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II. Highlights of international financing

1. The international banking market

Newly released comprehensive BIS data on the international banking market for the *third quarter of 1999* show the largest net lending flows since the second quarter of 1998. For the market as a whole, these flows surged to \$188 billion, more than four times the average of the two subdued quarters before. The rise was more than accounted for by an expansion of activity in industrial countries to \$238 billion, as claims on offshore centres fell by \$26 billion and another \$31 billion was repaid by emerging market borrowers (including eastern Europe). The rebound in the market as a whole was driven largely by activity in the *interbank* market among developed countries, where lending flows amounted to \$150 billion after three quarters of large cutbacks in claims. By contrast, net international lending to *non-bank* customers dwindled to \$18 billion after an unusually strong second

Main features of international claims of BIS reporting banks¹

In billions of US dollars

	1997	1998			1999			Stocks at end-Sept. 1999
	Year	Year	Q3	Q4	Q1	Q2	Q3	
Claims on developed countries	1,056.5	524.9	196.8	– 28.2	126.7	72.5	237.7	8,666.4
Interbank loans	733.4	276.5	179.5	– 75.0	– 59.7	– 92.1	149.5	5,089.4
Loans to non-banks	142.1	– 10.5	– 18.5	– 9.1	– 16.4	76.5	20.6	1,821.3
Other ²	181.1	258.9	35.8	55.9	202.7	88.0	67.7	1,755.6
Claims on offshore centres	199.5	– 191.0	– 43.3	– 79.9	– 65.1	– 44.8	– 25.8	1,283.7
Interbank loans	166.5	– 191.7	– 58.2	– 32.5	– 74.1	– 53.0	– 48.0	911.3
Loans to non-banks	27.9	– 20.3	7.4	– 49.7	2.8	2.0	13.7	259.7
Other ²	5.1	21.0	7.5	2.2	6.1	6.2	8.5	112.8
Claims on developing countries³	76.7	– 83.6	– 47.2	– 25.8	– 4.2	– 6.6	– 30.9	890.5
Interbank loans	16.0	– 64.0	– 28.4	– 8.6	– 8.4	– 13.3	– 20.8	376.5
Loans to non-banks	48.3	– 12.8	– 12.4	– 12.3	4.2	4.2	– 10.4	412.5
Other ²	12.3	– 6.8	– 6.5	– 4.9	0.1	2.5	0.3	101.5
Unallocated	1.1	– 34.0	– 44.0	– 10.2	– 5.5	7.8	6.7	226.4
Total	1,333.8	216.3	62.3	– 144.2	51.9	28.9	187.7	11,067.0
Interbank loans	911.4	– 4.3	66.6	– 122.3	– 151.0	– 158.5	88.5	6,499.4
Loans to non-banks	222.9	– 55.0	– 27.9	– 81.1	– 22.6	89.0	17.5	2,516.9
Other ²	199.5	275.6	23.6	59.2	225.5	98.5	81.6	2,050.7
<i>Memorandum item:</i> <i>Syndicated credits⁴</i>	<i>1,136.3</i>	<i>902.0</i>	<i>229.9</i>	<i>219.8</i>	<i>169.3</i>	<i>284.5</i>	<i>264.8</i>	

¹ Changes in amounts outstanding excluding exchange rate valuation effects. ² Mainly changes in holdings of international debt securities. ³ Including eastern European countries. ⁴ Announced new facilities.

Currency composition of external bank lending of industrial reporting countries¹

In billions of US dollars

	1997	1998			1999			Stocks at end- Sept. 1999
	Year	Year	Q3	Q4	Q1	Q2	Q3	
US dollar	456.2	129.1	87.6	44.8	-122.7	21.1	11.9	3,223.1
Euro ²	248.0	288.9	31.6	- 64.7	292.6	51.3	143.0	2,853.6
<i>of which: intra-euro 11</i>	22.6	88.4	- 5.7	51.1	206.8	51.0	71.4	1,283.5
Japanese yen	172.5	- 29.4	10.1	58.3	-133.0	- 75.4	- 25.3	817.8
Pound sterling	78.0	41.1	16.8	7.8	16.2	2.0	24.2	450.8
Swiss franc	30.0	4.2	- 5.8	- 9.9	14.9	- 1.4	5.3	253.7
Other and unallocated	30.0	24.3	16.8	- 44.8	..	- 0.8	9.5	389.0
Total	1,014.7	458.2	157.0	- 8.6	68.1	- 3.3	168.6	7,988.1

¹ Changes in amounts outstanding excluding exchange rate valuation effects. ² For 1997 and 1998, data relate to five euro legacy currencies (BEF, DEM, FRF, ITL and NLG) and the ECU, which were reported separately. Changes for 1999 Q1 are adjusted on an estimated basis to exclude the shift from "Other and unallocated" to "Euro area currencies" of data for six euro legacy currencies which were previously not reported separately under foreign currency positions (ATS, ESP, FIM, IEP, LUF and PTE).

quarter.⁴ Announcements of new facilities in the international syndicated loan market indicate that a further decline in lending to non-bank borrowers is likely to have occurred in the fourth quarter.

The interbank market: resurgence due to a combination of factors

Three factors contributed to the major turnaround in interbank transactions in the third quarter. First, Japanese banks reduced the withdrawal of funds from overseas subsidiaries to \$39 billion. These inter-office transfers to home offices had been a previous dampening factor for the interbank market as measured by BIS locational data. Japanese subsidiaries abroad had also been able to return yen funds to home offices in Japan because the Japan premium in international interbank money markets had virtually disappeared by the end of the first quarter, allowing them to fund themselves internationally again. Secondly, the resurgence of the interbank market seems to have resulted in part from the difficulty of finding enough new non-bank borrowers for recycling unusually large repayments from existing borrowers. In the third quarter, large repayments came from emerging market borrowers and non-bank borrowers in the United States, and the absorption of these funds by the interbank market involved passing them through a chain of banks in a portfolio adjustment process that resulted in a temporary expansion of interbank balance sheets. A third factor was a \$61 billion surge in cross-border business in euros between banks located mainly in the London market but involving mostly banks with head offices outside the euro-11 countries, particularly Swiss (\$36 billion) and UK institutions (\$11 billion).

Currency composition: the rise in cross-border business in the euro

The third quarter saw a surge in cross-border business involving the euro. Altogether \$72 billion of total euro-denominated flows were due to transactions with residents outside the euro area. The interbank market accounted for the bulk of such transactions. Demand for the euro might have been partly related to carry trade strategies, because conditions were consistent with a switching of cheap euro funds into higher-yielding currencies such as the dollar and sterling. The other half of total reported euro lending was due to the expansion of intra-EMU cross-border domestic currency

⁴ International lending is defined as cross-border (i.e. external) lending in all (foreign and domestic) currencies and lending to residents in foreign currencies. See Annex Table 1.

transactions (see the table on page 15). While the figures shown for the first quarter of 1999 may suggest even larger cross-border flows in the euro, these numbers are not readily comparable to those of subsequent quarters because of a one-time adjustment for currencies that had been classified under “other and unallocated” but are now reported as euro area currencies.

At the same time, net repayments in yen continued, albeit at a slower pace, while lending flows in sterling rose significantly. Improved Japanese growth prospects and the strong rise in the yen vis-à-vis the dollar may have encouraged banks in the United Kingdom to lend \$14 billion in yen to entities in Japan, which was, however, more than compensated for by further Japanese bank retrenchment from yen lending. Swiss banks providing funds largely to UK non-banks more than accounted for the \$24 billion rise in total sterling assets.

Role of offshore centres: Caribbean centres see inflows while others shoulder outflows

Reporting banks’ international claims on offshore centres fell in the third quarter (–\$25.8 billion). However, the overall figure masked a divergent pattern between the Caribbean and Asia. Cross-border flows to Caribbean centres, excluding the Cayman Islands, rose by \$32 billion during this period. The bulk of the rise (\$30 billion) was denominated in US dollars, and was split almost evenly between bank and non-bank entities. In contrast, the \$20 billion decline in claims vis-à-vis the Cayman Islands was due to a cutback in dollar-denominated interbank credit stemming from banks located in the United States.

Meanwhile, claims on Asian offshore centres fell sharply, with total claims on Hong Kong and Singapore declining by \$19 billion and \$18 billion respectively. With respect to Hong Kong, over half of the decline was due to yen interbank repayments to Japan, a decline linked to the retrenchment of Japanese banks from international lending. As explained in the box on page 19 and in the June 1999 edition of the *BIS Quarterly Review*, prior to the outbreak of the Asian crisis in mid-1997, Hong Kong functioned as an extension of the domestic intermediation of the Japanese banking system. Funds flowed from Japanese to Hong Kong banks and back to Japan in the form of loans to non-banks. However, since then the drive to clean up Japanese bank balance sheets coupled with weak loan demand has led to a repayment of liabilities by banks in Hong Kong (and correspondingly, a decline in Japanese claims on Hong Kong). Similarly, the decline in interbank claims vis-à-vis Singapore is largely due to repayments in yen to Japan.

Lending to emerging markets: bank claims decline sharply as borrowers shift to securities

Data for the third quarter of 1999 show the largest decline in claims outstanding on emerging markets since the sharp cutback in the wake of the Russian debt moratorium in the third quarter of 1998. As shown in the table opposite, claims on emerging economies fell by \$31 billion during the quarter, nearly six times the average of the two preceding quarters. Such an acceleration of repayments to banks so late after the credit squeeze of 1998 suggests a demand-driven move away from bank loans to securities issuance.

As noted in the overview section, emerging Asia’s shift from current account deficits to large surpluses in 1999 obviated a need for fresh bank credit. In addition to the surpluses, the region has also received equity inflows. The third quarter saw a \$22 billion reduction in bank claims on this region which represented largely the continued repayment of existing debt.⁵ The steady

⁵ It should be noted that the quarterly banking flows are calculated on an exchange-rate-adjusted basis. In other words, the published flow figures are net of currency fluctuations and thus attempt to measure the actual flows during the period. Due to the 13% appreciation of the yen in the third quarter, and the large role it plays in capital flows to emerging Asia, the exchange-rate-adjusted decline of \$22 billion is much larger than the absolute decline of \$8 billion, and should be considered in this context.

Banks' claims on transition and developing countries*

In billions of US dollars

	1997	1998			1999			Stocks at end-Sept. 1999
	Year	Year	Q3	Q4	Q1	Q2	Q3	
Total claims	76.7	- 83.6	- 47.2	- 25.8	- 4.2	- 6.6	- 30.9	890.5
Eastern Europe	18.7	- 0.1	- 10.6	- 0.5	- 2.0	- 1.9	- 1.0	100.9
Russia	9.9	- 6.1	- 10.7	- 1.7	- 3.6	- 1.4	- 1.7	46.1
Africa	10.0	- 1.6	- 0.5	- 0.5	2.0	- 0.1	- 0.9	57.8
Asia	4.9	- 96.4	- 28.9	- 22.4	- 0.2	- 5.4	- 21.6	339.2
China	10.5	- 10.6	- 7.3	- 2.1	- 1.8	- 0.4	- 7.3	72.8
Indonesia	7.2	- 14.1	- 2.8	- 3.8	1.3	- 1.5	- 3.2	49.3
Korea	- 4.0	- 32.9	- 5.5	- 7.5	2.2	0.0	- 1.0	75.7
Malaysia	3.5	- 6.6	- 1.3	- 1.6	- 0.2	- 0.7	- 1.5	21.8
Philippines	3.2	- 0.8	- 2.2	1.2	0.0	1.0	- 1.8	15.8
Thailand	- 19.6	- 28.9	- 6.6	- 8.7	- 5.0	- 2.5	- 5.5	39.3
Latin America	30.9	- 8.8	- 13.8	- 12.3	- 0.2	3.0	- 10.6	289.5
Argentina	7.5	0.7	1.5	- 2.2	1.1	0.7	- 2.0	47.8
Brazil	13.8	- 10.8	- 11.5	- 8.4	- 4.9	0.1	- 3.4	86.2
Mexico	- 7.2	0.2	- 2.8	- 0.2	1.4	3.3	- 1.1	69.0
Middle East	12.2	23.3	6.6	9.8	- 3.7	- 2.2	3.1	103.1

* Changes in amounts outstanding excluding exchange rate valuation effects.

decline in Asian sovereign spreads from a peak in the third quarter of 1998 seems consistent with an improved financial position of Asian borrowers. International bank lending to Thailand fell by \$5.5 billion, to Indonesia by \$3.2 billion, and to the Philippines by \$1.8 billion. A \$7.3 billion decrease in China's international bank borrowing reflected repayments to Asian banking centres and the unwinding of a large repo transaction with banks in the United States. At the same time, banks in China increased their deposits with Asian and EU banks by \$5.5 billion.

While Latin American countries needed funds to finance their current account deficits, they relied more on securities than on bank credit. Indeed, bank claims on the region declined by \$10.6 billion, largely involving creditor banks in the United States and US branch offices operating in offshore centres. All major Latin American borrowers were affected, including Brazil (-\$3.4 billion), Argentina (-\$2.0 billion) and Mexico (-\$1.1 billion). About half of the overall decline in the headline figure represented a reduction in loans to the non-bank sector. At the same time, borrowers in the region issued a net amount of \$4.6 billion in bonds and notes.

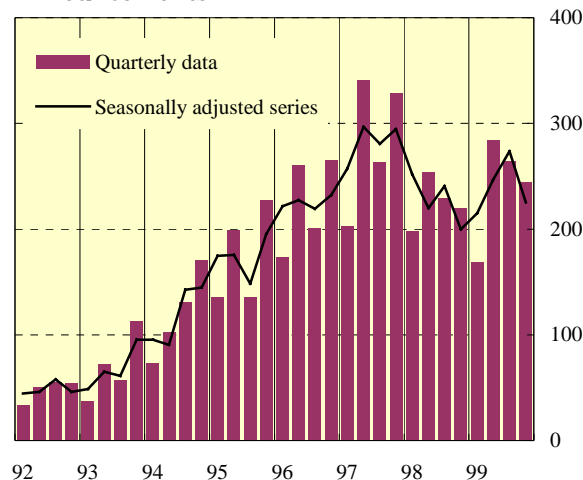
Bank lending to eastern Europe fell by \$1 billion in the fifth consecutive quarter of contraction since the Russian crisis. At the same time, securities held by banks rose by \$1.4 billion. Once again, a cutback in exposure to Russia more than accounted for the decline in overall lending to the region. Lending to Russia's banking system fell by \$1.7 billion, owing to the withdrawal of credit to the country by a large European bank. In contrast, loans to Poland increased by \$1.1 billion.⁶ Concealed in the headline borrowing figure for the region is the fact that eastern European non-banks, including Russia's private sector, succeeded in obtaining \$0.7 billion in new loans from the international banking market after a large cutback in the previous quarter.

⁶ Total claims on Poland, however, rose by \$2.1 billion because of a \$1.0 billion equity investment in a Polish bank by another European bank.

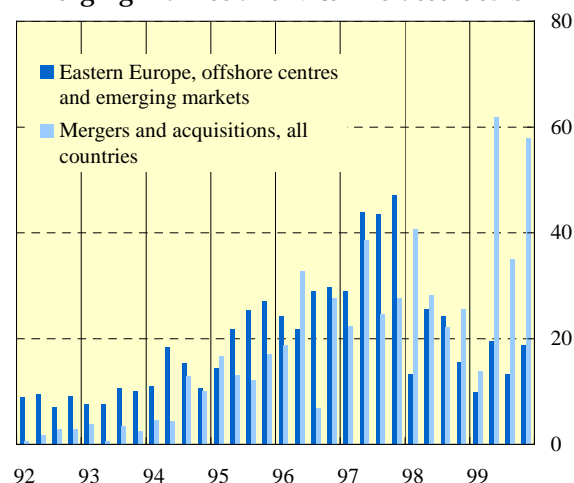
Announced facilities in the international syndicated credit market

In billions of US dollars

Announcements



Emerging market and M&A-related deals



Sources: Capital DATA; BIS.

Outlook for the fourth quarter of 1999: likely slowdown in lending to non-banks

Comprehensive BIS data on international bank lending in the *fourth quarter of 1999* will become available in three months' time. Some advance indication of lending to non-banks, especially to emerging market borrowers, is provided by new facilities in the syndicated loan market (Annex Table 10), although these refer to commitments rather than disbursements.

Aggregate activity in international syndicated loans declined in the fourth quarter in spite of a rebound in merger and acquisition deals. As shown in the graph above, announced facilities for the market as a whole amounted to \$245 billion, a decrease of 8% from the previous quarter. The decline is especially significant because the fourth quarter has historically been more active than the third.⁷ A few very large deals boosted merger-related transactions to \$58 billion. One of the largest deals consisted of £8 billion (\$13 billion) in two tranches arranged to finance the purchase by Mannesmann AG in Germany of Orange Plc in the United Kingdom. This particular deal helped to make the year as a whole a record one for merger-related business, with \$169 billion in announced facilities of that type. In contrast to the buoyancy of acquisition financing, syndicated lending for emerging market borrowers remained subdued, with \$13 billion in facilities in the fourth quarter and \$43 billion for the year.

⁷ On a seasonally adjusted basis, the quarterly decline would be 21%.

An update on developments in Hong Kong's international banking business

Robert McCauley and Y K Mo

Last June's *BIS Quarterly Review* (pp. 13–14) analysed developments in Hong Kong's banking balance sheet from mid-1997 to the end of 1998. In those six quarters, the reversal of the round-tripping of funds from Japanese banks in Japan to Hong Kong and back to non-banks in Japan explained much of the contraction in Hong Kong's international balance sheet. Despite the onset of the Asian crisis in mid-1997, the reduction of advances to the five emerging Asian economies most affected by the crisis and China was relatively modest. This box updates the analysis for the first three quarters of 1999, showing that the forces identified in the earlier period continued.

Banks in Hong Kong continued to repay their international interbank liabilities in 1999, albeit at a somewhat slower rate than in the previous six quarters. Again, the bulk of the interbank advances repaid were to banks in Japan. And once again, a large share of the decrease in funding from Japan was associated with a decline in claims on Japan: \$33 billion on the non-bank sector and \$5 billion on the bank sector. Thus, much of the shrinkage in Hong Kong's international balance sheet reflected a continued reversal of the round-tripping of funds from Japan to Hong Kong and back. In other words, Hong Kong's international balance sheet shrank because an offshore extension of Japanese bank intermediation either shrank or was repatriated.

In contrast, the decline in claims booked in Hong Kong on banks in Indonesia, Korea, Malaysia, the Philippines and Thailand decelerated substantially, while that in claims on banks and non-banks in China accelerated. Thus the shrinkage of Hong Kong's balance sheet continues to reflect events in Japan more than the Asian crisis and its aftermath.

The Hong Kong banking data also offer a perspective on the \$77 billion drop in BIS reporting banks' net claims on Hong Kong in the first nine months of 1999. After stripping out the reduced funding of loans to Japanese companies (\$33 billion) and reduced claims on the five Asian crisis countries and China (\$14 billion), there remains a substantial decline in net claims. From Hong Kong's perspective, this outflow is

External assets and liabilities of banks in Hong Kong

In billions of US dollars

		Assets			Liabilities		
		Total	Bank	Non-bank	Total	Bank	Non-bank
World	end-1998	501	319	182	447	367	80
	Oct. 1999	465	324	141	372	290	82
	Change	– 36	5	– 41	– 75	– 77	2
Japan	end-1998	225	104	121	203	199	4
	Oct. 1999	187	99	88	154	150	4
	Change	– 38	– 5	– 33	– 49	– 49	0
Indonesia, Korea, Malaysia, Philippines and Thailand	end-1998	33	22	11	21	16	5
	Oct. 1999	28	20	8	20	15	5
	Change	– 5	– 2	– 3	– 1	– 1	0
China	end-1998	42	35	7	37	35	2
	Oct. 1999	33	29	5	36	33	3
	Change	– 9	– 7	– 2	– 1	– 2	1
Memorandum items		BIS reporting banks' positions vis-à-vis Hong Kong					
	end-1998	321	299	22	286	238	48
	Sept. 1999	254	231	23	296	256	40
	Change	– 67	– 68	1	10	18	– 8

Sources: Hong Kong Monetary Authority, *Monthly Statistical Bulletin*; BIS.

related to a declining stock of foreign currency debt of Hong Kong firms. Local banking data show a decline in outstanding foreign currency loans extended by Hong Kong banks of \$12 billion in the first 10 months of 1999.* Repayment of foreign currency loans was part of a general reduction in corporate bank debt in Hong Kong, reflecting weak investment (including construction) and also a shift in financing by large firms from bank borrowing to bond issues. But foreign currency loans fell faster than Hong Kong dollar corporate loans, perhaps owing to relative cost: three-month dollar Libor was 256 basis points lower than Hibor in 1998 but only 48 basis points lower in 1999.

To summarise, funds flowed into the international interbank market from Hong Kong first and foremost because of developments in Japan. In addition, the flow of funds reflects reduced foreign currency funding of banks in East Asia and China and repayments of foreign currency loans by companies in Hong Kong.

* One source of the funds to repay foreign currency loans was offshore deposits by Hong Kong non-banks, which the BIS data show fell by \$8 billion in the first nine months.