4*	*18.5*	*1.0*

[1] Other than the NIEs. [2] Countries whose exports of fuel accounted in 1984–86 for over 50% of their exports of goods and services.

Sources: IMF World Economic Outlook and national data.

barriers, greater openness to export-oriented foreign investment and, more generally, attempts to diversify exports.

Reasons for the weakening trade balance

Last year's surge in imports has to be seen as the outcome of the reform efforts and the recovery in domestic demand rather than as a continuation of the economic imbalances that characterised the early 1980s. At the same time, the weakness of the region's main export market, the United States, explains much of the sluggishness of export growth, though a lack of productive capacity following years of low investment activity also played a role. In addition, the upward pressure on real exchange rates caused by rising capital inflows stimulated import growth while dampening that of exports. Weak export demand also contributed to a 4½% drop in the dollar price of exports, leading to a terms-of-trade loss for the seventh year in succession.

This pattern was visible in most Latin American countries last year, with particularly strong import volume growth registered in Argentina, Mexico and Venezuela. In Brazil and Chile, however, the picture was somewhat different. Both exports and imports grew modestly in Brazil, while in Chile import growth was also weak, largely because of the delayed effects of earlier adjustment policies.

External positions in Asia ...

Although the overall current account position of *Asia* (excluding the NIEs) changed very little last year, developments in individual countries differed markedly. Large and widening deficits in Thailand, Indonesia and Malaysia contrasted with a narrowing deficit in India and a high surplus in China. Many Asian countries showed remarkable resilience in the face of the recession in the Anglo-Saxon countries and the growth slowdown in other industrial economies, as intra-regional trade continued to expand rapidly. Overall growth in Asia hardly slowed, providing Asian exporters with buoyant markets in neighbouring countries that partly compensated for the more sluggish markets elsewhere. Export volumes expanded by around 11%, unchanged from the rates recorded in preceding years. However, sustained rapid growth also implied a quickening pace of import growth.

... distinguished by regional growth ...

Prime examples of countries with continuing robust growth in exports and imports were Thailand and Malaysia. Exports, mainly manufactured goods, have to a large extent been driven by export-oriented foreign direct investment. However, in conjunction with buoyant domestic demand, these inflows led to a sharp rise in imports and current account deficits widened to between 8 and 10% of GDP. China, too, experienced a very strong increase in trade flows, with both exports and imports expanding by close to 20% in current dollar terms (see Chapter IV). Elsewhere, domestic and external imbalances forced countries such as the Philippines, India and Indonesia to restrain import demand through tighter domestic policies or import restrictions. As exports in these countries grew only slowly, trade and current account positions showed little improvement.

... and differences between countries

External debt of the developing countries

Last year a number of the most heavily indebted middle-income developing countries made clear strides forward in their attempt to achieve a lasting solution to the problems of excessive external debt that have plagued them for nearly a decade. At the same time, many of the poorest countries were no closer to moving onto a path of sustainable economic growth and some other nations, notably those in the former Soviet Union and eastern Europe (see page 65), encountered debt service difficulties which show no signs of being resolved quickly.

Little change in the aggregate debt burden

For the developing countries as a whole aggregate external debt increased slightly in dollar terms. There was, however, no change in the debt/export ratio and some improvement occurred in the geographical pattern of indebtedness. A number of dynamic developing countries, particularly those in Asia capable of meeting additional debt service obligations, stepped up their external borrowing whereas the heavily indebted middle-income countries, notably those implementing coherent adjustment programmes, were able to achieve a modest reduction in their external debt. Another salutary development was the substantial inflow of capital on a voluntary basis to several previously troubled debtors, particularly in Latin America. Because of these inflows, there was less need for new money packages and rescheduling as sources of external financing.

Large inflows in Mexico ...

Mexico, the first country to implement an officially supported programme of debt reduction, attracted foreign capital in a variety of forms and added considerably to its foreign exchange reserves. Inflows of portfolio and direct investment totalled about $12 billion, and issues in the international securities market amounted to $9 billion. The repatriation of flight capital has been put at more than $5 billion.

... and progress in Argentina ...

Argentina and Brazil made progress in dealing with their debt problems and, like Mexico, received substantial foreign direct investment. In April of this year Argentina reached agreement on an outline accord with its bank creditors covering $11 billion of medium and long-term debt and $8 billion of arrears. The accord provides for a range of options similar to those contained in earlier Brady Initiative programmes. Funds to support this programme will come from the IMF and other official creditors.

... and Brazil

Brazil, which owes more to foreign creditors than any other developing country, is seeking to restructure its medium and long-term debt to official and private creditors. In February this year agreement in principle was reached with the Paris Club for the rescheduling of $23 billion of debt owed to official bilateral creditors. Shortly before, the IMF approved a $2.1 billion standby credit, part of which is to be used for bank debt and debt service reduction.

Timely action in India ...

India's recent experience illustrates how timely and coordinated action by national authorities and international financial institutions can avert a liquidity crisis and enable a country to remain current on its external debt obligations. In the first half of 1991, as a result of concerns about political stability, the growing burden of external debt and the authorities' commitment to appropriate economic policies, the previously steady inflows from bank creditors were reversed, and the country had to draw heavily on its international reserves, which dropped to the equivalent of only about three weeks of imports in August. India then announced a radical change in its development strategy, forsaking its inward-looking approach in favour of one based on gradual liberalisation and the reduction of the role of the state in commercial and industrial activity. In support of this strategy and to resolve the payments crisis, the IMF and the World Bank made funds available, and by March this year the reserves had risen to a more comfortable level. However, India's external debt has grown steadily in recent years and now amounts to well over $70 billion, making it one of the largest debtors among the developing countries. Moreover, debt service burdens have risen since much of the newly contracted debt is not on concessional terms.

... but protracted negotiations in the Philippines ...

Elsewhere efforts to deal with existing debt problems have been laborious. In the summer of 1991 the Philippines became the first country to reach preliminary agreement on a second debt relief package under the Brady Initiative. However, the IMF programme targets on which this agreement was based were not met, and a revised arrangement had to be negotiated with the banks. The agreement, which was finalised in February 1992, covers virtually all of the remaining $5 billion of eligible commercial bank debt. Creditors may choose among a cash buyback, the conversion of existing loans into collateralised bonds bearing low rates of interest and the provision of new money.

... and in Nigeria

Negotiations between Nigeria and its bank creditors on more than $5 billion of debt were also protracted. Agreement was finally achieved in December 1991 only after all interest arrears were cleared through cash payments. The country has not received funding from official sources for its debt reduction package. Instead it intends to use its own resources. At the end of 1991 its official reserves amounted to $4.4 billion, equivalent to over half a year of imports. The agreement in principle worked out with the banks provided for buybacks at a 60% discount, conversion of debt at par into collateral bonds and new money, but the new money option was not taken up by the banks.

Debt relief as a supplement to stabilisation policies

The experience to date demonstrates that debt and debt service reduction can be a useful supplement to comprehensive and sustained programmes of structural adjustment and macroeconomic stabilisation. Some of the potential problems anticipated when debt reduction was first proposed have not proved insurmountable. For example the "free rider" problem, which arises when an existing creditor declines to participate in a programme but benefits from any increase in the creditworthiness of the debtor, has been minimised by taking into account the prices prevailing in the secondary market and ensuring that there are sufficient options to meet the varying needs of different creditors. Moreover, creditors have not been reluctant to extend spontaneous new loans to countries with debt reduction programmes in place. There are three main reasons for this. Firstly, such programmes reduce transfer risk by making it less likely that administrative restrictions will be imposed. Secondly, debt reduction in connection with privatisation programmes has helped to reduce fiscal deficits and the distortions associated with excessive state ownership. Thirdly, and most importantly, debt relief has been provided within the context of medium-term policies that have improved the debtor countries' underlying economic performance.

Extension to official debt of middle-income countries ...

One indication of the success of debt relief is its extension in 1991 to cover the official debt of selected lower-middle-income countries. Although official creditors have assisted troubled debtors by providing funds after commercial lenders became reluctant to increase their exposures, the members of the Paris Club of official bilateral creditors had long been unwilling to grant relief in the form of outright debt reduction to any but the poorest and most troubled debtor countries. In the spring of 1991 agreements in principle on official debt and debt service reductions were reached with two middle-income countries, Egypt and Poland. The main difference from earlier Paris Club arrangements is that the entire stock of eligible outstanding debt is covered and reductions of up to 50% in the net present value of these countries' official bilateral debt are envisaged. Debt relief is to be phased over a period of years and is conditional on a multi-year agreement with the IMF being worked out and observed. Egypt also received relief on $14 billion of official bilateral debt from the United States and some Middle Eastern countries in compensation for its contribution to the Gulf war.

A further new development in this field was the call at the 1991 London Summit for additional debt relief on a case-by-case basis for the poorest, most indebted countries. Although these countries had received concessions under the terms agreed in Toronto in 1988, the relief provided so far has been limited and, unlike many of the middle-income debtors, most of these countries are at present unable to cope with their debt burdens. Further assistance will be provided in the form of substantial debt or debt service reductions on the official bilateral debt of countries undertaking adjustment programmes supported by the IMF and World Bank.

... and further relief for the poorest countries

Developments in eastern Europe

Worsening performance owing to:

1991 was a far more difficult year for the eastern European countries than had been expected. The fall in real output steepened and in some countries the cumulative decline since 1989 reached 30–35%, with poor prospects of a near-term return to positive growth (see the table opposite). Despite continued overmanning, the fall in output was accompanied by a sharp rise in unemployment, albeit with wide variations across regions and sectors within each country. Even for those still employed living standards declined sharply as the liberalisation of prices last year led to very large once-for-all price adjustments, while incomes policies restrained the rise in nominal wages. Against this background there have been clear signs of reform fatigue and growing social unrest, in some cases taking the form of armed conflict.

absence of supply response ...

There were four main reasons for the dismal and disappointing performance. In the first place, the hoped-for supply response did not materialise because of delays in implementing structural reforms, inadequate infrastructures, shortages of raw materials and foreign exchange and a breakdown of the production and distribution systems in the absence of reforms or as a result of social unrest and outright civil war. Secondly (see Chapter IV), in countries outside the former Soviet Union these factors were compounded by external shocks due to the unexpected collapse of their major export market and large terms-of-trade losses following the dismantling of the trade and payments system of the Council for Mutual Economic Assistance (CMEA). The direct aggregate impact was profound, though difficult to quantify. Because of the dependence on exports to the former Soviet Union and on cheap sources of energy, a substantial part of industry became unprofitable. Thirdly, to reduce the risk of a wage-price spiral, fiscal and monetary policies were significantly tightened or kept restrictive and incomes policies aimed at restraining nominal and real wage growth further curtailed domestic demand. Finally, notwithstanding a marked decline in the rate of price increase over the last twelve months (see the table on page 52) various cost-push factors tended to keep inflation

... collapse of export market ...

Developments in real GDP[1]

Countries	1981–86	1987	1988	1989	1990	1991[2]
	percentage changes, annual averages					
Czechoslovakia	2.3	2.4	2.6	1.4	– 0.4	–16.0 (–23.0)
Hungary	1.5	4.1	–0.1	–0.2	– 3.3	– 8.0 (–19.0)
Poland	–0.8	2.0	4.8	0.3	–11.6	– 9.0 (–12.0)
Albania	3.4	2.0	2.0	2.0	–10.0	–21.0 (–50.0)
Bulgaria	3.7	6.1	2.6	–1.9	–11.8	–23.0 (–28.0)
Romania	3.6	0.7	–0.5	–5.9	– 7.4	–13.5 (–22.0)
Soviet Union[3]	3.0	1.6	4.4	2.5	– 2.3	–17.0 (– 8.0)
Yugoslavia[4]	1.1	–1.1	–1.7	0.6	– 8.5	–15.0 (–20.0)
Average[5]	3.0	1.8	3.7	1.7	– 4.1	–16.8 (–11.0)
OECD countries	*2.7*	*3.3*	*4.4*	*3.3*	*2.6*	*0.9 (– 0.5)*

[1] For the Soviet Union, changes in net material product up to 1989. [2] Preliminary or estimated; figures in brackets refer to industrial production. [3] Data for 1981–90 refer to the former Soviet Union and those for 1991 to the CIS. [4] Including Croatia, Slovenia and Bosnia-Hercegovina. [5] Weighted average, based on 1984–86 output and non-commercial exchange rates.

Sources: OECD Economic Outlook and Main Economic Indicators, UN Economic Commission for Europe, Vienna Institute for Comparative Economic Studies and IMF International Financial Statistics.

relatively high. A slow adjustment of employment to the fall in output meant that labour productivity declined sharply and the growth of unit labour costs accelerated despite nominal wage moderation. Higher import prices, especially for energy, created additional cost pressures, while continued non-competitive behaviour by state enterprises was a further source of inflation.

... and cost-push factors

There were, however, wide differences in the extent to which these underlying factors, and especially the external shocks, affected individual countries. The very large relative price shifts associated with the dismantling of the CMEA trading system complicate a precise calculation of the external shocks, but changes in exports and imports (measured in US dollars) give a tentative impression of their relative size and of the adjustments undertaken in each country. On this basis it appears that two of the countries most advanced in the transformation process (Czechoslovakia and Hungary) were able to partly offset the effects of the collapse in CMEA trade by exporting more to the western world. Poland had recorded a similar increase in 1990, whereas last year the dominating feature was a surge in imports, mainly from western countries.

Strong export growth in some countries ...

In a second group of countries – Bulgaria, Romania and later Albania – where the reform process started only last year, all four adverse factors were present. In adjusting to the internal and external demand shocks these countries were severely hampered by shortages of raw materials and intermediate goods and by the collapse of the central plan before an alternative system could be put in place. Given the scarcity of foreign exchange reserves and limited access to foreign credit, they were also forced to meet the loss of export revenues by cutting imports, thus further aggravating the shortages. Forces of political and economic disintegration were

... but unfavourable conditions in others dominant in parts of the former Soviet Union and Yugoslavia, particularly during the second half of the year when civil unrest escalated into open war.

Developments in the countries at an advanced stage of transition

Hungary was the first among the eastern European countries to adopt reform measures. Although recent macroeconomic indicators might suggest a gradual deterioration in economic performance, progress has been made in a number of areas. Despite the collapse of CMEA trade and large terms-of-trade losses, the surplus on current account rose further. This outcome, mainly due to increased exports to western countries, points to a successful adjustment of relative prices to conditions in the world market. In addition, foreign direct investment has progressively increased and last year total capital inflows amounted to almost 5% of GDP. As a result, foreign exchange reserves rose sharply and continued to grow during the early months of 1992. At the same time, net external indebtedness registered a significant decline.

Several positive features in Hungary ...

After a gradual acceleration in the annual rate of inflation until 1991, efforts to reduce inflation have shown positive results more recently. A tight monetary policy combined with wage restraint has significantly reduced the inflationary effects associated with the adjustment of domestic prices to world market prices and the removal of subsidies. Indeed, the rise in price inflation last year was largely confined to the first quarter, when subsidies were cut, while for the remainder of the year the monthly rates of inflation were limited to 1–1½%.

Major progress has been made in reforming and strengthening the financial sector and in broadening the range of monetary policy instru-

Developments in consumer prices (CPI) and nominal wages (W)

Countries		1980–85	1986	1987	1988	1989	1990	1991[1]	1992[1,2]
		percentage changes, annual rates							
Bulgaria	CPI	1.0	2.6	2.7	2.4	6.4	26.3	480.0	73.3
	W	3.3	5.1	4.3	7.7	8.8	36.0	150.0	–
Czechoslovakia	CPI	2.0	0.5	0.1	0.1	1.5	10.0	58.0	10.8
	W	1.8	1.5	2.0	2.3	2.3	3.7	16.5	–
Hungary	CPI	6.7	5.3	8.2	16.5	17.0	28.3	35.0	24.7
	W	7.1	7.4	8.9	11.0	17.0	20.0	23.5	–
Poland	CPI	32.5	17.7	25.2	60.2	251.1	585.0	70.4	38.1
	W	28.2	21.1	21.5	84.0	283.0	365.0	76.5	–
Romania	CPI	5.0	2.0	0.5	2.9	0.6	4.7	165.0	265.0
	W	4.8	1.0	0.5	2.5	4.0	10.6	122.0	–
Soviet Union	CPI	1.0	2.0	1.3	0.6	2.0	4.7	95.0	–
	W	2.4	3.0	3.6	8.4	9.5	14.2	70.0	–
Yugoslavia	CPI	47.5	89.8	121.0	194.1	1,240	583.0	118.0	303.0
	W	42.5	105.0	112.5	170.5	1,586	421.0	81.0	–

[1] Preliminary. [2] Change over twelve months to March.

Sources: IMF International Financial Statistics, UN Economic Commission for Europe, Vienna Institute for Comparative Economic Studies and national data.

ments. Government guarantees have partly reduced the risks on banks' outstanding stock of non-performing loans and limits on banks' dividend payments serve to strengthen capital adequacy ratios. Despite increases in private sector demand for money, mainly attributable to the break-up of large enterprises, the National Bank has held the growth of money balances below that of nominal GDP. Finally, as a direct effect of the reform policies, private enterprises have absorbed about half the workers laid off from state enterprises. Output in private enterprises is also rising but is still only partly reflected in official GDP statistics.

... but difficulties also encountered

Among the difficulties encountered in 1991 mention should be made of delays in the privatisation process owing to legislative problems and of inflationary pressures attributable to the non-competitive behaviour of state enterprises. Other negative features were the fall in fixed investment and the rapid rise in unemployment. The budgetary situation also worsened as revenue declined in step with economic activity while expenditure rose, and the speed of the deterioration appears to have accelerated in the first quarter of this year. Finally, the policy of maintaining international competitiveness through an adjustable exchange rate increasingly faced a dilemma: on the one hand, with an annual rate of price increase of 35% it was difficult to maintain a fixed nominal rate for very long; on the other hand, adjusting the nominal rate to stabilise the real effective exchange rate risked fuelling inflation and inflation expectations.

External imbalance in Poland ...

Exchange rate problems were also experienced in *Poland* last year. A fixed rate against the US dollar had served as one of the principal measures to anchor inflation expectations following the 1990 reform programme. However, the maintenance of a fixed nominal rate became increasingly difficult as the rate of inflation remained well above that of Poland's major trading partners. As is discussed in Chapter IV, the currency was devalued several times, but despite these adjustments the current external account deteriorated last year, with exports declining while the volume of imports, influenced by a strong revival in private consumption, increased by over 40%.

... combined with worsening position of state enterprises

The growing external imbalance was not the only sign that price liberalisation and stabilisation policies are not sufficient to transform a previously centralised system into a market economy. The financial position of the state enterprises worsened drastically and the number of firms which had lost creditworthiness rose from less than 600 to almost 3,000 in the course of 1991. In addition, even though the state enterprises hesitated in adjusting their workforce to the fall in output and about one-quarter of the workers laid off found employment in the private sector, the rate of unemployment climbed to almost 12% (see the table overleaf). Reflecting the erosion of enterprise profits, the absence of alternative revenue sources and rising expenditure, especially on social security, the general government financial balance deteriorated sharply and bank credits to the public sector boosted the money supply by nearly 50% (see the table on page 55). Another problem was that the tax-based incomes policy gradually lost its effectiveness as state enterprises granted wage increases above the norm,

Unemployment rates							
Years	Bulgaria	Czecho-slovakia	Hungary	Poland	Romania	Yugoslavia	Soviet Union
	registered unemployed as a percentage of the total labour force,[1] end of period						
1989	0.0	0.0	0.6	0.1	0.0	15.4	n.a.
1990	1.5	1.0	1.7	6.1	0.4	17.8	n.a.
1991	10.1	6.6	7.5	11.5	3.1	20.5	0.8
1992 Q I	12.5	6.5	8.9	11.9	4.6	20.8[2]	n.a.

[1] For Romania, the former Soviet Union and, up to September 1991, Bulgaria and Hungary, as a percentage of the dependent labour force. [2] January.
Source: National data.

while leaving the resulting rise in tax liabilities largely unpaid. As a result, real wages rose by 2–3% in 1991, which, together with declining productivity, aggravated price pressures and the fall in enterprise profits. Finally, as a further result of the worsening profit situation and possibly also reflecting a certain "crowding-out" effect of the rise in bank credits to the government, the ratio of fixed investment to GDP declined to 18%, after having risen in 1990.

In response to growing social pressures arising from the disappointing developments last year, the Government in February proposed modifications to the reform course, but was unable to find a majority in Parliament. An austerity budget calling for higher state-controlled prices and large cuts in subsidies and other expenditure has been submitted to Parliament for this year. A deficit, limited to 5% of GDP with about one-third to be financed by the National Bank, is seen as a principal anchor of stabilisation policies. However, two expenditure measures adopted by Parliament in May have considerably worsened the prospects of meeting the budget target and the conditions for further debt relief.

Reform measures in Czechoslovakia

A major price reform was introduced in *Czechoslovakia* early last year, but the underlying legislative measures had already been adopted earlier and foreign trade had been partly liberalised in 1990. The price reform was accompanied by stabilisation policies with two principal aims: containing inflationary pressures and safeguarding the balance-of-payments position. The authorities further relied on a fixed nominal exchange rate to anchor inflation expectations and a tripartite agreement, aimed at reducing real wages by 10%, alleviated the risk of a wage-price spiral.

The initial conditions ...

The outcome should be seen against the initial conditions, which differed from those in Poland and Hungary. On the one hand, given a low level of foreign debt and a history of stable fiscal and monetary policies, the need for measures to correct inherited financial imbalances was small. On the other hand, there was virtually no private sector and the industrial base, heavily dependent on subsidised energy and exports to former CMEA countries, was very exposed and vulnerable to changes in relative prices and patterns of trade. In the event, the rate of price increase quickly subsided following a once-for-all adjustment early in the year. Despite

Changes in domestic credit and real money balances[1]

Countries and items	1980–85[2]	1988	1989	1990	1991[3]
	as a percentage of the broad money stock, annual averages				
Czechoslovakia					
General government	−1.1	3.0	13.7	8.8	− 4.6
Public enterprises	5.2	2.9	−1.8	0.3	26.0
Private sector	0.4	0.8	0.3	0.6	0.6
Total domestic credit	4.5	6.7	12.2	9.7	22.0
Real money balances	4.6	11.0	3.1	−16.2	−16.5
Hungary					
Central government	0.8	6.8	15.6	0.5	6.2
Public enterprises	} 8.7	4.3	11.1	12.6	21.1
Private sector[4]		0.3	9.0	10.3	1.5
Total domestic credit	9.5	11.4	35.7	23.4	28.8
Real money balances	−1.0	−10.2	−2.6	− 3.1	− 6.8
Poland					
General government	6.0	10.4	48.0	−13.9	21.6
Public enterprises	17.2	37.8	70.0	94.6	27.0
Private sector	2.4	4.9	7.3	20.4	14.5
Total domestic credit	25.6	53.1	125.3	101.2	50.0[5]
Real money balances	−6.4	− 3.7	−6.0	−32.5	− 7.0

[1] *Changes in the broad money stock less changes in consumer prices (fourth quarter to fourth quarter).* [2] For Hungary, 1982–85. [3] Preliminary. [4] Including local governments. [5] Including balancing items.

Sources: IMF International Financial Statistics and national data.

terms-of-trade losses and a steep fall in exports, the current account registered a small surplus.

... and the outcome

However, the costs were high, with real GDP falling by 16% and the balance-of-payments surplus mainly resulting from weak domestic demand and lower imports. Reflecting large regional differences in industrial structures, the rise in unemployment was uneven, which heightened social and political tensions. Furthermore, the process of industrial restructuring barely got under way. In fact, because energy subsidies were partly maintained, the smallest output losses were recorded in the energy-intensive sectors and, overall, energy consumption per unit of output rose further. Finally, the ratio of fixed investment to GDP fell to only 10½%, which is hardly sufficient to cover replacement investment. The exceptionally poor investment performance may reflect uncertainties pending the large privatisations scheduled for this year. A certain "credit crunch" effect was probably also present. Even after budgetary measures to partly relieve banks of their stock of bad loans and strengthen capital adequacy ratios, they remained very cautious in their lending policies. This can also be seen from the sharp rise in inter-firm credits during the first months after the price reform.

The reform process in these three countries has been accompanied by improvements in household saving, which may have important implications for their potential ability to finance future investment (see the table overleaf).

Developments in household saving[1]							
Countries	1982	1985	1987	1988	1989	1990	1991[2]
	as a percentage of nominal GDP						
Czechoslovakia	2.2	2.2	2.4	1.9	1.7	−0.6	1.6
Hungary	1.8	3.7	3.3	3.5	2.2	6.2	6.6
Poland	3.6	3.7	2.6	4.6	4.2	5.3	6.6
Group of Seven countries	*8.0*	*7.1*	*6.4*	*6.2*	*6.2*	*6.8*	*7.0*

[1] Estimated as changes in deposits of households and private enterprises, including foreign currency deposits adjusted for exchange rate movements. For Hungary saving also includes changes in securities holdings and for the Group of Seven countries saving is measured as gross household saving according to national accounts. [2] Partly estimated.

Sources: UN Economic Commission for Europe, OECD National Accounts and national data.

The turnround in household saving was particularly pronounced in Hungary and would be even larger if saving were measured as changes in net assets, as households took advantage of a fiscal measure facilitating repayment of mortgages on favourable terms. The rise in the estimated saving rate may reflect uncertainty linked to rising unemployment, but it could also be the result of a wider range of financial investment opportunities as household acquisitions of securities have grown sharply in Hungary. The more modest saving increase in Czechoslovakia should be measured against the steep fall in households' real income and appears to reflect a build-up of precautionary balances.

Rising household saving, notably in Hungary ...

... but also in Czechoslovakia ...

In Poland, the rise in household saving was not sufficient to accommodate a widening budget deficit and a worsening financial position of the enterprise sector. Nonetheless, developments in Poland are especially noteworthy. Prior to the reform process there were widespread fears of a substantial "monetary overhang" and the fact that household saving was positive in 1990 and rose last year would indicate that this overhang has been eliminated. In addition, foreign currency deposits had accounted for almost 60% of household deposits at the end of 1989 and posed a potential threat to financial stability. However, by the end of last year the share of such deposits had fallen to 40%, pointing to increased confidence in the domestic currency and in the outlook for inflation.

... and Poland

Countries in the early stages of transition

In *Bulgaria* the reform process started late and because it has taken place under extremely unfavourable external and internal conditions the costs in terms of lost output and rising unemployment have been severe. Under the influence of shortages of foreign exchange and a rapid disintegration of the former centralised system economic performance had already deteriorated sharply in 1990. Output declined, open inflation accelerated and suppressed inflation increased even more. A steep rise in the budget deficit, largely financed by central bank credit, combined with price controls and shortages of consumer goods, led to a marked increase in monetary balances held by households. Moreover, with 80% of exports going to former

Adverse conditions in Bulgaria ...

CMEA countries and 60% to the former Soviet Union, Bulgaria was hard hit by the dismantling of the CMEA trading system and the collapse of the Soviet market. The direct effect of the terms-of-trade loss and the fall in exports may account for about half of the decline in GDP last year and was compounded by the continued scarcity of foreign exchange, which forced the authorities to compensate for the drop in export revenue by suppressing imports. While a price reform and accompanying stabilisation measures were adopted in 1991, and a financial reform is also being implemented, a plan for further structural measures was only approved by the Parliament in April this year.

... but reform measures adopted last year

The reform package launched early last year was broadly similar to those adopted in Czechoslovakia and Poland: the elimination of virtually all price controls and subsidies; restrictive fiscal and monetary policies; and a tripartite agreement to curb wage growth. The short-term results were also similar, though more pronounced: an initial price surge followed by a sharp decline in the rate of inflation; large cuts in real wages; and the elimination of excess demand and the monetary overhang. However, in one important respect the reform programme differed from those of other countries, as Bulgaria introduced a floating exchange rate, determined in an interbank market for foreign exchange. Following some initial volatility, the exchange rate stabilised at around Leva 18–20 to the US dollar, compared with an average rate of 2.65 in 1990.

Gradual price liberalisation in Romania

Romania liberalised prices in three stages starting in November 1990. A tight monetary policy, used as the principal nominal anchor, helped to dampen the effects of the decontrol of prices. However, because structural reforms have not yet been adopted and probably also reflecting the gradual liberalisation of prices and the absence of incomes policies to curb nominal wage growth, the monthly rate of inflation has remained above 5%. Moreover, the decline in real wages last year led to considerable social unrest and frequent work disruptions. As part of the reform process government expenditure has been sharply reduced but, unlike in most other countries, the cuts have mostly affected government investment. Another feature of fiscal policy in Romania has been the absence of major imbalances in the past. In fact, banks' stock of non-performing loans has largely been absorbed by writing down government net assets.

Countries in various stages of disintegration

Deteriorating conditions in the former Soviet Union ...

Signs of a system beyond repair and of a worsening economic performance have been evident in the former *Soviet Union* since 1985 but the situation deteriorated dramatically last year. Real output may have fallen by some 17% and the decline was felt in virtually all republics (see the table overleaf). Shortages of final goods as well as intermediate inputs and raw materials were widespread as food products were withheld from the state distribution system, imports were curtailed to conserve foreign exchange reserves and the rouble progressively lost its value as a medium of exchange. In addition, enterprises hedged against future price increases by building up inventories of intermediate goods rather than delivering to

... due to shortages ...

Soviet republics: basic economic indicators (1988 data)								
Republics	Population	Per capita income	Output per employee	Monthly wages	Wages per unit of output	Redistribution of taxes[1]	*Memo items* Output[2]	*Prices*
	% of total	indices, average = 100				ratio	*percentage changes 1990–91*[3]	
Armenia	1.1	79	83	91	109	1.55	−12.0	84.0
Azerbaijan	2.5	71	92	79	86	1.05	− 0.5	86.5
Belarus	3.6	117	107	95	89	1.10	− 3.0	80.0
Estonia[4]	0.6	117	111	117	105	1.35	−11.0	212.0
Georgia[4]	1.9	86	83	84	101	1.10	−23.0	59.0
Kazakhstan	5.8	74	80	99	123	1.40	−10.0	83.0
Kirgizstan	1.5	53	71	84	117	1.50	− 2.0	88.0
Latvia[4]	0.9	119	107	106	99	1.20	− 8.0	172.0
Lithuania[4]	1.3	110	100	103	102	1.20	−13.0	245.0
Moldova	1.5	81	84	83	99	1.15	−12.0	97.5
Russian Federation	51.4	119	111	108	97	0.90	− 9.0	90.0
Tajikistan	1.8	43	70	80	115	1.35	− 9.0	103.0
Turkmenistan	1.2	61	80	92	115	1.30	− 6.0	84.5
Ukraine	18.0	90	87	90	103	0.95	− 9.5	84.0
Uzbekistan	6.9	48	69	82	117	1.40	− 1.0	83.0

1 Measured as the shares of tax revenue retained by the republics relative to their shares of net material product. 2 Real GDP or real net material product. 3 Preliminary. 4 Not members of the CIS.

Sources: Commission of the European Communities, IMF, OECD and World Bank, special reports.

downstream producers. A partial decontrol of prices led to a doubling of retail prices. With the growing loss of financial and monetary control in conditions of widespread shortages, suppressed inflation is likely to have increased even more. Due in part to higher subsidies to close a widening "gap" between wholesale and retail prices but mainly as a result of the increasing fiscal autonomy of the republics, the general government deficit rose to some 20% of GDP. Most of the shortfall was financed by the central bank and, given also massive increases in credits to state enterprises, domestic credit expanded by around 100%. As further evidence of worsening financial imbalances, household savings deposits increased by some 175%, aggravating an already large monetary overhang.

... and loss of financial control

In the course of 1990 all fifteen republics had declared themselves independent and various attempts to agree on a new union treaty met with little success. The process of political and economic disintegration accelerated after the failed coup attempt last August. Towards the end of the year three of the largest republics formed a Commonwealth of Independent States (CIS) and they were joined later by eight other republics. In December the Soviet Union formally ceased to exist, but a formal agreement on the extent of cooperation and policy coordination between members of the CIS has not yet been reached, creating major uncertainties over the future reform process and near-term economic developments. So far the most significant step has been the liberalisation of most prices in

Further disintegration ...

... culminating in the formation of the CIS

Reform in Russia ...

Russia in January this year, followed more hesitantly by other states. This led to a price jump of 300–400%, eliminating the monetary overhang but not immediately relieving the shortages. In fact, a further decline in output appears to have taken place well ahead of any reform measures. In an attempt to stabilise the economic situation, a tentative budget agreement was also reached for the first quarter, calling for tax increases and large expenditure cuts. However, subsequent tax concessions and expenditure measures have severely eroded the government financial position. Similarly, following an initial tightening of credit conditions by the central bank, lending to state enterprises has been significantly increased. This was done to ease the problem of inter-firm debts, which have risen from less than R. 50 billion to almost R. 900 billion in just four months.

... but need for stabilisation ...

Given its size, stabilisation in Russia is obviously crucial for bringing the financial deterioration in the CIS to a halt. Stabilisation policies also need to be adopted by other states, but a number of them are in a less favourable position to take the necessary measures and sustain the costs involved. This is particularly true in states with low per capita incomes which in the past benefited from the redistribution of income via the Union budget and from subsidised imports of energy and other raw materials. As is discussed in Chapter IV, another urgent task is to prevent a breakdown of trade within the CIS. Indeed, the high degree of inter-republican division of labour underlying earlier trade patterns makes it essential to coordinate reform measures and macroeconomic policies.

... and coordination

To date, however, agreement on even the most vital reform measures has been virtually absent. In fact, in the wake of the general disintegration individual states as well as large enterprises have experimented with the use of coupons and several successor states have announced their intention of issuing their own national currencies. In the case of Ukraine the decision to issue coupons was prompted by disruptions in the production and distribution of banknotes and by the more rapid liberalisation of prices in Russia which led Russian residents to cross into Ukraine to buy goods. Initially coupons could be used only together with roubles but subsequently multi-use coupons were issued and made the only means of payment. In March this year the Parliament approved a plan calling for the introduction of a separate Ukrainian currency.

Moves towards separate currencies

Worsening performance in Yugoslavia ...

While political events dominated economic developments in the former Soviet Union they literally paralysed those in *Yugoslavia*. Trade between the individual republics had already been disrupted before the outbreak of hostilities and it virtually collapsed during the second half of 1991. Moreover, because of a sharp drop in export revenues, low foreign exchange reserves and the imposition of trade sanctions, there was no possibility of replacing domestically produced raw materials and intermediate goods by imports. The resulting shortages, combined with a breakdown of transport and communications, were the main reasons for an overall output fall of 15%. This is no more than the declines recorded in other eastern European countries, but it needs to be seen in a longer-term perspective as parts of the infrastructure and numerous private homes have

... following a long period of decline

Yugoslav republics: basic economic indicators (1990 data)									
Republics	Population	Exports to western countries	Per capita income	Average wages	*Memo items*				
					Industrial output	*Real GDP*	*Prices*	*Real wages*	*Unemployment*
	% of total		indices, average = 100		*percentage changes 1990–91*				*% end-1991*
Croatia	19.7	20.9	132	112	*−28.5*	*−23.5*	*123.0*	*−21.5*	*18.0*
Slovenia	8.2	35.1	241	133	*−12.5*	*−13.0*	*118.0*	*− 9.0*	*11.5*
Bosnia-Hercegovina	19.0	12.5	68	80	*−24.0*	*−21.0*	*116.0*	*−16.5*	*22.1*
Serbia and others	53.1	31.5	83	92	*−17.5*				

Source: Vienna Institute for Comparative Economic Studies.

been destroyed. Moreover, coming on top of the economic deterioration during the 1980s, this latest decline reduces the level of real per capita income in Yugoslavia to that of 1972.

Bleak outlook ...

With Slovenia and Croatia becoming independent in October 1991 and Bosnia-Hercegovina in April this year Yugoslavia has ceased to exist in its previous form but the final outcome is still uncertain. The immediate outlook is bleak, especially in the areas where the dinar is still the currency in use. Following the introduction by Slovenia and Croatia of their own currencies (in October and December respectively) other republics, notably Serbia, received a large inflow of dinars. Moreover, because federal expenditure last year was almost entirely financed by credits extended by the National Bank, inflation accelerated sharply during the second half of 1991 and may return to the three-digit rate recorded only three years ago. In all states there is a serious risk of food shortages and, with war destruction and a 30% fall in fixed investment, capital shortages could raise unemployment above the 20% rate reached in 1991. Future patterns of trade between the republics will also have a significant impact on overall economic developments. Although the inter-republican division of labour is lower than in the former Soviet Union, internal trade in all cases accounts for a larger share of output than trade with other countries. A solution to this problem is crucial to Croatia (see the table above), which has not only suffered severe war damage and a significant loss of revenue from tourism but was also heavily dependent on trade with former CMEA partners.

... with a risk of runaway inflation ...

... and a need to restore trade

Common trends and unresolved issues

Common features include:

Despite differences in the initial conditions and in the nature and timing of the reform process, certain common trends could be observed among the eastern European countries last year. Firstly, the rate of inflation is still very high in most countries but mainly because of cost pressures and the uncompetitive behaviour of state enterprises. The price reforms do not appear to have triggered a wage-price spiral, largely owing to tight fiscal and monetary policies. Indeed, a typical feature has been that about six months after the price reforms entered into effect inflation had fallen significantly and

containment of price shocks ...

... but falling investment ...

a mid-course correction was made, relaxing the overall policy stance. Secondly, fixed investment has declined by nearly 40% since 1988 in countries outside the former Soviet Union. In most cases the decline can be related to the erosion of profits, difficult borrowing conditions and uncertainty with respect to future developments and policies, although there have also been cuts in government investment. Thirdly, following an initial improvement in the budget, all countries have experienced a rapid rise in government borrowing requirements. This is mainly the result of a steep rise in social security expenditure combined with falling revenues, reflecting a tax structure highly dependent on profits in the weakened state enterprise sector and/or not compatible with market-determined prices (see below). Finally, notwithstanding progress in reforming the financial sector and establishing central bank independence, financial markets are still too underdeveloped to absorb large budget deficits. Consequently, all reforming countries have seen a rise in bank credit to the public sector and, as a result of this, either upward pressure on money supply growth or "crowding-out" of credit to the private sector.

... and fiscal imbalances

On balance these broad trends can all be traced to two areas where reform measures have so far been absent or subject to major delays: the restructuring or privatisation of state enterprises and reform of the level and structure of government revenue and expenditure. Plans for privatisation have been adopted or proposed in most countries but their implementation will take time. Plans for fiscal reforms have also been adopted or proposed but more is urgently needed, given the steep rise in budget deficits last year and the risk this poses to anti-inflation policies.

Areas in urgent need of reform

The need for fiscal reform

Budgetary policies under central planning. Under the former centralised system budgetary policies were primarily geared to meeting distributional and allocational targets. Little attention was paid to stabilisation except to eliminate shortages of particular goods or the effects of supply shocks. A large share of expenditure was devoted to subsidising basic consumer goods and loss-making state enterprises, while the share of social transfers was relatively small, since most social services were provided by enterprises (see the table overleaf). On the revenue side profit, payroll and turnover taxes were the major sources, whereas personal income taxes were non-existent or very low. The tax system contained numerous disincentives and had large price-distorting effects. Another main feature was its lack of transparency and the absence of predetermined fixed rates. In fact, the profit tax was often decided in a bargaining process between individual state enterprises and the central authorities. Moreover, the turnover tax was essentially set as the difference between producer and retail prices, with adjustments in specific rates frequently used in an attempt to clear markets. Because most taxes were imposed on state enterprises collection was simple and tax arrears and evasion were rare. In most countries local governments had little autonomy and the budgets were generally balanced. By contrast, state enterprises tended to run large financial deficits and

Main features of budget structures and policies under central planning

Indicators of budgetary developments[1]									
Items	Bulgaria			Czechoslovakia			Hungary		
	1988	1990	1991	1988	1990	1991	1988	1990	1991
	as a percentage of GDP								
Total expenditure	58.4	71.3	45.9	60.1	58.3	47.0	63.3	58.2	61.1
Subsidies	17.6	16.1	3.5	13.0	14.0	4.2	11.8	8.9	8.2
Social security	10.1	13.0	12.1	11.7	12.0	15.0	15.4	17.5	24.0
Investment	5.4	4.3	n.a.	8.6	5.5	5.0	7.7	4.1	4.7
Total revenue	56.9	57.6	32.4	57.7	58.9	45.9	63.3	58.0	56.7
Income and profits	25.2	22.5	15.0	25.2	20.5	18.1	9.9	8.7	10.4
Goods and services	11.6	9.7	5.7	16.8	17.5	13.2	21.9	16.3	14.2
Social security	9.5	9.6	n.a.	6.7	14.3	11.2	13.7	19.8	20.0
Net lending	−1.5	−13.7	−13.5	−2.4	0.6	−1.1	0.0	−0.2	−4.3

For footnotes and sources see the table opposite.

accounted for a major share of bank lending, notably during the second half of the 1980s.

Major challenges of fiscal reform. Virtually all countries face an urgent need for budgetary reform, the most challenging task being to reduce not only the fiscal deficits but also the size of the public sector relative to GDP. In addition, stabilisation instruments, including a market for government debt, need to be developed and intergovernmental fiscal relations have to be restructured as state enterprises are privatised and local governments granted more autonomy. Finally, the timing of the various reforms is crucial as there is a high risk of growing expenditure needs coinciding with or preceding falling revenues.

Principal reform issues:

Even excluding state enterprises, government expenditure relative to GDP in most eastern European countries has been well above the ratios recorded in OECD Europe. When the comparatively low levels of per capita income are taken into account there is a clear need to reduce expenditure if punitive tax rates are to be avoided. As recent developments have shown, reducing subsidies can provide large once-for-all savings, but this alone will not be sufficient as growing expenditure needs are bound to appear in other areas. Social expenditure will increase in step with rising unemployment and the transfer to central or local governments of services previously provided by enterprises. Expenditure on salaries and pensions may also rise if real income levels are to be restored and the growing wage differential vis-à-vis the private sector reversed. In addition, future increases in public debt would have to be financed at market interest rates, whereas in the past most of the public debt was held by the central banks at low or zero interest. Moreover, government capital expenditure needs to be raised in order to tackle the problems of underdeveloped infrastructures and environmental damage. Finally, the burden of non-performing loans still lodged with the banks and/or in the form of inter-firm credits may eventually have to be alleviated via the budget. Several countries have

reducing expenditure in conditions of growing needs ...

Indicators of budgetary developments[1] (continued)

Items	Poland			Romania			OECD Europe[2]
	1988	1990	1991	1988	1990	1991	1989
	as a percentage of GDP						
Total expenditure	48.2	35.2	46.5	39.0	42.0	31.0	47.6
Subsidies	16.0	7.5	5.5	0.5	7.5	5.7	2.0
Social security	11.2	n.a.	n.a.	7.9	8.6	7.3	19.0
Investment	7.0	4.0	3.0	16.8	8.4	3.2	3.0
Total revenue	46.9	39.0	43.0	44.9	41.7	29.0	45.4
Income and profits	14.8	17.0	11.2	5.5	n.a.	n.a.	16.0
Goods and services	13.1	6.5	6.9	17.4	n.a.	n.a.	14.5
Social security	6.9	11.2	20.1	6.3	n.a.	n.a.	12.2
Net lending	−1.3	3.8	−3.5	5.9	−0.3	−2.0	−2.2

[1] For several countries the figures are not comparable across years because of substantial changes in definitions and in the structure of the budget accounts. [2] Estimated.

Sources: IMF International Financial Statistics and Government Finance Statistics; OECD Country Surveys of Czechoslovakia and Hungary, Economic Outlook and National Accounts; and national data.

already taken steps in this direction and accepted a worsening of the net financial position of the government sector.

... restructuring taxes ...

Two of the most serious weaknesses of existing tax systems are their high dependence on enterprise profits and, as exemplified by the turnover tax, their incompatibility with market-determined prices. To remedy the second problem most countries plan to replace the turnover tax with a value added tax, but to date only Hungary (in 1988) has implemented such plans. Reducing the dependence on enterprise profits may prove even more difficult. It requires not only a shift of the burden of taxes from enterprise to household incomes but also an extension of the tax administration to cover households and private enterprises, including the adoption of an unambiguous definition of profits and accounting rules for depreciation and deduction of interest payments. The reliance on social security contributions may also have to be reduced. Faced with growing expenditure needs, several countries have recently increased contribution rates to 50% or more, and the resulting rise in unit labour costs has eroded enterprises' international competitiveness.

... ensuring financial control under federal structures ...

To raise the efficiency of public services in step with the move towards a market economy, intergovernmental fiscal relations will have to be redesigned. At the same time, to maintain overall financial stability it is crucial that a higher degree of fiscal autonomy for state and local governments does not lead to loss of monetary control. In countries with a *federal* structure the distribution of expenditure decisions and revenue between the central government and the authorities of individual republics or states is the most important issue. In the former Soviet Union one reason for the loss of financial control in 1991 was that several republics incurred large deficits disregarding the inflationary consequences. At the same time, taxes were withheld from the central government, leaving the latter with bank credits as the only source of finance. Developments in Czechoslovakia last year also illustrate the problem of maintaining an overall restrictive fiscal policy stance in a federal structure, as the unexpected deficit was entirely the result of increased expenditure by the governments of the two republics, while the central and local government budgets were in surplus. In countries with a *non-federal* structure the main issue concerns the distribution of expenditure functions between central and local governments. This should be decided on efficiency criteria and the risk of losing overall control is less than in the former group of countries. A final problem concerns government relations with state enterprises. In the past state enterprises provided many public services and there was no clear distinction between profit taxes and income transfers to the government or between gross income and income net of replacement costs. In future the general government will have to meet additional expenditure and find alternative revenue sources to finance it.

... as well as non-federal structures ...

The timing of expenditure and tax reforms. The timing element is probably the most important aspect of the reform process. While government financial balances normally worsen in periods of recession, the speed with which government borrowing requirements have increased in 1990–91 suggests that the deterioration is not just cyclical. Indeed, while subsidy cuts and increases in revenue from profits helped to stabilise budgets during the initial phase of reforms, these gains were mainly of a once-for-all nature. In the years ahead expenditure needs are likely to increase far more rapidly than the revenue side can be restructured, so that additional borrowing would seem unavoidable. Consequently, during this phase it is important that markets for government debt should be developed in order that budget deficits do not endanger monetary objectives and revive inflationary pressures.

... limiting short-run deficits ...

In the medium term, the containment of government borrowing requirements and a rise in saving is essential. The experience of industrial countries and of most developing countries clearly shows that stabilisation policies which are not supported by sound fiscal policies will eventually fail. In addition, because of the need to modernise and expand the capital stock, ratios of investment to GDP will have to increase in all eastern European countries. While part of this increase may be financed by capital imports, it has proved helpful in maintaining financial stability if 80–90% of investment is met by domestic saving. Finally, while past saving ratios in eastern Europe have not been low by international standards, most of the saving was by the public sector or reflected involuntary saving by the household sector. With the move towards a market economy, private sector saving will depend on incentives. Recent trends in Czechoslovakia, Hungary and Poland are encouraging, but very little is known about the behaviour of retained profits, which in most industrial countries account for the bulk of national saving. It is, therefore, vital that the underlying fiscal balances be strengthened and that governments make a substantial contribution to aggregate saving.

... and increasing long-run government saving

External debt of the former Soviet Union and eastern Europe

The gradual dissipation of central control, serious disruptions in production and a sharp deterioration in the current account led to debt service difficulties in the Soviet Union in the course of 1990. Arrears accumulated on debts owed to suppliers and commercial banks, which became highly reluctant to extend new credits. In an attempt to meet its liquidity needs, the country compressed imports in 1991 but was still unable to honour its debt service obligations. At the turn of the year both official and bank creditors granted a postponement of the payment of principal until March, which was later extended.

Growing debt servicing difficulties in the former Soviet Union

Another issue which had to be resolved was how to apportion among the successor states the $65 billion of external debt in convertible currency of the former Soviet Union. In negotiations with major western creditors in the autumn of 1991 Russia and seven of the smaller republics declared themselves to be jointly and severally responsible for the debt of the former Soviet Union. In other words, each party to the agreement undertook to service the debt in the event that one or more of the successor states failed to do so. The remaining republics were reluctant to sign the memorandum of understanding, which implied that debt service payments would be made through an entity subject to Russian control. Only when this feature was modified did Ukraine, the second largest republic, accept the terms of the agreement. The Baltic states have stated that they were never legally incorporated into the Soviet Union and cannot be held responsible for its debts.

Apportioning the convertible external debt ...

The successor states of the Soviet Union also face the question of how to deal with their external claims and liabilities in non-convertible currencies. Most of the Soviet Union's debts in non-convertible currencies arose as a result of the earlier CMEA trading arrangements, which enabled several of the smaller members of this bloc to build up sizable transferable rouble balances. It is not possible to determine with any accuracy just how large these balances are. Estimates of a total of $15 to 20 billion in non-convertible debt obligations of the former Soviet Union are at best indicative. Moreover, the complex political and economic relationships among the countries of eastern Europe mean that there are a whole range of countervailing claims.

... and settling non-convertible balances

Elsewhere in eastern Europe, Bulgaria and Poland attempted to resolve their debt service difficulties. Faced with a contraction of nearly one-fifth in its convertible currency exports and hit particularly hard by the collapse of CMEA trade and strife in the Middle East, Bulgaria had already declared a moratorium on the payment of principal in March 1990, which was subsequently extended to the payment of interest. Since then the debt burden has become heavier as arrears have accumulated and real GDP has fallen. The country has, however, met its IMF targets and has sought to restore normal relations with its creditors. In 1991 the Paris Club agreed to reschedule $0.6 billion of official bilateral credits, and negotiations are under way to conclude an agreement relating to the almost $10 billion of commercial bank debt.

Debt servicing difficulties in Bulgaria ...

In contrast to Bulgaria, most of Poland's $47 billion of debt is owed to official creditors. For this reason relief on bank debt would not greatly reduce the country's debt burden, and official creditors have agreed in principle that substantial and exceptional concessions are justified. However, one condition for obtaining these concessions is that Poland and its bank creditors reach agreement on how to deal with $11 billion of bank debt. These negotiations have been protracted owing to emerging signs of reform fatigue in the country and the reluctance of the banks to establish new precedents.

... and debt relief for Poland

In contrast to the developing country debt crisis of ten years ago, the debt problems of the eastern European countries and the successor states of the former Soviet Union do not constitute a serious threat to the soundness of the international financial system. A large proportion of banks' claims are officially guaranteed and provisions have been built up. Exposures are thus not large relative to the banks' reserves and capital. Moreover, exposures are not heavily concentrated, though there are significant variations across countries in the amount of bank claims, with banks in Europe having a notable share.

IV. International trade and payments

Highlights

The pattern of global trade last year was marked by much slower growth in the industrial countries and by the effects of market-oriented reform in some other parts of the world. Recession in the United States and the United Kingdom contributed to a reduction in what had been the largest current account deficits. And the continuation of the German boom until about mid-year turned the largest surplus into deficit.

Real exchange rate changes have also affected current account positions. The maintenance for several years of a lower real dollar rate has made an important contribution to the steady reduction of the US deficit. By contrast, the sharp real appreciation of the yen that took place from early 1985 to late 1987 has not been sustained, a factor that has played a role in the marked slowdown of import penetration in the Japanese market. Furthermore, there are signs that substantial real appreciation over recent years in a number of European countries, in Canada and in South Korea has tended to aggravate current account deficits.

Economic reform in Latin America in general, and trade liberalisation in particular, has attracted greater inflows of foreign capital and supported a sizable expansion in income and imports. Asian countries continued to liberalise imports, and the area remained an important source of dynamism in world trade. China's integration with the world economy has proceeded apace and has provided a striking example of just how far-reaching the stimulus of foreign trade can be.

The countries of eastern Europe have had to cope with the need to replace command economy barter with market-oriented trade. Considerable progress has been made; those that maintained competitive exchange rates did best. Reform in Russia and in some of the other new states of the former Soviet Union has been set in the same direction; they face a formidable challenge in developing efficient trade and payment regimes to facilitate mutual trade and integration with the world economy.

The awakening of so much of the developing world to the benefits of free trade places a special responsibility on the countries in the industrial world to open their markets. Yet trade policies in many industrial countries have in many ways become more restrictive in recent years. By early May, no agreement had been reached in the much-delayed Uruguay Round.

Capital flows have remained very large, with cross-border flows into foreign equities setting new records: heavy foreign investment in Japanese shares was a key feature of developments last year. Developing countries again received a larger share of global direct investment as flows to Asia and Latin America rose sharply while flows to the industrial world fell. Many countries in the developing world also enjoyed improved access to international capital markets – through bond issues and by attracting foreigners to invest in local stock markets.

The developing world also made large additions to reserves. The Group of Ten countries, however, saw a substantial decline as a major off-market transaction extinguished reserves. There was a tendency to invest relatively more in dollar instruments.

World trade

Developments

Trade slows ...

The dollar value of world trade rose by less than 2% last year, compared with 13% in 1990. The real growth rate also fell, but by much less than that of world output. For the year as a whole, the economic slowdown in western Europe and Japan, and recession in the Anglo-Saxon world, reduced industrial countries' import volume growth from about 4½% in 1990 to less than 2½% last year. At the same time the end of special barter trading arrangements cut the volume of imports of former CMEA members by almost one-fifth.

... but not in the developing world

In striking contrast, the developing world saw an acceleration in trade, with import volumes rising by about 15% in Asia and Latin America. As described in more detail in Chapter III, Asia continued to be the most dynamic area, while major liberalisation measures permitted rapid import expansion in several Latin American countries as real income growth resumed in the wake of macroeconomic reform and a lighter burden of external debt servicing.

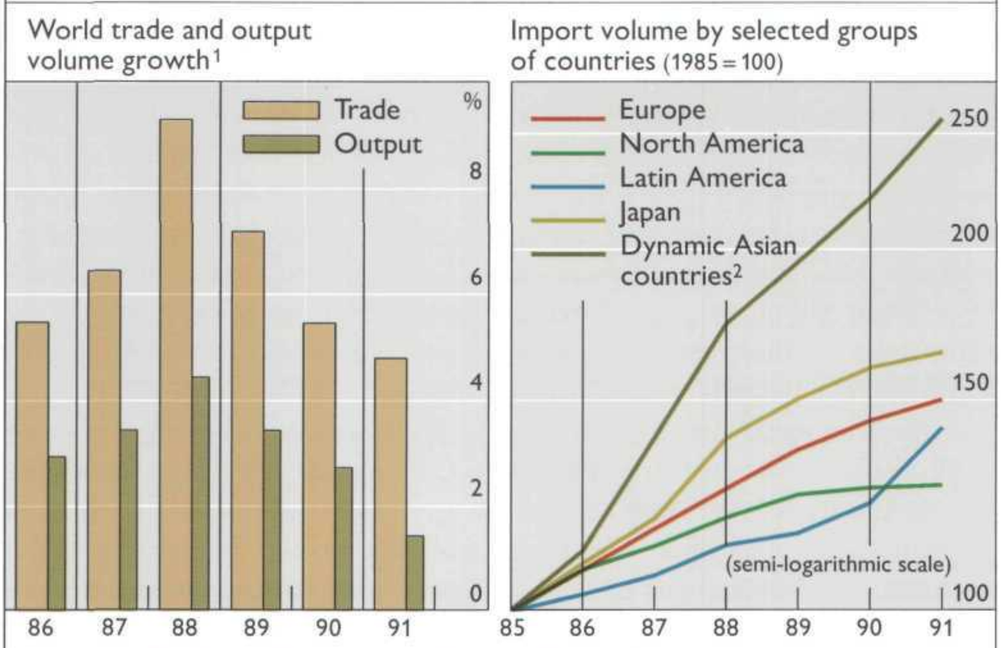
Commodity prices weak

The cyclical downturn in the industrial countries combined with continued high output of some primary products created excess supply conditions that reduced the dollar prices of non-oil commodities by 5%. The underlying trend of oil prices was also weak, particularly since the loss of capacity in Iraq and Kuwait was rapidly offset by increased production elsewhere. Indeed, in late 1991 and early 1992 OPEC production reached its highest level for over a decade, putting significant downward pressure on oil prices. To support prices, an OPEC agreement in mid-February 1992 sought a 5% cut in production. 1991 also saw average dollar export prices of manufactured goods stabilise. The net result was a small deterioration in the terms of trade of the developing world as a whole (excluding eastern Europe and the former Soviet Union); fuel exporters lost rather more.

Asian dynamism

The spectacular growth in Asian developing countries' trade has increased their share of world trade from a little less than 9% in 1980 to 15½% by 1991. This shift has been reflected in a marked redirection of much of the industrial world's trade. US imports from the Asian developing countries, for instance, now exceed imports from Canada, western Europe or Japan, a striking reversal of the 1980 pattern. In the European Community, too, the trade share of Asian developing countries has doubled over the course of just ten years: together with Japan they now represent the

Indicators of world trade



[1] Excluding eastern Europe and the former Soviet Union. Output growth as measured by percentage changes in real GDP. [2] Hong Kong, Indonesia, Malaysia, Singapore, South Korea, Taiwan and Thailand.

Sources: IMF and national data.

Community's main non-EC source of imports and have become almost as important an export destination as the United States.

Trade policies

Trade liberalisation in the developing world ...

In recent years many countries outside the industrial world have taken radical measures of trade liberalisation. The clear successes of those countries that pursued policies designed to make the most of the opportunities available on world markets, and the failure of those that relied instead on autarkic policies of import substitution, had created a climate of opinion distinctly favourable to liberalisation. More competitive exchange rates, a greater openness to foreign direct investment and reduced external protection have been the major ingredients of this policy shift. Over the last five years no fewer than seventeen Latin American countries have taken unilateral action to liberalise trade. Nowhere was the change in policy greater than in eastern Europe and in Russia after decades of rigid autarkic control of foreign trade. A number of Asian countries have also liberalised imports. All told some fifty-one countries in the developing world have announced unilateral – and often far-reaching – trade liberalisation measures during the past five years.

These reforms, which have been actively encouraged by industrial countries, will only bear full fruit if markets in the industrial countries themselves become more open to exports from the developing world; the more rapidly this support is offered, the less will be the risk of policy reversal. At present many of developing countries' potential exports are among those goods most protected by industrial countries – agricultural products, various semi-finished manufactures, clothing and textiles.

... but more protectionism in the industrial world

Policy in many industrial countries has in recent years increasingly strayed from the free trade ideal that motivated progressive and multilateral trade liberalisation during much of the post-war period and which was rewarded by decades of unprecedented prosperity. Four aspects of this have been important: there has been a tendency for liberalisation to be negotiated in a regional, rather than global, context; agricultural production and trade have become increasingly divorced from comparative advantage; more and more trade in manufactured goods has been "managed" by various devices designed to limit competition and restrict consumer choice; and the growing trade in services has remained outside the GATT.

Trade blocs

Most important among the regional trade arrangements are the single market programme of the European Community and the prospective North American Free Trade Area. Such agreements can benefit consumers by increasing competition within the trading bloc and by permitting the exploitation of economies of scale. Yet they tend to divert demand from more efficient producers in the wider world unless accompanied by vigorous measures to reduce barriers to trade with third countries. The importance of such "outside-area" trade for a number of regions often identified as potential trading blocs is illustrated by the trade patterns shown in the table opposite. Not only is trade between these regions large, but in many cases it has also grown more rapidly than intra-regional trade. The fact that trade flows have *not* usually tended to cluster regionally suggests that underlying forces of comparative advantage have much more global roots.

A policy of lowering barriers within regional trading blocs may increase the temptation to erect higher barriers to outside-area goods as a way of compensating enterprises for having to accept more intense intra-bloc competition. Such dangers underline the need to ensure that regional trading agreements extend more open access as widely as possible. Many of the directives adopted under the single market programme have indeed sought to do just this. Yet a recent agreement between the European Community and Japan extended "transitional" limits on Japanese car exports to Europe until 1999, and may have included tacit understandings which further impede competition.

Agricultural policies

Agricultural policies in most industrial countries insulate domestic markets from the influence of world prices. Present policies have their roots in the early post-war period, when memories of food shortages were fresh and when a large proportion of the population was still employed in agriculture. All this has been radically changed by many years of steadily increasing productivity in agriculture and very slowly rising consumption. Full-time agricultural employment has fallen steeply, and is now relatively small; excess production has replaced the earlier shortages and huge stockpiles of food have been accumulated; and previous net importers of major groups of agricultural commodities have become exporters. The European Community has attempted to dispose of its surpluses by subsidising agricul-

Direction of trade in 1990 (1975 figures in parentheses)[1]					
Reporting areas	Percentage share in reporting areas' total trade[2]				
	European Community	EFTA	NAFTA	Eastern Asia	Rest of the world
European Community	59.2 (51.4)	10.0 (9.4)	8.4 (8.7)	7.3 (3.6)	15.1 (26.9)
EFTA	59.4 (51.7)	13.3 (17.0)	7.9 (7.0)	7.7 (3.9)	11.8 (20.4)
NAFTA	18.3 (18.6)	2.8 (2.5)	37.6 (36.2)	26.7 (15.6)	14.6 (27.1)
Eastern Asia	16.0 (12.0)	2.6 (1.9)	26.9 (24.8)	37.6 (28.0)	16.8 (33.3)
Memorandum item:	annual average trade growth, in percentages[3]				
European Community	*11.4*	*10.8*	*10.1*	*15.6*	*6.2*
EFTA		*8.1*	*11.0*	*16.1*	*6.0*
NAFTA			*10.4*	*14.1*	*5.7*
Eastern Asia				*16.0*	*8.6*

[1] The prospective North American Free Trade Area (NAFTA) comprises Canada, Mexico and the United States. Eastern Asia includes the ASEAN countries (except Brunei), China, Hong Kong, Japan, South Korea and Taiwan. There are no data on direct Taiwanese trade with China and Mexico.
[2] Total trade equals the sum of merchandise exports and imports. [3] 1975–90.
Sources: IMF Direction of Trade Statistics and national data.

tural exports to third countries, a policy that has provoked the United States to retaliate by increasing the subsidies given to its own exports in certain selected markets. Such conflicts have intensified the downward pressures on food prices in world markets, which have remained very depressed (in real terms they are now about one-half of what they were in the 1970s). Not only have these policies severely squeezed natural food exporters (including a number of poor developing countries), but they have also become increasingly costly to industrial countries. OECD calculations put the total costs of supporting agriculture – subsidies to producers and the implicit cost imposed on consumers by making them pay more than world prices – at about $320 billion last year, the equivalent of almost 2% of GDP in the OECD area.

"Managed" trade

Recent years have seen a steady drift to "managed" trade in manufactured goods, often on a purely bilateral basis. The measures in place take many guises. Anti-dumping measures often mask attempts to protect domestic producers from more efficient foreign competitors. The number of anti-dumping investigations notified to the GATT was almost twice that of the previous reporting year; in many cases, the formal imposition of anti-dumping duties is made unnecessary by bilateral deals to restrict exports. Explicit market-sharing arrangements govern about half of trade in textiles, clothing and steel. "Voluntary" restraints limit the export of cars and electronic goods, mainly from Japan. Various minimum price arrangements – informal as well as formal – impede trade in memory chips. More recently, special import "targets" have been negotiated: Japan agreed in January this year to double annual imports of car parts from the United States by 1994/95; a recent agreement envisages a 20% foreign share of the Japanese computer chip market.

Such measures restrict consumer choice, inflate costs and raise prices.

By allowing some enterprises to be quite relaxed about their own inefficiencies, a vital force for greater productivity in the medium term is considerably weakened. Contrary to popular myth, they do little to promote domestic output and employment as a whole as measures that protect one industry inevitably hurt others – through exchange rate appreciation and by inflating costs. Restricting Japanese exports, to cite the most important case, contributes to an undervaluation of the yen which makes it much more difficult for unprotected producers to compete with Japanese goods, effectively protects some Japanese producers, and may bring about little or no net reduction in Japan's external surplus.

It is difficult to overstate the extent to which such measures undermine the multilateral trading system, distort the allocation of resources, weaken investment and act as a drag on the growth of the world economy. Large countries and companies are able to secure discriminatory preferences for their own goods at the expense of others. The lack of transparency of the newer forms of protectionism makes it even harder to galvanise the consumers and voters who are indirectly made to pay. And the scope of international dispute settlement procedures is reduced.

Services

Trade in services now represents one-fifth of current account transactions but remains outside the GATT framework. The trend towards a service-based economy in recent years and rapid technological progress in some areas have greatly increased the potential benefits of freer trade – particularly as many services (e.g. air travel, telecommunications) are still dominated by domestic monopolies in many countries and sometimes governed by international associations of producers that seek to maintain high prices and limit competition.

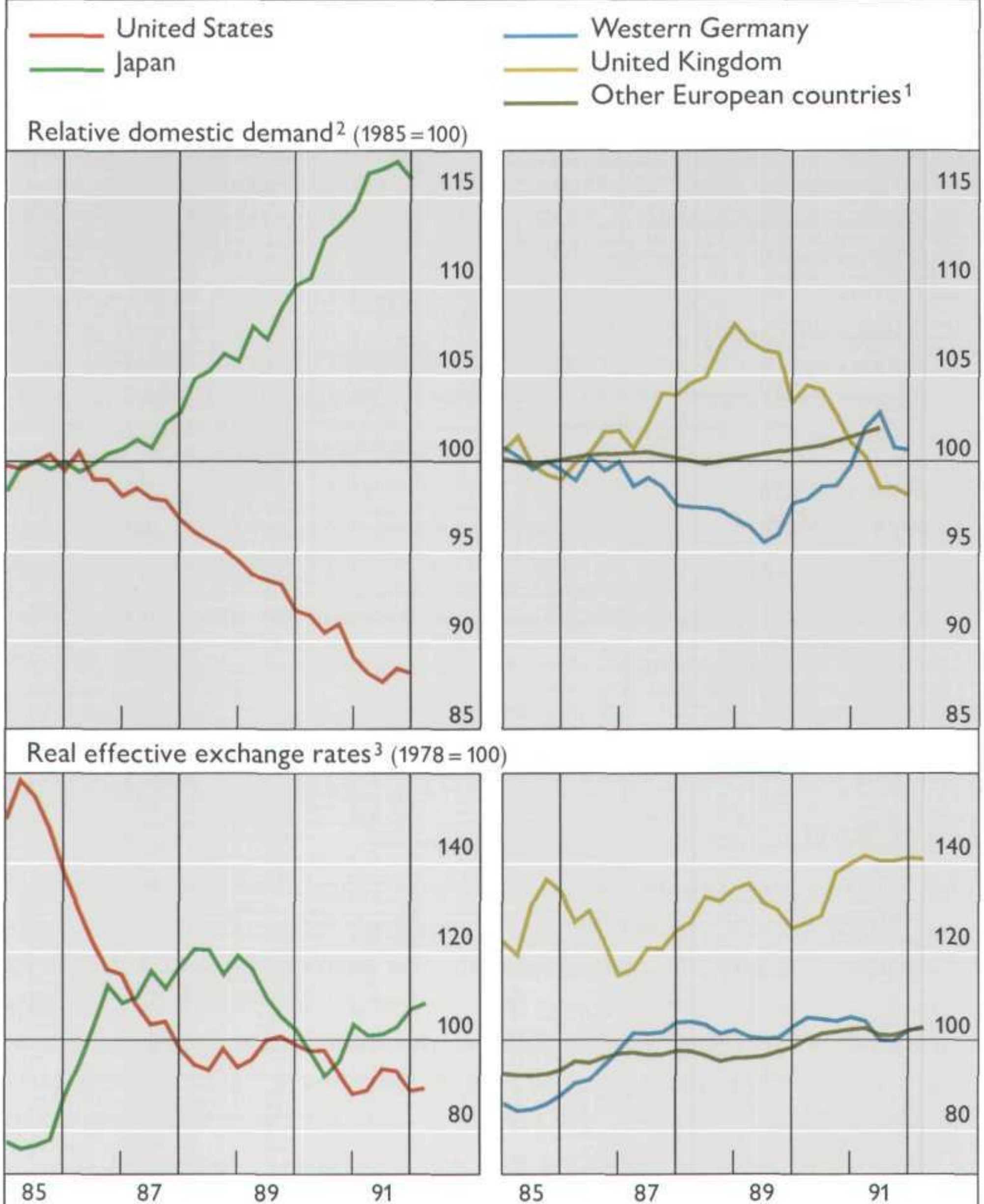
Uruguay Round

The Uruguay Round of trade negotiations, launched in September 1986, was set an unusually ambitious and wide-ranging agenda that sought squarely to address many of these issues. Unfortunately, it has proved more difficult and contentious than any other GATT round. The original completion deadline of December 1990 passed without agreement. There was a further stalemate between the main participants in December 1991, with agricultural policy apparently the main sticking point. It appears, however, that some progress had been made with tentative agreement on easing restrictions on textile and clothing trade; on tightening GATT rules on grey-area protective measures (anti-dumping, subsidies, etc.); on the respect of intellectual property rights; and on dispute mechanisms. The Director-General of the GATT proposed the principle that all agricultural non-tariff barriers be converted into tariffs and then progressively lowered. He also proposed cuts in the value of subsidised agricultural exports and in domestic support prices. Negotiations were still continuing in early May.

Current account developments in the industrial countries and the Asian NIEs

Last year cyclical conditions again had a powerful impact on trade and current account developments in the industrial countries. While nearly all countries were affected, the degree of the slowdown in activity varied

Relative domestic demand and real effective exchange rates



Note: Averages have been calculated using 1989 GDP weights and exchange rates.

[1] Austria, Belgium, Denmark, Finland, France, Greece, Ireland, Italy, the Netherlands, Norway, Portugal, Spain, Sweden and Switzerland. [2] Total domestic demand relative to average demand in the other industrial countries (indices, at constant prices). [3] Nominal effective exchange rates adjusted for movements in relative unit labour costs.

greatly, with many deficit countries – notably the Anglo-Saxon countries and Sweden – in recession for most of the year. By contrast, domestic demand remained relatively buoyant in Germany and Japan until mid-year.

Although some special factors helped, the improved competitive position of the United States has nevertheless made an important contribution to the sharp reduction in the US external deficit. It has also provided some support to US economic activity in the face of a sharp decline in domestic spending. In other cases, however, poor or deteriorating international competitiveness may have impeded deficit reduction: Canada, Finland, Italy,

The US current account						
Items	1987	1988	1989	1990	1991	
					Year	Q IV[1]
	in billions of US dollars					
Current account	−160.2	−126.2	−106.3	− 92.1	− 8.6	−41.2
Trade balance	−159.5	−127.0	−115.9	−108.1	−73.6	−74.6
Net investment income	7.6	5.3	2.7	11.9	9.4	0.9
Other services	6.3	10.4	22.4	26.4	35.9	38.3
Transfers	− 14.7	− 14.9	− 15.5	− 22.3	19.7	− 5.6
Memorandum items:						
Oil imports	*42.9*	*39.6*	*50.9*	*62.1*	*51.4*	*48.8*
Non-oil trade balance[2]	*−114.1*	*− 76.4*	*− 55.2*	*− 37.7*	*−13.9*	*−17.0*
	percentage changes					
Export volumes	*10.0*	*19.3*	*11.8*	*7.4*	*7.6*	*9.0*[3]
Import volumes	*4.2*	*4.0*	*4.4*	*1.8*	*0.3*	*5.2*[3]
Terms of trade	*− 3.2*	*1.3*	*− 1.0*	*− 3.0*	*1.0*	*6.0*[3]

[1] At a seasonally adjusted annual rate. [2] At constant 1987 trade unit values. [3] Change over fourth quarter 1990.

South Korea, Sweden and the United Kingdom have suffered from substantial losses in competitiveness in recent years.

United States

Sharp US deficit reduction is partly temporary ...

The US current account deficit narrowed sharply to near-balance last year, partly because a number of transitional factors were particularly favourable. The largest single factor was the payment of $42.5 billion by Kuwait, Germany, Japan and several other countries to defray the costs associated with the Gulf war. In addition, the trade deficit shrank by almost $35 billion in 1991, the biggest drop ever, narrowing further in the early months of 1992. Moreover, the surplus on non-factor services rose from its already high level in 1990 (see the table above).

Although a $11 billion drop in oil imports – reflecting a decline in prices as well as in demand – contributed to the reduction in the trade deficit, the main factor was a further narrowing of the non-oil deficit. With the non-oil terms of trade largely unchanged, this was entirely due to volume developments: non-petroleum imports were virtually flat while export growth remained buoyant.

... but also reflects strong export performance ...

Non-agricultural export volumes rose by 8½% last year, well above the growth in world markets. The most recent surge in US exports, much stronger than those recorded during earlier US recessions, owes much to the sustained real depreciation of the dollar. The improvement in competitiveness brought about by the steep nominal depreciation of the dollar from early 1985 to late 1987 was by and large maintained during the following four years (see the graph on page 73). It is estimated that by the end of the decade US unit labour costs in manufacturing were significantly below those in both Japan and Germany. This strong competitive position has led to sizable increases in the US share of world markets in recent years. The growth of capital goods exports, which now represent a record 45% of US non-agricultural exports, was particularly vigorous. Exports to the OPEC countries, Latin America and the Asian NIEs greatly outstripped those to the industrial countries.

... and flat import volumes

The sluggishness of US domestic demand held non-oil import volume growth to less than 1% last year. Imports reacted strongly to demand conditions, initially falling significantly before rebounding sharply in the middle of the year when US demand recovered hesitantly and when a reconstitution of inventories of consumer goods (excluding vehicles) took place. Automobile imports fell. One medium-term influence of some importance is that Japanese car manufacturers are increasingly producing in the United States: last year their US production was around 1.4 million units, compared with a little over 2 million direct exports.

Price competitiveness also contributed to the widening surplus on non-factor services transactions. Following average annual increases of almost 15% in the preceding five years, service receipts grew by a further 8½% last year, with earnings from foreign tourists up by 12%. At the same time, imports of foreign services remained largely unchanged.

Japan

Japan's surplus widens ...

The gradual reduction in Japan's current account surplus that had marked the period 1987–90 was abruptly reversed last year. The trade surplus set a new record at over $100 billion, with the bilateral surpluses vis-à-vis EC countries and with South-East Asia each rising by about $9 billion. An increase in the deficit on transfers – partly to the United States for Gulf war-related expenses – provided only a partial and temporary offset to the

The Japanese current account

Items	1987	1988	1989	1990	1991	
					Year	Q IV[1]
	in billions of US dollars					
Current account	87.0	79.6	57.2	35.8	72.9	91.4[2]
Trade balance	96.4	95.0	76.9	63.5	103.0	118.8[2]
Net investment income	16.7	21.0	23.4	23.2	26.7	21.8
Other services	−22.4	−32.3	−38.9	−45.4	−44.3	−45.5
Transfers	− 3.7	− 4.1	− 4.2	− 5.5	−12.5	− 3.7[2]
Memorandum items:						
Oil imports	*27.4*	*25.8*	*29.8*	*41.3*	*37.8*	*40.0*
Non-oil trade balance[3]	*63.0*	*49.0*	*44.8*	*46.4*	*45.9*	*53.6*
	percentage changes					
Export volumes	*0.3*	*5.1*	*3.8*	*5.5*	*3.0*	*2.3*[4]
Import volumes	*9.3*	*16.7*	*7.8*	*5.8*	*3.0*	*1.8*[4]
Terms of trade	*2.2*	*2.3*	*− 4.2*	*− 6.1*	*8.5*	*19.1*[4]

[1] At an annual rate. [2] Seasonally adjusted. [3] At constant 1985 trade unit values. [4] Change over fourth quarter 1990.

growing surplus. By the first quarter of 1992 the current account surplus was running at an annual rate of almost \$115 billion, about 3% of GNP.

... as terms of trade improve ...

The widening of the trade surplus reflected two factors. Firstly, the terms of trade improved by 8½% as Japanese exporters allowed dollar prices to rise as the yen appreciated, rather than stabilise them as they had done on previous occasions. Dollar import prices, by contrast, hardly moved, mainly because the prices of fuel and raw materials, which account for about one-third of Japanese imports, weakened in 1991. The second factor was that the 1991 import figures in the balance-of-payments accounts included an estimated \$15 billion drop in gold imports that largely reflected a sharp decrease in Japanese residents' investments in gold. According to customs statistics, which count gold only when actually shipped, non-oil import volumes grew by 4%, a little faster than exports, leaving the trade balance expressed in constant prices largely unchanged.

... and real import growth declines

With real income growth and capital spending slowing, imports of highly income-elastic goods (luxury goods and cars) and of machinery and equipment decelerated sharply. This hit especially EC exports to Japan, which fell by almost 10%. The fact that the volume of imports grew almost exactly in line with the expansion of domestic demand for the second year running – after growing twice as fast over the period 1986–89 – suggests that the effects of the earlier yen appreciation have worn off.

Slower growth in most industrial countries and increased production by Japanese subsidiaries abroad reduced export growth. Exports to South-East Asia, however, continued to expand vigorously in the wake of the investment boom in the region: the South-East Asian countries now take almost one-third of Japanese exports, and have displaced the United States as Japan's most important export market.

Weakening domestic demand also affected Japan's balance on services. Japanese overseas travel spending, depressed by the Gulf crisis in the first half of 1991, failed to pick up much in the second half: expenditure fell by 4% for the year as a whole, after having risen at an average annual rate of almost 40% between 1985 and 1990. Together with a \$3½ billion increase in net investment income, reflecting Japan's growing stock of net foreign assets, the slowdown in service imports reduced the overall invisibles deficit (excluding transfers) after several years of sizable widening.

Western Europe

The unification-related boom ...

German unification stood at the centre of current account developments in Europe last year. It gave a powerful stimulus to domestic demand in unified Germany: with close to full capacity utilisation in the western part of the country and uncompetitive enterprises in the east, this extra demand could only be satisfied by a sharp increase in imports and a diversion of German goods from export markets. Higher German imports enabled other European countries to partly offset a significant weakening in their own domestic demand growth. As the year went on, however, domestic demand in Germany slowed down, leading to a very sharp fall in import growth.

The German current account

Items	1987	1988	1989	1990	1991 Year	1991 Q IV[1]
	in billions of US dollars					
Current account	46.2	50.7	57.5	46.5	−19.7	−15.6[2]
Trade balance	68.6	78.2	76.2	69.9	21.3	34.0[2]
Net investment income	4.0	5.2	11.8	17.3	17.8	16.6
Other services	− 6.6	− 9.9	− 7.3	−12.2	−15.8	−22.2
Transfers	−19.8	−22.8	−23.2	−28.5	−43.0	−44.0[2]
Memorandum items:						
Oil imports	*16.9*	*14.7*	*16.1*	*22.1*	*22.1*	*23.5*
Non-oil trade balance[3]	*55.2*	*58.2*	*60.7*	*36.5*	*4.6*	*11.2*
	percentage changes					
Export volumes	*2.9*	*6.7*	*8.2*	*1.4*	*1.4*	*3.4*[4]
Import volumes	*5.4*	*6.4*	*7.3*	*11.5*	*13.4*	*4.6*[4]
Terms of trade	*3.5*	*− 0.1*	*− 2.7*	*1.5*	*− 2.2*	*1.0*[4]

Note: The memorandum items refer to western Germany only; the other figures include the external transactions of the former GDR from July 1990.

[1] At an annual rate. [2] Seasonally adjusted. [3] At constant 1980 trade unit values. [4] Change over fourth quarter 1990.

... leads to a German deficit

For the first time since 1981 *Germany's* current account was in deficit last year, largely because of the sudden shrinking of the trade surplus (see the table above). A sharp decline in the traditional surplus with other EC countries accounted for about one-half of this shift. A second important factor was the $14 billion increase in transfer payments, reflecting contributions towards Gulf war costs, payments to the former Soviet Union for troop withdrawals and an increase in transfers to the EC budget.

The $49 billion reduction in Germany's trade surplus last year was due almost entirely to the demand effects of unification; the real effective exchange rate of the Deutsche Mark has changed little (see the graph on page 73). But after demand pressures reached a climax during the first half of 1991, the deterioration in the trade account halted, and began to be reversed. A major factor was a 40% real rise in the year to the second quarter of 1991 in imports of cars and other consumer goods, the demand for which had been long suppressed in eastern Germany. As households progressively came up against credit limits in the course of the year, however, this boom began to peter out and imports weakened.

Signs of reversal

Similarly, the stagnation of exports up to mid-year reflected the diversion of German output to the booming domestic market. The steep drop in eastern German exports to former CMEA partners upon the expiry of trading accords at the end of 1990 and the discontinuation of export subsidies also depressed exports. However, the considerable cooling of domestic demand around mid-year appears to have prompted German enterprises to seek foreign outlets for their output.

The turnround in Germany's current account balance brought its net accumulation of foreign assets to a halt. With the interest rate differential in favour of German assets widening in 1991, net investment income received from abroad was virtually flat for the year as a whole and weakened in the course of the year. As the balance on other services also deteriorated, mainly as a consequence of rising travel expenditure abroad, the earlier surplus on services all but disappeared last year.

Deficit in the rest of Europe declines

The current accounts of most other countries in Europe improved significantly in 1991, their overall deficit falling by about $30 billion. The *United Kingdom* accounted for much of this swing: a prolonged recession lowered the volume of imports and reduced the UK current account deficit to less than 1% of GNP. The economic downturn also produced a marked deceleration in continental European import demand. Import volume growth was about 2% last year, compared with an average of 7½% in the previous four years. Recession reduced imports in *Finland* (by 17%), *Sweden* (by 7%) and *Switzerland* (by a little over 1%). Only in *Spain* did import growth remain close to the rates recorded in 1990 despite a weakening of domestic demand.

Recession ...

Given the importance of intra-European trade, the slowdown of import demand depressed most European countries' exports. Moreover, there is some evidence that changes in international competitiveness are beginning to influence export patterns. The stability of most nominal exchange rates in Europe since the last general realignment of EMS parities in January 1987 has been associated with sizable changes in real exchange rates. Because the lowest inflation rates over this period as a whole were typically recorded in surplus countries, their real exchange rates tended to fall relative to the more inflation-prone deficit countries. Among the latter, Italy, Spain, Sweden and the United Kingdom have suffered a significant loss in international competitiveness: all but Spain (where labour costs are still low by international standards) lost export market share last year. The decline suffered by manufacturing industry in *Italy* was particularly sharp and does much to explain why the country was one of the very few in Europe not to experience an improvement on current account: the deficit grew to almost 2% of GDP. By contrast, a number of years of low inflation have improved competitiveness in *France*, which increased manufactured exports by more than any other large European country in 1991.

... and competitiveness play a part

The rising stock of net foreign liabilities and changes in international interest rate differentials increased the net investment payments of Italy and Spain. The Italian deficit on investment income account reached $17 billion last year, double what it had been only two years earlier.

Other industrial countries

There were certain similarities in the economic conditions confronting Australia, Canada, New Zealand and South Africa last year: in all domestic demand was very weak and the terms of trade deteriorated. Yet only Canada recorded a further widening in its current account deficit, now the largest among the industrial countries. South Africa's surplus rose to 2½% of GDP, while the Australian and New Zealand deficits narrowed.

South Africa in surplus ...

For the second year in a row, *South Africa's* strong export perfor-

Current account balances of the industrial countries and the Asian NIEs

Countries and areas	Current account balance			of which: Trade balance			of which: Balance on investment income		
	1989	1990	1991	1989	1990	1991	1989	1990	1991
	in billions of US dollars								
Industrial countries	−78.6	−100.0	−15.4	−39.5	−43.8	0.9	−7.9	−10.4	−16.6
United States	−106.3	−92.1	−8.6	−115.9	−108.1	−73.6	2.7	11.9	9.4
Japan	57.2	35.8	72.9	76.9	63.5	103.0	23.4	23.2	26.7
European Community	6.6	−7.9	−53.8	0.8	−4.7	−35.7	−1.6	−7.6	−15.3
BLEU[1]	3.6	3.6	4.0	0.8	−0.3	0.6	1.3	0.7	1.5
Denmark	−0.9	1.5	2.2	2.4	4.6	4.9	−4.4	−5.6	−5.3
France	−4.7	−9.7	−6.1	−10.7	−13.7	−10.2	−0.3	−3.2	−4.8
Germany	57.5	46.5	−19.7	76.2	69.9	21.3	11.8	17.3	17.8
Greece	−2.6	−3.5	−1.4	−7.4	−10.2	−10.3	−1.5	−1.6	−1.7
Ireland	0.4	0.9	1.9	3.3	3.0	3.2	−4.5	−4.8	−5.0
Italy	−10.7	−14.2	−19.2	−2.2	0.7	0.4	−8.3	−13.4	−17.0
Netherlands	8.1	10.5	9.3	8.2	10.4	11.9	1.3	1.1	1.0
Portugal	0.2	−0.2	−0.8	−4.9	−6.8	−7.8	−0.7	−0.2	0.0
Spain	−10.9	−16.8	−16.0	−24.5	−29.6	−31.7	−3.0	−3.8	−4.5
United Kingdom	−33.4	−26.5	−8.0	−40.4	−32.7	−18.0	6.7	5.9	2.7
Other European countries	−1.0	−2.5	5.7	−9.9	−11.0	−10.4	2.0	1.1	−0.2
Austria	0.1	1.0	−0.3	−6.6	−8.0	−12.0	−1.1	−1.1	−1.8
Finland	−5.8	−6.7	−5.9	−0.2	0.8	−2.0	−2.9	−3.7	−4.0
Iceland	−0.1	−0.2	−0.3	0.1	0.1	0.0	−0.2	−0.3	−0.3
Norway	0.2	3.9	5.0	3.8	7.8	9.0	−2.6	−2.7	−2.8
Sweden	−3.4	−6.5	−2.0	3.7	4.0	6.8	−2.2	−4.1	−4.0
Switzerland	7.0	8.6	8.9	−6.5	−6.1	−4.9	12.7	14.9	14.8
Turkey	1.0	−2.6	0.3	−4.2	−9.6	−7.3	−1.7	−1.9	−2.1
Other industrial countries	−35.1	−33.3	−31.6	8.6	16.5	17.6	−34.4	−39.0	−37.2
Australia	−17.9	−15.2	−10.3	−4.0	0.0	3.4	−12.2	−13.9	−13.4
Canada	−17.5	−18.8	−23.4	6.0	9.4	6.4	−17.9	−20.5	−20.1
New Zealand	−1.3	−1.6	−0.6	1.0	0.8	1.5	−1.7	−1.9	−1.7
South Africa	1.6	2.3	2.7	5.6	6.3	6.3	−2.6	−2.7	−2.0
Asian NIEs	24.1	14.5	9.9	19.3	7.5	2.8	2.7	4.7	6.2
Hong Kong	5.1[2]	3.5[2]	2.5[2]	1.0	−0.3	−1.7	n.a.	n.a.	n.a.
Singapore	2.5	2.4	4.2	−2.5	−5.1	−4.1	0.2	1.3	1.8
South Korea	5.1	−2.2	−8.8	4.6	−2.0	−7.1	−1.3	−1.0	−0.6
Taiwan	11.4	10.8	12.0	16.2	14.9	15.7	3.8	4.4	5.0

[1] Belgium-Luxembourg Economic Union. [2] Balance of trade in goods and non-factor services.
Sources: IMF, OECD, national data and BIS estimates.

mance reflected a big rise in manufactured exports, which now account for almost 20% of non-gold exports – some 5 percentage points higher than in 1987. At the same time financial constraints continued to oblige the authorities to restrain demand growth to contain imports. All this helped to improve the current account and reduce external debt, which today amounts to less than 20% of GDP, compared with 43% in 1985.

A sharp decline in domestic expenditure compressed import demand in both *Australia* and *New Zealand*. By contrast, export volume growth in both countries picked up markedly, helped by recent improvements in cost competitiveness as well as stronger import demand in Asia. Australia had its first sizable trade surplus for a decade.

... while Australian and New Zealand deficits narrow

There has been a major deterioration in *Canada's* international competitiveness: in the five years to the end of 1991 the real effective exchange rate (based on unit labour costs) rose by about one-third. This has inevitably affected the country's trade performance: the volume of manufactured exports grew by just over 3% a year during the period 1987–91, 1½ percentage points less than import growth in partner markets. Last year the US recession and weak commodity markets were additional important factors behind the decline in the trade surplus. Net external liabilities stood at about 40% of GNP by the end of 1991; net investment income payments abroad amounted to $20 billion last year.

Canadian competitiveness

The Asian NIEs

Last year saw a further narrowing in the combined current account surplus of the Asian NIEs. At almost $10 billion, this surplus amounted to less than 2% of GDP last year, down from $31 billion (over 10% of GDP) at its peak in 1987. Most of the change last year was accounted for by a widening of the South Korean deficit to more than 3% of GDP; as recently as 1988, the country had a surplus of 8% of GDP.

South Korean deficit widens ...

Export volume growth rose sharply in both Taiwan and Hong Kong; with the pace of fixed investment also quickening, there was a sizable increase in imports. In *Taiwan*, exports and imports rose by around 15%, widening the trade and current account surpluses. The momentum of Taiwanese exports was aided by a 45% increase in indirect exports to China sent via Hong Kong. The buoyancy of trade with China was even more important for *Hong Kong*, as re-exports from its manufacturing operations across the border rose sharply, while purely domestic exports stagnated (see the table on page 91).

... but other NIEs in surplus

The legacy of the 1987–90 period, when wage increases, labour unrest and exchange rate appreciation severely eroded the economy's competitiveness, has continued to damage *South Korea's* external performance. The volume of imports rose by about 17% last year, nearly twice as fast as exports, and the trade deficit widened by about $5 billion. Cyclical weakness in the industrial world depressed demand for electronic goods produced in *Singapore*, but strong activity in neighbouring countries (notably Malaysia) sustained overall export growth until late 1991. The trade deficit narrowed while the current account surplus increased.

Eastern Europe: trade, convertibility and exchange rates

Reorientation of trade to the West

Already beginning to disintegrate in 1990, the CMEA barter trading system effectively ended in the course of 1991, entailing for all eastern European

Loss of cheap oil imports ...

countries huge increases in the prices of oil and gas supplied by the former Soviet Union. Higher prices and the need to settle in hard currency forced most eastern European countries to curtail energy consumption drastically, a trend reinforced by sharp declines in domestic demand and in industrial production virtually everywhere. For the area as a whole (excluding eastern Germany), the volume of oil imports from the Soviet Union fell by almost one-half (see the table on page 87).

... a collapse in traditional exports ...

The second consequence of the CMEA's demise was a collapse in Soviet demand for goods from eastern Europe. The central Soviet authorities were confronted with an acute foreign exchange crisis and attempts to agree on special bilateral arrangements to maintain some trade with the Soviet Union in general came to little.

... and a reorientation of exports ...

This change made it all the more urgent for eastern European countries to begin to reorient their economies after years of virtual isolation from international markets. With the exception of Yugoslavia (which had redirected its trade towards the West much earlier), their share of OECD markets had fallen steadily for many years (see the graph on page 90). Moreover, the structure of their exports was heavily biased towards goods with a low income elasticity of demand: more than two-thirds of their exports were agricultural goods, raw materials or semi-finished manufactures, often the products most heavily protected by OECD countries.

... to the West

But these handicaps have not prevented a sharp increase in exports to the industrial world. The dollar value of eastern European exports (excluding former Yugoslavia) to OECD countries rose by about 10% in 1991, following an 18% rise in 1990. Measured against the growth in industrial country imports – see the table overleaf – this performance suggests that eastern Europe's market share increased again last year.

Some special factors ...

To some extent, however, exports may have been "overstimulated" by a combination of factors that may not recur. As enterprises in command economies typically held excessive stocks, the dishoarding of inventories on the liberalisation of prices may well have inflated exports. Secondly, the absence of hard budget constraints may have allowed the export of goods at below-cost prices. Thirdly, the depth of the recession throughout the region left little alternative but to export to the West.

... but price competitiveness is key

Those countries that maintained international competitiveness during 1991 fared much better than those that did not. Low inflation meant that *Czechoslovakia* retained much of the competitiveness gained by devaluation in 1990, whereas *Poland* did not. Czechoslovak exporters were the most successful in 1991: their exports to industrial countries rose by about one-quarter, with an apparent strengthening in the second half of the year. Poland, by contrast, managed only a modest increase. *Hungary,* which suffered a much smaller loss of international competitiveness than Poland, saw exports grow by 15%.

Competitiveness also appears to have influenced the cross-country pattern of imports from industrial countries. Polish imports rose by about one-half, with a particularly vigorous demand for consumer goods

Eastern European trade with the industrial world	1988	1989	1990	1991				
				Year[1]	Q I	Q II	Q III	Q IV[1]
	in billions of US dollars, at annual rates							
Exports								
Former Soviet Union	20.2	22.3	27.2	26.5	29.6	26.9	24.3	25.3
Former Yugoslavia	8.8	9.7	11.7	10.8	12.0	11.0	10.5	9.6
Other eastern Europe	17.7	18.9	22.4	24.7	24.2	23.0	25.6	26.3
Bulgaria	0.7	0.8	1.0	1.2	1.2	1.2	1.3	1.1
Czechoslovakia	3.7	4.0	4.7	5.9	5.1	5.3	6.4	6.9
Hungary	3.9	4.4	5.5	6.3	6.3	6.2	6.3	6.5
Poland	5.5	5.9	8.6	9.0	9.4	8.2	9.4	9.2
Romania	3.9	3.8	2.6	2.3	2.2	2.1	2.2	2.6
Imports								
Former Soviet Union	21.7	25.6	23.8	22.0	20.5	19.4	23.7	25.1
Former Yugoslavia	8.9	10.1	13.9	10.5	14.1	11.1	9.2	7.9
Other eastern Europe	16.3	18.2	22.0	28.4	28.9	27.3	28.7	28.2
Bulgaria	2.4	2.4	1.6	1.7	1.6	1.5	1.7	1.8
Czechoslovakia	3.6	3.7	4.9	5.9	6.9	5.5	5.7	5.7
Hungary	4.0	4.7	5.4	6.4	6.5	6.8	6.3	6.2
Poland	5.0	6.2	7.7	12.1	12.5	11.6	12.4	12.0
Romania	1.3	1.2	2.4	2.3	2.3	1.9	2.6	2.5
Balance								
Former Soviet Union	−1.5	−3.3	3.4	4.5	9.1	7.5	0.6	0.2
Former Yugoslavia	−0.1	−0.4	−2.2	0.3	−2.1	−0.1	1.3	1.7
Other eastern Europe	1.4	0.7	0.4	−3.7	−4.7	−4.3	−3.1	−1.9
Bulgaria	−1.7	−1.6	−0.6	−0.5	−0.5	−0.3	−0.4	−0.7
Czechoslovakia	0.1	0.3	−0.2	0.0	−1.8	−0.2	0.7	1.2
Hungary	−0.1	−0.3	0.1	−0.1	−0.2	−0.6	0.0	0.3
Poland	0.5	−0.3	0.9	−3.1	−3.1	−3.4	−3.1	−2.8
Romania	2.6	2.6	0.2	0.0	−0.1	0.2	−0.4	0.1
Memorandum item:	1990 = 100							
Industrial country imports[2]	*76.9*	*83.6*	*100.0*	*101.2*	*104.6*	*98.8*	*101.4*	*99.2*

Notes:
(i) Figures are based on OECD c.i.f. imports data converted to f.o.b. by multiplying by 0.96.
(ii) The trade of eastern Germany is excluded.
(iii) Bilateral trade between the former Soviet Union and Finland is excluded.
(iv) The quarterly data are at annual rates and (except for Romanian exports) are seasonally adjusted. They may not add up owing to rounding.

[1] Partly estimated. [2] Industrial country imports weighted according to importance as a market for eastern European exports.

Sources: OECD, German Federal Statistical Office and BIS estimates.

concentrated in the first half of the year: this virtually wiped out Poland's sizable convertible currency trade surplus.

Yugoslavia's trade balance, which had deteriorated sharply in 1990 in the wake of a huge real appreciation of the dinar, may have improved during 1991 as the civil war and foreign embargoes disrupted trade. Heavy short-term capital outflows and the servicing of foreign debt led to a loss in reserves of about $3 billion.

Convertibility and exchange rate policy

Under the old command economy system, official exchange rates were grossly overvalued and foreign trade transactions rigidly controlled. Trade liberalisation and decisive movement towards current account convertibility have therefore been key elements in the reform process of virtually all former CMEA countries.

Trade restrictions dismantled ...

Quantitative import restrictions have been reduced everywhere; however, domestic industry continues to be protected by tariffs which vary considerably from country to country. Most direct export subsidies have been removed. In a few cases, where domestic food and raw material prices remain controlled, export restrictions remain in place. The move to liberal trading arrangements has been both rapid and radical: the trade regimes now in operation in Czechoslovakia, Hungary and Poland compare favourably with those in a number of industrial countries.

... with major progress towards convertibility ...

Rapid progress towards trade account convertibility has transformed the international economic landscape of eastern Europe. By early 1991 Czechoslovakia, Hungary, Poland and Yugoslavia all had currencies that were almost fully convertible for domestic enterprises' purchases of foreign goods. To encourage foreign direct investment, most countries have also adopted rather liberal rules for the repatriation of profits and dividends. The restrictions that have remained in force typically concern services (e.g. foreign exchange allowances for travel abroad) and capital flows. In general, domestic enterprises have to surrender foreign exchange earnings and non-residents' use of domestic currency bank accounts remains restricted. Moreover, differences between the official and parallel exchange rates have generally remained modest.

... even in the countries in the early stages of transition

Among the other countries in transition to market economies, *Bulgaria* abolished multiple exchange rates in February 1991. At first, *Romania* maintained a dual exchange rate system, restricting access to the official exchange rate to "essential" industrial inputs. Although exchange rates were in principle unified in November 1991 on the basis of the auction-based interbank market rate (one-third of the official rate), the effective rationing of foreign currency continued.

Nevertheless, the speed and extent of the move to convertibility in eastern Europe has been all the more remarkable for the very different domestic economic situations confronting policy-makers. Both Poland and Yugoslavia introduced trade account convertibility at a fixed nominal exchange rate in the face of extremely high rates of domestic inflation. In both countries households at the outset held much of their savings in foreign currency bank accounts; moreover, foreign currencies were being used for many domestic transactions.

Fixed nominal exchange rates ...

... in Yugoslavia ...

Confronted with accelerating inflation (prices were rising by over 40% a month), the Yugoslav authorities had decided to make the dinar convertible at an exchange rate of Din. 7 to the Deutsche Mark at the beginning of 1990. A sizable current account surplus helped to sustain this exchange rate commitment. However, continued rapid domestic inflation led to a doubling of the real effective exchange rate by the end of 1990 (see the graph opposite). As the current account veered into deficit, exchange controls were tightened. Two substantial devaluations in the first half of 1991 failed to reverse this real appreciation in any durable way. Thereafter, the intensification of civil war – with its attendant shortages and runaway inflation – and the adoption of separate currencies by Slovenia and Croatia made the official exchange rate more and more a fiction. A series of devaluations in 1992 took the official exchange rate from Din. 13 to 200 to the Deutsche Mark by April; with inflation out of control, the dinar was much cheaper in parallel markets.

... and Poland ...

Polish policy differed from that in Yugoslavia in that the move to convertibility was accompanied by a massive devaluation of the zloty: the new official exchange rate was set below even that prevailing in the parallel market. Although this tactic made the exchange rate easier to defend in the months immediately after the introduction of convertibility – the $1 billion international stabilisation fund arranged to support it was not used – the improvement in competitiveness that resulted was quickly undone by continued high inflation. Indeed, the choice of such a low exchange rate made inflation worse. The net result was that by late 1990 the real effective exchange rate was higher than it had been before the devaluation. The authorities nevertheless resisted pressures for devaluation until May 1991, and maintained the principle of a fixed nominal exchange rate until October, when a crawling-peg policy was adopted, allowing a monthly depreciation of up to 1.8%. But this shift in policy did not reverse the huge real appreciation of the last two years. In early 1992 the real effective exchange rate, about 40% higher than in 1989, was still rising because of rapid domestic inflation; a further devaluation followed in February.

... associated with huge real appreciation

Czechoslovakia

Czechoslovakia's move to convertibility at the beginning of 1991 was preceded by three substantial devaluations during 1990. The authorities also chose a fixed nominal rate, defined against a basket of currencies, a commitment that has been maintained. Quite unlike the case of Poland, the real depreciation of the currency in 1990 was only partly reversed last year as domestic inflation – after the one-time adjustment to prices early in the year – remained much lower thanks to the maintenance of tight fiscal, monetary and wage restraint policies.

Hungary

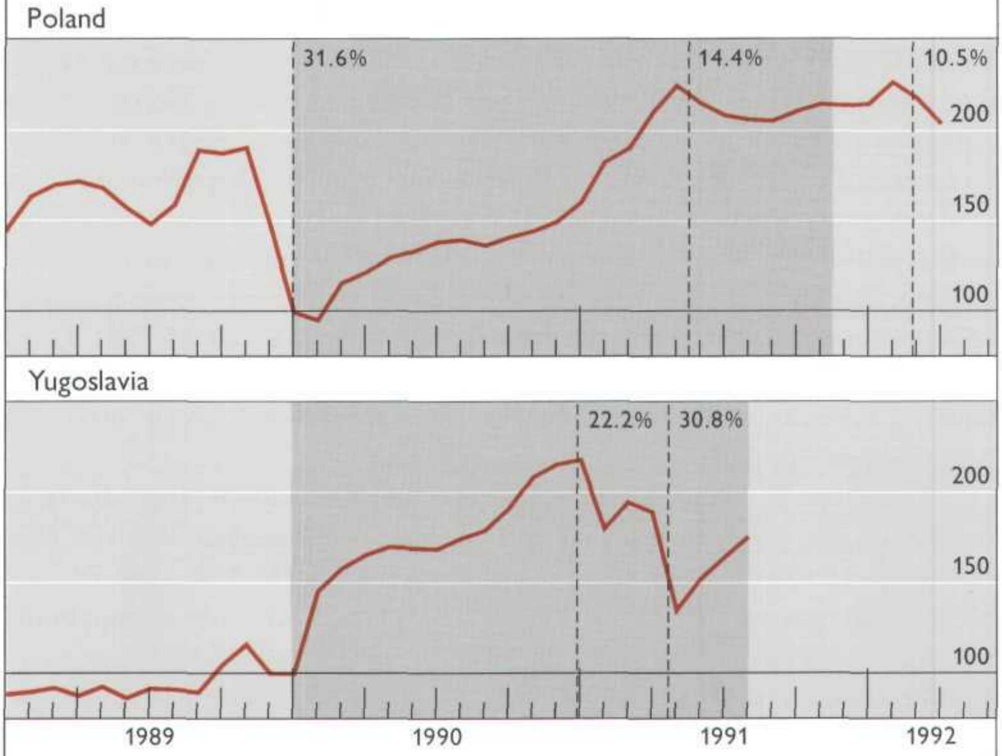
Hungary, which had been making progress towards convertibility for many years, has also maintained a fixed nominal exchange rate, with periodic adjustments. However, the devaluations – 15% in January 1991 and a further 5.8% in November – have been significantly smaller than the country's inflation differential vis-à-vis its trading partners: by the end of 1991, the real effective exchange rate had risen to almost 20% above its average 1989 level. The 1% depreciation in March 1992 reflects the new policy of smaller and less predictable adjustments.

Bulgaria

By contrast, a chronic shortage of reserves led Bulgaria to float the exchange rate on the abolition of the old multiple exchange rate system. The liberalised exchange rate rapidly rose to well above the rate previously prevailing in the parallel market.

Real effective exchange rates: Poland and Yugoslavia

December 1989 = 100



Note: The dotted lines indicate devaluation, with the magnitude shown. The shaded areas represent periods of fixed nominal exchange rates; Poland has had a crawling peg since mid-October 1991. The graph for Yugoslavia is not extended beyond July 1991, when civil war disrupted the economy.
Sources: National Bank of Yugoslavia, IMF and BIS estimates.

Instability of the real exchange rate

One notable common feature of eastern Europe's experience is that introducing a substantial measure of convertibility while defending, at least for a while, a fixed nominal exchange rate proved easier than feared at the time – even when countries were sliding dangerously close to hyper-inflation. But maintaining a fixed nominal exchange rate did not provide the hoped-for inflation discipline when not supported by restrictive fiscal policies or by rigorous incomes policies. In both Poland and Yugoslavia, domestic inflation, though subsiding, was still sufficiently strong to cause real exchange rate appreciation of over 100% in the first twelve months or so of fixed nominal rates.

Such volatility in the *real* exchange rate has inevitably confused the international price signals given to domestic agents – consumers as well as producers – and has impaired the domestic economy's responsiveness to international markets. In particular, a serious overvaluation makes the transition to a market economy a slower and more painful process.

Soviet Union: disintegration and trade

Trade, capital flight and the rouble

Soviet oil exports decline ...

Much uncertainty surrounds trade developments in the Soviet Union last year. International Energy Agency statistics, summarised in the table opposite, suggest that the volume of oil exports to the OECD countries fell by about one-quarter as oil production suffered serious disruption. With oil prices on world markets much lower last year than in 1990, the value of Soviet exports declined. However, imports fell more steeply so that the Soviet Union's surplus with the industrial world appears to have increased. Convertible currency earnings were also boosted by obliging former CMEA countries to pay hard currency for energy previously exported at grossly undervalued prices. Attempts to honour debt service obligations led to a marked compression in imports; imports from eastern Europe fell steeply as the authorities sought to retain virtually all hard currency earned from exports. Barter transactions were also banned in order to keep potential export earnings free to service external debt. By the end of 1991 it had become clear that the central authorities would be unable to meet foreign debt repayments and a postponement was agreed with foreign creditors (see Chapter III).

... imports compressed

Debt service delayed

There were further, at first hesitant and then radical, steps towards correcting the overvaluation of the rouble. In November 1990 a new commercial rate of about R. 1.7 to the dollar (one-third the official rate of R. 0.55) was set for many, but not all, current account transactions; this rate was retained for most of 1991. A special tourist exchange rate, already introduced in November 1989 at one-tenth the official rate, was sharply devalued during 1991, falling to below R. 100 by the end of the year. Finally, the exchange rate that emerged in the very thin auction market, also opened in November 1989, fell from R. 9 at the first auction to around R. 23 by the end of 1990 and to about R. 170 by the end of 1991.

Devaluation

The spread between the commercial exchange rate and those available in other markets thus widened dramatically as the year progressed, making exporters reluctant to surrender their foreign exchange at the commercial rate. The incentives to understate export earnings, keeping the difference in bank accounts abroad, therefore grew. At the same time uncertainty about the future of the Union became more acute. These factors limited the supply of foreign exchange to the central authorities, and a major flight of capital abroad appears to have taken place.

Capital flight

At the beginning of 1992, there was a radical freeing of foreign trade: imports were liberalised and export quotas generally limited to energy products. The reforms also included a devaluation of the commercial exchange rate to R. 110. However, the authorities continued to operate a system of multiple exchange rates; for example, exporters have to surrender two-fifths of export earnings at twice the commercial rate (viz. R. 55 to the dollar). In the first few months of 1992, market-influenced rates were highly volatile and differed sharply from the various official rates; exporters continued to withhold foreign currency from the authorities. In late April, however, the Russian government announced its intention to unify the various exchange rates by mid-year. The government also announced that it intends subsequently to stabilise the external value of the rouble, while at the same time allowing a wide margin of fluctuation around any central rate or path. To support these policies, the Group of Ten

Volatile exchange rate ...

... and policy intentions

Oil production and trade[1] of the former Soviet Union					
	1988	1989	1990	1991	1992 Q I[2]
	in millions of barrels per day				
Production	12.6	12.3	11.5	10.4	9.6
Apparent consumption	8.9	8.8	8.4	8.3	8.2
Exports	3.7	3.5	3.1	2.1	1.4
of which to:					
OECD countries[3]	*2.24*	*2.02*	*1.98*	*1.50*	*0.90*
Non-OECD Europe[4]	*1.25*	*1.20*	*0.90*	*0.50*	*0.40*

1 Excluding re-exports of crude oil of non-Soviet origin. 2 Estimated. 3 Including eastern Germany. 4 Almost entirely eastern Europe.

Source: International Energy Agency.

announced in late April its willingness to contribute to a $6 billion rouble stabilisation fund through the activation of the General Arrangements to Borrow.

The inter-republican predicament

Dependence on inter-republican trade ...

External problems have been compounded by special difficulties arising from the Soviet Union's disintegration into fifteen republics. The central planners' legacy is an economy marked by extreme specialisation and monopoly: in many cases only one or two enterprises, or even factories, were responsible for producing a specific commodity for the whole Union. This specialisation cut across republican boundaries and bred an extraordinarily high degree of inter-republican trade, with exports to other republics often amounting to 40–50% of GDP (see the table overleaf). Such specialisation applied also to the location of transport facilities – notably harbours and pipelines – so that those republics where the facilities are located may seek to extract very high usage fees.

At the same time the planning process made little provision for the export of manufactured goods outside the Union. Typically, the Soviet Union exported those goods whose export was almost inevitable given natural resource endowments: oil, other raw materials and semi-finished goods such as metals. Republics without such resources exported little outside the Union. The main exporter to the outside world was Russia – with plentiful supplies of oil and gas.

... at distorted prices

Because Russia supplied the other republics with energy at a fraction of world prices and provided a ready market for their output of, usually poor quality, manufactured goods, the republics were further insulated from the realities of international markets. Putting trade between the republics on a normal commercial basis – at world prices and open to competition from the rest of the world – would result in huge terms-of-trade gains for Russia, and sizable losses for almost all other republics. The potential medium-term benefits to Russia of a transition to world prices are still larger: the country's excessive domestic energy consumption could be reduced, production stimulated and exports increased. The other republics would lose. Belarus and the Baltic states, heavily dependent on Russia for

Trade patterns of the former Soviet republics[1]

	Exports			Trade balance		
	Inter-republican	Abroad	Total	At domestic prices	Adjustment to world prices	At world prices
	as a percentage of GDP					
Former Soviet Union	21.1	5.4	26.5	− 5.8	6.0	0.2
Russia	13.0	6.2	19.2	− 6.2	12.0	5.8
Ukraine	28.2	4.8	33.0	− 2.1	0.1	− 2.0
Belarus and Moldova	48.9	4.2	53.1	2.3	−12.1	− 9.8
Baltics[2]	45.5	4.4	49.9	−10.7	−12.1	−22.8
Caucasus[3]	41.8	2.4	44.2	− 1.6	− 8.5	−10.1
Asia[4]	28.1	3.4	31.5	−13.5	0.6	−12.9

[1] In 1988. The calculations assume that the ratio of GDP to net material product (NMP) is the same for all republics. Area averages calculated using 1988 NMP weights. [2] Estonia, Latvia and Lithuania. [3] Armenia, Azerbaijan and Georgia. [4] Kazakhstan, Kirgizstan, Tajikistan, Turkmenistan and Uzbekistan.

Source: IMF et al., A Study of the Soviet Economy.

energy, would be especially hard hit, and virtually all republics would face large trade deficits – often in excess of 10% of GDP.

Need to absorb terms-of-trade losses ...

This predicament creates many demanding challenges for economic policy. The need to adjust to terms-of-trade losses will require restrictive macroeconomic policies to reduce domestic absorption, higher energy prices to encourage energy saving and perhaps real exchange rate depreciation to stimulate external demand. The initial imbalances are so large and the isolation from world markets has lasted so long that the benefits of real exchange rate depreciation will take more time to come through than in market-oriented economies. This points to the need for transitional external finance to sustain current account deficits while adjustment policies are being pursued. In April 1992, the governments of the major industrial countries announced their intention to support a package of some $18 billion of external financial assistance to Russia, and to examine similar measures for the other republics.

... reform trade policies ...

The second challenge is the need to agree on rules to govern trade between the republics as well as with the outside world. Adopting world prices will be essential for efficient and non-discriminatory trading. The general case for trade to be as free as possible is reinforced not only by their extensive mutual interdependence but also by the dominance of domestic monopolies in many markets. The major contraction in inter-republican trade that began last year appears to have accelerated in the early months of 1992; much trade at present is still that agreed between governments, usually on the basis of earlier central plans, and is not yet the product of genuine inter-enterprise commerce. Moreover, there has been increasing evidence in recent months of barriers being erected to trade between the republics.

Finally, there is a need to develop means of payment for trade that are

... and develop payments mechanisms

acceptable to all parties. A stabilisation of the rouble's value and progress to external convertibility may in principle enable the rouble to fulfil this function. However, a number of republics have announced their intention to introduce their own currencies, and this may eventually erode the rouble area. One response would be to ensure that the new currencies become convertible at least for most international trade purposes. If this proves infeasible or undesirable in the short term, one possibility would be a special clearing system for settling mutual trade, partly with convertible currency and partly with credit. Such a system helped to put intra-European trade on a multilateral basis during the 1950s, when most European countries faced an acute shortage of dollars that prevented an early move to convertibility. A payments mechanism would not provide an easy option as credits extended would have to be repaid; its operation would presuppose stable domestic currencies, and thus the maintenance of rigorous macroeconomic policies; and it would require other measures to address the structural trade imbalances between the republics. But it would be preferable to the bilateralism that is becoming a hallmark of inter-republican trade at present.

China's growing role in world trade

Chinese exports boom ...

The importance of China in world trade has grown enormously during the last decade or so, with particularly large increases in exports seen in both 1990 and 1991. Industrial country statistics suggest that Chinese exports to the OECD countries rose almost fourfold between 1985 and 1991, when they exceeded $50 billion; as the value of imports has hardly risen, China's trade with the industrial world has swung to large surplus (see the table on page 91). Official Chinese statistics put the current account surpluses in the last two years at around $10 billion annually; at end-1991 foreign exchange reserves stood at almost $43 billion, up from $17 billion two years earlier. However, there were signs that continued strong import demand and some deceleration in exports were, towards the end of 1991 and early in 1992, beginning to reduce the surplus.

... and their structure improves

At the same time, the commodity structure of exports has been transformed. As recently as the mid-1980s Chinese exports consisted largely of raw materials or semi-finished manufactured goods, but by 1990 finished manufactured goods accounted for almost 60% of total exports (see the right-hand side of the graph overleaf). China's success stands in marked contrast to the very poor performance registered by former communist countries in Europe in earlier years. This strong performance is the fruit of the gradual liberalisation of foreign trade initiated in 1978, a deliberate policy of attracting foreign direct investment and the development of a competitive exchange rate. And the proximity of Hong Kong helps to account for the speed of the transformation.

Reforms decentralise trade ...

The grip of central planning on trade was progressively loosened in two ways. First, control over trade was decentralised, with local governments and domestic enterprises being given increasing responsibility. Extremely rigid foreign exchange controls were relaxed, and exporting enterprises permitted to retain a share of their foreign earnings. Over time this share rose, leaving more than half outside central control by the end of the 1980s. More and more enterprises were granted foreign trading rights: whereas before 1978 trade was determined by the centre and was in the exclusive hands of twelve foreign trade corporations, by the late 1980s many thousands of domestic enterprises were engaged in international trade and the bulk of exports was outside the central plan.

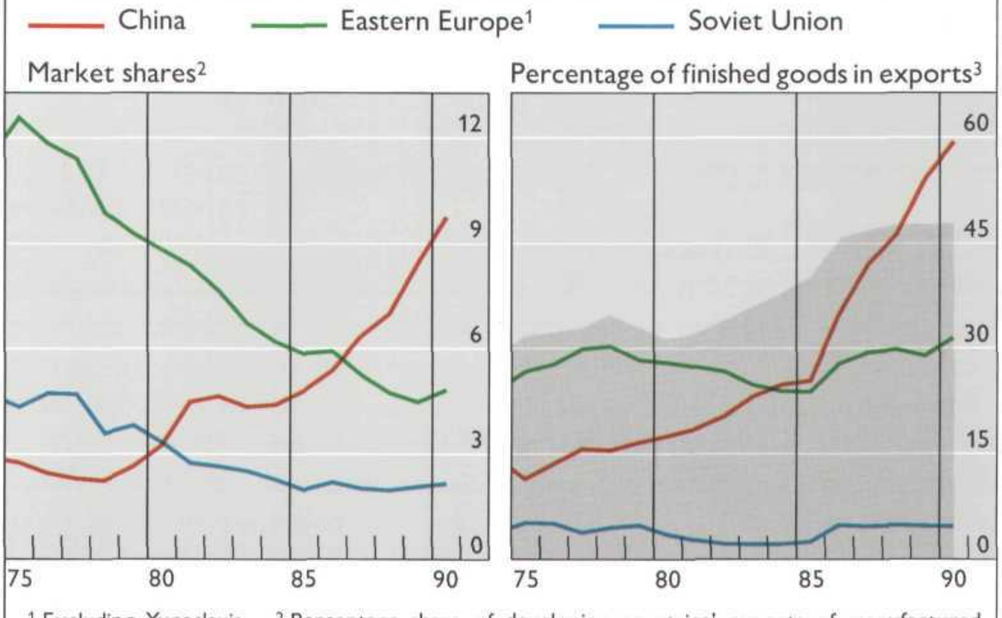
... encourage foreign direct investment ...

The second plank of policy was greater openness to foreign direct investment. At first, such investment was restricted in a number of ways: joint ventures were to be the main vehicle and could be located only in areas designated as Special Economic Zones. Foreign enterprises were also required to balance their foreign exchange accounts, a requirement that impeded profit repatriation and deterred investment designed to cater for the domestic market. Moreover, poor infrastructure and difficulties in dealing with the state bureaucracy limited the attractiveness of investing in China. Over time these restrictions and difficulties have been eased: wholly-owned foreign enterprises were permitted, the authorisation process was streamlined and the infrastructure improved.

... and foster a competitive exchange rate

The requirement to balance foreign exchange accounts was much eased by the development of a limited foreign exchange market in late 1986. This took the form of special Foreign Exchange Adjustment Centres (FEACs) where foreign enterprises could swap local for foreign currency at more market-related rates, effectively creating a dual exchange rate structure. From early 1988 domestic enterprises were allowed to convert their foreign exchange retention quotas in the FEACs. Although domestic access

China's foreign trade in an international comparison



[1] Excluding Yugoslavia. [2] Percentage share of developing countries' exports of manufactured goods to industrial countries. [3] Share of finished manufactured goods in total goods exports to industrial countries. The shaded area indicates world average share.

Source: OECD Foreign Trade by Commodities, Series C.

China: trade and payments statistics	1980	1985	1989	1990	1991[1]
	in billions of US dollars				
Current account	0.7	−11.4	−4.3	12.0	10.0
Trade balance	−0.1	−13.1	−5.6	9.2	8.9
Exports	18.2	25.1	43.2	51.5	59.6
Imports	18.3	38.2	48.8	42.4	50.7
Direct investment, net	0.1	1.1	2.6	2.7	n.a.
Inflow	n.a.	1.7	3.4	3.5	4.3
Outflow	n.a.	0.6	0.8	0.8	n.a.
Memorandum items:					
Trade with industrial countries[2]					
Balance	*−5.2*	*−10.8*	*9.9*	*20.7*	*27.3*
Exports	*8.1*	*13.8*	*34.3*	*41.9*	*53.3*
Imports	*13.3*	*24.6*	*24.4*	*21.2*	*26.1*
Exports of Hong Kong					
Domestic exports	*13.7*	*16.7*	*28.7*	*29.0*	*29.7*
Re-exports from China	*1.7*	*4.4*	*24.1*	*30.9*	*40.6*
Other re-exports	*4.4*	*9.1*	*20.3*	*22.3*	*28.2*

[1] Preliminary and partly estimated. [2] Based on OECD countries' trade data. Import data on a c.i.f. basis adjusted to f.o.b. by subtraction of an 8% f.o.b./c.i.f. margin. In most cases, the Chinese share of Hong Kong's re-exports is re-allocated to China.

Sources: Asian Development Bank, IMF Balance of Payments Statistics, OECD Monthly Statistics of Foreign Trade, World Bank World Tables and national data.

to the FEACs remained subject to administrative control (and could therefore be manipulated to influence the centres' exchange rates), the volume of transactions rose steadily. For most of the period 1987–89, when the authorities held the official exchange rate constant, the yuan traded in these centres at a very large discount. The black market rate was lower still. But two substantial devaluations of the official rate in December 1989 and November 1990 reduced these differentials. The fact that the difference between these rates and black market exchange rates had, by late 1991, narrowed to less than 10% raises the possibility of unifying exchange rates. In real effective terms, the official exchange rate had been cut to about one-third of its pre-reform level. Nevertheless, increasing inflationary pressure in early 1992 has tended to widen the differential between market and official exchange rates.

An acceleration in the pace of foreign direct investment in the 1980s – from virtually nothing at the beginning of the decade to around $3–4 billion annually in recent years – has played a major part in the expansion of foreign trade. Hong Kong has accounted for more than half of this foreign direct investment as Hong Kong companies have transferred manufacturing operations to Guangdong province to take advantage of low labour costs.

Hong Kong's role

By 1990 Hong Kong's re-exports from China had overtaken Hong Kong's own direct exports (see the table above). In addition, almost all trade between Taiwan and China – which is also growing rapidly – and most

Sino-Japanese trade goes through Hong Kong. Moreover, Hong Kong's banks have been the main suppliers of financial services to China. In short, Hong Kong has been able to seize the opportunities presented by China's controlled opening to the outside world in order to develop a service-oriented economy in the space of relatively few years. At the same time China has become the major foreign investor in Hong Kong, with around $10 billion invested, mainly in the service sectors.

Unfinished business

Nonetheless, China's trading regime is still characterised by a mercantilism that ill suits a major trading nation. It makes little sense for a capital-poor but labour-abundant economy to export capital by running large and persistent current account surpluses. Moreover, the complexity of subsidies and discretionary benefits granted to exporters makes it impossible to judge to what extent exports are being *over*-promoted, and sold at below their true cost. And imports are still constrained by an opaque web of quantitative controls. During the last decade successive bouts of excess demand have led to the (mostly temporary) retightening of controls, often in a very non-transparent way. Furthermore, the absence of hard budget constraints for much of the large-scale state sector is associated with an excess demand for imports that has to be contained by administrative controls. Nevertheless, the Chinese authorities, encouraged by the fruits of trade reform, have announced their intention to radically reduce import licensing requirements during 1992, and to further open the economy. Such steps will need to be accompanied by domestic reforms if policy is to be able to address the lack of effective macroeconomic control that has blighted Chinese economic performance.

Major capital movements

Direct investment

Direct investment falls ...

Foreign direct investment from industrial countries fell by about one-fifth in 1991. Japanese investment, especially in the United States, was sharply curtailed. The recession and the associated property market slump in the United States were significant depressive influences. Also, Japanese car manufacturers appear to have virtually completed a major relocation of production: their production in the United States is set to overtake direct exports by 1993. Another possible factor is that the apparently poor return on Japanese direct investment in the United States may have prompted a reassessment of the likely benefits of continued heavy investment. US balance-of-payments statistics put losses on Japanese direct investment at $1.3 billion in 1991, following a smaller loss in 1990 and poor earnings in previous years. In simple terms of measured profitability, then, Japanese investors have as yet little to show for the more than $80 billion worth of direct investment built up by the end of 1990; other objectives – such as defusing protectionist sentiment – may have been behind the recent direct investment boom.

... heavily in the United States ...

Foreign direct investment in European Community countries held up relatively well in the face of the weakness in economic activity. As much

Global pattern of direct investment	1975–79	1980–84	1985–89	1990	1991*
	in billions of US dollars, annual averages				
Total outflows	35.3	42.4	134.9	222.4	177.3
Industrial countries	34.7	41.0	128.4	209.5	165.5
of which: United States	*15.9*	*9.6*	*22.8*	*33.4*	*29.5*
Japan	*2.1*	*4.3*	*23.8*	*48.0*	*30.7*
European Community	*14.2*	*20.9*	*59.4*	*97.5*	*80.5*
Developing countries	0.6	1.4	6.5	12.9	11.8
of which: Asia	*0.3*	*0.8*	*5.6*	*11.2*	*10.3*
Latin America	*0.1*	*0.2*	*0.4*	*1.1*	*1.0*
Total inflows	26.9	52.6	117.6	179.6	157.9
Industrial countries	19.9	36.2	98.1	148.7	115.2
of which: United States	*6.1*	*18.6*	*48.2*	*37.2*	*22.2*
Japan	*0.1*	*0.3*	*0.1*	*1.8*	*1.4*
European Community	*11.4*	*14.2*	*38.4*	*85.9*	*67.7*
Developing countries	7.0	16.4	19.5	30.9	42.7
of which: Asia	*1.9*	*4.7*	*10.8*	*19.9*	*25.7*
Eastern Europe	*0.0*	*0.1*	*0.1*	*0.5*	*2.3*
Latin America	*3.6*	*5.4*	*5.7*	*7.8*	*12.0*

* Partly estimated.

Sources: IMF Balance of Payments Statistics and World Economic Outlook, Inter-American Development Bank, national data and BIS estimates.

... but less so in continental Europe ...

European direct investment tends to go to other European countries, this probably reflected a continued trend to increased intra-European mergers and investment in the context of European integration. Although the United Kingdom remained the most popular destination in Europe, UK inflows fell by $12 billion – in part because of the severity of the recession. Inflows into the continental members of the Community fell less sharply to around $46 billion. Investment in France set a new record of more than $11 billion, while that in Spain fell appreciably. Perhaps surprisingly, foreign direct investment in Germany amounted to only $3 billion last year – suggesting that foreign enterprises were not playing a major part in reconstruction in eastern Germany.

... and rises again in the developing world

In marked contrast with the industrial world, direct investment in developing countries grew strongly again last year. Three features stand out. Investment in the rapidly growing Asian economies continued to be buoyant, much of it coming from the higher-income areas, notably the four NIEs, and going to lower-income countries – mainly China, Indonesia, Malaysia and Thailand. A second, rather newer, feature was a revival of foreign investment in Latin America. A major liberalisation of trade policies, greater openness to foreign investment and the gearing of macroeconomic policies towards stabilisation all contributed to the creation of a more favourable climate for foreign investors than had existed for many years.

Portfolio capital movements in industrial countries					
	1975–79	1980–84	1985–89	1990	1991[1]
	in billions of US dollars, annual averages				
Total outflows	12.4	41.8	176.8	151.6	277.6
of which: United States	*5.8*	*5.8*	*9.5*	*28.5*	*46.2*
Japan	*2.6*	*13.8*	*89.9*	*39.7*	*74.3*
European Community	*3.8*	*18.9*	*62.6*	*79.8*	*144.0*
Total inflows	25.0	57.8	186.0	159.1	388.7
of which: United States	*4.6*	*16.7*	*59.2*	*2.9*	*52.3*
Japan	*3.0*	*11.9*	*23.3*	*34.7*	*115.3*
European Community	*8.5*	*17.7*	*70.4*	*94.4*	*173.7*
Memorandum item:					
Equity inflows[2]	*3.7*	*10.8*	*31.4*	*−16.0*	*90.1*
of which: United States	*1.5*	*3.4*	*8.7*	*−14.5*	*9.2*
Japan	*−0.2*	*3.5*	*−9.1*	*−13.3*	*46.8*
European Community	*2.2*	*2.1*	*22.7*	*11.5*	*32.1*

[1] Partly estimated. [2] Group of Ten countries except Italy plus Australia, Austria, Finland, Norway, Portugal, South Africa and Spain.

Sources: IMF Balance of Payments Statistics, national data and BIS estimates.

The third, most recent, trend is increased investment in eastern Europe. Hungary was the most successful, attracting some $1½ billion in 1991, more than four times as much as in the previous year. Nonetheless, total foreign direct investment in eastern Europe as a whole remains relatively low.

Portfolio capital

Portfolio capital flows rise

Cross-border securities investment reached a new record last year, with aggregate inflows rising by almost 150% (see the table above). Identified US and UK outflows into foreign equities each rose to over $30 billion last year after only modest investment in 1990. Overseas investors, undeterred by the pessimism that apparently haunted domestic investors, placed an unprecedented $47 billion in Japanese equities after being net sellers to the tune of some $13 billion the previous year. The US stock market also benefited from a favourable swing in sentiment as foreign investors put in almost $10 billion after taking out almost $15 billion in 1990. Finally, foreign portfolio investment increased in a number of markets in developing countries; the privatisation of state enterprises attracted funds to Latin America.

Equities

Bonds

Net investment in foreign bonds also rose appreciably. The increase in investment in US paper reflected a strong revival in foreign non-bank investors' purchases of US Treasury securities. Investment in German and Japanese domestic bonds set new records; the issue of bonds abroad by Japanese corporations rebounded strongly, but remained well short of the very heavy issuance rates seen in 1989. Foreign purchases of Canadian and Spanish bonds also rose sharply.

Capital accounts: United States, Japan and Germany

Items	1988	1989	1990	1991	1991 H I	1991 H II
	in billions of US dollars					
United States						
Capital account	89.9	123.3	63.6	−16.1	−22.9	6.8
of which:						
Direct investment	*41.5*	*37.2*	*3.8*	*− 7.3*	*− 4.2*	*− 3.1*
Securities[1]	*38.7*	*46.0*	*−25.6*	*6.1*	*15.0*	*− 8.9*
Banks, other than above	*13.9*	*12.1*	*15.3*	*−11.6*	*−25.7*	*14.1*
Statistical discrepancy	*− 9.2*	*18.4*	*63.5*	*− 3.1*	*− 4.6*	*1.4*
Net official monetary movements[2]	36.3	−17.0	28.6	24.7	2.8	21.9
Japan						
Capital account	−64.1	−81.9	−56.7	−90.0	−44.4	−45.6
of which:						
Direct investment	*−34.7*	*−45.2*	*−46.3*	*−29.4*	*−18.6*	*−10.8*
Securities	*−66.7*	*−28.0*	*− 5.0*	*41.0*	*9.5*	*31.5*
Banks, other than above	*44.5*	*8.6*	*−13.6*	*−93.5*	*−22.9*	*−70.6*
Statistical discrepancy	*2.8*	*−22.0*	*−20.9*	*− 7.8*	*− 3.3*	*− 4.5*
Net official monetary movements[2]	−15.5	24.7	20.9	17.1	15.5	1.6
Germany						
Capital account[3]	−69.9	−67.5	−39.6	19.4	7.4	12.2
of which:						
Direct investment	*−10.3*	*− 7.5*	*−20.8*	*−18.6*	*− 7.7*	*−10.9*
Securities[4]	*−43.7*	*− 4.4*	*− 2.4*	*23.8*	*− 3.1*	*26.9*
Banks, short-term	*−10.4*	*−30.3*	*− 1.0*	*23.1*	*33.9*	*−10.7*
Other private, short-term	*−12.5*	*−27.4*	*−11.3*	*3.5*	*− 4.9*	*8.3*
Net official monetary movements[2]	19.2	10.0	− 6.9	0.3	4.3	− 4.1

[1] Including US Treasury securities. [2] Changes in gold and foreign exchange reserves less changes in liabilities to foreign monetary authorities. Valuation effects are excluded. A minus sign indicates an increase in official assets. [3] Including the statistical discrepancy. [4] Including official domestic borrowers' notes.

Source: National data.

Financing of major imbalances

Japanese banks export capital

The combination of a widening in Japan's current account surplus, lower Japanese foreign direct investment and the much stronger overseas appetite for Japanese equities might have been expected to put strong upward pressure on the yen. One important offsetting factor, however, was that Japanese banks in effect exported capital to the tune of some $93 billion for the year as a whole; as can be seen from the table above, outflows were very heavy in the second half of the year. This took the form of a large contraction in external liabilities and reflected several factors. Weaker demand for bank loans at home reduced the incentives for Japanese banks to raise funds abroad. Secondly, the decline in long-term capital outflows – notably direct investment and bank loans – was associated with a simultaneous contraction in short-term bank financing flows. One of the more remarkable features of the international financial landscape during the second half of the 1980s – the massive import of capital through Japanese banks – was thus decisively reversed.

German flows

The pattern of German capital flows also changed markedly from the first to the second half of last year. The positive yield differential of German over US bonds – of about 1 percentage point at the beginning of the year – narrowed early in 1991. As exchange market sentiment also tended to favour the dollar until mid-year, foreign investment in German bonds was unusually depressed, while German investment in foreign bonds was sustained. As the traditional net direct investment outflow survived German unification, the substantial deficit on current and long-term capital account put downward pressure on the Deutsche Mark, and the accounts were balanced only by sizable short-term inflows through the banks. However, the factors weighing down on foreign investment in German bonds were reversed in the second half of the year when the long-term differential widened markedly: overseas demand for German bonds proved strong enough to offset the current account deficit.

Increased US investment abroad

With the US current account virtually balanced in 1991, net official inflows of almost $25 billion, mainly taking the form of increased foreign official assets in the United States, went together with net private outflows. One significant development was that US direct investment abroad exceeded foreign direct investment in the United States for the first time since 1980. In addition, US net purchases of foreign securities reached a record $46 billion in 1991, but still fell short of private foreign purchases of US securities; this may mark a new trend as US financial institutions appear to be diversifying into foreign assets.

International reserves

Slowdown in global reserve growth

The growth of total non-gold reserves was $51 billion last year, compared with $120 billion in 1990. Developing countries as a group experienced large accruals, with sizable increases in a number of the heavily indebted middle-income countries. Group of Ten holdings fell for the first time since 1984; there was a further $15 billion decline in the first quarter of 1992, which was, however, more than accounted for by exchange rate effects. By type of reserve asset, a notable feature was the increase in IMF reserve positions and holdings of official ECUs. The proportion of official reserves held in the form of bank deposits declined.

Although the 5.6% growth in non-gold reserves was only about a third of the rate in the preceding year, it was still well above the nominal growth of world trade. Excluding the effects of exchange rate changes, the expansion came to 5.3%. With countries' physical stocks of gold held as reserve assets virtually constant (see Chapter VI), the decline in the value of official gold holdings was almost entirely due to the 9.6% fall in the market price of gold.

One striking feature last year was that the non-gold holdings of the United States, Germany and Japan all fell significantly. This was the first

Changes in global reserves							
Areas and periods	Gold		Foreign exchange	IMF reserve positions	SDRs	Official ECUs	Total non-gold reserves
	in millions of ounces	in billions of US dollars at current prices[1]					
Group of Ten countries							
1989	−4.4	− 8.5	25.8	−0.9	−0.5	−1.1	23.3
1990	−1.4	− 7.8	51.4	2.8	1.9	−0.7	55.4
1991	−1.9	−28.0	−36.1	3.9	0.1	1.7	−30.4
Amounts outstanding[2]	*725.6*	*256.4*	*311.5*	*28.9*	*22.7*	*54.5*	*417.6*
Other developed countries							
1989	0.5	− 0.5	6.7	0.3	0.1	0.2	7.3
1990	0.7	− 0.5	30.7	−0.1	–	1.3	31.9
1991	2.1	− 2.2	12.1	0.2	−0.2	2.8	14.9
Amounts outstanding[2]	*79.3*	*28.0*	*146.0*	*3.8*	*2.4*	*12.7*	*164.9*
Eastern European countries[3]							
1989	0.5	0.1	2.3	–	0.1	–	2.4
1990	−2.3	− 1.0	− 8.0	–	−0.1	–	− 8.1
1991	0.3	− 0.2	− 1.8	–	0.2	–	− 1.6
Amounts outstanding[2]	*7.7*	*2.7*	*18.0*	–	*0.2*	–	*18.2*
Newly industrialised economies[4]							
1989	0.1	− 0.1	5.2	0.2	–	–	5.4
1990	–	− 0.1	6.1	0.1	–	–	6.2
1991	–	− 0.5	15.2	–	–	–	15.2
Amounts outstanding[2]	*13.9*	*4.9*	*129.6*	*0.4*	*0.2*	–	*130.2*
Developing countries							
1989	−2.0	− 1.8	11.4	−4.2	0.1	–	7.3
1990	0.9	− 0.9	37.1	−2.5	0.2	–	34.8
1991	−1.6	− 4.9	53.8	−0.9	0.3	–	53.2
Amounts outstanding[2]	*113.1*	*40.0*	*226.0*	*3.9*	*3.9*	–	*233.8*
Total							
1989	−5.3	−10.8	51.4	−4.6	−0.2	−0.9	45.7
1990	−2.1	−10.3	117.3	0.3	2.0	0.6	120.2
1991	−1.1	−35.8	43.2	3.2	0.4	4.5	51.3
Amounts outstanding[2]	*939.6*	*332.0*	*831.1*	*37.0*	*29.4*	*67.2*	*964.7*

[1] Gold reserves valued at market prices. [2] At end-1991. [3] Albania, Bulgaria, Czechoslovakia, Hungary, Poland, Romania, the former Soviet Union and former Yugoslavia; data for Albania, Bulgaria and, for 1989, the former Soviet Union relate to deposits with BIS reporting banks. [4] Singapore, South Korea and Taiwan.

time since the advent of floating that the three principal reserve currency countries all experienced a decline in their reserves in the same year. The main reason was that the impact on reserves of coordinated intervention undertaken to influence the dollar exchange rate, which tends to push US and other countries' reserves in opposite directions, was swamped by other transactions.

US, German and Japanese reserves all decline

Having more than quadrupled in just four years, US foreign exchange reserves were by mid-1991 at levels believed by the authorities to be well in excess of prospective needs. To cut them back without disrupting the market, the United States engaged in a series of bilateral off-market operations with two other central banks. It exchanged the equivalent of over $8.5 billion in foreign currencies for US dollars, thereby reducing international reserves.

These off-market transactions cut Germany's reserves by $5.5 billion. Contributions to the costs of the Gulf war and occasional dollar sales in the late spring offset interest income and other receipts so that German reserves contracted by 7% in 1991. In the case of Japan, the $7.7 billion decrease in foreign exchange reserves occurred largely in the spring when the dollar was appreciating sharply and Japan's Gulf war contributions were being transferred.

EMS countries

The reserves of a number of EC member countries were influenced by developments within the EMS. Faced with a widening current account deficit and declining capital inflows, Italy drew heavily on its reserves. The contraction was concentrated in the spring and also in the late autumn when the lira dropped sharply from near the top of the narrow band to well below the mid-point. In volume terms there was a further $2 billion fall in the first quarter of 1992. ERM pressures also lay behind the declines in the official reserves of France and Denmark, whose currencies remained in the lower half of the narrow band throughout 1991.

By contrast, high interest rates in Spain continued to attract capital in amounts well in excess of those needed to finance the current account deficit. The peseta reached the top of its 6% ERM fluctuation band early in the year and reserve holdings expanded by more than a quarter. Although Portugal joined the ERM only in April 1992, it also experienced large capital inflows, and its reserves grew by more than 40%.

As sterling was in the middle or lower part of the wider band throughout 1991, the expansion of UK reserves cannot be attributed to excessive upward pressure on the exchange rate. Instead it reflected a variety of special transactions. In the first quarter the proceeds of a large ECU bond issue were taken into the reserves. Other countries' payments towards the cost of the Gulf war and receipts relating to privatisation also boosted official assets.

Norway and Finland, which chose to link their currencies to the ECU in 1990 and 1991, experienced notable declines in reserves. In Norway the decrease reflected intervention in support of the krone following large short-term capital outflows from financial institutions. The sharp contraction in Finland was due to heavy intervention in support of the markka both in the first half of the year and just prior to the 12% devaluation of the central rate vis-à-vis the ECU in November.

Eastern Europe and...

The overall contraction of the aggregate non-gold reserves of the eastern European countries conceals wide differences among individual countries. Thanks to strong current accounts and inflows of capital, both Hungary and Czechoslovakia added substantially to their reserves. On the other hand, after having reached a post-war peak of over $5 billion in October 1990, Poland's official assets declined by a fifth as the current account swung into sizable deficit.

The two countries in the process of disintegration suffered severe

Official non-gold reserves by country[1]				
Countries and areas	Changes			Amounts outstanding at end-1991
	1989	1990	1991	
	in billions of US dollars			
Developed countries	30.6	87.3	−15.5	582.5
United States	26.8	8.7	− 5.6	66.7
Other Group of Ten countries	− 3.5	46.7	−24.8	350.9
Japan	−12.8	−5.5	− 6.4	72.0
Germany	2.4	6.8	− 4.4	63.0
Italy	12.1	15.9	−14.0	48.7
United Kingdom	− 9.3	1.1	6.0	41.9
France	− 0.7	12.1	− 5.4	31.3
Switzerland	1.0	3.9	− 0.2	29.0
Sweden	1.1	8.4	0.3	18.3
Netherlands	0.5	0.9	0.4	17.8
Canada	0.7	1.8	− 1.6	16.3
Belgium	1.5	1.3	0.5	12.6
Other developed countries	7.3	31.9	14.9	164.9
of which: Spain	*4.4*	*9.7*	*14.7*	*65.8*
Portugal	*4.9*	*4.5*	*6.2*	*20.6*
Norway	*0.5*	*1.6*	*− 2.1*	*13.2*
Finland	*− 1.3*	*4.5*	*− 2.0*	*7.6*
Denmark	*− 4.4*	*4.2*	*− 3.2*	*7.4*
Eastern European countries[2]	2.4	−8.1	− 1.6	18.2
of which: Poland	*0.3*	*2.2*	*− 0.9*	*3.6*
Hungary	*− 0.2*	*−0.2*	*2.2*	*3.3*
Czechoslovakia	*0.6*	*−1.1*	*2.1*	*3.2*
Former Yugoslavia	*1.8*	*1.3*	*− 2.8*	*2.7*
Newly industrialised economies[2]	5.4	6.2	15.2	130.2
of which: Taiwan	*− 0.7*	*−0.8*	*10.0*	*82.4*
Singapore	*3.3*	*7.4*	*6.4*	*34.1*
Developing countries	7.3	34.8	53.2	233.8
of which: China	*− 0.6*	*11.6*	*14.1*	*43.7*
Mexico	*1.1*	*3.5*	*7.9*	*17.7*
Thailand	*3.4*	*3.8*	*4.2*	*17.5*
Venezuela	*1.0*	*4.2*	*2.3*	*10.7*
Argentina	*− 1.9*	*3.1*	*2.1*	*6.6*
Egypt	*0.3*	*1.2*	*2.6*	*5.3*
India	*− 1.0*	*−2.3*	*2.1*	*3.6*
Philippines	*0.4*	*−0.5*	*2.3*	*3.2*
Total	45.7	120.2	51.3	964.7
Memorandum item:	reserves as a percentage of total imports			
The 15 "Baker" countries	*18.8*	*25.5*	*32.3*	

[1] Including official ECU positions. [2] See the table on page 97 for group definitions.

... the Soviet Union

losses of reserves. Yugoslavia saw its external assets plummet by more than 50%. Accurate information on the exchange reserves of the Soviet Union and its successor states is not available. Total deposits by residents of the former Soviet Union at BIS reporting banks stood at nearly $9 billion at the end of 1991, but only a small fraction of this can be presumed to be under the direct control of the monetary authorities. Some of the deposits may reflect the capital flight noted earlier in this chapter. Another part may have resulted from the transfers needed to ease the capital and funding difficulties of Soviet banks' foreign affiliates.

Asian NIEs

In the Asian NIEs, very strong reserve gains by Taiwan and Singapore more than offset a small decline in South Korea. Taiwan's official assets, which grew by 14% last year, are now the largest in the world. This rapid expansion in reserves created problems of monetary control as the authorities found it difficult to offset the impact on domestic liquidity.

Developing countries

The exceptionally large build-up of reserves in the developing world helped to alleviate shortages of international liquidity that had impeded the process of reform and structural adjustment in some countries. Although reserve growth was widespread, the increases were recorded mainly by the middle-income countries, some of which had protracted debt service problems. The poorest countries – which cannot borrow freely in the international market – still face severe liquidity constraints.

The single largest reserve gain in the developing world was recorded by China; its massive current account surplus allowed an addition to reserves that exceeded Taiwan's and came second only to Spain's. Inflows of capital led to the accumulation of reserves in Mexico, Thailand and Venezuela. The growth of India's official assets over the year conceals huge drawings around mid-year, when the country had to deal with a severe liquidity crisis, and a subsequent rebuilding of reserves (see Chapter III).

As regards the composition of reserves, the steady increase in the share of foreign currency in non-gold reserves, which had persisted unabated for seven years, came to a halt in 1991. This can be attributed to the off-market transactions, which extinguished foreign exchange reserves, and to the expansion of reserve positions in the IMF and official ECUs.

IMF reserve positions

As the 85% majority needed for approval of the June 1990 proposal to raise members' quotas by 50% has not yet been reached, last year's increase in IMF reserve positions arose mainly because of expanded lending by the Fund – the first increase in its total credit outstanding since 1985. This reflected the extension of the IMF's operations beyond traditional balance-of-payments support to the provision of funds for debt and debt service relief and the promotion of the process of transition in eastern Europe. At the end of 1991 the Fund had fifty programmes in place compared with forty-three at the end of the preceding year.

Official ECUs

Holdings of official ECUs, created through swaps between EMS member countries and the European Monetary Co-operation Fund, rose by $4.1 billion. Since the price of the gold used in the revolving swaps declined, the increase reflected an expansion in the dollar holdings of the EMS member countries. A further $0.4 billion was created as a result of very short-term financing operations. Evaluated at constant prices, the expansion in official ECUs amounted to less than $3 billion.

Last year saw signs of a move back towards the reserve investment

The composition of official foreign exchange reserves[1]						
Items	Changes					Stocks at end-1991
	1987	1988	1989	1990	1991	
	in billions of US dollars					
Total	142.7	48.9	54.1	84.2	42.5	831.1
Dollar reserves	103.3	3.8	4.3	36.2	30.2	462.1
of which held:						
In the United States	*53.8*	*40.1*	*−4.1*	*29.7*	*25.8*	*316.6*
With banks outside the United States[2]	*15.1*	*−6.1*	*2.7*	*9.6*	*8.3*	*107.6*
Non-dollar reserves	39.4	45.1	49.8	48.0	12.3	369.0
of which: Held with banks[2]	*26.1*	*24.7*	*9.3*	*16.6*	*−29.5*	*124.3*
Memorandum item:						
Identified reserves in:						
Deutsche Mark	*19.3*	*21.8*	*23.4*	*9.5*	*− 2.1*	*152.4*
Japanese yen	*7.8*	*4.6*	*10.6*	*16.1*	*7.7*	*86.4*
Private ECU	*1.4*	*8.1*	*7.3*	*13.7*	*2.3*	*38.6*
Pound sterling	*1.3*	*4.0*	*2.3*	*4.3*	*5.4*	*30.0*
French franc	*0.7*	*1.8*	*2.7*	*7.6*	*10.1*	*27.5*

[1] Estimated from IMF and BIS sources. Changes computed at constant (end-of-period) exchange rates. Valuation effects are excluded. [2] Deposits by official monetary institutions with banks reporting to the BIS. Includes all deposits with these banks by China, Albania, Bulgaria and, up to 1989, the former Soviet Union.

Preference for dollar holdings ...

patterns of earlier decades, with dollar reserves increasing more than those in other currencies and with funds being shifted from bank deposits to Treasury bills and other securities. This expansion in dollar holdings was partly a consequence of the geographical pattern of reserve growth. The developing countries recorded unusually large increases in international liquidity and showed a preference for dollar instruments. Unlike the European countries participating in the ERM, they do not generally see a need to hold the currencies of their neighbours for intervention purposes.

... and securities

Calculations suggest that about $26 billion in dollar reserves was placed in the United States directly, whereas estimated official holdings of dollars with banks outside the United States expanded by only about $8 billion. The shift away from the banking system as an outlet for official reserves was even more pronounced for other currencies. Official holdings of non-dollar currencies held with BIS reporting banks declined by almost $30 billion, the largest falls being for the Deutsche Mark ($13 billion) and the yen ($9 billion). The general narrowing of the spread between rates on commercial bank deposits and Treasury bills may explain the apparent shift in the pattern of reserve holdings in favour of securities.

V. Monetary policy: domestic and international aspects

Highlights

1991–92 was a period of stark contrasts in the conduct of monetary policy and in international monetary coordination. Monetary policy was eased in the United States and Japan in an effort to support economic expansion but was tightened in Germany in a struggle against inflationary forces. In a number of countries asset price cycles together with strong debt accumulation have raised the question of whether monetary policy should respond to such developments. A further question is how changes in monetary policy transmission mechanisms following deregulation and financial innovation in the 1980s may have affected the policy options of central banks and their ability to achieve objectives with respect to inflation and economic growth.

Although concern about short-run constraints on monetary autonomy in individual European countries increased during 1991, the Heads of State and Government of the EC countries reached agreement in December on plans for establishing a monetary union by the end of the decade. The Maastricht Treaty lays down the primary objective of price stability, and the organisation of an independent European System of Central Banks. It sets out convergence criteria for inflation and government budget and debt positions which countries must meet before joining the union. Risks remain, however, with respect to the achievement of the proclaimed objective and satisfactory overall economic performance.

Explicit initiatives aimed at coordinating policy in the major countries were conspicuously absent last year, because policy-makers did not in general think they were required. However, international consensus on the need for continuing structural reforms and for raising the rate of saving in the industrial economies in the medium term was reaffirmed. Cooperation and the exchange of information in international forums continued and may provide a basis for closer policy coordination should the need re-emerge.

Monetary policy in 1991–92

Interest rate policies in the largest economies

Divergent monetary policies in the United States, Japan and Germany

Divergences in short-term interest rate policies pursued in the United States, Japan and Germany over the past year mainly reflected differing business cycle situations. However, central bank policies were conditioned by country-specific developments in the financial and labour markets and by judgements about the relative priorities to be attached to sustaining output and restoring price stability. The continued easing of policy in the United

States reflected the Federal Reserve's desire to overcome perceived constraints on the pace of the economic recovery resulting from over-extended debt positions and tight credit supply conditions. The high level of asset prices and tight labour market conditions contributed to the Bank of Japan's caution in encouraging declines in market interest rates in early 1991. Bundesbank policy clearly took into account the threat to price stability posed by large wage claims and the unification-related government budget deficit.

Policy easing in the United States ...

A steep decline in the US federal funds rate between December 1990 and April 1991 had been designed to restore the economy to a moderate expansion path consistent with reduced inflation by offsetting the impact of financial constraints. Signs that the economy was faltering prompted a further sharp easing of monetary policy between June and December 1991 in a quick succession of steps aimed at counteracting a weakening of business and consumer confidence. By April 1992 the federal funds rate stood 4½ percentage points lower than in mid-1990.

... and Japan ...

In Japan, with the pace of economic growth slowing and consumer price pressures abating in the course of 1991, monetary policy was geared to facilitating a "soft landing". The Bank of Japan accommodated declines in short-term market rates as from June 1991, lowering its discount rate in four stages between July and early April 1992. Short-term yield curves suggest that each of the changes had long been expected in the markets.

... in contrast to Germany

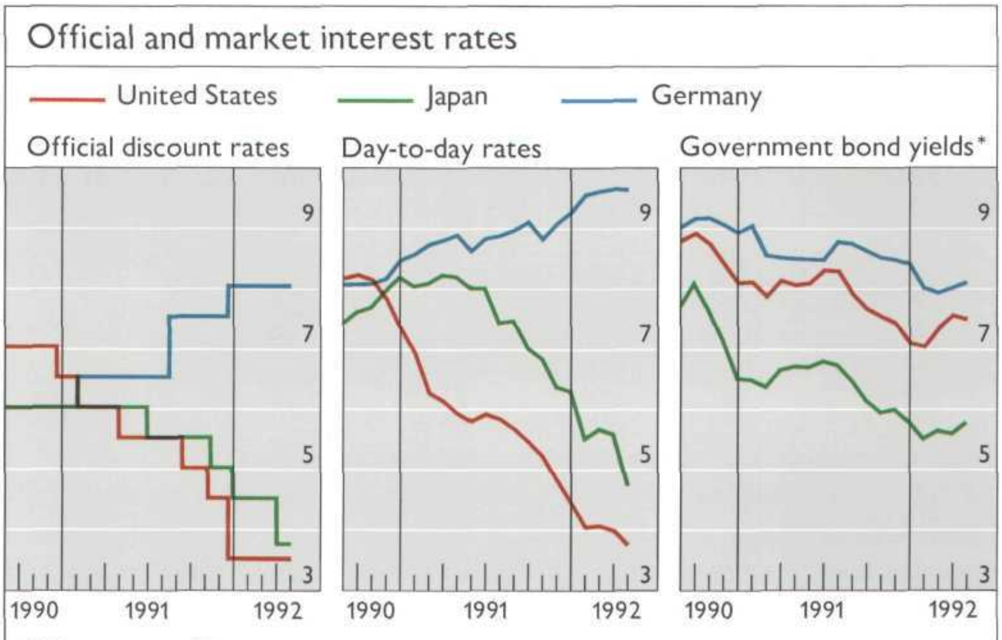
Although aggregate demand pressures in Germany also eased as from the spring of 1991, the inflation outlook deteriorated after mid-year under the influence of wage settlements averaging nearly 7% in 1991 and further large claims for the 1992 wage round. The Bundesbank increased its official rates in three stages between February and December, providing scope for a limited rise in the day-to-day market rate, which generally remained close to the lombard rate. The December increase, after the conclusion of the Maastricht agreement, contrasted with a full percentage point reduction in the Federal Reserve discount rate announced the next day.

Responses of long-term interest rates ...

Short-term interest rate policy interacted with a markedly different pattern of developments in long-term interest rates. In the United States a slow response to declines in short-term rates followed by a rebound in long rates in early 1992 gave rise to concern about the ability of easier monetary policy to stimulate the economy. The decline in long rates in Germany in two stages, each closely following a tightening of monetary policy, was widely interpreted as a sign of confidence that inflation would be kept under control. The subsequent firming, however, was a clear indication that in globalised financial markets developments in bond yields in different countries are somewhat synchronised.

... exchange rates ...

The exchange rate effects of divergent monetary policies were not unwelcome. In fact, the exchange markets were seen everywhere as an important transmission channel of monetary policy. Divergent policies clearly contributed to the depreciation of the US dollar in July–December 1991, which was not inconsistent with domestic objectives in the major countries. The Federal Reserve accepted some weakening of the dollar as



* Ten-year maturities.

potentially helpful in promoting the growth of US exports. The Bank of Japan regarded a gradual strengthening of the yen as a useful means of fostering external adjustment. The Bundesbank appeared to view appreciation of the Deutsche Mark against the dollar as helping to moderate cost inflation.

... and monetary and credit aggregates

The slowdown in credit expansion in the United States and Japan was reflected in the broad monetary aggregates. To a degree reduced monetary growth could be viewed as supporting the case for an easing of policy. However, the timing and magnitude of policy changes was influenced mainly by ongoing developments in the economy and in consumer and business confidence. In Germany a credit-led acceleration in monetary expansion in the course of 1991 was a consideration in the tightening of policy in December.

Interest rate policies in other EMS countries

Monetary policy in narrow band ERM countries

Between January and April 1991 countries participating in the EMS exchange rate mechanism with narrow fluctuation bands – France, Belgium, Denmark, Ireland and Italy – took advantage of the weakness of the Deutsche Mark to encourage declines in policy-influenced market interest rates. Short-term rates in France, Belgium and Denmark converged fully with German rates, as had rates in the Netherlands much earlier.

In Belgium and the Netherlands, where the central bank's policy was to keep exchange rate fluctuations against the Deutsche Mark within a much narrower range than the ERM band required, money market rates remained very close to German rates. Symbolising close monetary policy coordination, synchronised increases in official interest rates took place in August and December in Germany, the Netherlands, Belgium, Denmark and – outside the EMS – Austria, which continued to keep fluctuations of the currency's DM exchange rate within a very narrow range. Official interest rates in Italy and Ireland were also increased in December. In view of the slowdown in domestic economic activity the Bank of France permitted the French franc to remain close to the lower limit of the ERM band and encouraged small independent declines in French short-term interest rates, reducing its money market intervention rates in two stages in March and October. On each occasion three-month market rates subsequently rose in relation to German rates. The attempt to lower rates unilaterally may actually have contributed to a weakening of confidence. In December the official money market intervention rate was raised to its early 1991 level. Late in the year, particularly after a devaluation of the Finnish markka touched off market discussion of other exchange rate commitments, money market rates in Italy, Denmark and Ireland also rose sharply.

Short-term interest rate relationships in the ERM

At times in 1991 three-month interest rates in Belgium, the Netherlands, France and Denmark all fell below German rates. This situation did not prove lasting, however, even though current rates of increase in consumer prices in most of these countries had fallen below that in Germany. Short-term interest rates in ERM countries are now closely arbitraged through Euro-currency markets. In the absence of any indication that the authorities might decide to translate current inflation differentials into an upward realignment against the Deutsche Mark, money market participants had little incentive to bid interest rates on other ERM currencies far below rates on DM instruments. German rates tended to set a floor for rates in other countries. In principle there was scope for market forces to bring about a small appreciation against the Deutsche Mark of currencies which stood in the lower part of the ERM band. The prospects for such an appreciation did not appear good, however, in cases where

Money market rates and government bond yields in EMS countries

Countries	Three-month interbank rates[1]						Bond yields[2]		
	Levels				Differentials[3]		Levels		
	Dec. 1989	Dec. 1990	April 1991	March 1992	Oct. 1991	Dec. 1991	March 1990	March 1991	March 1992
	end of month, in percentages								
Germany	8.3	9.2	9.2	9.8			8.7	8.6	8.1
Netherlands	8.8	9.5	9.2	9.6	−0.06	0.09	8.8	8.8	8.5
Belgium	10.4	10.1	9.2	9.8	−0.03	0.02	9.9	9.4	8.9
France	11.4	10.1	9.3	10.2	−0.22	0.64	9.6	9.1	8.8
Denmark	12.1	10.4	9.9	10.2	−0.16	0.27	10.5	9.4	8.9
Ireland	12.1	11.5	10.2	10.7	0.75	1.08	10.4	9.3	8.8
Italy	12.6	12.4	11.3	11.9	1.53	2.20	12.3	11.4	11.0
United Kingdom	15.2	14.0	11.8	10.8	0.99	1.27	12.5	10.1	9.9
Spain	16.2	15.3	13.5	12.6	3.12	3.35	14.8	12.7	11.3
Portugal	13.8	13.6	14.2	13.5	4.73	4.53	15.2	15.2	12.5
Greece	18.3	27.1	18.3	22.0	13.63	18.63	.	.	.

[1] For Greece, one-month interbank rate; for Portugal, Treasury bills. [2] For Portugal, all issuers.
[3] Vis-à-vis Germany.

Source: National data.

governments scarcely concealed their desire for lower interest rates. An interest rate policy in France in early 1992 which permitted the French franc to move up closer to the position of the Deutsche Mark in the ERM band seems to have contributed to narrowing short-term interest rate differentials between France and Germany over time.

Monetary policy convergence and confidence in ERM commitments were also reflected in falls in long-term interest rates between early 1991 and the spring of 1992 in all narrow band ERM countries.

Monetary policy in other EC countries ...

At times in early 1991 a counter-inflationary monetary policy in Spain, which kept the peseta close to the top of its broad ERM band, seemed to be hindering declines in short-term interest rates in the United Kingdom and France. The situation was relieved in the summer by a decline in peseta interest rates, encouraged partly in the light of an easing of domestic inflationary pressures. In early 1992, after a slight rise in Spanish money market interest rates, the peseta and sterling were again at opposite limits of their wide ERM bands. On balance the wide band commitment proved consistent with substantial declines in both short and long-term interest rates in the United Kingdom last year. In Portugal, which joined the ERM in April 1992 with a central rate which implied a market rate in the upper half of the 6% band, interest rates declined considerably in 1991–92.

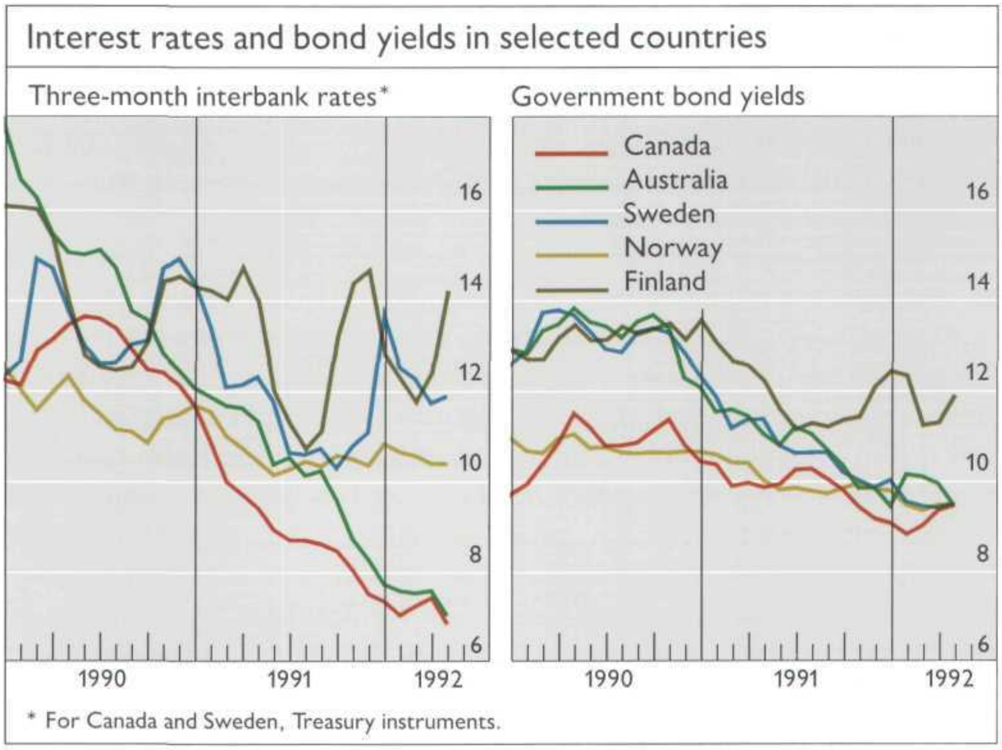
Interest rate policies in other industrial countries

... Norway, Sweden, Finland ...

Following the introduction of an ECU currency peg in place of a trade-weighted currency basket in Norway in October 1990, independent national commitments to stabilise the ECU exchange rate of the Swedish krona and the Finnish markka were announced in May and June 1991 respectively. While the exchange rate regimes of the three countries have converged, the specified fluctuation margins around the central rate still range from +/–1.5% in the case of Sweden to +/–3% in that of Finland. The new standards, adopted without parity changes, were interpreted in the markets as being more rigorous than those they replaced. In each case a substantial decline in interest rates ensued. The impact of a loss of policy credibility was seen subsequently, however, when, against a background of external disturbances and difficulties in concluding a national wage agreement, three-month money rates in Finland rose to around 20%. After the Finnish markka was devalued by 12.3% against the ECU they retreated a little but surged up again in early April 1992. In that month long-term interest rates in Finland were as high as before the adoption of the ECU standard. Three-month interest rates in Sweden rose to peaks of nearly 16% in December and 12½% in April 1992 but, with the Riksbank's determination to resist a devaluation of the krona established, fell to 11½% in late April 1992; long-term rates declined to 10%.

... Switzerland ...

In Switzerland policy-induced declines in money market rates in December underwent a sharp correction in early 1992 when the DM exchange rate of the Swiss franc came under strong downward pressure. By late March three-month rates were back to early 1991 levels. Although Swiss franc bond yields remained below German rates, a situation which has



prevailed for at least thirty years, the experience seems to confirm that a floating currency cannot always be expected to provide a large margin for manoeuvre for the monetary policy of a small open economy.

... Canada and Australia

A comparatively large decline in short-term interest rates was encouraged in Canada as from the spring of last year against the background of severe recession and a sharp fall in the rate of inflation. Long-term rates fell more than yields in the United States. Short-term interest rates were also lowered substantially in Australia in 1991. The fact that in February 1992 long-term interest rates in Canada and Australia stood at levels similar to bond yields in Norway and Sweden serves as a reminder that international interest linkages to larger markets may influence long-term interest rates under any exchange rate regime.

The effectiveness of monetary policy

The economic slowdown, accompanied, in some countries, by financial strains, raises the question of how actively monetary policy should respond to such a situation. Can a substantial lowering of short-term interest rates, by alleviating debt burdens and arresting falls in asset prices, effectively stimulate economic recovery? What might be the implications for price stability over various time horizons?

Differing approaches to policy and the transmission mechanism

Changes in monetary policy transmission mechanisms

Central bank assessments of the advantages of different approaches to monetary policy have clearly begun to diverge. To some extent the differences seem to be related to views about the expectational and other channels through which monetary policy affects economic activity and the price level, and the length and variability of the lags involved. In some countries substantial changes in the monetary policy transmission process have occurred in recent years following deregulation and financial innovation. They have affected the roles played by interest rates, asset prices, monetary and credit aggregates and the exchange rate. Some of the changes have evidently increased the divergences between the types of constraint countries seem to face in formulating monetary policy.

In recent years monetary policy in the industrial world has been based on the view that a commitment to price stability would achieve the most satisfactory overall economic results. In the late 1980s improved inflation and growth performance generally went hand in hand but in some countries an asset price cycle and rising debt burdens eventually contributed to protracted recession. Financial innovation and the debt cycle also distorted some monetary aggregates which had been used to define a medium-term counter-inflationary course. In general monetary policy was reformulated more in terms of exchange rates or a medium-term commitment to price stability. Even so, some central banks now consider that, in a context of sharp declines in current inflation rates, policy can safely be geared more to promoting a recovery in output and employment.

Differing transmission mechanisms and approaches to policy ...

It had never been assumed that stable policies would obviate the need for interest rate adjustments in response to external or domestic disturbances which increased or reduced inflationary potential. In some countries the effect of declines in money market interest rates on economic activity in the short run and inflation in the longer run may have become weaker and less certain in a context of falling asset prices and high debt burdens. A few central banks have concluded that larger declines in short-term interest rates were therefore justified. In other countries, however, domestic inflationary pressures or the desire to meet exchange rate commitments have argued against declines in interest rates which were not supported by gains in the credibility of exchange rate commitments. In varying degrees, the limited scope for further declines in exchange rate risk premia vis-à-vis the Deutsche Mark, combined with stronger cross-country interest rate linkages following the removal of exchange controls, can be seen as having narrowed the margin for manoeuvre in interest rate policy in many European countries. Fundamentally, however, the constraints have been viewed as an integral part of medium-term policies to which monetary authorities remain strongly committed.

... in the United States ...

In the United States, where, even more than in other large economies, most widely used models still suggest that changes in policy-determined interest rates influence inflation mainly by affecting economic activity in relation to productive potential, the Federal Reserve could point last year to the effect of the recession in moderating inflationary pressures. Given the size of the economy, the comparatively limited impact of import costs on the inflation rate and relatively flexible labour markets, exchange rate transmission mechanisms could also still be viewed as operating mainly through effective demand. More than elsewhere, monetary policy could be expected to influence inflation with a long lag and it could be hoped that any adverse effect would be minimised if policy were tightened quickly enough when the economy began to recover. Past experience has not been encouraging in this respect, but given the risk that falling asset prices could further weaken financial institutions, policy was directed mainly at encouraging business and consumers to spend.

... Japan, Canada ...

In Japan monetary policy was increasingly geared to supporting economic activity last year. Interest rate policy in Canada continued to be adjusted, in the light of exchange rate developments, with the objective of influencing monetary conditions. Since February 1991, however, it has operated within a framework of a published time path for reducing inflation which is designed to provide an anchor for inflation expectations.

... and European countries

In most European countries the conduct of monetary policy has continued to take close account of expectational and cost influences on the inflation rate transmitted through the exchange rate. In several countries falls in asset prices and debt accumulation have been impeding economic recovery but central banks have concluded that a stable monetary policy course is needed to strengthen confidence. In Europe a stable course could readily be defined in terms of exchange rates, given the importance of the exchange rate in the monetary policy transmission mechanisms and the comparatively low inflation standard set by a core of original narrow band ERM countries.

Developments in Germany over the past two years serve as a reminder, however, that shifts in government budget positions and behaviour in still rigid labour markets can also significantly condition monetary policy transmission processes – even if policy is kept on a course designed to stabilise inflation expectations. The Bundesbank provided clear signals of its intention to pursue a non-accommodating monetary policy. As demand pressures began to ease it became increasingly clear that the consequences for future developments in output and prices would depend upon the responses of unions and employers.

Economic openness and downward real wage rigidity are among the reasons why central banks in most core ERM countries have long based their monetary policies on exchange rate commitments. In some countries which have forged closer links with the EMS or the ECU in recent years economic and financial structures are different but exchange rate based policies could nevertheless help in getting high rates of inflation down. Whether, in a climate of lower inflation, some of the countries may begin to reconsider exchange rate options which they at present exclude remains to be seen.

Interest rate transmission mechanisms

Changes in the strength of interest rate transmission mechanisms

The liberalisation of controls over interest rates, credit-granting and domestic and cross-border financial activities weakened traditional liquidity constraints on consumers and businesses in many countries. In the new environment financial market prices and exchange rates were expected to be the main channels for transmitting monetary policy to the economy. In some countries the increases in debt ratios and asset prices following deregulation seemed, at the time, to be enhancing the potential impact of rises in interest rates on consumption and investment. It was recognised that some of the effects depend on expectational responses, which are not easily predictable, and that a weakening of confidence could occur if asset prices were perceived to have overshot or debt burdens came to be viewed as excessive. The question of how effective declines in short-term interest rates might be in reviving confidence received relatively little attention. Last year, however, concern developed, particularly in the United States, about whether a weakening of the impact of monetary policy on long-term interest rates and on interest rates charged by financial institutions was reducing its impact on borrowing, lending and economic activity.

Effect of deregulation and financial innovation

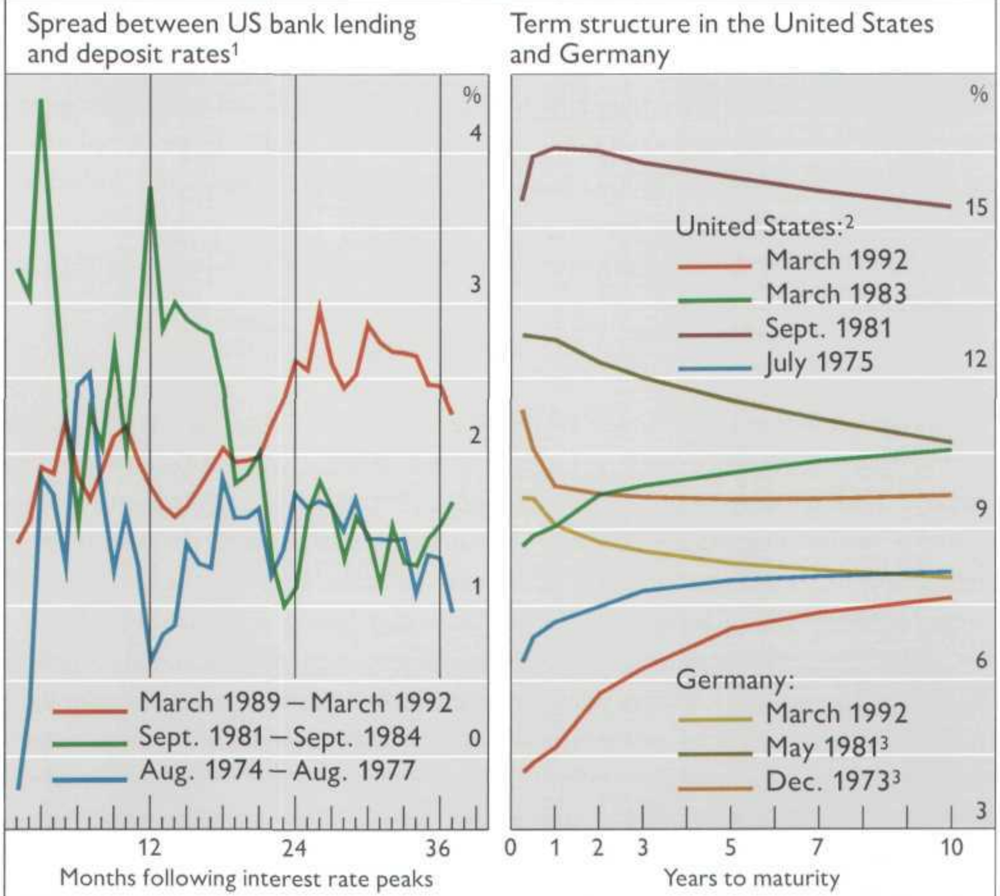
Interest rates applied by financial institutions. In many countries increased competition between banks and other financial institutions and the development of new market instruments such as money market funds and commercial paper have led to a considerable increase in the proportion of bank liabilities which are remunerated at market-related interest rates. For city banks in Japan this proportion rose from around 10% in 1980 to over 70% by 1990. In the United States, the United Kingdom and France there has been a substantial rise in the share of new instruments as well as in that of traditional sight, time and savings deposits which yield returns related to market rates. Banks in Japan, the United Kingdom and the United States have also adopted more flexible practices for adjusting prime lending rates. In the United States variable interest rate contracts have been used in a substantial proportion of new housing loans. Differentials between bank prime (or average) lending rates and money market rates have become smaller and less variable since the early 1980s in France, the Netherlands and Germany.

Increased responsiveness of interest rates on deposits to market interest rates has weakened transmission mechanisms that relied upon changes in this differential to influence the ability of deposit institutions to lend. The influence of changes in market interest rates on the banks' profits and willingness to lend has decreased in France, where the proportions of bank liabilities and assets bearing market interest rates are now similar. In the United States a weakening of the influence of monetary policy on the availability of funds for housing investment following the deregulation of deposit interest rates and the growth of mortgage securitisation in the 1980s was thought, until recently, to have been fully offset by a strengthening of other interest rate effects on aggregate demand, especially those operating via the exchange rate.

Impact of financial pressures on banks

During the past two years, however, the financial pressures experienced by US banks have induced them to attempt to improve their profit margins both by reducing lending charges by less than the fall in money market rates and by bidding less actively for deposits. The margin between bank prime rates and three-month CD rates seems to have remained considerably higher in 1991–92 than in previous periods of monetary policy easing. Interest rates charged by banks on personal loans declined even less. To this extent part of the fall in the federal funds rate was not passed on. In Japan banks continued to adjust their short-term prime lending rates

Interest rate relationships



[1] Prime lending rate minus three-month CD rate. [2] Twenty months after cyclical peaks. [3] Interest yield peak.

flexibly in relation to money market rates, generally bringing them down in advance of declines in the official discount rate. There are indications that banks in Japan, the United Kingdom, France, Norway and some other countries selectively raised margins in respect of certain types of lending, in response to pressures on their own profitability and a deterioration in the credit standing of borrowers.

Importance of response of long-term interest rates

Long-term interest rates. In the United States, where housing and other construction activity is sensitive to changes in long-term interest rates, the impact of monetary policy is heavily dependent on the response of long rates to changes in short rates. A comparison with similar phases of previous business cycles suggests that the slope of the US yield curve was unusually steep in March 1992, though the level of bond yields was lower than in the other periods shown in the graph. Particularly to the extent that this slope can be attributed to a belief that the Federal Reserve would take whatever action was necessary to support recovery, it suggests an inherent constraint on the effectiveness of activist policies. Risk premia paid by many private bond issuers increased during the recession, as a result of the downgrading of financial and non-financial firms. In Japan, where bond yields declined steeply in 1991–92, long-term prime lending rates fell substantially.

In Germany the yield curve was flat or inverted in 1989–92 for the first time since 1981–82, when monetary policy had succeeded in restoring confidence only after short-term interest rates had risen to levels far above those prevailing recently. Although bond issues normally account for only a minor share of enterprise financing in most European countries, bond yields may play a role in investment planning. Interest rates on a large proportion of new credit granted by financial institutions for housing and industrial investment are linked to bond yields and seem generally to have been adjusted downwards last year, even in EMS countries in which short-term rates rose.

Asset prices and debt

The huge increases in the value of private assets and debt in many countries during the 1980s were widely viewed as potentially increasing wealth and income effects on expenditure of changes in interest rates. One question is whether monetary policy contributed to the asset price cycle and rises in debt burdens. A somewhat different one is whether monetary policy should seek to offset the effects of debt burdens and falling asset prices.

Causes of debt accumulation in the United States

The rise in debt ratios in the personal and business sector during the 1980s in the United States was not primarily attributable to monetary policy, though expectations that continuing inflation would relieve debt burdens must have been an influence. Debt accumulation was not associated with generalised rises in asset prices on the scale seen in some other countries. The ratio of private financial assets to GNP remained below the peaks recorded in the late 1960s. As from about 1985 house prices rose on average by somewhat more than the general price level but commercial property prices fell continuously in real terms. Overinvestment in commercial construction and the resulting loan losses of financial institutions were largely attributable to tax incentives which were subsequently reversed, competitive pressures faced by banks and inadequate supervision of savings institutions empowered to undertake new types of lending. The rise in corporate debt was associated with retirement of equity, particularly in conjunction with highly leveraged mergers and buyout activity, which contributed to the need for corporate sector balance-sheet restructuring.

The monetary policy response

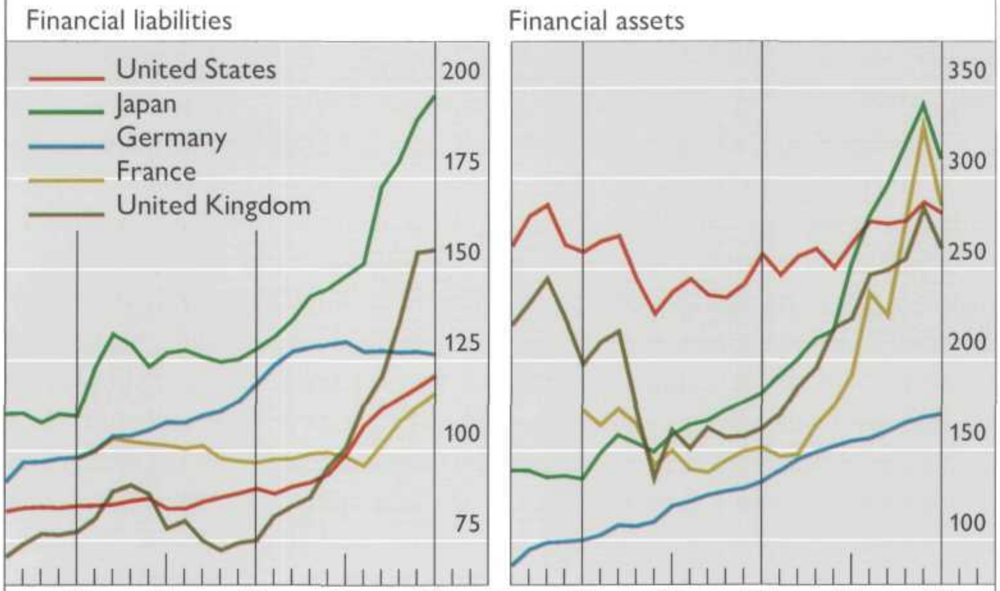
Taking the view that monetary policy should actively seek to counteract the effect of accumulated debt on developments in the goods and labour markets, the Federal Reserve began to ease policy in early 1989 well before the recession set in. The further lowering of short-term interest rates in 1990 and 1991 was designed not only to stimulate expenditures normally sensitive to interest costs but also to facilitate financial restructuring and to alleviate interest burdens.

Asset prices and debt accumulation in other countries

Large rises in personal sector debt/income ratios during the 1980s in Japan, the United Kingdom and Sweden probably made personal spending more sensitive to changes in interest burdens. Accompanying rises in personal sector assets largely reflected increases in the value of housing, which generally do not contribute to a cash income flow. In the United Kingdom house ownership became much more widespread with the privati-

Financial liabilities and assets of the private non-financial sector*

As a percentage of GNP



* Personal and business sector, not consolidated; for Germany and France, including public enterprises. Excluding trade credit and, in the case of liabilities, equities.

Source: National data.

sation of council houses and the personal sector as a whole actually moved into a net debtor position in respect of claims bearing variable interest rates. Notable rises in household debt took place in the 1980s following deregulation in France and Italy but, as in Japan, a far larger rise in household financial assets was also recorded. Equilibrium debt positions are likely to have increased, but in varying degrees debt burdens and interest payment commitments came to be regarded as excessive when asset prices turned down and prospects for income growth deteriorated.

A steep rise in the corporate debt ratio in Japan during the 1980s largely reflected equity-related borrowing partly used to finance an accumulation of financial assets. Corporate debt ratios rose substantially during the 1980s in the United Kingdom and some Nordic countries, but elsewhere in Europe any increase was generally modest. In many cases an improved corporate self-financing capacity may even have made enterprise investment less responsive to the cost of borrowing.

Implications for monetary policy

To point to changes in asset prices and debt ratios as elements in the monetary policy transmission mechanism raises a further question as to how reliable the effects are likely to be, particularly in the short run. Difficulties in applying interest rate policy to restrain inflationary booms which become reinforced by expectations of rising asset prices have been experienced over the years in many countries, most recently, for example, in Spain, Portugal and Greece. The asset price booms in the United Kingdom, Sweden and Canada in the 1980s seem to have been partly attributable to delayed or insufficient tightening of monetary policy, and monetary restraint eventually contributed to bringing them to an end. Central banks in these countries interpret their experiences as indicating the unpredictability of the responses and consider that to attempt to adapt monetary policy to stimulating a quicker economic recovery risks further undermining confidence.

Monetary aggregates in the transmission mechanism

In some countries deregulation and financial innovation undermined monetary targeting strategies intended directly to influence inflation expectations, mainly by blurring the concepts of liquidity reflected in narrow aggregates. In others, where broad aggregates were used, the main problem was the asset price boom, which in the United Kingdom, for instance, was accompanied by intense competition among banks and building societies to expand their assets and liabilities. Broad concepts of the money stock which continue to serve as targets in Germany and some other countries remain sensitive to portfolio shifts induced by changes in market interest rates. To the extent that these shifts precede responses in the economy, the aggregates can be used as leading indicators. Typically, however, movements in the broad money stock are influenced more by contemporaneous developments in bank credit, their main counterpart in bank balance sheets. As a result broad monetary aggregates often reflect changes in credit conditions which are related to current developments in economic activity. By the same token, however, they at times also provide supportive evidence of unusual developments in the banking system or debt positions in the economy.

Relationship between developments in broad monetary aggregates and credit conditions

Even in some countries where the demand for broad aggregates is not highly stable in econometric terms, their income velocity may be sufficiently predictable to justify the setting of targets based on the estimated growth of output or productive potential and norms for the inflation rate. Deviations from the targets can be indicative of the strength of potential inflationary pressures. This may not be so, however, when aggregates with a previously stable relationship to economic activity and inflation respond to developments in the credit markets which strongly affect banks' incentives to bid for deposits. If, as in the United States in 1990 and 1991, unusual changes in the opportunity costs of holding money balances thereby take place, there is no general presumption that central bank attempts to offset changes in velocity will be consistent with controlling inflation in the medium term. A course consistent with medium-term price stability has to be identified in some other way.

Implications for interpreting monetary developments

In the United States a long-standing tendency for changes in M_2 growth to lead rates of change in credit granted by deposit institutions and economic activity has become less reliable in the last two years. In retrospect the slowdown in M_2 growth in the summer of 1991 might have been interpreted as presaging the subsequent weakening of economic activity but the slow growth of bank credit was clearly the major influence on the relationship between broad money and income growth. The response of M_2 to declines in short-term market interest rates was blunted by a lowering of deposit rates while the steep yield curve and the attractive

Monetary developments in the United States ...

Monetary and credit aggregates: objectives and rates of expansion

		United States			Japan	Germany	France
		M_2	M_3	TDNS	M_2+CDs	M_3	M_3
		fourth quarter to fourth quarter, in percentages					
1991	Objective[1]	2½–6½	1–5	4½–8½	2–3	3–5[2]	5–7
	Outcome	2.8	1.2	4.5	2.2	5.2	4.2
1992	Objective[1]	2½–6½	1–5	4½–8½	ca. 2[3]	3½–5½	4–6
		United Kingdom	Italy	Spain	Portugal	Greece	Switzerland
		M0	M_2	ALP	L–	M_3	CBM
		December to December, in percentages[4]					
1991	Objective[1]	0–4	5–8	7–11	ca. 12	14–16	2
	Outcome	2.2	8.9	12.1	15.2	11.7[5]	1.4
1992	Objective[1]	0–4	5–7	8–11[5]	12–16	9–12[5]	1

Note: TDNS = total domestic debt of non-financial sectors; M0 = wide monetary base; ALP = liquid assets held by the public; L– = total liquidity held by non-financial residents; CBM = central bank money stock.

[1] For TDNS in the United States, monitoring range only; for M_2+CDs in Japan and CBM in Switzerland, projection only; for L– in Portugal, guideline only. The figure shown for Switzerland for 1992 is a medium-term norm only. [2] Revised from 4–6% in July 1991. [3] Second quarter to second quarter. [4] For the United Kingdom, twelve-month periods ending in March of the following year; for Switzerland, fourth quarter to fourth quarter. [5] New concept.

Source: National data.

returns offered by bond and stock mutual funds encouraged a shift of deposits into capital market investments. Another factor, allowed for in a lowering of the targets for M_3 for 1991 and 1992, was the taking of the assets of savings institutions onto the balance sheet of the Resolution Trust Corporation where they were financed by Treasury securities in place of deposits.

... Japan, the United Kingdom ...

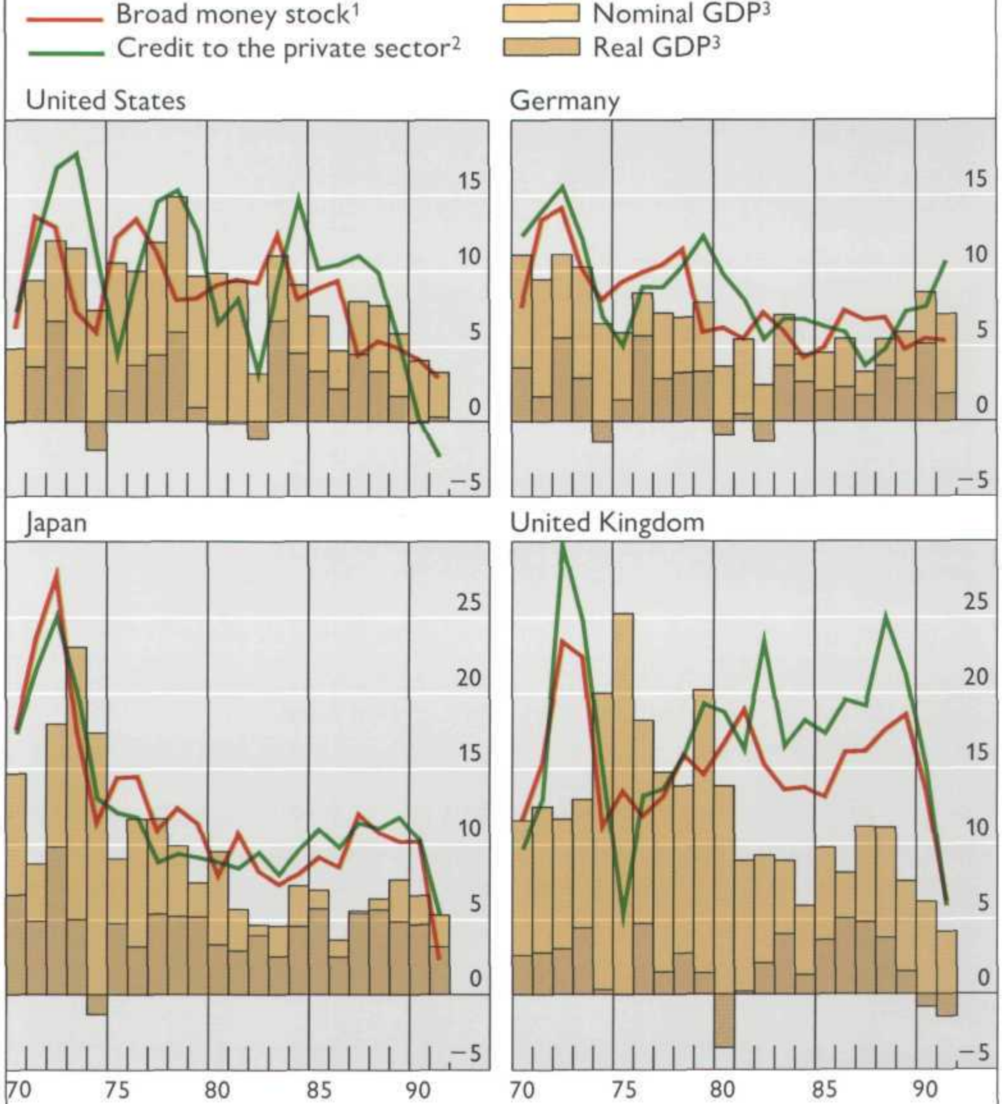
Close relationships between developments in broad money and in bank credit have previously been observed in other countries. In Japan, as in the United Kingdom, developments in broad money tracked the asset price and credit boom in the 1980s and the downturn in credit expansion and in the growth of household wealth in the last two years. Interest rate differentials that attracted funds into postal savings deposits, which are not included in M_2 + CDs, contributed to the slow growth of that aggregate. Last year M_4 growth in the United Kingdom moved into line with the growth of nominal GDP.

... Germany ...

Changes in M_3 growth in Germany over periods of several months or a year have generally given fairly reliable indications of future changes in economic activity and the price level. In recent years a source of uncertainty has been the extension of the Deutsche Mark to eastern Germany. Concern about the resulting high levels of money balances was reflected in a lowering of the Bundesbank's 1991 target for M_3 growth at mid-year. In view of the subsequent credit-led acceleration of M_3 growth the target for 1992, which was calculated on the basis of an unchanged 2% norm for inflation, implies a strict monetary policy.

Monetary and credit aggregates and GDP

Fourth quarter to fourth quarter changes, in percentages



[1] For the United States, M_2; for Japan, M_2 + CDs; for Germany, M_3; for the United Kingdom, M_4.
[2] Credit from banks, savings institutions and the central bank. [3] For Japan, GNP.
Source: National data.

Monetary aggregates continue to serve as indicators of developments in the transmission mechanism and to play a role in the presentation of policy even in some countries which rely mainly on exchange rate objectives as a monetary policy anchor. In France and Italy rates of broad money and credit expansion in 1991 seem fairly high considering the slowdown in the growth of nominal GDP. In Spain, given the strength of the peseta within the broad ERM band, as well as in Portugal and Greece, where some exchange controls remain in effect, monetary aggregates have continued to perform a useful indicator function. Still high rates of monetary expansion last year in these three countries (after allowing for the effect of tax changes which privileged government securities in Greece) testified to continuing inflationary pressures.

... and other EC countries

Credit in the monetary policy transmission process

Credit constraints were expected to play a reduced role in the transmission mechanism in a deregulated environment, although there was clearly a possibility that lenders would tighten credit conditions in recession. However, over the past two years credit aggregates in most countries have responded mainly to a weakening of credit demand, partly due to concern about debt positions.

Credit conditions in the United States

A contraction in credit to the private sector from deposit institutions in the United States last year reflected a further fall in savings institutions' assets combined with a modest 4.0% rise in commercial bank credit, essentially accounted for by investments in government securities. Mortgage borrowers had access to securitised loans and many businesses obtained funds through bond and stock issues. However, non-bank financial intermediaries, many of which normally lend to small or lower-rated businesses, tightened their lending conditions as a result of their exposures in the commercial real estate and low-rated bond markets.

The Federal Reserve's senior loan officer surveys show the percentage of banks reporting a tightening of credit conditions decreasing as from January 1991 though most banks continued to state that conditions remained tight. The overhang of bad loans and the continued decline in real estate prices kept sound US banks unusually cautious in contracting new loans, particularly for real estate. The bank supervisors' capital requirements were not the main influence – by September some 96% of banks were in a position to meet the 8% standard which is to apply under the Basle capital accord from the end of 1992, though the remaining banks accounted for some 9% of total banking assets. In addition to lowering reserve requirements and removing a 25% limit on the share of bank holding companies' tier 1 capital taking the form of non-cumulative perpetual preferred stock, the Federal Reserve acted together with other US supervisory authorities in an effort to allay public concern that bank examination might be contributing to over-restrictive bank lending attitudes. Joint statements by the supervisory authorities in March and

Response of policies relating to bank supervision

Growth in bank lending for specific purposes[1]

Items and years		United States	Japan	United Kingdom	Germany	France	Italy	Sweden
		December to December at an annual rate, in percentages						
Business[2]	1983–90	6.5	7.7	18.0	6.3	10.0	15.0	19.5
	1991	−4.0	2.4	6.3	14.4	6.2	14.4	1.0
Housing[3]	1983–90	14.3	19.0	14.9	5.0	9.1	–	–
	1991	3.3	4.4	4.3	6.1	5.5	–	–
Individuals[4]	1983–90	8.6	14.6	16.4	7.3	22.5	20.4	13.1
	1991	−4.1	6.1	3.6	13.3	−2.6	34.4	−16.3

[1] For France, credit system; for other countries, banks only. [2] For the United States, commercial and industrial loans. [3] For the United States and Japan, real estate loans; for France, including loans for property development. [4] For Japan, Italy and Sweden, including housing loans.

Sources: National data and BIS estimates.

Growth in bank credit to the private sector[1]

December to December, in percentages

	France	Netherlands	Belgium	Spain	Portugal	Switzerland	Australia
1982–84 trough[2]	5.2[3]	1.3	2.8	4.3	21.5	3.7	10.9[4]
1990	11.0	6.5	7.6	10.2	13.7	8.8	7.3
1991	5.5	6.9	7.9	12.8	24.4	5.1	−1.6
	Italy	Canada	Sweden	Norway	Finland	Denmark	Greece
1982–84 trough[2]	9.6	−4.7	7.8	13.3	16.1	11.0	17.3
1990	15.4	8.1	3.6	3.3	11.1	3.4	16.5
1991	15.2	6.3	−2.5	−1.4	5.3	2.1	16.2

[1] Including credit from savings institutions and the central bank. [2] Lowest December to December rate of increase during the period. [3] 1986. [4] Twelve months to June.

Source: National data.

October made clear that performing real estate loans should not be written down because of currently inadequate collateral values. Banks not meeting the capital standards but with programmes to reach them were authorised to continue to make new loans.

In the absence of clear evidence that business activity was being impeded significantly by restrictions on credit availability, central banks in most other countries viewed as acceptable, in the circumstances, a tendency for banks to apply conservative assessments of creditworthiness or to seek to widen margins in response to experience of loan losses.

Influences on credit conditions in the United Kingdom, Sweden, Switzerland, Japan and France

A retrenchment in banks' real estate lending following strong growth during the 1980s in the United Kingdom, Sweden and Switzerland largely reflected belated recognition of the accumulated exposure to the sector, given widespread declines in real estate prices. Competition from non-bank financial intermediation had not prevented a strong expansion in other bank loans to enterprises during the 1980s in Japan and many European countries. Though in some cases provisioning or write-offs directly affect the measure, slow growth or falls in banks' business lending in 1991 were attributable mainly to companies' reduced external financing needs and unwillingness to borrow. Corporate recourse to the bond markets increased in the United Kingdom and Japan. A slowdown in borrowing from insurance companies was also indicative of weak credit demand in Japan. The Bank of Japan took advantage of the situation to abolish its long-standing window guidance restrictions on bank lending.

Japanese banks responded to the pressure on their capital positions caused by falling share prices mainly by reducing interbank claims. The capital positions of large UK banks remained comfortable. The Bank of England encouraged financial institutions to adopt a collective supportive attitude towards companies facing temporary difficulties and drew attention to the potential impact on house prices of the disposal of repossessed properties. In France, credit stringency was largely confined to lending to individuals.

Contrasting developments in other countries

Commercial bank credit grew very slowly or contracted in Sweden, Norway, Finland and Australia, but credit from other financial institutions served as a partial offset and the slowdown in broad credit aggregates can largely be attributed to weakness in credit demand.

Credit expansion accelerated in Germany in 1991 under the influence of a deterioration in enterprises' self-financing capacity. Part of the rise was accounted for by credit for reconstruction in eastern Germany granted under government-subsidised programmes. Credit expansion also remained remarkably strong last year in Italy, Spain, Ireland, Portugal and Greece.

Uncertainties in the present situation

Impact of monetary and financial conditions on economic prospects

In the United States, where a slowdown in private debt accumulation began in 1989, the process of balance-sheet retrenchment has proved protracted. Declines in interest rates and rises in share prices facilitated restructuring of household and corporate balance sheets last year but lower debt service burdens and mortgage borrowing costs failed to stimulate a quick resumption of new borrowing to finance spending. The rebound in bond yields and the rise in the effective exchange rate of the US dollar in early 1992 threatened to weaken two channels through which monetary ease had previously begun to operate. In the United Kingdom, Canada and Australia, where substantial declines in interest rates took place last year, private sector debt positions also became better aligned with realistic expectations for income and asset values. Whether the remarkable reduction in current inflation rates recorded in some of these countries can be maintained and whether the deterioration in government budget positions which has taken place in recession can be reversed when recovery takes hold remains to be seen.

Falls in share prices in late 1991 and early 1992 in Japan tended to counter some of the effects of declines in interest rates. The falls could, perhaps, be interpreted as a correction of previous speculative rises. Nonetheless, it is uncertain how economic activity will respond to the easing of monetary policy and moderately expansionary budget measures. In Germany uncertainties surround the speed with which planned investments in eastern Germany – many of them subsidised and not very interest rate sensitive – will be implemented. The economic outlook depends on wage settlements and budgetary retrenchment, which will essentially determine the burden to be borne by monetary restraint.

The operation of the EMS and plans for European monetary union

Current problems in the operation of the EMS

During the past two years, while the political process directed towards cementing the achievements of the ERM into a monetary union was advancing, dissatisfaction with the operation of the mechanism has increased.

Strains in the operation of the ERM

Concerns have been expressed that economic and social change in Germany following unification might fundamentally weaken Germany's ability to serve as an inflation anchor and that other countries would not be able to assume that role. Inflation in Germany has risen considerably since 1987 to levels higher than in a number of other ERM countries. Divergent budgetary, wage and overall economic developments in Germany have also highlighted the limited scope available to other ERM countries for adapting policies to support domestic economic activity.

Impact of developments in Germany on other EC countries

Developments in Germany have given a direct stimulus to economic activity in other EC countries. In eastern Germany the collapse in output exceeded most forecasts but consumption was supported by government income transfers equivalent in 1991 to about one-half of GDP. With a huge rise in demand from eastern Germany placing pressure on productive capacity in western Germany, German imports from other EC countries increased, at a time when economic activity was slowing down, by the equivalent of 0.6% of their GDP in 1991, according to EC Commission estimates. The increase ranged from nearly 1% of GDP in Belgium and the Netherlands and 0.7–0.8% in France, Ireland and Denmark to 0.4–0.5% in the United Kingdom, Spain, Greece and Portugal.

The rise in long-term interest rates in Germany in 1990 evidently reflected market expectations that neither government nor private consumption would yield ground to a prospective rise in private and public investment. It is generally assumed that rates rose in real terms. Yet the Deutsche Mark subsequently remained generally weak on balance against other floating currencies. In the absence of nominal exchange rate adjustments it changed little in real effective terms on average against other European currencies.

That wages and prices in most other European countries did not quickly respond to rises in wages in Germany was fortunate but may reflect the limited integration of labour markets in Europe. In ERM countries where inflation rates remained below the German rate and began to contribute to improvements in competitiveness, a virtuous circle of domestic adjustment seemed to have appeared.

Interest rate constraints vary from country to country

The other side of the coin was nominal interest rates which could not in general be brought below German rates and seemed high in relation to recent domestic inflation rates. Yet the interest rate constraint varied from country to country. It appeared most direct in the case of Belgium, the Netherlands, Denmark and France where nominal interest rates were closest to German levels. These countries had benefited substantially from the surge in exports to Germany. By late 1991, however, this stimulus seemed to have tapered off. These were also the countries which had invested most over the years in building up the credibility of their exchange rate commitments. They faced the largest potential inflation and interest rate costs of a loss of credibility of their ERM exchange rate commitments. The margins by which interest rates in France, Denmark and more particularly Italy exceeded German rates in March 1992 suggested that there was some scope for bringing rates in these countries down by gearing domestic policies to strengthening credibility further. Interest rates in the United Kingdom stood ½ to 1 percentage point above German rates in April 1992. In northern European countries which had adopted ECU standards credibility premia remained higher. Spain, Portugal and Greece continued to face difficulties stemming from inflows of funds attracted by relatively high nominal interest rates needed to counter domestic inflation. These countries have scope for lowering rates as inflationary pressures ease.

Policy options of European countries other than Germany

In countries which came to see their interest rates as exchange rate constrained consideration of less rigid exchange rate approaches could not have been encouraged by interest rate developments in some Nordic countries in late 1991 and early 1992. Most European countries consider some kind of fixed exchange rate standard to be the only feasible option and are aware that interest rate premia have often been higher under flexible systems than under rigid ones. Yet in medium-sized countries the operation of wage-price spirals induced by exchange rate depreciation may not be as immediate or severe as in smaller countries, particularly in recession.

The scope for fiscal expansion in countries with large deficits or high debt ratios is clearly limited. A few countries have more comfortable budgetary positions but recent UK experience indicates a risk of deficits rising more rapidly than expected in recession even if discretionary fiscal stimulus is limited. It also points to some risk of adverse interest rate and exchange market reactions. Developments in Germany illustrate the difficulties which may be encountered in achieving consensus on expenditure cuts and tax increases, even when the public is aware that there is a need for burden sharing. Nevertheless, if budgetary and wage developments which might permit a reduction in German interest rates are slow to emerge, other countries may begin to rethink policies aimed at offsetting the budgetary impact of automatic stabilisers as economic growth slows. Some countries may be faced with increasing pressures to accept larger deficits than are consistent with their budget consolidation programmes.

The Maastricht agreement

Agreement to implement a European monetary union

Following discussions in two Intergovernmental Conferences during 1991 EC Heads of State and Government, meeting in Maastricht in December, reached agreement upon a draft treaty on European Union. It included amendments to the Treaty of Rome necessary to implement a European monetary union with permanently locked exchange rates and a single monetary policy, leading to the adoption of a single currency.

If the Treaty as signed in February is ratified by member states in the course of 1992 it could enter into force on 1st January 1993. Under a protocol to the Treaty only the United Kingdom retains an option which makes its entry into the monetary union conditional on a subsequent parliamentary decision.

The Treaty lays down an ambitious programme. During the first stage, which began in July 1990, all remaining restrictions on capital flows are to be abolished and direct central bank lending to the public sector is to be terminated. The currency composition of the ECU is to be frozen upon the entry into force of the Treaty.

A transitional stage two will commence on 1st January 1994 when a European Monetary Institute (EMI) will take over the functions of the

Committee of Governors of the EC central banks. It will strengthen coordination of member states' monetary policies and make technical preparations for stage three, but the ultimate responsibility for monetary policy will remain with national authorities. Steps will be taken during this stage to ensure that central banks gain full independence from other national authorities.

The EMI is to be directed by a council consisting of the EC central bank Governors and a full-time president. It could act as agent in managing foreign exchange reserves of member states wishing to hold some of their reserves with the new institution but would not operate in the exchange markets on its own account. Its location is to be decided before the end of 1992.

Date for implementation set

Somewhat unexpectedly, the Heads of State and Government agreed that a third and final stage of a full monetary union should begin no later than 1st January 1999 for EC member countries judged eligible to participate, even if they do not constitute a majority. Should the Heads of State and Government decide by qualified majority that a majority of member states fulfilled the necessary conditions and that it was opportune to advance the date, the union could be formed in 1997.

At the start of stage three exchange rates between participating currencies would be permanently locked and a European Central Bank (ECB) and European System of Central Banks (ESCB) would assume full powers to formulate and implement a single monetary policy. The ECB would be responsible for managing a single currency which would eventually replace national currencies.

Objectives and organisation

The Treaty and the statute of the ESCB and ECB lay down price stability as the primary objective of monetary policy and stipulate that neither the ECB nor national central banks shall seek or take instructions from Community institutions or member governments. The central bank Governors of participating countries are to be members of the governing council of the ECB together with a full-time executive board appointed by the Heads of State and Government for non-renewable eight-year terms.

The ESCB would hold and manage most of member states' official foreign exchange reserves and conduct day-to-day exchange market operations, but the Finance Ministers' Council (ECOFIN) would have responsibility for the choice of the external exchange rate regime and the central rate of the ECU against non-EC currencies, after consulting the ESCB about the implications for price stability. In the absence of a formal system Ministers could formulate "general orientations" for exchange rate policy vis-à-vis non-EC currencies, without prejudice to the objective of price stability. The ECB would have no specific operational responsibilities for bank supervision but the ESCB would contribute to the smooth conduct of policies pursued by the competent authorities relating to the supervision and stability of the financial system. The ESCB would also promote the smooth operation of payment systems.

The division of operational responsibility for monetary policy between the ECB and national central banks and the questions of what instruments or intermediate objectives might be used were left open. Matters such as the use which might be made of objectives for the monetary aggregates or instruments such as reserve requirements and the type of market or credit operations to be used for supplying bank reserves remain controversial.

The Treaty provides for surveillance of government budget deficits, designed to ensure that fiscal policy is consistent with the monetary policy objective of price stability. It includes numerical triggers designed to prompt Commission investigation, and fines for member states failing to correct excessive deficits. In line with the principle of "subsidiarity", other aspects of economic policy are left to the decisions of national governments.

Convergence criteria

Criteria for assessing eligibility of EC countries to join

The success of a monetary union is seen as depending on limiting participation to countries with low rates of inflation. Four principal criteria for assessing the eligibility of member states to join stage three are laid down in the Treaty and protocols. Numerical reference values are set out but their application is qualified in various ways. Countries not eligible to join at first would be given a derogation and could join later when judged to have met the conditions.

The criteria for consumer price inflation and that for long-term government bond yields, which would permit market judgements to play some role in determining eligibility, do not set absolute standards. They lay down maximum margins of 1½ and 2 percentage points respectively over the rates observed in at most three EC countries with the best inflation performance over the year preceding the examination. An exchange rate criterion calls for the observance of normal fluctuation margins within the ERM without devaluation, at the country's own initiative, against the currency of any other member state over a period of two years. The acceptability of government budget positions is to be assessed, in principle, by whether the ratio of the planned or actual general government deficit exceeds 3% of GDP and whether the ratio of government debt to GDP exceeds 60%. Derogations may be granted, however, to the extent that excessive deficits are temporary and that the ratio remains close to the reference level, or that an excessive debt ratio is diminishing and approaching the reference value at a satisfactory pace. Final judgements on whether countries have achieved sustainable convergence are to be made by the European Council on the basis of reports made by the Commission and the EMI or ECB.

Implications of monetary union

Since the Hanover meeting of the European Council in June 1988 set up the "Delors Committee" to study and propose concrete stages leading towards economic and monetary union, proponents of monetary union appear to have taken it for granted that its desirability had long been established, even though two previous attempts to move towards union had been quickly abandoned. Constrained by their exchange rate commitments, some governments may have felt that they had lost monetary policy autonomy. However, to concede that the EMS has been an effective anti-inflationary instrument while seeking ways of softening its constraints may seem somewhat paradoxical. Sceptics assumed that the proposals would again be shelved once the practical implications were realised. In most countries the loss of national sovereignty first emerged as an issue after the signing of the Treaty, when it became clear that most signatories had committed themselves, and their successors, to rigid deadlines.

Risks with respect to the achievement of the proclaimed objective

That a currency union would achieve price stability has been assumed in some contributions to the discussion, including the case for monetary union presented by the EC Commission. It includes benefits of exchange rate stability and low inflation which have already been realised, or could be achieved without moving to a single currency. Frequently quoted estimates of potential savings in transactions costs for tourists and business would have to be set against any implied further weakening of bank profitability and the costs and risks of price rises and financial market disturbances entailed in complex conversions to a common currency. Whether a monetary union which is essentially viewed as a stepping stone to political union should be presented as a necessary extension of the programme for completing the internal market in the Community may seem questionable.

While institutional and legal arrangements could be laid down in advance, the achievement of price stability would depend on the willingness of the ESCB council to take appropriate decisions and on its ability to win support for them in the economic circumstances and climate of public opinion prevailing at the time. Given the much more limited scope of agreement among Heads of State and Government on transferring political competence to a union, considerable uncertainty attaches to the implications of monetary policy-making at the EC level.

That many of the technical, financial and economic difficulties entailed in moving towards a common interest rate policy can be overcome, under favourable conditions, has been demonstrated in a small core of ERM countries. It has been recognised that a smooth transition to a currency union could not be achieved in countries which have not attained a high degree of interest rate convergence. However, moving to a jointly determined European monetary policy, even one decided by an institution in which central banks with demonstrated anti-inflation credentials are represented, may raise other questions. In many countries explaining monetary policy decisions in terms of external constraints has been helpful in securing public acceptance. In the absence of such standards of reference monetary policy decisions may be difficult to agree upon and defend, particularly as levels of structural unemployment will continue to differ from country to country. However much room for manoeuvre in formulating monetary policy the ECB proved to have in practice, the objective of price stability is inherently vulnerable to any faltering of the political consensus in support of it.

Only limited attention was paid in the negotiation of the Treaty to the dependence of monetary policy on exchange rate policy, which has increased in recent years but which is not fully reflected in the statutes of even the most independent central banks. Views about the desirability of

EMS convergence indicators and EMU criteria

Criteria and countries	Increase in consumer prices[1]		Long-term bond yield		General government			
					Net lending		Gross debt	
	1981	1991[2]	1981	1991[2]	1981	1991[2]	1981	1991[2]
	annual averages, in percentages				as a percentage of GDP			
Criteria[3]		4.2		11.4		− 3.0		60
Germany	6.0	3.5	10.4	8.6	− 3.6	− 3.6	36	46
France	13.4	3.0	15.8	9.0	− 1.9	− 1.5	24	47
Netherlands	5.8	3.2	12.2	8.9	− 5.5	− 4.4	50	78
Belgium	8.7	3.2	13.8	9.3	−12.8	− 6.4	88	129
Luxembourg	8.6	3.4	8.7	8.2	− 3.5	2.0	14	7
Denmark	12.0	2.4	19.3	10.1	− 6.9	− 1.7	44	67
Ireland	19.6	3.0	17.3	9.2	−13.4	− 4.1	82	103
Italy	18.2	6.4	20.6	12.9	−11.4	− 9.9	61	101
Spain	14.3	5.8	15.8	12.4	− 3.9	− 3.9	23	46
United Kingdom	11.2	6.5	14.8	9.9	− 2.6	− 1.9	51	44
Portugal	20.2	11.7	−	17.1	− 9.3	− 5.4	46	65
Greece	22.7	18.3	17.6	−	−11.0	−17.9	34	96
EC	12.1	5.0	15.1	10.4	− 5.3	− 4.3	43	62

[1] Private consumption deflators. [2] EC Commission estimates. [3] Reference value. For consumer prices and interest rates, 1½ and 2 percentage points respectively above the average of the three countries with the best inflation performance in 1991.

Source: EC Commission.

stabilising the exchange rates of the major world currencies differ. The establishment of a European monetary union could actually tend to strengthen pressures for stabilising the exchange rates of the union vis-à-vis non-EMS currencies even in the absence of price stability outside the Community.

Uncertainties relating to the convergence criteria

The agreement to link convergence criteria with a rigid timetable suggests some risk that political considerations could play a role in the application of the standards. If pressures for lax application of the standards resulted in the admission of countries before they met the criteria they, and the union as a whole, could face large adjustment problems after exchange rates were irrevocably fixed. But irrespective of whether a dilution of the standards eventually occurred, the convergence criteria framed within a strict timetable could lead to difficulties of a different kind. If 1991 performance were to be assessed by the implied standards only three countries – France, Luxembourg and Denmark – would appear to qualify. Many other countries fail to meet at least one of the standards by a substantial margin. While there need be no presumption that all EC countries should aim at meeting the standards by the time of the first examinations planned for 1996 and 1998, it would seem possible that efforts to do so could render exchange rate and, perhaps, budgetary policy in some countries too rigid in the next few years.

The conventional macroeconomic argument that – credibility considerations and wage-price links permitting – exchange rate changes can

Risks with respect to overall economic performance

facilitate adjustment to disturbances which affect different countries asymmetrically has not carried much weight in countries where independent counter-cyclical policies have long been eschewed. The European internal market programme is tending to increase the interdependence of individual countries and also to promote the mobility of capital between them. Capital mobility might compensate for immobility of labour in promoting the medium-term development of low-income regions, which many consider more important than an ability to adjust to short-term disturbances.

Earlier plans for monetary union foundered following the 1973 and 1979 oil shocks. The difficulties faced then might be viewed, in retrospect, as attributable mainly to divergent policy responses, an experience from which lessons have been learned. Monetary union might be seen as limiting exchange rate misalignments and interest rate disturbances by forcing policy convergence even in the fiscal sphere and preventing beggar-thy-neighbour exchange rate policies. Yet the possibility that large shocks with asymmetric effects will occur in future cannot be ruled out. Conceivably, financial pressures on exchange rates could increase as the effect of recent liberalisation of exchange controls is felt more fully. Indeed, the perseverance of policy-makers in some countries may be tested if existing problems cause economic growth rates to remain below expectations for an extended period.

Though monetary union could contribute to promoting growth in low-income countries, regional unemployment and large income transfers within existing currency areas suggest that not all problems would be solved. Demands for fiscal transfers made at Maastricht assume tendencies in economic development which would favour central Community regions. Initial responses to Commission proposals for increasing the Community budget suggest that achieving political consensus to release the necessary resources will not be easy. European experience with agricultural and industrial subsidies and direct income supports may not seem encouraging. Though some conditions would be very different, the experience of German currency union suggests possible problems with European monetary union to which little thought has so far been given. Wage and price levels in the Community vary widely. The introduction of a common

Hourly labour costs in manufacturing in EC countries

1991 data in ECUs

	Denmark	Germany	Luxembourg	Netherlands	Belgium	United Kingdom
Wages	12.4	10.6	9.8	8.6	8.3	7.8
Total	15.2	19.8	14.7	15.7	15.5	11.1
	Italy	Ireland	France	Spain	Greece	Portugal
Wages	7.7	7.4	6.9	6.8	3.3	2.2
Total	15.8	10.6	13.0	11.0	5.4	3.8

Source: National data.

currency could lead to a tendency towards price level convergence. In particular, any tendency for claims to be made for an equalisation of wage levels in different EC member countries without regard to differences in productivity could have unwelcome unemployment implications in relatively low-income countries in the Community.

Global international policy coordination and cooperation

The international economic situation did not call for exceptional levels of policy coordination

The period under review seems to have been characterised by a relatively low level of policy coordination activity amongst the industrial countries. Before reaching so strong a conclusion, however, it is necessary to take account of the extent to which the world economic situation required a high degree of explicit policy coordination. In fact, during 1991 and the early months of 1992, neither international payments imbalances nor exchange rate patterns were posing threats or pressures on the same scale as those seen for example in the run-up to the Plaza Agreement. Policy-makers were also necessarily preoccupied with other, novel, developments: Germany's situation was obviously unique; and all countries were attempting, both individually and collectively, to react appropriately to the ongoing transformations in eastern Europe and, especially, to the disintegration of the Soviet Union.

Summit agendas have broadened

In addition, international discussions and communiqués have in recent years come to deal with a broader – and perhaps even more intractable – set of issues than those customarily addressed. Thus the 1991 Group of Seven Summit communiqué dealt with trade in drugs and the global environment. The latter seems to be an issue increasingly occupying the minds of policy-makers. They appear to be taking ever more seriously the possibility that the continued pursuit of world economic progress based on the combustion of hydrocarbon fuels may not be indefinitely sustainable.

US authorities express concern over weak world growth ...

... but Germany resists pressure to lower interest rates ...

Such considerations did not, however, prevent some concern being expressed last year about the weakness of economic growth in the short term. At first this seemed to be largely a concern of the US authorities; but as the year progressed it gradually became apparent that world growth was indeed falling below earlier expectations and forecasts. Thus in the first half of 1991 the US authorities did not contradict reports that they had been urging other countries, especially Germany and Japan, to lower their interest rates. But with demand still relatively robust in these two countries, and with budgetary and wage pressures rising in Germany, they saw little case for such action. On the contrary, continued monetary firmness was judged appropriate in both. The situation in the foreign exchange markets in the first half of 1991, with the dollar rising against both the yen and the Deutsche Mark, added to the inappropriateness of interest rate reductions. Indeed there were several bouts of internationally concerted exchange market intervention designed to curb the dollar's strength. By the same token, exchange rate considerations did not inhibit the US authorities from taking unilateral action to lower interest rates in April. Later, as domestic developments were deemed to warrant, interest rates were eventually lowered in Japan too. But in Germany, although the budgetary deterioration turned out to be somewhat less than had been feared, wage pressures continued to mount and monetary growth accelerated. Official rates were therefore increased further in late December, despite signs that real demand pressures were abating and amid some concern about the international repercussions, especially in Europe.

With the yen relatively weak, and with US fears about delayed global recovery confirmed, certain bilateral meetings were held early in the new year between the US and Japanese authorities. These were followed by some joint action to support the yen, but in the area of macroeconomic policy the joint announcement of a commitment to growth-oriented policies did not amount to a major new policy package. On the US side, the serious state of the federal government finances precluded any major fiscal stimulus, and in Japan the political situation was unsettled. Just before the turn of the year, however, the Federal Reserve Board had surprised the markets by lowering the US discount rate by a further full percentage point. Again though, conditions in the foreign exchange markets had simply added to the desirability, and the possibility, of taking a policy step which was felt necessary on purely domestic grounds. Considerations of international policy coordination were probably of relatively little significance.

... while Japan moves cautiously to stimulus for mainly domestic reasons

On two policy matters, however, an international consensus was reaffirmed on several occasions during the period under review. The first was the continuing need to pursue structural policy initiatives on the supply side of the economy. Alongside this much stress was laid on the secular need to raise the rate of saving. At the same time, there was also continued affirmation of the need for a setting of monetary and fiscal policies conducive to a worldwide decline in real interest rates, the level of which was thought to remain excessive. To some extent these concerns reflected expectations, or fears, of a large increase in the demand for capital on world markets as a result of the transformations in eastern Europe and in the former Soviet Union, in addition to the requirements of the developing world and of environmental protection. And, insofar as the call for more saving was directed at the public sector, it was also consistent with the need for a sounder medium-term outlook for public sector deficits.

Supply side and stable macroeconomic policies stressed

What was not entirely resolved, however, was a certain contradiction between these obviously desirable medium-term aims and the state of the world economy in the short term. For example, eastern Europe's need for capital, while no doubt potentially very large, was not making itself felt in effective terms of any magnitude. Similarly, medium-term goals for fiscal policy were found to be in some competition both with the workings of the automatic budgetary stabilisers and, in some cases, with pressures to introduce a degree of temporary fiscal stimulus. In addition, a period of cyclical slowdown did not seem the most obvious time to encourage increases in private saving, which could only remove more demand from the system in the short term. Finally, there seemed to many to be a contradiction between the desire to increase private saving on the one hand and, on the other, to reduce real interest rates.

Medium-term policy aims in some conflict with short-term economic pressures

Nevertheless, despite such question marks, the ongoing, implicit, Potential for international policy coordination, when needed, probably still intact

degree of international policy cooperation should probably not be underestimated. A certain amount of de facto coordination is no doubt the unannounced by-product of the ongoing exchange of information in international forums, ranging from the relatively explicit surveillance activities of the IMF, through to the more informal arrangements in the monetary policy field. Given also the absence of any major need to pursue new and explicit policy coordination initiatives, the experience of 1991–92 need not be seen as implying any significant decline in such coordination. It is perhaps not so surprising however that, in the actual conditions of the recent period, with the United States pressing for expansion, comment tended to concentrate on the occasional and inevitable differences of view which did emerge.

VI. Domestic asset markets, exchange rates and gold

Highlights

The ebb and flow of optimism about the likelihood of recovery, particularly in the US economy, was often a major common factor affecting developments in domestic financial markets and in foreign exchange markets during the period under review. Early in 1991 for example, as optimism soared on the successful allied intervention in the Persian Gulf, there were also signs that the US recovery was about to get under way. As a result, domestic bond yields tended to fall less fast than during the previous half-year, and in some countries even drifted slightly higher. In the second half of the year, as these expectations were seen to be disappointed, long-term rates resumed their decline. Finally, early in 1992 the outlook appeared to improve again, and, in the United States at least, rates rose quite sharply for a time, and the declines were checked in many other countries.

Buoyant expectations of recovery were also in part behind the fairly universal jump in share prices early last year. Thereafter, however, national stock market indices diverged, with those in the United States and the United Kingdom at times reaching record levels, despite the continuing sluggishness of these economies. On the other side the Japanese stock market was mostly very weak after the early 1991 rise, and in the early part of this year prices touched a level nearly 60% below their 1989 peak.

Many countries have experienced a pronounced property market cycle in recent years and the downward phase of this cycle continued or even intensified during the period under review. Japanese land prices fell for the first time for seventeen years and particularly steep declines in commercial property prices were recorded in the United Kingdom, Australia and the United States.

In the foreign exchange markets the US dollar executed a complete cycle of appreciation and depreciation against other major currencies during 1991 and early 1992. Again, switches of opinion about the general economic outlook and related interest rate expectations, especially in the United States, seem to be one important explanation. In addition, in the second half of the year the widening of the Deutsche Mark/dollar interest rate differential continued, reaching record proportions, but without significant adverse effects on bilateral exchange rates. The yen strengthened only moderately on average during the period, but the Swiss franc declined. Early in 1992 the dollar began to rise once more for a time. In the EMS exchange rate mechanism relatively calm conditions prevailed on the whole. There was one particular period of tension towards the end of 1991, but realignments were avoided.

The price of gold continued to decline during the period under review, falling to its lowest level since 1977 in real terms, and since 1986 in nominal terms. Total market supplies remained stagnant, but demand was dampened by the recession and receding fears of inflation. With the exception of the very temporary period of the attempted coup in August, events in the Soviet Union tended to be bearish for the gold price. For a time there were fears of possible large Soviet sales. But even after much lower estimates of Soviet gold stocks were published, the worldwide relaxation of tensions stemming from the collapse of communism in its original home country seemed to weigh on the market. The volatility of the gold price was also unusually low.

Long-term interest rate developments

The further relaxation of monetary policy in several major countries last year found only a partial reflection in further declines in long-term interest rates. In Europe one reason was of course the special situation in Germany, together with the narrow linkage of interest rates in the EMS. In the United States the markets also reacted very sensitively to any signs of economic recovery, marking bond prices down whenever more hopeful indicators were published.

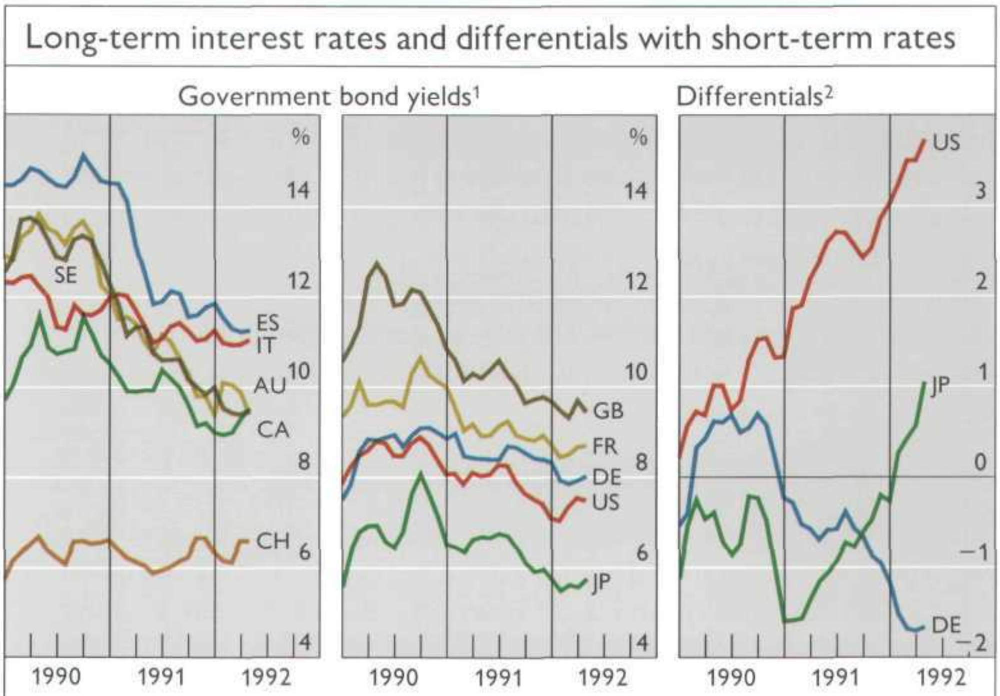
Long-term interest rates: three phases as optimism about economic recovery waxes and wanes

Broadly speaking, events in the long-term bond markets during the period under review can be divided into three main phases marked by shifts in prevailing expectations about the likely course of economic activity. In the first phase, which lasted from the end of the Gulf war in mid-February until about the middle of the year, markets were pervasively influenced by expectations of imminent global economic recovery. This was most clearly seen in North America and in the United Kingdom, but recovery in these economies was also thought likely to provide support for demand in the world as a whole. During this phase bond yields tended either to creep back upwards again or to decline more slowly than they had done in the second half of 1990.

The second phase began in mid-year and coincided with the onset of serious doubts as to whether a US recovery was indeed under way as had been thought. With the exception of Switzerland, long-term yields declined fairly generally and markedly during the second half of the year. This phase lasted until roughly the end of the year and, in the United States especially, was terminated by some fairly sharp reversals of the downward movements in long-term rates. Between early January this year and late March US long-term rates rose by more than 75 basis points. Even so, by the spring, reversals such as this had not been sufficient to prevent the period as a whole from being described as one of falling long-term rates in nominal terms, thus continuing a trend which for many countries had begun at some point during 1990. Again with the exception of Switzerland, by the spring of 1992 long-term rates in virtually all industrial countries stood between about 1 and 3¾ percentage points below their levels eighteen months earlier. At the same time, there was, however, a tendency for current rates of inflation to decline in most, though not all, countries. Thus,

In general, long-term rates decline ...

... but so does inflation



Note: AU = Australia; CA = Canada; CH = Switzerland; DE = Germany; ES = Spain; FR = France; GB = United Kingdom; IT = Italy; JP = Japan; SE = Sweden; US = United States.

[1] Various maturities between five and ten years; for Spain, public sector bonds with more than two years to maturity. [2] Government bond yields less money market rates, in percentage points.

measured against current inflation rates, "real" long-term interest rates showed less tendency to fall than did nominal rates.

Apart from a small and temporary fall in yields during the Gulf war, long-term rates in the United States did not respond to the easing of official short-term rates in the first quarter of last year. Instead, a post-war recovery in consumer confidence, together with large Treasury refinancing operations – which reached a new record in May – served to hold nominal yields relatively flat until June, when they actually rose again. Positive signs in the economy were one reason for this rise, and some observers suggested that inflation expectations were worsening. Less than two months later, however, unexpectedly weak economic indicators were reported for July and yields began a more or less uninterrupted decline which continued to the end of the year as confidence in the prospects for recovery waned. The latter proved a stronger factor than occasional fears about the outlook for the federal budget, and private borrowers took advantage of the opportunity to refinance earlier, higher-cost borrowings.

US markets: Gulf war euphoria and recovery hopes ...

... fade around mid-year

This phase reached its culmination in December when particularly disappointing employment data were published, and declines in market rates at the longest maturities began to indicate that inflation expectations might at last be undergoing a certain downward shift. This was followed by an unexpectedly large reduction in the Federal Reserve discount rate. In the long-term markets the immediate reaction was to mark bond prices higher still, but in early January a sharp upward correction in yields began. The size of the discount rate cut had apparently convinced many potential borrowers that the trough of the interest rate cycle had been reached, and

Sharp upward jump in US yields early this year as issuance rises ...

consequently new issuing activity rose sharply. The market was also able to absorb a further rise in issues of high-yield non-investment-grade (junk) bonds, which had already revived somewhat in 1991. There was also probably some reaction to the President's State of the Union Address in which a further deterioration in the federal budget deficit was acknowledged; although the proposed budgetary stimulus package was kept very small, the markets perhaps sensed an apparent downgrading of fiscal consolidation as a policy priority. A little later in the first quarter, various indicators for the real economy turned positive once more. The gap between long and short-term rates widened further to a relatively high level of around 3½ percentage points in February and March. On the other hand, to the extent that long-term interest rates, and indeed the exchange rate too, react so speedily to any signs and expectations of an upturn, they would seem likely to exercise a quasi-automatic dampening effect on the very cyclical developments they purport to anticipate.

... and various cyclical indicators improve

Long-term rate movements in Canada followed very closely those in the United States, except that for a time at least they fell by rather more. The recession in Canada has been deeper than that in the United States, and very explicit commitments have been made by the authorities to control inflation in the medium term. Long-term rates fell noticeably in Australia too, where the recession has also been relatively severe.

Bond yields in Japan move in parallel with those in the United States ...

Until the early months of this year movements in Japanese long-term interest rates mirrored international trends very closely indeed, especially those in US long-term rates. Indeed, during 1991 the differential with the latter hardly changed. In addition to growing interlinkages between financial markets, fundamental factors and expectations probably also played a role. In the Japanese case it was the growing perception during the second half of the year that the intended slowdown was in fact appearing. Similar reasoning probably also helps to account for the failure of Japanese long-term rates to follow the sharp upward jump in the United States during the early months of this year. By that time it was becoming apparent that the economic slowdown was steeper than had been expected, and already in January the 1991 reductions in the official discount rate had helped to bring short-term market rates back below long-term yields. However, the final lowering of the official discount rate on 1st April 1992 was not followed by any further declines in bond yields.

... until early this year

Decline in German bond yields is less than that elsewhere

Qualitatively at least, long-term interest rates in Germany followed the general downward trend during the period under review, though at a slower pace. Although pressures on productive capacity began to ease in the course of the year, concerns about the ongoing budgetary costs of unification and about rising wage pressures were an influence on the markets. In addition, short-term interest rates moved in the opposite direction as the Bundesbank reacted firmly to the perceived inflation risks (see Chapter V). However, this determination to fight inflation, an outturn for the public sector deficit considerably below original estimates and the trends in long-term interest rates elsewhere seem to have had a certain calming effect on the markets. Indeed, when official rates were raised again in late December, bond yields initially declined slightly, and a large issue for the German Unity Fund was floated at a rate of 7.9%, roughly the same as the market rates prevailing prior to the announcement of negotiations on German monetary and economic union in February 1990.

In other EMS countries rates move fairly closely with those in Germany, but differentials tend to narrow

In the rest of Europe long-term yields have also tended to decline since early last year. In several of the narrow band ERM countries, movements in rates were fairly closely correlated with those in Germany, and especially in France, Belgium and Denmark the positive differential with German rates tended to narrow. In France, the markets were apparently influenced by further improvements in certain fundamental indicators, notably the slowdown in the core inflation rate, as well as by the strength of the authorities' commitment to maintaining the franc's position in the ERM band. In Italy relatively high nominal yields combined with growing confidence in the lira's position within the narrow band to attract the interest of foreign investors last year. But more recently, in late March this year, the announcement of a large overshoot of the budgetary target in a period of pre-election uncertainty unsettled the markets somewhat.

UK authorities resume issuing activity

In the United Kingdom, following fairly steep falls after sterling's entry into the ERM in October 1990, long-term rates steadied early last year and even rose somewhat between the spring and the middle of the year. This was despite the fact that both short-term rates and inflation were falling very rapidly, and that the recession was showing little sign of ending. In addition to international trends, another factor on the other side of the balance was the return of the authorities to the gilt-edged market early in the year as the public finances swung back into deficit again. In 1991 as a whole the central authorities issued a net £6.4 billion of marketable securities, compared with net repayments of £14.1 and 8.8 billion respectively in 1989 and 1990. Government issuing activity was particularly pronounced in the second and third quarters. Early in the second half of 1991, the performance of sterling in the ERM supported a fairly strong rally in the gilts markets for a time. In March of this year, however, bond yields rose quite sharply again, in part in line with international developments, but also because of the announcement in the budget of a very large increase in the public sector borrowing requirement, together with growing uncertainties as to the outcome of the election. Following the surprise victory of the governing Conservative Party, rates fell back sharply by a full percentage point in April and remained at this lower level into May.

Yields fall sharply in Sweden, but hardly at all in Switzerland

It was, however, outside the EMS countries that the two extremes in European bond market developments were recorded in the period since the beginning of 1991. In Sweden in the early months of this year, and in a context of a sharp slowdown in inflation, yields occasionally touched levels 300 basis points below that at the end of 1990, while at the end of March yields in Switzerland were on balance hardly changed at all over the same period. The recession has of course been especially prolonged and severe in Sweden, and the announcement in May last year of the pegging of the krona to the ECU was followed by a particularly steep fall in rates as confidence increased. The credibility of the authorities' resolve to maintain this commitment was successfully demonstrated following the Finnish exchange rate crisis in November (see page 153 below) and, after only a relatively mild and temporary increase, yields fell to new lows in early 1992, well below those on short-term instruments.

In Switzerland, in contrast to nearly all other countries, long-term interest rates continued to fall between the spring and early summer of last year, but then rose to reach a peak for the period in October, which was in fact their highest level since April 1990. Nevertheless, although narrowing slightly from July onwards, the differential between Swiss long-term rates and those in Germany has remained decidedly negative despite several years of unusually high inflation by traditional Swiss standards.

Equity prices

General optimism raises stock prices in most countries early in 1991

World stock market prices rose with remarkable speed and unanimity even during, and then for a time after, the Gulf war early in 1991. Relief at the success of the military operation, and optimism about the economic outlook in general, seem to have been the main forces behind this rise, which on average amounted to over 15% between mid-January and early March. Thereafter there were no further general movements on anything like this scale and the FT Actuaries World Index tended to drift gently downwards between March and July, rising again for a time later in the summer before undergoing a temporary period of weakness during the fourth quarter. Nevertheless, in a somewhat longer perspective, world equity prices have on average not yet wholly recouped the losses which followed Iraq's invasion of Kuwait in the summer of 1990.

Thereafter there were some divergences, seen especially in the weakness of the Tokyo market ...

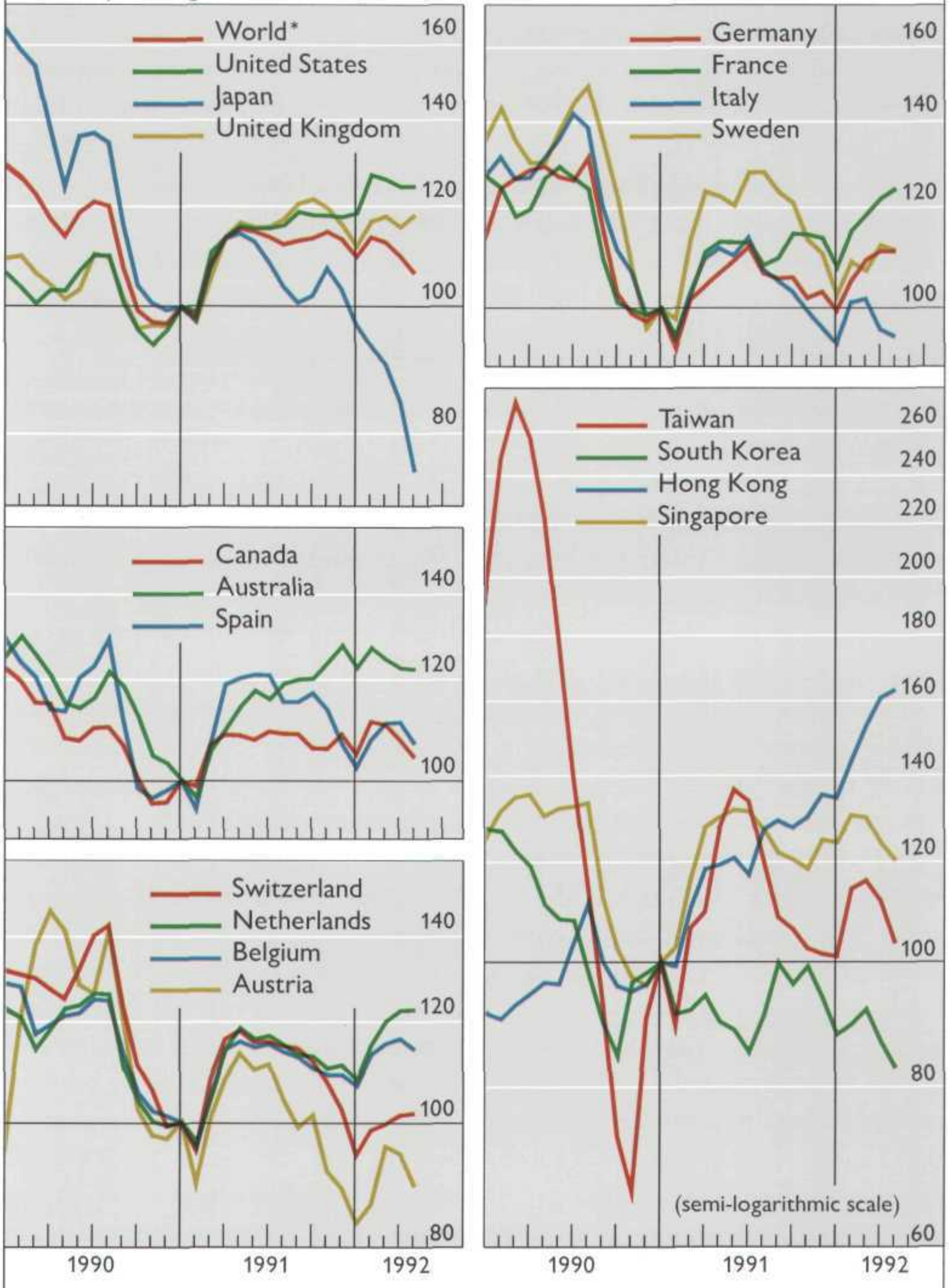
... while US and UK markets reach new peaks

For quite a number of individual countries, the average performance of world equity markets broadly describes their own share market experience over the period under review. Some of the exceptions, however, were to be found not only in the emerging markets in South-East Asia and Latin America, but also in the world's three largest markets. In Japan, despite a Gulf war rally which was soon reversed, and another, smaller one in the autumn, share prices basically continued their spectacular decline, reaching levels around 50% below their late 1989 peak early this year. In the United States and the United Kingdom, on the other hand, stock market performance tended to be stronger than average, with prices reaching new records at times, a phenomenon which presented a striking contrast to the current general economic situation in these countries. This was not, however, out of line with experience in the past, and could of course be interpreted as market confidence in the prospect of better times to come, as well as a reaction to declining short-term interest rates. The Australian market also recovered to its pre-August 1990 level, as did the Paris bourse early in 1992.

Whereas other markets have on average largely retained the gains made in the January–March 1991 rally, Japanese stock prices soon began to weaken again, and by mid-year had shed all their earlier gains. In the background was of course the earlier excessive "bubble" in prices, which the monetary authorities had made clear they intended to reverse, in this and

Stock market prices

Monthly averages, December 1990 = 100



* Financial Times Actuaries World (Local Currency) Index.

other asset markets. Several other factors also weighed on the market: a stream of revelations of financial scandal led to cautiousness, especially on the part of small investors; large liquidations from various tax-sheltered investment vehicles were feared; it looked increasingly likely that the coming wave of warrant bonds reaching maturity would not be refinanced by the exercise of the warrants; and, with the two-year minimum holding period for investment trusts coming to an end for many who had invested towards the top of the boom, a further spate of liquidations was feared.

Several factors weigh simultaneously on the Tokyo market ...

Nevertheless, as prices fell back further in the summer and as the government bond market began to rally, foreign investor interest rose appreciably and prices went up for a time in the autumn. However, a minor "crash" on Wall Street in mid-November, combined with increasing pessimism about the outlook for the real economy and corporate profits, brought on a renewed downtrend through the winter. The package of macroeconomic measures announced on 1st April this year was aimed both at the state of the economy in general and, indirectly, at the weakness of the stock market. However, the market saw little that was new in the package and the initial reaction was that prices were marked sharply lower again, taking the Nikkei index to its lowest level since early 1987 and more than 55% below its peak.

... and prices fall more than 55% below their earlier peak

Relatively buoyant prices and issuance in the US stock market

In some contrast, US stock market prices moved up in two main phases during the period under review to reach new record highs in combination with unprecedented levels of issuing activity. Share issuance rose to more than $70 billion in gross terms for the year as a whole, peaking at an annual rate of $108 billion in the fourth quarter as corporations sought to de-leverage their balance sheets and reverse some of the earlier increase in debt/equity ratios. Even so, as official interest rates were decisively lowered in December and confidence in an imminent upturn was once more fanned into life, prices rose quite sharply as did, a little later, the dollar and the level of bond yields, all three being in part indications of the same phenomenon. Nevertheless financial market opinion has constantly seemed to get ahead not just of actual events in the real economy, but also of business opinion more generally, which has been more guarded about the strength and imminence of an upturn.

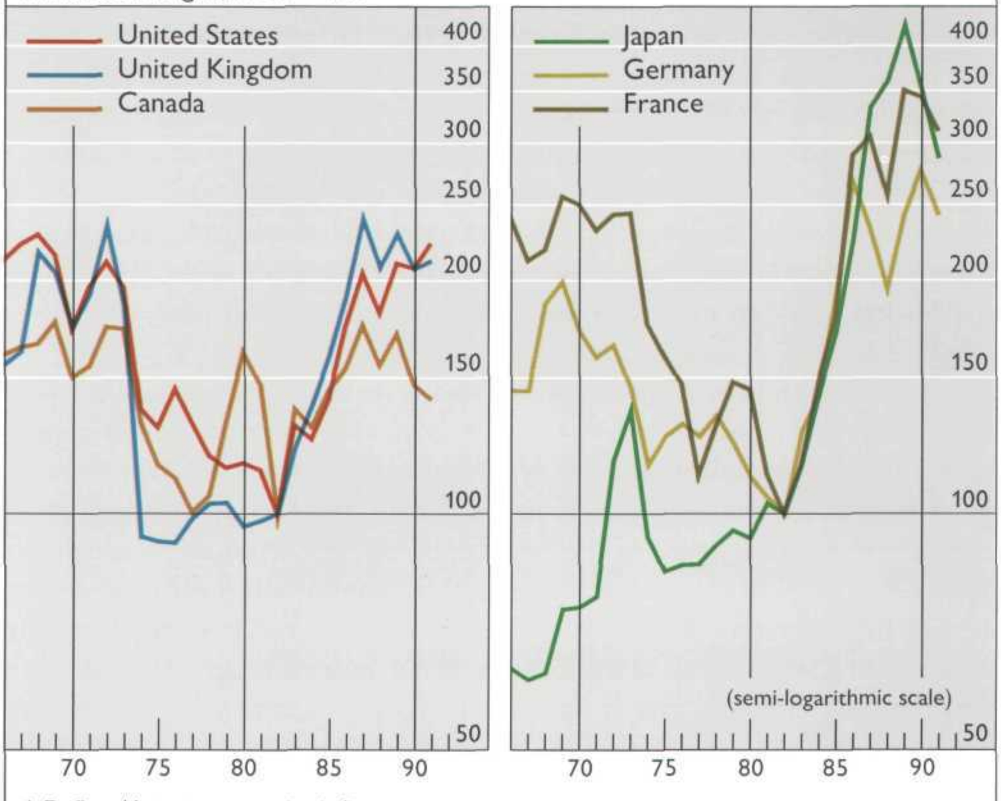
The market's tendency to occasional bouts of volatility was demonstrated again in relatively mild form when prices in New York dropped by around 4% on 15th November. This was the third time that the Dow Jones index had shown a daily fall of more than 100 points since October 1987. Various factors came together to trigger the nervousness, in particular fears concerning bank profits in the light of congressional discussions of possible legislation to put a cap on credit card interest charges, and rather vague concerns about possibly excessive fiscal reflation, with potential adverse consequences for long-term interest rates.

The UK market not quite as buoyant ...

The London stock market was not quite as buoyant as its US counterpart, especially after the middle of last year. This was perhaps not surprising given that it gradually became clear that the UK economy was experiencing the longest, if not the deepest, recession in the post-war period. Nevertheless, gross issuing activity nearly trebled compared with 1990, though at £10.8 billion it fell well short of the £15.9 billion recorded in 1987. Unlike prices in the United States, London market prices regained their early autumn peaks only after the surprise election result. Indeed, in October and November they fell quite sharply on general concerns about the economy and also about the strains then being experienced by sterling in the EMS exchange rate mechanism. And although UK prices did follow the general upturn around the turn of the year, they weakened again as

Inflation-adjusted stock market prices*

Annual averages, 1982 = 100



* Deflated by consumer price indices.

... until after the general election

uncertainty grew in the run-up to the general election. The result, however, led to a sharp rebound in stock prices of about 7½% in two days, and by early May, following a cut in bank base rates, prices reached a new record above their peak of the previous September.

In continental Europe share prices drift down after the Gulf war rally ...

Elsewhere in Europe there was a tendency for stock prices to drift downwards last year after the Gulf war rally. The emergence of a slowdown in the German economy, with its repercussions on other countries, was no doubt an important factor in this development. In addition, markets were also aware of the large budget deficit and strong wage pressures in Germany and of the potential for political instability in eastern Europe and the former Soviet Union. Nevertheless, like the bond market, the German equity market evidently took heart in the end from the firm stance of monetary policy. The latter raised the possibility that the peak in interest rates might have been reached. Continental bourses therefore rose fairly generally in early 1992, perhaps also benefiting indirectly from the uncertain prospects in Japan as well as nervousness about the steepness of the year-end rise in New York.

... until early 1992

Equity prices in real terms

In real terms, and with a considerably longer perspective, the graph above demonstrates the extent of the boom in the Japanese stock market during the 1980s. It also reveals, perhaps rather surprisingly, that, while the rise in real Japanese share prices between early 1982 and their 1989 peak amounted to a multiple of 4½ times, the comparable figures for France and

Germany were as much as 3½ and 2¾ respectively. Those for the major Anglo-Saxon markets were substantially lower. But perhaps the main difference is that in countries other than Japan the rise in real share prices during the 1980s was in large part – and in the Anglo-Saxon countries virtually entirely – a reversal of the falls seen in the 1970s. Thus, while their recent fall has brought Japanese real share prices roughly into line with those elsewhere in relation to their levels at the beginning of the 1980s, it still leaves them appreciably higher than they were in the late 1960s and early 1970s. Whether this means that Japanese equities are still overvalued or, on the other hand, that those in Anglo-Saxon markets are undervalued, is of course impossible to judge on such summary evidence. Qualitatively, at least, their relative positions would seem to be justified in the light of differences in economic growth over time: since 1970 GNP in Japan has risen cumulatively about 1½ times as much as it has for example in the United States.

The unique performance of real stock prices in Japan

Real estate prices

Downturn in real estate prices intensifies in many countries in line with pronounced "boom-to-bust" cycle

The slowdown or decline in real estate prices intensified in many countries during the period under review. And although in certain cases this was a development desired, or even triggered, by the monetary authorities, it nevertheless gave rise to varying degrees of concern. The key to this paradox was of course that it had been the earlier sharp rise in prices which had been the villain of the piece, a run-up which had to varying extents been excessive, and which therefore almost inevitably implied some kind of "boom-to-bust" cycle. The combination of deregulation of the financial sector in many countries at a time of general economic upswing had evidently produced overly optimistic investment appraisals, excessive credit growth and, in some cases, outright speculative excess.

Some of the consequences of these developments are dealt with more fully elsewhere in this Report. For example, in some countries the situation has raised concern about the health of parts of the financial system. It has also left behind several additional impediments to normal cyclical recovery: excess capacity in commercial property clearly reduces or eliminates incentives to investment in this area; and excessive indebtedness relative to more sustainable levels of property prices is a further disincentive to spending in corporate and household sectors alike.

Property prices finally fall in Japan

Some of the more significant price developments last year occurred in Japan, where, after an appreciable period of monetary policy tightening and even outright curbs on bank lending for real estate purposes, prices finally fell quite convincingly. Indeed, when it became clear that urban land prices themselves had begun to fall (for the first time in seventeen years and for only the second time in the whole post-war period), the Ministry of Finance, in December, announced some relaxation of the lending restraints which had been imposed in the spring of 1990.

The US cycle is further advanced ...

In the United States the property price cycle is further advanced, having had its origins in the US upswing of the first half of the 1980s, after which prices had risen more modestly. Nevertheless, the downturn in

Nominal property prices

Countries and cities	1980–85 average	1985–90 average	1985	1986	1987	1988	1989	1990	1991
	annual percentage changes[1]								
	Commercial								
United States[2]	8	1	5	4	5	2	0	− 7	−18
Japan[3,4]	7	22	13	48	61	3	5	4	− 7
United Kingdom[5]	2	5	−1	6	16	35	1	−24	−20
Canada[6]	n.a.	5	3	4	6	8	9	− 3	− 6
Australia[7]	18	11	11	17	40	30	6	−24	−21
Denmark	10	3	21	17	0	3	1	− 7	− 2
Sweden	6	21	12	27	− 8	49	− 2	51	− 1
Stockholm[8]							*25*	*0*	*−35*
	Residential								
New York	16[9]	5	27	20	14	0	0	− 5	− 2[10]
Los Angeles	4	11	3	8	8	22	5	14	0[10]
Tokyo[4]	4	19	3	22	69	0	7	7	− 9
London	14[11]	13	16	23	24	24	2	− 7	− 5
Paris[12]	10	18	10	10	19	20	24	18	6
Frankfurt[13]	4	5	−6	−11	5	14	0	20	20
Milan	n.a.	13	n.a.	3	9	13	33	10	n.a.
Toronto[4]	7[14]	14	16	38	25	26	3	−15	− 4
Brussels	−2	15	2	7	6	11	32	22	0
Copenhagen	−1[15]	−2	n.a.	13	−10	−1	− 2	− 8	2
Madrid	5	28	10	13	43	40	27	20	9
Stockholm	2	17	6	10	21	28	19	11	3[10]
Sydney[16]	5	11	11	14	25	53	−13	−10	8

[1] Based on annual averages unless otherwise stated. [2] The North-East; fourth quarter to fourth quarter. [3] Tokyo. [4] Twelve months to January of the following year. [5] Twelve months to March of the following year. [6] Fourth quarter to fourth quarter. [7] Sydney; twelve months to December. [8] Small-sample estimates. [9] 1981–85. [10] First three quarters. [11] 1983–85. [12] Twelve months to June. [13] First quarter to first quarter. [14] 1982–85. [15] 1980–84; break in 1985. [16] Twelve months to December.

Source: Various private real estate associations.

commercial property prices accelerated last year as some reports even suggested that enough office accommodation might have been built in the past decade to provide for all the likely increase in demand in the next. Property markets were also aware of the overhang now in the hands of the Resolution Trust Corporation, and which will continue to be sold off. In October the supervisory authorities publicly encouraged banks to make loans against commercial property and urged that such property be revalued in line with its likely income-producing potential, without fear of any supervisory reaction. In November, to back this up, bank examiners were requested to look at a wide range of factors when evaluating commercial real estate loans, rather than automatically forcing write-downs and the establishment of loss reserves. In addition, the burden of proof was reversed in that examiners were henceforth required to justify any downgrading decisions.

... and the authorities begin to urge support

Land prices in Japan	1980–85 average	1985–90 average	1986	1987	1988	1989	1990	1991
	annual percentage changes*							
Tokyo	4.0	19.0	23.8	65.3	1.8	7.2	7.0	− 8.4
Osaka	4.6	22.2	4.6	19.8	32.1	53.9	6.8	−21.3
Nagoya	3.4	12.9	2.4	8.3	16.4	19.9	18.4	− 5.1
Average	4.1	19.7	15.0	43.8	12.2	22.1	8.5	−11.6
Rural areas	3.9	6.7	1.5	2.4	4.8	11.7	13.8	1.9
All areas	4.0	13.0	7.7	21.7	8.3	16.6	11.3	− 4.6

* Twelve months to January of the following year.
Source: National Land Bureau of Japan.

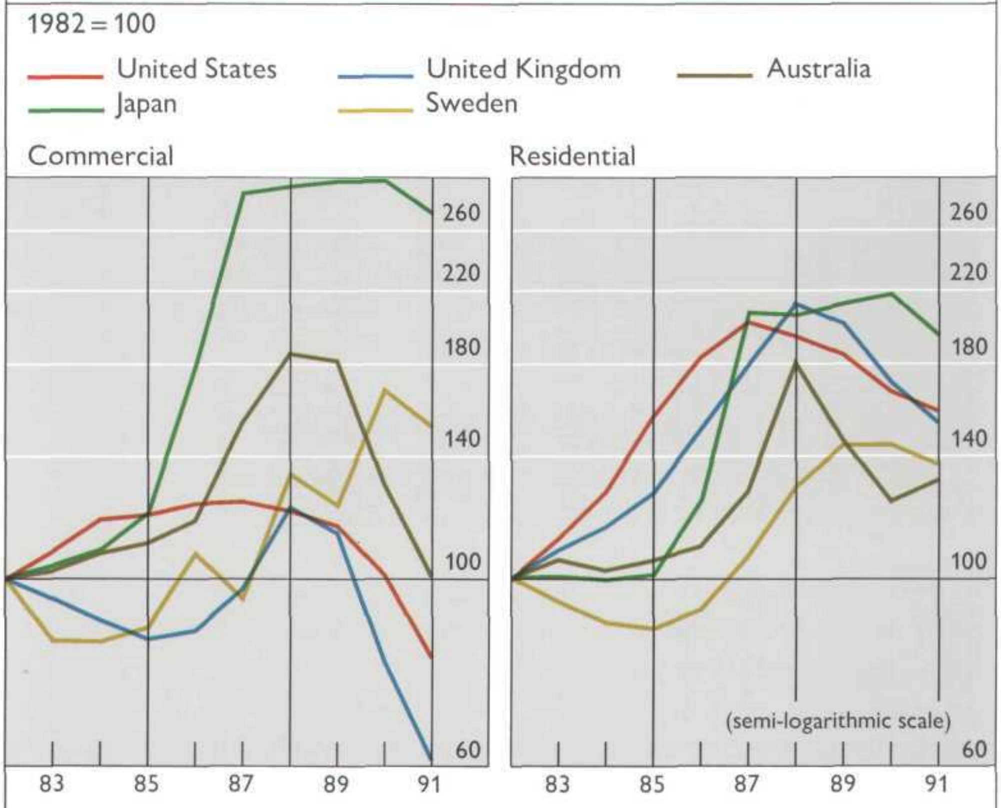
The property price cycle has been of unusual amplitude in many other countries

Elsewhere, while real estate prices might well normally be expected to show some sensitivity to the overall economic cycle – even to the point of causing some financial strains during the downturn – an unusually large number of countries seem on this occasion to have experienced a particularly pronounced cycle in property prices. In many, too, financial liberalisation had in preceding years combined with less unique factors such as excessive credit growth, unsound investment appraisal and an unrealistic climate of optimism. In the United Kingdom, for example, the downturn in both residential and commercial property prices has been relatively severe and, in the residential sector, prolonged. In this latter sector house repossessions reached record levels last year, prompting concern that sales of such properties might further weaken the housing market. The Government attempted to assist the market both by a temporary abolition of stamp duties on most house purchases and by encouraging mortgage lenders to adopt measures to stem the flow of repossessed properties onto the market. These measures included mortgage rescue schemes under which distressed borrowers may become part-owners or tenants of their dwellings.

Related strains emerge in the financial sector

In the commercial sector, notably in the London Docklands development, the crisis took on international dimensions when the related financial problems of a very large Canadian-based real estate investment firm came to light in the spring of this year. Similarly, the fairly dramatic situation in Sweden has been accompanied by problems of a like nature stemming from Swedish firms' foreign property ventures. In Sweden itself, commercial property prices, after rising at an average nominal rate of around 20% during the period 1984–88, have since fallen, in some cases quite sharply, and as a result strains have also emerged in various parts of the financial sector. In the residential sector the price cycle was exacerbated, in the upswing, by generous subsidies and mortgage interest relief against very high rates of taxation. And in the downswing the cycle has begun to reverse quite sharply as policy has moved away from such supports and incentives, and, in particular, as tax reform has lowered the implicit value of the tax reliefs which do remain. Certain of these features have also been present to some extent in some of the property-related financial

Inflation-adjusted property prices*



* Deflated by consumer price indices. For a description of the property price indices used, see the table on page 140.

strains which have appeared in Norway and Finland. In Denmark the cycle in the residential sector began earlier than in most other countries and nominal house prices fell during the period 1987–90, before showing a slight rise again last year. Some of the accompanying financial strains have had to be met by exempting mortgage institutions from the EC capital adequacy requirements. The property price cycle has also been pronounced in Australia, though somewhat less so in Canada, despite the similar severity of the recession in the two countries. Even Switzerland has not escaped the phenomenon, as, following a boom in the residential sector, it has been necessary to hold mortgage rates for some time at levels which are very high by historical Swiss standards.

In some countries the cycle might be ending without troublesome price declines

In some other countries, while prices have risen strongly in recent years, at least in certain sectors, the cycle seems to be ending without such sharp declines as elsewhere. The Paris market appears to be one example of this, in part perhaps because of tighter planning controls and less speculative activity in the upswing. Spain is another example, where secularly higher prices may be justified to some extent by the adaptation of the economy to EC membership and by the country's relatively high growth potential. Germany is possibly the most exceptional case in that the problem did not arise in the first place. There has even been some acceleration in the upward movement of prices against the international trend during the past two years. For example, western German land prices rose on average by nearly 11% last year, after a year of relatively weak demand in 1990. Such developments have clearly been related to the effects of unification and to the consequently atypical position of Germany in the international business cycle. The absence of an excessive property price boom in earlier years was also no doubt related to the earlier consolidation of financial deregulation in Germany and possibly to tighter monetary policy in general.

Exchange markets

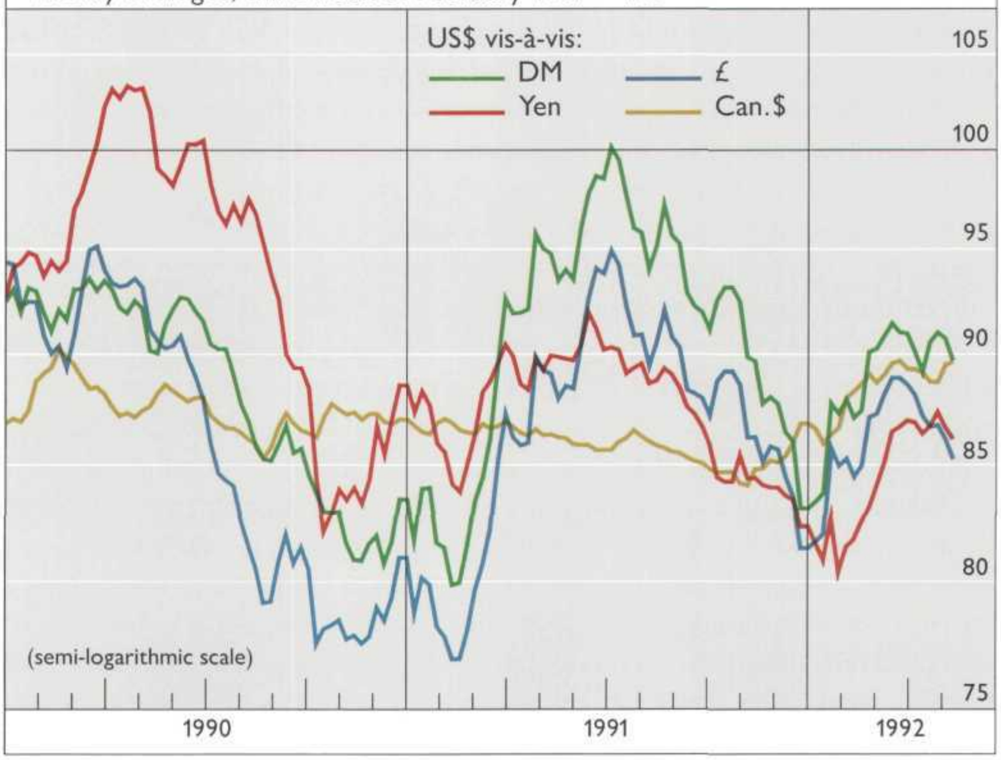
Developments in the major currencies

The dollar executes a complete cycle with no consistent relationship to the "fundamentals"

The salient feature of the exchange markets during the period under review was that the dollar described a complete and pronounced cycle against other major currencies during 1991 and the very early part of this year despite a continuously increasing negative interest differential vis-à-vis the EMS currencies. For a time at least, it also looked as though the cycle might be going to repeat itself in 1992. Thus, again, the foreign exchange markets demonstrated their capacity to move major exchange rates by relatively large amounts in apparent disregard of the so-called "fundamentals" and, on occasion, in the face of clear signals from the authorities in the form of exchange market intervention. Instead, as in the other financial markets discussed in this chapter, the ebb and flow of sentiment about the likelihood of recovery in the United States and related interest

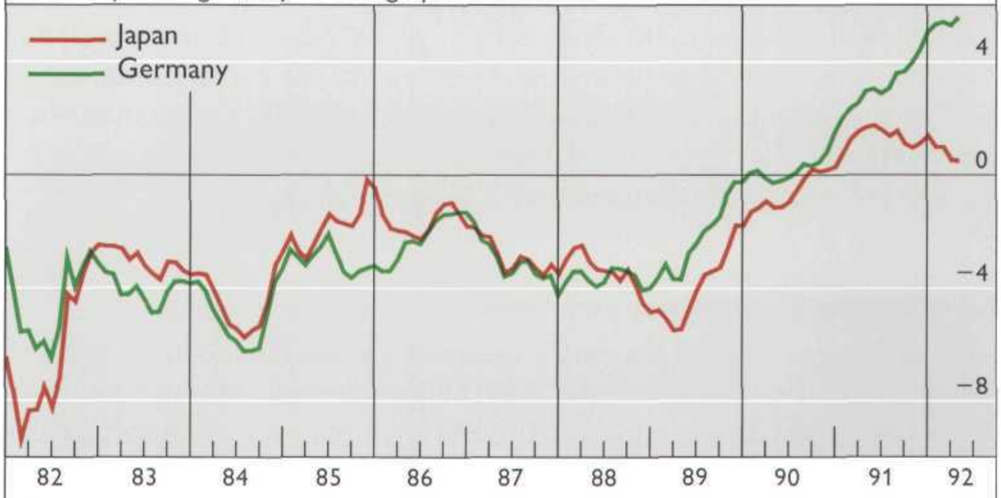
Bilateral exchange rates of the US dollar against selected currencies

Weekly averages, third week of February 1987 = 100



Interest rate differentials vis-à-vis the United States*

Monthly averages, in percentage points



* In terms of three-month Euro-rates.

rate expectations seem to have been one important factor affecting exchange market developments at times.

Following a further widening of short-term interest rate differentials against it during the winter of 1990–91, the dollar touched a new trading low against the Deutsche Mark (of DM 1.4430) on 11th February last year. There had been several rounds of concerted intervention to try to check this fall, but it was not until more buoyant economic indicators appeared that a rebound began. This rebound was so rapid that, with the markets threatening to become disorderly, the authorities intervened again several times in March, but now to try to dampen the US currency's buoyancy, which nonetheless persisted despite further movements in interest differentials against it. By the time the dollar did eventually peak in early July, it had risen, since its trough, by 26% against the Deutsche Mark and by about 24% against sterling. Vis-à-vis the yen its rise was more modest, at around 9%. However, when the downturn came, reversing nearly all of the earlier average effective gain, it was more uniform against the yen, the Deutsche Mark and sterling, at 12, 18 and 15% respectively. Early in 1992, however, the dollar summarily reversed its trend once more, and by March had moved up by about 10% against all three currencies.

The strong rebound of the dollar early in 1991 ...

... leads to a switch in official intervention from support to restraint

The rise in the dollar between February and July last year was in part influenced by the same factors which were described earlier in connection with other financial markets: optimism about a US recovery and soaring confidence in the wake of the success of the military operation in the Gulf. In addition, the rapidity of the allied victory, plus the willingness of other countries to contribute to it financially, helped to dissipate earlier concerns about the possible implications for both the US budget and the external current account balance. The speed and extent of the dollar's rise against the Deutsche Mark, however, suggest that other factors may also have been at work. For, despite Bundesbank-led intervention in both April and June, and a further slight widening of the Deutsche Mark/dollar short-term

General optimism fuels the dollar's rise interest differential, the Deutsche Mark continued to weaken against the dollar much more than did the yen. The reasons may well have been on the Deutsche Mark's side, including evidence of the sharp deterioration in Germany's trade balance, a growing appreciation of the scale of the problems in the eastern German economy, uncertainties regarding the possible reintroduction of a German withholding tax, the worsening political situations in Yugoslavia and the Soviet Union, and, finally, setbacks for the German Government in Länder elections.

In mid-year uncertainty creeps in ...

The dollar continued to rise against the Deutsche Mark until it reached a peak of nearly DM 1.84 on 5th July, when an unexpected drop in US employment was announced and confidence in a recovery suddenly began to weaken more decisively. The situation remained uncertain, however, given that the Bundesbank did not raise interest rates as the markets had been anticipating and as, a little later, another US labour market indicator was published, apparently contradicting somewhat the message of the June employment figures. The central banks, however, seized the opportunity offered by the markets' growing uncertainty, and by the proximity of the Group of Seven Summit, and undertook several rounds of concerted intervention, in which the US authorities also took part on 12th July. This combination of events and display of official attitudes proved decisive, and the dollar began to move downwards, a trend which broadly persisted for the rest of the year. In addition, it was very soon assisted by the start of a further noticeable upward movement in the Deutsche Mark's short-term interest rate advantage, which by the end of the year reached a new record of 5½ percentage points. This was also accompanied by some further widening of the long-term interest differential in its favour. The Summit communiqué published on 17th July reiterated support for close international cooperation in the foreign exchange markets, and the absence of intervention to stem the dollar's downward movement reinforced perceptions that the authorities were generally satisfied with its decline. Indeed, when the dollar jumped sharply, but temporarily, on 19th August at the time of the attempted coup in Moscow, joint intervention was undertaken by several central banks, before the US markets opened, to steady it.

... and carefully timed official intervention contributes to turning the dollar's trend downwards

Against the yen the dollar's decline in the second half of the year was somewhat less than against the Deutsche Mark. This was not considered to be particularly appropriate given Japan's steadily mounting trade surplus as the domestic economic slowdown began to emerge. Nevertheless, to try to cushion this latter development, the Japanese authorities took advantage of some of the yen's firmness against the dollar and lowered interest rates. The yen's short-term interest advantage therefore tended to drift downwards on average from the early summer onwards. At the long-term end, however, its interest disadvantage remained more or less stable throughout 1991 before increasing a little in early 1992.

Eventually the dollar reached lows of Yen 123 and DM 1.51 on 7th and 8th January respectively this year. In nominal trade-weighted terms this brought it to within 1% of the low point reached the previous February.

But just as nature is said to abhor a vacuum, so at times it seems do the foreign exchange markets abhor the absence of movement. In apparent reaction to these early 1992 lows the dollar suddenly rebounded again by about 7½% against the Deutsche Mark and by nearly 4½% against the yen in little more than a week as general expectations shifted once more. By the middle of March these gains had swelled further to touch almost 11% against the Deutsche Mark and nearly 9% against the yen. Furthermore, in contrast to its rebound a year earlier, on this occasion the US currency also rose against its Canadian counterpart following declining Canadian interest differentials last year and, more recently, certain portfolio adjustments by Japanese investors in response to the decline in the Tokyo stock market. In nominal effective terms, this served to make the magnitude of the dollar's January–March rise this year similar to that between mid-February and the end of March last year.

The dollar rebounds suddenly at the beginning of 1992 ...

In sum then, the large downward adjustment of the US discount rate and the upward adjustment of German official rates on 19th December 1991, the extent of both of which had taken the markets somewhat by surprise, did not basically have a further weakening effect on the dollar. On the contrary, by apparently removing uncertainties about future interest rate trends, they appear to have prepared the ground for some turnround in the US currency. It was felt that once these adjustments in official lending rates had worked themselves through, the future trends in interest rates could only be downward in Germany and upward in the United States. These expectations of a movement of interest rate differentials in favour of the United States were, moreover, underpinned once again by statistical evidence of a US economic pick-up and rather clear signs of slowdown in Germany and Japan.

... as the size of official interest rate moves seems pre-emptive

In fact, German short-term market rates did not on the whole react to the December rise in German official lending rates, while, after their steep fall during the preceding five months, US short-term interest rates showed only a small further decline. As a result, the short-term interest differential in favour of the Deutsche Mark showed only a modest increase, while, after the Japanese discount rate reduction at the end of December, the yen's positive short-term interest rate differential vis-à-vis the dollar narrowed further. In the field of more forward-looking interest rate differentials, developments in favour of the dollar were rather more pronounced. As the rise in German official lending rates helped to allay inflation fears, German long-term interest yields eased markedly in January, whereas US long-term rates turned up quite steeply. As a result the Deutsche Mark's ten-year interest premium over the dollar was nearly halved within the space of a month, and that at very long term was eliminated altogether. At the same time, the upturn of US long-term interest rates led to a widening of their premium over long-term Japanese interest rates.

Especially at long term, interest differentials move in favour of the dollar

The dollar's sharp rise in January was at one point interrupted by joint intervention by the Japanese and US authorities, who deemed a major rebound undesirable in view of the mounting Japanese trade surpluses and

Intervention undertaken to slow the dollar's rise related political tensions. Nevertheless, confidence in the dollar continued to strengthen, and in February and early March further official dollar sales, mainly by the Japanese authorities, did not seem to have much impact on the markets. Although during this period the dollar's rise vis-à-vis the European currencies was even more pronounced than against the yen, the European authorities refrained from intervention. In view of considerable domestic cyclical weakness, several European countries welcomed an improvement in competitiveness, particularly vis-à-vis the yen; and in Germany, where domestic inflationary pressures were the overwhelming concern, the authorities seem to have considered the time not yet ripe for such intervention, given the markets' optimism about the US economy and likely interest rate movements.

The dollar falters in the spring

In the event, this optimism has not proved wholly justified. Indeed, the US authorities nudged the federal funds rate down further early in April, while concerns over wage pressures in Germany were accompanied by some upward drift of German market rates during April and the early part of May. Hence, the dollar, whose rise had already come to an end in March, fluctuated thereafter against both the Deutsche Mark and the yen, before weakening somewhat in mid-May – at least against the Mark – as the German wage picture began to clear.

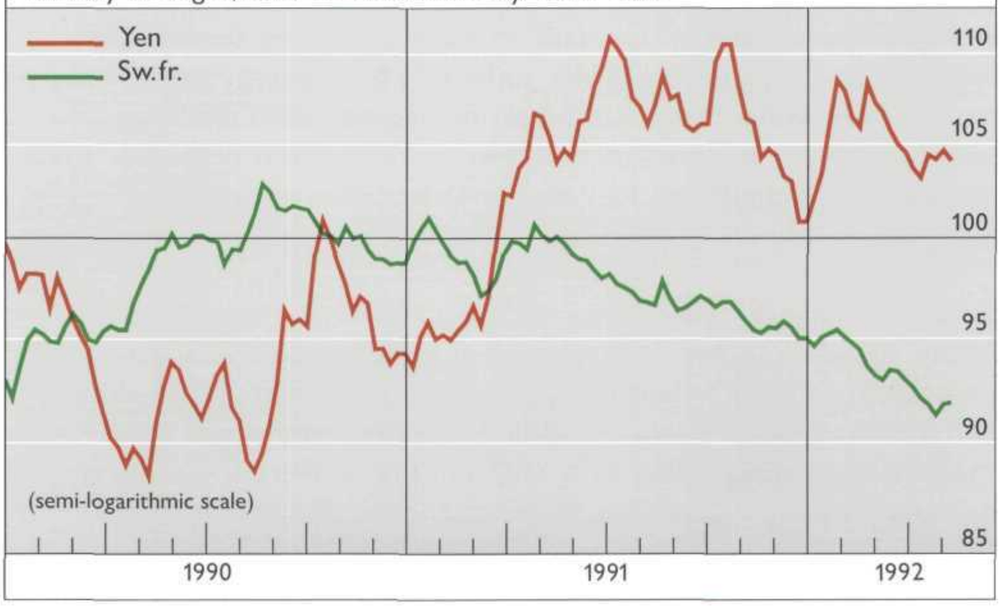
Cross rates: the yen and the Swiss franc vis-à-vis the Deutsche Mark

The yen recoups only part of its weakness in 1990 ...

Following its marked weakness during 1989 and the first half of 1990, the yen recovered somewhat in nominal effective terms after mid-1990 and, during the period under review, first consolidated and then moderately extended its earlier gains. As noted above, the yen did lose ground against the dollar during the first half of last year. But it did so to a considerably

Bilateral exchange rates of the yen and the Swiss franc against the Deutsche Mark

Weekly averages, third week of February 1987 = 100



smaller extent than did the Deutsche Mark. Consequently, and especially late in the first quarter, the yen went up quite sharply against the Deutsche Mark and by early July had risen by nearly 18% compared with its level at the beginning of 1991. One important contributory factor was no doubt the rapid elimination of the German current account surplus. Given its fall against the dollar, however, the yen's real effective value changed little during the first half of the year.

... and interest differentials begin to move against it

In the second half, both long and short-term interest differentials moved markedly against the yen. For example, vis-à-vis Germany the short-term differential widened from about 1 percentage point in April to nearly 4 percentage points by the end of 1991. Hence, despite the resurgence in Japan's external surplus, the yen fluctuated without any clear trend during the third quarter before actually reversing nearly half of its earlier gain by the end of the year.

Despite further evidence of the Bundesbank's firm policy stance in late December the yen began to recover again quite sharply against the Deutsche Mark during January, as expectations grew that German interest rates had peaked. Nevertheless, with Japanese short and long-term rates further down, the full extent of the January gain was not maintained. In real effective terms, early this year the yen was still slightly below its level at the time of the Louvre Accord in February 1987.

Continuous weakness of the Swiss franc

In some contrast, the Swiss franc weakened almost continuously against the Deutsche Mark during the period under review, and by early May this year it had fallen some 10% since early 1991. Although the Swiss currency's "safe-haven" attributes were mildly demonstrated again during the Gulf war and later during the coup attempt in Moscow, the collapse of communism may well have helped to reduce the value of such a status. Although domestic interest rates have been high for some time, they have remained below those in Germany in spite of higher inflation. In early 1992 the Swiss currency came under severe downward pressure as the short-term interest rate differential against Germany widened to over 2 percentage points and the franc fell almost to the low level seen a little over two years earlier. The National Bank conducted several substantial unilateral intervention operations, some of which, exceptionally, took the form of Deutsche Mark sales, and market interest rates rose sharply again. However, in early May the Swiss franc touched new lows around 93 centimes to the Deutsche Mark, levels not seen since 1981.

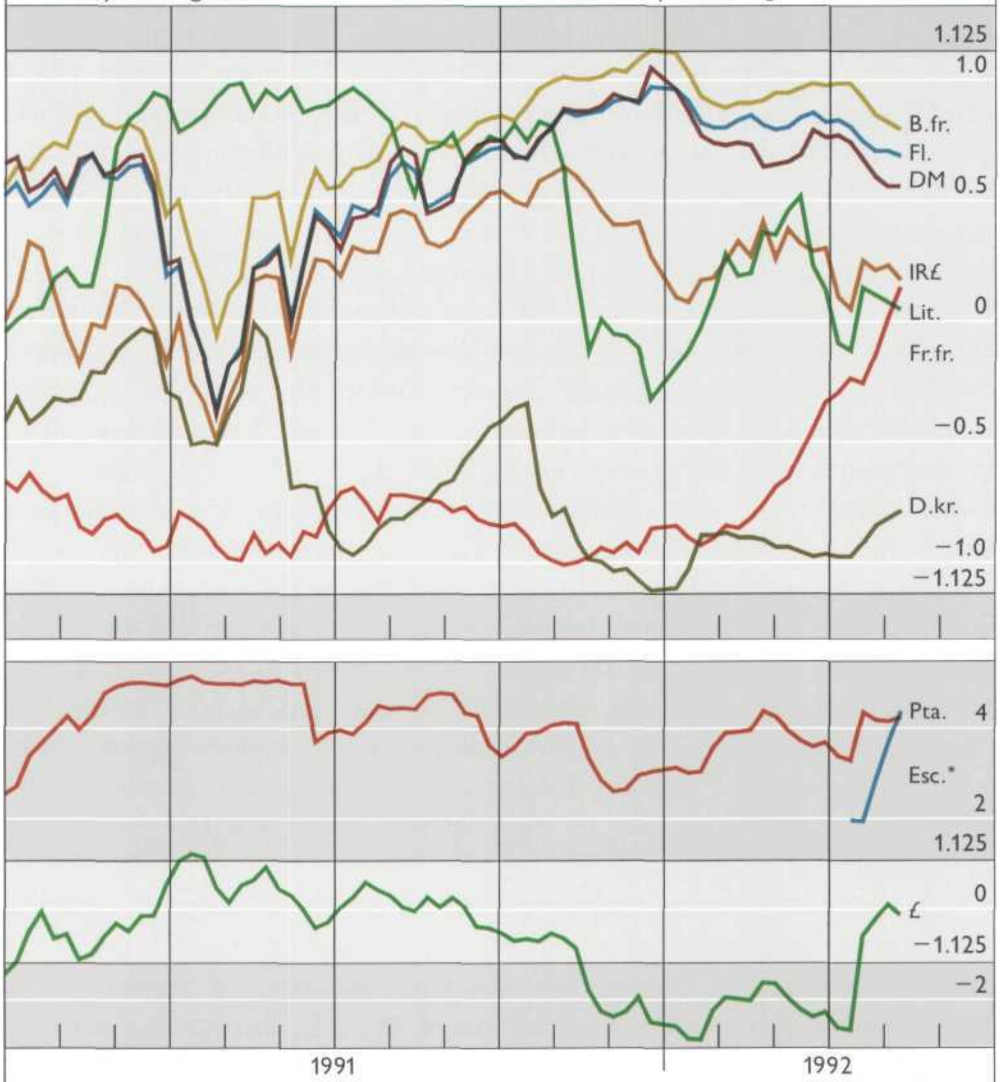
Developments in the EMS exchange rate mechanism

Mostly calm developments in the EMS in spite of the strains borne by macroeconomic policy in Germany

Given the further convergence of inflation rates in Europe, it was the strains placed on German macroeconomic policy by unification which were potentially the most important background factor affecting developments in the EMS exchange rate mechanism during the period under review. With their cyclical position quite different from that in Germany, most partner countries would no doubt have preferred lower short-term interest rates than those which were necessary to maintain ERM parities in the face of high rates in Germany, especially as in many cases lower rates of inflation

Positions of member currencies in the ERM bands

Weekly averages of deviations from central rates, in percentages



* The escudo entered the ERM on 6th April 1992 with a maximum permitted margin of fluctuation of +/−6%.

served to emphasise the situation in real terms. This meant that there was some tendency for countries, as it were, to test the limits of the parity grid at times in order to secure the lowest rates compatible with its preservation and with maintaining the policy credibility built up over many years. However, during the first half of 1991, and to some extent again in the early months of this year, external developments, such as dollar strength and specific uncertainties about the Deutsche Mark, served to prevent these strains from manifesting themselves as strongly as they might have done. Only for a relatively short period at the end of last year – with the dollar then in continuing decline – did the spread of narrow band currencies reach its maximum of 2¼ percentage points.

During the early months of 1991 conditions in the ERM were relatively free of tension despite Gulf war related instability elsewhere. Nevertheless, the spread of the narrow band widened slowly during the first quarter, partly under the influence of changing interest differentials. The French franc declined gradually, and the Italian lira recovered quite sharply until in late March it emerged as the highest currency in the narrow band. After a bout of weakness in February, which triggered some official intervention, the pound began to rise towards the centre of the narrow band and in April it strengthened further, influenced by the rising dollar and the simultaneous weakness of the Deutsche Mark. The other wide band currency, the Spanish peseta, rose more strongly during the first quarter and in March touched its upper limit against the French franc, occasioning fairly substantial intervention by the French and Spanish authorities.

Some intervention required in the first quarter of 1991

The peseta remained firm against the French franc from March to mid-June, and the lira remained at the top of the narrow band for longer. The peseta's strength occasioned continued bouts of compulsory intervention right up to mid-June despite a reduction of about 2 percentage points in short-term Spanish interest rates. With the lira's spread against the French franc continuing to hover around 2 percentage points, the Italian and French authorities also conducted intramarginal intervention on several occasions during this period. However, with the dollar rising strongly and with concern growing about developments in eastern Germany, as well as in the Soviet Union, the Deutsche Mark moved down quite sharply towards, and then into, the lower half of the narrow band during late March and April. And although it subsequently began to recover somewhat, it may well be that the Deutsche Mark's behaviour prevented the spring/early summer tensions in the ERM from being greater than in fact they were.

Peseta persistently strong ...

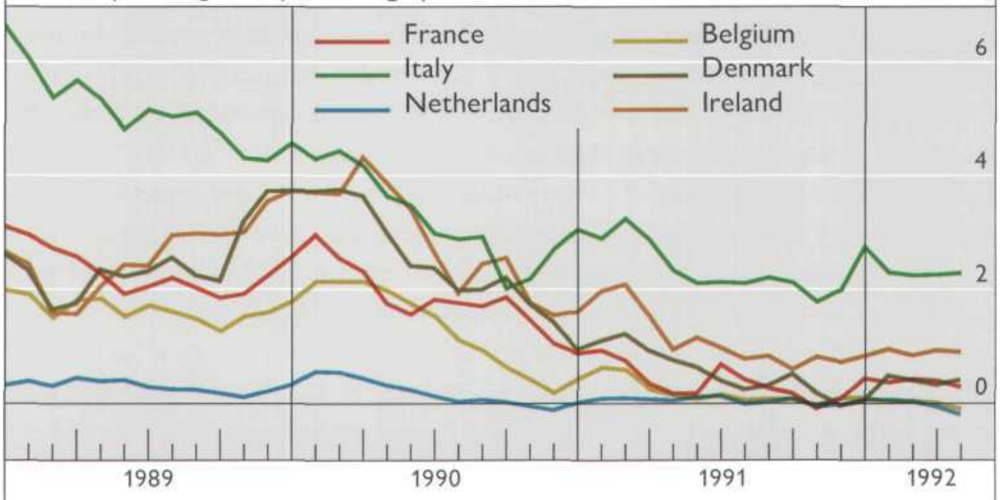
... but general tensions avoided as the Deutsche Mark falls

In mid-June the markets were suddenly swept by rumours that the peseta was about to be taken into the narrow band of the ERM, and the Spanish currency fell sharply. This effectively marked the beginning of a calmer period in the ERM, especially as in late July the lira also declined somewhat and the French franc edged higher following a rise in market interest rates in France in early June and favourable inflation indicators. Indeed, despite the dollar's turnround in July, the spread of the narrow band currencies declined from 2 to about 1½ percentage points by the end of that month. The pound came under some pressure as a result of political concerns and expectations of further falls in interest rates, but it so happened that the peseta's decline had also served to lower the floor of the wide band. On 15th August the Bundesbank led a concerted round of increases in official interest rates, in which, however, neither the French, Italian nor UK authorities took part. Nevertheless, conditions in the ERM remained calm despite the fact that the French franc and the pound continued to drift gently downwards. In early September the UK authorities lowered interest rates, for the seventh time in 1991, as the economy continued to be unexpectedly weak. The pound declined further, but later in the month another bout of speculation flared up over the possibility of the peseta moving to the narrow band and that currency fell sharply too. Meanwhile the spread of the narrow band had begun to widen again, reaching 2 percentage points once more in late October. However, as the

Calmness restored in the summer

Interest rate differentials vis-à-vis Germany*

Monthly averages, in percentage points



* In terms of three-month Euro-rates.

The French authorities feel able to reduce interest rates

Danish krone replaced the French franc at the bottom of the narrow band the French authorities felt able to reduce official interest rates again on 17th October, and for a time French short-term rates even fell below those in Germany. Shortly afterwards, the French franc began to come under a certain amount of pressure.

Tensions appear in the fourth quarter

This, however, was probably only one of the triggers of what proved to be the main phase of tension experienced in the ERM during the period. In the background, the dollar was continuing to fall, interest rates had declined in Italy as well as in France, and there were expectations that German interest rates would have to be raised further. Moreover, the crisis surrounding the devaluation of the Finnish markka on 15th November fuelled fears and speculation about a possible realignment within the ERM. Thus, in addition to pressure on the French franc, there was a sharp fall in the Italian lira and smaller declines in sterling and the peseta. All the while the Deutsche Mark, together with the guilder and the Belgian franc, continued to rise. The spread of both the narrow and wide bands increased, there was substantial intervention, and in the second half of November official interest rates had to be raised again in France and Italy, despite the sluggishness of their domestic economies. The pound moved down out of the narrow band for the first time since early February, in part as a result of the dollar's continuing decline.

Sizable intervention required and seven countries follow the rise in German interest rates in December ...

In December, as these pressures persisted, sizable intervention was undertaken again by France, Italy and Spain, and these countries, together with Belgium, Denmark, the Netherlands and Ireland, were all obliged to follow the Bundesbank-led increase in interest rates on 19th December. Interest differentials against the Deutsche Mark widened again. Roughly at the same time the spread of currencies in the narrow band reached its permitted maximum, with the Belgian franc at the top and the Danish krone at the bottom.

Almost immediately in the new year, however, the tensions in the system largely melted away. As in other markets the decisive moves in official interest rates in late December apparently convinced exchange market participants that German rates had probably reached their peaks. In addition, concern over wage pressures in Germany affected the Deutsche Mark, which fell back within the narrow band by rather more than did the two currencies which now shadow it most closely, the guilder and the Belgian franc. More generally, the events of November and December had clearly tested the resolve of the authorities and shown that they were prepared to take the necessary steps to defend the ERM bands even when such steps ran counter to domestic policy needs. Lastly, the pound may have benefited somewhat from the dollar's strength in February, something which probably also contributed more generally to the lessening of tensions in the ERM. At one point in February the Italian authorities took the opportunity to try to reconstitute their reserves and intervened to brake the speed of the lira's rise, before it fell back again in March owing to pre-election nervousness and budgetary concerns, and intervention was undertaken in the opposite direction. Between March and mid-May the French franc continued to strengthen markedly, reaching its highest level in the system during the period under review and permitting the French authorities to engineer some easing of market interest rates.

... a move which was seen as decisive and which helped disperse tensions

Nevertheless, with UK short-term interest rates declining in January and February the pound approached the lower limit of the wide band in February. Spanish interest rates were reduced slightly and there was soon upward pressure on UK rates, pressure which intensified as the election approached. In March the pound had to be supported by intervention. Following the surprise Conservative victory, the pound rose dramatically and even reached the centre of the narrow band late in April, leaving the Danish krone the lowest currency in the system. A cut in UK bank base rates early in May had only a very temporary effect on the pound, and it was soon back in the top half of the narrow band again.

Sterling rises sharply after the election

On 6th April the Portuguese authorities abandoned their unilateral linking of the escudo to an index of ERM currencies and took the Portuguese currency into the wide band of the ERM, where it immediately rose to its ceiling against the pound, before being checked by intervention by the Bank of Portugal and by a cut in interest rates. Following the post-election jump in the pound, the escudo rose sharply and in early May emerged as the highest currency in the ERM.

The escudo enters the ERM

The Swedish krona and Finnish markka

In 1991 the Swedish and Finnish authorities unilaterally pegged their currencies to the ECU, as Norway had done in October 1990. In the Swedish case, the decision taken on 17th May to peg the krona to the ECU with +/−1½% fluctuation margins led to large currency inflows and a sharp decline in short and long-term Swedish interest rates together with a strengthening of the krona. The shift from Sweden's previous exchange rate target vis-à-vis a trade-weighted currency basket also led to substantial

The pegging of the Swedish krona to the ECU ...

purchases of US dollars against Deutsche Mark by Swedish private entities seeking to readjust the composition of their net foreign currency liability positions. A side-effect of the Swedish move to an ECU target was a bout of downward pressure on the Finnish markka, based on speculation that Finland would devalue its currency before following Sweden's example and pegging it to the ECU. In the event, on 7th June, the markka was pegged unilaterally to the ECU without a devaluation, with a +/−3% fluctuation margin, leading to a prompt easing of pressure on the currency and a sharp decline in Finnish short-term interest rates, while at the same time it was decided to abolish all remaining exchange controls.

... is followed by a similar move in Finland ...

... but in November the markka experiences a severe crisis which results in devaluation

Despite the linkage to the ECU, however, the markka soon became the focus of recurrent downward pressure again, in part reflecting the continued severity of the Finnish recession, widening interest differentials against it and doubts about the acceptance of a recently concluded wage agreement. These tensions came to a head in early November and, after a temporary period of floating, culminated in a 12.3% devaluation of the markka's central rate against the ECU on 15th November. The markka crisis also generated very strong speculative pressures on the Swedish krona, which abated only after an impressive display of firmness on the part of the Riksbank. Since a 1 percentage point rise on 26th November did not suffice to stem the outflows, the Riksbank increased its marginal lending rate by a further 6 points to 17.5% on 5th December. This time the market accepted the message and after only a few days this unusually large increase in official rates could be partly unwound. The decline in Swedish interest rates came to a halt in early April, however, as renewed pressure on the markka again spilled over into the Swedish foreign exchange market. Pressures on both currencies then eased again as Finnish and Swedish official rates were once more raised sharply, and as the Bank of Finland's intervention resources were augmented through the activation of swap and credit facilities with the other Scandinavian central banks, and the Bundesbank extended similar assistance. In Finland, a package of macro-economic stabilisation measures was also announced at this time.

The Swedish authorities act decisively to protect the krona

Gold

Like most other commodities and many real and financial assets, the price of gold continued to display considerable weakness during the period under review. Although the supply of gold coming onto the market remained on a plateau, the price tended to move downwards for the fourth year in succession. Demand was muted by recession and the absence of a serious threat of an acceleration of inflation in most industrial countries.

Steady aggregate supply due to ...

Supply. No significant change occurred in aggregate gold supplies in 1991. The modest increase in mine production and some net sales by official holders were offset by the net repayment of gold loans and some contraction in overall supplies from the Soviet Union and China.

... higher mine output ...

Despite the persistent weakness of the gold price, world mine production continued to edge up last year as declines in some of the major producer countries were offset by the further expansion of output by

Estimated market sources and uses of gold					
Items	1987	1988	1989	1990	1991
	in metric tons				
Production	1,385	1,550	1,680	1,745	1,780
Other suppliers*	300	260	300	350	300
Estimated changes in official gold stocks through market transactions (− = increase)	95	−175	175	30	75
Net new gold loans	70	150	50	100	−25
Total (= estimated non-monetary absorption)	1,850	1,785	2,205	2,225	2,130

* The former Soviet Union, China and some minor producers.

North American and several smaller producers. The relative strength of mine output in the face of a further decline in gold prices was due in part to earlier forward sales by producers. Such sales allowed some producers to lock in to prices higher than those available in the spot market and to keep some marginal mines in operation.

South African output dropped by 0.7% to 600 metric tons, bringing total production to the lowest level in over thirty years. In Australia, output also contracted, for the first time since 1980, in part because of the introduction of corporate taxes on gold mining profits.

In both the United States and Canada there was a modest expansion of production, but growth failed to match the high rates of the 1980s. Elsewhere aggregate mine production continued to increase, though there were sharp differences among individual countries.

The disintegration of the Soviet Union has important implications for the gold market. Output in Russia and other republics producing gold, notably Uzbekistan and Kazakhstan, appears to have been smaller than the 260–310 tons reported for 1989 and 1990. The information available on the net amount sold in the market is less solid, in part because of extensive swap transactions. Nevertheless, sales clearly exceeded production, and total official holdings in the former Soviet Union are reported to have declined to only about 240 tons at the end of 1991. China increased its gold production last year, but domestic use of gold expanded, and the country appears to have been a net purchaser from the international market.

... reduced eastern disposals ...

Outside the former Soviet Union official stocks of gold declined by 75 tons. Although holdings remained static in the great majority of countries, increases in some, including South Africa, India, the Philippines, Algeria, Czechoslovakia and Colombia, were more than offset by decreases elsewhere. In the case of South Africa, the increase of 74 tons more than compensated for a decline in its non-gold reserves. India recorded a year-on-year accrual of 18 tons but used a large amount of gold as collateral in the middle of the year to replenish temporarily its severely depleted exchange reserves (see Chapter III). Brazil, after building up its reported official holdings steadily in the 1980s to a peak of 142 tons at the end of 1990, showed a decline of 79 tons in 1991. Canada disposed of 56 tons within the context of its continuing gold sales programme.

... modest official sales ...

World gold production[1]								
Countries	1953	1970	1980	1987	1988	1989	1990	1991
	in metric tons							
South Africa	371	1,000	675	607	621	608	605	601
Share of world gold production	*49.1*	*78.6*	*70.2*	*43.8*	*40.0*	*36.1*	*34.7*	*33.7*
United States	61	54	31	155	201	266	294	300
Australia	33	20	17	111	157	204	243	234
Canada	126	75	52	117	135	160	167	177
Brazil	4	9	35	85	102	101	84	80
Papua New Guinea	0	1	14	34	37	34	34	61
Chile	4	2	9	23	27	29	33	33
Colombia	14	7	17	33	33	32	33	32
Philippines	15	19	22	40	39	38	37	31
Ghana	23	22	11	12	12	15	17	26
Other countries[1]	104	64	79	169	188	194	197	207
World total	755	1,273	962	1,386	1,552	1,681	1,744	1,782
Memorandum items:	annual averages, in US dollars per ounce							
Market price of gold								
in current US dollars	*35*	*36*	*615*	*447*	*437*	*381*	*384*	*362*
in constant US dollars[2]	*35*	*25*	*200*	*105*	*99*	*82*	*79*	*71*

[1] Excluding the former Soviet Union, China and some minor producers. [2] Deflated by the US consumer price index (1953 = 100).

Sources: Consolidated Gold Fields PLC (London) and Gold Fields Mineral Services Ltd. (London).

... and net gold loan repayments

Last year net repayments of gold loans reduced the supply coming to the market. The interest rate on short-term gold loans declined from over 2% at the end of 1990, when the Gulf crisis added to uncertainty, to under 1% at the end of 1991.

Demand. Underlying demand for gold was weak last year. Recession moderated industrial purchases while investment and speculative demand was curtailed by the downward trend of the price of gold, by the absence of any serious inflationary threat in the industrial world and by relatively high real interest rates on liquid financial investments. Imports into Japan and Taiwan, which had underpinned the market in recent years, did not expand as rapidly as in the past. In some other parts of the Far East, however, interest in gold was unabated.

Weak industrial and investment demand

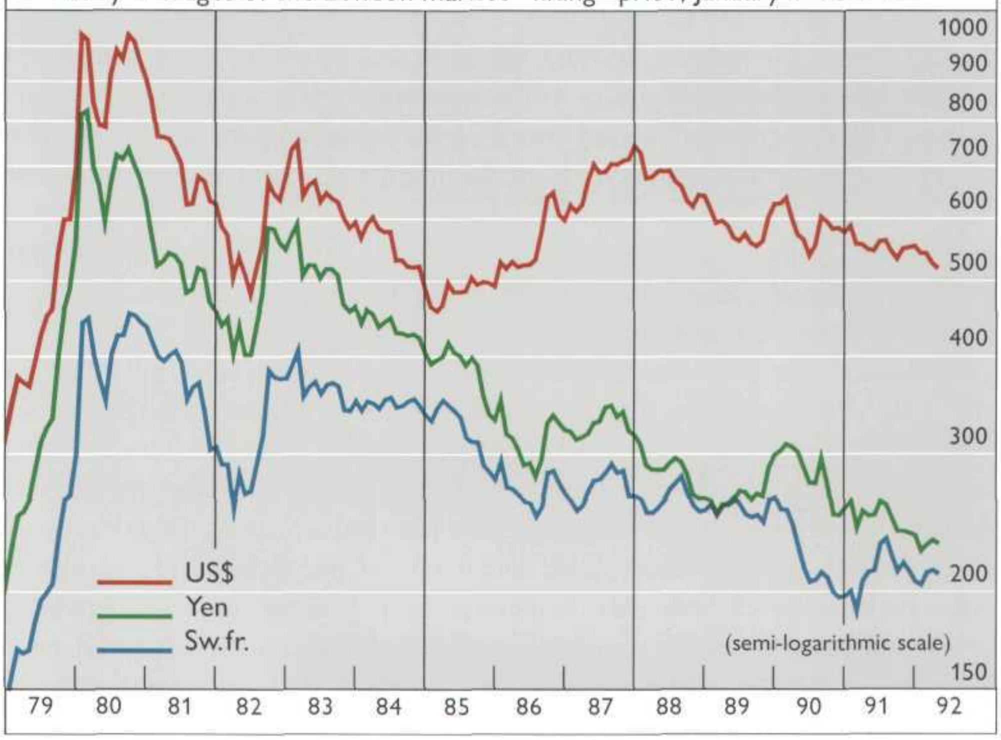
Industrial demand for gold has been buoyed in the past few years by the downward price trend, and total use for fabrication purposes has tended to exceed mine output. Last year, however, recession took its toll and held demand in check. Moreover, in the richer countries of the Far East, the jewellery market seems to have reached a plateau. Financial liberalisation has enabled investors in Japan to achieve portfolio diversification in ways that are less costly than holding physical gold. It has also allowed a greater number of savers to obtain market-related rates on their financial investments. Earlier restrictions on banks' retail deposit rates had been circumvented by placing funds in gold investment accounts. The resulting spot and forward transactions increased Japanese ownership of gold – though not necessarily physical imports – in the period when these accounts were growing in importance. Once their popularity waned as interest rate controls were relaxed and the gold price remained weak, gold lost some of its lustre for Japanese retail investors.

Downward price trend

Prices. At the beginning of 1991, gold staged a brief and surprisingly timid rally in response to the prospect of war in the Middle East. The price rose from $390 at the end of 1990 to breach $400 for just one day in mid-January. Once it became clear that hostilities would be short-lived, the underlying influences depressing the price reasserted themselves. Quotations fell to a low of $358 in late February before climbing back to $367 in less than one week. Over the next two months prices edged downwards, reaching $351 at the end of April. Then in May, despite the continued weakness of other commodity prices, gold began to strengthen and rose to over $370 in the second week of June. However, producers took the opportunity to hedge future output during what proved to be the sharpest price recovery in over a year. Quotations soon began to decline, dipping steadily throughout the summer to a low for the year of $344 in mid-September. It is noteworthy that the attempted coup in the Soviet Union did not trigger sufficient safe-haven demand to reverse the trend. It was only later in September that gold staged a minor rally. Buoyed by the announcement that Russian reserves were much smaller than had been widely supposed, the price climbed back to $371 in mid-December. Once again the price strength proved transitory and quotations resumed their downward trend, reaching a six-year low in dollar terms of $335 at the

Market price of gold in selected currencies

Monthly averages of the London market "fixing" price, January 1973 = 100



Volatility in daily gold prices[1]

Years	Number of days when price changes exceeded		Standard deviation of day-to-day percentage changes
	1%	2%	
1979–85[2]	116	49	1.66
1986	69	23	1.18
1987	72	17	1.04
1988	41	12	0.78
1989	43	4	0.78
1990	55	14	0.96
1991	24	2	0.65
1992 Q I	2	0	0.48

[1] London morning fixing, US dollars per fine ounce. [2] Annual average.

end of April this year. In yen terms, quotations at that time were the lowest in thirteen years.

Lower price volatility ...

On the whole, the gold price was unusually stable last year. Both the trading range and day-to-day volatility were clearly smaller than in earlier years (see the table above). Partly as a consequence of this, turnover in gold futures and options decreased sharply, falling to the lowest level since 1986. The reduction in price volatility observed last year is part of a longer-term trend. In earlier decades the gap between cyclical peaks and troughs in the gold price was far greater. Initially this reflected overshooting as the price sought a new equilibrium after national authorities ceased in 1971 to try to prevent the price from moving. High and variable rates of inflation in earlier decades also caused large shifts in the price of gold, which was seen as an inflation hedge.

... and some reasons for it

Changes in market conditions played a role in imparting greater stability to the gold price. Demand for jewellery purposes, by far the most important industrial use, has proved to be price-elastic, and purchases have tended to increase when the price has fallen. Secondly, the use of hedging techniques by gold producers has become much more widespread. Forward sales on rising prices, undertaken to reduce uncertainty about future revenue, tend to restrain price rallies. Thirdly, the emergence of a number of derivative instruments which allow highly leveraged positions to be taken may have diverted some speculative demand away from gold, for which delivery and storage costs are high. Finally, some major producers seek to prevent wide swings in the price through their operations in the market. Previously the Soviet Union was thought to engage in such operations, but it is unlikely that moderating gold price fluctuations was a paramount concern last year. South Africa continues to attempt to promote the stability of the price without, however, presuming to be able to change its direction.

VII. International financial markets

Highlights

1991 was a year of unparalleled contrasts in the international financial markets. Following several years of buoyant growth, international banking assets recorded the first ever absolute decline, while net of interbank redepositing the expansion in the credit aggregates slowed to an all-time low of 2½%. At the same time, activity in the international bond markets reached a new high and the markets for short and medium-term notes continued to expand strongly. The downturn in banking activity was in large measure the consequence of efforts by banks to improve their profitability and increase their capital base as well as heightened perceptions of credit risks. There was in particular a sharp cutback in interbank business, which was viewed as having low returns and potentially large counterparty risks. In the international securities market lower interest rates and an unprecedented volume of bond redemptions underpinned the issuance of straight fixed rate bonds. Activity was especially buoyant in ECUs and in a number of currencies with relatively high yields. Owing to a rebound in the Tokyo stock market, which proved to be short-lived, there was an increase in equity-related issues until the early summer, but business stagnated thereafter. The market for floating rate notes was subdued.

Financial innovation and competition remained major driving forces behind the vigorous growth in derivative instruments traded on and off exchanges and banks' involvement in this area increased further. However, last year saw policy concerns emerge with respect to the transparency of over-the-counter market transactions and the potential systemic risks arising from these markets.

Private use of the ECU continued to expand, with bank lending and issuance of international securities rising to record levels. Activity in ECUs appears likely to benefit further from the outcome of the Maastricht Summit.

One notable feature last year was the turnround in banks' business with non-OPEC developing countries. Countries in Asia were again recipients of a large volume of bank credits, while several major Latin American countries returned to the international securities markets, on a scale not seen since the outbreak of the debt crisis. The growing recourse to external finance has accompanied the process of liberalisation of domestic financial markets – including last year the privatisation of many banks – that is under way in many developing countries.

Overview of market activity

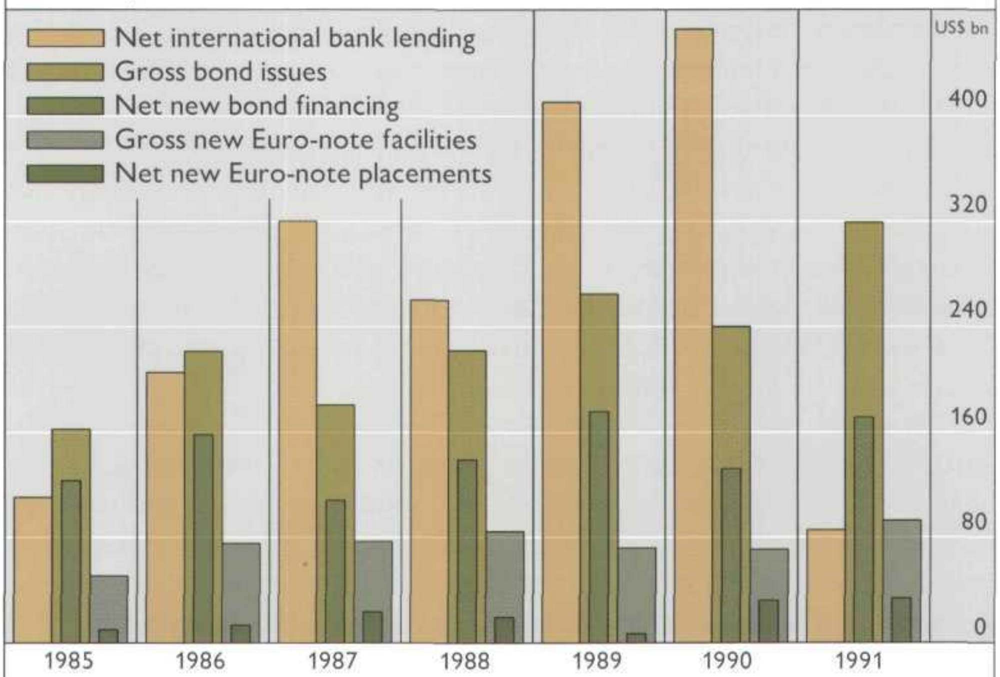
First ever absolute decline in banking aggregates

Last year witnessed the first ever contraction in international banking aggregates. The outstanding total of cross-border and local foreign currency claims of the BIS reporting banks, which had grown at rates in excess of 10% in each of the previous six years, decreased by $102 billion, or 1%. This decline reflected an even sharper cutback in interbank business. Net of the double-counting resulting from interbank operations, the estimated volume of new credit intermediated by the international banking system, at $85 billion, was less than one-fifth of the figure for 1990. There was a pronounced slowdown in final lending to residents within the BIS reporting area, who had been major borrowers from international banks in previous years following the liberalisation of capital controls and financial markets in several countries. However, new lending to outside-area countries, which were less affected by the recession in the industrial countries, recovered somewhat.

Factors behind the contraction

Efforts by banks to strengthen their capital base, heightened perceptions of credit risks in financial markets, the general process of financial restructuring and the cyclical situation appear to have been among the main forces behind the downturn in international banking activity (see Chapter VIII). In particular, banks increasingly perceived interbank activity as yielding low returns while entailing potentially high counterparty risks. Moreover, the deterioration in the quality of many banks' assets encouraged a more cautious attitude towards lending, which was on average reflected in the higher spreads and shorter maturities for new internationally syndicated credits.

Activity in international financial markets



Sources: Bank of England, International Securities Market Association (ISMA), Euroclear and BIS calculations.

Estimated net financing in international markets

Components of net international financing	Changes[1]						Stocks at end-1991
	1986	1987	1988	1989	1990	1991	
	in billions of US dollars						
Total cross-border claims of reporting banks[2]	509.5	601.8	436.1	684.9	608.3	− 56.4	6,239.9
Local claims in foreign currency	147.7	163.0	74.8	122.2	105.9	− 45.6	1,257.3
minus: Double-counting due to redepositing among the reporting banks	*452.2*	*444.8*	*250.9*	*397.1*	*249.2*	*−187.0*	*3,887.2*
A = Net international bank lending[3]	205.0	320.0	260.0	410.0	465.0	85.0	3,610.0
B = Net new Euro-note placements	13.4	23.4	19.5	6.9	32.0	33.7	144.9
Total completed international bond issues	220.9	180.3	221.6	264.6	239.8	318.9	
minus: Redemptions and repurchases	*63.2*	*72.7*	*82.6*	*89.2*	*107.9*	*147.8*	
C = Net international bond financing	157.7	107.6	139.0	175.4	131.9	171.1	1,651.4
D = A + B + C = Total international financing	376.1	451.0	418.5	592.3	628.9	289.8	5,406.3
minus: Double-counting[4]	*81.1*	*51.0*	*68.5*	*77.3*	*78.9*	*34.8*	*606.3*
E = Total net international financing	295.0	400.0	350.0	515.0	550.0	255.0	4,800.0

[1] Non-dollar flow banking data are converted into dollars at constant end-of-quarter exchange rates, and non-dollar bonds at rates ruling on announcement dates. Stock data are converted at current exchange rates. [2] Banks in the Group of Ten countries plus Luxembourg, Austria, Denmark, Finland, Ireland, Norway, Spain, the Bahamas, Bahrain, the Cayman Islands, Hong Kong, the Netherlands Antilles and Singapore, and the branches of US banks in Panama. [3] In addition to direct cross-border claims on end-users, these estimates include certain interbank positions: firstly, claims on banks outside the reporting area, the assumption being that these "peripheral" banks will not, in most cases, borrow the funds from banks in the financial centres simply for the purpose of redepositing them with other banks in these centres; secondly, claims on banks within the reporting area to the extent that these banks switch the funds into domestic currency and/or use them for direct foreign currency lending to domestic customers; thirdly, a large portion of the foreign currency claims on banks in the country of issue of the currency in question, e.g. dollar claims of banks in London on banks in the United States; here again the assumption is that the borrowing banks obtain the funds mainly for domestic purposes and not for re-lending abroad. [4] International bonds taken up by the reporting banks, to the extent that they are included in the banking statistics as claims on non-residents; bonds issued by the reporting banks mainly for the purpose of underpinning their international lending activities.

Further growth of off-balance-sheet activity...

At the same time, banks stepped up their use of derivative instruments, which can substitute for on-balance-sheet operations but involve less credit risk. Measured against the international assets of BIS reporting banks, the identified outstanding notional value of derivative contracts on interest rates and currencies can be estimated to have risen to nearly 100% by the end of 1991, from 75% a year earlier. Although precise data are not available on their direct involvement in derivatives, banks are the main intermediaries in the over-the-counter markets. They are also active on organised exchanges, accounting for well over one-third of outstanding sales and purchases of the Euro-dollar interest rate contract, the financial future with the largest volume of open positions.

... and surge in bond issues following the end of the Gulf war

The end of the uncertainties connected with the Gulf war and the ensuing decline in long-term interest rates on most currencies led many borrowers to refinance their debt in the bond markets and reduce their recourse to bank credit. Expectations of further falls in interest rates boosted investors' demand and contributed to the sharp expansion in bond financing. The volume of new international bond issues completed soared to $319 billion, one-third more than in 1990 and well above the previous peak. Activity was particularly buoyant in the first half of the year, when a number of very large issues were made by sovereign entities and the equity-related sector experienced a temporary revival. Only the issuance of floating rate notes remained depressed throughout the year. Overall issuing activity was, however, accompanied by a 37% increase in bond redemptions, which reached a new peak of nearly $150 billion. As a result, net international bond financing failed to match the all-time high recorded in 1989.

At the shorter end of the maturity spectrum the net volume of funds raised in the market for Euro-notes, at $34 billion, was slightly higher than in the previous year. Within the total there was a further shift away from short-term Euro-commercial paper towards the medium-term note sector.

Impact of developments in Japan

The international financial markets were once again strongly influenced by developments in Japan. Firstly, the decline in domestic property prices and the ensuing problems of some non-bank financial intermediaries reduced the demand for credit by Japanese residents, which in the preceding years had been partly channelled through the international banking system. Secondly, the depressed state of the Tokyo stock market in the second half of 1991 limited the issuance of equity-related bonds. As a result, Japanese corporations turned increasingly to the domestic and international markets for straight fixed rate bonds. Thirdly, Japanese banks pared their low-return interbank positions in order to improve their profitability and meet the Basle capital adequacy guidelines. The decline in the gross international banking aggregates last year was fully accounted for by a 9% contraction in Japanese banks' balance sheets. Finally, the weakness of the Japanese equity markets also appears to have dampened speculative activity in some yen-denominated derivative markets.

The international banking market

Exceptional contraction in interbank assets ...

The decline in the gross banking aggregates was the net result of a 3% contraction in the first half of the year, zero growth in the third quarter and a 2% recovery – partly of a seasonal nature – in the fourth quarter. The exceptional decrease in interbank claims within the reporting area was concentrated in the major currencies (US dollar, sterling, Japanese yen and Deutsche Mark), while in several other currency sectors, such as the French franc, the ECU, the Italian lira and the Dutch guilder, interbank activity remained brisk.

... due to efforts to strengthen balance sheets

The pronounced contraction in activity in the international interbank market was due in large measure to banks' efforts to comply with the Basle capital accord and raise their return on assets. As already mentioned, Japanese institutions, which in recent years had made the greatest use of the interbank market as a source of funding and for position-taking, were the most active in cutting back their interbank lines. Indeed, the $145 billion absolute decline in interbank claims between Japan and other inside-area centres more than fully accounted for the decrease in cross-border interbank business, and virtually the full amount of the contraction in foreign currency claims in local markets took place between banks in Japan. The lower demand for interbank funding was also a consequence of the reduction in syndicated lending activity, especially that for the financing

Main features of international banking activity					
Uses and sources of international bank credit	Changes, excluding exchange rate effects				Stocks at end-1991
	1988	1989	1990	1991	
	in billions of US dollars				
A = Claims on outside-area countries	13.5	− 1.7	−11.9	7.5	755.5
of which: On non-banks	*−4.4*	*−11.7*	*− 9.6*	*− 2.0*	*396.0*
B = International claims on entities within the reporting area	496.4	793.8	680.8	−100.8	6,593.6
(1) Claims on non-banks	*159.9*	*229.7*	*284.4*	*104.2*	*1,851.4*
(2) Banks' own use of international interbank funds for domestic lending	*85.6*	*167.0*	*147.2*	*− 18.0*	*855.0*
(3) Interbank redepositing	*250.9*	*397.1*	*249.2*	*−187.0*	*3,887.2*
C = Unallocated	1.1	15.0	45.4	− 8.7	148.0
D = A + B + C = Total gross international bank assets	510.9	807.1	714.2	−102.0	7,497.2
E = D − B *(3)* = Estimated net international bank credit	260.0	410.0	465.0	85.0	3,610.0
A = Liabilities to outside-area countries	41.5	57.6	92.2	− 12.6	725.4
of which: To non-banks	*21.5*	*29.7*	*37.7*	*− 12.7*	*316.2*
B = International liabilities to entities within the reporting area	460.9	720.4	626.2	−202.6	6,246.8
*(1) Liabilities to non-banks**	*66.2*	*158.1*	*175.7*	*13.6*	*1,264.4*
(2) Banks' own supply of domestic funds to the international interbank market	*119.0*	*148.6*	*165.1*	*27.9*	*1,233.7*
(3) Interbank redepositing	*275.7*	*413.7*	*285.4*	*−244.1*	*3,748.7*
C = Unallocated	33.3	45.7	32.0	56.1	386.5
D = A + B + C = Total gross international bank liabilities	535.7	823.7	750.4	−159.1	7,358.7

* As from 1990 including trustee funds channelled into the market via banks in Switzerland.

of mergers and acquisitions. Changes in the funding strategies of banks were reflected in a narrowing of the spread between interest rates on Euro-deposits and Treasury bill rates.

Marked slowdown in business with non-banks ...

Within the smaller volume of new lending, final credits intermediated by the international banking system went primarily to the reporting area, albeit to a lesser extent than in preceding years. Direct lending to non-banks within this area fell from nearly $285 billion in 1990 to just short of $105 billion, while banks repaid $18 billion which they had channelled from the international to their domestic markets. Identified claims on outside-area countries increased by $8 billion, after declining by $14 billion in the two preceding years. On the sources side of banks' balance sheets, new deposits by non-banks within the reporting area, at $14 billion, were only 8% of the amount recorded in 1990. At the same time, outside-area countries drew down their deposits by $13 billion, while official monetary institutions reduced their reserve holdings with the reporting banks by $24 billion.

... but resumption of lending to outside-area countries

The nationality structure of international banking activity

Japanese banks' domestic and foreign offices were responsible for more than the whole of the $105 billion decrease in the current dollar value of

Sharp reduction in the international activities of Japanese banks ...

the international claims of reporting banks in industrial countries (adjusted data are not available for individual nationality groups of reporting institutions but exchange rate effects were not very large last year). Their share in total outstanding positions slipped by a further 2.5 percentage points to 31% at the end of 1991, from a peak of 38% in 1988. The decline in the international positions of Japanese banks last year is especially striking when it is compared with earlier developments. Between the end of 1985 and the end of 1989 Japanese banks had expanded their international assets at an average annual rate of nearly 30%, with 41% of this build-up being accounted for by the growth of positions between related offices. The main driving forces behind this strong growth had been competition for market share and the arbitrage opportunities offered by the gradual

Types of international bank assets and liabilities, by nationality of banks*

Nationality	Change in current dollars in 1990				Change in current dollars in 1991				Total stocks at end-1991
	Total	of which vis-à-vis			Total	of which vis-à-vis			
		Related offices	Non-related banks	Non-banks		Related offices	Non-related banks	Non-banks	
	in billions of US dollars								
Japanese banks									
Assets	152.9	71.5	49.9	31.6	−190.0	−61.0	− 98.4	−30.6	1,931.5
Liabilities	132.4	35.6	56.4	40.3	−232.3	−53.2	−159.2	−19.9	1,824.5
US banks									
Assets	−15.3	10.1	−30.2	4.8	− 2.4	−22.2	− 3.3	23.1	711.6
Liabilities	− 2.1	14.3	− 5.9	−10.5	1.5	−40.1	16.2	25.4	743.7
German banks									
Assets	163.9	36.8	85.0	41.9	29.6	14.6	− 7.7	22.7	636.6
Liabilities	130.2	34.5	41.8	53.9	28.8	14.4	− 1.3	15.7	485.5
French banks									
Assets	122.3	39.3	49.8	33.2	− 10.5	10.6	− 3.2	−17.9	542.6
Liabilities	154.1	52.6	49.0	52.5	5.6	− 2.6	− 3.1	11.2	613.8
Italian banks									
Assets	73.4	8.8	27.3	37.3	21.7	7.1	− 1.5	16.1	348.8
Liabilities	74.1	10.8	42.5	20.9	27.0	10.3	12.0	4.8	356.0
UK banks									
Assets	25.2	0.0	20.8	4.4	− 12.5	− 1.9	− 17.1	6.5	260.2
Liabilities	13.2	0.3	11.6	1.3	− 9.6	− 2.6	− 4.2	− 2.9	312.0
Other									
Assets	322.9	88.3	129.5	105.2	59.4	7.1	21.6	30.7	1,715.5
Liabilities	378.3	77.7	110.1	190.6	33.1	33.6	3.7	− 4.1	1,748.2
Total									
Assets	845.3	254.8	332.1	258.4	−104.7	−45.7	−109.6	50.6	6,146.8
Liabilities	880.2	225.8	305.5	349.0	−145.9	−40.2	−135.9	30.2	6,083.7

* The table shows the cross-border positions in all currencies plus the foreign currency positions vis-à-vis local residents of banks in the following seventeen countries: Austria, Belgium, Luxembourg, Canada, Denmark, Finland, France, Germany, Ireland, Italy, Japan, the Netherlands, Spain, Sweden, Switzerland, the United Kingdom and the United States (cross-border positions in domestic currency only). The figures for US banks also include the cross-border positions reported by US banks' branches in the Bahamas, the Cayman Islands, Panama, Hong Kong and Singapore. The international assets and liabilities in this table are classified according to the nationality of ownership of the reporting banks. Non-bank positions include official monetary institutions and, on the liabilities side, banks' issues of CDs and other securities.

liberalisation of domestic financial markets, especially after the opening of the Japan Offshore Market (JOM) at the end of 1986. In fact, a large proportion of the funds exported by banks out of Japan were rechannelled to domestic borrowers via foreign affiliates. More recently, the need to comply with the new capital adequacy ratios, the elimination of many distortions in domestic markets and a growing awareness of credit risks have caused Japanese banks to revise their strategies. In 1990 they already trimmed their cross-border lending out of Japan and cut back the positions of their US affiliates, although at the same time they continued to expand their presence in continental European centres.

... and the main factors behind it

In 1991 the further decline of the Tokyo equity market, which reduced the value of latent reserves included in banks' tier 2 capital, the weakening of domestic credit demand and the abolition of the Bank of Japan's quantitative guidelines on yen-denominated lending to residents precipitated a sharp adjustment. 45% of the total $190 billion contraction in Japanese banks' international assets last year took place on the local foreign currency market in Tokyo, while another 38% was due to the reduction in the books of their European affiliates. Over two-thirds of the contraction was accounted for by a scaling-back of claims on non-related banks and on non-bank customers. The decline in Japanese banks' positions in the international interbank market was larger on the liabilities side of their balance sheets and, as a result, the outstanding net borrowing of Japanese banks from non-related banks in the international market dropped from $226 billion at the end of 1990 to a thirty-month low of $166 billion at the end of last year.

Slowdown in activity of other nationality groups ...

The retrenchment by Japanese banks had a general impact on the market, but a number of other influences also contributed to a slowdown in the activity of banks of other nationalities. Following record growth in 1990, the international claims of French, Finnish and Swedish banks either stagnated or declined. In 1990 the international assets of French banks had increased by nearly 30% as French residents diverted a large volume of domestic business to the international market in the wake of the dismantling of the remaining foreign exchange restrictions. As a result of the lowering of reserve requirements in October 1990, however, there were large-scale reflows to the domestic market and last year the international claims of French banks fell by $11 billion. This contraction was more than accounted for by an absolute decline in claims on non-bank entities. Last year UK, US and Canadian banks scaled back their international lending as they raised provisions for loan losses. After excluding certain off-balance-sheet commitments reported by a few banks in London on their balance sheets, the actual contraction in the outstanding international assets of US banks can be estimated at about $30 billion. With the exception of Austrian banks, all other nationality groups recorded a reduction in the rate of growth of their international business, particularly in the interbank market. The most significant slowdowns were recorded for German (from 38 to 5%), Italian (from 29 to 7%) and Danish (from 29 to 4%) banks.

Developments in individual market centres

... and in most major financial centres

Banks in the United Kingdom, where Japanese institutions account for 30% of external claims, and banks in Japan recorded the largest declines in cross-border assets last year, primarily as a result of repayments of earlier borrowings in dollars.

There were also sizable contractions in the outstanding claims of banks in France, Switzerland and Canada, and in virtually all other centres growth slowed down markedly. Banks in the United States represent the major exception, owing to a revival in cross-border lending by the US offices of non-US banks. As a consequence of the reduction in reserve requirements in early 1991, banks in the United States tended to shift their external assets from their IBF books to their onshore accounts.

Since the contraction in their external liabilities was much more pronounced than that in their assets, banks in Japan moved from a $8 billion net external liability position at the end of 1990 to a net creditor position

Developments in individual reporting market centres: assets

Positions of banks in	Changes, excluding exchange rate effects						Stocks at end-1991		
	1990			1991			External positions in		Local positions in foreign currency
	External positions in		Local positions in foreign currency	External positions in		Local positions in foreign currency	domestic currency	foreign currency	
	domestic currency	foreign currency		domestic currency	foreign currency				
	in billions of US dollars								
United Kingdom	9.0	77.1	25.9	−10.0	−41.9	14.9	84.3	934.3	329.7
France	8.9	55.8	−2.3	5.5	−21.6	− 9.9	72.4	336.4	67.5
Germany	29.6	42.9	3.0	− 6.4	16.6	1.3	234.8	148.3	9.1
Luxembourg	0.9	40.5	6.1	0.7	17.7	0.7	5.5	307.3	50.4
Belgium	1.9	20.9	4.9	3.2	− 1.6	1.7	17.2	181.7	57.7
Netherlands	0.5	21.3	1.7	6.3	0.9	9.9	39.5	140.2	35.9
Switzerland	10.4	35.4	0.3	− 8.2	1.7	− 0.2	103.1	291.4	19.6
Sweden	− 1.9	4.7	21.7	0.4	− 0.9	− 3.8	2.2	32.1	70.2
Other European countries	− 7.4	26.9	24.8	7.5	9.7	18.9	42.1	234.0	170.1
Total European reporting countries	51.9	325.5	86.1	− 1.0	−19.4	33.5	601.1	2,605.7	810.2
Japan: Offshore market	18.6	34.0	25.0	31.5	−50.0	−21.0	263.0	230.0	71.0
Other	1.3	18.7	−9.5	−10.7	− 6.7	−56.6	205.5	243.9	347.6
United States: IBFs	−38.5	−6.2	0.0	−17.2	3.5	0.0	234.2	56.4	0.0
Other	15.2	1.4	0.0	18.8	1.8	0.0	279.8	16.7	0.0
Asian market centres	2.2[1]	115.3[2]	..	0.9[1]	− 6.2[2]	..	7.8[1]	833.1[2]	..
Other centres[3]	0.3[4]	68.7	4.4[4]	− 0.7[4]	− 1.0	− 1.5[4]	3.8[4]	659.0	28.5[4]
Total	50.9	557.4	105.9	21.6	−78.0	−45.6	1,595.1	4,644.8	1,257.3

[1] Hong Kong only. [2] Including Bahrain. [3] Including Canada. [4] Canada only.

of nearly $97 billion a year later. This large net capital outflow through the Japanese banking system was the counterpart to the country's current account surplus, the surge of foreign investment in Japanese long-term securities and the lending to Japanese residents by the foreign affiliates of Japanese banks. Last year witnessed a further $33 billion increase in the net external liability position of banks in France owing to large reflows of foreign currency funds from abroad and the growing recourse by French banks to the international securities markets. Elsewhere, net foreign currency borrowing by banks in Italy amounted to $13 billion, whereas significant repayments on a net basis were made by banks in the Scandinavian countries. There was also a $11 billion reduction in the net external asset position in Deutsche Mark of banks located in Germany.

Large net capital outflows through banks in Japan

Banks' direct business with non-bank entities within the reporting area

The cyclical downturn in economic activity was the key factor in the

Developments in individual reporting market centres: liabilities

Positions of banks in	Changes, excluding exchange rate effects						Stocks at end-1991		
	1990			1991			External positions in		Local positions in foreign currency
	External positions in		Local positions in foreign currency	External positions in		Local positions in foreign currency	domestic currency	foreign currency	
	domestic currency	foreign currency		domestic currency	foreign currency				
	in billions of US dollars								
United Kingdom	30.2	74.3	36.6	−15.9	−27.5	5.4	156.2	998.6	289.6
France	40.9	47.2	−12.3	17.8	− 1.2	− 6.7	115.7	381.4	56.6
Germany	15.1	31.7	3.7	5.0	7.3	− 0.6	129.2	106.7	10.1
Luxembourg	0.8	35.4	7.8	0.1	11.5	5.3	5.2	275.8	67.7
Belgium	2.3	13.1	8.2	− 1.7	− 4.4	2.0	20.8	188.5	49.4
Netherlands	2.0	18.1	4.3	4.2	− 2.5	0.8	28.5	120.0	34.0
Switzerland	15.4	27.4	7.6	− 1.8	1.9	− 2.8	68.8	248.1	62.2
Sweden	− 0.4	21.8	4.0	− 0.1	− 6.8	− 1.3	4.0	89.2	11.0
Other European countries	1.6	39.2	15.3	3.2	24.8	11.7	46.7	380.1	69.0
Total European reporting countries	107.9	308.2	75.2	10.8	3.1	13.8	575.1	2,788.4	649.6
Japan: Offshore market	9.5	28.0	30.0	−25.5	−34.0	−38.0	118.0	248.0	52.0
Other	− 6.1	15.6	− 2.5	−35.9	−32.6	− 2.8	152.5	327.2	321.6
United States: IBFs	−16.4	−4.3	0.0	−20.0	4.6	0.0	297.8	60.9	0.0
Other	17.1	1.0	0.0	16.1	0.4	0.0	282.8	14.0	0.0
Asian market centres	2.0[1]	99.2[2]	..	3.6[1]	−23.8[2]	..	16.3[1]	755.4[2]	..
Other centres[3]	0.7[4]	84.4	0.9[4]	− 1.6[4]	2.8	− 0.3[4]	8.4[4]	679.5	11.3[4]
Total	114.7	532.1	103.6	−52.4	−79.5	−27.2	1,450.9	4,873.4	1,034.4

[1] Hong Kong only. [2] Including Bahrain. [3] Including Canada. [4] Canada only.

BIS reporting banks' claims on non-bank entities in the Group of Ten countries

Claims on non-bank entities in	Changes, excluding exchange rate effects						Stocks at end-1991		
	Cross-border positions		Local positions in foreign currency		*Memo item: Domestic bank credit**		Cross-border positions	Local positions in foreign currency	*Memo item: Domestic bank credit**
	1990	1991	1990	1991	*1990*	*1991*			
	in billions of US dollars								
United States	50.1	6.1	0.0	0.0	*1.3*	*−9.0*	278.2	0.0	*4,337.5*
Japan	63.7	44.1	8.4	−19.8	*351.5*	*133.7*	250.4	206.1	*4,998.1*
Germany	2.5	9.7	1.5	1.7	*141.7*	*174.9*	92.4	6.2	*2,084.9*
France	5.6	2.2	0.8	− 0.1	*108.4*	*36.0*	31.7	21.0	*1,602.1*
Italy	23.3	8.0	5.0	9.1	*69.4*	*80.8*	81.9	60.6	*848.0*
United Kingdom	10.8	5.6	8.5	16.2	*127.2*	*55.4*	60.3	148.7	*1,167.6*
Canada	8.3	3.3	4.2	− 1.9	*21.9*	*30.8*	38.3	25.7	*312.0*
Netherlands	15.8	4.6	1.9	10.1	*15.8*	*15.7*	60.8	27.9	*346.0*
Sweden	4.9	1.5	17.9	− 1.1	*2.0*	*11.5*	20.8	65.0	*140.6*
Switzerland	4.5	−1.3	1.4	0.2	*26.7*	*17.5*	24.0	14.2	*347.3*
Belgium-Luxembourg	3.4	0.9	0.4	− 1.2	*15.8*	*9.8*	29.1	34.9	*320.7*

* Excluding lending in foreign currency.

Marked weakening of credit demand in the industrial world ...

marked weakening of credit demand in the industrial world last year. Following several years of very strong growth, non-bank entities inside the reporting area cut back their new borrowing in the international market by over 60%. The most dramatic decline was recorded for cross-border lending to US non-banks. In 1990 $50 billion of new credits, largely from non-US banks in the Caribbean offshore centres, had to some extent offset the pronounced reduction in domestic bank lending. Last year, however, cross-border credits to US residents amounted to only $6 billion.

Reflecting the slowdown in Japanese economic growth and the end of the real estate boom, cross-border lending to Japanese entities, at $44 billion, was 30% less than in 1990. The affiliates of Japanese banks in the offshore centres in Asia continued to be the main source of these external funds. At the same time, following the lifting of the ceilings on yen-denominated domestic bank credit, Japanese non-banks paid back $20 billion of foreign currency loans which they had taken up previously from domestic banks.

In Europe, after several years of strong growth, borrowing by non-banks externally or in foreign currency from domestic banks fell back sharply in most countries. In France and Italy, where the portfolio adjustments following the dismantling of capital controls appear to have run their course, narrowing interest rate differentials vis-à-vis the Deutsche Mark, the economic slowdown and a shift towards financing through the securities markets were the main forces behind the decline in non-bank recourse to the international banking market. Indeed, banks' cross-border lending to Italian residents was channelled entirely through the Euro-lira market. The severity of the recession and changes in exchange rate expectations contributed to the abrupt turnround by non-banks from the Scandinavian

... particularly in Scandinavian countries ...

countries, which, having borrowed $36 billion externally or in foreign currency at home in 1990, paid back nearly $4 billion last year. The only country in which non-banks recorded a vigorous expansion in borrowing was Germany. Declining corporate cash flows in the face of strong domestic investment demand were the key factor behind the continued recourse to international bank credit. Reported new lending to UK non-bank residents also rose strongly, but the majority of such credits related to a build-up of certain off-balance-sheet commitments by a few banks.

... but increasing borrowing by German non-banks

Stagnation of non-bank deposits

On the sources side of banks' balance sheets, the growth of deposits by non-bank entities came to a near-halt. Cross-border deposits by non-banks from inside the reporting area stagnated, while local foreign currency deposits increased by $13.3 billion (5%), or one-third as much as in 1990. The only sizable expansion in cross-border deposits was recorded by German residents ($11.6 billion), but it was on a much smaller scale than in 1990. More than the whole of this increase occurred in the first half of the year, whereas later in the year German residents drew down their balances abroad by $9.7 billion. Italian and UK residents built up their international deposits by 12 and 6% respectively, much less than in 1990.

The $12 billion of withdrawals of Euro-dollar deposits by US residents appears to have been due in part to the narrowing of the differential between Euro-dollar deposit rates and domestic Treasury bill yields. Moreover, the lowering of reserve requirements in the United States in early 1991 reduced the attractiveness of Euro-dollar accounts relative to domestic deposits. Japanese and Canadian residents also repatriated funds from banks abroad.

The international banking market as a deposit outlet for non-bank entities in the Group of Ten countries

Liabilities vis-à-vis non-bank entities in	Changes, excluding exchange rate effects						Stocks at end-1991		
	Cross-border positions		Local positions in foreign currency		*Memo item: Broad monetary aggregates**		Cross-border positions	Local positions in foreign currency	*Memo item: Broad monetary aggregates**
	1990	1991	1990	1991	*1990*	*1991*			
	in billions of US dollars								
United States	22.1	−12.2	0.0	0.0	*60.0*	*65.5*	272.8	0.0	*4,101.8*
Japan	−2.0	− 5.9	..	..	*241.4*	*91.0*	17.7	..	*4,122.5*
Germany	28.8	11.6	2.1	−0.4	*46.7*	*64.3*	136.0	7.0	*1,053.8*
France	12.3	− 0.1	−6.5	−0.9	*77.8*	*17.9*	44.7	11.5	*991.0*
Italy	7.3	3.2	0.9	1.0	*101.4*	*123.5*	33.8	5.6	*1,209.0*
United Kingdom	14.3	3.9	19.5	5.5	*90.5*	*50.7*	70.5	102.3	*938.8*
Canada	6.2	− 3.6	0.5	−0.5	*19.8*	*15.2*	16.5	8.6	*288.9*
Netherlands	1.6	4.5	3.9	1.4	*9.7*	*6.3*	56.7	25.8	*146.1*
Sweden	−0.1	0.6	0.6	−0.1	*10.8*	*4.8*	5.0	4.9	*119.6*
Switzerland	10.6	0.2	6.6	−0.6	*8.1*	*9.0*	67.5	54.1	*284.8*
Belgium-Luxembourg	7.5	− 1.5	5.3	3.9	*7.1*	*8.5*	35.6	44.0	*181.4*

* M_2 for the Netherlands, M_2+CDs for Japan, M_4 for the United Kingdom, M_3-overnight and term Euro-dollars for the United States, total liquid assets for Italy, M_3 for other countries.

Developments in business with countries outside the reporting area

After declining in 1989 and 1990, banks' claims on countries outside the reporting area edged up by $8 billion last year, while outstanding deposits by this group of countries, which had surged by a cumulative $240 billion over the preceding four years, fell by $13 billion. There was a sizable volume of new credits to Mexico and to some Asian countries, but identified claims on most other developing countries decreased. Indeed, one salient feature, which is dealt with in further detail in the last section of this chapter, was the contrast between banks' credit relations with Latin American countries other than Mexico, which continued to stagnate or decrease, and the continuing buoyancy of activity in Asia.

Contraction in outstanding claims on countries in the Middle East ...

Elsewhere in the developing world, there were major changes in banks' business with OPEC and non-OPEC countries in the Middle East. With the exceptions of Iran, Saudi Arabia and Qatar, banks' claims on all Middle Eastern countries declined. At the same time, nearly all countries within the group reduced their deposits with the reporting banks. However, Egypt and Jordan, which received a sizable volume of funds from other Arab countries, increased their deposits and strengthened their net asset positions vis-à-vis the banks. By far the largest decline in deposits was recorded for Kuwait ($6.2 billion).

Several factors contributed to this downturn. The Gulf conflict left countries in the region with extensive damage and huge reconstruction costs. Moreover, they suffered from lower oil prices and, with the exception of Saudi Arabia, Iran and Oman, reduced crude oil shipments. The repercussions of the BCCI affair disrupted banking business in several countries and affected the financial links between the major centres in the region. Finally, in anticipation of possible United Nations economic sanctions, Libya drew down its deposits by $1.9 billion in the fourth quarter of 1991. The withdrawals from banks in industrial reporting countries alone were even larger ($2.5 billion).

... and eastern Europe

The $1.7 billion decline in banks' outstanding claims on eastern Europe understates the retrenchment in lending to most of these countries. While claims on the former Soviet Union rose on balance by $1.3 billion, they would in fact have fallen by about $4 billion had it not been for a large volume of officially guaranteed new credits, the bulk of which came from Germany. The largest declines in claims were recorded vis-à-vis Hungary ($1.5 billion) and Czechoslovakia ($0.8 billion). Both countries reported current account surpluses in convertible currencies, enjoyed substantial capital inflows, increased their exchange reserves and added to their deposits with the banks ($1.9 and 1.4 billion respectively). By contrast, in the face of a sharp turnround in its current account balance and a dearth of new credits, Poland's deposits with the reporting banks fell by $2.5 billion.

Finally, banks' new lending to developed countries outside the reporting area amounted to a mere $0.5 billion. On a net basis sizable inflows of new funds from the reporting banks were recorded for Portugal ($3.6 billion) and New Zealand ($1.5 billion). Outstanding claims and

BIS reporting banks' business with countries outside the reporting area									
Positions of banks vis-à-vis	Changes, excluding exchange rate effects								Stocks at end-1991
	1984	1985	1986	1987	1988	1989	1990	1991	
	in billions of US dollars								
Borrowing from reporting banks									
Non-reporting developed countries	5.2	7.3	7.2	4.8	2.1	2.9	6.0	0.5	149.3
Eastern Europe	−0.1	5.7	3.7	2.3	8.3	9.3	−9.9	−1.7	92.2
of which: former Soviet Union	*1.6*	*3.7*	*3.6*	*0.3*	*5.5*	*7.5*	*−6.2*	*1.3*	*54.0*
OPEC	−2.1	0.2	0.5	2.2	5.4	5.7	−2.3	−4.6	133.5
of which: Middle East	*0.3*	*−1.4*	*−0.9*	*2.2*	*4.5*	*7.6*	*−0.7*	*−6.7*	*54.1*
Non-OPEC LDCs	9.7	11.0	3.1	2.2	−2.4	−19.6	−5.7	13.3	380.6
*of which: Latin America**	*5.3*	*1.7*	*1.5*	*−3.7*	*−5.0*	*−16.7*	*−23.0*	*−0.9*	*186.4*
Asia	*4.8*	*8.1*	*2.6*	*7.7*	*3.9*	*0.3*	*18.0*	*17.8*	*159.0*
Africa	*0.1*	*0.9*	*−0.2*	*−0.6*	*−0.6*	*−1.8*	*0.0*	*−1.6*	*22.2*
Middle East	*−0.4*	*0.3*	*−0.8*	*−1.1*	*−0.7*	*−1.4*	*−0.7*	*−2.0*	*12.9*
Total borrowing	12.8	24.1	14.4	11.6	13.5	−1.7	−11.9	7.5	755.5
Deposits with reporting banks									
Non-reporting developed countries	2.7	3.5	7.4	6.1	13.4	17.3	7.8	−3.5	106.6
Eastern Europe	4.3	2.8	0.2	−0.7	4.1	0.2	−5.9	1.3	22.1
of which: former Soviet Union	*1.7*	*0.9*	*0.8*	*−1.9*	*1.8*	*−0.7*	*−6.6*	*0.3*	*8.8*
OPEC	4.0	6.6	−22.1	19.2	11.6	14.4	25.4	−14.0	233.5
of which: Middle East	*1.0*	*0.8*	*−13.5*	*17.5*	*12.0*	*9.5*	*18.0*	*−17.6*	*180.3*
Non-OPEC LDCs	19.3	5.7	12.9	24.2	12.4	25.7	64.9	3.7	363.1
*of which: Latin America**	*10.1*	*0.4*	*0.7*	*6.7*	*3.4*	*4.6*	*19.0*	*−2.9*	*115.4*
Asia	*9.8*	*2.5*	*13.1*	*14.0*	*7.7*	*16.5*	*34.6*	*2.1*	*174.9*
Africa	*1.0*	*1.4*	*0.0*	*1.6*	*1.5*	*1.7*	*3.7*	*−0.7*	*26.0*
Middle East	*−1.6*	*1.4*	*−0.9*	*1.9*	*−0.2*	*2.9*	*7.6*	*5.1*	*46.9*
Total deposits	30.3	18.6	−1.6	48.7	41.5	57.6	92.2	−12.6	725.4

* Including those countries in the Caribbean area which are not classified as offshore banking centres.

liabilities vis-à-vis the former Yugoslavia fell by $1.7 billion and $2.9 billion respectively. At the end of 1991 its deposits stood at only $4.9 billion, half the level at the end of September 1990.

The syndicated credit market

Reduced volume of new syndicated credit facilities ...

The recession in the industrial world, the specific uncertainties and tensions affecting international banking, and the receptiveness of the bond markets had a strong impact on syndicated lending. Last year announced new facilities declined by 14% to $137 billion, and of this total $20 billion alone was accounted for by jumbo credits arranged for Saudi Arabia, Kuwait and one US company. Terms on new lending hardened: average spreads rose to 77 basis points, the widest margin yet recorded, and the average maturity of new facilities fell to an all-time low of five years and four months. Banks also reportedly tightened covenants on new credits and required better gearing ratios from borrowers. The shift away from highly leveraged transactions was reflected in the low volume of facilities arranged for mergers and acquisitions, which shrank to less than $5 billion from $62 billion in 1989 and $29 billion in 1990.

... but resurgence in lending to developing countries

Despite the overall unfavourable market conditions last year, there was a marked resurgence in syndicated lending to developing countries, with major financings being arranged for Indonesia, South Korea, Mexico and Thailand. OECD countries received only two-thirds of new financing. Very pronounced declines were recorded in new syndicated loan facilities arranged for UK borrowers, which made greater recourse to bilateral credits, and for Italian entities, which were temporarily shut out of the market following a dispute over the status of government guarantees in the case of a major insolvency proceeding. There was also a pronounced shift by Canadian borrowers from the syndicated credit market to the international bond market.

The international securities market

The short and medium-term note market

Signs of consolidation in the short-term Euro-note market and shift to non-dollar issuance

New placements of short and medium-term Euro-notes accounted for 17% of the net volume of new funds raised in the international securities markets last year, against 20% in 1990. At the shorter end of the maturity spectrum, largely comprising Euro-commercial paper (ECP), the outstanding volume of Euro-notes rose by 19% to $106.4 billion. Over 40% of these net new placements were denominated in currencies other than the dollar, with a considerable volume of issuance being in ECUs and Italian lire. Despite the strong growth last year, there were indications of a consolidation in this market sector. Announced new programmes for the issuance of short-term Euro-notes declined to $38 billion, the lowest level since 1984. Moreover, net new placements of ECP were concentrated in the first quarter, with activity tailing off thereafter. Intensified concern about the credit standing of issuers tended to restrict the eligible pool of new borrowers and contributed to the better performance of underwritten paper relative to ECP in the latter part of the year.

Contraction in major domestic CP markets ...

... and the special reasons for it ...

The further expansion in the market for short-term Euro-notes contrasts with developments in many domestic commercial paper (CP) markets. After several years of very rapid growth the volume of commercial paper outstanding in domestic markets contracted worldwide, from $813 billion at the end of 1990 to $771 billion at the end of 1991. However, this decrease cannot be ascribed entirely to the recessionary climate or interest rate factors. Instead, it is largely attributable to a number of specific developments in individual countries. In the United States the raising of the minimum credit rating for eligible investments in commercial paper by money market mutual funds and heightened credit risk sensitivities were key factors in the 5% contraction in outstanding paper. In Japan, before 1991 issuers had tapped the market to exploit arbitrage opportunities. Last year the narrowing of interest rate differentials vis-à-vis other instruments reduced the scope for such strategies and contributed to the 16% decline in outstanding commercial paper. In Spain

Domestic and international markets for commercial paper and medium-term notes							
Items	Market opening	1986	1987	1988	1989	1990	1991
		amounts outstanding at end-year, in billions of US dollars[1]					
Commercial paper markets							
United States	pre-1960	325.9	373.6	451.6	521.9	557.8	528.1
Japan	end-1987	–	13.8	73.8	91.1	117.3	99.0
France	end-1985	3.7	7.6	10.4	22.3	31.0	30.8
Spain	1982	6.2	3.9	5.0	7.4	25.6	27.9
Canada	pre-1960	11.9	14.9	21.0	25.0	26.6	26.1
Sweden	1983	3.7	7.8	9.5	15.9	23.1	24.0
Australia[2]	mid-1970s	4.1	7.5	7.9	11.1	10.9	12.2
United Kingdom	1986	0.8	3.8	5.7	5.7	7.5	7.0
Finland	mid-1986	0.4	2.5	4.9	6.9	8.3	5.9
Germany	early 1991	–	–	–	–	–	5.4
Netherlands	1986	0.1	0.9	1.0	0.8	2.0	2.6
Norway	end-1984	0.9	2.1	1.7	2.0	2.3	2.0
Belgium	1990	–	–	–	–	0.1	0.3
Total domestic		357.7	438.4	592.5	710.1	812.5	771.3
Euro-commercial paper	mid-1980s	13.9	33.3	53.2	58.5	70.3	79.6
Other short-term Euro-notes	early 1980s	15.1	16.9	13.5	11.1	19.1	26.8
Total		386.7	488.6	659.2	779.7	901.9	877.7
Medium-term note markets							
United States	early 1970s	35.0[3]	50.0[3]	65.0[3]	75.9	99.7	141.7
Euro-medium-term notes	mid-1980s	0.4	2.6	5.6	9.6	21.9	38.5

[1] Converted at end-year exchange rates, except for Australia. [2] Amounts outstanding at end-June converted at end-June exchange rates. [3] Estimated.

Sources: Euroclear and national authorities.

CP issuance had surged in 1990 owing to the imposition of ceilings on the growth of domestic bank credit and to restrictions on foreign borrowing. Following the lifting of these restrictions last year, the market expanded at a much slower pace. Finally, in France the stagnation of the CP market was due partly to a shift by investment funds (SICAVs) into negotiable CDs following the lowering of reserve requirements in the last quarter of 1990.

... but growth of the new German market

By contrast, the German CP market, in which the first issuing programme was only announced in February 1991, recorded strong growth. At the end of March 1992 DM 28.5 billion of programmes had been established and DM 12.9 billion of securities had been placed in the market. Unlike other domestic markets, such as that for sterling commercial paper, the existing programmes of German borrowers have been heavily utilised. A number of major companies have turned to the CP market because of the lower cost of funding compared with borrowing from domestic banks. Issuing activity has also been underpinned by the attractiveness to investors of the high level of short-term Deutsche Mark interest rates.

The market for Euro-medium-term notes (EMTNs) witnessed a further very pronounced expansion last year. Announcements of new programmes amounted to $54.2 billion, or nearly two and a half times the

Further strong expansion of the EMTN market ...

volume in 1990, and outstanding paper rose by 75%. While the growth in the EMTN market reflected the general shift to longer maturities which occurred in most domestic and international financial markets, other developments also played an important role. Firstly, financial intermediaries committed themselves more fully to the market and attempted to widen the spectrum of investors and issuers. Secondly, the market matured in terms of issuance flexibility, increasing its competitiveness vis-à-vis private placements of Euro-bonds. EMTN facilities benefited from their relatively low cost once they had been established, as well as from the discretion with which new issues could be placed and from the wide spectrum of maturities available. The range of instruments issued under EMTN programmes has also broadened to comprise floating rate notes, and many new issues featured special embedded options. Finally, markets opened up in several new currencies. As a result, 58% of net placements were in currencies other than the dollar, whereas in 1989 the dollar had accounted for over 80% of net new issues. Issuance was especially strong in Italian lire, sterling, ECUs and yen.

... and of domestic markets for medium-term notes

The expansion of the EMTN market was mirrored in the domestic markets. The US market for medium-term notes grew strongly last year, with gross new issues by US entities expanding by 55% to $72 billion. Elsewhere, domestic markets for medium-term notes have been opened in the United Kingdom (1990) and France (1992), but issuance has been modest.

The international bond market

Buoyancy of the international bond market ...

Issue activity and turnover in the international bond market rose to record levels last year. Announced new issues soared to $317 billion, or 31% more than in 1990. The prevalence of expectations of declining interest rates and

Main features of international bond market activity

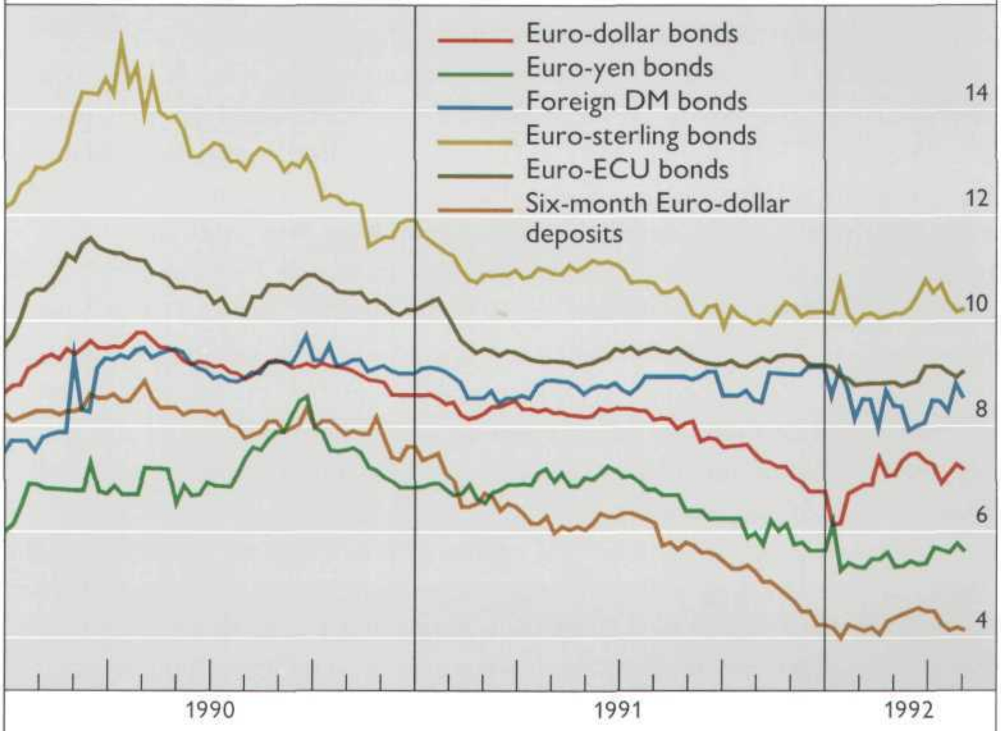
Components	Years			1991				Stocks at end-1991
	1989	1990	1991	Q I	Q II	Q III	Q IV	
	in billions of US dollars							
Total announced gross new issues[1]	262.8	241.4	316.7	91.4	83.4	75.6	66.3	
Straight fixed rate issues	*150.2*	*165.9*	*255.2*	*77.8*	*60.6*	*59.3*	*57.5*	
Floating rate notes	*27.3*	*42.5*	*19.1*	*6.3*	*4.1*	*4.5*	*4.2*	
Equity-related issues[2]	*85.2*	*33.1*	*42.4*	*7.4*	*18.6*	*11.8*	*4.6*	
Total completed gross new issues	264.6	239.8	318.9	83.9	81.5	68.7	84.8	
minus: Scheduled repayments	57.7	86.8	128.2	34.0	27.6	27.5	39.0	
minus: Early repayments	31.5	21.1	19.6	3.6	5.5	3.8	6.7	
= Total net new issues	175.4	131.9	171.1	46.3	48.4	37.4	39.0	1,651.4
Straight fixed rate issues	*89.7*	*80.5*	*142.7*	*41.7*	*33.4*	*26.6*	*41.0*	*1,158.5*
Floating rate notes	*11.0*	*28.3*	*3.2*	*2.5*	*2.1*	*0.7*	*−2.0*	*210.5*
Equity-related issues[2]	*74.8*	*23.1*	*25.2*	*2.1*	*12.9*	*10.1*	*0.0*	*282.4*

[1] Non-dollar bonds are converted into dollars at exchange rates prevailing on announcement dates. [2] Convertible bonds and bonds with equity warrants.

Sources: Bank of England, ISMA and BIS.

Yields of selected international bonds*
and Euro-dollar deposit rates

Wednesday figures, in percentages



* Yields in annual terms for a sample of bonds with an average life of five years.

diminishing concern about the inflation outlook boosted investors' demand for straight fixed rate bonds, whereas new issues of floating rate notes (FRNs) contracted markedly. There was a revival in issuance of equity-related bonds from the low levels recorded in 1990, but the bulk of new offerings was concentrated in the summer following the short-lived recovery of the Tokyo stock market.

... owing in part to increasing redemptions

A very sizable share of new issues replaced maturing or existing bonds. Moreover, the volume of scheduled redemptions, which amounted to $128 billion in 1991, is expected to increase further to about $190 and 270 billion in 1992 and 1993. One-quarter of the bonds maturing in these years are equity-related bonds issued by Japanese entities in the late 1980s which have not been converted into equity or whose warrants have not been exercised because of the decline in the Tokyo stock market in the past two years.

Unprecedented volume of fixed rate issues

Straight fixed rate bonds. New issuing activity in the straight fixed rate sector was 50% higher in 1991 than in 1990, while turnover volume in secondary markets, which had declined somewhat in recent years, rose to record levels. Activity was especially buoyant during the first quarter after the uncertainties associated with the Gulf war had receded. In the US dollar and sterling sectors investors' demand was boosted by the prospect, which in fact materialised, of falling interest rates and attendant capital gains.

Several other developments contributed to the sharp expansion in

Large-scale borrowing by governments

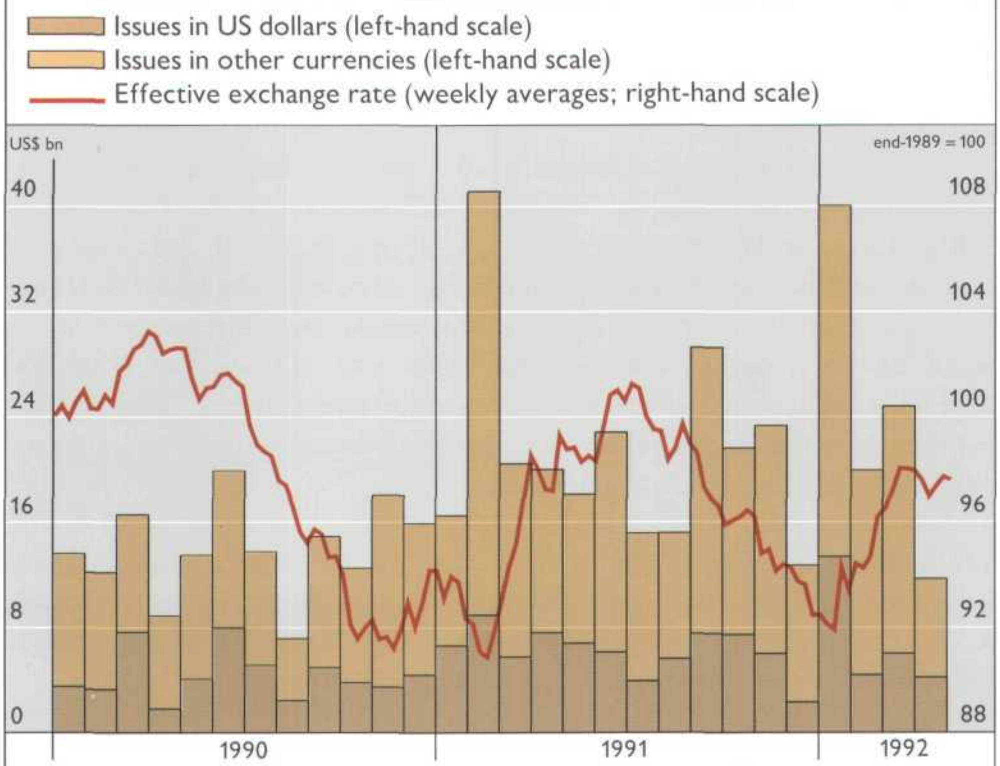
issuance in the straight fixed rate sector. Firstly, governments and other public sector entities stepped up their use of the international market, accounting for 22% of total new announcements, up from 17% in 1990. Secondly, new issues in "non-traditional" currencies expanded very markedly. The volume of ECU bond issues doubled, with activity heavily concentrated in the first quarter (see page 185). The strength of the Canadian dollar until the end of the year, combined with high yields, fuelled investor demand for Canadian dollar bonds. Other non-traditional Eurobond currency sectors, such as the French franc, the Italian lira, the Dutch guilder and the Spanish peseta, experienced vigorous growth rates of new issuing activity well in excess of 75%. Regulatory changes, high yields and the perceived stability of these currencies within the ERM were the main factors contributing to the expansion of these sectors. Finally, Japanese companies shifted their issuance in the international market from equity-related bonds to straight fixed rate issues in yen.

Buoyant business in non-traditional currency sectors

Subdued FRN activity

Floating rate notes. The sharp contraction in new issues of floating rate notes, from $43 billion in 1990 to $19 billion, reflected investors' expectations that interest rates on many currencies would decline. Moreover, there was mounting concern regarding the credit quality of issuers, in particular financial institutions, which account for about 70% of FRNs outstanding. Despite the difficulties of the property market and the downgrading of a number of financial institutions providing credit guarantees, the

Issuing activity in the bond market*
and the US dollar effective exchange rate



* Straight fixed rate issues, on an announcement basis.
Sources for bond issue data: Bank of England and BIS.

Type and currency structure of international bond issues

Sectors and currencies	Announced gross new issues				Net new issues				Stocks at end-1991
	1988	1989	1990	1991	1988	1989	1990	1991	
	in billions of US dollars								
Straight fixed rate issues	160.8	150.2	165.9	255.2	99.0	89.7	80.5	142.7	1,158.5
US dollar	47.3	54.6	52.2	74.3	26.7	26.0	15.9	27.9	349.7
Japanese yen	18.8	23.1	30.2	39.1	11.7	15.3	24.7	21.2	193.4
Swiss franc	18.2	5.7	15.5	13.5	0.9	−3.9	3.5	3.5	117.7
Deutsche Mark	21.2	9.4	7.3	12.1	14.0	6.2	1.3	4.7	114.1
ECU	10.7	11.7	15.1	30.2	9.4	7.5	9.6	24.4	92.8
Pound sterling	11.8	11.9	9.5	17.2	10.5	10.9	7.8	14.8	78.2
Canadian dollar	13.2	10.9	6.3	22.5	11.8	10.0	1.7	14.0	60.1
French franc	2.3	4.6	7.8	16.4	2.0	4.2	6.0	14.7	38.9
Other	17.3	18.2	21.9	30.1	12.0	13.5	10.1	17.6	113.5
Floating rate notes	24.4	27.3	42.5	19.1	5.9	11.0	28.3	3.2	210.5
US dollar	7.0	10.2	15.0	4.5	−9.2	−0.4	7.6	−4.9	110.8
Pound sterling	11.5	9.3	10.8	7.6	9.9	7.3	7.0	4.6	48.2
Deutsche Mark	1.4	2.6	8.2	2.8	1.4	2.2	7.3	2.7	23.7
Other	4.5	5.3	8.4	4.2	3.8	1.8	6.4	0.8	27.9
Equity-related issues	42.0	85.2	33.1	42.4	34.1	74.8	23.1	25.2	282.4
US dollar	29.0	65.1	19.5	24.8	26.2	60.4	15.9	15.3	184.8
Swiss franc	8.3	13.6	8.2	7.0	4.3	8.8	4.0	2.1	54.3
Other	4.7	6.5	5.4	10.6	3.6	5.5	3.1	7.7	43.2

Sources: Bank of England, ISMA and BIS.

issuance of sterling mortgage-backed securities remained quite buoyant, amounting to $5.1 billion, or $0.8 billion more than in 1990. Finally, the secondary market for FRNs continued to be plagued by a lack of liquidity. This was true particularly of the perpetual FRNs and variable rate notes issued by banks.

Uneven pace of equity-related issues

Equity-related bonds. Despite a 30% increase last year, issuance of equity-related bonds was less than one-half the record level attained in 1989. Moreover, the share of new issues accounted for by Japanese entities, the dominant borrowers in this market, contracted to less than three-quarters. Issuance was concentrated in the second and third quarters in the wake of the rally on the Japanese stock market (see the graph on page 136). Subsequently, the pronounced weakness of the Tokyo stock market, and the scandals involving several financial institutions, brought new issuing activity to a virtual standstill.

Resurgence of international share issues

Last year also witnessed a resurgence of new share issuance in the international markets. The volume of equity raised internationally amounted to $20 billion, or 50% more than in 1990. The major issuers were US companies seeking to restructure their balance sheets as well as European and Latin American entities being privatised.

Borrowers in the securities markets worldwide

There were several similarities between overall developments in the international and domestic markets. The total volume of gross issues placed in

Upsurge in domestic issues ...

the domestic bond markets also rose to record levels, from $2,230 billion in 1990 to $2,600 billion in 1991. As in the international markets, the volume of refinancings was very high and, in spite of the pronounced increase in gross issuance, the total net volume of funds raised expanded by only 9% to $1,157 billion.

... by public sector entities ...

The growth in net issues in domestic bond markets was more than accounted for by public sector entities, whereas the net volume of funds raised by private sector borrowers fell by 11% to $388 billion. Moreover, last year private sector entities repaid on a net basis $13 billion taken up in the domestic commercial paper and medium-term note markets. At the same time, private sector entities made increasing use of the international securities markets and as a result the share of international bonds and Euro-notes in their outstanding borrowing in securities markets worldwide rose to over 19%. Although there was a steep decline in the net volume of funds raised by financial institutions, they remained by far the largest private sector issuers of securities, taking up close to $310 billion worldwide.

... but shift of private sector borrowing to the international markets

Borrowers in various countries differed in the way they used the international and domestic markets. In the United States, as result of the recession and of balance-sheet restructuring, net issues by private sector entities worldwide fell by over one-third. In their domestic market US entities redeemed a large volume of commercial paper but issued medium-term notes. As the differential between interest rates in the US domestic CP and the ECP markets narrowed markedly, US borrowers also turned to the international market. The contraction in new borrowing in the US domestic bond market was due to a sharp decline in funds raised by financial institutions facing growing concern about their credit standing.

Pronounced decline in net volume of funds raised by US entities

The financing pattern of Japanese borrowers differed markedly in

Issuing activity in the domestic and international bond markets

Currencies	Domestic markets[1]				International markets				Amounts outstanding at end-1991	
	Total		of which: Public sector		Total		of which: Public sector[2]		Domestic	Inter-national
	1990	1991	1990	1991	1990	1991	1990	1991		
	net issues adjusted for exchange rate movements, in billions of US dollars									
US dollar	575.4	526.6	386.4	387.7	39.4	38.2	6.9	10.3	6,088.3	645.4
Japanese yen	120.5	141.5	40.8	61.6	26.7	21.1	7.5	3.9	2,737.1	202.4
Deutsche Mark	151.7	150.3	57.8	58.0	9.2	11.2	2.3	0.8	1,112.7	157.7
Italian lira	64.3	118.0	59.2	104.4	6.0	9.3	2.4	4.2	847.8	24.4
French franc	38.5	33.5	16.6	18.4	7.8	15.8	2.0	4.9	521.6	45.7
Pound sterling	−19.7	13.1	−17.5	14.4	16.2	21.0	2.0	4.7	259.8	138.2
Canadian dollar	23.3	32.1	17.8	27.7	1.6	14.0	−0.2	5.5	345.2	62.1
Swiss franc	12.0	13.4	3.5	2.3	7.3	5.3	1.2	1.8	105.0	172.9
Other[3]	99.1	128.1	64.5	93.9	17.7	35.2	10.7	22.4	1,371.5	202.6
Total	1,065.1	1,156.6	629.1	768.4	131.9[4]	171.1[4]	34.8	58.5	13,389.0	1,651.4

[1] OECD countries only, excluding Iceland and Turkey. [2] Including international institutions. [3] Including the ECU. [4] Including net international issues of $3.6 billion in 1990 and $12 billion in 1991 by entities from countries for which domestic bond issues are not included in the table. Of these net issues $3.1 and 7.3 billion respectively were issued by the private sector.

Sources: Bank of England, ISMA, national authorities and BIS.

Issuance by private sector entities in the domestic and international securities markets[1]

Countries and years	Domestic markets			International markets				Memorandum items	
	Total	of which		Total	of which			*Issues by financial institutions*	*International securities*[2]
		Commercial paper	Bonds		Short-term Euro-notes	Medium-term notes	Bonds		
	net issues adjusted for exchange rate movements, in billions of US dollars								*in %*
United States									
1990	236.4	47.4[3]	189.0	3.2	−2.8	2.6	3.4	*168.1*	*7.4*
1991	144.7	5.8[3]	138.9	4.5	3.7	2.5	−1.7	*53.2*	*7.1*
Germany									
1990	93.8	–	93.8	6.7	–	–	6.7	*100.1*	*9.5*
1991	97.7	5.4	92.3	10.7	1.1	0.2	9.4	*98.5*	*9.7*
Japan									
1990	99.8	20.1	79.7	38.7	1.0	0.4	37.3	*77.2*[4]	*27.4*
1991	53.0	−26.9	79.9	42.5	−0.1	−0.1	42.7	*48.6*[4]	*27.4*
France									
1990	27.6	5.8	21.8	13.8	1.6	1.0	11.2	*25.3*	*22.6*
1991	15.2	0.1	15.1	20.6	2.7	1.2	16.7	*27.1*	*25.7*
United Kingdom									
1990	−2.1	–	−2.1	25.4	6.2	2.5	16.7	*13.6*	*80.7*
1991	−1.7	− 0.4	−1.3	30.1	4.2	2.9	23.0	*11.1*	*84.5*
Italy									
1990	5.2	–	5.2	6.7	1.3	0.3	5.1	*11.0*	*21.1*
1991	13.6	–	13.6	8.6	3.9	1.8	2.9	*20.0*	*23.7*
Sweden									
1990	21.1	5.7	15.4	6.4	2.7	–	3.7	*25.4*	*14.4*
1991	13.9	0.2	13.7	1.4	−1.6	0.6	2.4	*14.6*	*13.9*
Australia									
1990	5.0	− 0.7	5.7	5.0	0.8	3.3	0.9	*5.9*[4]	*70.9*
1991	6.1	1.6	4.5	1.0	1.5	1.7	−2.2	*5.6*[4]	*66.3*
Canada									
1990	7.1	1.7	5.4	1.5	–	0.5	1.0	*0.9*[4]	*47.5*
1991	3.8	− 0.6	4.4	6.2	–	0.3	5.9	*−0.9*[4]	*48.3*
Other									
1990	41.2	19.1	22.1	16.7	7.7	1.0	8.0	*14.8*	*25.5*
1991	28.5	1.4	27.1	6.4	−2.6	2.8	6.2	*29.5*	*25.5*
Total[5]									
1990	535.1	99.1	436.0	124.1	18.5	11.6	94.0	*442.3*	*18.8*
1991	374.8	−13.4	388.2	132.0	12.8	13.9	105.3	*307.3*	*19.2*

[1] Excluding equities. [2] As a share of total securities outstanding in domestic and international markets at end-year. [3] Including corporate medium-term notes. [4] Excluding issues of commercial paper in domestic markets. [5] OECD countries only, excluding Iceland and Turkey.

Sources: Bank of England, ISMA, Euroclear, national authorities and BIS.

Shift in financing pattern of Japanese entities

1991 from the preceding year. The volume of funds raised by financial institutions in the securities markets worldwide tailed off from $77 billion in 1990 to $49 billion. Non-financial companies redeemed a sizable volume of commercial paper in the domestic market, while expanding their bond issuance worldwide. A shift to yen-denominated issues in the international market was favoured by the reduction to only one month of the period that must elapse before Euro-bonds issued by Japanese borrowers can be resold to Japanese investors.

Increased international borrowing by Canadian and European entities

Canadian, French, Italian and UK private sector entities sharply increased their recourse to the international securities markets. A large proportion of the new issues in the international markets were in these borrowers' own currencies. Italian entities were the largest issuers in the ECP market, whereas UK residents borrowed heavily in the international bond market. In the case of French and Italian entities funds raised by banks to strengthen their capital base accounted for a sizable share of such borrowing.

The markets for derivative financial instruments

Financial futures and exchange-traded options

New instruments boost trading volumes on European exchanges ...

There were marked regional differences in activity in derivative instruments traded on various organised exchanges last year. In Europe trading volume expanded by nearly 40%, with the largest increases being recorded in contracts linked to government bonds, of which a number of new ones were introduced in 1990 and 1991. Among these, the most successful contracts were the Swedish krona interest rate futures, the Italian government bond futures traded on LIFFE, the long-term ECU interest rate futures traded on the MATIF, the notional contract on peseta bonds and the Danish government bond futures. At the shorter end of the maturity spectrum open positions in contracts on short-term deposits denominated in European currencies increased by 65%.

... but growth falters in Japanese ...

Turnover in futures and options in many other markets suffered a setback. In Japan many market participants were led to unwind their positions in equity-linked derivatives as a result of the stagnation of the domestic equity market, the losses incurred by many traders and the scandals affecting some securities companies. Moreover, there was official pressure aimed at curbing cash/futures arbitrage and limiting the introduction of new equity-related derivatives. A 21% decline in the trading volume in government bond futures was due partly to the greater stability of bond yields.

... and US markets

A decline in turnover in the futures markets was also recorded for the US exchanges. Lower volatility of long-term interest rates, a reduced turnover in the cash government bond market and proposals to tax transactions in futures contributed to this contraction. By contrast, open positions in options contracts on interest rate futures doubled.

Trading in some futures contracts exceeds that in underlying cash markets

A number of indicators suggest that exchange-traded derivatives have grown in importance relative to the underlying cash instruments. Firstly, trading in futures in many instances now exceeds that in cash markets. By 1991 in several government bond markets the value of turnover in futures contracts exceeded cash transactions by a wide margin: for example, by 440 and 250% in the case of the French and German government bond markets respectively. Lower transactions costs, greater leverage and higher liquidity have been important factors in the substitution of futures trading

Derivative financial instruments traded on organised exchanges worldwide

Instruments	Annual turnover of contracts 1987	1988	1989	1990	1991	Open positions at end-1991
	in millions					in billions of US dollars
Futures on short-term interest rate instruments	29.4	33.7	70.2	75.8	84.8	1,907.5
of which: Three-month Euro-dollar[1]	*23.7*	*25.2*	*46.8*	*39.4*	*41.7*	*1,100.5*
Futures on long-term interest rate instruments	116.3	122.6	130.8	143.3	149.7	250.7
of which: US Treasury bond[2]	*69.4*	*73.8*	*72.8*	*78.2*	*69.9*	*29.8*
Notional French government bond[3]	*11.9*	*12.4*	*15.0*	*16.0*	*21.1*	*11.2*
Ten-year Japanese government bond[4]	*18.4*	*18.8*	*19.1*	*16.4*	*12.9*	*122.0*
German government bond[5]	–	*0.3*	*5.3*	*9.6*	*12.4*	*20.2*
Currency futures	20.8	22.1	27.5	29.1	29.2	17.8
Interest rate options and options on interest rate futures	29.3	30.5	39.5	52.0	50.8	1,072.4
Currency options and options on currency futures	18.2	18.2	20.7	18.8	21.5	59.4
Total	214.0	227.1	288.6	319.1	336.0	3,307.8
of which: In the United States	*161.4*	*165.3*	*198.1*	*205.7*	*199.7*	*2,004.3*
In Europe	*27.2*	*32.6*	*49.0*	*61.0*	*84.2*	*680.2*
In Japan	*18.3*	*18.8*	*23.7*	*33.6*	*30.0*	*390.5*

[1] Traded on the Chicago Mercantile Exchange – International Monetary Market (CME-IMM), Singapore Mercantile Exchange (SIMEX), London International Financial Futures Exchange (LIFFE), Tokyo International Financial Futures Exchange (TIFFE) and Sydney Futures Exchange (SFE). [2] Traded on the Chicago Board of Trade (CBOT), LIFFE, Mid-America Commodity Exchange (MIDAM), New York Futures Exchange (NYFE) and Tokyo Stock Exchange (TSE). [3] Traded on the Marché à Terme International de France (MATIF). [4] Traded on the TSE, LIFFE and CBOT. [5] Traded on the LIFFE and Deutsche Terminbörse (DTB).

Sources: Futures Industry Association, various futures and options exchanges and BIS calculations.

for dealing in the underlying instruments. Secondly, activity in the futures markets has increasingly complemented traditional forms of banking activity. The ratio of open positions in Euro-dollar futures to the outstanding dollar-denominated interbank assets of BIS reporting banks rose from less than 14% at the end of 1987 to 40% at the end of 1991. In the international yen and Deutsche Mark markets, where futures first made their appearance in 1989, the ratio of outstanding futures positions to interbank claims stood at 34 and 18% respectively at the end of last year. Moreover, banks expanded their own use of futures considerably. In particular, between the end of 1990 and the end of 1991 Japanese banks more than doubled their outstanding long and short open positions in the Euro-dollar futures contract traded in Chicago to over 35% in relation to their international interbank claims in dollars.

Banks' greater recourse to traded instruments

Interest and currency swaps

In 1990 the outstanding notional principal value of interest rate swaps increased by over 50% to $2,300 billion, and a further $760 billion of new swaps were arranged in the first half of 1991. There was also a further shift towards interbank (inter-ISDA members) swaps, the share of which rose to 39% of interest rate swaps outstanding at the end of 1990. This growing use of interest rate swaps as an asset/liability management tool was under-

Vigorous growth of OTC derivative markets scored by the decline in the average original maturity of new interbank swaps to only two and a half years during the first half of 1991.

Wider use of interest rate swaps

The share of currencies other than the dollar, which had continued to expand from 34% at the end of 1989 to 45% a year later, appears to have tapered off in the first half of 1991. Among the major currencies, between end-1989 and end-1990 the strongest growth in interest rate swaps was recorded for the Swiss franc, sterling and the Canadian dollar. The growing role of non-dollar currencies was associated with a shift in the geographical and sectoral distribution of end-users of swaps, towards financial institutions and governments in Europe and non-financial corporations in Asia.

Further expansion of non-dollar cross-currency swaps ...

The market for currency swaps, including cross-currency interest rate swaps, also expanded. At the end of 1990 the outstanding notional principal value amounted to nearly $580 billion, or 29% more than at the end of the previous year. In many respects developments mirrored those in the markets for interest rate swaps: the share of interbank business rose; in relative terms there was a pronounced increase in swaps arranged between non-dollar currencies; and the importance of US counterparties declined. One major development has been the expansion of currency swaps involving continental European currencies such as the Italian lira and the Swedish krona. Their growth has been stimulated by the lifting of capital controls, the persistence of interest rate differentials despite greater exchange rate stability vis-à-vis the ERM currencies and the rapid development of Euro-bond and deposit markets for these currencies.

... and of option-related OTC instruments

Data for other over-the-counter (OTC) contracts, such as caps, floors, collars and swaptions, also suggest continuing vigorous growth. At the end of 1990 the aggregate notional principal value of these instruments, at $560 billion, was nearly equivalent to that of exchange-traded interest rate options. Forward rate agreements (FRAs) appear to have expanded

Main features of the interest rate swap market

Components	US dollar	Japanese yen	Pound sterling	Deutsche Mark	Other	Total
	in billions of US dollars					
Notional principal value[1] of interest rate swaps outstanding at end-1990	1,272.7	231.9	242.1	193.4	371.5	2,311.5
by counterparty:						
End-user	*779.9*	*105.8*	*142.0*	*115.0*	*259.4*	*1,402.0*
Interbank[2]	*492.8*	*126.1*	*100.1*	*78.4*	*112.1*	*909.5*
Notional principal value[1] of new interest rate swaps in first half of 1991	448.0	73.5	62.6	48.4	129.6	762.1
by counterparty:						
End-user	*244.0*	*34.9*	*34.6*	*25.7*	*87.5*	*426.8*
Interbank[2]	*204.0*	*38.5*	*28.0*	*22.8*	*42.1*	*335.4*

[1] Hypothetical underlying amount on which swap payments are based. [2] Swaps between ISDA members adjusted for double-counting of positions.

Source: International Swap Dealers Association Inc. (ISDA).

Composition of new currency swaps in the first half of 1991					
Currencies	Total notional amount[1,2]	of which		of which	
		against US dollar[2]	against other currencies[2]	end-user	fixed/floating[2]
	in billions of US dollars				
Japanese yen	50.4	33.6	16.8	29.2	23.2
Australian dollar	15.2	6.1	9.0	10.2	3.1
Swiss franc	37.8	16.8	21.0	23.1	15.3
Deutsche Mark	15.1	7.3	7.8	10.6	6.4
ECU	12.7	7.8	4.8	10.3	8.5
Pound sterling	13.2	8.5	4.7	10.2	5.7
Canadian dollar	12.0	10.8	1.2	10.4	6.8
Sub-total	156.3	91.0	65.3	104.0	69.0
Other	50.9	24.5	26.3	37.4	21.5
minus: Double-counting of non-dollar swaps	*−45.8*	–	*−45.8*	*−33.0*	*−10.0*
Total	161.3	115.5	45.8	108.4	80.5

[1] Hypothetical underlying amount on which swap payments are based. [2] Adjusted for double-counting of positions reported by ISDA members.
Source: ISDA.

strongly since the end of the 1980s, although reliable estimates of the overall size of the market are not available. It appears that for many banks outstanding positions in FRAs approach those of their interest rate swap books. However, in Japan there are still many limitations, and even certain outright prohibitions, on the use of this instrument.

Changes in market structure and policy concerns

Growth of new derivative markets ...

Financial innovation has remained a key feature of activity in derivatives. In addition to the introduction of several new instruments on organised exchanges, last year saw the further extension of OTC financial products in a number of new areas. OTC equity-related derivatives, which typically consist of swaps in which one stream of payments is tied to an individual share price, a basket of shares or an equity index, have grown especially rapidly and by the end of 1991 the outstanding notional value was estimated by the International Swap Dealers Association (ISDA) at $125 billion. The uncertainties connected with the Gulf war stimulated the use of commodity swaps, which were described in last year's Annual Report. An increasing number of financial institutions, particularly in the United States, have been involved in these markets. Finally, end-user business appears to have been increasingly driven by "structured products" which generally carry highly complex option-like features tailored to the end-user's specific needs.

... for equity ...

... and commodity OTC contracts

Last year witnessed growing competition – often with official encouragement – both between the OTC markets and organised exchanges and among different exchanges. For example, in Europe the LIFFE and MATIF exchanges contended for market shares in the ECU and Italian lira bond

Competition between markets ...

futures contracts. And, as already mentioned, equity-related derivatives, which have traditionally been traded on exchanges, have now become more widely available as OTC instruments. However, there were a number of derivative products which did not succeed in attracting business away from their competitors; exchange-traded futures on swap contracts were one notable example.

... stimulates further innovation and improvements in contract design ...

Competition has in many respects been helpful to the development of the markets. It has stimulated product innovation and, as in the case of the Italian and German government bond contracts initially traded only offshore, has spurred the authorities to permit new markets to be opened at home. Competition between markets has also led to improvements in contract design, and in some instances new derivatives have enhanced the liquidity of the underlying instruments. Nevertheless, the proliferation of new products has given rise to some concern about the potential effects on the integrity and smooth working of the financial system. Firstly, exchanges may be led to attract business by raising or removing maximum

... but could have undesirable side-effects

daily fluctuation limits or reducing margin requirements. Indeed, the absence of margining has often been used to market OTC contracts. Secondly, excessive competition may result in the mispricing of contracts, especially when intermediaries take on highly complex credit exposures. Finally, the proliferation of contracts, the fragmentation of markets and the co-existence of disparate trading arrangements for similar products (for example, screen-based and open outcry systems) may reduce the market liquidity of certain instruments.

Heightened perception of counterparty risks among market participants

There have been several indications of heightened perceptions of the potential credit risks inherent in these markets. The change in the spread over Treasury securities of ten-year interest rate swaps, which in earlier years tended to lie close to the spread of A-rated bonds but has more recently moved closer to that of AA-rated bonds, appears to suggest that only institutions with a high credit standing can be acceptable as counterparties to longer-term swaps. The declining maturity of new interest rate swaps is also consistent with heightened risk perceptions.

The year under review also saw some regulatory concerns emerge with respect to certain aspects of OTC derivatives trading. In some cases these reflected a judgement that certain derivative activities are incompatible with banks' traditional business. For example, in the United States state banks were required to seek approval for their involvement in commodity and equity-linked derivative products. Other countries, in which banks are prevented by regulation from dealing in or holding commodities (usually with the exception of gold and silver), have also considered placing restric-

Concerns about practices designed to circumvent regulations ...

tions on banks' involvement in commodity-linked derivatives, in part because of the absence of natural hedging potential for such exposures in their balance sheets. In other cases, concerns reflected a perception that certain derivative techniques were applied in a deceptive manner. For example, off-market or discount swaps, in which one counterparty pays a rate considerably below prevailing market rates, amount in essence to credit extensions but are not recorded as such on banks' balance sheets.

A number of regulatory officials also expressed concern that the very sizable growth of OTC transactions might harbour potential risks for the financial system. This concern in part reflects a perception that the risks involved in OTC derivative operations may not always be properly understood and managed by all participants. Legal uncertainties and the lack of transparency of the many dimensions of exposure in OTC derivatives business, owing partly to the absence of a universally agreed accounting and disclosure framework for many such transactions, were also cited as causes for concern.

... and about legal uncertainties and market transparency

As the OTC derivative market has grown, bilateral netting of positions between large players has become increasingly common. Market participants have long argued for recognition of netted exposures for purposes of the calculation of capital adequacy requirements. Although properly designed and legally recognised netting arrangements may reduce counterparty exposures and settlement risk, and could contribute to lessening the potential systemic implications of a major default, regulators have been concerned that some schemes currently contemplated do not meet these criteria. Following the publication of the Report on Interbank Netting Schemes by a committee of senior central bank officials from the Group of Ten countries in November 1990, which set out criteria for central bank approval of such arrangements, a group of technical experts of the Basle Committee on Banking Supervision has considered whether some forms of netting might be recognised for capital adequacy assessments. The group recently solicited the views of market participants on a number of unresolved supervisory issues. These consultations have been undertaken on the understanding that they should not prejudge the recognition of netting schemes for supervisory purposes.

Netting increasingly common ...

... and bank supervisors consider its recognition

The private ECU market

The private ECU market continued to evolve last year. In the banking sector, the growth in reporting banks' outstanding ECU assets accelerated from 14% in 1990 to 18%, while net new financing in the international bond market rose by 135%, compared with 67% in 1990. At the shorter end of the securities markets, the outstanding volume of ECU Euro-notes, which had soared from $3.5 billion to $8.4 billion in 1990, advanced by a further $4 billion. At the same time, turnover in the secondary market for ECU-denominated securities rose by nearly 80%, and the ECU was increasingly used in currency swaps and futures and options contracts. The strong performance of the ECU appears all the more significant as bank credit, and to some extent even bond issuing activity, in certain other major Euro-currency sectors suffered a setback. As a result, for the first time in the history of the narrowly defined Euro-market the ECU ranked first in terms of both new bank credits and net new bond financing.

Growing importance of the private ECU market

However, the increasing use of the ECU in private financial transactions last year should be seen in relation to the strong expansion of some of the smaller currency sectors of the Euro-banking and Euro-bond markets. For example, a considerably higher rate of growth was recorded

The private ECU market

Instruments	1986	1987	1988	1989	1990	1991	Stocks at end-1991
	in billions of US dollars						
Total bank lending[1]							
Gross	6.2	11.1	23.4	24.6	24.9	35.6	239.5
Net[2]	5.0	8.0	12.0	10.0	18.0	20.0	85.0
International bond issues							
Gross completed	6.3	8.4	10.9	12.0	17.6	32.6	
Net	5.9	7.5	9.8	6.7	11.2	26.3	100.6
Net Euro-note placements					4.9	3.9	12.3
Domestic bond issues							
Gross completed	1.7	2.1	8.4	10.3	15.0	9.9	
Net	1.7	2.1	8.4	8.7	13.8	6.2	54.0
Short-term domestic Treasury bills and notes							
Gross	0.0	2.0	8.3	19.5	20.2	18.7	
Net	0.0	2.0	6.5	3.7	−2.4	−2.0	9.2
Memorandum item: Official holdings of private ECUs[1]	*1.1*	*1.4*	*8.1*	*7.3*	*13.7*	*2.3*	*38.6*

[1] Changes at constant end-of-period exchange rates. [2] Minus double-counting due to redepositing among the reporting banks.

Sources: ISMA, Euroclear and national authorities.

by the French franc and the Italian lira markets, although in terms of absolute size they remained much smaller than the ECU sector.

Record volume of ECU issuance in the international bond market ...

In the bond market newly announced ECU issues rose to a record $33 billion. After allowing for redemptions, net ECU financing amounted to $26 billion, representing a 35% surge in the volume of such bonds outstanding. Transactions were heavily concentrated in the first few months of the year, when a series of jumbo issues by sovereign entities and international institutions was launched. The strong demand for these ECU securities was reflected in a widening of the spread between the theoretical and actual yields on ECU bonds. Later in the year new issuance activity fell back to the average of 1990, owing to market saturation and to uncertainties concerning the future status of the basket. These uncertainties, which increased with the approach of the Maastricht Summit, also affected the secondary market for ECU bonds, where during the fourth quarter there was a sharp increase in the spread between interest rates on bonds denominated in ECUs and on those in other currencies. Following the Summit in December, which called for the freezing of the ECU basket, spreads returned to their previous levels and issuing activity rebounded.

... but slowdown of government issuance in domestic markets

At the same time, the rate of growth of outstanding issues of ECU government bonds on domestic markets slowed down considerably, from 40% in 1990 to 13%. While the outstanding total of domestic ECU bonds issued by Spain doubled, France, Greece and Italy reduced net recourse to their own markets. Moreover, redemptions of ECU Treasury bills by Italy exceeded new issues. In enhancing their issuing programmes in the international bond market, EC governments aimed at widening the range of investors and promoting the homogeneity of instruments and conditions over a broad spectrum of maturities.

Strong growth of bank lending ...

In the banking sector there were two major developments. Firstly, new credits to non-bank customers expanded strongly, accounting for 45% of the increase in BIS reporting banks' assets in ECUs. However, nearly half of the total $16 billion of borrowing by the non-bank sector was accounted for by Swedish residents, who switched a large proportion of their foreign currency debt into ECUs following the linking of the krona to the ECU in May 1991. ECU borrowing by Italian and Spanish entities, the second and third most important nationality groups of non-bank borrowers last year, amounted to $1.8 billion and $1.3 billion respectively. Given the relatively small exchange rate risks, residents of these two countries were attracted by the lower level of ECU interest rates in comparison with those prevailing on their own domestic markets.

... and major shifts in banks' net positions in ECUs

The second important development in the structure of the ECU banking market was the shift which took place during the year in the combined net position of the BIS reporting banks. Their net liability position first widened to $10 billion at the end of March 1991, from $2 billion at the end of 1990. Subsequently, there was a sharp turnround and by the end of the year the banks recorded a net asset position. These movements mirrored the changes in the attitude of investors towards ECU deposits. Non-bank deposits, which rose by $7 billion, or 27%, in the period to the end of June, came to a standstill in the third quarter, when the controversy over the standing of the "hard" or "frozen" ECU reached its climax. At the same time, identified official deposits, which represent only a fraction of the actual amount of ECU assets held by monetary authorities in market instruments, rose by $1.7 billion (16%) in the first quarter of the year, before declining by $3.6 billion in the subsequent quarters.

Developing countries and the international financial markets

Last year witnessed a pronounced increase in private capital flows to the developing world. For the first time since 1986 the BIS reporting banks recorded an increase in their outstanding net claims on Latin America and several of the countries in the region regained access to voluntary financing through the international financial markets. Asian countries, which for the most part had been less affected by the debt crisis, continued to borrow large amounts from the banks but at the same time added substantially to their official reserve holdings. In Africa, however, short-term trade credits, often backed by official guarantees, remained the only source of private external financing for the majority of countries.

Continuing heavy reliance of Asian countries on bank credits

With heavy reliance on bank financing and little recourse to the international securities markets, the international financing of the Asian countries diverged greatly from the general pattern for 1991. In fact, excluding Taiwan, since the end of 1987 these countries have borrowed $55 billion

BIS reporting banks' credit relations with selected developing countries[1]

Countries and regions	Gross lending (exchange rate adjusted changes)				Stocks at end-1991		*Memo item: Ratio of gross banking debt to external debt*	
	1988	1989	1990	1991	Gross claims	Net claims	*end-1987*	*end-1991*
	in billions of US dollars						*in %*	
Latin America[2]	−4.3	−18.6	−31.0	−1.3	208.8	65.0	*58.4*	*48.6*
Argentina	3.0	− 5.4	− 2.8	0.2	30.9	9.9	*60.3*	*55.0*
Brazil	−3.9	− 5.5	− 5.8	−5.9	61.0	37.6	*65.5*	*51.7*
Chile	−1.8	− 1.8	− 0.6	−0.9	8.0	1.3	*59.9*	*41.5*
Mexico	−3.6	− 1.2	−15.0	6.3	62.3	34.0	*69.3*	*63.4*
Venezuela	0.8	− 1.6	− 7.3	−0.1	17.8	−6.9	*72.2*	*52.1*
Asia[3]	6.5	2.4	25.2	21.2	175.8	32.4	*39.4*	*45.8*
China	7.1	− 0.5	7.5	5.7	37.0	−9.8	*47.5*	*64.8*
India	1.4	1.2	1.4	−1.3	12.4	2.3	*19.5*	*16.4*
Indonesia	0.9	1.6	7.6	4.5	34.2	22.8	*37.1*	*47.2*
Philippines	−1.9	− 2.6	− 0.4	−0.9	8.7	3.9	*48.2*	*28.5*
South Korea	−2.0	1.2	4.1	6.7	39.1	28.7	*72.7*	*93.2*
Thailand	1.4	1.7	4.7	6.6	22.7	17.3	*40.9*	*82.9*

[1] Including OPEC countries. [2] Including those countries in the Caribbean area which are not classified as offshore banking centres. [3] Excluding Taiwan.

from the banks whereas their net issues of international bonds and notes have amounted to only $5 billion. Because of the banks' overall retrenchment in lending to the developing world, exposures to Asia have increased in relative importance. By the end of 1991 they accounted for 34% of banks' claims on developing countries, as against 30% four years earlier. Moreover, in most major Asian countries the share of external indebtedness accounted for by bank borrowing has risen markedly in the last few years.

Reasons for bank lending to Asia

Commercial banks have no doubt been impressed in recent years by the strong economic performance of Asian countries and their relatively low debt and debt service ratios. At the same time, corporations and banks from many Asian countries have found the international short and medium-term credit markets easier to tap and sometimes cheaper than their often underdeveloped domestic financial markets. This combination of factors has been particularly important in the case of South Korea, which, having reduced its external debt/GNP ratio from 53 to 14% between the end of 1985 and the end of 1990, was easily able to finance a deterioration in its current account balance last year with only minor drawings on its foreign exchange reserves. Similarly, a comparatively low debt burden combined with liberalisation measures in the past two years contributed to a surge in international bank credits to Thailand. Faced with an extremely tight domestic monetary policy, Indonesian entities, especially banks, borrowed heavily from BIS reporting banks in 1990 and 1991. However, last October the authorities, confronted with a rapid deterioration in external debt ratios, decided to impose a ceiling on domestic banks' external borrowings.

BIS reporting banks have also been willing to lend on a large scale to China, which recorded strong export growth and made substantial additions to its deposits last year.

The Philippines, the only Asian country engaged in debt relief negotiations, stands out as a major exception to the rise in banks' claims on Asian countries. Lending to India was also temporarily reversed in the first half of 1991, when the country experienced acute domestic problems (see Chapter III).

Latin American countries' increased business with the banks ...

Between the end of 1987 and the end of 1990 the identified outstanding claims of BIS reporting banks on Latin America fell by $54 billion owing largely to debt conversions, outright loan sales, write-offs and other debt reduction operations. As a result, the share of claims on Latin America in banks' total exposures to developing countries contracted by 9 percentage points to 42%. Last year, however, witnessed a recovery in banks' business with Latin America. Moreover, improved prospects in several countries, tight domestic monetary conditions and the relaxation of exchange controls encouraged the repatriation of flight capital. Excluding the impact of debt reductions on BIS reporting banks' outstanding exposures, which can be estimated at $3.6 billion last year compared with $26.6 billion in 1990, claims on Latin America rose by over $2 billion.

... and issuance of securities in the international markets

There was also a sizable expansion of net issues of publicised international securities by this group of countries, from $3.5 billion in 1990 to $5.6 billion. US and European institutional investors were attracted by high yields and an improving economic performance. The largest issuers in the international bond market were Mexican entities ($2.6 billion), which also raised $0.3 billion through publicised Euro-note programmes. In addition, Mexican financial institutions placed privately nearly $5 billion of CDs. Despite the absence of an agreement on how to deal with unpaid debt and accumulated interest arrears, Brazil and Argentina were also able to tap the bond market, taking up $1.4 and 0.8 billion respectively. Investors have been willing to purchase issues launched by these countries because in the past bonded debt has benefited from effective seniority over normal loans.

Recovery in secondary market prices of LDC debt ...

The strong macroeconomic performance of several Latin American countries also had a positive impact on average prices in the secondary market for LDC debt. Between the end of 1989 and the end of 1991 the secondary market prices of the traded debt of the fifteen "Baker" countries rose on average by 75%. Owing in part to the substitution of bonds for bank debt, turnover in this market soared by over 50% to roughly $100 billion in 1991, after having expanded steadily at a rate of 5 to 10% in the two preceding years. There has also been an increase in the number of market-makers and investors. As a result, liquidity has improved for some types of debt and bid-ask spreads have narrowed. Brokers now operate in the market and firm quotations can be obtained for selected instruments.

... but concerns with respect to the proper functioning of the market

The proper functioning of the secondary market for LDC debt is of considerable importance to financial market participants, the authorities responsible for the institutions participating in the market and the developing countries themselves. Despite the recent expansion of the market, prices are on occasion highly volatile, as they were in October and in early November last year. Moreover, market practices are not standardised and settlement procedures are complex. Owing in part to the heterogeneous nature of the debt instruments traded and the wide differences in the creditworthiness of debtors, the market is segmented. For these reasons, there appears to be an emerging consensus about the need for common practices and codes of conduct, and for improvements in settlement and clearing procedures.

Domestic financial reform ...

In addition to modifying their domestic macroeconomic policies and reassessing the role of external financing, many developing countries have in recent years undertaken major efforts to reform and liberalise their domestic financial systems. These measures, which in many respects resemble the transformations in the developed world in the 1980s (see Chapter VIII), have included the lifting of administrative controls on interest rates, the dismantling of credit allocation mechanisms, the freeing of capital movements, the privatisation of large segments of the banking system, the lowering of institutional barriers, the introduction of a broad range of short-term money market instruments and the opening-up of domestic markets to foreign financial institutions and investors. This process was accompanied by a higher level of real interest rates in most countries, thereby discouraging capital flight and spurring domestic capital formation.

... at varying speeds in different countries

The process of financial liberalisation has started at different points, proceeded at varying speeds and taken diverse guises. In Asia, apart from Hong Kong and Singapore which already have very free and sophisticated markets, Malaysia and the Philippines have advanced the furthest in the process of deregulation since the mid-1970s. By contrast, Taiwan, in spite of very sizable current account surpluses and a large net external asset position, still maintains fairly extensive controls on its financial market and on access to foreign investments by domestic residents. South Korea, which began to loosen its controls on interest rates in 1988, last year announced further measures which should lead to the complete liberalisation of all interest rates in four stages by the end of 1997. At the same time the Korean authorities continued to liberalise access to foreign investments by domestic residents and open up the Korean securities markets to foreigners. In Latin America Argentina, Bolivia, Colombia, Ecuador, Mexico, Peru and Venezuela have introduced important changes in their legislation regarding foreign access to domestic financial markets.

Privatisation of banks

The privatisation of banks and other financial institutions has been a noteworthy element in many countries' programmes for improving financial market efficiency. Argentina, Chile, Colombia, El Salvador, Mexico, Peru, Uruguay and Venezuela have already sold off state-owned financial institutions or plan to do so in the near future. In Mexico, the sale of eight banks last year raised $7 billion, equivalent to about 3% of GDP. The privatisation of Mexican banks has been accompanied by a widening of their powers and a relaxation of exchange controls.

Finally, mention should be made of the development of domestic equity markets, which has been a major reason for large portfolio inflows into some countries. The number of companies quoted on the most important exchanges has risen rapidly, turnover has soared, the transparency of the market has been improved and foreign access has been liberalised. In addition, privatisation programmes have provided an ample supply of equity, and both institutional investors and country funds have bought large amounts of such paper. Moreover, with rates of return tending to exceed those in the industrial countries in recent years, foreign investment in emerging stock markets has increased. The great bulk of funds has gone to markets in Asia, but more recently interest in Latin American equity markets has also grown.

Growth of domestic equity markets

While these reforms promoting more open financial markets should ultimately lead to greater efficiency in the intermediation of savings, the experience of many developed countries in recent years suggests that the process of deregulation can be accompanied by a heightened potential for systemic risks. Moreover, several countries, including Thailand, Malaysia and Chile, experienced periods of financial stress in the 1980s. The closure of BCCI had widespread repercussions in the developing world last year. In the light of these experiences many developing countries have been taking steps to improve the supervision of their domestic banks and strengthen the regulatory framework of their capital markets. Several developing countries, especially in Asia and Latin America, have moved towards adopting the Basle capital ratios, at least as far as on-balance-sheet business is concerned. This will compel many banks to increase their capital base and help to make the global financial market sounder and competitive conditions more equitable.

Need for an adequate regulatory framework

VIII. Structural aspects of financial markets and prudential supervision

Highlights

The past ten years or so have seen momentous change in the structure of the financial industry worldwide in the wake of deregulation and financial innovation. They have also been a period of sharp contrasts, with an unprecedented expansion in financial activity but considerable financial strains, especially more recently. The time now seems appropriate to take stock of these developments and to consider some of the fundamental questions that are likely to dominate the years ahead, drawing in part on the analysis set out in previous Annual Reports.

After outlining the main structural changes of the period in question, this chapter turns to several important issues that they raise for both policy-makers and market participants. A first set of issues concerns the costs and benefits of the process of deregulation and financial innovation and centres on the relationship between efficiency and financial stability. A second relates to the immediate challenges posed by the legacy of the past years: the unwinding of over-indebtedness and asset price inflation in some countries, the elimination of excess capacity in segments of the financial industry and the adjustment to a world in which capital has become a scarcer resource for financial institutions. A final set of issues pertains more to the longer-term challenges, which are simply different guises of the fundamental questions always confronting policy-makers: where to set the boundary between government involvement and market forces in the determination of the industry's structure, the continued adaptation of the prudential regulatory and supervisory framework to the changing environment, and the limits of prudential regulation and supervision.

Salient structural developments

Structural changes in financial markets:

During the last ten years or so the structure of financial markets has undergone profound changes. In many respects these represented the strengthening of a trend which first emerged in the 1970s and which subsequently gathered momentum as a result of the growing ascendancy of free market philosophy, favourable macroeconomic conditions and an acceleration in the pace of technological innovation.

The scope, timing and speed of these structural changes varied greatly from country to country depending on the initial conditions and other specific factors. The direction and key features of the process, however, were common to virtually all.

easing of restrictions ...

Deregulation considerably enhanced the role of free market forces in the determination of the choices open to economic agents. Partly with a

The expansion of selected financial derivative markets						
Instruments	1986	1987	1988	1989	1990	1991
	notional principal amounts in billions of US dollars[1]					
Exchange-traded instruments	583	724	1,300	1,762	2,284	3,518
Interest rate options and futures	516	609	1,174	1,588	2,054	3,231
Currency options and futures	49	74	60	66	72	77
Stock index options and futures	18	41	66	108	158	210
Over-the-counter instruments	500	867	1,330	2,402	3,451	4,080[2,3]
Interest rate swaps	400[2]	683	1,010	1,503	2,312	2,750[2,3]
Currency and interest/ currency swaps[4]	100[2]	184	320	449	578	700[2,3]
Other[4,5]	–	–	–	450	561	630[2,3]
Grand total	1,083	1,591	2,630	4,164	5,735	6,900[2,3]
Memorandum items:						
Ratio of grand total to:						
International claims[6] of BIS reporting banks	*0.27*	*0.31*	*0.47*	*0.64*	*0.76*	*1.00[7]*
OECD GDP	*0.10*	*0.13*	*0.19*	*0.29*	*0.35*	*0.40[7]*

[1] Amounts outstanding at year-end. [2] Estimate. [3] June. [4] Adjusted for reporting of both currencies. [5] Caps, collars, floors and swaptions. [6] Cross-border and local foreign currency claims. [7] Estimates on the basis of June figures.

Sources: Futures Industry Association, International Swap Dealers Association, various futures and options exchanges worldwide and BIS calculations.

view to limiting competition, in the late 1970s significant restrictions on the lines of business and geographical location and operation of financial enterprises still existed in many countries, sometimes supplemented by ceilings on deposit rates and/or official tolerance of cartel-type agreements. At the same time, quantitative and, to a lesser extent, interest rate controls on the asset side of the balance sheet were often in place, reflecting mainly interventionist approaches to the implementation of monetary policy and the remnants of credit allocation policies. By the beginning of the 1990s many of these constraints had either been removed or else undermined by market developments.

... on quantities, interest rates and prices ...

The easing of quantitative, interest rate and price restrictions was particularly extensive. By the early 1990s none of the larger industrialised countries retained ceilings or other major constraints on lending. Compulsory portfolio investment requirements for banks were rare and, where they existed, of little significance; portfolio restrictions on institutional investors such as pension funds and insurance companies had been relaxed in several countries. Compulsory reserve requirements had been generally reduced. Controls on foreign exchange transactions and international capital flows had largely been lifted. Restrictions on lending rates were a thing of the past and only a few countries, notably Japan, retained significant controls on retail deposit rates or fixed brokerage commissions. In a context of much greater freedom, the strengthening of prudential capital adequacy standards came to be perceived as the main regulatory constraint on bank portfolio choices.

... and on location and business lines;

Restrictions on the geographical location and lines of business of financial institutions had also been substantially reduced, although the process in this area had not gone as far. Many countries had begun to decompartmentalise their credit systems, by extending the spectrum of permissible lending and funding activities and harmonising other restrictions on credit institutions' balance sheets. Where it had existed, the separation between commercial and investment banking had broken down, while countries in which barriers remained, notably the United States and Japan, had seen their institutions actively engage abroad in activities that were prohibited at home. Although deregulation was generally more limited in the insurance sector, by the early 1990s a few countries, especially in Europe, had eased restrictions on the combination of insurance with banking business. Both across and within national borders the geographical sphere of operation of financial institutions had been broadened as obstacles to establishment had been relaxed or eroded.

enriched spectrum ...

The spectrum of available financial instruments has been greatly enriched during the past decade. In 1980 only a handful of countries had established markets in Treasury bills, certificates of deposit and commercial paper; by 1991 few had not. In the wake of advances in information technology and applied finance theory, the decade also saw the rapid growth of sophisticated instruments such as futures, options, swaps and combinations thereof (see the table opposite). Alongside the rapid expansion of over-the-counter markets, a growing number of countries equipped themselves with exchanges on which some of these instruments could be traded. While in 1980 only the United States and the Netherlands had exchanges for futures or options, by 1991 only a very small number of industrialised countries had neither. Increasingly, over-the-counter instruments were tailored to the specific needs of investors, borrowers and intermediaries.

... and greater marketability of financial instruments;

As the range of financial instruments expanded, a rising proportion became marketable. The accumulation of government debt lent breadth and depth to short and long-term government securities markets. Private

Cross-border transactions in bonds and equities[1]

Countries	1970	1975	1980	1985	1990
	as a percentage of GDP				
United States	2.8	4.2	9.3	36.4	92.5
Japan	n.a.	1.5	7.0	60.5	118.6
Germany	3.3	5.1	7.5	33.9	57.5
France	n.a.	n.a.	8.4[2]	21.4	53.3
Italy	n.a.	0.9	1.1	4.0	26.7
United Kingdom	n.a.	n.a.	n.a.	367.5	690.1
Canada	5.7	3.3	9.6	26.7	63.8

[1] Gross purchases and sales of securities between residents and non-residents. [2] 1982.

Source: National balance-of-payments data.

issuers, both financial and non-financial, also tended to rely more heavily for their funding on marketable instruments. The use of commercial paper, certificates of deposit, floating rate notes, bonds, shares and related instruments grew rapidly at the expense of traditional deposits and loans. In a few countries, in particular the United States, bank loans and enterprise receivables started to be packaged and sold in the market. Derivative markets substituted for more costly trading in the underlying securities.

integration of domestic and offshore markets;

During the period in question domestic markets became progressively more integrated with each other and with those offshore. With the easing of restrictions on foreign exchange transactions and on establishment, capital flows across borders intensified and the number of institutions operating in foreign centres rose (see the table on page 193). The increase in arbitrage possibilities as a result of the development of new instruments and the reduction in computation and telecommunications costs raised the responsiveness of market participants to price differentials and to tax and regulatory differences between markets. As regulatory regimes converged and became less restrictive, the distinctions between domestic and offshore markets grew increasingly blurred.

institutionalisation of savings;

In several countries, notably in the main financial centres, these developments went hand in hand with a greater institutionalisation of savings (see the table below). The higher share of savings channelled into pension funds, insurance companies and other collective investment schemes underpinned the expansion and greater sophistication of the securities markets. The institutions' gradual move away from buy-and-hold strategies to portfolio indexing or more active trading put pressure on existing market practices and arrangements, now called upon to accommodate potentially larger and more concentrated trading demands. Their drive towards international diversification was a major force behind the internationalisation and integration of markets.

rise in indebtedness;

For non-financial agents, particularly households, the weakening of financial constraints coincided with a fairly generalised rise in indebtedness in relation to current income (see the table opposite). This increase tended

The growth of institutional investors

Countries	Pension funds and life assurance companies			Collective investment institutions			Total		
	1980	1985	1990	1980	1985	1990	1980	1985	1990
	financial assets as a percentage of household financial assets								
United States	17.8	21.1	23.5	2.2	5.0	7.7	20.0	26.0	31.2
Japan	13.8	16.6	20.8	1.8	3.6	5.6	15.6	20.2	26.4
Germany	19.4	24.2	27.1	3.2	4.8	8.1	22.6	29.0	35.1
France	8.0	11.2	14.7	2.7	12.4	21.7	10.6	23.6	36.3
Italy[1,2]	1.6	0.9	3.2[3]	n.a.	2.1	2.9[3]	n.a.	2.9	6.1[3]
United Kingdom[1]	39.9	49.9	53.7[3]	1.6	3.1	4.9[3]	41.5	53.1	58.6[3]
Canada	19.4	23.3	26.7	1.0	1.6	3.0	20.4	24.9	29.7

[1] Total assets. [2] At book value. [3] 1989.

Source: National data.

Private sector indebtedness in selected countries								
Countries	Non-financial companies				Households			
	1975	1980	1985	1990	1975	1980	1985	1990
	as a percentage of GNP/GDP				as a percentage of disposable income			
United States	36	36	41	49	67	75	80	97
Japan	94	86	101	135	45	59	70	96
Germany	66	68	73	74	62	76	88	84
France	63	57	60	69	52	56	54	69
Italy	n.a.	49	57	62	n.a.	n.a.	n.a.	n.a.
United Kingdom	46	41	49	82	47	49	77	107
Canada	89	98	97	99	77	85	72	90
Australia[1]	87	87	109	138[2]	n.a.	n.a.	n.a.	n.a.
Sweden	57	60	68	100	94	100	103	124

[1] Total private sector; fiscal years. [2] 1988, as the series has since been discontinued.
Source: National data.

to be associated with a similar rise in their financial investments and a more active management of both assets and liabilities. The greater sophistication and importance of the financial departments of large corporations is perhaps the most telling illustration of this process.

despecialisation of institutions;

Among financial intermediaries the relaxation of constraints favoured a trend towards despecialisation, as institutions embraced a growing range of activities. Complex conglomerate structures, often straddling national borders, became increasingly common. These companies typically combined traditional banking services with various types of securities business and, more recently, the provision of insurance.

Against this background, the nature of banking activities changed in many respects. Although deposit-taking and lending generally remained the core of banks' business, a higher portion of their income tended to come from sources other than net interest (see the table overleaf). These include trading, brokerage, underwriting, advisory services and the provision of backup liquidity and credit enhancement. Through these backup facilities and their key role in the payments mechanism, banks supported the growth of the markets for securities and derivatives even in those countries where they were prevented from engaging in certain types of securities business. They also became increasingly active users of derivatives themselves, notably as a substitute for operations in the traditional interbank deposit market. As a result of these developments a greater proportion of their credit and liquidity exposures was incurred off-balance-sheet.

and increase in off-balance-sheet exposures

Greater competition ...

The fundamental structural changes in the regulatory and technological environment resulted in a heightening of competitive pressures across the financial spectrum and, given the favourable macroeconomic climate, in a major expansion of the industry (see the table on page 197). In a context of volatile interest rates, exchange rates and asset prices, they also fostered an unprecedented surge in financial activity and trading (see the graph on page 198). This surge can to some extent be seen in the explosion

... and surge in payments

in the value of payments over the last decade (see the graph on page 199). While commercial transactions grew broadly in line with economic activity, the increase in financial transactions led to a sharp rise in the ratio of payments to GDP.

An evaluation of deregulation and financial innovation

Reasons for deregulation

The deregulation that has taken place since the 1970s may be regarded in part as the later stages of a long-term process reversing the generally pervasive government involvement in financial systems which characterised the immediate post-war period. The process was driven by the perception that existing constraints on financial activity were proving ineffective or causing serious inefficiencies in the allocation of capital and the operation of monetary policy. Deregulation then developed a momentum of its own, as the elimination of restrictions in certain areas led to pressures for their relaxation elsewhere.

Often the pressure for change arose from differences in regulatory treatment. At the domestic level, less regulated institutions or market segments could grow and prosper at the expense of more regulated ones. Internationally, the dismantling of exchange controls in certain countries sapped the effectiveness of similar controls in others. The impact of regulatory differences was reinforced by the macroeconomic climate of the late 1970s and early 1980s, when the inflationary environment and subsequent anti-inflation efforts contributed to higher levels of interest rates. Higher rates further encouraged the disintermediation of the more regulated sectors and the avoidance of constraints, both within and across national borders. As deregulation spread and markets became more integrated, the risk of undermining the international competitiveness of domestic institutions became a strong motivating force. In some instances, external commitments under international or supranational agreements also played a significant part, as in the case of the yen-dollar accord of 1984 and EC single market legislation.

The balance between government-led deregulation and market-driven

Banks' non-interest income[1]

Countries	1980–82	1984–86	1989–90	1990	Countries	1980–82	1984–86	1989–90	1990
United States[2]	30.0	31.4	37.4	38.0	Belgium[3]	19.6	23.4	25.2	23.0
Japan[2,3]	20.4	24.6	36.6	35.9	Finland	48.8	58.3	50.4	46.9
Germany[2]	30.6	28.6	34.3	34.9	Netherlands	25.0	24.7	30.0	29.7
France[2]	14.6	15.3	24.4	24.9	Norway	27.3	35.2	29.5	25.9
Italy	26.0	30.3	26.3	26.8	Spain[2]	15.7	18.1	20.7	22.3
United Kingdom[2]	28.5	36.9	39.7	41.1	Sweden	29.8	33.5	27.4	26.2
Canada[3]	21.6[4]	23.7	30.1	31.0	Switzerland	46.6	47.5	50.0	49.1
Australia[3]	32.1	33.5	33.9	34.0					

[1] Share of non-interest income in the gross income of commercial banks; the data are not fully comparable across countries.
[2] Large commercial banks. [3] Fiscal years. [4] 1982.

Sources: For Australia, Reserve Bank of Australia; for other countries, OECD and BIS estimates.

Indicators of growth in the financial industry

Countries	Share in total employment			Share in value added[1]		
	1970	1979	1989	1970	1979	1989
United States	3.8	4.2	4.8	4.1	4.5	5.7[2]
Japan	2.6	2.8	3.4	4.5	4.9	5.6
Germany	2.3	2.8	3.1[3]	3.1	4.2	5.0
France	n.a.	12.6[4]	16.1[4]	3.3	3.5	4.7
Italy	1.6	1.6	1.8	2.9	3.9	4.4
United Kingdom[4]	6.0[5]	7.0	11.4	12.5	14.8	20.0
Canada	n.a.	4.8[4,6]	5.2[4]	1.9	1.8	2.3[2]
Australia[4]	7.1	8.1	11.0[3]	8.5	9.0	12.1
Belgium	3.2[7]	3.4	4.1	3.2[7]	4.2	5.9
Finland	2.4[8]	2.5	3.1	3.1[8]	3.0	3.9
Netherlands	n.a.	3.5	3.8	2.9	4.5	4.9[2]
Norway	1.9	2.2	3.0	2.3	3.1	4.4
Spain	n.a.	2.2	2.5	3.5	5.7[9]	6.5
Sweden	n.a.	1.7[9]	2.0	n.a.	3.1[9]	4.4
Switzerland	2.7	4.2	5.3	4.6	5.8[7]	10.1[10]

[1] GNP/GDP plus imputed bank service charge, at current prices (1980 prices for France). [2] 1987. [3] 1988. [4] Including real estate and business services. [5] 1971. [6] 1983. [7] 1975. [8] 1976. [9] 1980. [10] 1985.

Sources: OECD, national data and BIS estimates.

financial innovation varied greatly from country to country, depending on the restrictiveness of regulatory arrangements and the degree of autonomy allowed by national legal systems. However, regardless of the proximate cause and form of change, the process held forth the promise of a leaner and more efficient financial sector, better suited to meeting the changing needs of suppliers and users of funds. The main mechanism through which these goals would be achieved was a greater scope for the free play of market forces at the expense of government guidelines and the related heightening of competitive pressures.

Benefits of deregulation

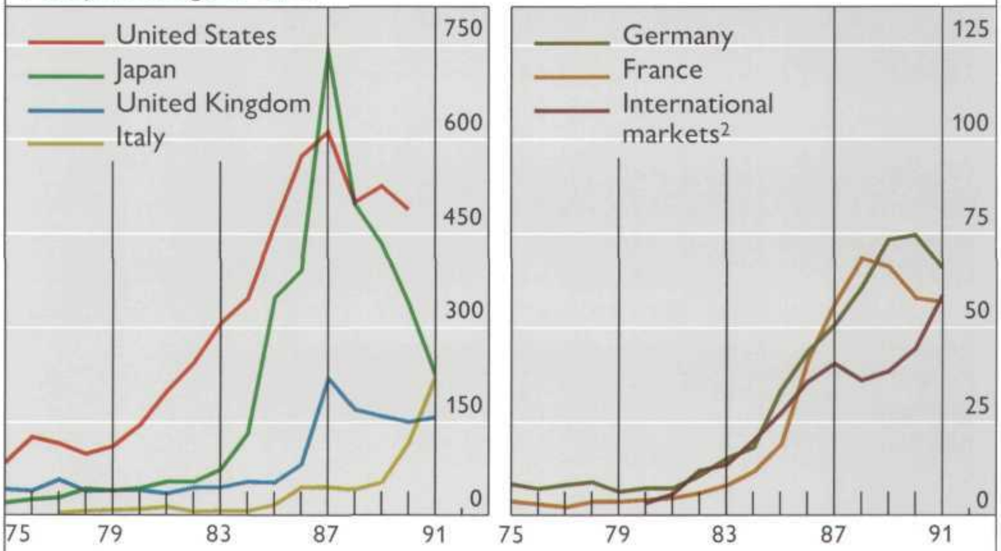
In many respects the promised benefits of deregulation have materialised. Original suppliers and end-users of funds have secured better terms in the form of a richer and higher-yielding menu of financial assets for their investments and of easier and cheaper access to external finance. The breakdown of foreign exchange controls has permitted a greater diversification of portfolios. The broader spectrum of financial instruments has allowed a better distribution and management of risk. The reduction in transaction costs has raised the liquidity of securities markets. Capital can now flow more freely towards higher returns.

Potential costs of deregulation

Harder to answer is the question of the costs at which these benefits have been secured. There is a widespread perception that deregulation and financial innovation have gone hand in hand with greater financial instability, be it in the form of "excessive" fluctuations in asset prices or distress among financial institutions. In that case, is there a causal relationship between the two? Is this relationship a characteristic of the transition process or of the final financial environment? Could the link have been broken or loosened by a more appropriate policy?

Indicators of trends in turnover on securities markets[1]

As a percentage of GNP



[1] Estimates of the annual value of secondary market transactions in equities and bonds, including in some cases those carried out over the counter. Purchases and sales are counted only once. [2] Total transactions settled through Euroclear and CEDEL as a percentage of total GNP (in US dollars) in the Group of Ten countries.

Source: National data.

Evidence of financial instability

Asset prices and exchange rates have gone through periods of sharp fluctuations in the last ten years or so (see the graph on page 200). Concern has arisen not so much in connection with very short-term volatility: as information spreads more quickly and widely, speedier price reactions are natural and, unless extreme, relatively harmless. Rather, attention has focused on longer-term fluctuations, especially when prices have appeared to deviate from realistic views regarding their sustainable levels, and on the often related possibility of sudden, sharp and disorderly falls. Such misalignments have more serious potential costs in terms of misallocation of resources and the painful unwinding of incorrect decisions, while crashes raise the spectre of wider systemic instability. The past decade has seen a number of cases in which financial prices apparently took on a life of their own: the dollar overvaluation of the mid-1980s, the global stock market crash of October 1987 and the mini-crash two years later, and the major, more protracted cycle in equity prices in Japan. In that country, and to a lesser extent in many others, real estate prices have also been subject to sizable medium-term movements.

Since the beginning of the 1980s there have been several major episodes of distress among financial enterprises. As economic activity weakened around the end of the decade credit intermediaries in some countries experienced the toughest period since the widespread instability of the inter-war years. In the United States the difficulties encountered by banks called for government resources to bolster deposit insurance funds, adding to the problems connected with the earlier savings and loan industry crisis. The banking industry in Norway faced acute distress. By the beginning of the 1990s strains were evident also in Sweden, Finland, Australia and Japan, among both banks and non-bank credit institutions; and the breadth of credit downgradings was significantly greater. In addition, the LDC debt crisis of the early 1980s undermined the asset quality of a number of internationally active banks for much of the decade.

Instability in asset prices and institutional financial distress are clearly related, since financial intermediaries either hold, or lend against the value of, assets. In particular, as banks in several countries increased their securities business and their exposure to real estate, their earnings and financial strength became more sensitive to price fluctuations (see the table on page 201). Losses in securities markets since the mid-1980s and, above all, the weakness of real estate markets have been important factors behind the recent problems faced by many institutions.

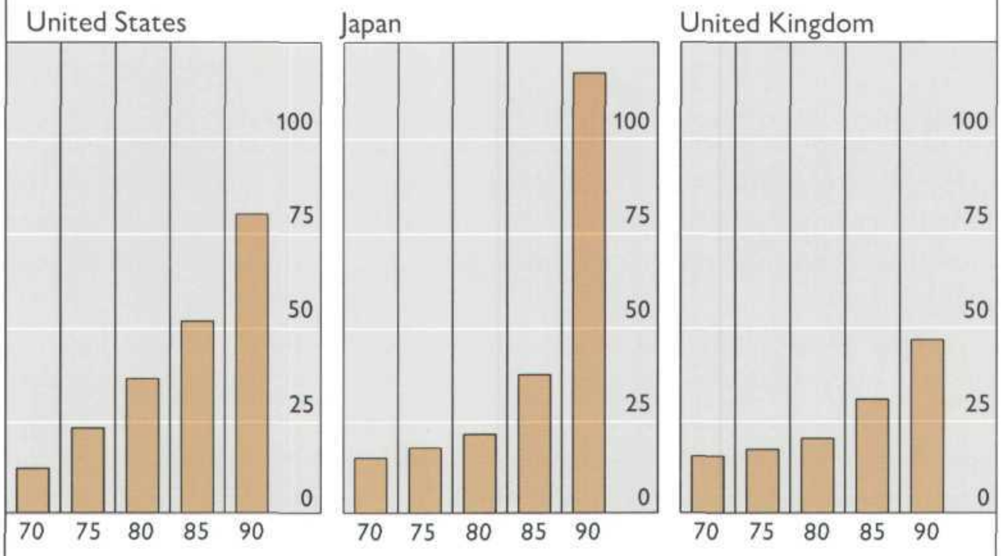
Factors behind instability:

With hindsight, it is clear that the observed instability has involved an element of collective bad judgement. The stock market crash of 1987 was a vivid illustration of the illusion of liquidity and brought home the message that liquidity is only partly a property of market arrangements, as it ultimately rests on the diversity of perceptions about asset values. The ground for the crisis in lending to less developed countries was laid by overly sanguine judgements of sovereign risk. The recent problems in connection with lending for highly leveraged transactions (HLTs) stemmed from over-optimistic assessments by both borrowers and lenders of the companies' ability to sustain historically unprecedented debt burdens. Those in real estate lending resulted from similarly misplaced optimism regarding property values and hence the soundness of collateral.

In this respect, the mechanisms behind the recent instability are not new. Moreover, the general euphoria which underlay many of these

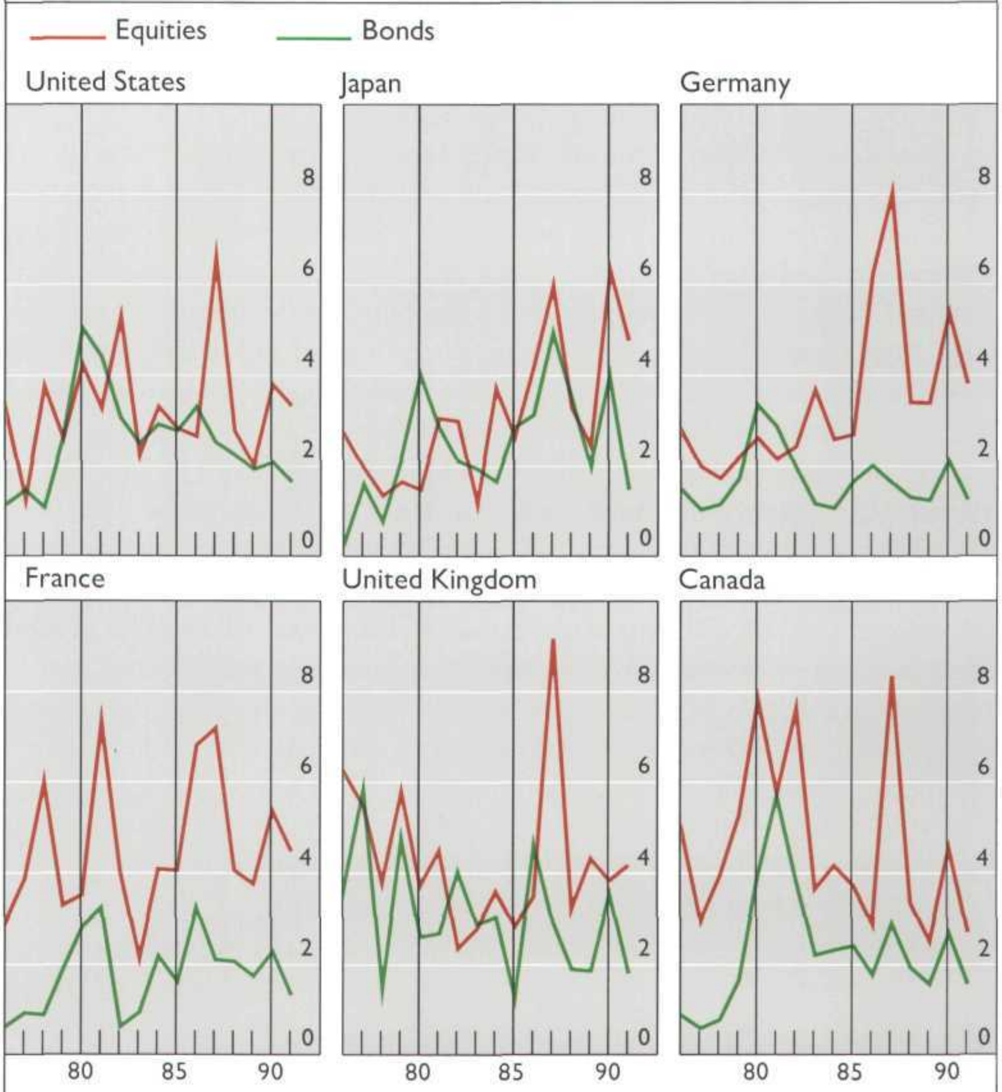
Indicators of trends in the value of payments*

Ratio of the annual value of transactions to GNP



* Payments through the main interbank funds transfer systems.
Sources: National data and BIS estimates.

Indicators of stock market and bond return volatility



Note: The yearly volatility of stock market returns is measured by the standard deviation of monthly returns; that of bond monthly holding period returns is estimated on the basis of the maturity of the bonds and their yield to maturity.

Sources: National data and BIS calculations.

excesses was in part a by-product of the vigorous and long-lasting economic expansion of the 1980s. At the same time, the changes in the financial environment helped to make such collective errors of judgement more likely and their implications more serious and widespread internationally.

The greater internationalisation and integration of the financial industry meant that shocks were more easily and swiftly transmitted across borders, from one market to another or between different units of the same institution. Mention need only be made of the global nature of the stock market crashes of 1987 and 1989, the importance of cross-border investments in some of the most buoyant real estate markets or the heavy losses incurred by foreign institutions in securities business, HLTs and property markets.

heightened competition;

Over time, the greater competitive pressures unleashed by deregulation and innovation tended to reduce the cushion of protected rents and make earnings more variable, as some enterprises or sectors gained at the expense of others. Those same competitive pressures encouraged greater acceptance of risk. Moreover, conscious risk-taking, underpricing and over-expansion were fostered by the tendency to give priority to aggressive growth objectives over return on capital, often as a means of establishing a dominant position in a new market or as a way of compensating for the loss of business elsewhere. The common practice of assessing performance in relation to the average and the fear of being "left behind" helped to breed uniformity of judgement, potentially compounding individual error.

adjustment difficulties;

Some of these elements are part and parcel of competition. But they are much more prominent in the transition from a protected to a competitive environment, from one where enterprises are confined to conducting business in familiar markets, following well-rehearsed operating rules, to one where new rules of the game apply. All market participants, whether financial institutions, non-financial companies or individuals, require time to learn how to act in a new environment.

Practically all the instances of instability observed recently have involved elements of the kind just described. Suffice it to mention here the surge in indebtedness in the wake of the relaxation of credit constraints, which facilitated investment in real and financial assets and the financing of expenditure sometimes beyond sustainable levels, setting the stage for subsequent strains and painful balance-sheet adjustments; or, on a smaller scale, the experience of the "Big Bang" in the United Kingdom; or again, the limited understanding of the relationship between futures and cash markets, of the demands that the new derivative markets made on trading capacity and order handling techniques in the underlying market, and of the systemic implications of dynamic hedging techniques such as portfolio insurance – all prominent factors in the stock market crash of October 1987 in New York.

Banks' real estate lending in selected countries[1]

Countries	1980	1985	1987	1991	Countries	1982	1985	1987	1991
	as a percentage of total loans outstanding					as a percentage of loans to the private sector			
United States					Canada	30	33	39	49
Total	28	29	34	42	France	28	29	29	31
Commercial	10	13	17	17	Germany	44	46	45	40
United Kingdom					Norway	51[2]	48	41	52
Total	12	19	23	31[3]	Portugal	23	28	33	32
Non-housing[4]	7	7	8	12[3]	Spain	19[2]	19	20	29
Japan[5]	11	13	15	17	Switzerland	27	28	29	34[6]

[1] The data are not fully comparable across countries. [2] 1983. [3] Break in series resulting from the inclusion of a building society which was converted into a bank. [4] Construction and property companies. [5] Construction and real estate management firms. [6] 1990.

Sources: National data and BIS estimates.

There is clearly a risk, however, of attributing too much responsibility for the observed instability to deregulation and innovation as such. The origins of the recent turmoil can in many cases be found in the starting conditions, in the long tradition of controls on portfolio, line-of-business and pricing decisions. Furthermore, both macro and microeconomic policies have played a significant role.

In some cases, direct controls had resulted in portfolio configurations ill-suited to the new environment of interest rate and asset price volatility, as in the savings and loan industry. In others they had prevented fundamental diversification, as long-standing branching restrictions in the United States still do. More generally, they had fostered bloated cost structures and left enterprises ill-equipped to operate, assess risks and price in a liberalised and more competitive environment. Moreover, the less open conditions in which financial intermediation had taken place before deregulation in many countries, mainly because of heavy government involvement and less disclosure, make it difficult to evaluate the true extent of previous financial distress.

and inadequate policies

Macroeconomic policy has often been found wanting. It has sometimes failed to secure a sufficiently stable environment. The inflation of the 1970s, for example, sowed the seeds of the sharp upward adjustment and volatility of interest rates in the early 1980s which triggered the problems of many institutions and heavily indebted borrowers. It has also on occasion failed to support the deregulatory process with the necessary safeguards. In several countries, for instance, the relatively lax monetary policy accompanying deregulation permitted the overextension of both lenders and borrowers; by contrast, the monetary discipline enjoyed by ERM members appears to have helped to contain some of the excesses observed elsewhere.

Micro policy has also been deficient in certain respects. Often generous tax deductibility of interest payments encouraged the growth of indebtedness, notably in a number of Nordic countries. In some cases the uneven distribution of controls and supervisory standards resulted in insufficient checks on imprudent behaviour and excessive risk concentration, as exemplified by the serious problems experienced by non-bank credit institutions in Sweden and Japan. In others, arguably overly generous explicit or implicit safety nets encouraged risk-taking, as in the US savings and loan industry. More generally, the strengthening of prudential supervision sometimes lagged behind the change in the financial environment.

As for market participants, and for much the same reasons, it is the transition towards a deregulated environment that has posed the more serious challenges for policy-makers. In many countries the rapidly changing financial structure clouded the interpretation of the behaviour of interest rates as well as monetary and credit aggregates, complicating the setting and implementation of monetary policy. At the microeconomic level, in certain cases the speed and scope of deregulation placed unexpectedly heavy demands on prudential supervision.

If the above analysis is accepted, the conclusion to be drawn is that

Lessons

the benefits of deregulation and financial innovation are worth striving for. They are not, however, a free good, and the costs of attaining them were underestimated. The new financial landscape offers major opportunities but also commensurate risks. Securing and preserving the benefits while minimising the costs calls above all for prudent macro and micro policy, particularly in the fields of monetary policy and supervision.

The immediate challenges

Two related challenges loom large for the years ahead. The first is the elimination of the excess capacity existing in many segments of the financial industry, partly as a result of the rapid expansion of the 1980s. The second is the adjustment to a financial environment in which capital has become a scarcer resource, as a less attractive outlook for earnings and the erosion of the capital base of many institutions have coincided with a strengthening of capital standards. The present less benign or even hostile macroeconomic climate together with the unfolding of strains in the debt and asset markets in several countries render the task confronting the industry all the more difficult.

Need for consolidation ...

The stock market crash of 1987, the subsequent major downward correction in Japan and the widespread weakening of economic activity at the turn of the decade have helped to reveal the need for retrenchment and consolidation in large areas of the financial industry.

... in the securities industry ...

This need has been apparent in the securities industry, most notably in the major financial centres and international markets. The focus on revenue growth with scant regard for costs in the years of expansion and the struggle for market shares in the wake of liberalisation have whittled down the return on capital for many participants below what are generally regarded as sustainable long-run levels. The rebound in profitability in 1991 in countries enjoying lower long-term interest rates and rising stock markets has offered a welcome respite, but is unlikely to have fundamentally altered the picture.

A need for consolidation also exists in parts of the banking industry. In

Bank profit margins[1]

Countries	1980–82	1984–86	1989–90	1990	Countries	1980–82	1984–86	1989–90	1990
United States[2]	0.83	0.83	0.61	0.59	Belgium[3]	0.34	0.39	0.26	0.33
Japan[2,3]	0.40	0.46	0.40	0.33	Finland	0.49	0.55	0.22	0.21
Germany[2]	0.50	0.97	0.88	0.83	Netherlands	0.31	0.66	0.59	0.53
France[2]	0.34	0.21	0.33	0.31	Norway	0.63	0.75	−0.43	−1.02
Italy	0.68	0.96	1.19	1.24	Spain[2]	1.09	0.92	1.75	1.72
United Kingdom[2]	1.04	1.05	0.28	0.59	Sweden[4]	0.38	0.55	0.34	0.22
Canada[3]	0.63	0.74	0.96	1.22	Switzerland	0.65	0.71	0.64	0.53
Australia[3]	1.41	1.33	1.20	0.94					

[1] Ratio of pre-tax profit to average total assets of commercial banks; the data are not fully comparable across countries. [2] Large commercial banks. [3] Fiscal years. [4] A break in series in 1986 considerably raises profit margins in that and subsequent years in comparison with 1980–85.

Sources: For Australia, Reserve Bank of Australia; for other countries, OECD and BIS estimates.

some countries longer-term pressures on profitability can be discerned in the decline in accounting profit margins: by 1990 these were lower than, or broadly similar to, those of the 1980–82 recession, even though the weakening in economic activity had not generally been as marked (see the table on the previous page). In a greater number of countries, the pressures appear to be reflected in the behaviour of bank share prices, which, in contrast to the 1970s, have lagged significantly behind the overall market index during the past decade (see the table below). More generally, even allowing for major national differences in the timing and scale of the increase in competition, in a less favourable macro climate competitive forces are obliging many banks to consolidate. This is true regardless of whether the competition stems from within the industry or outside it, from other financial intermediaries, open capital markets or even non-financial companies themselves (see the sixty-first Annual Report).

... and in banking

Much of the required retrenchment is a result of past developments; but part is also in anticipation of prospective changes in the financial environment. Deregulation and the internationalisation of financial markets have not yet run their full course. In some cases the changes are too recent for their impact to be completely felt, as with the liberalisation of branching restrictions in Italy, the overhaul of securities markets in several European countries and the further desegmentation of the financial industry in Canada. In others they are far from complete, as in Japan or at the level of the European Community.

Consolidation has begun ...

Consolidation has already begun in several sectors, as enterprises attempt to reduce the supply of financial services and/or the costs of providing them. Signs of a tightening of lending terms and widening spreads have been visible in international markets and in those countries where a rapid expansion of lending was followed by a marked deterioration in asset quality. Disillusionment with despecialisation and foreign expansion has led some firms to refocus on core business and to withdraw from certain markets. Expensive branch networks and, especially in the securities industry, employment levels have come under growing pressure. Increas-

Long-term movements in bank share prices

Countries	1970	1980–82	1984–86	1992 Q I	Countries	1970	1980–82	1984–86	1992 Q I
	ratio of bank index to overall index, 1980 = 100					ratio of bank index to overall index, 1980 = 100			
United States	142	111	120	71	Belgium[1]	110	97	92	93
Japan[1]	71	103	149[2]	169[2]	Finland	84	98	84	45
Germany	95	95	85	79	Netherlands[1]	n.a.	92	77	56
Italy	n.a.	139	96	83	Norway	101	103	67	7
United Kingdom	85	97	90	85	Spain	56	112	78	83
Canada	113	106	107	133	Sweden	69	99	84	54
Australia	103	131	153	151	Switzerland	64	99	92	59

[1] Including other financial institutions. [2] The rise between 1983 and 1987, when the ratio reached 202, is largely due to the breakdown of restrictive arrangements aimed at controlling bank share prices.

Source: National stock exchanges.

ingly, institutions are exiting through mergers which foreshadow internal reorganisation. All of these elements are symptoms of a rediscovery of profitability as the key benchmark in the assessment of performance in place of mere size or growth.

The required restructuring poses serious challenges for both market participants and policy-makers. Voluntary withdrawal from markets may be hindered by the inability to recover the costs incurred in entry and by the fear of losing reputation. Especially in the banking industry, cost structures appear to exhibit a certain rigidity. Mergers may hold forth the promise of leaner organisations, better able to reap the benefits of economies of scale and scope, but past experience indicates that these gains are often difficult to realise. Policy-makers for their part are called upon to manage the process in such a way as to limit the risk of disorderly exit. This risk is particularly serious when whole sectors see their raison d'être undermined by changes in the regulatory environment, as in the case of certain previously protected specialised credit institutions, and where past expansion has resulted in poor asset quality. The task of policy-makers involves not only strengthening prudential supervision and crisis management, but also removing legal or other barriers to the necessary consolidation, as exemplified by recent or prospective legislative changes in Italy and Japan.

... aided by capital standards

The strengthening of capital standards has been a significant factor in promoting consolidation in the banking industry. It has encouraged the renewed focus on profitability as a guide to business policy and yardstick of performance. It has placed banks under the scrutiny of the capital markets as they seek to raise funds. It has stimulated cost-cutting and a strategic reappraisal of lines of business and geographical areas of operation. Finally, it has provided an added incentive to merge so as to pool capital resources.

The influence of capital requirements on banks' policy choices has depended on initial conditions and developments in the quality of portfolios. For some banks, such as many large German and Swiss institutions, the capital cushion has generally been sufficient, so that the standards have not acted as a significant constraint. For others, such as some French and Italian banks, public ownership at a time of restraint on public finances has narrowed the availability of external capital, hence the recourse to share exchanges with other public sector companies (in France) or changes in legislation allowing for access to other sources of external equity financing (in Italy). But the greatest impact has been on those enterprises facing a marked deterioration in the quality of their portfolios, notably some of the largest US banks, banks in a number of Nordic countries and Japanese institutions, as the need for additional capital has coincided with a reduced willingness on the part of the markets to provide it. In Japan the impact has been reinforced by the sharp downward correction in the stock market, given the banks' heavy reliance on revaluation reserves.

The influence of capital standards can be expected to be stronger during the period of adjustment, not least because of the present unfavourable macroeconomic climate, which tends to push up provisioning needs. It is then that the strain on existing portfolio configurations is greatest. Their influence, however, is likely to extend further and to form a permanent feature of the new financial landscape. As other constraints on portfolio choices are relaxed, capital standards become a significant regulatory influence on banks' pricing and investment decisions. As such, they will probably also assume growing importance as determinants of the competitiveness of banks in different centres and, above all, of banks vis-à-vis other financial institutions. In addition, by increasing the recourse to capital market funding, they may stimulate greater convergence of accounting and disclosure requirements, one of the areas in which profound differences still exist internationally.

The longer-term challenges

As the 1990s unfold, there will be a continuing need for policy-makers to assess the scope, mechanisms and limits of government involvement in the financial industry. It would clearly be futile to speculate on the outcome of this assessment, which will inevitably depend on unforeseeable developments. Nevertheless, it seems possible to identify some of the issues that may attract increasing attention in the light of the structural changes that have taken place or can be expected to occur in the near future.

Contrasts in the determination of financial structures ...

An important feature of the 1990s will be the contrasting approaches to the determination of financial structures in the United States, Japan and the European Community.

In the United States the legislative approach has been essentially reactive and has exhibited a bias towards maintaining the status quo. The conflicting lessons regarding the merits of deregulation derived from previous crises, a historically ingrained distrust of the concentration of economic power and the nature of the political process have all combined to halt progress in the relaxation of remaining restrictions on banks' geographical area of operation and lines of business put forward in the Administration's recent bill. Against this background, a major force shaping the financial system may well be innovations aimed at alleviating the existing constraints. Past examples of this process are the syndication and selling-down of loans, which enabled banks to carry out quasi-investment banking activities, and the development of junk bonds, which permitted some otherwise restricted institutional investors to hold securities with equity-like properties.

Japan, starting from a much more regulated structure, has opted for a gradualist approach to liberalisation in line with the need to muster consensus for change and with a view to avoiding major dislocations. Changes are expected in several areas, including the desegmentation of the credit system, the lowering of barriers between commercial and investment banking, the development of domestic capital markets, the completion of the deregulation of deposit interest rates and the liberalisation of brokerage commissions.

In the European Community the creation of a single market for financial services is likely to test free market forces and competition to the full. Subject to the harmonisation of "essential" supervisory standards, this market is founded on the principle of "mutual recognition" of, and hence competition between, national laws, regulations and practices. The single market framework sets no geographical limits on the operation of financial companies and no significant restrictions on their lines of business.

... and pressure for convergence

Notwithstanding these differences certain pressures for further international convergence in financial structures will probably persist. Advances in information technology and telecommunications should make the cross-border provision and relocation of financial services less costly, so that national financial services become increasingly substitutable. This can foster convergence by exposing less efficient structures, by leading to increased calls for "level playing-fields" and by undermining less attractive national regulatory, legal and tax arrangements. The possible risk of competition in laxity puts a premium on international coordination.

The task of safeguarding the integrity of the financial system will remain central to policy-makers' concerns. The last ten years or so have already seen major efforts to strengthen the prudential framework as a necessary complement to structural deregulation. Much still remains to be done, however, to take account of the new market realities.

Changes in the nature of systemic risk:

As a result of the changes in the structure and workings of the financial system, the nature and transmission of systemic risk have changed in many respects. As discussed below, these changes have heightened the importance of payment and settlement arrangements and of market risks, have vastly increased the speed with which turmoil can spread and have highlighted the role of liquidity provision as the lifeblood of financial activity. They have also complicated the resolution of problems by rendering markets and institutions more opaque and participants less homogeneous.

payment and settlement systems;

Payment and settlement systems have always been the key institutional channel for the propagation of systemic crises, typically triggered by the inability of one or more institutions to settle their obligations. But the explosion in the volume of financial transactions and related settlement flows over the last fifteen years or so has radically altered the dimensions of the risks involved. The risks tend to concentrate in the interbank large-value funds transfer systems which support financial activity. Banks participating in these systems now incur unprecedented intraday liquidity and credit exposures, potentially on a larger scale than the exposures traditionally captured in their balance sheets and often less closely monitored and controlled. In principle, this exacerbates the vulnerability of the system to the default of a participant or to technical failure and heightens the risk of domino effects. The international ramifications of the bankruptcy of Bankhaus Herstatt in 1974 – although exposures were much smaller then – the technical failure affecting the Bank of New York in 1985 and even the difficult unwinding of Drexel's operations in 1990 have helped to raise awareness of the magnitude of these risks.

market risks;

With the rapid development of securities and derivative markets as well as foreign exchange contracts, institutions have become more exposed to market risks. Fluctuations in the market price of assets are a more important source and channel of transmission of potential shocks. This puts a premium on risk management procedures to control exposures, generally through hedging via derivative instruments. It also highlights the importance of the smooth functioning of markets under adverse conditions: prices should continue to be quoted and transactions executed and settled. As positions are increasingly taken across a number of markets, problems in one segment can quickly be transmitted to others. The stock market crash of 1987 is a vivid illustration of how very different operating arrangements across markets for highly substitutable instruments can have destabilising effects by resulting in widely differing price reaction speeds, uncoordinated stoppages and excessive funding pressures. The failure of a major market-maker in over-the-counter derivative markets, for example, could have serious ramifications.

speed of transmission of disturbances;

The transmission of disturbances in financial markets has typically been quite fast, but its speed and reach have increased substantially as a result of the developments in information technology and the integration of market segments. The generalised withdrawal of deposits by retail customers is no longer a serious trigger of a crisis, partly because of the deposit protection schemes in place in many countries. The main potential channel is the seizing-up of funds in the wholesale markets or the unwillingness to enter into transactions with an institution as counterparties react to doubts about its soundness. The difficulties of the Bank of New England in unwinding billions of dollars' worth of derivative contracts outstanding are a telling example. The limited time available to take decisions in possibly disorderly market conditions coupled with the size of the exposures involved heightens the risk of a general withdrawal from the markets and compounds the problem of those institutions responsible for their integrity.

importance of liquidity;

These observations suggest that the provision of liquidity has become a more important function in the new financial environment. This may appear somewhat paradoxical in that the greater marketability of assets should in principle reduce the need for outside sources of funds. Moreover, the design of many derivative instruments limits settlement flows. In practice, however, securities and derivative markets could hardly function without appropriate liquidity support: it is the transactors' ability to settle, and their confidence in the ability of their counterparties to do likewise, which underpins trading. Consequently, as the main source of readily available funds, banks still lie at the core of financial activity, even in those countries where according to measures of intermediation their importance in the financial system may have declined. Any doubts in this respect should have been dispelled by the experience of the 1987 stock market crash, which highlighted the necessity of maintaining open credit lines to operators in the securities and derivative markets in order to avoid systemic instability.

opaqueness of markets;

In many ways financial markets have become more opaque, for participants and supervisors alike. Much has of course been done to improve disclosure. But greater opaqueness has developed with regard to instruments, relationships across instruments and markets and the organisational structure of institutions. A precise understanding of the new financial instruments and trading techniques is the preserve of a relatively restricted group of people, while the relationships across instruments and markets and their vulnerability to changing market conditions are more difficult to fathom and have been tested only in a few isolated cases. Although participants may be able to assess their own exposures, they find it increasingly hard to form a view of the overall exposures of their counterparties and of market concentration. This development has been noticeable in the interbank market, for example, given the much greater use made of over-the-counter derivatives. The growing complexity of organisational structures, typified by the emergence of national and international financial conglomerates, further clouds the assessment of the soundness of an institution and its component units. As was recently illustrated by the BCCI affair, in the banking industry financial globalisation has allowed ample scope for the creation of opaque corporate structures. Under these conditions, the evaluation of risks, particularly counterparty risks, becomes considerably more difficult.

and composition of participants

As barriers to entry have fallen and markets have grown, the composition of participants in individual market segments has become more heterogeneous. As a result, the significance of differences in size, objectives, corporate cultures and regulatory constraints has increased. This development, especially marked in the main international financial centres, has raised two related problems. On the one hand, it has tended to increase the likelihood of unequal competition between institutions. On the other hand, it has undermined informal prudential arrangements while hindering the emergence or effectiveness of self-regulation because of the differences of interests involved.

The four challenges:

The changing nature of systemic risk has presented the authorities with at least four challenges. The first three correspond to the key lines of defence which can be set up to cope with the risk of a crisis: prudential regulation and supervision of individual institutions, the design of system checks and balances, and crisis management techniques. The fourth concerns a vital dimension of all lines of defence, viz. the balance between government involvement and market discipline.

prudential supervision of individual institutions;

By tackling excessive risk-taking at the source, prudential regulation and supervision of individual institutions could go a long way towards dealing with the origin of systemic disturbances. Any such system needs to address a number of issues.

The system should in principle *cover* at least those financial companies whose failure could trigger systemic turmoil. There is unavoidably some disagreement as to what this should mean in practice, although past experience indicates that coverage limited to "banks" may not be sufficient. It is, however, widely recognised that despite the major steps taken to broaden coverage over the last decade, both nationally and internationally, a number of supervisory gaps still exist. Perhaps the most obvious is that which allows some securities houses to engage in certain types of activity through unsupervised affiliates.

Partly related to coverage is the issue of whether institutions should be supervised on a *consolidated basis*. While the precise meaning of this term is open to different interpretations, the underlying question is whether independent capitalisation of units within the same financial group, possibly combined with "firewalls" aimed at limiting the transfer of capital between them, can be relied upon to isolate those units from the rest of the group in times of distress. Recent experience, such as the failure of Drexel in the United States and British and Commonwealth in the United Kingdom, has indicated that market perceptions and group interdependencies undermine effective separation. Failure to consolidate can therefore blur an assessment of the real soundness of financial companies and result in supervisory gaps. Consolidation is now a standard practice in banking supervision following concerted international action in the early 1980s. It is not a principle as yet generally accepted in the supervision of securities and insurance business. Furthermore, its implementation in organisations covering widely differing activities is fraught with conceptual difficulties.

The question of the *distribution of supervisory responsibilities* and *coordination* among different authorities has acquired greater significance in the light of the despecialisation and internationalisation of institutions. National authorities remain divided as to the merits of the centralisation of supervisory responsibilities, views being significantly affected by the historical legal framework, for example with respect to the possibility of combining commercial and investment banking. There is a consensus, however, on the need for further cooperation nationally and internationally in areas such as the precise allocation of responsibilities, the exchange of information and, to a lesser extent, greater consistency of supervisory methods. Cooperation among banking supervisors was intensified in the 1980s, as the conclusion of the Basle Concordat and the later accord on capital standards testify. Since the late 1980s cooperation has begun to take shape between banking, securities and, more recently, insurance supervisors and regulators.

As regards the *methodology of supervision,* the issue of capital adequacy has taken on a new dimension since the mid-1980s. The Basle accord on capital standards was designed to strengthen banks against potential losses, notably through a more balanced treatment of credit risk and the inclusion of off-balance-sheet exposures in the capital framework, while reducing competitive inequalities arising from differences in national arrangements. The 1990s should see the extension of the accord to cover market and interest rate risks, an extension which raises complex technical questions. Work is also under way, at both the EC and a wider international level, to achieve greater consistency of standards between banking and securities supervisors in an effort to reduce the scope for regulatory arbitrage. Despite marked differences in supervisory philosophy (see the sixtieth Annual Report), considerable progress has been made, as exemplified by the understanding reached at the meeting between the Basle Committee on Banking Supervision and the Technical Committee of the International Organisation of Securities Commissions in early 1992. It is not clear, however, to what extent consistency can be achieved given the profound differences in the nature of the activities.

system checks and balances;

The supervision of individual institutions needs to be complemented with prudential arrangements at the systemic level designed to cope with the problems that may result from the linkages between institutions and from general shocks. Typically this second line of defence involves the pooling of resources in order to share losses or secure external liquidity support (e.g. deposit insurance schemes for small depositors). It may also include mechanisms for the monitoring and control of aggregate exposures of participants in specific sub-systems (as in some organised exchanges). One challenge for the 1990s will be to devise such arrangements and extend their coverage so as to take account of the growing complexity of financial relationships. At the top of the agenda are arrangements for payment and settlement systems, especially interbank large-value funds transfer systems, where some progress has already been made since the mid-1980s with the introduction of risk reduction policies. These have included, for instance, the setting-up of collateral-pooling or loss-sharing schemes and centralised facilities for the monitoring and containment of settlement exposures. A related area is that of cross-border interbank netting schemes, aimed at reducing settlement flows and reciprocal credit and liquidity exposures, for which a recent report by the central banks of the Group of Ten countries recommends a set of minimum safety standards and lays down the principles for cooperative central bank oversight.

crisis management;

If a crisis does occur and cannot be fully resolved by the safety mechanisms built into the system, the authorities may be called upon to intervene so as to limit its range and severity. The form taken by this third line of defence will vary depending on the origin and magnitude of the shock, the sectors affected and other, country-specific factors. However, it will often involve the central bank, as the institution ultimately in control of the liquidity in the system. The task facing the authorities is to adapt their techniques of intervention to the new financial environment, where the sources of the shocks and hence the need for liquidity may be more remote from their "privileged interlocutors" (the banks), where the complexities of the market and institutional interrelationships may complicate judgements as to the scale and compass of the required intervention and where the time available to act is much reduced compared with the past. This task calls for an intimate knowledge of market mechanisms and participants.

and the balance between market discipline and official involvement

A key issue in the design of the system of lines of defence is the balance between market discipline and the authorities' involvement. The limitation of market discipline is that it may be insufficient or may exert itself in a way which is not consistent with systemic stability. A drawback of the authorities' involvement is that it may be counterproductive in certain circumstances if it gives market participants a false sense of security, encouraging them to take on further risks – a problem often referred to as "moral hazard".

There are national differences in where the balance is struck between official involvement and market discipline; but the overall recent tendency has been to make greater room for market discipline alongside official prudential supervision. The search for this balance has dominated the policy debate in the United States, where changes in the payment and settlement systems, a tightening of deposit insurance schemes and a reconsideration of the "too big to fail" doctrine have been motivated by the belief that incentives to prudent behaviour had been blunted for too long through an overgenerous and underpriced "safety net". More generally, the global strengthening of capital standards can also be seen as creating greater room for market discipline. Although the capital requirement is an external constraint on portfolio behaviour, providing a cushion against potential losses, its strengthening also increases the incentive and provides a means for capital markets to monitor and discipline an institution.

Shifting the balance towards market discipline is not a simple task. It calls for improved information disclosure, a step which raises controversial issues concerning the choice of accounting systems and the nature and range of the information disclosed. Above all, reducing incentives to excessive risk-taking will depend on the credibility of the authorities' commitment to limiting intervention to the necessary minimum in the event of turmoil. That credibility is only partly a question of legislation and regulations: in the complex present-day financial environment, it inevitably requires a degree of official discretion. In much the same way as the monetary authorities' anti-inflation commitment, it needs to be demonstrated in consistent action.

Importance of internal risk management

Irrespective of the effectiveness of the framework set up to cope with systemic risk, however, the lesson which can be drawn from past experience is that the key to financial stability lies within institutions themselves. Financial activity is not only about the taking of risks, but also about the proper pricing and management of those risks as a means to lasting success. The best supervision, ultimately, begins at home.

IX. Activities of the Bank

1. Cooperation between central banks and international organisations

During the past year the Bank has continued to play its traditional role in fostering international monetary cooperation.

The Bank participated as an observer both in the work of the Interim Committee of the Board of Governors of the International Monetary Fund on the International Monetary System and at the meetings of the Finance Ministers and central bank Governors of the Group of Ten countries and of their Deputies. Furthermore, the Bank continued to perform the functions entrusted to it in August 1964 by the Ministers and Governors of the Group of Ten of collecting and distributing to all the participants in the Group and to Working Party No. 3 of the Organisation for Economic Co-operation and Development data concerning the financing of external surpluses and deficits of the Group of Ten countries.

In addition to the regular meetings in Basle of the Governors of the central banks of the Group of Ten countries, the Bank continued to organise periodic meetings of central bank officials on a variety of subjects. As in the past, it also provided the secretariats for various committees and groups of experts.

The Euro-currency Standing Committee continued to monitor international banking and capital market developments. In particular, it discussed the implications for international financial markets of developments in certain asset markets and the role of international bank lending in the process of transition in eastern European countries. In the course of the year, the Committee also reviewed developments and examined some policy issues in the area of international interbank relations and derivative markets. The Bank continued to compile, analyse and publish statistical data on developments in international banking and financial markets.

The Basle Committee on Banking Supervision has given priority to three projects over the past year. First, in the aftermath of the BCCI affair, the Committee carried out a review of the collaborative arrangements for the supervision of international banks. It is likely that a set of minimum standards designed to strengthen the Basle Concordat will be issued by the Group of Ten central bank Governors shortly. Secondly, as part of its continuing work of monitoring the progress of the Basle capital accord of July 1988, an amendment was issued in November 1991 in respect of the inclusion of general provisions and general loan loss reserves in capital. Thirdly, preliminary understandings were reached with the Technical Committee of the International Organisation of Securities Commissions on the introduction of minimum capital requirements for the market risks incurred by banks and securities firms. It is intended that proposals in this area should be issued for formal consultation with the banking and securities industries in the course of 1992. In June 1991 Mr. E. Gerald Corrigan, President of the Federal Reserve Bank of New York, was appointed Chairman of the Basle Committee following the death of Huib J. Muller, who had chaired the Committee since October 1988.

The Service for Eastern European Countries and International Organisations, set up in mid-1990, intensified its work of coordinating the technical assistance and training provided by the central banks of the Group of Ten countries and Austria to central banks in eastern European countries. In close cooperation with the International Monetary Fund, these coordination activities were extended to include a much larger number of donor central banks and, on the recipient side, the central banks of the republics of the former Soviet Union. The Service participated on behalf of the BIS in IMF missions to this region. In keeping with the Bank's role as a forum for the exchange of views among central bank officials, the Service organised meetings and seminars for representatives from central banks of industrialised and eastern European countries for the purpose of exchanging information on their experience in specific areas.

The Committee on Payment and Settlement Systems held its regular meetings in June and December last year. It continued to review developments in domestic and cross-border payment, netting and settlement arrangements in the Group of Ten countries. Attention was focused on the existing and developing infrastructures which provide major links between payment and settlement systems in different countries. The Committee also discussed reports drawn up by working groups on delivery versus payment methods for settling securities market transactions and the measures that central banks might take, individually or on a cooperative basis, to improve efficiency and reduce risks in the settlement of cross-border and multi-currency transactions.

The Group of Computer Experts continued to devote attention to the area of telecommunications, studying, in particular, the networks and EDP systems which provide the technical infrastructure for the main payment systems in the Group of Ten countries; it also embarked on a survey of the links which the central banks maintain with other banks and with providers of services for the automated exchange of information. Its Working Party on Security Issues, while complementing the Group's work on these two subjects from the security standpoint, undertook a further analysis of the phenomenon of computer viruses and examined the dependence of computer installations on the technical environment in which they operate.

The Group of Experts on Monetary and Economic Data Bank Questions continued to focus its attention on ways of strengthening BIS Data Bank Services for central banks in the Group of Ten countries. Efforts towards improving the timeliness and quality control of statistics were reviewed and further initiatives were agreed. Information security issues were explored, particularly in the context of upgraded telecommunication arrangements with participating institutions. With respect to central bank interest in broadening the coverage of statistics in the database to include countries outside the Group of Ten, the BIS reported on favourable developments in its bilateral arrangements for data exchange with central banks in these countries.

The Committee of Governors of the Central Banks of the Member States of the European Economic Community and the Board of Governors of the European Monetary Co-operation Fund (EMCF) as well as their sub-committees and working parties continued to hold most of their meetings at the BIS, where the Committee of Governors' permanent Secretariat is also located. The Committee of Governors is the principal forum for monetary cooperation in the Community and contributed significantly to the preparation of the Treaty on European Union, which was agreed by the Heads of State and Government in Maastricht in December 1991.

In accordance with its mandate, as extended by the Decision of the Council of the European Communities on 12th March 1990, in April 1992 the Committee of Governors published its first Annual Report on its activities and on the monetary and financial conditions in the Community. The Report, which covered the period from July 1990 to December 1991, was transmitted to the European Parliament, the Council of the European Communities and the European Council.

2. Functions as Agent and Trustee

During the past financial year the Bank continued to perform various Agency functions in connection with international financial settlements.

(a) Agent for the European Monetary Co-operation Fund (EMCF)

The Bank continued to perform the functions of Agent for the EMCF which it has been executing since 1st June 1973.* These functions, on the one hand, are connected with the operation of the EMS and, on the other, relate to the execution of financial operations in connection with Community borrowing and lending for the purpose of balance-of-payments support for EC member countries.

During the period from 1st April 1991 to 31st March 1992 interventions carried out by EMS central banks in other EMS member countries' currencies and entered in the books of the EMCF in the framework of the very short-term financing mechanism amounted to approximately ECU 302 million.

The volume of ECUs issued by the EMCF through three-month swap operations with each of the EC central banks that are signatories to the Agreement of 13th March 1979 and with the Luxembourg Monetary Institute fell slightly from ECU 46.6 billion at 1st April 1991 to ECU 46.3 billion at 31st March 1992.

* For a description of the structure and functions of the Fund, see the fifty-fourth Annual Report, pages 162–164.

As regards the Community borrowing and lending operations referred to in Council Regulation (EEC) No. 1969/88 adjusting the Community loan mechanism designed to support the balance of payments of member states,* particulars of which were given in the fifty-sixth, fifty-seventh and sixty-first Annual Reports on pages 171, 183 and 205–206 respectively, during the period under review the Agent continued to receive from the borrowers, namely France and Greece, and to distribute to the creditors vis-à-vis the Community the sums due in respect of interest, commission and expenses on loans outstanding.

The Agent also carried out the financial transactions connected with the following operations relating to Community loans granted to these two countries:

– at the interest maturity date of 26th July 1991, the advance repayment by France of the ECU 30,000,000 loan 1983–93 at 11.50% per annum, corresponding to the third tranche of the ECU 150,000,000 issue of notes 1983–87/90/93 in three tranches;

– at the following final maturity dates, the repayment by Greece of the following loans:
on 2nd January 1992, the DM 30,000,000 loan 1987–92 at 5.54% per annum, corresponding to the bank loan in the same amount,
on 29th January 1992, the ECU 100,000,000 floating rate loan 1988–92 (the second tranche of the ECU 350,000,000 loan 1988–91/92/93 in three tranches), corresponding to the second tranche of the issue of notes at 7⅜% per annum in the same amount,
on 21st February 1992, the DM 500,000,000 floating rate loan 1986–92, corresponding to the issue of notes in the same amount, and
on 25th February 1992, the ECU 150,000,000 loan 1987–92 at 7½% per annum (the first tranche of the ECU 350,000,000 loan 1987–92/94 in two tranches), corresponding to the first tranche of the issue of notes in the same amount.

The following table shows, as at 31st March 1992, the total of outstanding Community lending operations.

Outstanding Community loans as at 31st March 1992

Borrowing country	US dollars	Deutsche Mark	Swiss francs	Yen	ECUs
	in millions				
Greece	250	836	227	25,000	1,090

(b) Agent for the private ECU clearing and settlement system

Since October 1986 the Bank has performed the functions of Agent for the private ECU clearing and settlement system in accordance with the

* With effect from 24th June 1988 this Regulation replaced Regulation (EEC) No. 682/81 of 16th March 1981, which had previously been the legal basis for the EMCF's activity in connection with Community borrowing and lending operations.

provisions of successive agreements concluded between the ECU Banking Association (EBA), Paris, and the BIS, the most recent of which was signed and entered into force on 27th December 1990.* Member banks of the EBA may be granted the status of clearing bank on the basis of criteria drawn up by that body. As a result of the merger between Algemene Bank Nederland N.V. and Amsterdam-Rotterdam Bank N.V. in September 1991 the number of clearing banks stood at forty-four on 31st March 1992.

(c) Trustee for international government loans

As reported in previous years until 1988, the Bank fulfilled the functions of Trustee for the conversion and funding bonds which were issued by the Government of the Federal Republic of Germany in accordance with the London Agreement on German External Debts of 27th February 1953. Those bonds reached final maturity in October 1972 in the case of the German External Loan 1924 (Dawes Loan) and in June 1980 in the case of the German Government International Loan 1930 (Young Loan). So far as the exchange guarantee for the Young Loan under the London Agreement is concerned, reference should be made to pages 168–169 of the fiftieth Annual Report of the Bank, which was published in June 1980.

As a consequence of German reunification on 3rd October 1990, and in the light of the obligations which it had assumed under the London Agreement, the Government of the Federal Republic of Germany announced its intention of settling arrears of interest, for the period 1944 to 1952, both for the Dawes Loan and for the Young Loan. For that purpose, the German authorities have already started to float thirteen new issues of funding bonds. The new bonds carry interest at 3% per annum from 3rd October 1990, payable half-yearly as from 3rd April 1991, and will reach final maturity on 3rd October 2010.

Bearing in mind the technical developments which have taken place in recent years so far as bond issues are concerned, the German authorities have approached the Bank with a view to the latter assuming, in a simplified form, certain of the functions which it had previously performed as Trustee. The Bank has indicated its willingness, in principle, to lend its assistance with respect to the new funding bonds 1990–2010. However, the related negotiations have not yet been concluded.

3. Financial assistance to central banks

Whereas the BIS had been approached to arrange bridging finance on a number of occasions in previous years, it set up only one operation of this kind during the financial year 1991–92. This was a facility arranged in favour of the National Bank of Romania in September 1991 for a total of ECU 180 million, of which ECU 145 million was granted by the BIS and ECU 35 million by the KfW (Kreditanstalt für Wiederaufbau) of the Federal Republic of Germany. The BIS share was backed by ten EC central banks.

* For a description of the structure and operation of the clearing system, see the fifty-sixth Annual Report, page 172.

The loan was intended to prefinance the first tranche of an EC credit to the Republic of Romania which was due to be made available in November 1991. However, for technical, procedural reasons the EC credit was not available until the end of January 1992. Accordingly, it was decided by mutual agreement that the bridging facility would expire on 31st January 1992; on that date the funds obtained by the National Bank of Romania enabled it to repay the loan in full.

4. Operations of the Banking Department

The Balance Sheet of the Bank and the Profit and Loss Account at 31st March 1992, certified by the auditors, are reproduced at the end of this Report; they are expressed in gold francs.*

At the end of the sixty-second financial year, on 31st March 1992, the balance-sheet total stood at GF 47,961,052,059

On 31st March 1991 it had amounted to	GF 45,719,139,929
There was thus an increase of	GF 2,241,912,130

or 4.9%.

This rise, which compares with that of 10.7% recorded in the previous financial year, was chiefly due to an increase in resources; exchange rate movements over the financial year under review were not significant and consequently accounted for only a small part of the rise in the balance-sheet total. It should be mentioned that most currencies other than the US dollar appreciated in gold franc terms, with the exception, in particular, of the Swiss franc.

BIS: Development of the balance-sheet total over the past five financial years

Financial years ended 31st March	Balance-sheet total	Movement over the year	
	in millions of gold francs		in percentages
1988	38,151	+ 8,207	+ 27
1989	42,234	+ 4,083	+ 11
1990	41,291	− 943	− 2
1991	45,719	+ 4,428	+ 11
1992	47,961	+ 2,242	+ 5

The following are not included in the Balance Sheet:

– bills and other securities held in custody for the account of central banks and other depositors;

– accounting entries arising from the Bank's functions as Agent for the European Monetary Co-operation Fund as described in Section 2 above;

– gold held under earmark for the account of various depositors; this item, which declined slightly, amounted to 1,246 million gold francs on 31st March 1992, compared with 1,275 million gold francs on 31st March 1991.

* The gold franc (abbreviated to GF) is the equivalent of 0.290 322 58... grammes fine gold – Article 4 of the Statutes. Assets and liabilities in US dollars are converted at US$ 208 per ounce of fine gold (equivalent to 1 gold franc = US$ 1.941 49...); all other items in currencies are converted on the basis of market rates against the US dollar.

Liabilities (composition of resources)

BIS: Development of resources over the past five financial years
(after allocation of the net profit for the year
as proposed to the Annual General Meeting)

Financial years ended 31st March	Paid-up capital and reserves	Borrowed funds	Other liabilities	Balance-sheet total
	in millions of gold francs			
1988	1,335	35,658	1,158	38,151
1989	1,404	39,875	955	42,234
1990	1,476	38,673	1,142	41,291
1991	1,557	42,856	1,306	45,719
1992	1,644	44,866	1,451	47,961

A. Capital and reserves

(a) Paid-up capital GF 295,703,125

The Bank's authorised capital remained unchanged at 1,500 million gold francs; there was likewise no change in the issued capital, which is made up of 473,125 shares paid up to the extent of 25%.

(b) Reserves

The movements in the various reserve funds, commented on below, are shown in the table at the end of this Report, under Item I.

(1) Legal Reserve Fund GF 30,070,313

The total of this Fund showed no change. It has remained unchanged since 1971, when it reached 10% of the then paid-up capital, this being the proportion laid down in Article 51 (1) of the Statutes.

(2) General Reserve Fund
after allocation of the net profit
for the financial year 1991–92 GF 672,816,157

This Fund had stood at 646.7 million gold francs on 31st March 1991; it is proposed that a sum of 26.1 million gold francs be transferred to it from the net profit for the financial year, in conformity with the provisions of Article 51 (3) of the Statutes.

(3) Special Dividend Reserve Fund
after allocation of the net profit
for the financial year 1991–92 GF 42,530,055

This Fund had been raised to 39.5 million gold francs at the end of the financial year 1989–90; it shows an increase of 3 million gold francs.

The proposed increase, also by transfer from the net profit, is in accordance with the provisions of Article 51 (4) of the Statutes.

(4) Free Reserve Fund
after allocation of the net profit
for the financial year 1991–92 GF 603,066,872

compared with 545.2 million gold francs on 31st March 1991. It has been recommended that a sum of 57.9 million gold francs be allocated to this Fund, also from the profit.

The total sum which it is proposed to transfer to the reserves from the net profit for the financial year 1991–92 therefore amounts to 87 million gold francs.

The reserves will thus stand at GF 1,348,483,397 compared with 1,261.5 million on 31st March 1991.

B. Borrowed funds

The following tables show the origin, nature and term of the Bank's borrowed resources.

BIS: Borrowed funds, by origin

Origin	Financial years ended 31st March		Movement
	1991	1992	
	in millions of gold francs		
Deposits of central banks	40,636	43,204	+ 2,568
Deposits of other depositors	2,220	1,662	− 558
Total	42,856	44,866	+ 2,010

The increase in resources was entirely due to a rise of more than 6% in the currency and gold deposits of central banks. On the other hand, the total of "Deposits of other depositors" declined by 25%; this item, which had recorded an increase of 71% in the preceding financial year, mainly comprises funds placed by international organisations.

"Deposits of central banks" now represent 96.3% of all resources in currencies (compared with 94.8% previously), while "Deposits of other depositors" account for only 3.7% (compared with 5.2%).

The expansion in deposits in currencies was due primarily to a more or less steady increase in deposits in US dollars, whereas the items denominated in other currencies remained stable or declined, in the case of liabilities in Deutsche Mark and Japanese yen in particular, markedly. As a result, on 31st March 1992 the share of deposits in US dollars represented 53% of total resources in currencies, compared with 40% at the end of the previous financial year, that in Deutsche Mark 24% (compared with 30%) and that in the third-largest item, ECUs, 12% (against 10%).

Both deposits in gold and those in currencies increased, by 2.7% and 4.9% respectively. As a proportion of total resources, the share of deposits in gold decreased slightly to stand at only 10.2%, compared with 10.4% at the end of the previous financial year; deposits in currencies accounted for 89.8%, compared with 89.6%.

The expansion in borrowed funds was reflected in an increase in deposits with a maximum maturity of three months; sight deposits and deposits at over three months declined.

BIS: Borrowed funds, by nature and term to maturity									
Term	Deposits in gold			Deposits in currencies			Total		
	Financial years ended 31st March		Move-ment	Financial years ended 31st March		Move-ment	Financial years ended 31st March		Move-ment
	1991	1992		1991	1992		1991	1992	
	in millions of gold francs								
Sight	4,399	4,562	+163	2,145	1,862	− 283	6,544	6,424	− 120
Not exceeding 3 months	51	9	− 42	35,323	37,853	+ 2,530	35,374	37,862	+ 2,488
Over 3 months	–	–	–	938	580	− 358	938	580	− 358
Total	4,450	4,571	+ 121	38,406	40,295	+ 1,889	42,856	44,866	+ 2,010

It should be noted that the total of sight deposits in currencies may vary appreciably from one month to another; those with a maturity of more than three months had recorded a sharp increase in the early months of the financial year.

In terms of the maturity of the deposits received, sight deposits represented 14.3% of total resources, deposits with a maximum maturity of three months 84.4% and those at over three months 1.3%; the respective percentages had been 15.3, 82.5 and 2.2% at the end of the preceding financial year.

(a) Deposits in gold GF 4,571,239,869

This compares with 4,450 million gold francs on 31st March 1991. The increase of 121 million represents the difference between the rise in sight deposits and the contraction in time deposits with a maximum maturity of three months.

(b) Deposits in currencies GF 40,295,093,969

This item had stood at 38,406 million gold francs on 31st March 1991 and thus showed a rise of 1,889 million, or 4.9%. This increase was due to the expansion in deposits with a maximum maturity of three months; sight deposits and deposits at more than three months declined.

C. Other liabilities

Other liabilities comprise the "Staff pension scheme", the item "Miscellaneous" and the dividend payable on 1st July 1992.

The total of these three items amounted to GF 1,450,531,699 against 1,306 million gold francs on 31st March 1991.

(a) The item "Staff pension scheme" stood at GF 158,256,993

compared with 150 million gold francs at the end of the preceding financial year. This item represents the Bank's liability in respect of staff pensions. The amount in Swiss francs, in which it is denominated, was increased during the financial year.

(b) The item "Miscellaneous" amounted to GF 1,259,814,546

against 1,122 million gold francs on 31st March 1991.

The rise of 138 million reflected, in particular, the influence of exchange rate fluctuations on currencies other than the US dollar.

(c) Dividend payable on 1st July 1992 GF 32,460,160

The amount of the dividend has been fixed at 200 Swiss francs per share, the same as that paid at the end of the previous two financial years.

The sum of 32.5 million gold francs which it is proposed to set aside out of the net profit for the financial year 1991–92 is slightly lower than that allocated at the end of the preceding financial year owing to the effect of the exchange rate factor on the Swiss franc.

The net surplus for the financial year 1991–92, before allocation, amounted to 119,460,160 gold francs, compared with 114,892,783 gold francs recorded at the end of the financial year 1990–91. It is proposed that this surplus be allocated in accordance with the provisions of Article 51 of the Statutes. Details are given in Section 5 of this chapter.

Assets (employment of resources)

The following table gives a breakdown of the balance-sheet asset items according to their nature:

BIS: Development of investments and other assets, by nature

Nature	Financial years ended 31st March				Movement	
	1991		1992			
	in millions of gold francs					
Sight assets						
Gold	4,861		4,808		− 53	
Currencies	7	4,868	12	4,820	+ 5	− 48
Treasury bills		2,461		3,623		+ 1,162
Time deposits and advances						
Gold	389		460		+ 71	
Currencies	30,604	30,993	31,588	32,048	+ 984	+ 1,055
Government and other securities at term		7,384		7,458		+ 74
Miscellaneous		13		12		− 1
Total						
Gold	5,250		5,268		+ 18	
Currencies	40,469	45,719	42,693	47,961	+ 2,224	+ 2,242

The increase in resources received by the Bank was mainly reflected in a corresponding expansion in investments in Treasury bills and in the form of time deposits and advances in currencies. There was also a rise in the total of time deposits in gold.

There follows a more detailed examination of each item in the table above.

(a) Gold

The increase of 18 million gold francs in assets in gold compares with that of 121 million recorded in liabilities in gold. The difference of 103 million reflected the contraction in forward gold operations, to which reference is made at the end of this section.

– Holdings on sight account	GF 4,807,721,945

This compares with 4,861 million gold francs on 31st March 1991.

– Time deposits	GF 459,895,173

This compares with 389 million on 31st March 1991.

(b) Cash on hand and on sight account with banks	GF 12,412,915

On 31st March 1991 this item had amounted to 7 million gold francs.

(c) Treasury bills	GF 3,623,143,845

This portfolio had stood at 2,461 million gold francs at the end of the previous financial year; its volume and composition fluctuated appreciably during the financial year as operations were expanded.

(d) Time deposits and advances in currencies	GF 31,588,007,613

This compares with 30,604 million gold francs on 31st March 1991, representing an increase of 984 million, or 3.2%.

(e) Government and other securities at term	GF 7,457,890,914

This item had amounted to 7,384 million gold francs on 31st March 1991 and thus shows a rise of only 74 million, although it fluctuated substantially during the financial year under review.

In parallel with the development of resources, investments in currencies – in the form of time deposits and advances, in Treasury bills and in miscellaneous securities – were marked by a sharp expansion in operations in US dollars and an appreciable contraction in those denominated in Deutsche Mark, Japanese yen and pounds sterling. Assets in US dollars and Deutsche Mark remained the largest items, however, followed by those in ECUs, whose volume remained stable.

The following table gives a breakdown according to residual term to maturity of investments in time deposits and advances (in gold and currencies) and in government and other securities at term:

BIS: Time deposits and advances and government and other securities at term, by term to maturity

Term	Financial years ended 31st March		Movement
	1991	1992	
	in millions of gold francs		
Not exceeding 3 months	33,126	32,083	−1,043
Over 3 months	5,251	7,423	+2,172
Total	38,377	39,506	+1,129

There was a slight decline (−3.1%) in investments with maturities not exceeding three months, which thus represented 81.2% of the total of investments shown in the table above, compared with 86.3% on 31st March 1991. On the other hand, operations concluded at over three months recorded a proportionately greater increase (+ 41.4%) to account for 18.8%, compared with 13.7%.

(f) Miscellaneous GF 11,979,653

This compares with 13 million gold francs on 31st March 1991.

Forward gold operations

These operations, which are mentioned in Note 2 to the Balance Sheet, resulted in a negative balance of GF 34,282,943 compared with a negative balance of 137.7 million gold francs on 31st March 1991.

The maturing of a transaction concluded during the preceding financial year resulted in an appreciable reduction in the volume of forward operations involving the repayment of a weight of gold by the Bank at maturity.

5. Net profits and their distribution

The accounts for the sixty-second financial year ended 31st March 1992 show a net operating surplus of 134,110,445 gold francs, compared with 134,066,732 gold francs for the preceding financial year. This year's result is shown after deduction of 46,056,417 gold francs in respect of costs of administration, the increase of 11% over the previous year's figure of 41,614,970 gold francs reflecting the fall in the gold franc value of the Swiss franc; the percentage increase in terms of Swiss francs, in which currency most of the Bank's expenditure is incurred, was around twice as large.

The Board of Directors has decided to transfer 3,650,285 gold francs to the Provision for Exceptional Costs of Administration and to supplement – by means of a further transfer of 11,000,000 gold francs – the Provision for Modernisation of Premises and Renewal of Equipment, the main purpose of which is to meet the cost of the continuing series of technical projects involving investment expenditure. As a result of these transfers the net profit amounts to 119,460,160 gold francs, against 114,892,783 gold francs for the previous financial year. The allocation of this amount is governed by Article 51 of the Statutes.

On the basis of this Article, the Board of Directors recommends that the net profit of 119,460,160 gold francs be applied by the General Meeting in the following manner:

(i) an amount of 32,460,160 gold francs in payment of a dividend of 200 Swiss francs per share;
(ii) an amount of 26,100,000 gold francs to be transferred to the General Reserve Fund;
(iii) an amount of 3,000,000 gold francs to be transferred to the Special Dividend Reserve Fund; and

(iv) an amount of 57,900,000 gold francs, representing the remainder of the available net profit, to be transferred to the Free Reserve Fund. This Fund can be used by the Board of Directors for any purpose that is in conformity with the Statutes.

If the above proposals are accepted, the dividend will be paid on 1st July 1992 to the shareholders whose names are contained in the Bank's share register on 20th June 1992.

The Balance Sheet, the Profit and Loss Account and a summary statement showing the movements during the financial year in the Bank's reserves will be found at the end of this Report. The Bank's accounts have been audited by Price Waterhouse, who have confirmed that the Balance Sheet and the Profit and Loss Account, including the notes thereon, give, on the basis described in Note 1, a true and fair view of the state of the Bank's affairs at 31st March 1992 and of its profit for the year ended on that date. Price Waterhouse's report is appended at the foot of the Balance Sheet.

6. Changes in the Board of Directors and in the Management

M. B. Clappier relinquished his position as Vice-Chairman of the Board of Directors on 27th November 1991, when his term of office expired. The Board elected Lord Richardson of Duntisbourne as his successor for a period of three years commencing on 28th November 1991.

Herr K.O. Pöhl ceased to be a member of the Board at the end of July 1991, when he relinquished the office of President of the Deutsche Bundesbank. His successor in that post, Prof. Dr. H. Schlesinger, became an ex officio Director as from 1st August 1991. M. B. Clappier was re-appointed to the Board in November 1991 and Dr. M. Lusser was re-elected to the Board in March 1992.

As regards the Management of the Bank, Mr. G.M. Gill was appointed Deputy Head of the Banking Department and Manager as from 1st December 1991. Mr. R.T. P. Hall, Assistant General Manager, retired at the end of January 1992. M. R. Gros succeeded him as Assistant General Manager as from 1st February 1992, while retaining his existing functions as Head of the Banking Department. Sig. T. Pollonio, Assistant Manager, relinquished his appointment at the end of January 1992.

Conclusion

This Report has covered a broad canvas of past developments, but, looking ahead, the problems economic policy-makers worldwide will have to confront present a picture differing greatly from earlier patterns. New issues and challenges have appeared, while some perennial problems have almost faded from the scene.

The most striking new feature, stretching from the immediate foreground to the middle and even long-term distance, is without doubt the emergence of the fifteen states from the dissolution of the Soviet Union, struggling to find for themselves a new political and economic order. At an extremely rapid pace the heirs of the Soviet Union have followed its former satellites on the arduous road out of the impasse into which socialism and central planning had led them. Several aspects of this struggle have been addressed in earlier chapters. The integration of the former Soviet republics into the world economy is a sine qua non for their ultimate success, a point which will be taken up again in the last part of this Conclusion. The many new states will need to guard against the temptation of creating barriers to mutual trade and to allow new economic ties to develop on the basis of world market prices and the principle of non-discriminatory trade. This will require above all a breakthrough domestically in placing the price mechanism firmly at the centre of their economies and in bringing fiscal and monetary policies under control. Much the same applies to other eastern European countries, which are not out of the woods yet, although some have made remarkable progress. The apparent spread of "reform fatigue" should not be allowed to weaken the authorities' resolve to persevere with necessary adjustment measures.

Countries in the developing world continue to occupy an important part of the overall picture. Just when the old East-West dichotomy has lost its significance a divide is beginning to open up within the developing world, between countries making large strides forward and those left far behind. Perhaps they should no longer all be called by the same name. The division is not absolutely clear-cut, however, as some of the countries which last year achieved high real growth rates still need to consolidate their improved performance; sustaining the momentum of reform may also depend on extending recent gains to those – mainly in the poorest groups – who suffered most during earlier years of stabilisation. In more than one sense the extremes are moving further apart, on the one hand gradually reducing the areas of misery in the world but on the other making it even more urgent to enhance the specific strategies designed to help the worst-off cases. Moreover, concern about the global environment has added a new dimension to the relationship between rich and poor nations; we shall return to some aspects of this issue below.

Dominating the picture in the area of immediate policy problems is the uncertainty regarding the outlook in the industrial world. The balance of probability is that this uncertainty will soon be resolved, with growth resuming at least in those countries that entered recession first, almost two years ago. This would also boost demand in the countries less advanced in the cycle. The fact that similar optimism prevailed a year ago and proved unfounded does not necessarily make the present optimism unreasonable, although it does indicate a need for caution. A number of factors give grounds for optimism now. The revival in housing investment in North America and in Australia, notwithstanding occasional setbacks, does suggest that interest rate declines have begun to stimulate spending. Private sector debt service burdens have fallen noticeably, particularly in the United States and the United Kingdom; US households and businesses seem to have made some progress in actually reducing debt to more sustainable levels. Furthermore, lower inflation should help to ensure that a revival in activity can be sustained.

Might there nevertheless be elements in the current situation of the industrial countries that will prevent a return to "growth as usual"? In particular, will any recovery, even if now on the way, only be weak? The fact that this recession has persisted for longer than was widely expected could be an indication of such a new element, although it should be borne in mind that the recession has not been severe by past standards, except in a very small number of countries. Over-indebtedness and real asset price deflation, which have been identified as factors retarding the recovery in some countries in 1991, no doubt have an ominous ring, as both figured prominently in early, and also in quite recent, explanations of the Great Depression.

Yet to draw any further parallels between the early 1930s and the present situation would be rather far-fetched. There is no question that the general understanding of basic economic issues is now much greater, as is the spirit of international cooperation if such a need is clearly recognised by all concerned. The much larger size of government budgets nowadays tends in any case to cushion demand, while the regulatory regime in place is much better equipped to prevent a systemic financial crisis. All this can be said with full confidence. It is true that macroeconomic policies of demand management are encountering problems in many areas and will continue to do so. These difficulties are not without significance since the macroeconomic policy arsenal serves as the main defence against any downside risks in the industrial countries. Perhaps of more immediate relevance than countering downside risks, however, is what should be done to further enhance the structural vitality of the industrial economies and to overcome the handicaps arising from pronounced asset price cycles and over-indebtedness. But first, what is the position with regard to the tools of macroeconomic policy?

The 1980s opened with the United States adopting a fiscal policy of bold tax cuts which, by stimulating economic growth, were expected not to lower but actually to bolster revenue. It did not work. The budget deficit soared and remained high. Other countries also faced large budget deficits. The second half of the 1980s was therefore a period of fiscal consolidation in most industrial countries. Faced with interest charges which absorbed up to 20% of current revenue and were rising further, one country after another came to the conclusion that something radical – either raising taxes, or cutting spending, or both – had to be done. The long upswing did help to bring deficits down, and even briefly eliminate them in a few countries. But it became evident that even quite drastic action to rein in burgeoning deficits was doing little to contain – let alone reduce – the ratio of debt to GNP. This experience has left governments very reluctant to allow deficits to rise again. Far from standing ready to use fiscal policy actively to stimulate the economy, a number of countries have even tended to offset the automatic increase in the deficit associated with the economic slowdown. Only the United Kingdom and Japan take a slightly different view, having previously advanced further than most industrial countries along the road of fiscal consolidation.

The earlier notion that governments could easily stabilise national income failed to take account of the significance of the stock effects that arise from a lack of symmetry in the operation of fiscal policy in most countries. The political process works overwhelmingly to convert the mere prospect of surpluses into higher expenditure. In these circumstances it is futile to expect the public sector to swing back into surplus and largely wipe out accumulated debt as soon as the need for fiscal stimulus has passed. Yet this would be essential in order to keep the armoury stocked for future needs under an active fiscal policy. If the deficits are allowed to persist they feed on themselves by automatically raising expenditure, the more so the higher the level of nominal interest rates. It would also help if additional spending was as a matter of principle channelled into public investment rather than public consumption, and into projects chosen on the basis of their likely return over the medium term.

For all these reasons, fiscal policy cannot be relied upon to fine-tune the pace of recovery. In an economic emergency, however, these medium and long-term considerations would clearly be outweighed by short-term imperatives: the active use of fiscal policy could prevent the industrial economies from sinking into depression if such a risk were to materialise. Fiscal policy is quite capable of delivering the immediate stimulus which would then be required.

For many people, nevertheless, macroeconomic policy today is virtually synonymous with monetary policy. Central banks, by virtue of their monopoly over the creation of high-powered money, can control very short-term money market interest rates in their domestic markets with great precision and can use this power to influence the path or range of one other financial variable: a monetary aggregate, the exchange rate or even, to a limited extent, a long-term interest rate, the choice between them largely depending on factors such as country size and institutional arrangements or existing commitments. Short-term interest rates, and whichever financial variable the central bank chooses to target, have a bearing on real activity in the economy and on prices. But it has long been realised that such effects are subject to long and variable lags. It is also an old subject of debate whether, here again, there is not a basic asymmetry: monetary policy is undoubtedly effective in the end when used restrictively, but how effective it is likely to be as a means of stimulating activity is much more of an open question. "Liquidity traps", "pushing on a string", are the traditional images that come to mind. Perverse effects on expectations may delay the hoped-for direct effects. Recent US experience seems to confirm that one cannot count on quick and predictable results when monetary policy is applied in an expansionary direction.

The experience of two countries in Europe with strong records in terms of their ability to keep inflation at bay, Germany and Switzerland, demonstrates that even restrictive monetary policies can encounter formidable difficulties. In Germany this is largely due to strong demand effects of unification exacerbated by wage-push and higher indirect taxes. The Swiss monetary authorities have on occasion been unwilling to match German interest rate rises, so that the exchange rate has fallen. The resulting inflationary impulse has been magnified by extensive implicit indexation mechanisms and has undone much of the price-dampening effect of higher real interest rates. Apart from these two cases, however, the outlook on the inflation front has greatly improved. In virtually all industrial countries the reduction of inflation has been the main target of monetary policy. Some are even considering making price stability the only objective of the central bank. Although no country has yet reduced inflation to zero, many now have rates so low that distorting effects on decisions and judgements have probably been all but eliminated. This is likely to have a favourable effect on the supply side of their economies and, while not providing a direct stimulus to demand, will soften the impact of unexpected setbacks to the recovery. Indeed, the fact that the most recent phase of expansion was one of the longest in the post-war period may well have been largely the result of the improved inflation environment.

A third area for policy action concerns the various structural measures and reforms which in recent years have been the focus of increasing attention in national as well as international discussions. In spheres such as the financial markets growing interdependence between countries has given the reform process strong momentum. International competitiveness has also been an important consideration in the implementation of tax reforms and the strengthening of market forces in product markets. One positive feature in this respect is that in several countries high rates of capacity utilisation in industry have not so much led to inflationary pressures but have rather been reflected in improved profits and higher investment. Better training and the elimination of rigidities have also improved the functioning of labour markets, but much still remains to be done before unemployment rates could fall to earlier levels. Slow progress also characterises attempts to reform agricultural policies, which on average involve costs of almost 2% of GDP in the OECD countries. Another field in which there is scope for improvement is investment in the infrastructure, which in several countries has suffered from badly targeted cuts in public spending. The policy of privatisation now being pursued in many countries could in the medium term help to strengthen infrastructure investment.

There remains the question of whether there are certain special influences which are likely to significantly dampen any recovery. Specifically, will the greater volatility of real asset prices and over-indebtedness be a lasting drag on activity? It has already been mentioned that at least in the United States signs of improvements in debt ratios are increasing. Bank and corporate balance sheets are looking healthier, owing partly to higher profits and partly to increased share issuance. The financial balances of private households show a similar tendency. It should also be borne in mind that real asset prices are likely to fluctuate more than the prices of goods and services. To the extent that real assets generate an income stream or because of the opportunity costs involved in holding them, their prices are affected by interest rate fluctuations as well as by replacement costs. Fluctuations in inflation expectations can aggravate these price cycles further, depending on the hedging qualities of the assets concerned. Macroeconomic policy mistakes can result in sharper fluctuations in both interest rates and inflation expectations. Hence excessive real asset price volatility may reflect unfavourably on the quality and the steadfastness of macroeconomic policies.

It may also reveal weakness in microeconomic policies, especially given the over-indebtedness and balance-sheet problems in a number of countries. The way in which the deregulation process in the financial sector has been allowed to unfold is an important case in point. Chapter VIII has given a broad description and analysis of this process. Suffice it here to draw attention to some of the important policy lessons:

- deregulation should proceed speedily, but at a pace that gives market participants sufficient time to prepare themselves for the new environment in terms of internal controls, restructuring and other adjustments in business strategies, training of personnel and so on;
- a proper balance must be kept between deregulation in different segments of financial markets to ensure that competition between them is not grossly distorted;
- the *right* time for deregulation may be best defined in terms of the *wrong* time, which is when the economy is in or moving into a powerful boom. Admittedly, getting the timing right may not be easy, given the relatively long gestation period of some deregulation measures;
- deregulation should be accompanied by a strengthening of supervision so as to establish rules of the game (the Basle capital adequacy guidelines are a good example) and by appropriate macroeconomic policy, especially monetary policy.

If these lessons are heeded there should be no reason to fear that distortions on the financial side will continue to seriously hamper economic recovery.

Apart from the general policy background to the present situation of the industrial countries discussed so far, there are a number of particular aspects which deserve mention here. One important feature is that global exchange markets have stood up fairly well to the impact of widely divergent monetary policies in the major industrial countries, in fact much better than could have been expected in the light of previous experience when major misalignments sometimes arose from comparatively minor causes. It is true that this outcome may have been partly fortuitous in that other factors, mainly of a political nature, just happened to offset a large part of the interest rate effects on exchange markets last year. This cannot always be expected to be the case. On the other hand, while the major floating exchange rate relationships have certainly not been completely stable in real terms, extreme misalignments have largely been avoided since the Louvre Accord in 1987. Some of the credit for this is no doubt due to official commitments to greater exchange rate stability, backed up at times by highly visible coordinated exchange market intervention and by stability-oriented domestic policies.

The prospects in the EMS exchange rate mechanism are open to contrasting interpretations, either bright or gloomy, depending largely on which opportunities and risks are emphasised. With the Maastricht Treaty successfully negotiated and assuming that it will be sealed by ratification and the referendums to be held in at least two countries, the policy of de facto monetary union can be seen in a sense to have been vindicated. With virtually no realignments since 1987, it can be considered technically feasible to preserve the present exchange rate structure within the ERM until it is fixed for good at the beginning of the third stage of economic and monetary union. The credibility of the commitment to nominal exchange rate stability has gradually allowed other ERM members to reduce the premia they have traditionally had to offer over German interest rates.

But in order for them to gain enough leeway to take their short-term interest rates significantly *below* corresponding German rates the expectation of a depreciation of the Deutsche Mark vis-à-vis the other currencies would have to gain ground – something that is ruled out by the very commitment to nominal exchange rate stability within the ERM, and which, if it turned out to be a realistic expectation, would bode ill for general price stability in Europe. Thus other ERM members, in spite of their lower inflation rates, seem to be largely tied to German short-term interest rates. At the same time, they have to admit that Germany, four or six years ahead of economic and monetary union, has every right, some would even say the obligation, to pursue the monetary policy necessary to ensure an acceptable degree of price stability. Clearly, the management of the transition will not be an easy task.

For this reason, there are fears that the period leading up to economic and monetary union could be marred by a deflationary bias even more pronounced than the conditions of fiscal discipline for participation are widely believed to imply. These fears are exaggerated. The effects of high real interest rates on economic activity have been surprisingly benign over long periods. One should therefore be wary of associating high real interest rates too firmly with weak growth. Indeed, the policy-makers responsible for ERM currencies can be expected to remain resolute and to endure this difficult period in order to achieve their goal of monetary union in Europe. This places a heavy burden of responsibility on the shoulders of German policy-makers to bring inflation and the budget deficit back under control, and the sooner the better.

Most of the current discussions on the situation in the industrial economies are in terms of how to get them back onto a "normal" growth path. Estimates of the growth potential in the major industrial economies vary between 2½ and 3%, perhaps as high as 4% in Japan. Persistent growth below potential will, it is feared, not only create problems on the fiscal side but also push up unemployment further from what are already high levels by historical standards. With little or no cross-reference, another discussion that also concerns the future level of industrial activity is growing more active. Twenty years ago the Club of Rome raised the question of whether globally the limits to further growth had not been reached, and the first oil price shock of 1973 served as a forceful demonstration that the question was one to be taken seriously. It was soon pointed out, however, that the analysis presented lacked a satisfactory economic basis in that no account was taken of price and market reactions. The available resources would not simply be exhausted at current prices and current consumption levels; rather, growing scarcity would drive up prices, reduce consumption and bring substitution effects into play. These reactions were clearly in evidence after the first oil price rise but gradually became weaker as the scarcity eased and the adjustment to new price levels was completed.

Whatever the merits of the opposing positions in the earlier debate, twenty years later rather different questions concerning the environment have arisen which also have a bearing on growth prospects. More and more people have become convinced of the urgent need for action to protect the life-supporting properties of the earth's atmosphere. Such action may mean channelling resources into the defence of nature on a scale which cannot fail to restrict growth indirectly by absorbing funds that would otherwise have been destined for "productive" investment. There are still those who argue that the protection of the environment cannot be achieved by less but only by more growth, as the only way to generate the necessary funds. It is true that the most successful economies are also those able to make the greatest efforts in this regard. But scarcely anyone would still maintain that it is enough to "go for growth" and let that also take care of environmental concerns.

Specific action is clearly needed. It does not have to take the form of direct and extensive regulation. In many cases environmental objectives can be most efficiently attained by using the price mechanism. This is an area in which progress depends on global cooperation, not only because most aspects are parts of global problems and the investment required is huge, but also in view of concerns about "level playing-fields". Distortions of competition due to differing degrees of environmental laxity among countries would tend to reduce the willingness to take action. Such concerns do play a role among industrial countries, but they are much more important in the relationship between North and South. The developing countries largely want for themselves what the developed countries already have. Arguments that amount to denying them further progress in this direction and to restricting population growth are seen by some developing countries as hypocrisy, an attempt by the developed world to defend its fortunate position against the have-nots.

The whole issue is one of the utmost complexity, taking in questions ranging from population growth, constraints on energy availability and technology risks to pollution as the by-product of production and consumption, to name only those most widely discussed. In some cases methods for dealing with the specific problems are already technically available; in others they might become available if sufficient resources were devoted to them, but the time required to find solutions may be long. Moreover, the world as a whole may not be rich enough to afford them all. This points to a basic dilemma: it may be hard enough to feed the present world population by using production methods which do not place too heavy a burden on the environment; the prospect of population increases on an unprecedented scale year by year makes the matter a frightening race against time.

To return to the more immediate policy issues that concern both industrial and developing countries, as well as those in the process of transition to market economies, the final point to be addressed in this Conclusion is the future of the world trading system. The uncertainty about activity in the industrial countries tends to foster protectionist sentiment and encourage moves towards "managed" trade. But it would be tragic if the shift towards free markets by the formerly centrally planned economies and the adoption of more market-oriented policies by developing countries were made much more difficult by the erection of additional trade barriers in the industrial countries. As it is, the goods that many of the developing countries can readily export – agricultural products, textiles and clothing – are among those most protected by industrial countries. Moreover, the growing importance of trading blocs has dangers: unless accompanied by a significant lowering of trade barriers vis-à-vis the outside world it will lead to trade diversion rather than trade creation. Unfortunately, there is little evidence of any such lowering of external barriers. With the retention of Article 115 of the Treaty of Rome in the Maastricht agreement individual EC member countries are still entitled to take unilateral ad hoc protective measures (with the consent of the Commission) against imports from third countries. This even conflicts with the idea of a genuine single market within the Community.

The arguments for free trade are almost as old as economics as a subject of serious study, and are on a global scale irrefutable. Free trade brings about a better allocation of resources and thus fosters growth. Protectionism draws strength from the fact that it gives special favours to relatively small groups which are more conscious of their particular interests and more vocal in promoting them in the political arena. The costs of protectionism are widely spread over society as a whole, notably over consumers, and hence are more difficult to identify. Also in terms of the longer time that it takes for the full benefits to emerge, the case for free trade is at a political disadvantage. The more democratic and the less exposed to pressure groups a country's political system, the stronger will tend to be its support for free trade.

Such considerations have an interesting international parallel. Free trade goes a long way towards ensuring the equal treatment of small nations in the international sphere. Only the strict observance of the principle of free trade based on open markets offers protection against large countries' abuse of political power to gain economic advantage at the expense of others.

The risk of protectionism in a world which does not adhere to the principle of free trade discourages longer-term capital investment as access to foreign markets cannot be relied on. Moreover, protectionist measures do not necessarily safeguard domestic employment or further current account objectives since in the longer run they tend to be offset by exchange rate adjustments. While the protected industries will benefit, the unprotected industries in the same country – and, within a fixed exchange rate area, in the other member countries too – will be hurt by a less competitive exchange rate. In short, while largely ineffective from the point of view of employment and the balance of payments, protectionist measures and particularly non-tariff barriers create uncertainties and seriously distort the allocative role of the price mechanism in general.

The industrial countries bear a heavy responsibility for the well-being of the world economy at large. To give developing countries and the countries in the process of transition to market economies free access to their markets is the greatest single contribution they can make to these countries' prosperity. If they were to weigh the interests of their own citizens impartially and consider the longer-term benefits they would also see that such policies would not even represent a real burden. As the communiqué issued after the recent IMF Interim Committee meeting put it with reference to the Uruguay Round: "The success of the negotiations is a must."

To sum up: there is growing evidence that the United States is moving out of recession and that the improvement in quite a few fundamentals – be they debt service ratios of households and corporations in industrial countries, the external debt situation of major developing countries or the broad inflation outlook – will allow other countries to follow. General pessimism about the imminence of a worldwide slump or financial crisis is, therefore, unwarranted – not only because of this evidence but also because we possess the appropriate policy tools capable of preventing it from happening. What, however, is much less predictable is the pace, shape and breadth of recovery. At the same time, it is also clear, firstly, that fiscal policy will not be available on a global scale to provide any sizable stimulus to growth and, secondly, that it would be unwise to use monetary policy indiscriminately for this purpose.

This still leaves policy-makers with important lines of action. Monetary authorities should ensure that their ability to prevent or at least handle manifestations of crisis, which has been well demonstrated by past events, keeps pace with the rapidly changing landscape of globally integrated and innovative financial markets. Governments, with their ability to speed up growth directly through demand management impaired, should concentrate policies on further improving the fundamentals. Structural policies must remain high on the agenda if the flexibility of labour and product markets in the industrial economies is to increase. Bringing Germany's emerging inflationary tendencies under control, by reverting to the best German traditions, is of major importance not only for Germany itself and the rest of Europe, but also for the world economy. The pursuit of stabilisation policies in the successful Latin American and eastern European countries and the implementation of such policies in the former Soviet republics and elsewhere are a precondition for their own progress. Finally, the most important task is to preserve and indeed strengthen the free multilateral trading system, bringing in both the developing world and the former socialist economies. Without such a system, the great opportunities opened up by the radical political changes of the past few years cannot be seized. It is perhaps not utopian to express the hope that the consensus which now appears to be taking shape on how best to approach economic policy issues will in the end steer all countries, in recognition of their own best interests, towards a stronger sense of international solidarity.

Basle, 27th May 1992

ALEXANDRE LAMFALUSSY
General Manager

Balance Sheet and Profit and Loss Account

at 31st March 1992

Balance Sheet at 31st March 1992

(in gold francs - see Note 1)

Assets

Gold		4 807 721 945
Cash on hand and on sight account with banks		12 412 915
Treasury bills		3 623 143 845
Time deposits and advances		
Gold		
Not exceeding 3 months	222 004 872	
Over 3 months	237 890 301	
Currencies		
Not exceeding 3 months	27 231 812 094	
Over 3 months	4 356 195 519	
		32 047 902 786
Government and other securities at term		
Not exceeding 3 months	4 629 091 936	
Over 3 months	2 828 798 978	
		7 457 890 914
Miscellaneous		11 979 653
Land, buildings and equipment		1
		47 961 052 059

Note 1:
The gold franc is the equivalent of 0.290 322 58... grammes fine gold - Article 4 of the Statutes. Assets and liabilities in US dollars are converted at US$ 208 per fine ounce of gold (equivalent to 1 gold franc = US$ 1.941 49...), and all other items in currencies on the basis of market rates against the US dollar.

Note 2:
At 31st March 1992, gold payable against currencies on forward contracts amounted to 34 282 943 gold francs.

		Before allocation of the year's Net Profit	After allocation of the year's Net Profit
Liabilities			
Capital			
Authorised: 600 000 shares, each of 2 500 gold francs	1 500 000 000		
Issued: 473 125 shares	1 182 812 500		
of which 25% paid up		295 703 125	*295 703 125*
Reserves			
Legal Reserve Fund	30 070 313		*30 070 313*
General Reserve Fund	646 716 157		*672 816 157*
Special Dividend Reserve Fund	39 530 055		*42 530 055*
Free Reserve Fund	545 166 872		*603 066 872*
		1 261 483 397	*1 348 483 397*
Deposits (gold)			
Central banks			
Sight	4 562 668 734		
Not exceeding 3 months	8 570 736		
Other depositors			
Sight	399		
		4 571 239 869	*4 571 239 869*
Deposits (currencies)			
Central banks			
Sight	1 823 379 546		
Not exceeding 3 months	36 234 316 484		
Over 3 months	575 079 090		
Other depositors			
Sight	39 055 050		
Not exceeding 3 months	1 618 101 350		
Over 3 months	5 162 449		
		40 295 093 969	*40 295 093 969*
Staff Pension Scheme		158 256 993	*158 256 993*
Miscellaneous		1 259 814 546	*1 259 814 546*
Profit and Loss Account		119 460 160	—
Dividend payable on 1st July 1992		—	*32 460 160*
		47 961 052 059	*47 961 052 059*

Report of the Auditors to the Board of Directors and to the General Meeting of the Bank for International Settlements, Basle

In our opinion the Balance Sheet and the Profit and Loss Account, including the notes thereon, give, on the basis described in Note 1, a true and fair view of the state of the Bank's affairs at 31st March 1992 and of its profit for the year ended on that date. We have obtained all the information and explanations which we have required. The Bank has kept proper books, and the Balance Sheet and the Profit and Loss Account are in agreement with them and with the information and explanations given us.

Basle, 24th April 1992 — *PRICE WATERHOUSE*

Profit and Loss Account

for the financial year ended 31st March 1992
(in gold francs)

Net interest and other operating income		180 166 862
Less: Costs of administration		
Board of Directors	713 310	
Management and Staff	28 255 767	
Office and other expenses	17 087 340	46 056 417
Net operating surplus		134 110 445
Less: Amounts transferred to		
Provision for Exceptional Costs of Administration	3 650 285	
Provision for Modernisation of Premises and Renewal of Equipment	11 000 000	14 650 285
Net Profit for the financial year ended 31st March 1992		119 460 160

The Board of Directors recommends to the Annual General Meeting that the Net Profit should be allocated in accordance with Article 51 of the Statutes as follows:

Dividend: 200 Swiss francs per share on 473 125 shares	32 460 160
	87 000 000
Transfer to General Reserve Fund	26 100 000
	60 900 000
Transfer to Special Dividend Reserve Fund	3 000 000
	57 900 000
Transfer to Free Reserve Fund	57 900 000
	—

Movements in the Bank's reserves

during the financial year ended 31st March 1992
(in gold francs)

I. Development of the Reserve Funds resulting from allocations for the financial year 1991–92

	Legal Reserve Fund	General Reserve Fund	Special Dividend Reserve Fund	Free Reserve Fund
Balances at 1st April 1991, after allocation of Net Profit for the financial year 1990–91	30 070 313	646 716 157	39 530 055	545 166 872
Add: Allocations for the financial year 1991–92 .	—	26 100 000	3 000 000	57 900 000
Balances at 31st March 1992 as per Balance Sheet	30 070 313	672 816 157	42 530 055	603 066 872

II. Paid-up Capital and Reserve Funds at 31st March 1992 (after allocation) were represented by:

	Paid-up Capital	Reserves	Total
Net assets in			
Gold..	295 703 125	366 391 184	662 094 309
Currencies..	—	982 092 213	982 092 213
	295 703 125	1 348 483 397	1 644 186 522

Board of Directors

Bengt Dennis, Stockholm
Chairman of the Board of Directors,
President of the Bank

The Rt.Hon. Lord Richardson of Duntisbourne, London
Vice-Chairman

Dr. Carlo Azeglio Ciampi, Rome
Bernard Clappier, Paris
Dr. Lamberto Dini, Rome
Dr. W.F. Duisenberg, Amsterdam
Prof. Dr. Leonhard Gleske, Frankfurt a/M.
Jacques de Larosière, Paris
The Rt.Hon. Robert Leigh-Pemberton, London
Dr. Markus Lusser, Zurich
Prof. Dr. Helmut Schlesinger, Frankfurt a/M.
Alfons Verplaetse, Brussels
Philippe Wilmès, Brussels

Alternates

A. D. Crockett, London, or
M. D. K. W. Foot, London
Dr. Antonio Fazio, Rome, or
Dr. Carlo Santini, Rome
Philippe Lagayette, Paris, or
Francis Cappanera, Paris
Jean-Jacques Rey, Brussels
Dr. Hans Tietmeyer, Frankfurt a/M., or
Dr. Wolfgang Rieke, Frankfurt a/M.

Management

Alexandre Lamfalussy	General Manager
Rémi Gros	Assistant General Manager, Head of the Banking Department
Dr. Giampietro Morelli	Secretary General, Head of Department
Dr. Horst Bockelmann	Economic Adviser, Head of the Monetary and Economic Department
G.M. Gill	Deputy Head of the Banking Department, Manager
Marten de Boer	Manager, Operational Security, Accounting and Budgeting
Jean Vallet	Deputy Secretary General
André Bascoul	Deputy Manager, General Secretariat
Dr. H.W. Mayer	Deputy Manager, Monetary and Economic Department
Dr. Kurt Spinnler	Deputy Manager, Banking Department
Prof. Dr. Mario Giovanoli	Legal Adviser, Deputy Manager
Dr. Joseph R. Bisignano	Assistant Manager, Monetary and Economic Department
Jean-Claude Dagassan	Assistant Manager, EMCF Agent
P.C. Bridge	Assistant Manager, Banking Department
Jean-Marc Andreoli	Assistant Manager, General Secretariat
Yukio Iura	Assistant Manager, Banking Department
Alexander Radzyner	Assistant Manager, General Secretariat
Claude Sivy	Assistant Manager, Control Operational Security
Günter Pleines	Assistant Manager, Banking Department
Robert von Werra	Assistant Manager, Monetary and Economic Department

Dr. Gunter D. Baer	Secretary General of the Committee of Governors of the Central Banks of the Member States of the EEC