BANK FOR INTERNATIONAL SETTLEMENTS

59th ANNUAL REPORT

1st APRIL 1988–31st MARCH 1989

BASLE, 12th JUNE 1989

Bank for International Settlements

59th Annual Report

1st April 1988–31st March 1989 Basle, 12th June 1989

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59th Annual Report

submitted to the Annual General Meeting
of the Bank for International Settlements
held in Basle on 12th June 1989

Ladies and Gentlemen,

I have the honour to submit herewith the fifty-ninth Annual Report of the Bank for International Settlements for the financial year which began on 1st April 1988 and ended on 31st March 1989.

The net profit for the year amounted to 94,885,615 gold francs, after transfer of 828,177 gold francs to the Provision for Exceptional Costs of Administration and 10,500,000 gold francs to the Provision for Modernisation of Premises and Renewal of Equipment. This compares with a net profit for the preceding year of 95,937,052 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 25,885,615 gold francs in payment of a dividend of 175 Swiss francs per share.

The Board further recommends that 24,463,364 gold francs be transferred to the General Reserve Fund, 4,000,000 gold francs to the Special Dividend Reserve Fund and the remainder of 40,536,636 gold francs to the Free Reserve Fund.

If these proposals are approved, the Bank's dividend for the financial year 1988–89 will be payable to shareholders on 1st July 1989.

I. A qualified change for the better

Growth in most industrialised countries accelerated markedly in 1988, but in its wake some of the problems which had been responsible for "stop-go" policies in the past seemed to return. Furthermore, the adjustment process – the gradual reduction of the major external imbalances between the major industrial countries – which was clearly under way at the beginning of 1988 has come to a halt and has in part even been reversed.

In most countries central banks responded to signs of increased inflationary dangers by pushing up short-term interest rates, and they are now waiting for indications that this is having the desired effect in moderating demand pressure. There was a general upsurge of aggregate demand, which was particularly strong in some countries but which also spilled over into others, with capacity constraints becoming visible almost everywhere. Not surprisingly, demand growth encountered bottlenecks long before the surplus labour in many European countries had been absorbed to any significant extent. The common argument that much of the unemployment was "classical" rather than "Keynesian" and not amenable to demand treatment seems to have been borne out. Inflationary pressures emerged earlier in labour than in final product markets. At the same time, the state of the labour market in the countries in question is a sad reflection on the rather limited capacity of policy-makers to apply forcefully the therapy which follows from their own diagnosis. Efforts towards removing rigidities on the supply side are known not to bear fruit quickly. Cost/benefit analysis makes bold moves unattractive to governments which cannot be sure that they will reap the longer-term benefits. Thus, while there are fears that even the significant tightening of monetary policy at an early stage may not have succeeded in keeping inflation at bay, there are equally fears that further moves in this direction would undermine the upswing in private investment which has at long last been pushing the economies onto a higher and healthier growth path.

At the centre of this domestic policy malaise is the question of what rate of growth the older industrialised countries can hope to achieve without courting inflationary dangers. Most governments and central banks put that figure at somewhere around 2½%. Depending on the amount of slack still existing at the beginning of 1988 in individual economies (but largely taken up by now), growth last year was too high in a number of countries not to spell trouble. This judgement is of course based on hindsight; hardly anybody was able to anticipate the upsurge before it occurred. The growth process is not sufficiently transparent in statistical terms for it to be possible to determine with any degree of accuracy what the underlying forces are and how they will be stimulated or reined in by different policy measures or by a given policy

stance. Perhaps it might have been possible to foresee the stimulative effect of the marked relaxation of monetary policy after the stock market crash, which lasted for between two and six months. But the purpose of that relaxation was to cushion the widely expected negative impact of the stock market crash. There was, it is true, little concern that the 1929–30 experience might repeat itself, but it seemed safer not to be too confident of a moderate or even benign effect. In short, there is little point in arguing now about what the policy should have been on the basis of trends which had not yet become visible.

Even now, as the following chapter describes, the sudden acceleration in growth cannot be fully explained. This also makes it difficult to predict with any certainty whether the trend will continue for some time or whether demand pressures will abate under the influence either of the more restrictive policies already in place or of cyclical factors. It is as yet impossible to gauge the strength of the inflationary pressures that have been unleashed. It might well be argued that the earlier windfall gains for price stability stemming from a decline in oil prices, low commodity prices and appreciating currencies in some countries had created the illusion of a more complete victory on the inflation front than had actually been achieved; when these trends were reversed, the underlying inflation rate reasserted itself – which should not give any great cause for alarm. Also, in a number of countries tax measures and administrative price increases have distorted inflation indicators. Unfortunately, the dynamics of price developments are such that even a seemingly innocuous rise in the general price level, once it has passed a very low threshold, can easily set in motion a price/cost/price spiral and affect inflationary expectations. And once this process is under way disproportionate efforts are required to halt it. This is one of the most difficult current policy issues, to which we shall return at the end of this Report.

Financial markets were generally calm in 1988 after the turmoil of 1987 – something which is all the more remarkable in view of the tightening of monetary policies referred to earlier. All stock markets started to climb back from the levels to which they had fallen in late 1987. In Tokyo new record highs were repeatedly established after November 1988. In a few markets stock prices have almost reached or slightly exceeded their previous peaks. In others, including the US, UK and German markets, 65–80% of the losses have been recovered.

The most frequently discussed financial market development in 1988, however, concerns the bond markets, where until recently prices were remarkably stable or had fallen only slightly in spite of the significant rise in short-term rates. This was widely taken to be an indication of greater market confidence in the ability of the monetary authorities to cope with whatever inflationary pressures might develop. In a closed economy this would indeed appear to be the only possible explanation for the fact that movements in short-term interest rates are not transmitted to the long end of the market. However, for certain countries at least, some doubt may have to be cast on the interpretation of the present slope of the yield curve as a vote of confidence in anti-inflationary policies. With free capital movements, prices in bond

markets – in contrast to policy-determined short-term interest rates – are governed as much by international portfolio decisions as by domestic factors. The relatively high degree of nominal exchange rate stability which has, on balance, prevailed since the early part of 1988 has stimulated enormous capital flows into the bond markets of countries with high nominal interest rates. Even though real interest rates in these countries may be no higher than in those which have managed to keep their inflation rates lower, they are attractive to portfolio investors who are confident that they can enjoy high nominal interest rates and pull out in good time should purchasing power parity reassert itself and place downward pressure on the currencies of countries with higher inflation rates and large external deficits. With the high and rising short-term interest rates which these countries use to keep their inflation rates from accelerating further and, it is hoped, to slow them down, nominal exchange rate stability can persist despite significant inflation differentials as long as the capital flows continue.

As an explanation for flatter or even inverted yield curves, the attractiveness of high nominal interest rates in bond markets to foreign investors seems to suffer from a lack of symmetry: should not the opposite effect on the yield curve be observed in the capital-exporting countries? To some extent yield curves have indeed been behaving differently there, but they have also become flatter. It has to be borne in mind, however, that one of the main capital-importing countries at present is the United States, which exercises a kind of interest rate leadership in bond markets worldwide. International interest rate linkages, which have become stronger during the last two years of increased nominal exchange rate stability, are a multi-faceted phenomenon; actual capital movements are only one means by which they are established. Signal effects can also provide links and can even work in the opposite direction from the actual capital flows. One should not draw too much comfort from the way long-term interest rates have so far reacted to the tightening of monetary policy.

The increased stability of nominal exchange rates has no doubt owed much to a continued commitment on the part of the major industrial countries to the principle of policy co-ordination and, in particular, to co-ordinated intervention in the exchange markets. But it would seem that the exchange markets have also themselves lost some of the nervousness seen in 1987 and before. Which is not to say that exchange market developments posed no problems last year. What in early 1988 could be taken as a reaction to excessive dollar depreciation at the turn of the year developed into repeated periods of dollar strength. On balance the dollar rose against the currencies of surplus countries, for example the yen and more especially some EMS currencies and the Swiss franc, while a number of deficit countries saw their currencies appreciate in parallel with the dollar. The role which high short-term nominal interest rates and capital flows played in this development has already been mentioned. While under conditions of free capital movements the same market forces that shape long-term interest rates can also have a dominating influence on exchange rates, national control over short-term rates is an exogenous factor that can pull the exchange market in the opposite direction

from that which the fundamentals would warrant. There was some temptation for the surplus countries to use the same instrument to defend themselves against a depreciation of their currencies. The deteriorating price climate provided an additional argument for such a policy course. Some already saw on the horizon a danger that what had started as an early move to contain inflationary pressures might develop into an outright interest rate war with no other purpose than to resist undesired exchange rate movements. The authorities in both surplus and deficit countries are, however, well aware of this danger and of what it would imply. They have preferred so far to live with the nominal exchange rate structure which has emerged.

This may seem surprising in view of the role that exchange rate changes had been assigned in correcting the huge current-account imbalances between the major industrial countries. Progress in this direction had long been slow but, at least in volume terms, was gaining momentum towards the end of 1987. After the second quarter of 1988, when the dollar continued to appreciate, this momentum was lost, most notably in Germany but also in Japan and the United States. There had been a great deal of controversy ever since the Louvre Accord of February 1987 about whether the dollar had come down far enough. Those who argued in favour of a period of exchange rate stability wanted to give the economies concerned the necessary time to adjust to the new exchange rate structure. They also pointed out that the exchange rate was only one of the determinants of trade flows, and that savings/investment imbalances were at the root of the problem. The case for some degree of exchange rate stability was clearly strengthened when US exports rose sharply, demonstrating that the international competitiveness of US industry had recovered. A further improvement, it was pointed out, might increase profits but not push up exports much further as capacity limits would quickly be reached. Only if domestic demand slackened could room be made for further progress in reducing the US current-account deficit. Not everybody was convinced by these arguments. Some observers in the academic world insisted that only a further depreciation of the dollar could reduce the US current-account deficit to a level which would be sustainable, not just on a short-term basis, as the markets seemed to prove, but in a medium and longer-term perspective.

However, nobody in either camp ever went so far as to suggest that the dollar could now safely rise again without the risk of serious repercussions for the adjustment process. This rise was not due only to market forces which the authorities were unable to resist; although market sentiment certainly played a part, the appreciation also owed much to the policy-induced increase in short-term interest rates, which was designed to contain inflationary pressures. At the same time, the US authorities intervened on occasion against the dollar in the exchange markets and built up sizable foreign exchange reserves in the process, but, as already mentioned, this did not prevent some overall appreciation of the dollar and an even more marked gain vis-à-vis the main surplus countries' currencies.

In a typical conflict between external and domestic goals it is almost without exception the domestic goals that prevail. A currency appreciation,

even if unwelcome from an adjustment point of view, helps to contain inflationary pressures, which makes the "conflict of interest" even more acute. It does not help much if monetary policy uses different instruments such as interest rates and exchange market intervention in different directions. Indeed, monetary policy itself becomes overburdened if it tries to serve two masters. It has long been argued that the problem of conflicting goals can be resolved only if fiscal policy fully shares the responsibility for macro-economic management. With the right policy mix the room for manoeuvre becomes greater. However, decisions on fiscal matters are so much a part of the domestic political process that few governments prove capable of choosing a good policy mix. The United States is certainly not alone in this, but the case for using whatever measures are available to reduce the US Federal deficit has been made so often and so convincingly that the lack of significant further progress is deplorable. With monetary policy engaged in the all-important task of guarding against inflation and fiscal policy immobilised between self-imposed restrictions and partisan struggles, the attention given in the United States to the current-account deficit has clearly not been very great.

What has been said about the United States could be said, mutatis mutandis, about the main surplus countries. They are in the same position in that their surpluses show little, if any, sign of shrinking. They differ considerably in the strength of their domestic demand, but what Japan can show in this respect as its contribution to greater international harmony, Germany can show in the area of openness and ease of access to its markets. In that field Japan still lags well behind; import volumes have, it is true, been rising quite rapidly, but from a low level. Germany can point to the fact that the imbalances no longer constitute a three-cornered problem, since the deficits of the United Kingdom and some other European countries have become major counterparts to the German surpluses, while the trade surplus vis-à-vis the United States has narrowed quite considerably.

Given that adjustment efforts have ceased to figure high on the policy agenda, it has to be asked whether the earlier anxiety about the sustainability of the current-account imbalances was justified, at least to the extent that pre-emptive action was urged. This question will be taken up at the end of the Report. Presumably, if the matter is to receive more attention, the limits of sustainability will have to be more clearly in view. Given the asymmetry between the pressures experienced by surplus and deficit countries in this regard, that point may be reached sooner in the United States and the United Kingdom than in Japan or Germany, but one can only hope that it happens before protectionism has gained any further ground, not just as a political force but gradually also as a proposition with a claim to intellectual respectability. It should be clear from what has been said so far, and it will run as a common thread throughout the Report, how closely intertwined the problems of monetary policy, international capital flows, exchange rates and current-account imbalances are. They have to be addressed together, that is, not as separate issues and not on a national but on an internationally co-ordinated basis.

A question which will also receive due attention in this Report is develop-

ments in the non-industrialised and newly industrialising countries of the world, particularly those with debt problems. In dealing with the debt crisis there had earlier been a partial breakthrough in the case of the poorest countries, which are indebted mainly to official creditors. Now the Brady Plan has opened the door to new ideas for dealing with the highly indebted middle-income countries where large amounts of bank money are at stake. So far the various elements which are needed to implement the proposals have not yet been put in place. Many highly complicated and controversial issues will have to be resolved. Chapter V contains a detailed discussion of what has emerged as this Report goes to print.

The structure of the Report has been retained, with the analysis moving from the real side of the economy to financial markets and on to policy, each of the three areas being dealt with in two chapters, one more nationally and one more internationally oriented. The Conclusion is less a summary than an outlook, not on developments but on policy options and constraints.

II. General economic developments in 1988

Highlights

Growth in the world economy accelerated last year to a little over 4%. This outcome was largely the result of similar developments in the industrial countries, developments which turned out to have already been under way in the second half of 1987. Particularly surprising – and encouraging – was the widespread buoyancy of business investment. Disappointment over the apparent absence of a positive reaction to the 1986 oil price fall and fears about the effects of the 1987 stock market crash thus gave way to optimism as the extent and nature of the upturn became apparent.

The generally medium-term orientation of industrial countries' macro-economic policies, their structural adjustment efforts, and increased international co-ordination of policies seemed to be paying dividends. In the first half of the year especially inflation remained under control and the international adjustment of trade volumes quickened. More countries began to experience some decline in unemployment, although its level still remained high in many European countries.

In the second half of the year, despite some deceleration in the pace of growth, inflation began to creep up, and by March this year it averaged 4½%, compared with slightly under 4% in December 1987. The international adjustment process also faltered, while unemployment continued to fall, even in the United States, where by March of this year it was down to 5.0%. In the same month US inflation rose to 5%.

It is true that the present upturn has been accompanied by much less inflation than was the recovery which followed the first oil shock. Nor is another major external price shock expected at present. Even so, in the period since 1982 inflation has not fallen to the levels seen in the late 1950s and early 1960s, though in the last three years it has been lower than for twenty years. Now, however, concerns about overheating have surfaced again, especially in North America and the United Kingdom.

This development also underlines the importance of reducing the US Federal Government's structural budget deficit. No further progress was made last year in this respect, nor is any expected in the current financial year. The resumption of the international adjustment process would also be assisted by prompt action in this field. In most European countries more determined efforts in the field of structural adjustment are clearly necessary if unemployment is to be reduced in a sustainable fashion.

The developing countries benefited from the faster rate of expansion in the industrial world last year. On average, their growth rate rose from 4% to a little over 4½%. The pick-up was noteworthy in the two largest countries,

China and India. Non-oil-producing countries also benefited from some decline in oil prices and in many cases from increases in non-oil commodity prices. The improvement in growth performance was not, however, shared by all developing countries. Inflation accelerated especially in Latin America, contributing to a sharp slowdown in growth, and in parts of Asia and Africa price performance also deteriorated.

World output growth[1]

Country groups and regions	1986 GDP		1977–82 average	1983	1984	1985	1986	1987	1988
	in billions of US dollars	as % of total	percentage changes in real GDP						
Seven major countries	9,275	64.5	2.0	3.0	5.2	3.4	2.8	3.4	4.2
Other industrial countries[2]	1,543	10.7	1.7	1.4	3.6	3.1	2.5	3.0	3.3
Developing countries	2,360	16.4	4.3	3.3	4.2	4.0	4.3	4.0	4.5
Major oil producers[3]	727	5.1	2.5	0.6	0.2	0.3	0.0	1.0	1.5
Other developing countries	1,633	11.3	4.9	4.5	6.0	5.7	6.3	5.4	5.8
Africa and Middle East	185	1.3	4.5	2.4	1.6	4.0	3.6	−0.3	2.2
Asia	962	6.7	6.2	8.0	7.8	6.7	6.9	7.7	9.2
of which: NIEs[4]	224	1.6	7.1	8.9	9.1	3.6	10.6	11.8	9.2
Latin America	486	3.3	4.0	−1.2	4.1	4.5	6.3	2.8	0.5
Eastern Europe[5]	1,214	8.4	3.0	3.4	3.2	3.2	3.8	2.2	3.8
World	14,392	100.0	2.4	3.0	4.7	3.4	3.0	3.4	4.1

[1] For industrial countries, group averages are calculated using GDP weights and exchange rates of the preceding year. For other country groups and for the world total, averages are calculated using 1986 GDP weights and exchange rates, including all countries with 1986 GDP of at least US$ 0.1 billion. [2] Includes the countries listed in the table on page 20, Iceland and Luxembourg. [3] OPEC members, Mexico and Trinidad and Tobago. [4] The newly industrialising economies: Hong Kong, Singapore, South Korea and Taiwan. [5] Net material product converted at non-commercial exchange rates.

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

The industrial countries

Output in the industrial countries rose by over 4% last year. This represented an acceleration of nearly one percentage point as compared with growth in 1987 and, moreover, it came after the upswing had already been under way for five years. Leaving aside the United States, whose particularly rapid rebound in 1984 raised the average for the industrial countries sharply in that year, the average growth rate in all other industrial countries, at 4¼% last year, was the highest rate recorded since 1976. Indeed, it is necessary to go back to the period before the first oil crisis to find higher growth rates – rates which in any case ultimately proved to be unsustainable.

Output growth accelerated last year...

Another feature of last year's improved growth performance was that it was unusually widespread. To varying degrees, all but one of the seven major countries recorded an acceleration in growth, as did many of the smaller ones. What was also remarkable, and encouraging, was the extent to which business fixed investment generally contributed to the strength of demand, even in some cases where overall growth declined (see page 12 below). In the longer run this investment performance should also contribute to supply potential and thus improve the prospects for further sustainable growth.

... led by buoyant investment spending

But, although inflation remained low ...

The strengthening of growth at this stage of the upturn should also be viewed in the context of inflation. For the year to December consumer price inflation increased only marginally compared with 1987, although, at 3¾%, it was a full percentage point higher than in 1986; in that year, however, the sharp fall in oil prices had been a significant restraining influence. In terms of GDP deflators, which more accurately reflect domestic inflationary pressures, inflation hardly changed at all on average in the industrial countries, taking last year as a whole. And it was marginally below the level recorded in 1986 – partly on account of better productivity performance. For Japan, Germany, France and Italy the comparison with 1986 was even more favourable.

Taken at their face value, these facts seem to give further cause for encouragement. It is true that oil prices fell moderately for most of the year. Nevertheless, after five to six years of recovery, average inflation was still lower than it had been in 1983, the first year of the upturn; in countries other than the United States it was less than one-third as high as it had been in 1976, the most recent year in which growth reached last year's rate; and for the industrial countries as a whole, each of the last three years has seen average inflation lower than at any time since the mid-1960s.

... price pressures became apparent as the year progressed

While it is useful to view last year's developments in the perspective just described, it is also necessary to record – as is done on page 28 below – that inflationary pressures did grow during the course of last year and during the early months of 1989. Rates of capacity utilisation have risen to high levels, and with unemployment falling as well – rapidly in some countries and to low levels in a few others – the risk of a revival of domestic inflationary pressures became evident. Monetary policy was therefore adjusted promptly in many countries with a view to averting any upsurge of inflationary expectations.

The international adjustment process stalled during the year

It is also necessary to note a disturbing pause in the international adjustment process among the three largest countries during the second half of last year and, it seems, in the first quarter of this year (see the graph on page 56). For example, excluding a rather erratic pattern of inventory building, final domestic demand in the United States rose at an annual rate of 3.3% in the second half of the year after rising at a rate of 1.9% in the first half. The real foreign balance, which had improved by 1½% of GNP in the first six months, showed no further improvement later in the year. In Japan domestic demand growth slowed in the second half of the year, although it was then still rising relatively fast. Export growth, however, picked up at this time. In Germany final domestic demand growth slowed to 1.3% per annum in the July–December period, and the real foreign balance moved in a positive rather than a negative direction, thus reversing much of the adjustment recorded in the first half of the year. In addition, a fourth country, the United Kingdom, moved very rapidly into large external deficit in the course of last year.

The strength of activity was unexpected ...

These qualifications aside, it remains true that, in general terms, economic performance last year was considerably better than had been expected by virtually all observers, official and private alike. Indeed, although the pick-up in activity had already begun in 1987, but was late in being recognised, there is a sense in which the output acceleration came when it was least expected. The collapse in share prices in October 1987 had been generally thought likely to

presage a significant expenditure retrenchment in the private sector despite prompt central bank action, while hope had begun to fade that the sharp fall in oil prices in 1986 was going to exert qualitatively the opposite effects of those experienced when prices had risen in 1973–74 and in 1979–80.

The extent of the under-assessment of economic activity last year may be gauged by comparing actual growth in the seven major countries over the period from the first half of 1986 to the first half of 1988 with earlier predictions. Taking a wide range of official and semi-official forecasts, it appears that real GDP was underestimated by some 2¾%, whereas the level of prices was reasonably accurately foreseen; that is, faster-than-expected output growth did not lead to faster-than-expected inflation. Moreover, although the full effect of the Japanese fiscal package was not known in mid-1987, unexpected policy developments seem to have played only a minor role. Inventory movements and changes in the real foreign balance also had little influence, as the under-prediction of final demand, at around 3%, was close to that of GDP. On the other hand, within total final demand business fixed investment alone accounted for nearly half of the discrepancy, its growth being more than

Growth of private non-residential fixed investment

Countries	1967–73 average	1973–79 average	1979–85 average	1986	1987	1988
	percentage changes					
United States	4.4	3.5	2.6	− 4.5	2.8	9.5
Japan	13.2	1.0	7.0	5.9	7.9	15.9
Germany	6.5	1.9	1.0	4.4	4.4	7.2
France	7.3[1]	−0.5	−0.3	3.3	4.4	8.0
United Kingdom	6.1	3.7	4.0	0.3	14.4	17.2
Italy[2]	3.5[1]	−0.2	1.5	2.8	9.8	6.6
Canada	3.9	6.8	2.9	3.2	8.8	17.8
Australia[3]	4.2	1.9	2.6	4.5	0.8	15.8
Austria[4]	7.2	1.2	0.0	3.6	1.8	4.9
Belgium	3.9	0.6	2.6	5.6	10.7	13.7
Denmark	3.5[2]	1.0[2]	3.5	17.6	−8.9	−5.8
Finland	7.0	−2.5	5.3	2.9	5.3	6.8
Greece[4]	12.4	−0.2	−3.0	− 5.7	−3.2	10.0
Ireland[4]	10.4	5.6	−3.0	0.7	−1.1	0.2
Netherlands	4.1	1.7	0.5	12.5	2.0	6.8
New Zealand[3, 4]	3.1	−2.1	4.7	4.4	−6.3	4.5
Norway	5.9	8.6	3.8	14.6	−3.2	−5.6
Portugal[4]	7.0	−0.4	−2.4	9.5	19.5	13.5
South Africa	7.9	−0.3	3.7	−15.9	3.1	16.3
Spain[4]	7.6	−1.1	−1.0	10.0	14.6	14.0
Sweden	4.3	−0.7	3.5	0.5	5.4	4.7
Switzerland[4]	5.9	−2.9	3.9	8.5	7.6	5.8
EC countries[5]	6.0	1.0	1.2	4.3	7.4	9.2
Total[5]	6.6	2.1	3.0	1.0	5.4	10.7

[1] 1970–73. [2] Total non-residential investment. [3] Fiscal years, ending second quarter in the case of Australia, first quarter in that of New Zealand. [4] Total investment. [5] Calculated using 1986 GDP weights and exchange rates.

10 percentage points greater than expected and in some countries (Japan and Canada) more than 15 points.

... and the surprise may have been in part due to the nature of the investment process

An analysis of the unusually strong and generalised performance of business fixed investment is given on page 34 below. Here it will suffice to note one important clue to the favourable overall outcome in 1988. An explanation partly couched in terms of this expenditure component helps to account for the delayed response to the oil price fall in 1986 and for the apparent absence of any depressive effects stemming from the share price collapse. In addition, although a long period of low investment in many countries implied less spare capacity than trend extrapolations of potential growth rates might have suggested, international policy co-ordination might also have played a role. To the extent that earlier gross misalignments of exchange rates under the floating regime had led entrepreneurs perhaps to delay investment projects, so might clear official re-commitment to more realistic rates have had the reverse effect on business confidence, particularly after domestic policies had succeeded in restoring much healthier levels of profitability. Admittedly, financial markets experienced a bout of severe disturbance in October 1987,

Developments in real GNP/GDP[1] and demand components

Countries	1977–82 average	1983	1984	1985	1986	1987	1988	1988 Q4[3, 4]
	percentage changes							
United States								
Private consumption	1.7	4.7	4.8	4.7	4.3	2.7	2.8	3.7
Public consumption	1.7	1.1	4.4	7.9	4.0	2.6	0.3	0.4
Gross fixed investment	−0.8	8.2	16.8	5.3	0.0	2.0	6.1	4.6
Inventory changes[5]	−0.4	0.6	2.1	−1.5	0.2	0.5	0.2	−1.0
Net exports[5]	0.4	−1.5	−2.0	−0.6	−0.9	0.2	0.7	0.5
GNP	1.4	3.6	6.8	3.4	2.8	3.4	3.9	2.8
Japan								
Private consumption	3.7	3.3	2.7	2.7	3.1	4.2	5.0	4.3
Public consumption	3.8	3.0	2.8	1.7	6.2	−0.7	2.1	2.8
Gross fixed investment	3.5	−0.2	4.8	5.7	6.0	10.1	13.5	10.6
Inventory changes[5]	0.0	−0.4	0.4	0.4	−0.1	−0.4	0.2	−0.2
Net exports[5]	0.7	1.5	1.3	1.1	−1.4	−0.6	−1.9	−1.3
GNP	4.3	3.3	5.1	4.9	2.5	4.4	5.8	4.7
Germany								
Private consumption	1.3	1.7	1.5	1.4	3.4	3.6	2.5	1.1
Public consumption	2.1	0.2	2.5	2.1	2.5	1.5	1.8	1.3
Gross fixed investment	0.8	3.2	0.8	0.1	3.2	2.5	5.8	3.8
Inventory changes[5]	−0.3	0.5	0.5	−0.4	0.3	0.1	0.4	1.1
Net exports[5]	0.5	−0.3	1.3	1.2	−1.1	−1.2	0.1	−0.1
GNP	1.5	1.9	3.3	1.9	2.3	1.8	3.4	2.6
Memorandum items:								
Domestic demand								
United States	1.0	5.1	8.7	3.8	3.7	3.0	3.0	2.2
Japan	3.6	1.8	3.8	3.9	4.1	5.1	7.8	6.1
Germany	1.1	2.3	2.0	0.8	3.6	3.1	3.5	2.9

For footnotes see the table on page 17.

but continued moderate inflation and further co-ordination efforts thereafter – among other factors – may have served to place the financial turbulence in the category of events far too short-term in nature as noticeably to affect ongoing capital expenditure projects.

The three largest economies

With an increase in GNP of nearly 4% last year, the *United States* recorded its sixth consecutive year of growth during the present recovery. Despite the effects of the drought, which are estimated to have reduced the year's agricultural supply by an amount equivalent to 0.4% of GNP, this result already represented an acceleration compared with the previous year. Between fourth quarters growth slowed to 2¾%, but this was more than accounted for by erratic, drought-related, inventory movements. In terms of real final domestic demand (that is, excluding inventory changes) growth between the fourth quarters of 1987 and 1988 came to 3¼%, a slight acceleration compared with the figure recorded a year earlier. Private consumption growth rose to 3¾% over the same period as a slight rebound in the saving ratio petered out.

Final domestic demand remained strong in the United States ...

It is therefore not surprising, as the graph on page 56 in Chapter III shows, that the welcome improvement seen in the real net foreign balance since mid-1986 came to a halt in the second half of 1988. Export growth in volume terms slowed in the second half of the year, only partly as a result of the drought, and import growth quickened.

... leading to a slowdown in adjustment ...

With demand pressure apparently continuing to be strong in the early months of this year, and with signs of inflationary pressure also appearing, the question of whether monetary policy can continue to be relied on to provide adequate restraint is becoming more pressing. It is true that the Federal budget deficit did fall slightly as a percentage of GNP in the fiscal year 1988, and, on a calendar-year basis, the general government deficit ratio fell by a greater amount (see page 16 below).

... and inflationary pressures

Nevertheless, much, if not all, of the improvement was probably related to the strength of activity, and the structural deficit has therefore not improved further. In addition, the new Administration estimates that no further progress will be made in the current fiscal year. In the absence of any further measures, the outturn for the Federal deficit is officially expected to be some $24 billion above the original Gramm-Rudman target in the fiscal year 1989. This fact points to one of the weaknesses in the Gramm-Rudman procedures, namely that the targets only apply to projected deficits and not to actual outcomes. An important part of the reason for the current year's overshooting lies in the measures which the new Administration has taken to deal with the problems of the savings and loan institutions. There is, however, nothing in the Gramm-Rudman legislation which requires offsetting changes in the other items of the budget in order to meet the original target for a fiscal year which is already under way.

Little further underlying adjustment of the US Federal budget ...

The Congressional Budget Office considers that the economic assumptions underlying the Administration's projections lead to an over-optimistic assessment of the size of future required budget cuts. Thus, while the

... has increased the need for more convincing action

immediate question earlier this year was whether an agreement could be reached between the Administration and Congress on the 1990 budget, or whether the automatic sequestration procedures should be allowed to come into effect, there is also a question as to whether further cuts are needed. The President is reluctant to jeopardise the tax reforms of the previous Administration by raising income taxes. The resultant need for further expenditure cuts will continue to pose severe political problems unless, for example, the Administration concludes that the international political situation could now permit defence spending reductions without prejudice to security. Without some further action, the risk is that either interest rates – and thus also debt servicing costs – will rise further, and/or that a cyclical slowdown in private activity will result in a renewed, automatic, rise in the deficit, and thus in the public debt/GNP ratio.

Domestic demand growth was very strong in Japan ...

The growth rate of the *Japanese* economy rose sharply last year to 5¾%, and, while the expansionary fiscal measures introduced in 1987 were no doubt partly responsible, the economy also appears to have experienced an autonomous shift in private sector behaviour centring on buoyant business investment. The rise in tax revenues was such that, in spite of the previous year's expansionary measures, the budget surplus rose further (see page 16 below). *Domestic demand growth was very strong, especially in the first half* of 1988 when it registered an annual rate of increase of more than 8½% compared with the previous half-year. Some slowdown in spending in the final quarter of the year may prove to be partly temporary given the reportedly subdued atmosphere in the country connected with the Emperor's final illness.

... and led to further external adjustment early in the year

The strength of domestic demand was no doubt in part responsible for the acceleration in the adjustment of the real foreign balance in the first half of the year. However, as is detailed in the following chapter, terms-of-trade changes served to offset much of the potential effect of this development on the nominal current-account balance, and more recently there has been some concern that the adjustment process may have stalled. There has also been some concern about inflationary pressures despite virtually no increase in consumer prices on average in 1988. The price level may, however, be raised slightly this year as a result of the introduction of a value added tax in the context of the tax reform programme.

No further adjustment was seen in Germany...

In *Germany* the halt to the international adjustment process was already apparent in the volume figures for net exports in the first half of last year despite faster growth of domestic demand and imports. After declining by about 1% of GNP in both 1986 and 1987, last year's reduction in the real foreign balance was minimal. Strong international demand for capital goods was no doubt one factor in the acceleration of Germany's export growth. Consumer expenditures were boosted early in the year by a further reduction in taxes, but investment, private and public, was the most dynamic component of demand (see the table on page 13 above). Thanks to this latter development, total domestic demand rose by 3½%, which, as in other countries, was faster than had been expected. Boosted in the early months of the year by the effects of a mild winter, output also grew by 3½% for the year as a whole and unemployment fell slightly – with the fall quickening early this year. Against this

General government budget balances[1]							
Countries	1973	1983	1984	1985	1986	1987	1988[2]
	as a percentage of GNP/GDP						
United States	0.6	− 3.8	− 2.8	− 3.3	− 3.4	− 2.3	− 1.8
Japan[3]	0.5	− 3.7	− 2.1	− 0.8	− 0.9	0.6	1.3
	−2.7	*− 6.8*	*− 5.8*	*− 4.2*	*− 4.2*	*− 1.4*	*0.3*
Germany	1.2	− 2.5	− 1.9	− 1.1	− 1.3	− 1.8	− 2.0
France	0.9	− 3.1	− 2.8	− 2.8	− 2.9	− 2.3	− 2.0
United Kingdom	−2.6	− 3.3	− 3.9	− 2.7	− 2.3	− 1.5	0.5
Italy	−7.0	−10.7	−11.5	−12.5	−11.4	−10.5	−10.2
Canada	0.9	− 6.9	− 6.5	− 7.0	− 5.4	− 4.6	− 3.1
Australia	1.8	− 4.0	− 3.1	− 2.8	− 2.2	− 0.8	0.9
Austria	1.3	− 4.0	− 2.6	− 2.5	− 3.7	− 4.1	− 2.7
Belgium	−5.5	−11.9	− 9.7	− 9.1	− 9.2	− 7.4	− 7.1
Denmark	5.3	− 7.2	− 4.1	− 2.1	3.4	2.1	0.6
Finland	5.8	− 1.7	0.4	0.1	0.8	− 0.8	1.0
Greece	n.a.	− 8.1	− 9.9	−13.5	−10.6	−10.2	−13.9
Ireland[4]	−3.8	−12.9	−12.3	−13.0	−13.0	−10.1	− 3.3
Israel[5, 6]	n.a.	− 3.4	−10.4	− 2.9	2.5	− 1.2	n.a.
Netherlands[7]	1.9	− 6.6	− 5.7	− 4.3	− 4.9	− 4.6	− 4.3
New Zealand[5, 8]	−2.5	− 7.1	− 9.4	− 7.5	− 4.3	− 3.8	0.8
Norway	5.8	4.2	7.5	10.4	5.7	4.2	3.1
Portugal	1.4	− 8.5	−10.9	−11.1	− 8.5	− 7.5	− 7.2
South Africa[8]	−1.1	− 4.7	− 4.3	− 3.5	− 4.9	− 6.0	− 5.4
Spain	1.1	− 4.8	− 5.5	− 7.0	− 6.1	− 3.6	− 3.2
Sweden	4.1	− 5.0	− 2.6	− 3.8	− 0.7	4.0	3.1
Switzerland[7]	−1.1	− 0.9	− 0.3	− 0.1	1.1	0.7	0.7
Turkey	−1.8	− 2.6	− 5.3	− 2.8	− 3.6	− 4.0	−3.4

[1] Including the social security sector but excluding capital transactions of a financial nature. [2] Partly estimated. [3] Figures in italics include nationalised industries (flow-of-funds basis). [4] Exchequer borrowing requirement. [5] Fiscal years. [6] Domestic government budget. [7] Excluding the social security sector. [8] Central government only.

Sources: OECD Economic Outlook, IMF International Financial Statistics, European Economy, and national data.

background, inflation drifted up slowly last year and rose to 3% in April this year following some indirect tax increases.

... although domestic demand growth did increase slightly

Demand growth slowed down in the second half of last year, especially consumer demand; stocks were built up, and this year, as just noted, some fiscal consolidation measures are being introduced before tax reductions resulting from the final stage of the tax reform programme are put in place in 1990.

Other large industrial countries

Stronger investment spending and export growth in France

The *French* economy benefited last year from the general buoyancy of investment spending and from a marked acceleration in export growth stemming from the generally stronger international conjuncture. Total output rose by 3½%, the fastest rate seen since 1978. Unemployment fell early in the year and, although it remains high and the decline has not continued, 1988

Developments in real GNP/GDP[1] and demand components (continued)

Countries	1977–82 average[2]	1983	1984	1985	1986	1987	1988	1988 Q4[3, 4]
	percentage changes							
France								
Private consumption	2.7	0.9	1.1	2.3	3.7	2.7	2.7	2.4
Public consumption	3.5	2.1	1.1	2.3	1.7	3.0	2.3	2.1
Gross fixed investment	0.9	−3.6	−2.6	2.8	3.3	3.7	7.0	5.8
Inventory changes[5]	−0.1	−0.9	0.0	−0.2	1.0	0.1	0.1	1.2
Net exports[5]	0.1	1.4	1.0	−0.6	−1.8	−1.1	−0.3	−1.2
Domestic demand	2.3	−0.7	0.4	2.2	4.2	3.0	3.6	4.2
GDP	2.4	0.7	1.3	1.7	2.3	1.9	3.4	3.0
United Kingdom[6]								
Private consumption	2.1	4.5	1.8	3.7	5.7	5.4	6.5	5.8
Public consumption	1.4	2.0	0.8	0.1	2.0	1.1	0.5	0.2
Gross fixed investment	−0.7	5.0	8.6	3.8	1.7	8.3	11.8	8.5
Inventory changes[5]	−0.3	0.8	−0.1	−0.1	0.0	0.1	0.3	1.9
Net exports[5]	−0.3	−1.0	−0.8	0.9	−0.7	−0.5	−3.9	−4.4
Domestic demand	1.2	4.8	2.6	2.7	4.2	5.1	6.5	7.2
GDP	0.9	3.9	1.8	3.7	3.5	4.5	2.6	2.8
Italy								
Private consumption	2.7	0.7	2.4	3.0	3.5	4.3	3.8	4.3
Public consumption	2.4	2.9	2.6	3.5	3.1	3.4	3.0	3.5
Gross fixed investment	2.0	−0.1	5.3	2.5	1.4	6.7	4.9	3.4
Inventory changes[5]	−0.1	−0.6	0.9	0.2	0.2	0.2	0.5	n.a.
Net exports[5]	−0.1	0.8	−0.8	−0.3	−0.4	−1.7	−0.6	−0.2
Domestic demand	2.4	0.2	4.0	3.1	3.2	4.6	4.3	4.8
GDP	2.2	1.1	3.2	2.9	2.9	3.0	3.9	4.5
Canada								
Private consumption	1.6	3.4	4.6	5.4	4.3	4.7	4.3	4.0
Public consumption	2.0	1.4	1.2	2.7	1.2	1.6	2.8	2.7
Gross fixed investment	3.1	−0.7	2.1	8.2	5.0	9.6	12.5	9.4
Inventory changes[5]	−0.8	1.9	1.8	−0.3	0.2	−0.5	−0.4	−0.7
Net exports[5]	0.5	−0.3	0.9	−0.3	−0.7	−0.6	−1.1	−1.4
Domestic demand	1.4	4.1	5.3	5.1	3.9	4.7	5.5	4.3
GDP	2.0	3.2	6.3	4.6	3.2	4.0	4.5	3.4
Seven major countries[7]								
Private consumption	2.2	3.6	3.6	3.8	4.0	3.4	3.6	3.7
Public consumption	2.2	1.5	3.2	5.3	3.6	2.0	1.2	1.2
Gross fixed investment	1.0	3.2	8.6	4.7	2.4	5.5	9.1	6.9
Inventory changes[5]	−0.3	0.3	1.3	−0.8	0.2	0.2	0.2	−0.2
Net exports[5]	0.3	−0.4	−0.6	0.0	−1.0	−0.4	−0.5	−0.5
Domestic demand	1.7	3.4	5.8	3.4	3.8	3.8	4.5	3.8
GDP	2.0	3.0	5.2	3.4	2.8	3.4	4.2	3.4

[1] GNP for those countries (the United States, Japan and Germany) which include factor payments to and income from abroad under imports and exports. [2] For Italy, 1977–82 average on the basis of accounts at 1970 prices. [3] Preliminary. [4] From fourth quarter 1987 to fourth quarter 1988. [5] Changes as percentages of previous year's GNP/GDP. [6] Figures are expenditure-based. The average measure of GDP grew by 4½% in 1988. [7] Expenditure weights and exchange rates of the preceding year.

nevertheless saw the first fall in the annual unemployment rate for fifteen years, and the largest decline since 1969. At the same time, inflation picked up only slightly during the course of the year. Indeed, taking 1988 as a whole, consumer price inflation was lower than in the previous year, but by March of this year the twelve-month rate had returned to a figure of 3.4%. Some deterioration also occurred during the year in the current-account deficit, which doubled between the fourth quarters of 1987 and 1988.

Domestic demand grew surprisingly fast in the United Kingdom ...

This was, however, minor compared with what occurred in the *United Kingdom,* where, after two strong increases in 1986 and 1987, domestic demand growth accelerated further last year to 6½%. This was the fastest growth since 1973. The acceleration was also influenced by private investment spending, both residential and non-residential. However, the overall strength of total demand was strongly supported by the unexpected and unprecedented behaviour of the personal sector. Personal consumption had already been growing strongly for some time, and the saving ratio had already fallen sharply from its peak at the start of the decade (see the graph opposite). Last year, however, the decline continued until in the third quarter the personal saving ratio was only 2.9%. This result was the counterpart of continued heavy consumer borrowing against the background of deregulated credit markets and large increases in personal sector wealth, especially in the form of house price increases. Indeed, the latter formed the – often implicit – collateral for much of the rise in borrowing for consumption purposes.

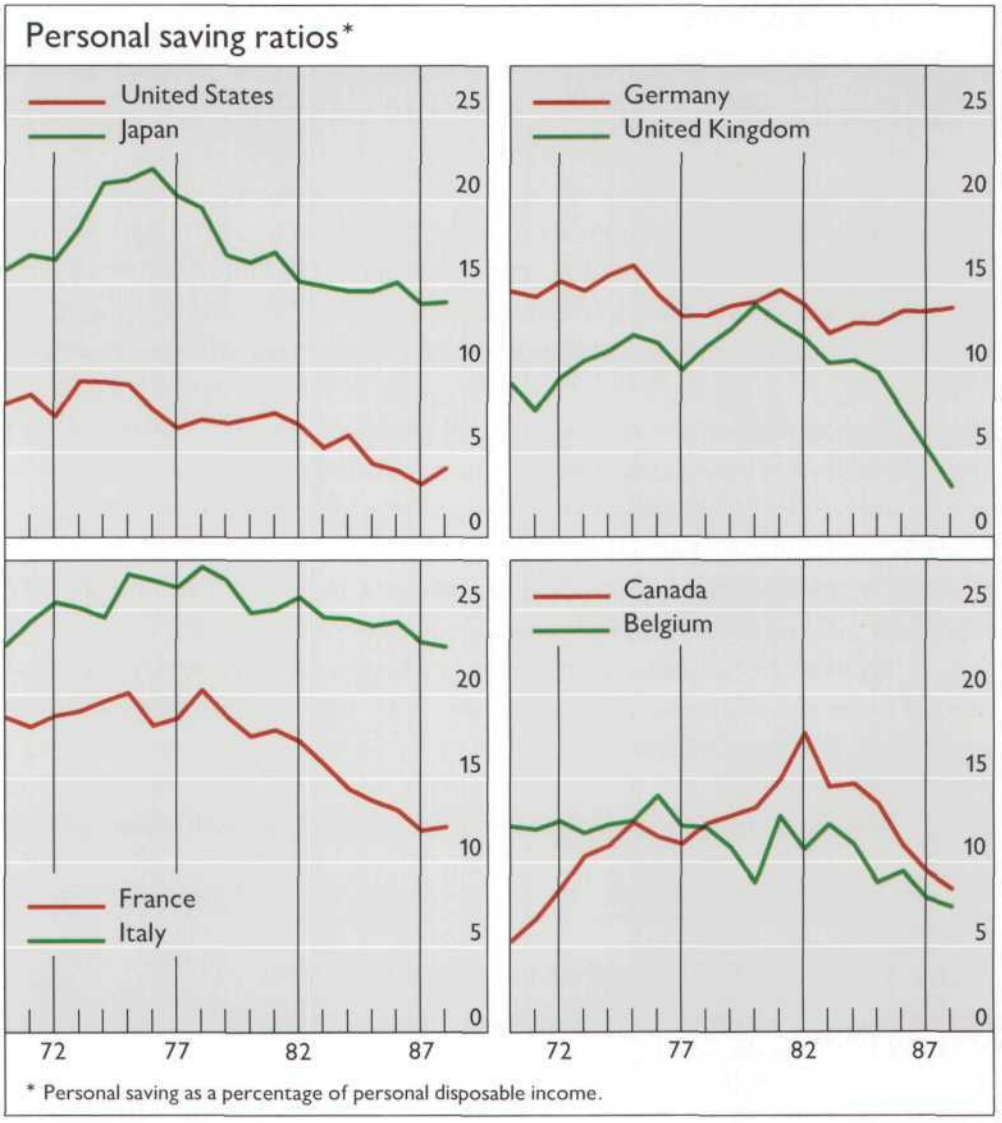
... leading to overheating ...

The United Kingdom's case is also worthy of comment in other respects. Firstly, and not surprisingly, the strength of demand has led to clear signs of overheating. Only some of this pressure has so far manifested itself in the form of faster price rises; the rest has taken the form of a large deterioration in the balance of payments on current account. Unemployment has continued to fall rapidly. A major by-product of the private spending boom, however, is that it has helped to push the public sector accounts into surplus. For example, the public sector borrowing requirement (which included asset sales of some £7 billion) became a public sector debt repayment of over £14 billion, or 3% of GDP, in the financial year 1988–89. This healthy state of the public sector's finances raises the interesting question of whether, and for how long, it implies that imports can continue to provide a kind of safety valve for the relief of domestic demand pressures. The Government has budgeted for a similarly large public sector surplus in the current financial year, a year in which the sharp rise in interest rates engineered in 1988 is expected to bring the necessary restraint of demand.

... and a large deterioration in the balance of payments

Growth accelerated in Italy ...

Growth also accelerated in the *Italian* economy last year, though the contrast with the United Kingdom in the public sector's finances could hardly be greater. As elsewhere, business investment was buoyant, and in Italy's case this was for the second successive year. Total domestic demand rose by 4¼%, which was in fact rather less than in 1987. Net real exports, however, declined by much less than in the previous year, so that GDP rose by some 4%, after approximately 3% in 1987. Consumer price inflation increased to 5% on average last year and to 6.7% by April of this year, partly as a result of an increase in VAT. Wage pressures emerged in the public sector, adding further



... but the budget deficit remained excessive

to the public sector deficit problem. The general government deficit ratio fell slightly last year, but only to 10% of GNP, so that, with interest rates rising, it is not surprising that the public debt/GNP ratio is also continuing to rise strongly.

Exports and investment also led the acceleration in demand growth in Canada

As in the United Kingdom, consumer spending in *Canada* has also been fuelled for some years by a declining saving ratio (see the graph above), albeit at not quite the same rate. There were also signs in the course of last year of an end to this decline, and consumer spending growth fell to 4.3% from 4.7% in 1987. However, with private non-residential investment rising by 18%, total domestic demand growth rose to more than 5% again. Export growth also picked up sharply, but the investment boom soon resulted in a large increase in imports of capital goods, so that output rose by about 4½%, implying some acceleration from the growth seen in 1987. Inflationary pressures thus began to appear during the year as unemployment fell further. Continued growth helped to reduce the general government deficit from 4.6% to 3.1% of GNP, a figure which, in the context of little further slack in the economy, is not yet low enough to guarantee medium-term sustainability of the public finances.

The smaller industrial countries

Many smaller industrial countries benefited from strong world trade growth

The smaller industrial countries tended to be favourably affected by the general buoyancy of world trade and demand last year. As the table on page 12 above makes clear, many of them were also already experiencing, or began to experience, an upturn in business investment. There were, however, some exceptions to this generalisation. As a result, the average growth rate for the group as a whole did not rise by as much as it did in the larger countries and, at 3⅓%, it was nearly a full percentage point lower.

An important reason for this outcome was that several of these countries were involved in adjustment efforts designed either to curb inflationary pressures or to deal with external account weakness, or both. Denmark and New Zealand were two cases in point where fiscal policy had been tightened in recent years. Fiscal consolidation also continued in Ireland, where a prime concern has been the medium-term unsustainability of previous trends in the public finances. The need to counter inflationary pressures had also already influenced policy in Norway, and the same need became pressing in Israel and Turkey last year. In Australia, on the other hand, although monetary and fiscal policies were set in a restraining mode last year, domestic demand, including investment, was very buoyant. It was an exceptional, sharp decline in export growth and a marked acceleration in imports which led to some decline in output growth. Finally, in Spain and Portugal, although growth rates fell last

Changes in real GDP in other industrial countries

Countries	1986 GDP in billions of US dollars	1977–82 average	1983	1984	1985	1986	1987	1988[1]
		percentage changes						
Australia	164.6	2.4	0.2	6.9	5.2	2.1	4.5	3.8
Austria	93.2	1.8	2.2	1.3	2.6	1.4	1.5	4.2
Belgium	111.5	1.5	0.2	2.2	0.9	2.1	2.1	4.1
Denmark	82.5	1.3	2.5	4.4	4.2	3.1	−0.7	−0.2
Finland	71.1	4.0	3.0	3.3	3.5	2.3	3.8	4.8
Greece	39.6	2.5	0.4	2.7	3.0	1.3	−0.5	3.5
Ireland	24.9	3.8	−0.2	4.2	1.6	−0.4	4.1	2.5
Israel	29.4	3.2	2.6	2.4	3.6	3.3	5.2	1.6
Netherlands	175.5	0.7	1.4	3.2	2.6	2.1	1.5	3.0
New Zealand	27.6	1.3	6.1	2.7	2.8	0.7	0.3	−0.3
Norway	69.6	3.0	4.6	5.7	5.3	4.2	3.4	2.8
Portugal	29.4	3.6	−0.3	−1.6	3.3	4.3	4.6	4.3
South Africa	61.6	3.1	−2.1	5.1	−1.2	0.6	2.0	3.0
Spain	228.1	0.7	1.8	1.8	2.3	3.3	5.5	5.0
Sweden	130.8	1.5	2.4	3.9	2.1	1.1	2.4	2.1
Switzerland	135.3	1.5	0.7	1.8	4.1	2.8	2.3	3.0
Turkey	58.3	1.4	3.3	5.9	5.1	8.1	7.4	3.4
Average[2]		1.7	1.4	3.6	3.1	2.5	3.0	3.3

[1] Preliminary. [2] Calculated using GDP weights and exchange rates of the preceding year.
Sources: OECD National Accounts, IMF International Financial Statistics, and national data.

year, they remained at a relatively high level as the investment boom connected with their accession to the European Community continued.

The current upturn in perspective

The duration of the upturn is now a peacetime record ...

The present upturn in growth in the industrial world began in the United States in 1982 and has now entered its seventh year. This makes it a peacetime record in terms of durability. It has also taken place against the background of a major change in the intellectual climate within which policy-making is conducted. The emphasis in most countries has been on steady and inflation-reducing macro-economic policies; on halting, and then reversing, the deterioration in public sector finances; and on structural adjustment measures at the micro-economic level to improve the functioning of market mechanisms. Only in this way, it was thought, could economies be put onto longer-term non-inflationary growth paths and unemployment be brought down in a sustainable way. In short, the former cycle of "stop and go" in policies was to be ended.

... but signs of inflationary pressures are disturbing

Against this background, the increase in inflation during the second half of last year and the first part of this poses an obvious and crucial question: has the approach thereby failed? Or, less bluntly, is it rather that more vigilance is required at the macro-policy level and/or that structural adjustment efforts need to be pursued further and more vigorously in order that growth can continue on a sustained basis?

Clearly, it will not be possible at this stage to provide unambiguous answers to these questions. The remainder of this chapter seeks rather to provide at least some of the factual background against which some judgement may tentatively be made. The analysis begins with an examination of the broad statistical facts of the upturn set in a historical perspective. Then three areas are examined in rather more depth. The first, and possibly most important, covers inflation, not just per se, but also in relation to the unemployment which still accompanies it in many countries in Europe. The second deals with the behaviour of saving both in terms of its effect on consumer demand during the upturn and from a longer-term point of view. Finally, leading from this examination of saving, the third area considered is investment, which, though making a welcome recovery last year, has not yet responded fully to the needs of sustainable medium-term growth.

Three areas to be examined in historical perspective

The broad statistical background

The accompanying graphs present average indicators for the Group of Seven countries, showing in each case developments since 1982 in comparison with the indicator's average value during the 1975–81 upturn. Being averages, the indicators naturally tend to mask any divergences in individual countries. For example, the early strength of the upturn was not general but concentrated in North America and to a lesser extent in Japan. Similarly, the decline in unemployment was not general until fairly late in the day, and even then was only slight in, for example, Germany and France.

At just under 4% per annum, the average growth rate of output since the 1982 trough has been slightly higher than in the 1975–81 period. But it was still

more than 1 percentage point below the rate recorded between 1960 and 1968. This may of course have helped prolong the upturn.

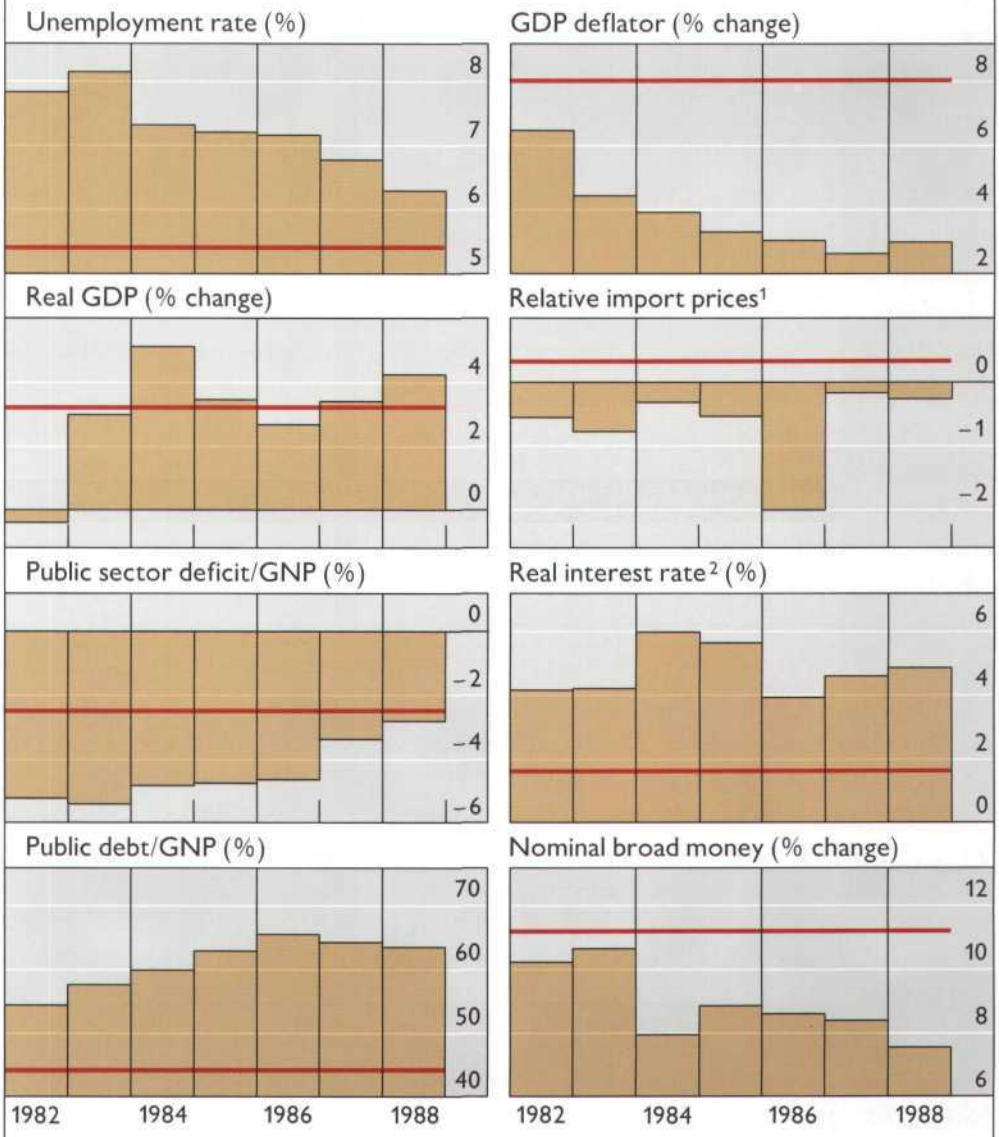
In terms of GDP deflators, which reflect purely domestic inflationary pressures more accurately than do consumer prices, the progressive reduction in inflation between 1982 and 1987 was both unusual and encouraging, even – or perhaps especially – in the context of little or no improvement in labour productivity growth. The deceleration of domestic inflation after the first oil shock was much more gradual and came to a halt after three years, just before

The upturn of the 1980s: Selected indicators – I

Weighted averages of annual data for the Group of Seven countries

Developments since 1982

Average levels 1975–81



[1] Measured as the percentage change in the import deflator relative to the GDP deflator multiplied by the average share of imports in GDP. [2] Long-term bond yield less the three-year uncentred moving average of changes in the GDP deflator.

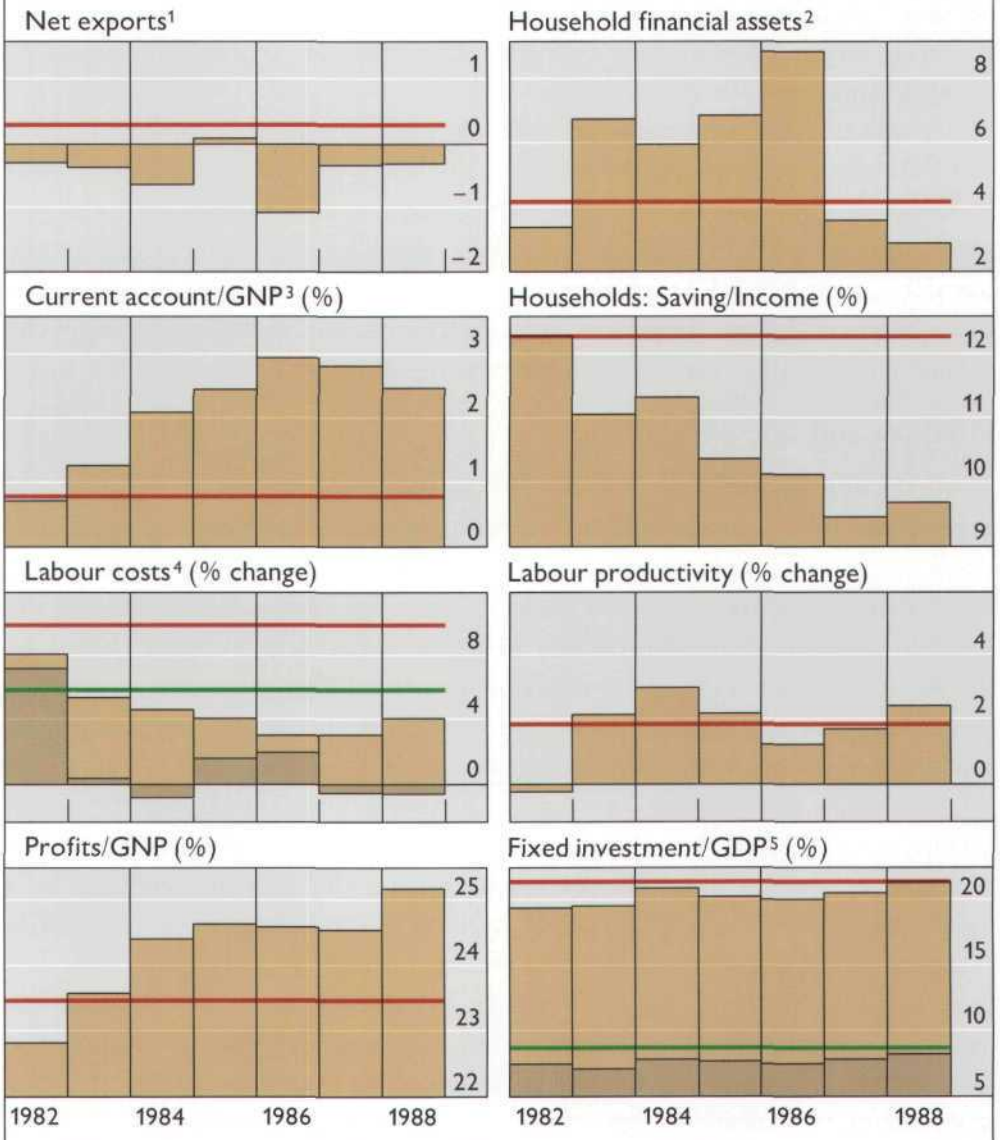
the second oil crisis struck. The average level of inflation in 1976–78, at about 7½%, was thus significantly higher than it was in 1983–86. Nevertheless, it is striking that, at its lowest point, domestic inflation was below the 1960–68 average in only 1987 and 1988.

Moreover, as is examined in greater detail below, the most recent price picture is less encouraging, and unemployment has continued at historically high levels, especially in much of Europe. Taking the seven countries together, unemployment, at 6¼%, was still more than twice as high last year as it was

The upturn of the 1980s: Selected indicators – II

Weighted averages of annual data for the Group of Seven countries

Developments since 1982
Average levels 1975–81



[1] Change in exports minus imports (at constant prices) as a percentage of the previous year's GDP. [2] Percentage change in household financial assets deflated by consumer prices. [3] Current-account imbalances measured without regard to sign. [4] Lighter shading and red line, nominal wages; darker shading and green line, unit labour costs. [5] Lighter shading and red line, gross fixed investment; darker shading and green line, net fixed investment.

during the 1960s. The important question is thus whether further progress can be made here, while at least maintaining the lower rates of inflation established in the last three years of the upturn.

In the field of public finance consolidation, progress has clearly been made, but from a very unsatisfactory base. The average general government budget deficit ratio last year had not quite returned to the 1975–81 average, let alone to the figure of less than ½% of GNP recorded during the 1960s and early 1970s. Concomitantly, public debt ratios have continued to rise during much of the latest upturn, partly as a result of the high level of real interest rates. Only last year was the first small decline registered, which nevertheless left the average debt ratio well above earlier levels. In this sense, one element of the new policy approach remains unfinished business.

Another important element of the medium-term strategy, however, namely the restoration of profit margins, was in large measure achieved. This no doubt facilitated last year's investment boom, but it did so at a relatively late stage of the cycle in most countries. It is thus not surprising that rates of capacity utilisation are generally very high.

In this connection, private household saving has played a rather ambiguous role. On the one hand, the decline in saving since its peak in the early 1980s contributed appreciably to the autonomous upturn in demand. On the other, and in the context of government dissaving, there has been concern about the possible inadequacy of economies' overall investible resources, as well as, in some countries, about the role of growing international saving disparities in the record payments imbalance which has accompanied the present upturn.

Inflation and unemployment

Duration of the upturn owes much to moderate inflation ...

The behaviour of inflation between 1982 and 1987 was no doubt of crucial importance to the duration of the current upturn, as it removed one element which had brought most previous cycles to an early halt. It is generally recognised that restrictive monetary policies were instrumental in reversing the inflation trend early in the decade and that stable policies have helped to reduce inflationary expectations throughout the 1980s. However, the initial phase of disinflation would not have been maintained without continuing moderate wage behaviour and favourable supply shocks later on.

Although the average rate of unemployment in the Group of Seven countries has fallen since 1982, nominal wage growth has remained low – and much lower than in the 1975–81 cycle. In part, this may be explained by a reversal of the price/wage cycle as nominal wage claims were reduced in response to lower price inflation. However, real wage growth has also remained low, thus opening the way for a rise in profit margins without any rise in inflationary pressures. Wage moderation has been most pronounced in US manufacturing, while in the European countries the continued high level of unemployment explains a large part of the decline in nominal and real wage claims.

... the latter helped by external price developments

One of the sharpest contrasts to developments in the 1970s has been the behaviour of import prices. During 1975–81 import prices pushed up domestic price inflation in the Group of Seven countries by about ¼% per year,

whereas during 1982–88 they dampened price increases by almost ¾% per year (disregarding the indirect effects of the wage/price cycle), with a particularly large decline occurring in 1986 when oil prices fell dramatically. Moreover, the accompanying terms-of-trade improvement has boosted real disposable income by a cumulative 2%, thereby offsetting some 45% of the terms-of-trade losses experienced since 1970 and widening the scope for a non-inflationary increase in both real earnings and profits.

However, this relatively favourable picture looks less promising when the most recent trends in inflation and unemployment are also considered. Thus the strength of demand and output growth last year was reflected in labour market developments and, with a lag, in the evolution of wages and prices. Employment continued to grow strongly in North America and Australia and it accelerated quite sharply in Japan, while in Europe moderate increases of around 1% were recorded for the third successive year, the United Kingdom and Spain being the main exceptions with a second year of increases of around 3%. These developments were even more clearly reflected in the behaviour of unemployment, which continued to fall in North America but which also registered a larger decline in Europe than it had done in 1987. Even so, the average level of European unemployment remains high at something over 10%. At the other extreme, the unemployment rate in the United States fell to 5% at one point early this year, a level which, it is feared, may carry the risk of renewed wage pressures.

But the acceleration of inflation last year raises a question mark

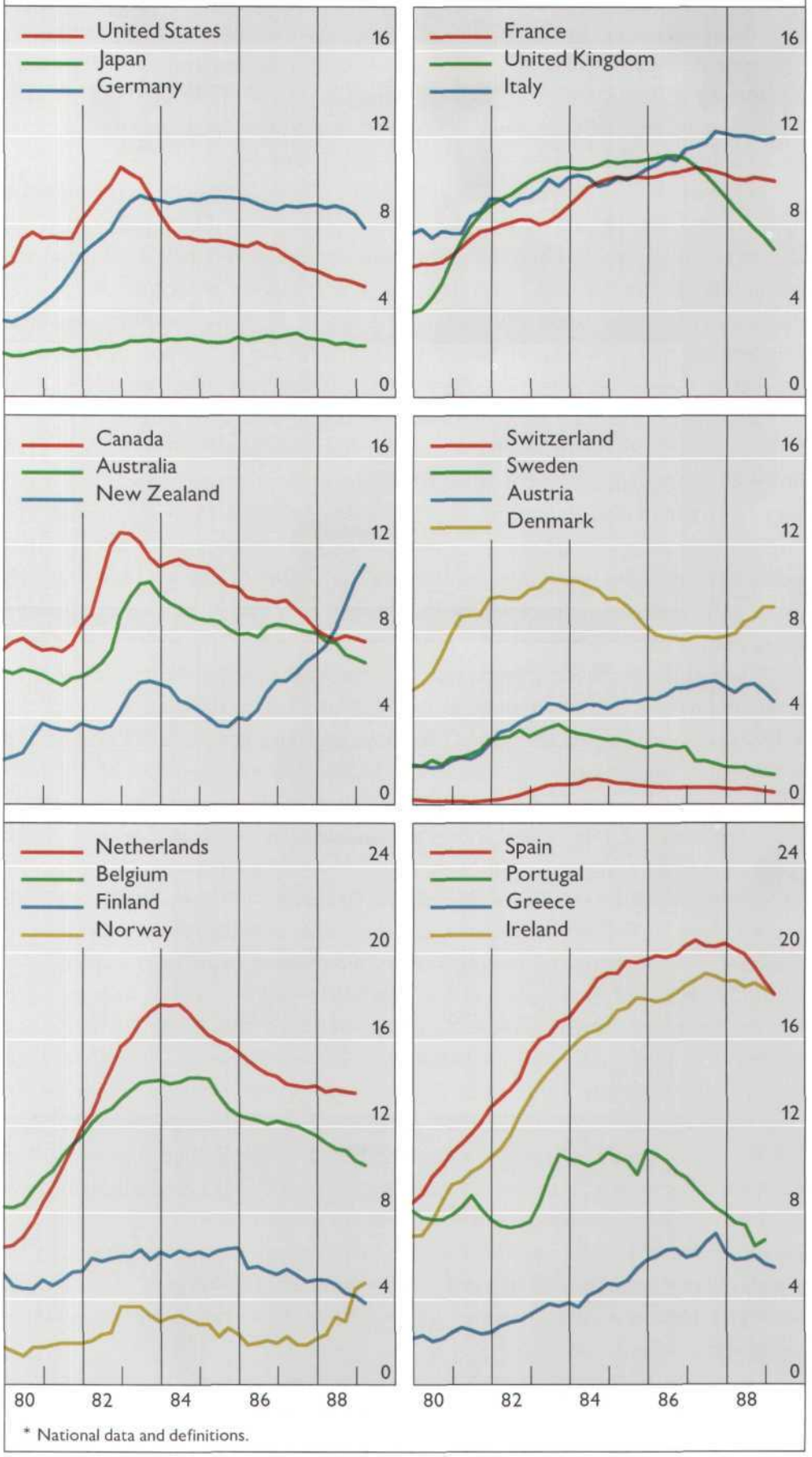
Indeed, wage developments last year perhaps signalled more clearly than consumer prices that the trough in the long process of disinflation during the 1980s may now have been passed. Nominal earnings growth accelerated, for example, in North America, and in the United States the effect of this was compounded, for total labour costs, by a rise in employers' social security contributions. In Europe, too, moderate increases in the rate of nominal wage growth were recorded, although there were exceptions. In Norway concerted action by the Government, management and labour reduced wage growth, and in Finland an income tax reduction together with a cut in the discount rate were part of an agreement which helped to restrain wage claims. New Zealand and Denmark, where restrictive policies are in force, were other exceptions. In the United Kingdom, although the extent of the wage acceleration was small, it was from a base which was higher than countries such as Italy and, especially, France and Germany had previously managed to secure (see the graph overleaf). For a time at least the modest acceleration in wage inflation was partly offset by cyclically buoyant productivity growth, for example in Japan and Germany. And, in the near term, high profit margins may provide a cushion should productivity growth return to more normal levels. Nevertheless, the wage situation remains one which policy-makers are likely to watch closely, especially as in most countries direct interference in the wage-setting process is viewed as either ineffective or counter-productive in terms of its likely side-effects.

Nominal wage developments—the core of domestic inflation

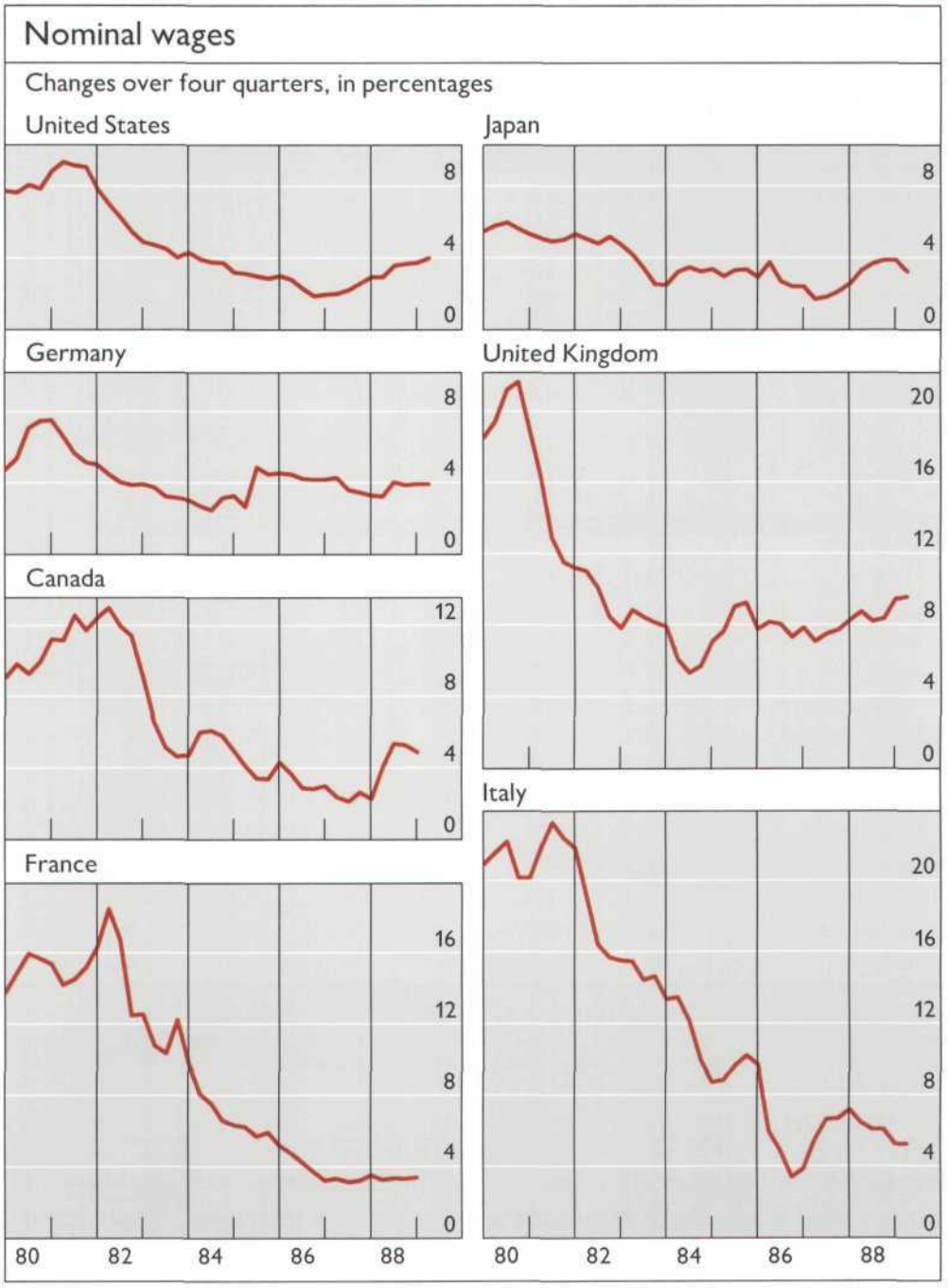
Most countries are reluctant to intervene in wage-setting processes

Recently inflationary warning signals have also appeared in consumer price developments. In the first half of 1988 inflation remained close to the levels recorded at the end of 1987, even though the pace of output growth was then

Unemployment rates*



* National data and definitions.



at its most rapid. However, over the twelve months to December 1988, as the table shows, average consumer price inflation accelerated, and the worsening price performance became even more pronounced in the early part of this year.

On balance, import prices still played a small, benign, role last year

By and large, international developments and import price pressures played a mildly restraining role in the overall price picture last year (see page 36 below for a more detailed discussion of commodity price trends). Food prices rose in the United States because of the drought, but oil prices weakened up to the autumn. On the other hand, a sharp rise in metals prices no doubt reflected the buoyant world demand conditions, although temporary supply disturbances also played a role. In countries such as Germany, where there was some incipient exchange rate weakness, a measure of inflationary

Consumer prices

Countries	1986	1987	1988				1989
			March	June	Sept.	Dec.	March
	percentage changes over twelve months to end of period[1]						
United States	1.1	4.4	3.9	4.0	4.2	4.4	5.0
Japan	−0.3	0.8	0.7	0.2	0.6	1.0	1.1
Germany	−1.1	1.0	1.0	1.1	1.4	1.6	2.7
France	2.1	3.1	2.5	2.6	3.0	3.1	3.4
United Kingdom	3.8	3.7	3.5	4.6	5.9	6.8	7.9
Italy	4.2	5.2	4.9	5.0	4.9	5.4	6.4
Canada	4.2	4.2	4.1	3.9	4.1	4.0	4.6
Australia	9.8	7.1	6.9	7.1	7.3	7.7	6.9[2]
Austria	1.1	1.7	2.3	1.4	1.9	1.9	2.2
Belgium	0.6	1.4	1.0	1.1	1.2	1.9	2.8
Denmark	4.3	4.1	4.7	4.6	4.5	4.5	4.7
Finland	2.8	4.2	4.0	5.2	5.6	6.5	6.6
Greece	16.9	15.7	13.2	11.7	14.8	14.0	13.5
Ireland	3.2	3.1	1.9	1.8	2.1	2.7	3.3
Israel	19.7	16.1	15.7	16.1	16.4	16.4	19.5
Netherlands	−0.3	−0.5	0.6	0.7	0.9	1.2	0.8
New Zealand	18.2	9.6	9.0	6.4	5.6	4.7	4.0
Norway	8.9	7.4	7.2	7.1	6.4	5.6	4.3
Portugal	10.6	8.9	8.2	9.2	11.0	11.7	12.4
South Africa	18.0	14.7	13.4	12.5	12.4	12.5	13.8
Spain	8.3	4.6	4.5	4.3	5.7	5.9	6.0
Sweden	3.3	5.2	5.5	6.9	5.5	6.0	2.3
Switzerland	0.0	1.9	1.9	2.1	2.0	1.9	2.3
Turkey	43.8	53.7	71.2	76.7	82.8	66.4	64.5
Average[3]	2.0	3.7	3.5	3.6	3.9	4.1	4.5

[1] Quarterly figures for Australia, Ireland and New Zealand. [2] New series as from 1989. [3] Calculated using 1986 GDP weights and exchange rates.

Source: National data.

pressure from this source was the cause of some concern, while the sharp rise in consumer prices early this year was importantly affected by higher indirect taxes. In the other five countries consumer price inflation rose progressively in 1988, with the acceleration recorded in the United Kingdom owing something to the rise in mortgage interest rates (which affect housing costs in the retail price index), even though the ultimate aim of the authorities in raising rates is to curb inflationary pressures.

When viewed in the context of unemployment, however...

The recent deterioration in wage and price performance looks more serious if the changing combination of inflation and unemployment is considered in a longer-term perspective. Taking inflation first, it is worth recalling that the worst bouts of price rises over the past twenty years were associated with severe external price shocks – something which seems unlikely at present on anything like the same scale. What is more, part of the recent acceleration merely reflects a natural rebound from the favourable external shock which occurred in 1986. On the other hand, with average rates of 4% or more, inflation has not returned to the levels which prevailed in the late

1950s and early 1960s, which, furthermore, did not benefit from favourable supply shocks.

... recent inflation performance is the more disappointing ...

Nor, more clearly, has the earlier situation been restored in terms of unemployment, as the graph overleaf shows. Taking the average for all industrial countries first, the top left-hand panel of the graph shows how, when the inflation/unemployment points are followed chronologically, they tend to form loops, two of which were clearly connected with the oil price shocks and the anti-inflationary measures adopted in response to them. In all countries the rise in oil prices immediately led to a sharp acceleration in nominal wage growth, which was followed by a rise in unemployment as profits fell and governments took restrictive measures. However, the shape of the loops clearly differs between the major countries, perhaps depending on how quickly wages responded to the rise in unemployment. In Japan, which was most unfavourably affected by the first oil price shock, with inflation rates shooting up to levels of over 20%, a "more normal" inflation performance soon followed, even though unemployment did not rise very much. In the United States the loops also tend to be relatively complete, as the rise in unemployment following a price shock is usually capable of being reversed – though not entirely – as inflation comes under control again. Even so, the recent path of the plotted points has only returned to the area occupied just before the last oil shock, and not to the more benign combinations seen in the early 1960s.

... particularly in Europe

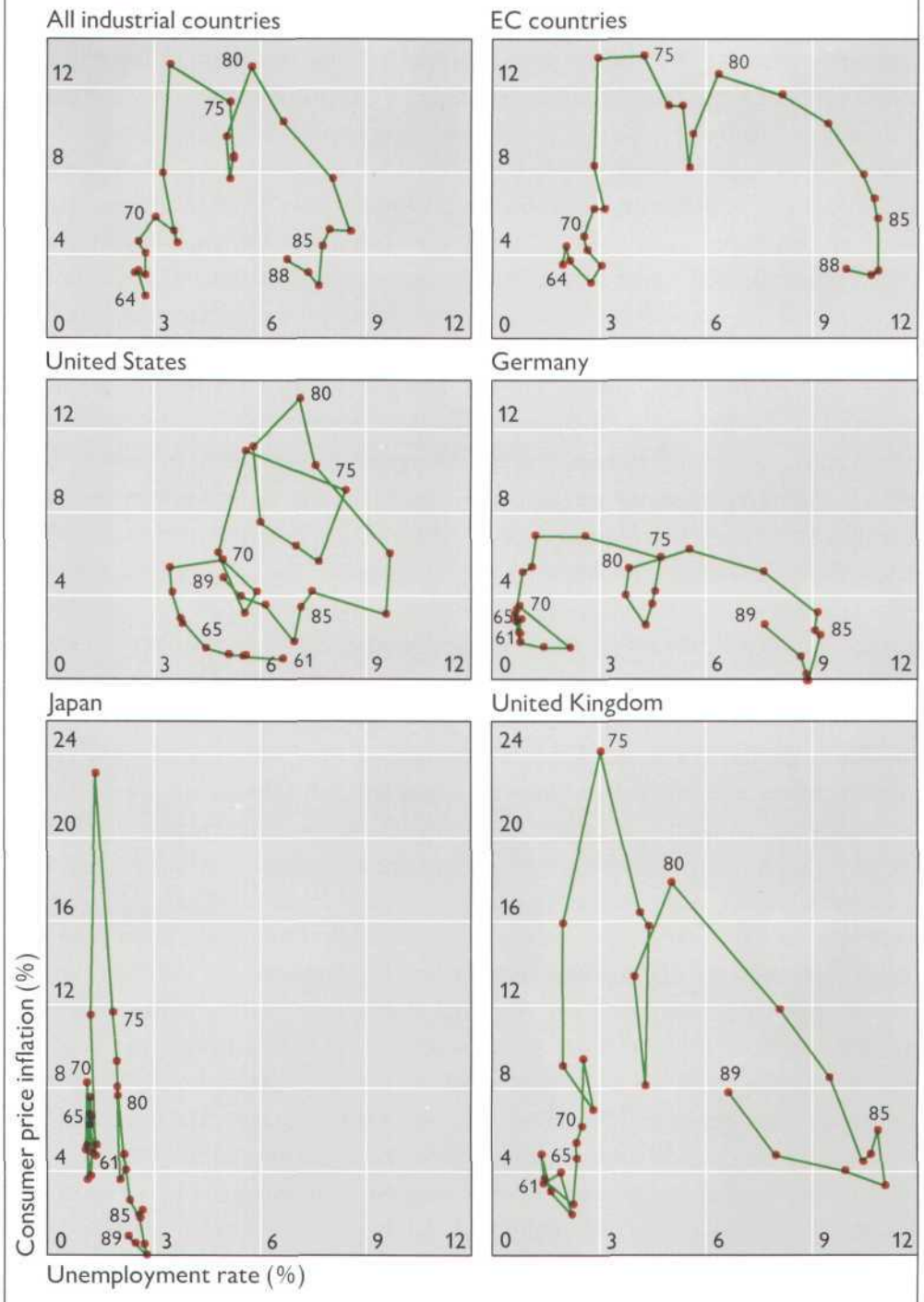
In this respect, the situation in Europe looks much worse. After both oil shocks wage earners resisted the real income reductions caused by the rise in import prices and were also slow to adjust to the subsequent slowdown in productivity growth. Substantial increases in unemployment followed. However, the most disturbing element in Europe is that, even after the fall in nominal and real wage increases and the return to a more buoyant growth path, the rate of unemployment has remained high. Only the United Kingdom has so far managed to improve its combined unemployment/inflation performance more than temporarily. Although European governments have been making attempts at various types of structural reform in labour markets and elsewhere, the evidence suggests that much more needs to be done to bring unemployment down to the level that the United States has recorded, let alone to levels considered normal a quarter of a century ago.

Capacity utilisation rates have risen strongly ...

While the labour market figures suggest continuing wide variations in margins of slack among the industrial countries, the picture presented by indicators of capacity utilisation is more uniform (see the graph on page 31). More importantly, it is a picture of uniformity at historically high levels of utilisation. After many years of slow investment growth during the late 1970s and early 1980s it is perhaps not surprising that high levels of capital stock utilisation have been reached before most of the unemployed have been reabsorbed into employment. It may, however, also be the case – training and work experience programmes notwithstanding – that the unemployment figures give, in some countries, misleading indications of the number of people available for re-employment. Statistical problems concerning labour market data have received increasing attention in a number of countries.

... before the unemployed have been fully reabsorbed

Inflation and unemployment, 1961–89



Sources: All industrial and EC countries, OECD Main Economic Indicators; otherwise national data (1989 data are March figures).

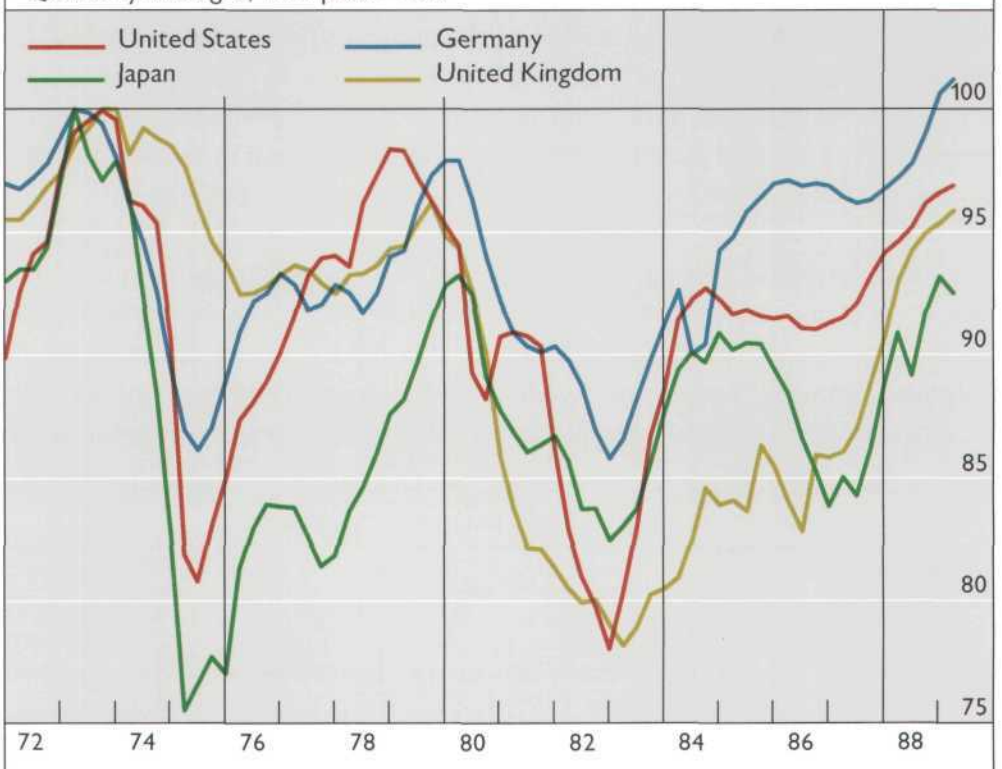
Saving behaviour in the short and longer term

On average, household saving propensities rose slightly last year

As the graph on page 23 shows, the average household saving ratio in the seven major countries rose slightly last year for only the second time during the present upswing. Thus, as far as aggregate demand is concerned, household saving behaviour played a slightly dampening role in 1988, and cannot as such have contributed to the surprisingly strong growth of demand in the very short

Measures of capacity utilisation in manufacturing*

Quarterly averages, 1973 peak = 100



* For the United States and Germany, based on the percentage of normal full capacity; for Japan, based on the 1985 index of operating rates; for the United Kingdom, BIS estimate based on national survey data.

term. The continued growth of private consumption at an average rate of 3½% was thus entirely due to a faster rate of growth of real disposable income, though this was not the case for all seven countries taken individually. As was already noted above, demand in the United Kingdom was especially affected by a further decline in personal savings last year.

In the upturn as a whole they have fallen, thus boosting demand

Nor does last year's result contradict the uniquely stimulative role which household saving behaviour has played in the present upturn as a whole. For the Group of Seven countries the fall in the saving rate of this sector may be estimated on average to have boosted private consumption by 0.9% per year and overall demand growth by 0.5–0.6% per year since 1982. At the same time disparities in individual countries' saving behaviour have been increasingly cited as one important cause of the unprecedentedly large international imbalances which have accompanied the present upturn.

But total national saving has also declined

Nevertheless, stepping back from immediate events, household sector saving behaviour does not appear to have changed fundamentally. What does seem to have changed over the longer term is the behaviour of economies' total net saving (see the table on page 32), giving rise to concern that insufficient resources will be available to finance the rates of investment required for growth to continue at a desirable rate.

Looking first at household saving, it was the turbulent inflationary period of the 1970s which was untypical. No doubt influenced by the effects of inflation on the real value of financial assets, household saving ratios tended to rise in the 1970s in nearly all countries shown, whereas in the 1980–87 period

they merely returned to the average levels prevailing before the first oil crisis. Seen in this perspective, it would seem very likely that first the rise in inflation, and then the decline as policies became less accommodating in the 1980s, are an important part of the explanation of the pattern of saving since the first oil shock.

Total net national saving has, however, been appreciably lower as a proportion of national income in the early 1980s than it was in the pre-oil crisis period. A decline in saving occurred in all of the thirteen countries shown in the table, and was not necessarily smaller in countries which had historically recorded low rates of saving. Thus, in the United States the ratio was more than halved, and in Japan it fell by about one-fifth which also amounted to 6 percentage points. The ratio in Germany also fell by almost one-half and in Belgium, Denmark, France and Sweden by up to two-thirds. In countries with a particularly low level of national saving in the 1980s there was a tendency

The decline in total saving in the period 1980–87...

Saving and investment: a longer-term comparison

Countries	Net saving								Net fixed investment	
	Total			Households			General government			
	1960–74	1975–79	1980–87	1960–74	1975–79	1980–87	1960–74	1980–87	1960–74	1980–87
	as a percentage of national disposable income									
United States	10.5	8.5	4.2	6.9	7.3	6.2	0.4	−3.9	9.8	6.0
Japan	26.4	22.5	20.4	13.1[1]	17.8	13.4	6.9[1]	4.1	26.0	18.5
Germany	19.6	12.5	11.0	8.5	9.7	9.1	6.3	1.4	18.6	9.4
France	19.4	14.7	8.6	15.3[2]	15.8	12.5	5.2[2]	1.3	18.5	9.2
United Kingdom	10.9	7.3	6.3	4.1	5.7	5.3	3.2	−1.6	11.6	5.3
Italy	18.4	14.6	12.8	n.a.	n.a.	n.a.	n.a.	−7.6	19.4	13.8
Canada	12.1	12.6	9.9	5.0	9.2	10.9	2.9	−4.0	14.1	11.2
Austria	19.0	15.6	13.4	6.4	7.3	7.0	7.7	2.3	19.1	13.8
Belgium	15.3	12.8	7.1	11.7	13.8	12.1	1.2	−7.3	14.3	8.3
Denmark	17.5	11.3	6.2	n.a.	n.a.	n.a.	9.1[3]	−1.2	19.6	10.4
Netherlands	20.0	14.5	13.2	11.0[2]	10.0	10.5	4.5[2]	−1.3	19.2	10.4
Sweden	16.2	10.1	6.2	2.5[2]	2.5	0.8	9.4[2]	0.0	16.1	7.9
Switzerland	21.9	17.6	20.0	9.8	8.7	9.4	5.1	3.9	21.9	16.0
Average[4]	17.5	13.4	10.7	8.6	9.8	8.8	5.2	−1.1	17.6	10.8

[1] 1965–74. [2] 1970–74. [3] 1971–74. [4] Unweighted.

Source: OECD National Accounts; figures for 1987 are partly estimated.

for the effects on investment to be somewhat cushioned by drawings on savings from abroad. The well-known case is, of course, that of the United States, but the same was also true of Belgium, Denmark, Italy and Sweden.

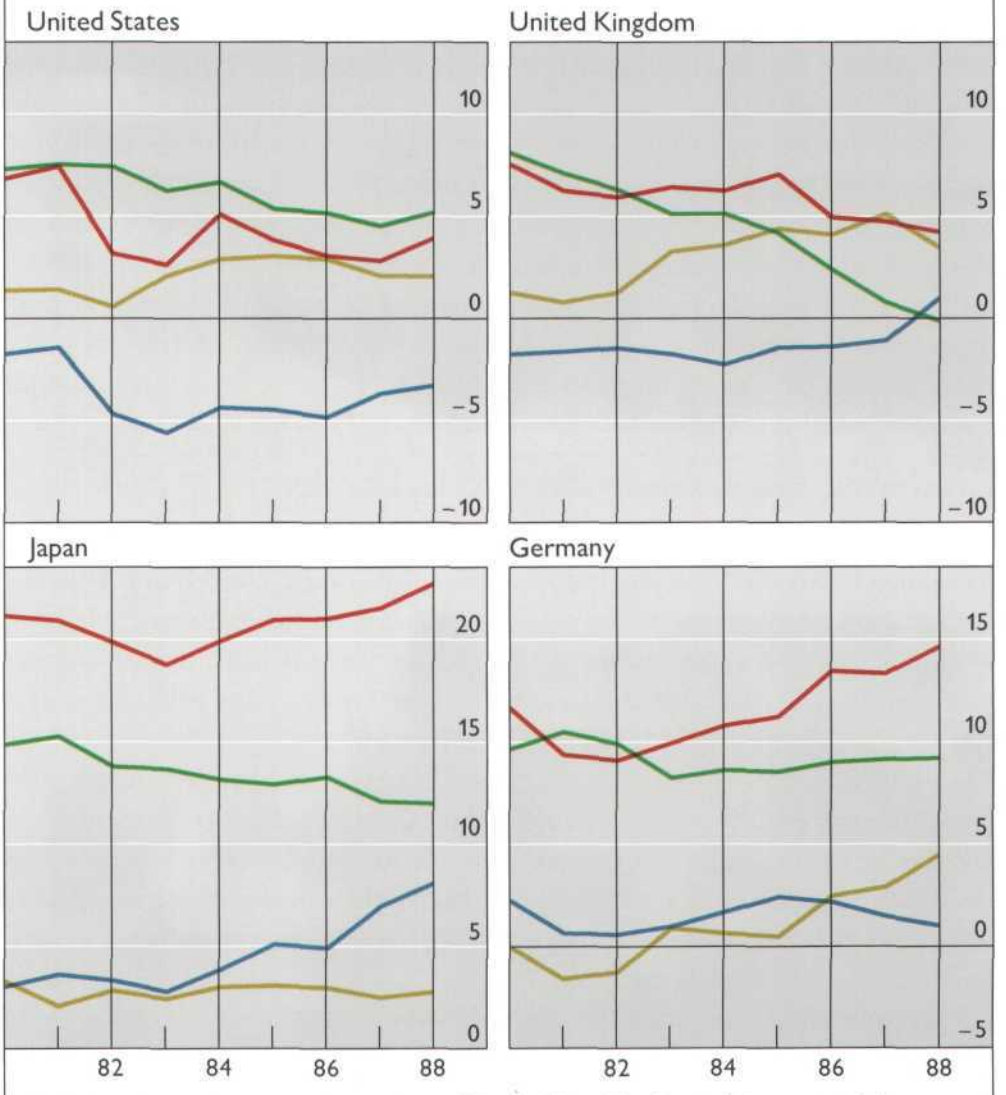
The main feature of the table is, however, that it was the general government sector which overwhelmingly accounted for the decline in overall saving. Only in France, Germany and, to a lesser extent, Japan did the corporate sector (including public corporations) also contribute significantly to the decline in overall saving. Together with the timing of the declines (mainly after the two oil shocks), this suggests that part of the explanation for the fall in national saving might be found in the deflationary aspects of the oil price

... has been largely the result of a fall in public sector saving as compared with the pre-1973 period

The sectoral composition of national saving

As a percentage of national income

Total
Households[1]
General government
All corporations[2]



[1] Including private unincorporated enterprises. [2] For the United Kingdom, including statistical discrepancy.
Source: OECD National Accounts; figures for 1987 and 1988 are partly estimated.

shocks, that is, in their automatic effects on budgets as well as the fiscal policy responses of many countries in the face of the first shock. After the second shock the rise in real interest rates added appreciably to the debt service component of public spending, thus compounding the automatic budgetary effects of recession and the continuing problems of budgetary control.

Coming back to the present, the 1980s have seen some reversal of the processes just described. An interesting case is that of the United Kingdom, where general government saving turned positive in 1988 but the strength of demand was such as to push the economy into large external deficit. In the United States only relatively slow progress has been made in reducing the

budget deficit, and in increasing personal saving, while a recovery in total saving is apparent in Japan and, especially, Germany. In both countries the household sector has contributed relatively little to this recovery. At the same time, a sharp rebound in corporate saving after 1985 accounts for more than the whole of the increase in German national saving, and in Japan budgetary consolidation together with strong domestic demand growth have resulted in rising general government saving since 1983. Corporate saving in Japan probably also rose last year as profits grew with the boom in domestic sales.

Some partial reversal of this development has occurred recently

Sufficient data are not available to present a comprehensive picture of the position reached by last year, but assuming that the graph on page 33 is representative of other countries too, the broad implications seem to be: firstly, for the industrial world as a whole, there cannot be a return to the levels of investment ratios once recorded without a further recovery in saving, at least some of which, in many cases, should come from the government sector; secondly, the international adjustment process clearly calls for more support from both government and private sector saving in the deficit countries, the most obvious case being the United States. So far, however, it is the surplus countries which have recorded the largest recovery in national saving rates.

But in general higher saving is still desirable

Investment, real interest rates and productivity

For the Group of Seven countries as a whole, the lower national savings ratios have been "matched" by relatively low investment ratios in the 1980s. Thus the output share of fixed investment returned only last year to the average level of 1975–81 (see the graph on page 23), and the share of *net* investment has remained low, so that capital/output and capital/labour ratios have grown less fast than in earlier cycles. Moreover, spending on machinery and equipment has been the most buoyant component, whereas, with the possible exception of Japan, the share of long-run investment in buildings and plant has remained low and has actually fallen in the United States. It thus appears that investment in the 1980s has been of a capital-deepening rather than a capital-widening nature, which has also contributed to the very high capacity utilisation rates experienced by most countries last year.

Low national saving has been reflected in low investment/output ratios

As mentioned on page 13, fixed investment, especially in the private business sector, was the most important source of growth in 1988. The causes of this unexpected strength are still not very well understood. Around mid-1987, when most investment plans for 1988 were drawn up, expectations of future demand growth were not particularly buoyant and in real terms both long and short-term interest rates seemed fairly high. In addition, the stock market crash increased the costs of equity financing, which were only partly and temporarily offset by lower borrowing costs. On the other hand, profit shares as well as capacity utilisation rates were high and the prospect of greater exchange rate stability may have reduced the risk factor on real investment. Moreover, the timing of the investment upturn, together with the fact that it also occurred in Europe, suggests that plans for a single European market and preliminary evaluations of its macro-economic implications may have led to more optimistic demand expectations and some advancing of investment plans. All in all, it appears that the underlying conditions for a more

The upturn in investment

favourable investment trend had improved throughout the 1982–88 upturn. However, this alone was not sufficient as long as demand expectations – the most important determinant of business investment – remained uncertain and depressed. Consequently, during most of the 1980s firms, especially in Europe, have preferred to place their available funds in high-yielding financial assets. However, 1988 also shows that it may take only a small – though unpredictable – change in expectations to spark off a switch from investing in financial assets to investing in real assets.

The role of real interest rates

As shown in the graphs on page 22, real interest rates have been much higher in the 1980s than in the previous cycle. One reason for this may have been the surge in public debt combined with the fall in saving, implying that fiscal policies may have crowded out private investment. Another influence on confidence, though of a more indirect nature, may have been the sharp rise in external imbalances, which for the last six years have attained 2–3% of nominal GNP, compared with less than 1% during 1975–81. The precise impact of this is difficult to assess, but during part of the period lack of progress in reducing imbalances no doubt fuelled disturbances in financial markets, which, in turn, led to higher real interest rates. On the other hand, one important feature of the current upturn has been the aforementioned rise in profit shares and in the return on capital. According to estimates by the OECD, the real return on capital in private business may on average have increased by 4–5 percentage points during 1982–88, suggesting that the rise in real market interest rates may reflect the higher marginal productivity of capital rather than just restrictive monetary policies and absorption of loanable funds by the public sector. Additional problems in explaining and evaluating real interest rates concern the measurement of inflationary expectations and the impact of taxes. Expectations may adjust relatively slowly to actual rates of inflation during periods of falling inflation, so that ex post real rates tend to exceed ex ante rates at such times.

Productivity growth has been weak, given trends in the composition of investment

The trend and composition of capital spending also make it more difficult to understand aggregate productivity developments. Capital for labour substitution, complemented by measures taken to strengthen the supply side, should normally generate stronger growth in output per man hour, but productivity increases in the 1980s have been below the trend of the 1975–81 cycle. The aggregate measure does, however, conceal very different patterns in manufacturing, where substantial gains have been recorded, and in the services sectors, which have experienced a further fall in productivity growth but, at the same time, have been the major source of aggregate employment growth. It may be added that productivity developments have on average contributed very little to the improved inflation performance in the industrial countries, except in the years of above-average output growth when pro-cyclical increases in productivity have helped to dampen the inflationary impact of higher nominal wage claims.

The weak productivity trend may also have implications for future inflation. As mentioned earlier, one reason for the rise in unemployment in the 1970s and early 1980s was that wage earners – especially in Europe – resisted the real income losses imposed by the higher import prices and the lower

productivity trend. Later in the current decade terms-of-trade changes in the industrial countries became favourable, creating a windfall real income gain and making it easier to realign real wage aspirations with productivity growth. The other side of this coin, however, was a terms-of-trade deterioration and an associated real income loss for the developing countries, which, as is discussed in the following section, have added to their adjustment problems. A continuation of this trend cannot be counted on for future years, and to avoid inflationary pressures in the industrial countries it is important that wage earners' real income aspirations are brought into line with current productivity changes and that supply-side measures are more vigorously implemented.

Real wage aspirations need to be adapted to productivity performance

The developing countries

Helped by the upturn in world trade and in real demand in the industrialised countries, real GDP growth in the developing countries rose to 4½% last year, compared with 4% in 1987. However, as in earlier years, there were large regional variations around the overall average. The Asian countries experienced a further expansion, with real output growth increasing to 9%, bringing the rise in their average living standards since the outbreak of the debt crisis to more than 5% per year. Output performance improved in the African countries too, though not sufficiently to raise per capita incomes. Preliminary figures suggest that GDP growth also rose in the Middle East, despite the fall in oil prices. By contrast, the Latin American countries saw real output growth decline to less than 1%, as macro-economic imbalances and mounting inflationary pressures more than offset the benefits of stronger growth of export earnings.

The developing countries benefited from the faster growth in the industrial world in 1988

Latin America was the major exception, as inflation worsened

The wide differences in regional output performances can be related to several factors. Some of them, such as oil and non-oil commodity price developments and changes in the growth and composition of world trade, are of an external nature. Others, for instance domestic and monetary policies, developments in savings and investment and partly also problems relating to the external debt situation (see Chapter V), are of a more domestic origin and mainly affect countries' long-run growth potentials, their ability to profit from an upturn in world trade (or dampen the repercussions of a downturn) and their susceptibility to inflationary pressures.

Commodity price developments and other external influences

The recovery of non-oil commodity prices, which had started in mid-1987, gained further momentum during the first half of 1988 in response to the strong demand growth in the industrial countries, but weakened during the second half. Nevertheless, for the year as a whole prices measured in SDRs were some 20% higher than in 1987 and prices measured in real terms also rose, though their level is still some 20% below that of 1980. As in 1987, commodity prices for the developing countries were below the world average for such prices, mainly owing to a relatively high output and export share of tropical beverages, which recorded a price decline for the third consecutive year. On the other hand, and largely reflecting a drought-induced recovery of

Non-oil commodity prices rose strongly in the first half of last year...

... but they remain low in real terms

GDP growth in developing countries

Countries and country groups	1977–82 average	1983	1984	1985	1986	1987	1988	Per capita 1982–88 average
	percentage changes							
Africa	3.5	− 1.4	− 0.5	4.3	1.3	1.2	3.0	−1.5
Nigeria	1.5	−17.4	−13.0	8.5	−2.1	1.8	4.0	−6.7
Sub-Saharan countries	2.5	0.3	1.0	2.7	3.1	1.3	2.8	−1.0
Ghana	−0.6	0.7	2.6	5.1	5.2	4.8	6.2	0.8
Kenya	4.5	2.7	2.0	3.8	5.7	5.8	4.0	−0.4
Malawi	1.8	3.5	4.5	4.1	2.8	−0.2	3.6	−0.3
Middle East	1.1	4.0	− 0.5	−1.4	0.5	0.2	2.0	−1.5
Egypt	7.9	9.0	5.0	10.8	7.4	−2.0	2.2	2.8
Asia	6.3	7.7	7.7	6.5	6.7	7.4	9.0	5.3
China	7.8	9.8	13.5	13.1	7.8	9.4	11.2	9.8
India	3.8	7.8	3.3	6.1	4.4	3.6	9.0	3.6
Malaysia	7.2	6.3	7.8	−1.0	1.2	5.2	8.1	2.0
Thailand	6.2	7.3	7.1	3.5	4.7	7.1	10.3	4.1
NIEs	7.1	8.9	9.1	3.6	10.6	11.8	9.2	7.5
Latin America	3.3	− 2.1	3.7	3.9	4.5	2.5	0.9	0.0
Brazil	3.7	− 2.8	5.7	8.3	8.0	3.0	−0.3	1.5
Mexico	6.8	− 4.2	3.6	2.6	−3.8	1.4	1.1	−2.0
Argentina	−1.2	2.9	2.5	−4.3	5.3	2.0	2.2	0.2
Chile	2.7	− 0.7	6.3	2.4	5.7	5.7	7.4	2.7
All developing countries*	4.3	3.3	4.2	4.0	4.3	4.0	4.5	2.0

* Calculated using 1986 GDP weights and exchange rates.

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

food prices, the distribution of non-oil price gains within the group of developing countries was more even last year than in 1987, with all major regions benefiting from real price gains.

Oil prices fell until the autumn, and developing countries' terms of trade declined overall last year

However, this picture is substantially changed when the large drop in fuel prices is also taken into account. Including fuels, commodity prices fell by 7½% in 1988, and measured in real terms prices now stand 40% below their 1980 level. Moreover, the overall terms of trade of the developing countries declined by almost 6% in 1988 (equivalent to a loss in real disposable incomes of 1½–2%), with particularly large losses in the Middle East and in the African countries, whereas for Latin America the terms of trade were largely unchanged. If movements in export volumes are also included, the overall external influence was positive, but substantially less so than in 1987 and showing large regional differences. The Latin American countries were able to improve further their relatively favourable export performance of 1987, as marked gains in Argentina and Venezuela more than offset declines in Peru and Colombia. The Asian countries experienced a decline in export growth owing mainly to developments in the four NIEs (Hong Kong, Singapore, South Korea and Taiwan) and despite the strong export performance of countries such as

Commodity price developments

Based on indices in SDRs, 1980 = 100

By major commodity groups and regions	1980–85 average	1986	1987	1988	1988
	percentage changes				index
All commodities[1]	2.4	−37.3	− 5.5	− 7.6	63.6
Oil[2]	−0.6	−57.2	15.0	−25.2	35.7
Non-oil commodities[3]	−0.4	−16.6	− 1.8	19.2	95.0
Food	−0.7	−24.1	− 7.3	23.0	83.5
Beverages	2.6	− 0.5	−34.7	− 3.9	71.0
Agricultural raw materials	0.0	−12.3	21.0	5.3	111.8
Metals	−2.1	−18.8	8.6	42.6	112.7
Developing countries[4]	−0.5	−14.7	− 6.3	13.8	88.6
Africa	−0.5	−11.0	−11.1	11.6	86.6
Asia	−1.9	−24.1	5.6	16.0	84.7
Middle East	−1.0	−18.7	8.2	13.8	95.6
Latin America	−0.5	− 9.4	−15.1	15.8	87.1
Non-oil commodities, real[5]	−3.3	−18.2	− 3.3	17.4	78.9

[1] HWWA index. [2] Spot price of Arabian light crude. [3] IMF index. [4] Excluding oil. [5] Deflated by export unit values of manufactures.

Sources: IMF World Economic Outlook, IMF International Financial Statistics and national data.

Malaysia and Thailand. In the Middle East stronger export growth could not offset the effects of weaker terms of trade, and a similar picture is observed for the African countries, even though the decline in exports was brought to a halt.

Domestic output, inflation and policies

Asian countries. All of the acceleration in real GDP growth in the Asian countries between 1987 and 1988 can be attributed to developments in *India* and *China*, which account for more than half of Asian GDP. India, in particular, benefited from a marked recovery in agricultural output and a steady expansion of industrial production. However, partly as a result of expansionary

Acceleration in growth in India and China

External influences on output developments

By region	Terms of trade				Export volumes			
	1980–85 average	1986	1987	1988	1980–85 average	1986	1987	1988
	percentage changes							
Africa	−1.7	−32.0	0.9	−14.0	− 1.5	3.2	−0.7	3.6
Middle East	0.2	−48.0	9.8	−21.2	−11.2	19.3	1.8	12.2
Asia	0.3	− 6.6	3.0	− 0.7	7.0	16.4	18.7	13.4
Latin America	−2.4	−11.4	0.5	− 0.1	5.6	0.0	8.3	9.9
All developing countries*	−0.4	−18.7	3.8	− 6.0	2.3	12.0	11.6	11.7

* Calculated using 1986 export weights and exchange rates.

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

fiscal and monetary policies, in both countries signs of overheating became apparent in the course of last year in the form of surging imports and accelerating inflation, which in China reached 25% by the end of 1988 and has increased further this year. The four *NIEs* saw some slowdown in output growth as domestic demand progressively replaced exports as the main engine of growth. This development took place in response to appreciating nominal exchange rates, accelerating unit labour costs and import liberalisation. In fact, net exports had a negative effect on GDP growth in *Taiwan* last year and were largely neutral in *South Korea,* where the real exchange rate has appreciated by almost 20% as accelerating price and cost increases coincided with a 14% appreciation of the won against the US dollar.

Some slowdown in the NIEs

This export slowdown in the NIEs can also in part be ascribed to the increasing international competitiveness of other Asian countries. *Thailand* last year saw real exports growing by 20% and real fixed investment by some 15%, of which a large part was financed by capital inflows from Japan and the four NIEs. Imports have also shown strong growth and produced a weakening current external account, but real GDP nevertheless grew by more than 10%. Helped by cautious monetary policies, the rate of inflation accelerated only moderately (from 2.5 to 4%) and the public sector financial balance moved into surplus. However, the strong growth performance was partly the result of once-for-all factors as agricultural output recovered from a 2% decline in 1987 and rising commodity prices combined with falling oil prices produced a sizable terms-of-trade gain. Pressures have also appeared in the form of insufficient infrastructure. Further output gains may depend on how smoothly the rural areas, which account for about two-thirds of the total population but only for around 15% of total output, can be absorbed into the industrial growth process. *Malaysia* is another country benefiting from large direct foreign investment, which in 1987 financed more than 25% of total fixed investment and last year even more. The effect of the capital inflow is most clearly seen in manufacturing, which has risen to almost 25% of GDP and accounts for almost 50% of total exports, thus reducing Malaysia's earlier dependence on exports of primary commodities (mainly rubber, palm oil and mineral oil). Exports have also been helped by a depreciating real exchange rate (some 30% since 1984) reflecting low inflation (only 2¾% in 1988 but widely expected to rise this year) and a depreciating nominal exchange rate. The latter may in part be related to a policy of lowering interest rates which, in turn, was made possible by the reduction of the public sector deficit from 20% of GDP in 1982 to 8% in 1987 and probably a small surplus last year.

Economic performance improves in Thailand and Malaysia

African countries. Despite an acceleration in growth during the past year, the poor longer-run growth performance and prospects of this region, and especially those of the countries south of the Sahara, have received increased international attention. Although it is difficult to draw general conclusions for a region comprising forty-five countries, four reasons for the poor performance may be highlighted. Firstly, dependence on a narrow range of export commodities subject to large price fluctuations and inelastic demand has made the countries extremely exposed to external shocks. Since 1980 non-oil commodity prices (in SDRs) have fallen by more than 13% and the terms of

Growth accelerated in Africa, but serious underlying problems remain

trade (including oil but excluding Nigeria) have deteriorated by some 30%, or about twice the rise in export volumes. Secondly, despite a very high infant mortality rate, population growth averages some 3% per year, forcing many countries to spend a large part of foreign exchange earnings on food imports. Thirdly, the external debt burden is higher than for other developing regions. The debt/export ratio, which is in some cases close to 1,000%, averages 325%, and debt service payments as a percentage of GDP are not only high but also markedly higher than in 1980. Finally, but not independently of the influences mentioned above, the development of investment and saving has not been conducive to growth. The national savings rate has fallen as governments did not manage to reduce public spending relative to revenues, which are mostly well below the average for other developing countries. Moreover, the investment ratio has declined substantially, and the average rate conceals very large country differences, with fixed investment in some areas too low even to maintain the capital stock.

There are, however, also exceptions to this generally bleak picture. *Malawi,* for instance, which has only few natural resources, a per capita income level of only $165 and a debt/export ratio of 400%, has managed to reduce the public sector deficit from 17 to 7% of GDP in less than ten years and yet grow at 3% per year since 1982. In *Ghana,* where real per capita income had fallen by almost 40% between 1973 and 1983, the Economic Recovery Programme of 1983 (including privatisation, cuts in government spending and a dismantling of import licensing) was instrumental in generating an annual GDP growth of 4% during 1983–88. Over the same period the rate of inflation fell from 125% to 25%, despite higher food prices and an annual devaluation of around 50% against the US dollar, while a budget deficit of 5.2% of GDP (1982) was turned into a surplus. However, Ghana remains severely exposed to fluctuations in commodity prices and interest rates, as cocoa beans account for more than 50% of total exports and the debt service/export ratio is around 45%. Moreover, an important factor behind the turn-around was foreign aid, which has averaged $40 per capita annually since 1983. *Kenya,* helped by prudent demand management policies, has managed to keep the fall in per capita income to ½%, even though the population growth (4.9% per year since 1982) is probably the highest in the world. International competitiveness has improved and the rate of inflation, which in 1982 stood at over 20%, has been brought down to 8% under the influence of stable fiscal policies and tighter monetary policies. Thus, by raising interest rates and financing a larger share of the public sector borrowing requirement by Treasury bill sales to the non-financial private sector, money supply growth was reduced from more than 30% in 1986 to less than 7% last year.

Nevertheless, there are some brighter spots, for example in Malawi and Kenya

Latin American countries. The 1988 slowdown was general but most pronounced among the non-oil exporters, even though the combined effect of their improved terms of trade and stronger export growth was equivalent to 3% of total output. By contrast, the external influences were negative in the oil-exporting countries, as a further rise in the growth of export volumes was more than offset by a deterioration of over 10% in the terms of trade. Moreover, owing mainly to a 45% import surge in *Mexico,* real net exports

A pronounced slowdown in Latin American growth last year despite favourable external influences ...

provided a negative contribution to GDP growth for the group of oil exporters. Fiscal policies are likely to have had a dampening influence in most Latin American countries, as central government borrowing requirements were reduced, though in several of the largest debtor countries not by as much as envisaged in their stabilisation and adjustment programmes. Moreover, the fall in public sector borrowing requirements was not matched by higher national savings or stronger capital formation. In fact, at 16% of GDP, the national saving rate is more than 5 percentage points below the average level for developing countries.

... the prime cause was a marked upsurge in inflation ...

The main reason for the failure of the Latin American countries to benefit from the stronger output growth in the industrial countries was probably the surge in inflation. The average rate of consumer price increases had already increased to 130% in 1987 and it accelerated further in 1988, reaching 475% by the end of the year. The most striking feature of this upsurge, and probably the most damaging to economic efficiency and growth, was the speed with which inflation accelerated, as the average rate went up by more than 400 percentage points in the course of only twenty-four months. The deterioration in price performance was widespread and showed several features common to a number of countries: overheating, external price shocks, increasing monetisation of budget deficits and, above all, a high degree of indexation, which tends to perpetuate inflation. In such conditions, attempts to correct relative prices – often distorted by wage and price controls, inappropriate exchange rate policies and government subsidies – release inflationary pressures as wage earners resist cuts in real wages associated with the removal of subsidies on food products and higher import prices. Developments in *Peru* exemplify how, in a climate of worsening inflationary expectations and lack of

Inflation in the developing countries

Countries and country groups	1977–82 average	1983	1984	1985	1986	1987	1988
	percentage changes in consumer prices						
Africa and Middle East	19.0	14.0	16.6	15.7	16.9	17.9	18.8
Egypt	13.4	16.1	17.1	12.1	23.9	19.7	17.7
Nigeria	14.4	23.2	39.6	5.5	5.4	10.2	35.0[1]
Asia	8.2	6.6	7.2	7.1	9.1	9.8	14.6
China	3.0	1.9	2.7	11.9	7.0	8.8	20.7
India	8.2	11.9	8.3	5.6	8.7	8.8	9.8[2]
Philippines	13.3	10.0	50.3	23.1	0.7	3.8	8.8
South Korea	18.0	3.4	2.3	2.5	2.8	3.0	7.1
Latin America	55.3	108.7	133.0	145.0	88.0	130.0	277.6
Argentina	141.0	343.8	629.6	672.0	90.0	131.0	343.0
Brazil	75.5	141.2	197.6	227.0	150.0	219.7	582.0
Mexico	29.0	101.8	65.5	57.7	86.2	131.8	114.2
Peru	64.7	111.2	110.2	163.4	77.9	85.8	669.3
All developing countries[3]	25.0	38.4	46.9	49.8	34.4	47.4	90.0

[1] Estimated. [2] Second quarter. [3] Calculated using 1986 GDP weights and exchange rates.

Sources: IMF International Financial Statistics, World Economic Outlook and national data.

credibility of government policies, such pressures can quickly generate an unstable and uncontrollable wage/price spiral. During the first two years of the 1985 reactivation programme inflation was held back by harnessing unused capacities and increasing imports, but during the twelve months to end-1988 Peru experienced a more than tenfold rise in inflation as imports were cut back in response to dwindling foreign exchange reserves and production capacities were exhausted. Moreover, to reduce the public sector deficit, subsidies were cut and taxes and prices of essential goods produced by nationalised firms were raised; however, to prevent a drastic reduction in living conditions, minimum wages were also increased, which added further fuel to the inflationary spiral. Problems of relative price adjustments and public sector deficits in conditions of a high degree of price and wage indexation were also encountered in *Argentina* and *Brazil.* In both countries price and wage freezes introduced late in 1987 had failed. In Argentina the new stabilisation plan of August 1988 seems to have produced a temporary slowing of inflation during the second half of the year. However, the social pact concluded in Brazil (in November) did not show any effect and by early this year consumer price inflation had climbed above 1,000%, or more than double the previous historical peak. In January this year the Government proposed a new package of stabilisation measures (the "Summer Plan"), including a temporary freeze on prices and wage indexation, fiscal restraint, various liquidity-absorbing measures and a new currency subject to regular devaluations against the US dollar. However, this plan has also collapsed and in April indexation was reintroduced.

... Peru was a particularly clear example of the problem

Failure of price and wage freezes in Argentina and Brazil

There are some exceptions to the deteriorating price performance. *Chile* has relied on a market-oriented stabilisation policy with import liberalisation, a relatively stable nominal exchange rate and fiscal restraint as the main elements. Initially, this approach was very costly in terms of lost output and employment, but the rate of inflation had been gradually reduced to only 11% by the end of last year. At the same time Chile improved its output performance, thus more than compensating for the earlier setbacks. *Mexico,* by contrast, chose to fight inflation through fiscal restraint combined with incomes policies. This approach (the Solidarity Pact concluded in December 1987 and subsequently prolonged) has been based on a programme of a fixed nominal exchange rate, de-indexation, a price freeze on public sector goods, a wage freeze and an agreement with the private sector to avoid large price increases. It has so far been successful in reducing the public sector deficit and the rate of inflation, which fell from 160 to 52% in the course of 1988. Moreover, the fall in output has probably been smaller than a market-oriented approach would have required. However, certain problems have emerged pointing to an accumulation of inflationary pressures and a difficult decontrol phase. As already mentioned, Mexico experienced an import surge in 1988, reflecting a real exchange rate appreciation of some 30% combined with a programme of import liberalisation. Moreover, because of the wage freeze real wages have fallen to only 50% of their 1980 level. Consequently, a new pact concluded in December 1988 foresees a daily devaluation of the peso against the US dollar until the end of July as well as increases in minimum wages and certain public charges.

Chile was one exception to the deteriorating inflationary environment

Large declines in real wages in Mexico led to new policy adaptations

What lessons can be drawn from recent trends in the developing countries? The most dramatic and serious development has been the deterioration in price performance in the Latin American countries. This clearly demonstrates again that higher growth cannot be achieved through higher inflation. In addition, given the flat trend of import prices (measured in US dollars) during most of this decade, inflation has been largely "home-made", with policy failures and attempts to freeze or change relative prices the most important causes.

Investment and output growth[1]

Countries	1960–73		1974–80		1981–88		Capital formation and potential output	
	Investment	GDP	Investment	GDP	Investment	GDP	Investment[2]	GDP[3]
	Annual averages, in percentages						Percentage points	
Africa	18.5	4.7	25.1	4.2	19.3	1.2	−8.0	−1¾
Middle East	21.7	8.7	25.5	5.7	24.8	0.5	−6.0	−1
Asia	18.2	6.1	24.5	6.2	28.0	7.0	−0.7	− ¼
Latin America	20.3	7.0	24.1	5.4	18.3	1.7	−6.0	−1⅓
Total[4]	19.5	6.7	24.7	5.7	23.8	3.6	−4.0	− ¾
Industrial countries	21.7	4.9	22.3	2.4	21.0	2.8		

[1] Investment is measured as a percentage of GDP and output as the percentage change in real GDP. [2] Change in the investment/GDP ratio between 1980 and 1988. [3] Change in potential output growth, assuming a capital output ratio of 1½ (Middle East 3) and a profit share of ⅓ (Middle East ½). [4] Weighted averages using 1986 GDP weights and exchange rates.

Another striking feature has been the external shocks to which the developing countries have been exposed. Non-oil commodity prices have been weak, and when they started to recover in 1987–88 oil prices declined. Consequently, since 1980 unfavourable terms-of-trade changes have reduced real national income by a cumulative 5.7% relative to output and imposed an adjustment burden on top of higher debt service payments which exceeds that experienced by developed countries after the two oil shocks.

The external adjustment burden has been large ...

The poor investment performance outside the Asian countries also gives cause for concern. As the table above shows, there is no unique relationship between the size of the investment/GDP ratio and the average rate of output growth, either between country groups or over time. A given rate of output growth may require a high or a low investment ratio, depending on the composition of output and the capital intensity of production, and a rise in the investment/GDP ratio does not necessarily generate higher output growth. By the same token the fall in the investment ratio in the 1980s explains only a small part of the deterioration in output growth. What is important, however, is that a fall in investment reduces future output growth and thereby the prospects for raising per capita incomes. This deterioration appears to have been most pronounced in the African countries, where per capita income is already very low and population growth high. The fall in potential future output growth has also been large in Latin America, whereas in Asia it is likely to have been small.

... and is the more intractable in the context of inadequate investment

III. International trade and payments

Highlights

In line with the unexpected dynamism of world economic activity the growth of international trade quickened markedly last year to a rate of over 9%, the highest recorded since 1976, with most countries sharing in the upswing. At the same time, the rise in world trade prices in dollar terms slowed significantly as oil prices weakened up to December 1988 and those of manufactured goods rose at a much slower pace than in 1987.

Against this background and the potentially favourable opportunities it offered for external adjustment, the progress made in redressing current-account imbalances was disappointing in 1988. The combined current-account deficit of the industrial countries widened considerably last year, though much of this overall deterioration was accounted for by an unexpectedly large rise in the external deficit of the United Kingdom. In the three largest industrial countries the adjustment process had gained considerable momentum after the middle of 1987, but it began to falter in the second half of last year. Much of the welcome reduction in the imbalances of the United States and Japan registered for the year as a whole thus actually occurred in the first six months of 1988. In Germany the decline in the current-account surplus had practically come to a halt in 1987, and last year the surplus stabilised in relation to GNP.

In the developing world many non-oil-exporting countries benefited from more advantageous world market conditions, but as the margin for manoeuvre afforded by growing export earnings was generally used to relax policies of import restraint, external balances showed relatively little change. The fuel-exporting developing countries, which include some of the major debtor countries, suffered from the substantial decline in oil prices but began to expand their import volume for the first time after six years of large-scale cutbacks. As a consequence their aggregate current-account deficit increased sharply.

With the return to greater calm in the foreign exchange markets and with capital movements strongly responding to nominal interest rate differentials, current-account imbalances were generally financed by market-determined capital flows. With few exceptions, changes in official exchange reserves, which had been an important source of external financing in 1987, played only a fairly limited role last year.

In the developing world the major debtor countries continued to face severe financing difficulties. The absence of significant further progress in adjustment and uncertainties about the future debt strategy stiffened the reluctance of private creditors to provide new funds. Moreover, for the first time since 1983 there was also a substantial fall-off in new financing granted by

official creditors. The financing problems were most acute in the fuel-exporting countries, which were forced to draw heavily on their official exchange reserves.

World trade

World trade growth at twelve-year high ...

Following an appreciable acceleration to 6% in 1987, world trade growth in volume terms strengthened further in 1988, reaching an estimated annual rate of over 9%. The principal reason for this buoyancy was the upswing in economic activity in the industrial countries from the second half of 1987 onwards. Indeed, the annual average figures tend to mask the fact that trade growth was at its fastest at the end of 1987 and in early 1988, although it seems that the momentum of growth was well sustained throughout last year.

... with price increases decelerating

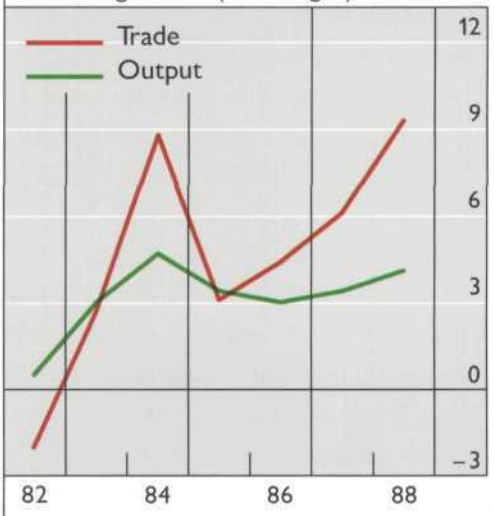
The rate of increase of trade prices decelerated sharply in dollar terms, being halved last year to just under 5%. This deceleration owed much to the slowdown in the rate of increase of prices of manufactured products from 12% in 1987 to 5½% in 1988, which primarily reflected the renewed strength of the dollar. In addition, oil prices dropped by 20½% on average over the year, reversing most of the previous year's increase of 29%. By contrast, non-oil commodity prices rose by 18%; thus, for the first time since 1984, these prices increased more rapidly than those of manufactured goods.

Broadly based upswing ...

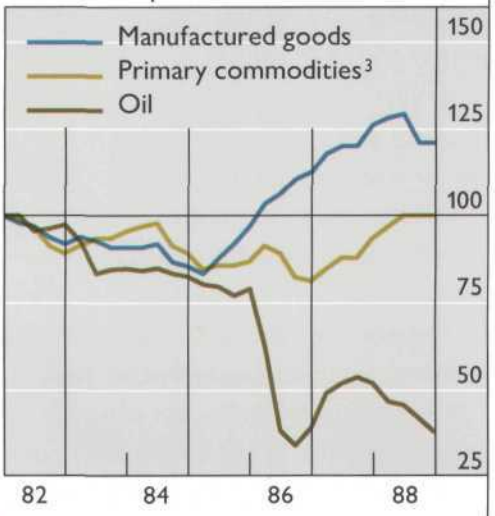
The acceleration of world trade growth in volume terms in 1988 was broadly based, covering all major groups of commodities and extending to all major regions of the world. Trade in manufactured goods expanded by an estimated 10½%, or about 4 percentage points more than in the previous year. At the same time, trade in oil and mining products grew by 7%, ending a seven-year period of stagnation. The volume of agricultural trade increased by 4%; while this was 2 percentage points less than in 1987, it was nonetheless

Indicators of world trade

World trade and output volume growth[1] (% changes)

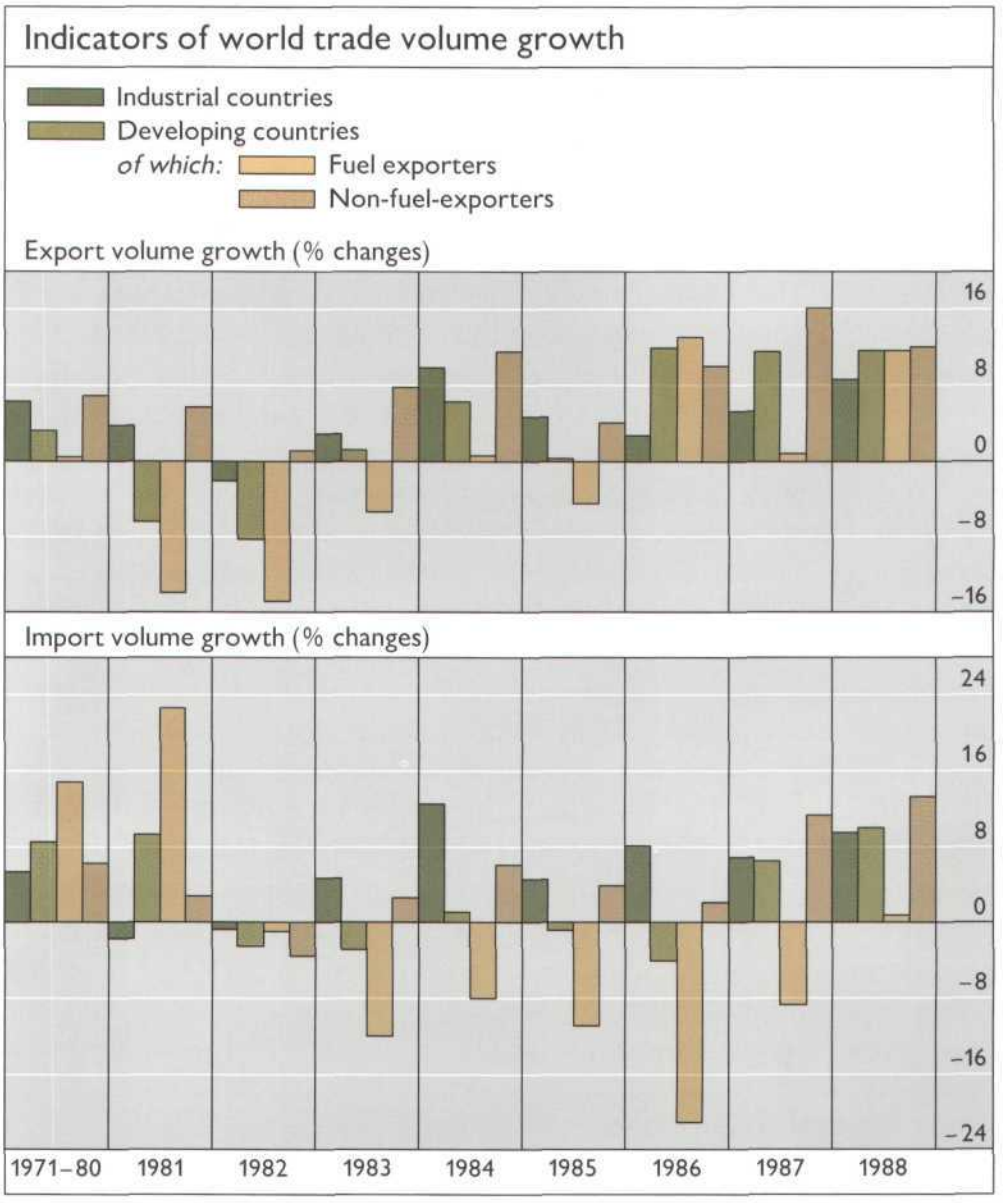


World trade prices[2]



[1] Output growth as measured by changes in real GDP. [2] Fourth quarter 1981=100, in US dollar terms. [3] Excluding oil.

Sources: IMF World Economic Outlook and UN Monthly Bulletin.



notable in view of the decline in agricultural output in 1988. With regard to the geographical distribution of trade, the graph above shows that 1988 was the first year in almost two decades during which the volume growth rates of exports and imports of major groups of countries did not diverge widely from the world average as a whole.

... including rapid export and import growth in most developing countries

The aggregate export volume of all developing countries expanded last year by 12%, roughly the same rate as in the previous two years. Within the group there were, however, some marked shifts in export performance. The fuel-exporting countries, benefiting from quite a strong recovery in the world demand for oil, succeeded in raising the volume of their exports by nearly 12%, compared with less than 1% in the previous year. By contrast, real export growth of the non-fuel-exporting countries fell back from 16% in 1987 to 12% in 1988, but this decline was almost entirely attributable to a deceleration in export growth, from 22½ to 16%, in the four newly industrialising economies (NIEs) in Asia. The other non-fuel-exporting countries were able to maintain real export growth at about 9%. In the wake of these generally

favourable export volume movements, both fuel and non-fuel-exporters also began to increase the volume of their imports. In the non-fuel-exporting countries (excluding the Asian NIEs), where export growth was supported by a 4% improvement in the terms of trade, the volume of imports grew by more than 9%, twice as fast as in the preceding year. In the fuel-exporting countries the increase in real imports of close to 1% represented the first rise after six years of retrenchment during which there had been a cumulative decline of nearly one-half.

Import growth in industrial countries markedly exceeds domestic demand growth ...

Much of the improved trade performance of the developing countries must be attributed to the surge in import demand – from 7% in 1987 to 9½% last year – in the industrial world. In part, this acceleration in import volume growth reflected the sustained strength of economic activity in the industrial countries. However, the fact that real import growth was much faster than the expansion of domestic demand, which picked up slightly from 3.7% in 1987 to 4.3% in 1988, suggests that factors other than aggregate demand growth also contributed to the import expansion. Firstly, the acceleration of economic activity which started in the major industrial countries in the second half of 1987 spread last year to a number of other countries, some of which have relatively large import/demand ratios. Secondly, demand effects on imports may have been reinforced by the lagged effects of earlier exchange rate changes; for example, the rise in Japanese imports, at nearly 17%, was large even relative to the 8% increase in domestic demand. Thirdly, some countries may have experienced capacity constraints earlier than others, which could, for example, have accounted for part of the rise in imports in the United Kingdom and the United States. Finally, the particular strength of business fixed investment last year may also have accounted for some of the strength of imports in that this component of demand has an above-average import content in many countries.

... and is mirrored in rapid export growth

Given that the bulk of industrial countries' trade is with one another, the mirror image of the acceleration in import growth in the industrial world was an equally pronounced pick-up in the growth of their export volumes from 5½% in 1987 to 8½% last year. Supported in part by the lagged effects of earlier gains in competitiveness, US exports increased by nearly one-quarter, a rise which accounted for about one-third of the total increment in world merchandise exports. Moreover, as the principal suppliers of capital goods, a number of other industrial countries experienced a favourable impact on their export performance from the surge in investment activity. Reflecting this, export growth in Japan increased from ½ to 5%, and in Germany it rose to over 7%. With the notable exceptions of the United Kingdom and Australia, export growth in the other industrial countries strengthened fairly generally in 1988.

Protectionist pressures persist ...

Despite the resumption of more vigorous and balanced world trade growth since mid-1987, there are still no signs that protectionist activity has abated. In general, the trading regimes in the developing world remain rather restrictive and complex, including the frequent use of non-tariff measures justified on balance-of-payments grounds. However, also in industrial countries which have long prided themselves on having a more liberal trade policy stance, the recourse to non-tariff measures involving voluntary export restraint

arrangements, anti-dumping measures and countervailing duty actions, spread significantly in the course of the 1980s.

... and there is a growing tendency to "manage" trade

A more recent phenomenon is the increasing predisposition towards "managing" world trade on the basis of bilateral or sectoral arrangements. A growing number of bilateral trade agreements contain conditions whose main purpose is to ensure a strategic advantage for the signatory countries in gaining access to each other's markets; for instance, the US Omnibus Trade and Competitiveness Act includes a number of provisions which seek to facilitate unilateral discretionary action and to govern market access; and the proposals for a unified EC market in 1992 retain certain restrictions on trade with third countries or do not automatically extend the advantages of the single market to third countries.

While providing perhaps a short period of relief or affording a country or a sector a temporary competitive edge, managed trade must be viewed as an inefficient solution to economic problems. By provoking retaliation and running counter to the basic principle of comparative advantage, attempts to manage trade will eventually leave all parties to world trade worse off. Against this background, it must be hoped that the current Uruguay Round of multilateral trade negotiations will succeed in safeguarding the functioning of the multilateral world trading system. This hope was given new strength in April 1989 when significant progress was made on a number of issues over which the December 1988 meeting of Trade Ministers in Montreal had broken down.

External developments in the three largest industrial countries

Reduced imbalances in the United States and Japan ...

Some progress was made in 1988 towards correcting the external imbalances of the United States and Japan. While in 1986 and 1987 external adjustment in these countries had been confined to changes in volume terms, in 1988 adjustment also became clearly visible in value terms. The lion's share of this improvement reflected a reduction in the US current-account deficit of close to $19 billion, implying a fall from 3.4% of GNP in 1987 to 2.8% in 1988. But in Japan, too, a notable correction of the external imbalance was recorded, not only in terms of Japanese yen or as a percentage of GNP, but also in dollar terms.

... but adjustment slows in the second half of 1988

However, the substantial overall progress achieved in 1988 requires qualification. In Germany the current-account surplus widened somewhat, although as a percentage of GNP it stabilised at 4%. Moreover, the pace of adjustment in the United States and Japan lost much of its momentum during the second half of the year, when some upward drift in their merchandise trade imbalances became visible. These developments gave rise to concern as to whether the adjustment process, after fairly short-lived progress, had come to a halt or had merely stalled temporarily. This issue will be addressed in greater depth on pages 52–60 below.

Sizable decline in the annual US trade deficit

The significant reduction in the current-account deficit of the *United States,* from $154 billion in 1987 to $135.3 billion last year, was brought about by a remarkable improvement in its merchandise account. At constant prices the trade deficit had already peaked in the second half of 1986, but it was only in 1988 that its narrowing by almost $34 billion signalled a substantial

Alternative measures of the current-account balances of the three largest industrial countries

Current-account balances	1986	1987	1988	1987*		1988*	
				first half	second half	first half	second half
United States							
In billions of US dollars	−138.8	−154.0	−135.3	−157.0	−151.0	−141.6	−129.0
As a percentage of GNP	− 3.3	− 3.4	− 2.8	− 3.5	− 3.3	− 3.0	− 2.6
Japan							
In billions of US dollars	85.8	87.0	79.6	92.4	81.6	79.6	79.6
In thousand billions of yen	14.2	12.5	10.2	13.6	11.4	10.1	10.2
As a percentage of GNP	4.4	3.6	2.8	4.0	3.2	2.8	2.8
Germany							
In billions of US dollars	39.7	45.4	48.6	47.8	43.0	50.5	46.7
In billions of DM	85.1	81.2	85.2	86.4	76.0	84.1	86.3
As a percentage of GNP	4.4	4.0	4.0	4.2	3.8	4.0	4.0

* Seasonally adjusted at annual rates.

adjustment in nominal terms. However, part of this improvement was offset as the invisibles balance swung from a surplus of $6.3 billion in 1987 to a deficit of $8.8 billion in 1988. This deterioration, however, essentially reflected valuation changes included in investment income on direct investment. In 1987 the depreciation of the US dollar produced valuation gains of $15.6 billion on the stock of US direct investment abroad and thereby boosted the reported direct investment income figures. By contrast, in 1988 when the US dollar appreciated slightly, there was a valuation loss of $1.6 billion.

Only about $3½ billion of the improvement in the US trade account was attributable to lower oil imports. Given a 17% fall in oil import prices, this decline was remarkably small and reflected an upward trend in US oil consumption as well as increasing purchases of oil from foreign sources. While imports had covered one-third of oil consumption in 1986, their share rose to

Non-oil trade balances of the three largest industrial countries[1]

Non-oil trade balances	1986	1987	1988	1987[2]		1988[2]	
				first half	second half	first half	second half
	in billions of US dollars						
United States							
In current dollars	−110.1	−117.4	−87.2	−121.0	−113.6	−90.4	−84.0
In constant dollars[3]	− 95.5	− 83.4	−41.6	− 91.4	− 75.4	−43.4	−39.8
Japan							
In current dollars	106.9	107.2	103.4	106.2	108.0	96.0	110.8
In constant dollars[3]	72.8	60.8	43.6	63.0	58.6	39.0	48.4
Germany							
In current dollars	68.0	82.7	87.5	77.6	87.8	84.6	90.2
In constant dollars[3]	49.7	44.3	47.4	41.8	46.6	45.6	49.2

[1] On the basis of balance-of-payments data for the United States and customs data for Japan and Germany.
[2] Seasonally adjusted at annual rates. [3] Calculated at constant 1982 trade unit values.

an estimated 40% by end-1988. Most of the progress in reducing the trade deficit accordingly originated in the non-oil trade balance, where the deficit last year was over one-quarter smaller than in 1987 and more than halved when expressed in constant 1982 unit values (see the table on page 49). The improvement was most pronounced in the first half of the year, but slackened considerably in the second half.

Strong growth of US exports in the first half of 1988 ...

For 1988 as a whole, US export volumes expanded by a remarkable 24%, the growth rate for non-agricultural exports doubling to 26% in 1988. Export growth was particularly dynamic in the first half of the year, when exports soared by about 30% compared with the same period in 1987, reflecting substantial volume gains in all major categories of exports. In particular, agricultural exports benefited from a bunching of grain shipments to the Soviet Union. Export volume growth slowed significantly, however, in the second half of 1988. Although at 18% it still appeared impressive compared with the same period in 1987, when set against the preceding half-year the fall-off in export volume growth to about 3½% attested to the growing difficulty of sustaining the exceptional pace. While part of this slowdown was attributable to the drought-related drop in agricultural exports, the more general weakening of the export performance could also be detected in stagnating sales of industrial supplies and materials.

... slows down thereafter

With pressure on domestic demand scarcely abating in 1988, import developments contributed little to adjustment. In fact, non-oil import volumes registered an increase of nearly 6½%, slightly more than in 1987. The main element in this expansion was a surge in capital goods imports of nearly one-quarter. Imports of other commodities were generally weak or even declined, particularly in the early part of the year, but signs that import demand was strengthening surfaced by year-end. Indeed, whereas imports of automotive vehicles and consumer goods had been subdued in early 1988 – possibly as a result of large inventory building at the end of 1987 – their growth picked up considerably as the year went on.

A small improvement in Japan

Following a small rise in 1987, *Japan's* current-account surplus was reduced to $79.6 billion in 1988, equivalent to 2.8% of GNP. The lion's share of the reduction was realised in the services account, where, in spite of a $4.4 billion increase in net investment income receipts, the deficit rose by $5.6 billion. In particular, net expenditure on foreign travel increased at a very rapid pace, nearly doubling to $15.8 billion in 1988. However, some progress was also made in the trade balance, with the non-oil surplus narrowing by $3.8 billion. This reduction was entirely due to favourable volume developments, as Japan's terms of trade improved once more.

Continued rapid import growth ...

On the import side the adjustment was particularly rapid. In spite of a $1.6 billion drop in oil imports, reflecting primarily the fall in oil prices, imports rose last year by almost $37 billion, or over 25%. Measured in constant prices, non-oil imports soared by 21% in 1988 after increasing by 12% in 1987. The volume of imports of manufactured goods rose at a particularly impressive pace of 30½%, although this large increase needs to be viewed against the very low level of such imports to Japan. Indeed, in many respects Japan's markets remain relatively closed to foreign products. Import penetration in

Japan – i.e. the share of manufactured goods imports in total domestic consumption of these goods – remains by far the lowest among the industrial countries. Whereas for the industrial world as a whole this ratio currently stands at around 20%, it barely exceeds 4% in Japan. Moreover, compared with the level recorded in 1970, the ratio has risen significantly in most industrial countries. By contrast, in Japan it currently stands at about the same level as in 1970.

... and real exports start to grow again

On the export side it became apparent that Japanese exporters were progressively overcoming the competitive disadvantage which had been brought about by the appreciation of the yen. After having practically stagnated in 1987, export volume growth amounted to 5% in 1988. Most of this expansion occurred in the second half of the year, when real exports grew by over 10% compared with the preceding six months. The acceleration of export growth last year was, however, associated not only with the adjustment of the export sector to the changed external environment but also with the Japanese policy of expanding production bases abroad, in particular in South-East Asia and the United States. Indeed, exports of machinery and parts to equip foreign production bases ranked among the fastest growing components of foreign trade.

The growing importance of Japanese direct investment abroad has frequently been cited as one of the factors expediting the process of external adjustment. The argument is based on the notion that by shifting productive capacity away from surplus countries, foreign direct investment can create the potential for reversing trade flows and reducing previously existing bilateral merchandise imbalances. This conclusion, however, needs to be qualified in two respects. Firstly, as noted above, at the initial stage foreign direct investment is likely to be accompanied by accelerated exports of capital and semi-manufactured goods from the investor to the host country, which tend to increase the former country's trade surplus. Secondly, in the longer run the effect of foreign direct investment on the trade balance largely depends on the nature of the investment project. While investment in manufacturing will ultimately shift, and possibly reverse, trade flows, the impact of foreign investment in real estate or trading infrastructure is likely to be only small, if not negative. In this context it is noteworthy that Japanese direct investment in the United States has fallen predominantly into the two last-mentioned categories.

No correction in Germany...

Evidence of continuing external adjustment was lacking in *Germany.* For the year as a whole, the current-account surplus amounted to $48.6 billion, over $3 billion more than in 1987. Moreover, the growth of the external imbalance would have been even more pronounced had larger foreign travel expenditures, a decline in net income from foreign direct investment and an increase in transfer payments not raised the deficit on invisibles transactions.

Germany's trade surplus rose by $8.9 billion to $77.2 billion in 1988, owing largely to an increase of nearly $5 billion in its non-oil trade surplus. While this was significantly less than the $13.7 billion surge recorded in 1987, underlying developments appeared to be much less consistent with external adjustment. Indeed, in 1987 the rise in the non-oil trade surplus could be fully explained by an improvement in Germany's terms of trade, which more than

offset the effects of volume movements. In 1988, however, Germany's non-oil terms of trade worsened slightly, but net export volumes expanded sufficiently to prevent this price development from reducing the trade surplus.

... as export growth accelerates

The increase in the trade surplus at constant prices can be traced entirely to developments on the export side, where volume growth accelerated sharply in 1988. After growing by 2.9% in 1987, real exports expanded by over 7% in 1988, the highest rates being recorded in the second half of the year. This strong export performance suggests that German producers were gradually adjusting to the heavy losses in competitiveness experienced in the two preceding years. Moreover, with the pick-up in world economic activity being fuelled by investment spending, especially in neighbouring European countries, Germany with its traditionally strong position in the capital goods sector was well placed to benefit from this development. Indeed, particularly strong volume growth rates were recorded for exports of steel products and machinery.

On the import side, however, there were some signs that external adjustment had not come to a standstill. At 7% for the year as a whole, and 10% in the final quarter of 1988, non-oil import volume growth remained as buoyant as in the preceding year, reflecting the favourable competitive position of foreign producers, the strength of domestic demand growth and capacity constraints affecting a number of German producers.

International imbalances and adjustment in the three largest industrial countries

Factors influencing external adjustment include ...

Last year's Report pointed to three reasons for the relatively slow pace of adjustment of the external imbalances of the three largest economies observed until the end of 1987: firstly, the lags with which trade flows responded to exchange rate changes and, in particular, the unexpectedly small rise in US import prices; secondly, structural factors primarily reflecting differences in the commodity composition and the geographical distribution of trade; and, thirdly, insufficient changes in the pattern of domestic absorption in the three countries. These factors continued to play a role in 1988, although there were some shifts in their relative influence.

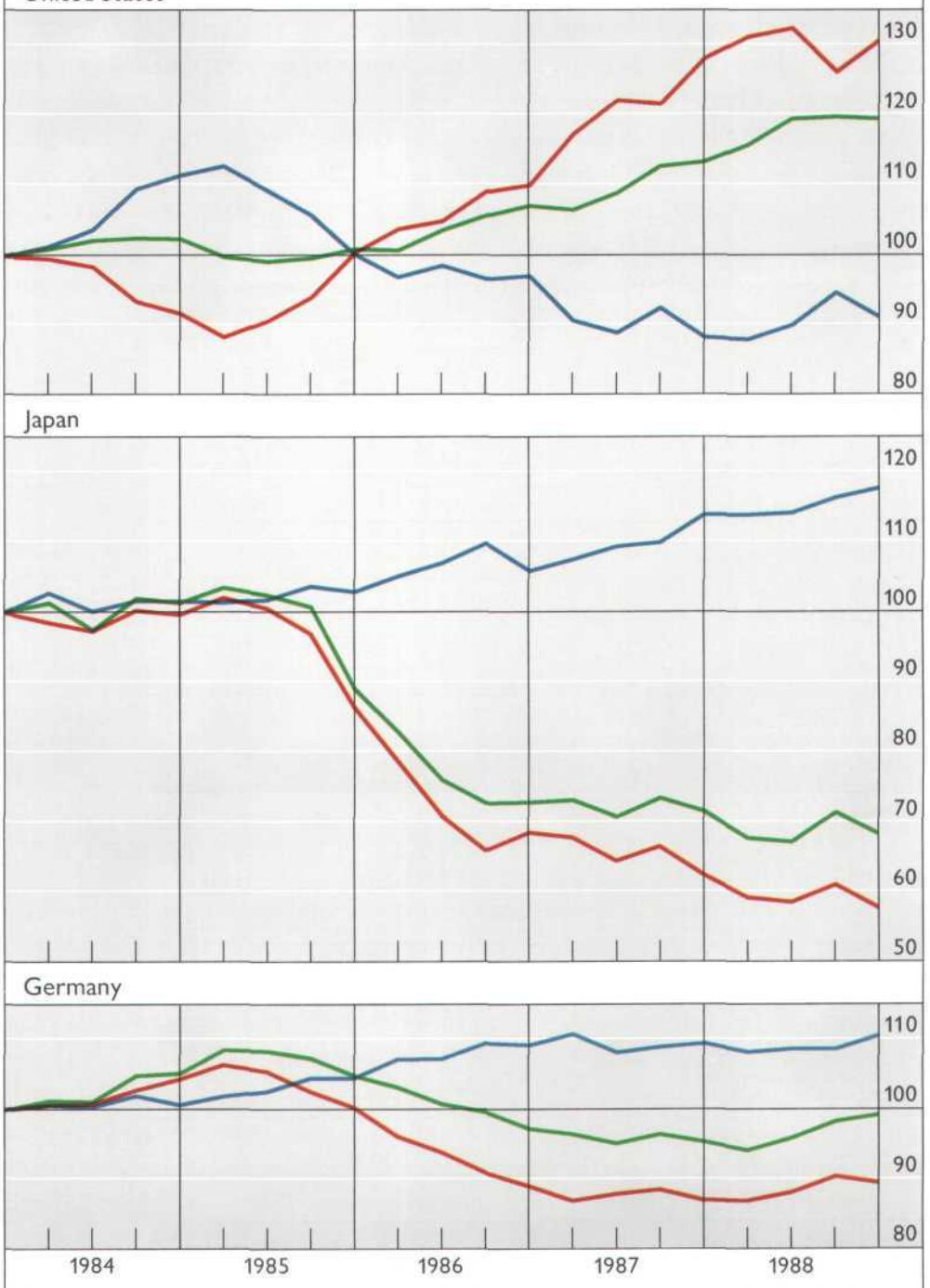
... changes in merchandise trade prices ...

One factor of crucial importance to the response of import volumes to exchange rate changes is the behaviour of import prices. As shown in the graph opposite, US import prices rose very slowly relative to the production costs of foreign suppliers in 1985–87, thus causing a marked fall in suppliers' profit margins and a sluggish adjustment of import volumes. At the same time, in Japan and Germany profit margins of foreign suppliers increased only moderately, and falling or stable import prices helped to increase import volume growth and correct the real imbalances. Last year the rise in US import prices showed some acceleration in the early part of the year but then slowed. By the fourth quarter import prices were only 20% higher than in 1985 (when the US dollar peaked), compared with an estimated increase of more than 45% in suppliers' production costs. Recent developments in import prices in Japan may have contributed to the slowdown in volume growth in the course of 1988 (see below) as profit margins strengthened, while German import prices

Estimated production costs and profit margins of foreign suppliers to the markets of the United States, Japan and Germany, 1984–88

In the importing country's currency; fourth quarter 1983 = 100

Foreign suppliers' production costs[1]
Import unit values[2]
Profit margin[3]



[1] Estimated on the basis of an import-share-weighted average of unit labour costs (65%) and wholesale prices of raw materials (35%) in other major countries. [2] For the United States, all goods excluding petroleum; for Japan and Germany, manufactured goods. [3] Ratio of import unit values to production costs.

started to rise from the second quarter but flattened towards the end of the year when costs were falling. On the export side (see the graph opposite) exporters in all three countries were able to increase profit margins as well as volumes last year. In Japan this represented a marked change in comparison with previous years, when Japanese exporters had cut their margins. These movements of relative trade prices produced an improvement in the US terms of trade, which has helped to reduce the nominal trade deficit, dampen the J-curve effects and limit the extent of imported inflation. For Japan and Germany, on the other hand, relative price movements have partly offset the influence of changes in the real external balances.

... the commodity composition and regional distribution of trade ...

The influence of differences in the commodity composition and the regional distribution of trade is most evident in the pattern of changes in bilateral trade balances, as shown in the table below using fob/cif customs data. Of the $32½ billion overall improvement in the US trade balance, almost one-third was accounted for by trade with European countries (excluding Germany) and almost $6 billion by a lower deficit vis-à-vis the NIEs. At the same time, the deficit vis-à-vis the other two major countries fell by more than $8 billion.

Bilateral trade balances, selected countries[1]

Balance vis-à-vis / Countries	United States	Japan	Germany	United Kingdom	Other Europe[2]	Asian NIEs[3]	Others[4]	Total
	changes between 1987 and 1988, in billions of US dollars							
United States	–	4.3	4.0	3.7	6.6	5.8	8.0	32.4
Japan	−4.3	–	0.7	1.6	0.9	4.1	−5.2	− 2.2
Germany	−4.0	−0.7	–	3.5	9.7	−0.1	−2.1	6.3
United Kingdom	−3.7	−1.6	−3.5	–	−9.7	−1.2	−1.5	−21.2

[1] Estimated from fob/cif customs data (excluding military trade) and adjusted to eliminate discrepancies in mutual balances. [2] Austria, Belgium, Denmark, Finland, France, Greece, Ireland, Italy, Netherlands, Norway, Portugal, Spain, Sweden and Switzerland. [3] Hong Kong, Singapore, South Korea and Taiwan. [4] Including residual.

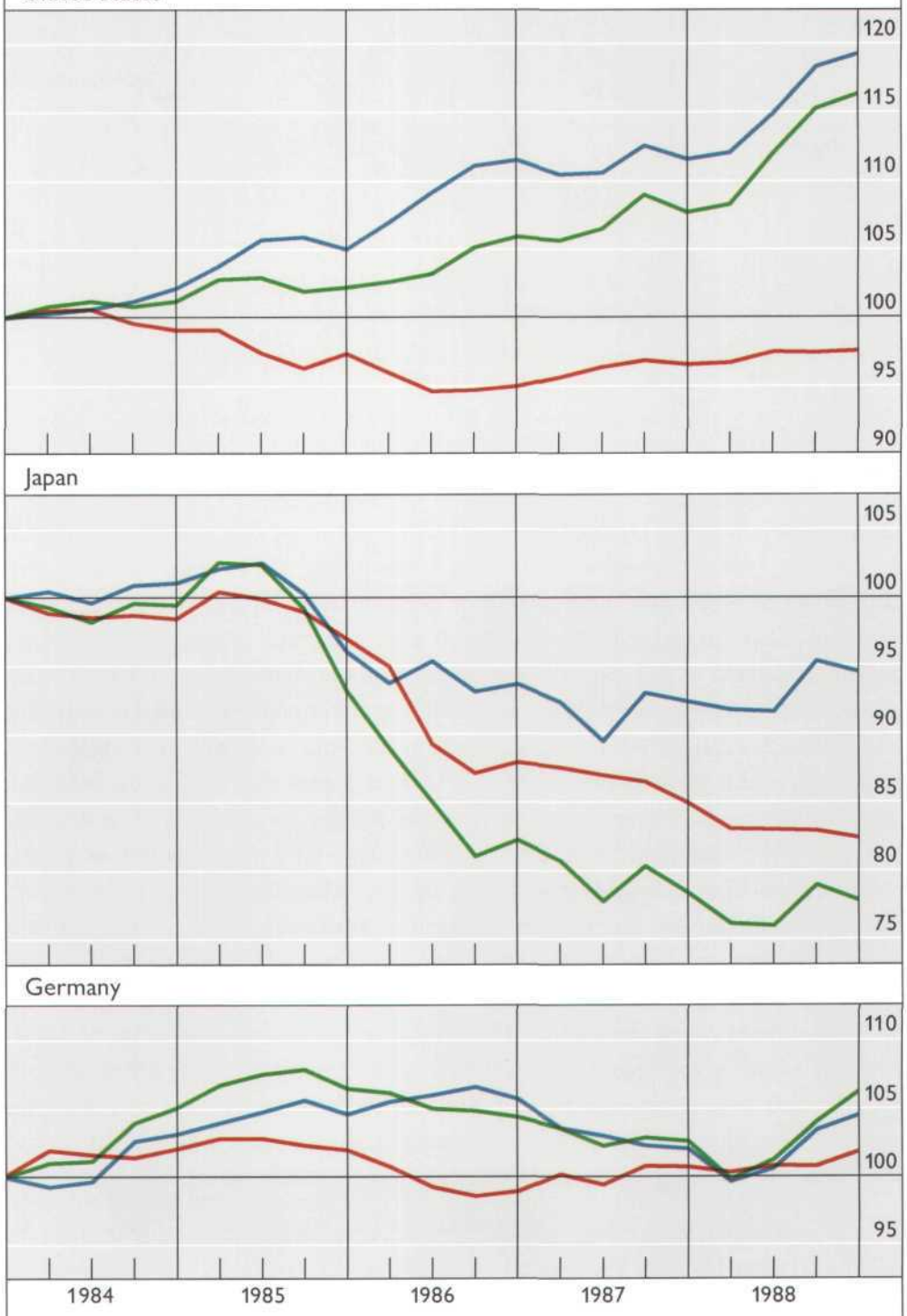
However, in both Japan and Germany the reduction in the trade surplus vis-à-vis the United States was wholly or partly offset by changes vis-à-vis other countries. Japan benefited from the strong demand growth in most Asian countries, and, together with improvements in the balances vis-à-vis European countries, this limited the fall in the overall trade surplus to about $2 billion. Developments in Germany were even more striking, as its trade surplus rose by $6.3 billion, owing, in particular, to a rise in the surplus vis-à-vis European countries of over $13 billion. As noted above, this change, which took place against a small real appreciation (in terms of unit labour costs) of the Deutsche Mark within the EMS, was largely the result of the strength of investment demand throughout Europe. On balance, it appears that only about 40% of the reduction in the US trade deficit in 1988 was absorbed by countries which had had a significant surplus in 1987, while about one-third was taken up by deficit countries (most of them in Europe).

For 1988 as a whole, changes in real domestic demand relative to output helped to reduce the external imbalances of the three largest countries.

Estimated production costs and profit margins of exporters in the United States, Japan and Germany, 1984–88

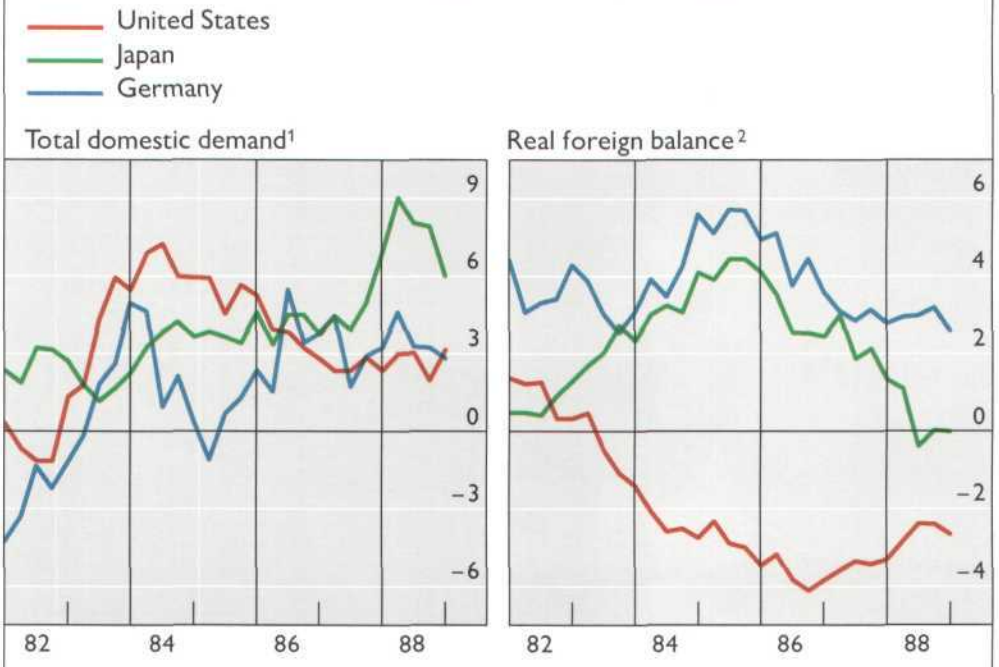
In domestic currency; fourth quarter 1983 = 100

Exporters' production costs[1]
Export unit values[2]
Profit margin[3]



[1] Estimated on the basis of an average of unit labour costs (65%) and wholesale prices of raw materials (35%). [2] For the United States, non-agricultural goods; for Japan and Germany, manufactured goods. [3] Ratio of export unit values to production costs.

Total domestic demand growth and the real foreign balance



[1] Changes over four quarters, in percentages; for the United States, excluding changes in business inventories. [2] Net foreign balance of goods and services as a percentage of GNP, at constant prices.

... and differences between output and demand growth

Output growth in the United States exceeded domestic demand growth by 0.9 percentage points, compared with 0.4 points in 1987, and in Japan the difference between demand and output growth widened from 0.7 to 2 points (see the table on page 13 in Chapter II and the graph above). In Germany, however, where a 1.3 percentage point gap between demand and output growth had opened up in 1986 and 1987, it narrowed in 1988 to only 0.1 points. These changes were also apparent in the volume of goods transactions, as shown in the table opposite. In the United States the difference between export and import volume growth widened sharply between 1987 and 1988, and a similar widening, with the opposite sign, can be observed in Japan. However, as shown in the lower part of the table and as was pointed out earlier, the favourable patterns in the United States and Japan changed in the course of last year, suggesting that the adjustment was faltering. The gap between export and import growth in the United States progressively narrowed from more than 21 to 12 percentage points in the course of 1988, while in Japan it narrowed to −5½ points. In Germany, where real import growth had exceeded real export growth by a large margin in 1986, the situation was reversed as early as the second quarter; but by the end of last year imports were again expanding faster than exports.

The potential for further reductions in the international imbalances of the three largest industrial countries

Further reductions of the US imbalance may be small ...

These recent developments raise certain questions concerning the scope for further reductions in external imbalances, particularly in the United States, at current exchange rates. Simulations made on international macro-models on

Developments in trade volumes in the United States, Japan and Germany

Year and quarter	United States		Japan		Germany	
	Exports	Imports	Exports	Imports	Exports	Imports
	percentage changes over corresponding period of previous year					
1985	3.2	4.5	4.6	0.4	5.9	4.2
1986	7.1	13.2	−0.6	9.5	1.9	6.1
1987	13.2	5.5	0.3	9.3	2.9	5.4
1988	23.8	7.0	5.1	16.7	7.4	6.7
1988 Q I	32.1	10.9	2.6	21.4	2.5	4.8
Q II	29.2	8.8	2.5	19.6	8.3	3.7
Q III	19.4	4.3	6.5	15.3	8.8	6.9
Q IV	16.4	4.4	5.9	11.3	8.8	10.2

Note: Quarterly data for the United States and Germany are seasonally adjusted.

the assumption of unchanged exchange rates and real output growth in all major countries generally point to a further small reduction in the US current-account deficit in 1989, followed by a progressively increasing deficit, with the speed and the extent of the deterioration varying with the particular model used. There are generally three reasons given for these results. Firstly, with real income growing at the same rate in all countries, the US trade balance would deteriorate because of the size of the existing imbalance, even if income elasticities of imports were the same for all countries. The deterioration would be more pronounced when – as appears to be the case – the US elasticity is higher than those of other countries. Secondly, because of growing external indebtedness, rising interest payments to foreigners add to the US current-account deficit. Thirdly, it is generally assumed that once all the lagged responses to a change in the real exchange rate have come through, it is very difficult to gain further market shares.

... unless supported by a favourable cost position ...

It is possible, however, that, if the competitive advantage is large enough, trade shares may continue to rise. Conventional analyses of the impact on trade of an exchange rate change tend to focus on the demand effects and to neglect longer-term supply-side changes, which may be larger as well as more sustainable. For instance, Japan gained export market shares in the 1950s and 1960s on the basis of low but not declining production costs, and more recently the same could be observed for the four Asian NIEs. Indeed, they continued to gain market shares last year even as their real exchange rates were appreciating. One important condition for such a development is, however, that a favourable cost position is backed up by an expansion in capacity sufficiently large to prevent bottlenecks in the exporting and import-competing sectors. The scope for trade share gains is also likely to increase if the rate of capacity growth is larger than in major trading partners. Past experience suggests that countries with a high rate of capital formation benefit from technical innovations and favourable supply-side changes.

... and strong capacity growth

Against this background, the scope for further growth in US export market shares and for reducing the degree of import penetration into the

United States depends on two factors: firstly, whether exchange rate changes together with developments in unit labour costs have opened up a favourable cost position for US industries; and, secondly, whether US investment has grown fast enough to prevent bottlenecks. Regarding the first condition the upper panel of the graph opposite shows that the real effective dollar exchange rate reached its lowest level in early 1988, following a peak in early 1985. Moreover, as may be seen from the middle panel of the graph (which shows levels of unit labour costs in the United States and its major trading partners), the fall in the real effective exchange rate has been accompanied by the emergence of a favourable relative cost position of US manufacturing industries. These indicative calculations suggest that, in terms of competitiveness, further market share gains would be feasible for US industries. However, it appears doubtful whether the cost advantage can be fully exploited. As shown in the lower panel, the growth of US investment exceeded that of its major trading partners until 1985, but this trend has been sharply reversed in the last three years. Moreover, capacity utilisation last year was approaching peak rates in many countries, including the United States (see page 31).

Adjustment of internal financial balances ...

There may, therefore, be a risk that despite the favourable cost position of US industries the comparatively slow growth of US investment and the emergence of output constraints will make further reductions in the trade deficit difficult. This risk may also be seen in the context of recent changes in saving and investment behaviour and of the need to adjust underlying financial balances. These issues were discussed in Chapter II and are illustrated in the table on page 60. As the table shows, changes in the fiscal deficits between 1979 and 1985 were in all cases accompanied by changes in the external account in the same direction, though movements in net private saving partly offset the changes in budgetary positions. In more recent years, however, the picture has been less uniform. Between 1985 and 1988 the fall in the US Government deficit was accompanied by only a small improvement in the current account as the drop in private sector net saving offset about 90% of the budgetary correction. In Japan net private saving also fell, but this helped to neutralise part of the fiscal consolidation and reduce the external surplus, whereas in Germany a rise in the fiscal deficit was more than offset by an increase in net private saving.

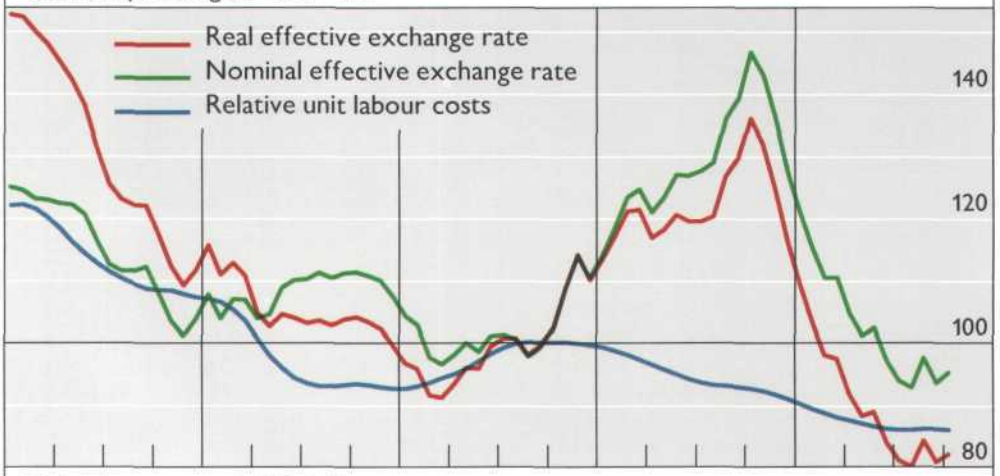
... could buttress further progress in correcting international imbalances

Two general conclusions may be derived from these developments. Firstly, it is important that a further reduction in the US Government deficit be accompanied by higher household and company saving and stronger investment growth. Secondly, financial resources set free by the expected fiscal consolidation in Germany need to be taken up by stronger private investment growth if the external surplus is not to rise further. Japan, on the other hand, has already taken important steps to reduce external and internal imbalances, and further progress may depend mainly on whether the fall in net private saving is sustained.

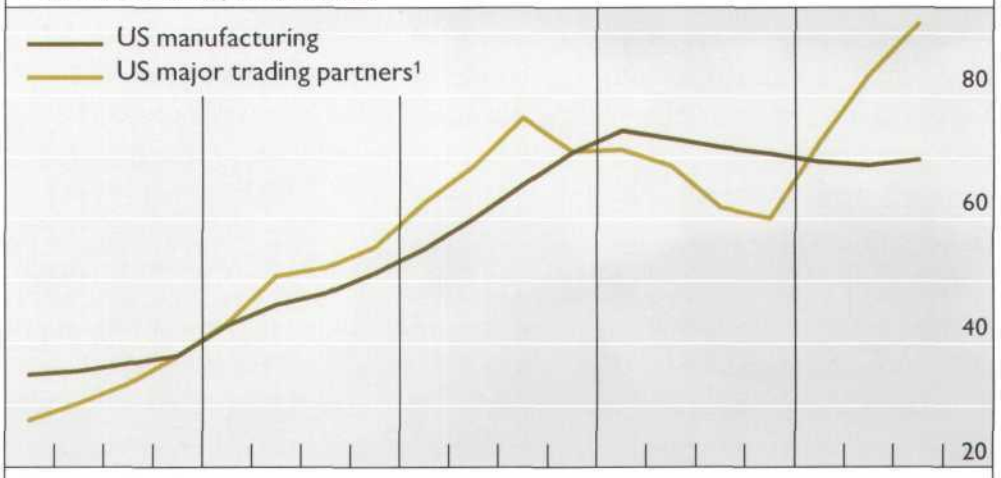
The importance of strengthening US private sector saving and investment may also be seen in the context of the progress achieved last year. Contrary to many predictions the United States managed to reduce its current-account deficit without depressing either world trade or domestic demand. This

Developments in US effective exchange rates, relative cost position and business fixed investment

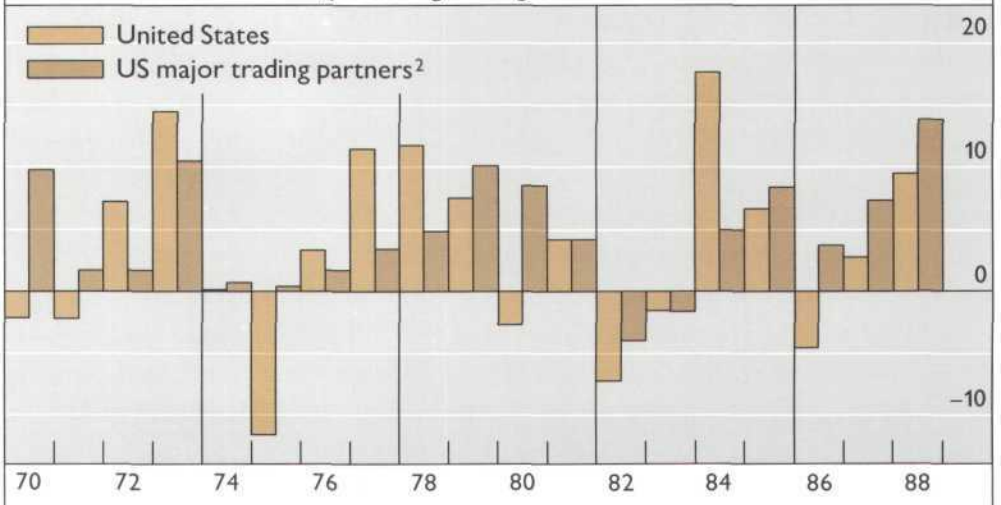
Effective exchange rates and relative unit labour costs
Quarterly averages, 1980 = 100



Unit labour costs, in US dollars



Business fixed investment, percentage changes



[1] Calculated as the trade-weighted average of compensation per employee, converted at current exchange rates, deflated by output per employee at 1980 prices, converted at 1980 purchasing power parities for manufacturing. [2] Trade-weighted averages.

Source: Hooper, P. and Larin, K.: "International Comparisons of Labor Costs in Manufacturing", International Finance Discussion Paper, No. 330, Federal Reserve Board, August 1988.

Current-account and domestic financial balances*					
Countries	1979	1982	1985	1987	1988
	in percentages of GNP				
United States					
Current account	0.0	−0.3	−2.9	−3.4	−2.8
Fiscal balance	0.5	−3.5	−3.3	−2.3	−1.8
Private net saving	−0.5	3.2	0.4	−1.1	−1.0
Japan					
Current account	−0.9	0.6	3.7	3.6	2.8
Fiscal balance	−4.7	−3.6	−0.8	0.6	1.3
Private net saving	3.8	4.2	4.5	3.0	1.5
Germany					
Current account	−0.7	0.8	2.6	4.0	4.0
Fiscal balance	−2.6	−3.3	−1.1	−1.8	−2.0
Private net saving	1.9	4.1	3.7	5.8	6.0

* Fiscal balance refers to general government, and private net saving is gross saving (companies and households) less gross investment plus residual items.

achievement was helped by the upturn in demand outside the United States. However, a key condition for the continuation of this process is that US industries are able to contribute to the further growth of world trade without encountering capacity limits, and this may be difficult without curtailing domestic demand growth.

Current-account developments in the other industrial countries

Among the other industrial countries, the most striking feature of balance-of-payments developments in 1988 was the sharp deterioration in the United Kingdom's current-account position, which accounted for nearly the entire $20 billion rise in the combined trade deficit of these countries and for 80% of the deterioration in their aggregate current account. The industrial countries (excluding the United States, Japan and Germany) can be broadly divided into three groups: one comprising countries whose current-account position deteriorated rather sharply in conditions of rapid domestic demand growth with real imports rising markedly faster than real exports; a second group of countries with a largely unchanged external position, reflecting in most cases stronger trade balances offset by a less favourable invisibles balance; and a third group of countries which experienced a significant improvement in the external current account, albeit not always for similar reasons.

Strong demand pressures produce a sharp deterioration in the United Kingdom's external position ...

In the *United Kingdom* the current-account deficit widened sharply from $5 billion in 1987 to $26 billion in 1988. Smaller net income receipts on invisibles transactions and falling oil receipts accounted for $5½ billion of the overall current-account deterioration. However, the principal cause was the sharp rise in domestic demand, which at 6½% was 2 percentage points higher than the average for all industrial countries and, with domestic producers approaching capacity limits, generated a 13% surge in real imports. Together with an erosion of the United Kingdom's competitive position due to accelerating labour costs and an appreciating exchange rate, the rise in domestic

International current-account balances

Countries and areas	Trade balance			Invisibles balance			Current-account balance		
	1986	1987	1988	1986	1987	1988	1986	1987	1988
	in billions of US dollars								
Industrial countries	− 8	− 29	− 7	− 8	− 16	− 51	− 16	− 45	− 58
Major industrial countries	− 0.7	− 13.5	7.5	− 13.9	− 26.8	− 59.5	− 14.6	− 40.3	− 52.0
Canada	7.1	8.3	7.8	− 14.6	− 16.3	− 16.9	− 7.5	− 8.0	− 9.1
France	− 2.4	− 9.2	− 8.7	5.5	5.1	4.5	3.1	− 4.1	− 4.2
Germany	54.6	68.3	77.2	− 14.9	− 22.9	− 28.6	39.7	45.4	48.6
Italy	4.5	− 0.1	− 0.8	− 1.6	− 1.5	− 4.7	2.9	− 1.6	− 5.5
Japan	92.8	96.4	95.0	− 7.0	− 9.4	− 15.4	85.8	87.0	79.6
United Kingdom	− 12.8	− 16.9	− 36.5	13.0	11.9	10.4	0.2	− 5.0	− 26.1
United States	−144.5	−160.3	−126.5	5.7	6.3	− 8.8	−138.8	−154.0	−135.3
Other industrial countries	− 6.8	− 15.0	− 14.8	5.7	10.0	8.4	− 1.1	− 5.0	− 6.4
Australia	− 2.1	− 0.5	− 1.1	− 7.7	− 8.3	− 9.9	− 9.8	− 8.8	− 11.0
Austria	− 4.6	− 5.1	− 4.3	4.7	4.7	4.0	0.1	− 0.4	− 0.3
BLEU[1]	0.6	− 0.1	0.9	2.5	3.0	2.5	3.1	2.9	3.4
Denmark	− 1.1	0.8	2.1	− 3.3	− 3.8	− 3.9	− 4.4	− 3.0	− 1.8
Finland	1.5	1.2	1.0	− 2.2	− 3.1	− 4.0	− 0.7	− 1.9	− 3.0
Greece	− 4.4	− 5.5	− 5.9	2.7	4.3	4.9	− 1.7	− 1.2	− 1.0
Iceland	0.1	− 0.1	0.0	− 0.1	− 0.1	− 0.2	0.0	− 0.2	− 0.2
Ireland	1.1	2.6	3.1	− 1.8	− 2.2	− 2.1	− 0.7	0.4	1.0
Netherlands	7.2	5.3	8.0	− 2.9	− 2.3	− 2.8	4.3	3.0	5.2
New Zealand	0.2	0.5	1.5	− 1.7	− 2.3	− 2.3	− 1.5	− 1.8	− 0.8
Norway	− 2.1	− 0.9	− 1.0	− 2.4	− 3.2	− 2.7	− 4.5	− 4.1	− 3.7
Portugal	− 1.6	− 3.6	− 4.9	2.7	4.0	4.5	1.1	0.4	− 0.4
South Africa	7.2	7.2	5.2	− 4.0	− 4.2	− 3.9	3.2	3.0	1.3
Spain	− 6.5	− 13.0	− 17.6	10.3	13.3	14.6	3.8	0.3	− 3.0
Sweden	5.2	4.7	5.2	− 5.1	− 5.8	− 7.6	0.1	− 1.1	− 2.4
Switzerland	− 3.7	− 5.2	− 5.8	10.6	12.5	12.1	6.9	7.3	6.3
Turkey	− 3.1	− 3.2	− 1.8	1.6	2.2	3.3	− 1.5	− 1.0	1.5
Yugoslavia	− 0.7	− 0.1	0.6	1.8	1.3	1.9	1.1	1.2	2.5
Eastern European countries[2]	10	16	14	0	0	0	10	16	14
Developing countries	10	49	31	− 53	− 52	− 55	− 43	− 3	− 24
Fuel-exporting countries[3]	20	47	32	− 51	− 51	− 52	− 31	− 4	− 20
Non-fuel-exporting countries	− 10	2	− 1	− 2	− 1	− 3	− 12	1	− 4
Exporters of manufactured goods[3]	9	24	21	− 2	− 1	− 1	7	23	20
Exporters of primary products[3]	2	− 2	0	− 15	− 15	− 17	− 13	− 17	− 17
Other non-fuel-exporting countries	− 21	− 20	− 22	15	15	15	− 6	− 5	− 7
Total[4]	12	36	38	− 61	− 68	−106	− 49	− 32	− 68

[1] Belgium-Luxembourg Economic Union. [2] Bulgaria, Czechoslovakia, German Democratic Republic, Hungary, Poland, Romania and the USSR. [3] Countries whose exports of fuel, manufactured goods and primary products respectively accounted in 1984–86 for over 50% of their exports of goods and services. [4] Equals the world current-account discrepancy.

Sources: IMF, OECD, national sources and BIS estimates.

demand also contributed to a decline in real export growth of manufactured goods to only 5% as UK-produced goods were increasingly diverted to the domestic market. In the course of 1988 measures were taken – mainly in the form of interest rate increases – to dampen demand growth, but by the end of the year, when the current-account deficit had climbed to over 4% of GNP, their impact on import growth had yet to become visible.

Although the deterioration was by far the largest in 1988, the deepening of the UK non-oil trade imbalance is not a recent phenomenon. In 1982 the UK non-oil trade account already recorded a deficit of $4.2 billion, which progressively increased to $23.7 billion in 1987, or by an average $ 4 billion per year. In 1988, however, an increase four times that size was registered. The worsening imbalance reflected primarily the growth of domestic demand pressures in the UK economy over these years, which resulted in a significant demand growth differential vis-à-vis other industrial countries. For instance, relative to the United Kingdom's main trading partners in the European Community, the differential throughout this period averaged nearly 2 percentage points per year. The impact of relative demand pressures was, however, mitigated between 1982 and 1987 by a steady improvement in the competitiveness of the UK manufacturing sector.

... but also some weakening in a number of other industrial countries

Signs of overheating and a worsening external balance could also be found in a number of other industrial countries. Rapid growth in investment spending underpinned a 13½% increase in import volumes in *Canada*, attributable in particular to imports of machinery and equipment. Buoyant exports and improved terms of trade held the deterioration of Canada's trade balance to only $0.5 billion, but, owing to a rising deficit on investment income, the current-account deficit increased by $1.1 billion. Demand pressures also stimulated import growth in *Italy*, where, with a rather low responsiveness of industrial exports to world demand, the trade account showed a small deficit of $0.8 billion. Moreover, as a surge in residents' tourism-related expenditure abroad following liberalisation measures contributed to a strong deterioration of the invisibles balance, the current-account deficit widened to $5.5 billion.

A generally restrictive policy stance in *Australia* did not succeed in cooling domestic demand, and real imports rose by over 17% while real exports stagnated. A terms-of-trade improvement limited the deterioration of the trade balance, but, with the invisibles balance also weakening, the current-account deficit widened further to $11 billion. *Spain* and *Portugal* both recorded further sharp increases in their trade deficits in 1988. Imports in both countries grew strongly in volume terms, partly reflecting stepped-up investment activities financed to a large extent by capital inflows. The invisibles account showed a small improvement in both countries, but not sufficient to prevent a worsening of the current-account position, which in Spain gave rise to a $3 billion deficit. *Sweden's* trade balance did not deteriorate, but this was entirely due to improving terms of trade. Domestic demand growth went well beyond output growth, and a worsening competitive position adversely affected export growth. As the invisibles balance deteriorated sharply, Sweden's current-account deficit widened by $1.3 billion. *Finland* also recorded an increase in its current-account deficit as a result of weak export growth and

a rising deficit in the services account. In *South Africa* a pick-up in domestic demand brought import growth to close to 25%. Although export growth recovered from its drop in 1987, the trade surplus and, in turn, that of the current account shrank by approximately $2 billion.

Other countries maintain their external position ...

Countries which largely maintained their current-account position in 1988 included *France, the Belgium-Luxembourg Economic Union, Austria, Greece* and, to a somewhat lesser extent, *Switzerland.* Greece aside, these countries all enjoyed fairly stable terms of trade and relatively strong real export growth owing to a somewhat stronger competitive position. The growth in their domestic demand was close to the average for the industrial world but, reflecting a shift towards import-intensive fixed investment, import volume growth expanded in each case at about twice the rate of domestic demand growth. In the Belgium-Luxembourg Economic Union and Austria, where intermediate and semi-manufactured goods constitute an important share of exports, the growth rate of manufacturing exports was particularly buoyant. In France, on the other hand, certain industrial sectors still appeared to be insufficiently adapted to prevailing international demand trends. Nonetheless, helped significantly by a reduction in the oil trade deficit and the strong performance of the agricultural sector, the trade deficit narrowed marginally while that on the current account stabilised. In Greece a small deterioration in the trade balance was entirely offset by a significant increase in the surplus on invisibles transactions, while Switzerland recorded a slight deterioration of both the trade and the invisibles balances.

... or strengthen it markedly

A number of industrial countries succeeded in significantly strengthening their external position. In some the improvement reflected export buoyancy, while in others it was largely the result of import restraint. The *Netherlands* and *Turkey* both recorded current-account improvements of $2–2½ billion, mainly as a result of a strong performance with respect to exports of manufactured goods, which in real terms rose by around 14%. In the Netherlands domestic demand growth was higher than in 1987 but well below that of most other industrial countries, while in Turkey the growth of domestic demand and, concomitantly, that of real imports slowed significantly as more restrictive policies were introduced in the course of the year. Spurred by the strong domestic demand growth in the United Kingdom, real export growth was also the main source of the improvement in the current-account position of *Ireland,* while import growth was held down by low domestic demand growth.

The impact of restrictive domestic policies on external positions was most apparent in *Denmark* and *New Zealand.* Both countries had followed such policies for external reasons over a number of years and succeeded in 1988 in restraining import demand. Owing to losses in competitiveness, their export performance was weaker than that of other industrial countries, although in New Zealand the impact on the trade balance was attenuated by terms-of-trade improvements. In *Norway* the policy stance of the authorities was quite similar to that in Denmark and New Zealand, and import demand fell sharply. Nonetheless, the trade balance failed to improve owing to a significant deterioration in the terms of trade and the structural weakness of the shipping sector.

The combined merchandise trade surplus, as well as the current-account

surplus, of eastern European countries is estimated to have narrowed by $2 billion to $14 billion in 1988. Net convertible currency earnings, however, are likely to have been much smaller – perhaps by as much as $10 billion – given that a major part of trade between these countries and the developing world is conducted on a barter basis or under bilateral clearing agreements. The reduction of the merchandise surplus was entirely related to a turn-round in the trade balance with western industrial countries from a surplus of $1.6 billion in 1987 to an estimated deficit of $1.7 billion in 1988. The *Soviet Union* accounted fully for this deterioration, as its trade with industrial countries (excluding gold sales) produced a $3.5 billion deficit, compared with approximate balance in 1987. While weak oil prices limited the growth of exports to 10%, rapidly rising imports of grain in the first half of 1988 and substantial imports of machinery throughout the year, supporting the drive for modernisation, pushed the growth rate of imports to an estimated 25%. In the other eastern European countries external balances changed relatively little from the preceding year. In *Poland,* where exports to and imports from western industrial countries rose by more than 20%, the trade surplus in convertible currency increased moderately to $1.3 billion, but the current-account deficit is estimated to have remained at $0.4 billion. Relatively buoyant export growth of about 15% was also recorded in *Hungary* and *Romania;* however, import growth was restrained, in the former country to promote external adjustment and in the latter to sustain its debt reduction policy. Romania's trade surplus in convertible currency rose by $0.3 billion to $2.6 billion and the current-account surplus may have risen to about $2 billion in 1988. In Hungary, where a trade surplus of $0.7 billion emerged, the current account continued to register a deficit of $0.6 billion. Some deterioration also occurred in the external positions of the *German Democratic Republic* and *Bulgaria* as both countries' export performance weakened while imports expanded strongly.

Developments in eastern European countries

External developments in the developing countries

The current external account of the developing countries as a group weakened from a position of approximate balance in 1987 to a deficit of $24 billion in 1988. This deterioration – the largest since 1982 – mainly reflected a fall in the trade surplus. Export volumes continued to rise, but import volumes grew as well and the terms of trade worsened (see the table on page 66). The 10% surge in imports, which followed a 6½% rise in 1987, appears to reflect some relaxation of the widespread policy of import compression characterising the post-1982 period.

The reappearance of a sizable aggregate current-account deficit ...

As in earlier years, the aggregate changes mask very wide differences between geographical regions and between countries grouped by their predominant exports. About 75% of the aggregate deterioration in the current-account position of the developing countries, or $16 billion, was accounted for by the group of fuel-exporting countries, which suffered from the fall in oil prices. The bulk of the remainder can be ascribed to a decline in the external surplus of the four Asian NIEs. The external deficit of the exporters of primary products remained unchanged last year, and the heavily

... mainly reflects external developments in the fuel-exporting countries and the Asian NIEs

indebted countries, which include fuel exporters as well as exporters of primary products and manufactured goods, recorded a slight deterioration in their aggregate current external account.

Commodity-price-induced terms-of-trade gains ...

Looking at trade prices and real flows on a more disaggregated basis, several features of the developments in 1988 are worth noting. Firstly, owing to the strong recovery in non-oil raw material prices and the fall in oil prices, the terms-of-trade gain of all countries exporting primary products improved by 5½%, but this helped to recoup only a small part of the cumulative terms-of-trade losses since 1982. For exporters of manufactured goods the terms of trade hardly changed and the rise in the purchasing power of exports was almost entirely the result of higher export volumes. As mentioned in Chapter II (page 36), the rise in non-oil commodity prices was smaller for developing countries than for industrial countries producing such commodities. Moreover, because of long-term contracts, changes in world market commodity prices usually affect export prices only with a considerable time lag (see the last two columns of the table overleaf).

... but large increases in real imports

Secondly, a large part of the strong growth in import volumes in the developing countries was accounted for by exporters of manufactured goods, particularly the four NIEs but also a number of other Asian countries. It is also noteworthy that fuel exporters as a group recorded a small increase in real imports, following a cumulative fall of almost one-half in the 1982–87 period. However, much of this change was accounted for by a 45% surge in Mexico's import demand, which also explains the higher import growth observed for the group of heavily indebted countries. Exporters of primary goods used only part of the rise in export revenues to increase imports, although within the group higher import growth could be observed for the sub-Saharan countries.

A third feature of developments in 1988 was the fall in the current-account surplus of the four NIEs, following several years of increase (see the table on page 67). This outcome was entirely the result of developments in Taiwan, which recorded a $7.7 billion fall in its current-account surplus, much of this decline being attributable to gold imports of an estimated $4.7 billion from the United States. Other important factors behind the adjustment in Taiwan's external position were import liberalisation, a strong expansion of domestic demand and a real appreciation of the exchange rate. South Korea registered a further rise in its current-account surplus last year, bringing it to $14 billion. However, the 1988 outcome was boosted by some once-for-all export revenue gains. Moreover, double-digit increases in nominal wages together with an appreciation of the nominal exchange rate might induce a weakening of its external position in the future. In Hong Kong the current-account surplus remained largely unchanged as both exports and imports (in nominal terms) rose by almost 30%, while Singapore saw a small improvement even though very strong growth pushed up import spending by almost 35%.

Taiwan's external surplus declines

The current-account deficit of exporters of primary products remained at $17 billion in 1988. Exports and imports in real terms increased at about the same rate, and as a percentage of export earnings the current-account deficit fell to 25% (from almost 30% in 1987), with a particularly steep fall for exporters of mineral products.

Indicators of foreign trade: Selected groups of developing countries

Country groups	Period	Import volumes	Export volumes	Purchasing power of exports[1]	Terms of trade	Export unit values	Memorandum item: World market prices in US dollars
		percentage changes, annual averages					
Exporters of primary goods	1982–85	– 6.7	2.7	2.0	– 0.8	– 3.5	– 4.5[2]
	1986	2.9	4.3	– 2.0	– 6.1	– 0.5	3.2
	1987	6.2	2.3	– 3.8	– 6.0	1.4	6.6
	1988	3.7	3.2	8.8	5.4	10.3	21.3
Fuel exporters	1982–85	– 7.9	–6.2	– 9.0	– 3.0	– 5.2	– 5.5[3]
	1986	–21.1	13.1	–40.8	–47.7	–41.4	–50.5
	1987	– 8.6	0.8	11.3	10.6	21.0	26.8
	1988	0.7	11.7	–11.3	–20.7	–15.0	–22.3
Asian NIEs	1982–85	4.8	8.9	10.3	1.3	– 2.0	–
	1986	10.5	20.6	19.3	– 1.2	– 0.6	–
	1987	25.1	22.3	24.9	2.1	10.1	–
	1988	23.1	15.7	15.1	– 0.5	7.7	–
Heavily indebted countries[4]	1982–85	– 7.8	4.4	2.2	– 2.1	– 6.1	–
	1986	– 4.0	–3.2	–21.5	–18.7	–15.6	–
	1987	0.7	5.6	3.5	– 2.0	8.4	–
	1988	8.7	12.1	8.6	– 3.2	1.0	–
All developing countries	1982–85	0.2	2.3	1.5	– 0.8	– 5.1	– 4.8[5]
	1986	– 3.8	12.0	– 8.9	–18.7	–15.8	–27.4
	1987	6.5	11.6	16.0	3.9	12.2	4.2
	1988	10.0	11.7	5.0	– 6.0	0.3	– 3.9

[1] Percentage change in export earnings deflated by import unit values. [2] HWWA index, non-oil raw materials. [3] Spot price of Arabian light crude. [4] See table on page 67. [5] HWWA index, all raw materials.

Sources: IMF World Economic Outlook and HWWA – Institut für Wirtschaftsforschung – Hamburg.

Improved external situation in the heavily indebted countries ...

The external situation of the most heavily indebted countries showed some promising changes last year. Firstly, the growth of export volumes and the purchasing power of exports increased, making it possible to expand import volumes by almost 9% (compared with an average annual decline of 4½% during 1982–87) and still leave room for an increase in the trade surplus. Secondly, despite the lower price for oil (which in 1987 accounted for nearly one-quarter of total export earnings) the deterioration in the terms of trade was limited to 3%, as the heavily indebted countries also benefited from a rise of almost 20% in the dollar export price of their non-oil commodities and from a slowdown in the growth of import prices for manufactured goods. Thirdly, for the first time since the outbreak of the debt crisis these countries' aggregate external debt declined both in US dollar terms and relative to total export earnings. At the same time, internal developments in these countries suggest that the more favourable external situation did not result from an improvement in the underlying economic conditions. Real GDP growth fell to only 1½%, and the output share of fixed investment declined to 16¾%, which

... is not supported by internal developments

Newly industrialising economies in Asia: Current-account balances

Items	Four economies*			Taiwan		
	1986	1987	1988	1986	1987	1988
	in billions of US dollars					
Trade balance	18.8	25.0	22.1	16.9	20.2	13.8
Exports	130.1	175.2	220.9	39.5	53.2	60.3
Imports	111.3	150.1	198.8	22.6	33.0	46.5
Services (net) including transfers	4.3	6.1	6.9	−0.7	−2.3	−3.6
Current-account balance	23.1	31.1	29.0	16.2	17.9	10.2
as a percentage of GDP	*11.0*	*11.8*	*8.9*	*22.3*	*18.4*	*8.8*

* *Hong Kong, Singapore, South Korea and Taiwan.*

is 4½ points below the 1982 level and implies that two-thirds of the improvement in the real foreign balance since 1982 has been achieved at the expense of lower capital formation. Moreover, the rate of inflation accelerated to 230%, or to more than twice the rate recorded in 1987 and six times the rate in 1982.

External adjustment in heavily indebted countries since 1982

Looking at the 1982–88 period as a whole, the fourteen heavily indebted countries managed to reduce their aggregate current-account deficit by almost $40 billion and to increase the trade surplus by $23½ billion, equivalent to 23% of merchandise exports in 1982. Higher export earnings and lower import expenditure each contributed about one-half to this change, but the real adjustments were much larger than the nominal figures suggest. Thus the cumulative growth in real exports increased the trade surplus by over $40

Current-account balance and external debt of fourteen heavily indebted countries[1]

Items	1982	1987	1988
	in billions of US dollars		
Current-account balance	−50.3	−10.7	−11.5
Merchandise exports	102.0	101.0	114.3
Services receipts	25.6	25.0	26.8
Merchandise imports	−95.6	−74.5	−84.4
Services payments[2]	−40.5	−37.0	−35.7
Interest payments	−42.3	−29.0	−36.7
Transfers	0.5	3.8	4.2
External debt	362	459	455
as a percentage of exports of goods and services	*283*	*364*	*323*
Memorandum items:			
Real trade balance[3]	*6*	*51*	*61*
Real merchandise exports	*102*	*129*	*145*
Real merchandise imports	*−96*	*−78*	*−84*

[1] Argentina, Bolivia, Brazil, Chile, Colombia, Ecuador, Ivory Coast, Mexico, Morocco, Nigeria, Peru, Philippines, Uruguay and Venezuela. [2] Excludes interest payments on external debt. [3] Calculated at constant 1982 trade unit values.

billion, and cuts in import volumes contributed another $12 billion. However, more than half of these favourable effects were offset by terms-of-trade losses.

These developments clearly show that external conditions – particularly with respect to prices – have not been favourable to these countries. At the same time, it is instructive to note that, if these countries had achieved the same growth of real exports as other developing countries, they could, despite the severe worsening of their terms of trade, have improved their trade balance without cutting imports – which would probably have allowed their economies to grow more strongly. Moreover, the terms-of-trade change was not entirely exogenous. Obviously, these countries have little influence on the fall in oil and non-oil commodity prices. However, because of excessive inflation and a deteriorating competitive position, most of the fourteen countries had repeated recourse to sharp devaluations of their currencies, which in turn aggravated the decline in the terms of trade and contributed to the acceleration of inflation.

International capital movements and the financing of current-account imbalances in the industrial countries

Market-determined financing flows dominate ...

In contrast to 1987, when the pattern of external financing flows was strongly influenced by large-scale exchange market interventions and concomitant changes in official monetary positions, 1988 saw a return to more market-determined financing of the major payments imbalances. Private financing flows were the main counterpart to current-account imbalances, and, although there were at times very large gross exchange market interventions, official reserve accumulation (excluding valuation changes) within the industrial world as a whole amounted to less than $3 billion. The greater ease with which the current-account imbalances were financed was associated with a more stable exchange market environment in 1988. As discussed in greater detail in Chapter VII, market perceptions of a relatively stable exchange rate outlook, supported not least by timely and strategic rounds of official intervention, made interest rate differentials a powerful determinant of private capital flows. This applied in particular to the financing of the US current-account deficit, but also to the external imbalances of EMS countries.

... responding to interest rate differentials

In the United States financing flows ...

Identified net private capital inflows (including the statistical discrepancy) into the *United States* totalled close to $100 billion, nearly the same amount as in the previous year. However, relative to the US current-account deficit, the 1988 outcome represented a marked improvement over 1987, when the same amount of net private capital inflows represented less than two-thirds of the deficit. Moreover, the actual improvement in 1988 was probably stronger because of the under-recording of foreign official dollar reserve accumulation in the United States in 1987 and a correction in 1988 (see Chapter VII). As recorded in the official US balance-of-payments statistics, US net liabilities to foreign official holders rose by $40 billion in 1988, or only $7.5 billion less than the increase in 1987. Most of the rise in net official liabilities took place in the first quarter. Thereafter, relatively little change was recorded. During the last three quarters, non-resident capital inflows into the United States picked up

United States: Capital-account transactions

Items	1986	1987	1988[1]				
			year	first quarter	second quarter	third quarter	fourth quarter
	in billions of US dollars						
Capital-account balance[2]	105.0	97.1	98.6	10.7	27.2	42.2	18.4
Resident capital	−98.3	−85.1	−88.4	5.0	−19.1	−31.8	−42.5
of which: US direct investment abroad	−27.8	−44.5	−20.4	− 6.5	0.5	− 5.2	− 9.2
Foreign securities	− 4.3	− 4.5	− 7.5	− 4.5	1.5	− 1.6	− 3.0
US banks' assets	−60.0	−40.5	−57.5	17.1	−13.3	−27.8	−33.5
Non-resident capital	187.8	163.7	170.5	1.3	59.0	50.3	59.9
of which: Direct investment in the United States	34.1	42.0	42.2	7.3	13.1	8.4	13.4
US securities	74.8	34.6	46.8	9.3	15.2	11.3	11.0
US banks' liabilities	79.8	87.8	78.9	−17.2	31.1	29.2	35.8
Unidentified capital[3]	15.5	18.5	16.5	4.4	−12.6	23.7	1.0
Changes in the net official monetary position[4]	33.8	56.9	36.7	26.3	6.6	− 9.6	13.5
of which: Liabilities to foreign official holders	33.5	47.8	40.3	24.7	6.5	− 2.2	11.2

[1] Seasonally adjusted. [2] Including unidentified capital. [3] The statistical discrepancies in the balance of payments. [4] Excluding valuation adjustments; a minus sign indicates an improvement.

sharply, reaching an annual rate of $225 billion, i.e. one-third more than the level of inflows recorded in 1987. At the same time, however, resident capital outflows also increased substantially, exceeding the 1987 level by nearly 50% on an annual basis.

... mainly reflect foreign purchases of US securities ...

Against the background of a positive interest rate differential in favour of US assets and at a time when the exchange rate of the dollar was fairly stable or even strengthening, private foreign purchases of US securities proved to be the driving force in the upturn of foreign investment in the United States. Having been halved in 1987, they rose again by $12 billion to a total of $46.8 billion in 1988. Particularly strong were net purchases of US Treasury securities, which totalled almost $20 billion last year following net sales of $7.6 billion in 1987. Net investment in US corporate and other bonds continued at a level of around $27 billion. By contrast, non-resident investors' interest in US stocks did not recover in 1988. Following massive net sales in the wake of the October 1987 stock market crash, transactions in stocks gave rise to a small outflow in 1988, compared with an inflow of $15.5 billion in 1987.

... and direct investment inflows

However, direct investment inflows remained buoyant and accounted for close to one-quarter of total non-resident inflows.

As far as capital transactions by US residents are concerned, it was essentially the rapidly growing outflow of funds from US banks after the first quarter which explained the buoyancy of capital exports during that period. For 1988 as a whole, US bank assets grew by $57.5 billion, or $17 billion more than in 1987. The expansion was mainly related to increased funding by US banks of their own affiliates abroad, particularly in the United Kingdom and Japan; these outflows may have been prompted in part by the fact that the

dollar deposits held by official monetary authorities with banks in the Euro-market, which had grown substantially in 1987, were drawn down in 1988 (see Chapter VII). US foreign direct investment outflows fell significantly in 1988, as reinvested earnings declined, mainly reflecting the turn-round from large capital gains in 1987 to small losses in 1988.

Although the official monetary reserves of *Japan* continued to rise last year, the increase of $15.5 billion was $27 billion less than that recorded in 1987. In comparison with 1987, capital-account transactions showed three important features in 1988. Firstly, resident long-term capital outflows increased significantly, owing primarily to a rise in Japanese direct investment abroad of nearly $15 billion, equivalent to one-quarter of total net outflows. Overall purchases of foreign securities were almost of the same magnitude as in 1987, but there was a marked change in their composition: outflows associated with purchases of foreign shares were $14 billion lower, but purchases of foreign bonds rose by a similar amount. Secondly, the balance on non-residents' capital transactions turned round sharply, from net outflows of almost $4 billion in 1987 to net inflows of $19 billion last year. There was, in particular, a spectacular reversal in non-resident transactions in Japanese shares from net sales of almost $43 billion in 1987 to net purchases of $7 billion in 1988. With the Japanese stock market quickly recovering its buoyancy following the crash, foreign purchases of Japanese shares were particularly large in early 1988 and in the last quarter of 1988, when the yen strengthened. By contrast, low nominal interest rates and a draw-down by fuel-exporting countries of their investments in Japan contributed to heavy net sales of Japanese bonds by non-residents. Finally, capital inflows via the banking sector were well below their 1987 levels. Against the background of higher short-term interest rates abroad and greater stability in exchange markets in 1988, this probably reflected a reduced incentive for resident investors to cover as large a share of their foreign investments as in 1987 through short-term borrowing in foreign currency.

Marked rise in Japanese residents' purchases of foreign bonds ...

... and in non-resident purchases of Japanese shares

Japan: Capital-account transactions

Items	1986	1987	1988				
			year	first quarter	second quarter	third quarter	fourth quarter
	in billions of US dollars						
Long-term capital (net)	−131.5	−136.5	−130.9	−15.1	−36.6	−42.2	−37.0
Resident capital	−132.1	−132.8	−149.9	−25.7	−38.1	−45.3	−40.7
of which: Direct investment	− 14.5	− 19.5	− 34.2	− 7.4	− 7.7	− 8.5	−10.6
Securities	−102.0	− 87.8	− 86.9	−11.9	−25.9	−27.1	−22.0
Non-resident capital	0.6	− 3.7	19.0	10.6	1.6	3.1	3.7
Short-term capital (net)[1]	59.4	91.8	66.8	1.7	19.5	25.3	20.3
of which: Banks	58.5	71.8	44.5	− 3.7	21.1	20.4	6.6
Non-banks	− 1.6	23.9	19.5	− 2.0	0.7	10.1	10.7
Changes in the net official monetary position[2]	− 13.7	− 42.3	− 15.5	− 5.0	− 1.5	− 2.1	− 6.9

[1] Including errors and omissions. [2] Excluding valuation changes; a minus sign indicates an improvement.

Germany: Capital-account transactions

Items	1986	1987	1988				
			year	first quarter	second quarter	third quarter	fourth quarter
	in billions of US dollars						
Long-term capital (net)	15.1	−13.6	−48.8	−14.3	−15.2	− 8.7	−10.6
Resident capital	−25.6	−34.7	−53.7	−13.5	−14.1	−11.3	−14.8
of which: Securities	− 9.7	−13.7	−41.5	− 9.6	−10.0	− 9.0	−12.9
Non-resident capital	40.7	21.1	4.9	− 0.8	− 1.1	2.6	4.2
of which: Purchases of German securities[1]	34.0	17.9	4.3	0.6	− 0.8	0.8	3.7
Short-term capital (net)[2]	−51.7	− 8.4	−19.0	2.8	− 5.0	−12.0	− 4.8
of which: Banks	−27.9	− 3.9	−10.3	8.4	− 3.2	−10.2	− 5.3
Private non-banks	−23.8	− 6.4	−10.8	− 7.4	− 1.6	− 0.5	− 1.4
Changes in net official monetary position[3]	− 3.1	−23.4	19.2	1.8	5.8	12.0	− 0.4

[1] Including official domestic borrowers' notes. [2] Including errors and omissions. [3] Excluding valuation changes; a minus sign indicates an improvement.

Germany's official reserves decline ...

In *Germany,* despite the large current-account surplus, the net official monetary position deteriorated by $19.2 billion in 1988 as the authorities drew heavily on their reserve holdings to resist downward pressure on the Deutsche Mark in the foreign exchange market. Net outflows of long-term capital more than tripled to $49 billion, reflecting essentially an unprecedented surge in purchases of long-term foreign securities by German residents, from $13.7 billion in 1987 to $41.5 billion in 1988. These purchases were related to two factors. Firstly, investors were attracted by the significant interest rate differentials in favour of a number of foreign currencies as expectations of an appreciation of the Deutsche Mark faded. Secondly, in anticipation of the introduction in January 1989 of a 10% withholding tax on domestic interest income, German investors expanded their purchases of foreign Deutsche Mark bonds (to which the tax did not apply) from $1.9 billion in 1987 to $7 billion in 1988. Foreign investors, too, continued to scale back their purchases of domestic fixed rate Deutsche Mark bonds, from $19 billion in 1987 to $1 billion last year. In April 1989 the German authorities announced that the withholding tax would be abolished as from 1st July 1989. The increase in net short-term capital outflows was largely accounted for by a widening in the net external asset position of German banks, which tended to reflect in part the immediate impact of official dollar sales.

... as net outflows on account of securities transactions soar

Many deficit countries record improvements in their official monetary position

The strong influence of nominal interest rate differentials in an environment of relatively stable exchange rate expectations was also clearly demonstrated by developments in a number of other major industrial countries with weak current-account positions. Many of these countries experienced substantial inflows of private capital which more than offset their current-account deficits and put upward pressure on their exchange rates. For example, notwithstanding the rise in their current-account deficits, *Canada, Italy, the United Kingdom, Spain* and *Australia* all recorded increases in their official reserve holdings in 1988.

In the United Kingdom short-term capital inflows via the banking system reacted strongly to the massive increase in UK short-term interest rates. These inflows, together with a record rise in the balancing item of $7 billion (which is considered to reflect mainly unidentified capital inflows), offset both the sharp rise of $21 billion in the UK current-account deficit and the outflows on account of residents' portfolio investment transactions. The sizable balancing item in 1988 presumably included a significant amount of unrecorded financial asset purchases by non-residents, as the identified portfolio investments of non-residents roughly halved.

In Canada the reserve accumulation of $9.4 billion was more than twice as large as in the preceding year. The most important factor behind net capital inflows was purchases by non-residents of Canadian bonds and Treasury bills. These inflows surged by $12 billion to a total of almost $19 billion in 1988 and contributed to the firming of the Canadian dollar against most major currencies.

In Italy net inflows of capital doubled to $13.8 billion in 1988. In response to high interest rates and favourable sentiment towards the Italian lira, particularly in the second half of the year, as well as the attraction of ECU-denominated bills issued by the Treasury, non-resident long-term capital inflows totalled $21 billion, or twice the amount recorded in 1987. In addition, owing to the strong demand for foreign currency credits by residents, Italian banks took up a further $8 billion from abroad. At the same time, Italian non-bank residents, taking advantage of a further liberalisation of foreign exchange controls, continued to diversify their foreign portfolio, increasing their purchases of foreign securities from $3.6 billion in 1987 to $5.5 billion in 1988. Overall, net non-official capital inflows were considerably larger than the current-account deficit, so that official reserves increased by $8.3 billion.

Large improvements in net official monetary positions, of $9.7 and 5.2 billion respectively, were also recorded in Spain and Australia. In spite of its deteriorating current-account position, Spain's attractiveness to foreign investors did not suffer in 1988. Investment-related inflows, reaching nearly $13 billion last year, continued to reflect the positive impact of EC membership on economic prospects in Spain. At the same time, financial investment in Spain also accelerated. With foreign investment in the long-term securities markets being restricted, rising non-resident inflows induced by favourable interest differentials and a firm peseta primarily took the form of short-term deposits with banks. In Australia the worsening underlying current-account position proved to be no deterrent to foreign investment in Australian securities, with foreign demand being boosted by high Australian interest rates and the firming of the exchange rate of the Australian dollar.

Official reserves decline in France and Switzerland

For the second year in succession, *France* registered a deterioration in its net official monetary position in 1988. At $1.2 billion the deterioration was, however, much smaller than the $8.4 billion recorded in 1987. A reversal to net inflows took place in the balance on short-term banking capital, which, following a net outflow of $9.3 billion in 1987, recorded inflows of $3 billion. This development can be attributed to the build-up of French franc deposits by non-residents and the increase in foreign currency borrowings by residents,

both in response to a positive interest rate differential and the strength of the French franc, particularly during the latter part of the year. *Switzerland,* too, was among the relatively small number of industrial countries experiencing a worsening net official monetary position in 1988. Low interest rates in combination with bearish sentiment about the external value of the Swiss franc led to net capital outflows of $7.3 billion, which, in conjunction with the smaller current-account surplus, resulted in a decline in its net official reserves of about $1 billion.

External financing of the developing countries

Financing becomes more difficult

The financing of the external deficit of the debtor countries in the developing world (i.e. excluding the NIEs in Asia and the major Middle Eastern fuel producers in a creditor position) became more difficult in 1988, partly because their combined current-account position deteriorated and partly because new financing declined. As a consequence, the debtor countries' aggregate holdings of official reserves fell and a number of countries accumulated sizable arrears.

The financing difficulties appear to have been partly related to heightened uncertainty surrounding the debt strategy and the roles to be played by debtor countries and their creditors. One reason for this uncertainty was the growing recognition that the debt strategy adopted in 1982 and strengthened under the 1985 Baker initiative needed to be revised. This introduced a certain degree of insecurity during the protracted negotiations of new financing programmes in 1988. Various new plans were discussed in 1988, but few concrete proposals emerged. Secondly, political instability was a source of concern, especially in some of the major middle-income countries in Latin America, where elections were held in the course of 1988 or scheduled for 1989. These circumstances made it more difficult to resolve economic or financial issues and probably increased the reluctance of foreign creditors to negotiate financing packages. Thirdly, as discussed earlier, although the export performance of many developing countries was in general favourable in 1988, domestic developments gave little cause for optimism and the prospects for the years to come did not appear to be particularly promising.

Official reserves are drawn upon ...

The importance of these factors obviously differed from country to country. Nevertheless, many of the debtor countries experienced acute financing problems. For the group as a whole, outflows of funds through the current account increased by $10 billion in 1988, while at the same time total external financing declined by $5 billion last year (see the table overleaf). This growing gap was covered essentially by recourse to official reserves, which, after having been built up by $12 billion in 1987, were drawn down by $7 billion in 1988. As a result the ratio of the debtor countries' official reserves to imports of goods and services decreased from close to 26% in 1987 to 21½%, not far above the level recorded at the time when the debt crisis came to a head in 1982.

... as external financing flows decline ...

The reduction in external financing flows in 1988 is particularly worrying in view of the fact that last year's total included a significant amount of new arrears, estimated at about $11 billion – more than twice as much as in 1987. In absolute terms, the decline in financing flows was most pronounced with

Developing countries: Estimated external financing of the current-account imbalances of selected groups of countries[1]

Items	Indebted developing countries[2]		Of which:					
			Fuel-exporting countries		Exporters of manufactured goods		Exporters of primary commodities	
	1987	1988	1987	1988	1987	1988	1987	1988
	in billions of US dollars							
Current-account balance	−33	−43	− 4	−14	−7	−6	−17	−17
Changes in foreign assets (− = increase)	−16	− 1	−12	6	−9	−7	2	− 1
Official reserves	−12	7	− 8	12	−8	−5	2	− 1
Other assets	− 4	− 8	− 4	− 6	−1	−2	0	1
External financing[3]	49	44	16	8	17	13	15	17
Borrowing from official creditors	37	26	11	7	12	6	14	8
Borrowing from private creditors[4]	3	8	0	− 4	9	3	− 1	7
of which: Change in BIS reporting banks' claims[5]	− 1	− 4	− 1	− 5	3	5	− 1	− 2
IMF credit	− 3	− 3	1	0	−2	−2	0	0
Other inflows (net)	12	14	4	5	−2	6	2	2
Direct investment	9	14	4	4	3	6	1	2
Other, unclassified	3	0	0	1	−5	0	1	0

[1] Totals may not add up owing to rounding. External financing of developing countries the nature of whose current-account receipts cannot be classified among the sub-groups specified above is not detailed in the table. [2] Excluding the NIEs in Asia and the major Middle Eastern fuel exporters in a creditor position. [3] Equals the sum of the current-account balance and changes in foreign assets, with the sign reversed. [4] Includes interest arrears. [5] Excluding bank lending to offshore centres.

Sources: IMF World Economic Outlook and BIS International Banking and Financial Market Developments.

regard to funds obtained from official creditors, reflecting considerable cutbacks in credits provided bilaterally or by multilateral development banks to a number of middle-income countries. At the same time, the reduction in BIS reporting banks' claims accelerated in 1988. The only relatively buoyant component of external financing in 1988 was direct investment, with inflows rising from $9 billion in 1987 to $14 billion in 1988. This increase partly reflected the growing use of debt/equity conversion schemes in dealing with the debt problems.

... especially in the indebted fuel-exporting countries

The greatest difficulties in attracting external financing were experienced by the indebted fuel-exporting countries. They were faced with a substantial deterioration in their current-account position, and their recourse to official reserves was most pronounced. The situation was slightly more favourable for the non-fuel-exporting debtor countries. Overall, these countries succeeded in raising their stock of official reserves, but in a number of instances arrears increased markedly. Official financing inflows into most of these countries were significantly below the levels recorded in preceding years.

IV. Developments in domestic financial markets

Highlights

Since the beginning of 1988 financial markets have gone through a relatively calm period compared with the turbulence that characterised much of 1987. Bond yields have remained comparatively stable, while equity prices have recovered steadily from the post-crash lows. Yet, a number of concerns that seemed to underlie the turbulence of 1987 are still with us: there has been only a modest further correction of the US budget deficit, the process of adjustment of international imbalances has recently stalled, and inflationary pressures have re-emerged.

Well over a year has passed since the 1987 stock market crash and little has been added to our understanding of its origins. More recently, our ability to explain the behaviour of equity prices has again been tested by the remarkable buoyancy of the Japanese stock market. The lack of a consensus on the causes and mechanics of the October 1987 events partly explains the relatively muted regulatory response which followed. However, the fading of the sense of urgency which prevailed in the immediate aftermath of the crash seems to stem primarily from the much stronger-than-expected performance of the real economy and from the relatively limited longer-term impact the crash has had on financial markets. The revival of the "high-yield" bond market and, more generally, the renewed momentum of mergers and acquisitions are perhaps the two most conspicuous examples of this apparent resilience.

While the wave of mergers and acquisitions has affected many countries, in the United States it has been the main engine behind a development unique to that country: a marked increase in the leverage of non-financial enterprises. Particularly in the light of the unprecedented levels reached in a significant number of cases, this increase in leverage has raised concerns about the financial vulnerability of the US corporate sector because of its potential for amplifying any slowdown of the economy, creating strains in the banking system and constraining monetary policy. In view of these risks, the recent closer prudential supervision of banks' involvement in highly leveraged transactions seems well-founded.

Last year marked the beginning of the implementation of the Basle agreement on the convergence of banks' capital standards. Whilst the importance of strengthening the prudential supervisory framework for banks has been recognised, concerns have nonetheless been voiced about the possible adverse effects of the new standards on bank performance and risk-taking. The need for an appropriate regulatory framework when government policies prevent market forces from imposing the necessary discipline on risk-taking has been highlighted by the US savings and loan industry crisis. Although

admittedly in part the outcome of extreme economic circumstances, that crisis is a prime example of the problems that may result from insufficient market discipline on risk-taking and inadequate supervision in the banking industry.

The strengthening of supervisory arrangements in recent years has gone hand in hand with the process of deregulation and integration of financial markets. The reform of London's capital markets, the "Big Bang", while increasing competition in domestic securities markets, has also entailed adjustment costs and provides an interesting contrast to the more gradual liberalisation efforts in Japan. Turning to the future, the contours of the single European market in financial services to be achieved by 1993 are beginning to become clearer, though a number of key questions remain unanswered.

Performance in equity and related markets

1988 could be described as the year in which equity markets "returned to normal" after the turmoil of 1987. Equity prices in virtually all markets increased substantially from their post-crash lows. This recovery was accompanied by a significant reduction in price volatility compared with 1987 and by either declines or modest increases in the volume of trading on different markets.

In 1988 equity markets generally return to normal ...

The market prices of equities traded on the main exchanges are presented in the table below. In all cases prices currently exceed their post-crash lows by more than 25%. In most markets they have risen above their end-1986 levels

Stock market indices[1]

Beginning of 1987=100

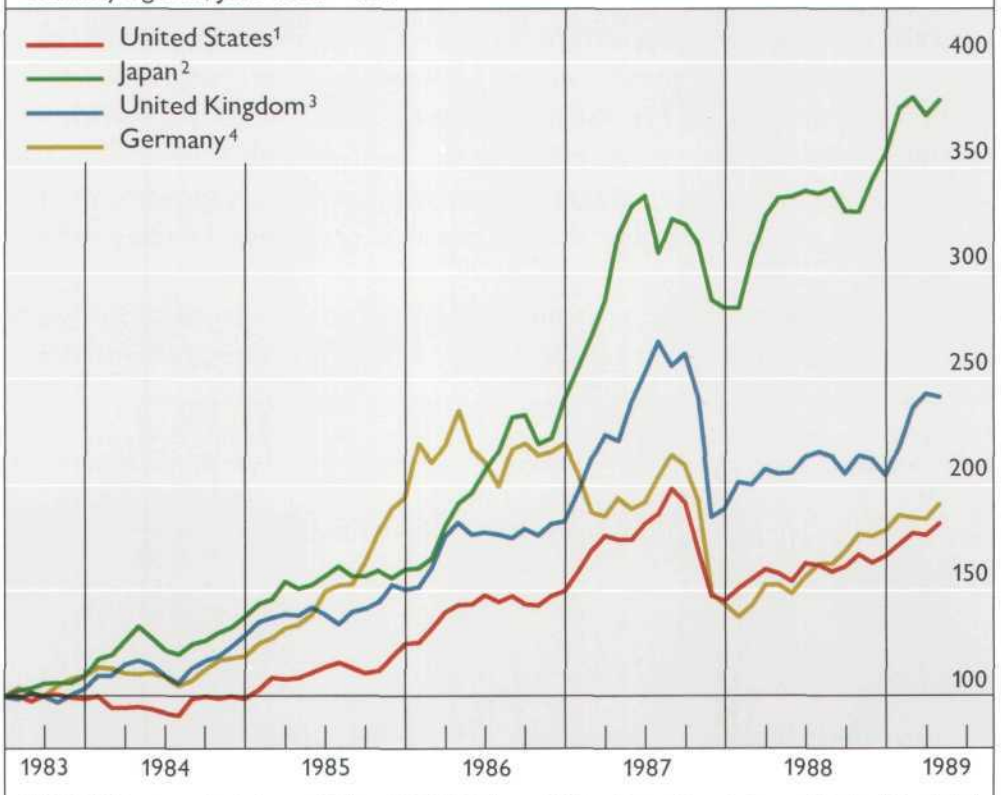
Countries	High 1987		Post-crash low		8th May 1989
	Index	Month	Index	Month	Index
United States	138.3	August	91.9	December	125.6
Japan	144.5	June	108.2	January[2]	162.8
United Kingdom	147.2	June	94.1	November	134.7
Canada	134.9	August	93.1	October	117.4
Germany	100.2	January	58.7	January[2]	85.8
France	115.6	March	63.1	January[2]	116.5[3]
Italy	107.0	April	59.1	February[2]	84.5
Switzerland	108.4	October	67.0	November	100.4
Netherlands	120.0	August	69.0	November	120.4
Spain	156.2	October	96.5	December	145.6
Belgium	132.1	August	85.6	December	145.1
Australia	156.8	September	78.3	November	102.9
Hong Kong	154.3	October	74.0	December	127.7
Singapore	168.9	August	78.6	December	143.7[3]
Taiwan	449.7	October	221.1	December	804.3[4]
South Korea	192.6	December	167.2	November	348.1[4]

[1] For the United States, S & P 500 composite index; for Japan, TOPIX index; for the United Kingdom, FT ordinary share index; for Germany, FAZ general index; for other countries, representative indices. [2] 1988. [3] 9th May 1989. [4] 6th May 1989.

Sources: National stock exchanges.

Stock market prices

Monthly figures, June 1983 = 100



[1] S & P 500 composite index. [2] Tokyo TOPIX index. [3] FT ordinary share index. [4] Federal Statistical Office general index.

but remain 5–20% below their 1987 highs. The only markets on which prices remain below their end-1986 levels are those in Germany and Italy, while only in Japan, Belgium, Taiwan and South Korea have they substantially exceeded their pre-crash high.

... though volume in derivative markets remains depressed ...

Trading declined sharply in the four major equity markets in the months immediately following the crash. However, the rate at which market activity subsequently recovered varied. The volume of transactions in the London stock market in 1988 was more than 30% below the level attained in 1987, while the decline in trading volume in US equity markets was more modest, at about 13%. By contrast, equity trading in Germany and Japan increased by just under 10% last year.

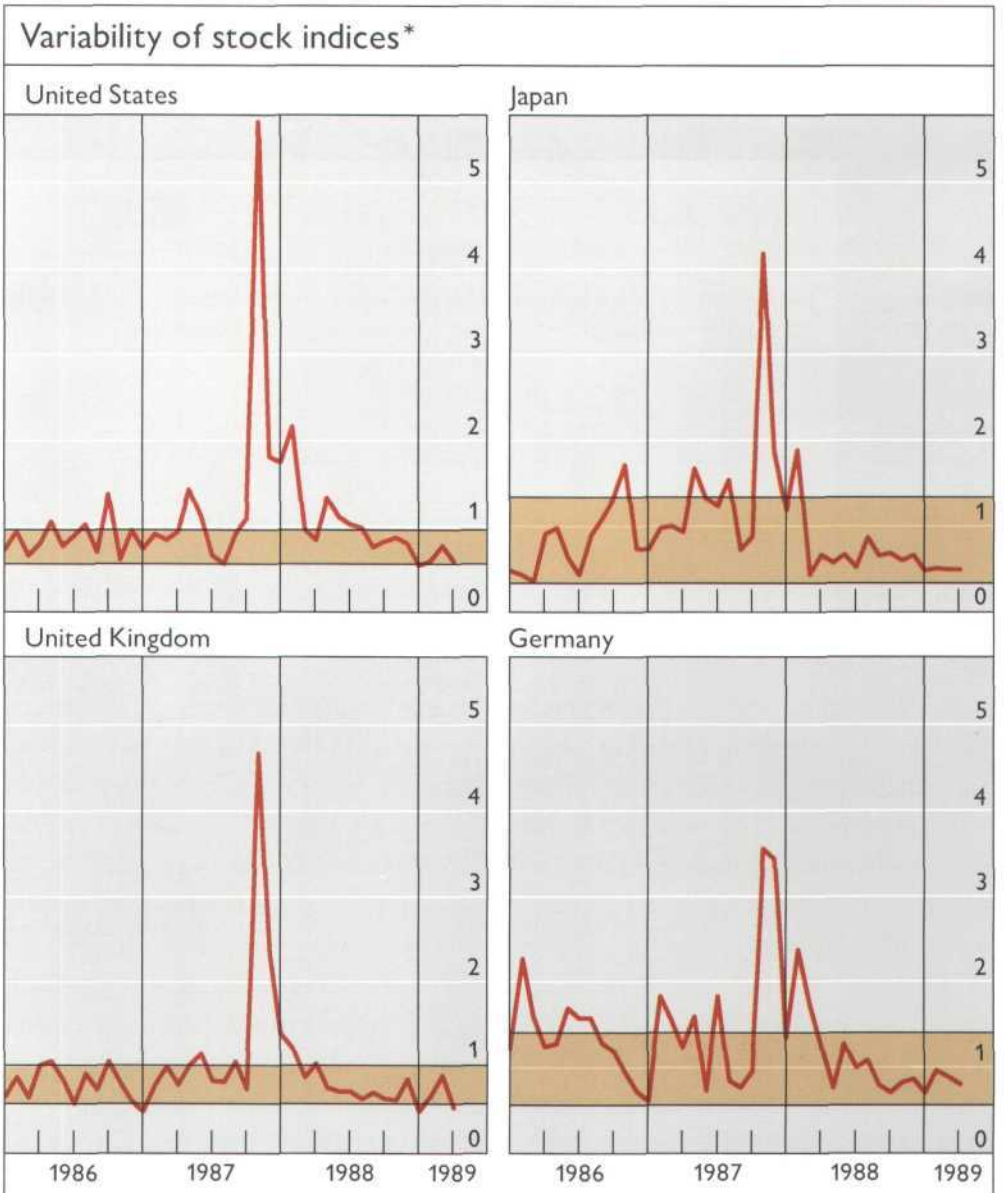
Trading in a number of derivative markets fell markedly from pre-crash levels. The number of Standard and Poor's 500 index futures contracts traded in 1988 was down by about two-fifths compared with 1987 and lower than in any year since 1983. Similarly, trading in US stock index options also declined substantially. Volume in futures contracts for the Hang Seng index in Hong Kong in 1988 was less than 5% of the 1987 level as the Hong Kong market underwent a major regulatory restructuring. In London trading in the FT-SE futures contract was depressed for much of the year, but, after picking up in the fourth quarter, it was virtually unchanged relative to 1987 for the year as a whole.

The volatility of equity prices declined significantly in 1988, returning to pre-1987 levels. As the graph below indicates, volatility remained high for a number of months following the market break, but for most of 1988 and early 1989 it was relatively low compared with recent years.

... and daily price correlations are higher than before the crash

On the other hand, the correlation between daily stock price movements in the four major markets, while decreasing since the end of 1987, has generally remained above pre-crash levels (see the table opposite). This suggests that the stronger linkages in very short-term price movements that characterised the period around the stock market crash have, to some extent, persisted.

In some ways current economic conditions are similar to those which preceded the crash. Inflation has accelerated in several industrial countries and



* Calculated monthly as the standard deviation of daily percentage changes in stock price indices. The band represents the mean volatility for the period 1984–86, plus/minus one standard deviation of the monthly volatility over the same period.

Sources: For the United States, S & P 500 composite index; for Japan, Tokyo TOPIX index; for the United Kingdom, FT 100 index; for Germany, Commerzbank index.

monetary policy has been tightened in response. Real interest rates continue to be high by historical standards. The adjustment of trade imbalances among industrial countries slowed and in some cases was reversed in 1988. The US Federal budget problem appears as intractable as ever. On the other hand, conditions are different in important ways as well. In contrast to that in 1987, the tightening of monetary policy in 1988 and the associated sharp rise in short-term interest rates in most industrial countries did not lead to marked increases in long-term rates (see the graph overleaf). The differences in the slope of the yield curve between October 1987 and the first quarter of 1989 suggest that in the countries considered investors' medium-term expectations regarding nominal interest rates and inflation have declined relative to the time of the crash. In addition, the strong investment-led expansion in economic activity in 1988 suggests that the prospects for continued real growth in industrial countries are more certain now than they were in October 1987.

Correlations between daily percentage changes in stock price indices, 1984–89

Countries and items	1984–86	1987	1988–89[1]
Overlapping trading days[2]			
United Kingdom and Germany	0.127	0.514	0.314
United Kingdom and United States	0.364	0.531	0.405
"Day" begins in North America[3]			
United States and Japan	0.225	0.492	0.364
United States and Germany	0.335	0.306	0.551
"Day" begins in Japan[2]			
Japan and Germany	0.123	0.393	0.359
Japan and United Kingdom	0.087	0.473	0.265
Japan and United States	0.106	0.263	0.146
"Day" begins in Europe[4]			
Germany and United States	0.113	0.394	0.097
United Kingdom and Japan	0.171	0.199	0.270
Germany and Japan	0.083	0.206	0.152

[1] To mid-March 1989. [2] Correlation between the percentage change in stock prices on the same calendar day. [3] Correlation between the percentage change in stock prices in the United States and changes in stock prices in Japan and Germany on the following calendar day. [4] Correlation between the percentage change in stock prices in Germany and the change in stock prices in the United States on the same calendar day, and correlations between the percentage changes in stock prices in the United Kingdom and Germany and the change in stock prices in Japan on the following calendar day.

Sources: See the graph on page 78.

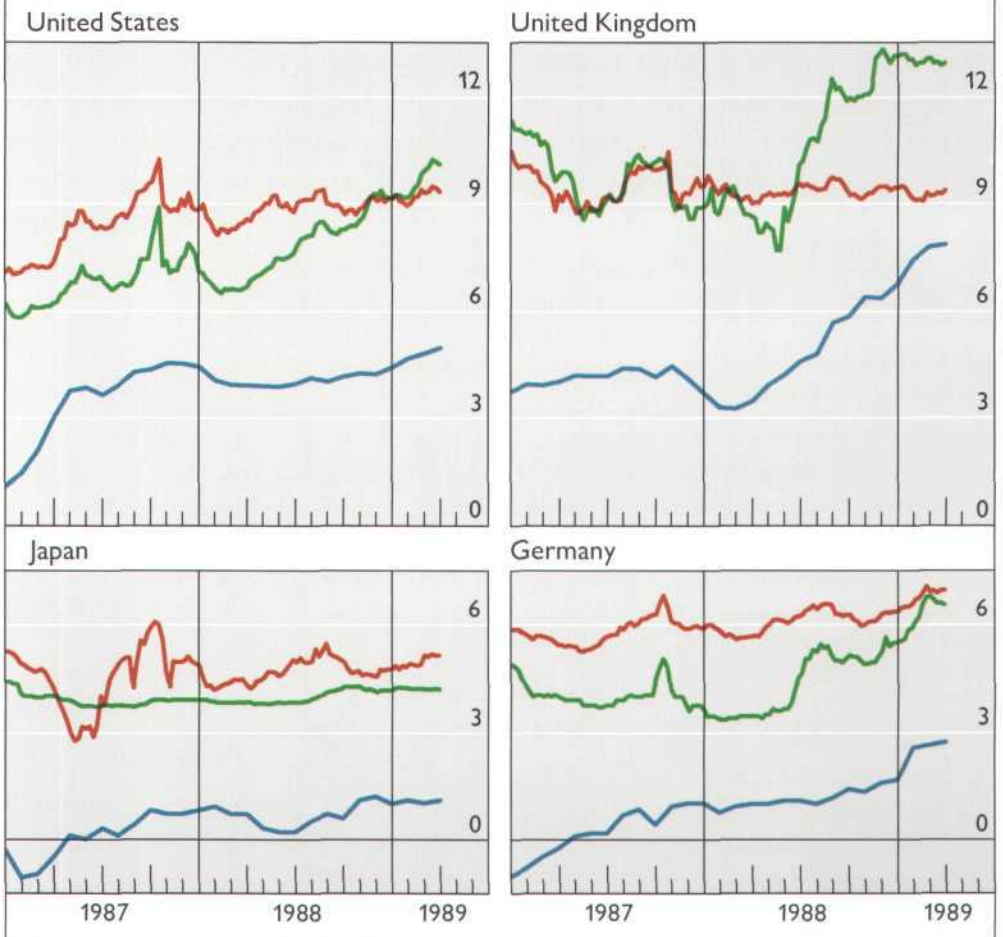
No new light on the causes of the crash

Perhaps the most striking aspect of economic performance in 1988 is how small an impact the crash appears to have had in most industrial countries. The crash may partly account for the moderate rise in the private savings rate in the United States but, other than that, its direct consequences are not readily apparent. This may indicate that investors had not fully incorporated in their wealth perceptions the rise in stock prices during the first half of 1987, so that their behaviour was not greatly affected by the price declines in the second half of the year. This would appear to be consistent with the argument that the crash in part reflected the bursting of a speculative bubble. Similarly, the significant rebound in equity prices from their post-crash lows may indicate that

Recent developments in interest rates and inflation*

In percentages

Long-term interest rate
Short-term interest rate
Consumer price inflation



* Representative long-term bond yields and money market rates (end-week data); inflation measured as percentage changes in consumer prices over twelve months.

temporary market failures caused a number of markets to fall "too far". On the other hand, the relaxation of monetary policy which followed the break, the buoyancy of profit rates relative to historically high real interest rates, and the associated investment boom in 1988 were probably not anticipated in October 1987. Seen in this light, the increases in stock prices in 1988 seem quite logical and are not inconsistent with the possibility that the crash was partly caused by concerns about fundamentals.

The buoyancy of the Japanese equity market ...

The one major market that performed significantly better than any other in 1988 was the Japanese stock market, where prices rose well beyond their pre-crash highs. But even given the excellent economic performance of the Japanese economy in 1988, the factors supporting Japanese equity prices are not obvious.

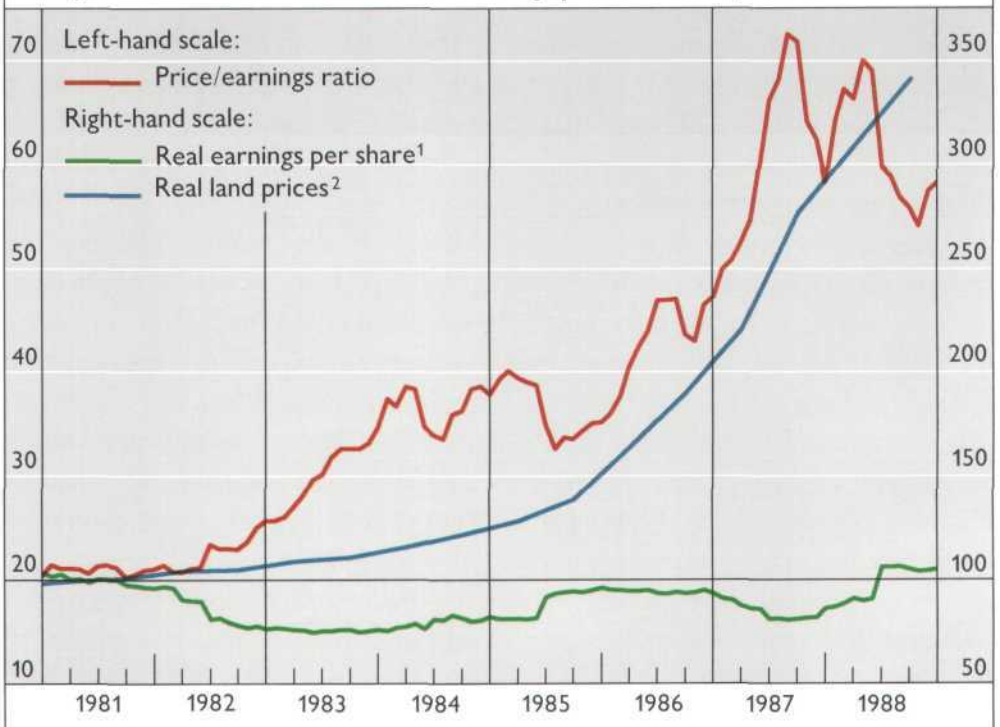
Measuring the "fundamental" value of stocks is extremely difficult since it depends on expectations of future economic conditions and the manner in

which asset prices are determined. Two complementary indicators of "fundamental" value are the yield gap and the price/earnings (PE) ratio.

Prior to the early 1970s, the PE ratio for the Japanese stock market was usually below 20. In the following decade it generally fluctuated between 20 and 30. However, as is shown in the graph below, from the end of 1985 onwards it increased dramatically, reaching a peak of over 70 before the crash. By the first quarter of 1989 it had fallen back somewhat to about 60.

There are a number of possible explanations for the unprecedented increase in the PE ratios of Japanese equities after 1985. Firstly, long-term bond

Tokyo stock market indicators and Japanese land prices



[1] Earnings per share deflated by the consumer price index (March 1981 = 100). [2] Price of commercial real estate in six major Japanese cities deflated by the consumer price index (March 1981 = 100).

yields have declined from about 6% to about 4% since 1985, which, by itself, would imply a substantial increase in PE ratios. However, the decline in nominal interest rates has approximately matched the fall in inflation. This fall should have depressed the expected rate of growth of nominal earnings, thereby offsetting to some degree the positive effect of lower interest rates on equity prices. Secondly, Japanese corporations hold a considerable amount of land. As shown in the graph above, land prices in Japan have risen sharply since 1985. This increase may have significantly boosted the market value of Japanese corporate assets without raising reported earnings. Finally, the current level of PE ratios may reflect expectations that earnings per share will grow rapidly in the future.

A complementary indicator of "fundamental" value is the difference between the long-term bond yield and the dividend yield, which can be related to the difference between the expected rate of growth of dividends per share and a risk premium. This so-called "yield gap" for the Japanese market rose in

1987 from 2.8% in April to 4.9% in September, before falling to 3.5% in early 1988. In the first quarter of 1989 it stood at about 4%. Assuming, as is commonly done, a positive risk premium for Japanese stocks relative to government bonds, that yield gap implies an expected long-run annual growth rate of dividends per share of at least 4%. In turn, the expected long-run growth of corporate earnings per share should not be lower than this rate to the extent that dividend pay-out rates cannot rise indefinitely.

... may not be in line with dividends and earnings performance

Although since 1970 corporate earnings in Japan have increased at an average annual rate of 8.5%, earnings per share have grown at a rate of only 2.9% as the issuance of new shares has continually diluted rising corporate profits. As a result, in recent years the growth in earnings per share has only marginally exceeded Japanese inflation (see the graph on the previous page). In addition, dividend pay-out rates have declined modestly in recent years. It would therefore appear that current levels of yield gaps and PE ratios in Japan may be inconsistent with the historical behaviour of corporate earnings and dividends. Expectations of future capital gains rather than of earnings potential seem to be driving the market.

Regulatory response to the market crash. In the months following the crash a variety of proposals for changing the regulatory structure of financial markets were put forward to deal with perceived problems that arose during October 1987. Relatively few of these regulatory changes were implemented in 1988. Indeed, a reconsideration of some of the more sweeping recommendations started almost as soon as they were made. For example, in the United States the interim report of the Presidential Working Group on Financial Markets, released in May 1988, rejected two of the main recommendations of the Brady Report, which was submitted in January 1988.

The regulatory response to the crash has varied

In general, the changes that have been implemented attempt to correct technical and structural deficiencies which appeared to impair the smooth functioning of equity markets during the extreme conditions on 19th and 20th October 1987. The Hong Kong stock market is the only one that has embarked on a major reform of its regulatory structure. In the United States the trading capacity of the exchanges has been expanded; the capital and liquidity of futures clearing systems have been increased in order to reduce settlement risk; capital requirements for market-makers have been raised; and a co-ordinated system of "circuit breakers" has been introduced between the cash and futures markets so that trading halts can be synchronised. By contrast, in the United Kingdom changes have been dominated by the response of market participants to the decline in the volume of transactions rather than by performance during the crash (see below). At the international level, some preliminary steps have been taken to consider ways of improving co-ordination across markets, especially with regard to clearing and settlements.

The recommendations that have not been implemented are the more controversial ones. There has been no move to reconcile margin requirements in cash and futures markets, or to alter significantly the distribution of regulatory authority for cash and futures markets in the United States as recommended in the Brady and Securities and Exchange Commission (SEC) reports. Some US brokerage firms have limited their use of program trading

strategies for their own account, and the New York Stock Exchange imposed limits on the use of computerised order systems for a trial period of six months. But there has been no substantive attempt to restrict program trading, particularly portfolio insurance techniques. At the same time, the Tokyo Stock Exchange launched a new stock index futures contract in September, and Germany and France made plans to do the same in 1989, in spite of the negative role US futures markets are alleged to have played in the market break, according to some reports.

The "high-yield" bond market has been little affected by the crash

The "high-yield" bond market. Another indication of the relatively modest impact of the sharp decline in equity prices in 1987 is the fact that in the United States the "high-yield" bond market was relatively unaffected by the break in equity prices. Yields on such bonds went up by about 1 percentage point during the month of October 1987, but the average spread over US Treasury securities with comparable maturities had returned to pre-crash levels by April 1988.

The junk bond segment is now a large part of the bond market

The so-called junk bond segment has become an established part of the US bond market. It is composed of non-investment-grade bonds, that is, bonds that cannot be held by banks as normal investments because of their substantial default risk. Such high-yield securities now represent about one-fifth of the outstanding stock of all corporate bonds in the United States.

The high-yield bond market is linked to the increase in leverage of the US corporate sector. Initially mainly a source of investment funds for less well-established enterprises, over time this market has become an increasingly important source of financing for so-called leveraged buy-outs (LBOs). This type of financial operation generated one-third of the high-yield bonds issued in 1988. In spite of the 1987 stock market crash and a number of other adverse shocks in 1988, the high-yield bond market has maintained its liquidity. The value of new issues in 1988 was over $30 billion, exceeding 20% of new corporate bonds issued for the third year running.

Yield spreads for high-yield bonds and other fixed income securities vary depending on market conditions and the perceived credit quality of the debt in question, but, on average, price volatility in the high-yield market has been comparable with that of investment-grade corporate bonds. Over the last ten years annual defaults have averaged only 2.2% of the outstanding stock, ranging from 0.2 to 6.7%. Even though these figures understate the default rate of individual bonds because of the rapid growth of their stock over the period, total returns on hypothetical junk bond portfolios which take this factor into account have consistently exceeded those on comparable portfolios of standard corporate bonds. However, as the high-yield market was much smaller during the last recession, it has not yet really been tested during a significant economic downturn.

Leverage and financing of non-financial enterprises

In December last year RJR-Nabisco, the tobacco and food giant, was purchased and taken private by a financing group for an unprecedented and previously unthinkable US$25 billion. No less than four-fifths of the finance for this LBO was in the form of debt, some 70% of which was vis-à-vis banks. The deal

marked a peak in the wave of mergers and acquisitions in the United States since the early 1980s, to which LBOs have made a growing contribution. It also represented the most conspicuous example of the increasing leverage of US non-financial corporations over the same period. As such, it focused attention on the implications of this process for financial vulnerability, for the efficiency and competitiveness of corporations and, finally, for the desirability of a policy response.

Only in the United States has leverage been rising ...

As shown in the table below, according to a commonly used measure of leverage (the ratio of debt to total assets at book value), the indebtedness of US non-financial corporations has indeed increased considerably since the early 1980s. Even if its present level does not differ markedly from that reached in the early 1970s, the recent upward trend has been particularly steep and has shown little sign of abating. This trend is, furthermore, unique to the United States amongst the countries in the sample.

... though remaining low by international standards

At the same time, the level of leverage of US corporations would appear to be relatively low by international standards, being more on a par with those in Canada and the United Kingdom than with the significantly higher levels in the remaining Group of Seven countries. While sample characteristics and accounting conventions may be partly responsible for some of the observed differences, it is doubtful whether they can invalidate the basic picture.

The uniqueness of the US developments is largely confirmed when equity is measured at market, rather than book, value (see the table opposite). In this case, the indebtedness of US corporations appears to have remained broadly stable in the 1980s in contrast to a generalised tendency for leverage to fall elsewhere, especially in Japan. The different behaviour of market and book value estimates mainly reflects the general buoyancy of stock market valuations since 1982. The figures confirm the basic distinction between relatively low-leverage countries, such as the United States, Canada and the United Kingdom, and the rest.

The factors contributing to the different levels of leverage between the two groups of countries have been the subject of considerable attention. It is

Ratios of gross debt to total assets (book values)

Countries	1970	1975	1980	1985	1986	1987
Low leverage						
United States[1]	0.49	0.45	0.44	0.48	0.50	0.51
United Kingdom[1]	0.53	0.54	0.53	0.53	0.53	n.a.
Canada[2]	0.54	0.61	0.59	0.58	0.57	0.57
High leverage						
Japan[2]	0.85	0.85	0.84	0.81	0.81	n.a.
Germany[2]	0.65	0.65	0.66[3]	0.63	0.62	0.60[3]
France[2]	0.66	0.70	0.69[3]	0.71	0.67	n.a.
Italy[4]	0.66	0.68	0.65	0.68[5]	n.a.	n.a.

[1] Non-financial corporations, consolidated or partly consolidated. [2] Private non-financial enterprises, partly consolidated or non-consolidated. [3] Break in the series. [4] Large manufacturing companies, non-consolidated. [5] 1983.

Sources: OECD Financial Statistics and national flow-of-funds statistics.

Ratios of gross debt to total assets (market values[1])						
Countries	1970	1975	1980	1985	1986	1987
Low leverage						
United States	0.45	0.52	0.50	0.50	0.49	0.51
United Kingdom	0.51	0.64	0.63	0.52	0.48	0.48
Canada	0.50	0.58	0.54	0.47	0.45	0.45
High leverage						
Japan	0.86	0.83	0.84	0.73[2]	0.63	0.59
Germany	0.72	0.76	0.81	0.71	0.70	0.77

[1] Private non-financial corporations (all producing enterprises for Germany) with total assets calculated as gross debt plus equity at market value. [2] Break in the series.

Sources: National flow-of-funds statistics and BIS estimates.

possible to point to the relatively early development of stock markets in the low-leverage group, as a number of institutional impediments retarded their growth elsewhere. However, at least since the early 1960s, the importance of the stock market as a source of finance in fact appears to have been lower in the United States, and probably in the United Kingdom, than in some high-leverage countries, suggesting relatively greater reliance on retained earnings. Alternatively, differences in the structure of corporate and personal tax rates might be a possible explanatory factor. But while one can find situations in which tax considerations have been important in determining financing decisions at the company level, at the sectoral level they would not appear to be the primary determinant of cross-country differences in leverage. At least on the basis of representative statutory corporate and personal income tax rates, there seems to be relatively little correlation between the ranking of countries in the sample in terms of the tax advantage of debt over equity and their observed leverage (see the table overleaf). Yet another possible explanation could be the relatively faster growth performance and therefore greater investment needs of high-leverage countries in the post-war period, coupled with the institutional limits to the availability of risk capital.

Some factors favour debt capacity in high-leverage countries:

Whatever the merits of the aforementioned factors, they fail to explain how enterprises in relatively high-leverage countries have been able to support significantly higher debt burdens. A number of structural features in those countries, largely related to the form of investor/company relationships, may in fact go some way towards providing an answer. Three such features are: the simultaneous holding of debt and equity claims; the smaller degree of fragmentation of equity and debt holdings; and government policy.

simultaneous equity and debt holdings

In both Germany and Japan banks have traditionally held significant equity stakes in non-financial enterprises (see the table on page 87). In Japan they hold about one-fifth of the total stock of shares. In Germany they only hold close to 10% but effectively control substantially more through the proxy voting system. In addition, in both countries the influence of banks is increased by the fact that between about one-third (Japan) and two-fifths (Germany) of the stock of shares is held by non-financial enterprises themselves. Banks may also be represented on the board of directors. Not only do these arrangements facilitate the monitoring of performance and the control of the borrowers'

Taxation and leverage, 1985

Countries	After-tax income ratios[1]		Ranking of tax advantage of debt relative to:		Ranking of leverage[2]
	Dividends/ interest	Capital gains/ interest	New issues	Retained earnings	
Low leverage					
United States	0.54	0.76	2	5	7
United Kingdom	0.68	0.72	6	4	6
Canada	0.66	0.67	5	2	5
High leverage					
Japan	0.49	0.63	1	1	1
Germany	1.00	0.82	7	6	4
France	0.66	0.93	4	7	2
Italy	0.61	0.71	3	3	3

[1] Ratio of income from equity (dividends or capital gains) to that from debt (interest) received by a representative individual investor in a company after payment of both corporate and personal tax. Values lower than unity indicate that debt finance is preferred to equity finance in the form of new share issues (dividends) or retained earnings (capital gains). The ratios were estimated on the basis of representative statutory tax rates. Tax rates on capital gains are adjusted for the deferral of the realisation of such gains. The estimates should be interpreted with caution as they do not take into account arbitrage opportunities and a variety of tax forms which may, directly or indirectly, affect leverage decisions (e.g. taxes on net worth and turnover taxes on securities markets). [2] Book values (see the table on page 84).

Source: BIS estimates.

policies, they also tend to reduce the credit institutions' incentive to force bankruptcy and liquidation at times of financial stress. They therefore provide an environment more favourable to leverage.

equity and debt concentration

The concentration of equity and especially debt claims among a relatively small number of investors may favour leverage by helping the resolution of financial crises. Such concentration tends to limit free-riding opportunities, i.e. the possibility of benefiting from the resolution of a crisis without incurring a proportionate burden of the cost. It may reduce the claimants' incentive to force bankruptcy (if creditors) or to abstain from injecting new funds (if equity holders). Concentration of creditor claims, in addition, may tend to promote longer-term relationships between borrower and lender which, by enhancing information flows, would make a financial institution more tolerant of leverage.

A number of indicators, indeed, point to a greater concentration of equity holdings in high-leverage relative to low-leverage countries (see the table opposite). In high-leverage countries, non-financial enterprises hold a major portion of the total equity stock and hostile takeovers are extremely rare. By contrast, in low-leverage ones, households' holdings are sizable and even institutional investors put a premium on diversification rather than control. With regard to debt, the limited reliance on securitised claims as opposed to loans from credit institutions in high-leverage countries is indicative of a smaller fragmentation of debt claims and a greater relative importance of longer-term relationships.

Evidence for Japan suggests that debt concentration has been particularly high there, with the "main bank" of a typical group of non-financial enterprises

(Keiretsu) nowadays providing between one-fifth and one-third of the group's borrowings, though the proportion was significantly larger in the 1960s. It is also noteworthy that the recent greater reliance on securities markets in Japan, partly in the wake of deregulation, has largely taken the form of issues of hybrid securities (convertible bonds and bonds with warrants) and has coincided with a reduction in leverage. Similarly, the general strengthening of the net worth position of enterprises during the 1980s has occurred at the same time as ties with credit institutions have weakened in a number of countries, notably Germany and Italy.

and government intervention

In at least three of the four high-leverage countries in the sample (Italy, France and Japan) government policy would seem to have been a significant additional factor accounting for greater debt capacity. The government has relied on credit institutions (especially those specialised in long-term lending) for the provision of assistance to industry in various forms, such as subsidised credit and/or government guarantees. It has also played an active role as owner or co-owner of enterprises, both financial and non-financial (Italy and France), in the pursuit of public policy objectives. This has at times permitted the underwriting of losses.

There is little evidence that the increase in US corporate indebtedness has been accompanied by a convergence towards those characteristics of high-

Indicators of financial structure, 1985

Items	Low-leverage countries			High-leverage countries			
	United States	United Kingdom	Canada	Japan	Germany	France	Italy
	in percentages						
Composition of companies' debt:[1]							
Domestic banks	32	62	40	53	73	58	56
Other domestic credit institutions	9	6	21	38	5	18	29
Securities	56	19	32	8	4	15	7
Other[2]	4	13	6	2	17	10	7
Total equity stock[3] held by:							
Non-financial enterprises	—[4]	10	1	30	43	41	66
Banks[5]	0	0	4	17	8	4	3[6]
Other financial institutions	28	52	21	22	9	8	3
Households	67	24	69	23	18	24	13
Government	–	5	2	0	9	10	9
Other[2]	4	10	4	7	13	13	5
Memorandum item:							
Stock market capitalisation (as a percentage of GDP)[7]	*49*	*64*	*43*	*57*	*24*	*13*	*13*

[1] Credit market debt, excluding trade credit. [2] Mainly non-residents. [3] Including financial as well as non-financial companies. For Japan, fiscal year. [4] Consolidated. [5] For the United Kingdom, monetary sector. [6] Only shares of financial companies. [7] In the presence of interlocking shareholdings the stock market capitalisation appears artificially high.

Sources: National flow-of-funds statistics, Tokyo Stock Exchange, Morgan Stanley International and BIS estimates.

leverage countries that would point towards greater debt capacity. During the 1980s there has been no shift away from capital markets towards credit intermediaries. In fact, between 1982 and 1988 the percentage of securities in total corporate credit market debt rose somewhat from 54 to 56%, and a growing proportion has been in the form of high-yield bonds. It is precisely debt-financed mergers and acquisitions, rare in high-leverage countries, that have largely driven the increase in debt. On some tentative estimates, about half of the growth in US corporate credit market debt between 1982 and 1988 may have resulted from merger and acquisition activity and over one-tenth from LBOs alone. Share repurchase programmes, often in response to takeover threats, have also played an important role.

These factors are not significant in the United States ...

At the same time, some elements of investor/company relationships which favour debt capacity can also be found in the United States. Not surprisingly, they appear in the most highly leveraged transactions, such as LBOs, where debt/asset ratios typically range between 80 and 95% on completion of the deal. The equity of the firm is closely held after the transaction among relatively few investors. In addition, some institutions are reported to hold debt and equity or equity-convertible claims simultaneously, though precise statistics are not available. However, the practice of selling portions of the original loan to reduce the agent bank's exposure (secondary participations), while protecting banks, results in a de facto fragmentation of creditors' claims which may not be conducive to a smooth resolution of situations of financial stress for the enterprise.

The moderation of the risk inherent in the leveraged structures partly relies on new financial instruments and on managements' and financial practitioners' judgement. Interest rate risk can be reduced through a greater use of financial innovations such as swaps, interest rate caps, futures and options. In the specific case of LBOs, hedging part of the exposure to interest rate increases is common and often required by banks as a condition for lending. Recession-induced cash flow risk may also be lower than is suggested by aggregate debt figures as the increase in indebtedness and leverage has been greater in comparatively less cyclically sensitive sectors, such as non-durables. Some 60% of LBOs have reportedly taken place in such sectors, notably food and tobacco and the retail trade, since one of the primary characteristics of LBO targets is cash flow stability.

... but other elements moderate risk

Ultimately, the underlying increase in the ability to support debt, especially in highly leveraged transactions, largely turns on the extent to which the new structures will promote greater profitability. The stream of contractual payments associated with higher debt could restrict managers' discretion to pursue non-profit-oriented goals by forcing them to sell off assets which are more valuable in alternative uses or to come under the closer scrutiny of capital markets when in need of investment funds. The larger equity stakes held by managers in management-initiated LBOs (about one-fifth of all LBOs) could also make them more sensitive to profit considerations and allow them to capitalise on their presumed superior information about the company's potential value. However, empirical evidence on the profitability of higher leverage is still mixed and preliminary and not such as to allay concerns

Vulnerability to an economic downturn is a valid concern

about the viability of companies restructured through highly leveraged operations in a more unfavourable economic environment. From this perspective, the unprecedented number of downgradings in the credit rating of corporations in a period of relatively strong economic growth is not particularly encouraging.

Policy issues

The higher leverage of non-financial corporations raises questions of policy with regard to both enterprises and the financial system. At the enterprise level, to the extent that a riskier financial structure is perceived as undesirable, it would appear appropriate to move in the longer run away from a taxation system which subsidises leverage towards one which is more neutral with respect to financing choices.

At the level of the financial system, the main concern is the risk exposure of the US banking system. It had been estimated that by end-June 1988 some 10% of the outstanding stock of commercial and industrial bank loans was LBO-related. Typically, if bridge loans are excluded, the maturity of LBO loans ranges from around four to nine years, but it is unclear what proportion of these longer-term loans is ultimately held by US as opposed to foreign banks. Admittedly, suggestions that the kind of crisis experienced with the developing countries' debt may be repeated are misleading, not least because of the greater degree of control over borrowers' policies and the collateral requirements requested by banks. At the same time, the novelty and complexity of the financial arrangements involved and the fact that they have not as yet been tested in unfavourable economic conditions call for close prudential supervision. The supervisory authorities have already taken some steps in that direction, mainly by stepping up monitoring.

Issues outside the United States

Highly leveraged acquisitions have not been widespread outside the United States. The only partial exception has been the United Kingdom, where LBOs have been growing in number and size, though they are still dwarfed by operations in the United States; it is estimated that in 1988 over 300 LBOs may have involved not much more than US$5 billion. However, foreign bank participation in US LBOs has been growing along with the size of the deals. Japanese banks in particular have been quite active recently, having reportedly provided about 45% of the bank finance for the largest LBO deal to date.

Although highly leveraged transactions have been rare, a wave of corporate restructurings has also swept Europe. In contrast to experience in the United States, these operations have been mainly motivated by longer-term strategic concerns, have predominantly resulted in larger firms, have often increased concentration in fragmented sectors and have rarely been hostile in nature. The existing high leverage levels, which narrow the scope for further increases, the numerous regulatory and institutional barriers to hostile, especially international, acquisitions and, possibly, the prospects of a single market by end-1992 have been the main forces shaping the process. The prospect of 1992 will presumably give further impetus to the restructuring wave. It has also raised awareness of the need for greater uniformity across countries in the regulatory framework governing takeovers, especially those opposed by existing managements.

Regulation of banks' financial structure

In July 1988 the Committee on Banking Regulations and Supervisory Practices of the Group of Ten countries and Luxembourg (the "Basle Supervisors' Committee") agreed on a framework for achieving international convergence in the measurement of banks' capital and in capital standards (referred to here as the convergence agreement). The origins of this agreement can be traced back to the early 1980s, when bank supervisors in several Group of Ten countries were confronted with a substantial deterioration in the quality of banks' loans to developing countries and with rapid financial liberalisation which tended both to increase competition among banks and to enlarge their scope for taking on high-risk assets. At the same time bank leverage ratios in some countries were at historically high levels. As a result, bank supervisors became convinced of the need to strengthen banks by raising capital standards.

New international agreement on banks' capital adequacy

Initial efforts in this direction, based on simple leverage ratios in some countries and on balance-sheet risk asset ratios in others, met with some success. However, it soon became apparent that further progress would require both a more sophisticated measure of capital adequacy and a greater degree of co-ordination among supervisors in different countries. The more sophisticated measure was required to help limit any tendency for tighter capital standards to have an adverse effect on bank portfolio choices. For example, the use of a simple leverage ratio had been found to discourage banks from holding low-risk liquid assets, while measures based solely on balance-sheet items had encouraged them to substitute off-balance-sheet exposure for conventional assets. Greater international co-ordination was necessary to prevent differences in national capital definitions and requirements from increasing competitive inequalities among banks from different countries as standards were raised.

The convergence agreement sought to meet these requirements by establishing a common framework among the Group of Ten countries for measuring the size of a bank's capital and setting minimum standards for its adequacy in relation to the bank's credit exposure.

Equity capital is given special emphasis

In defining bank capital the agreement makes an important distinction between "core capital", comprising shareholders' equity and disclosed reserves, which must account for at least half a bank's total recognised capital, and "supplementary capital", comprising other types of reserves and various debt instruments. Core capital is given special emphasis because it is uniformly recognised as the highest-quality capital, having a known, and relatively stable, nominal size and being available to absorb losses while a bank continues as a going concern. The relative contribution of core capital to a bank's total funding is a key variable determining its shareholders' decisions, particularly their preferred choice in the trade-off between portfolio risk and return.

Assets are risk-weighted

A bank's credit exposure is assessed under the convergence agreement by weighting and then summing various broad categories of asset and off-balance-sheet exposure. The weights, which are for the most part specified in the agreement, are chosen according to the perceived credit risk of the exposure categories. Finally, a bank's capital adequacy is measured by the ratio of its

recognised capital to its aggregate risk-weighted credit exposure. The convergence agreement lays down a transitional timetable of minimum levels for this ratio, culminating in an 8% ratio by the end of 1992.

The basic principles will be widely applied

The terms of the convergence agreement apply only to internationally active banks from the Group of Ten countries and Luxembourg. However, parallel decisions by various national supervisors will mean in practice that the basic principles are applied in a wide range of countries outside the Group of Ten. The United States and the member countries of the European Community intend to apply the basic principles of the agreement to all banks. In Japan the agreement's provisions will be mandatory only for thirty-five banks with overseas subsidiaries or branches, while other banks, including most "regional" banks, will have the option of conforming to existing domestic capital adequacy regulations.

Only credit risks are covered

At present the convergence agreement covers the adequacy of capital in relation only to credit risk and not to the various forms of market risk, such as interest rate or foreign exchange position risk. It is also important to note that, for practical reasons, the measurement of capital is largely based on book valuations of assets and liabilities. However, the possible inclusion of part of the unrealised capital gains on equity holdings in supplementary capital means that fluctuations in the market value of assets may in some cases have a significant impact on the size of banks' recognised capital.

Some consequences are already visible

The Committee first published its proposals on bank capital in December 1987, while the move towards an international agreement on risk-based capital adequacy had begun well before that. Thus, although national supervisors have only recently begun to implement the convergence agreement, it is already possible to discern some consequences of the underlying methodology. For example, Japanese banks were given permission to raise new equity through domestic convertible bonds in 1987. In Japan and France the authorities have made it easier for banks to securitise certain types of asset, while in the United States issues of asset-backed securities rose by more than 50% in 1988 to reach $15.3 billion. Reports suggest that Japanese banks are phasing out the system of compensating balances, are channelling a larger share of funds into zero-risk-weighted government bonds and are increasing the use they make of government guarantee programmes.

Estimates of additional capital required

At the time the convergence agreement was announced, various estimates were made of the amount of new core capital that banks in individual countries would need to meet the final 8% ratio. Estimates of this kind are highly sensitive to the assumptions made regarding future balance-sheet growth and provisions for bad debt. In the United States it appeared that most small banks and "super-regionals" would easily meet the 8% minimum, as would several money centre banks. However, the aggregate requirement for the twelve or so largest US banks was variously estimated at between $5 and 15 billion. Projections for the thirty-five internationally active Japanese banks put their combined requirement for new core capital in the range of Yen 6,000 to 8,000 billion (some $45 to 60 billion). A figure of this magnitude now seems achievable in view of the strength of the Japanese stock market and the fact that Japanese banks appear to be more highly rated by their local market than

banks in some other countries. In the year to March 1989 major Japanese banks were able to raise a total of Yen 3,700 billion in new shares and convertible bonds. Major banks in the United Kingdom, Germany and Switzerland were also expected to have little trouble in meeting the 8% ratio. However, some banks in France which are publicly owned may face difficulties in raising the required additional capital because of limitations on their access to new private equity.

How banks should be strengthened

Higher capital standards should strengthen individual banks in two main ways: by increasing the size of the cushion for a bank's creditors against losses, whether the bank continues as a going concern or is forced into liquidation; and by reducing the attractiveness of high-risk investments for a bank's shareholders. The second mechanism hinges on the interaction between capital standards and other forms of government intervention in the banking industry.

In view of the vital economic importance of a country's banking system and the need to maintain the confidence of bank depositors, governments in many countries have made provision, for example through deposit insurance schemes or the availability of emergency liquidity support, to prevent bank runs from occurring unnecessarily and to minimise the damage to the financial system should one occur. However, by partially insulating bank creditors from some of the risks associated with banks' investment decisions, such government activities may tend to interfere with normal market forces.

In particular, creditors may become less sensitive to the tendency for a profit-oriented bank to choose high-risk investment projects with the potential for high returns. Shareholders benefit from the choice of such investments since they enjoy the full return if the investments prove successful but experience a limited loss in the event of failure. Creditors would normally check this tendency by demanding higher yields as the default risk of a bank's portfolio rises. However, in the presence of a safety net, the costs of failure and therefore the task of monitoring and controlling bank risk are, in part, transferred to official regulators.

Regulators employ four main techniques to perform this task: they collect extensive information on banks' activities; they impose direct restraints on the business that banks are allowed to undertake, such as large-exposure limits and, in some countries, restrictions on securities or insurance activities; they insist that a bank's management should be experienced and competent and therefore inclined to exercise a certain degree of self-discipline in its pursuit of increased shareholder wealth; and they use capital standards to ensure that the proportion of a bank's risk borne by shareholders does not fall below a certain minimum level. Raising capital standards increases this proportion and therefore reduces the benefit to a bank's shareholders of high-default-risk investments. The analysis of the US thrift crisis in the following section clearly illustrates how financial institutions benefiting from certain types of government support may develop a dangerous appetite for high-risk projects if they are allowed to operate without adequate capital and supervision.

The convergence agreement could also contribute to a moderation of risk-taking behaviour as a result of the greater competitive equality that it establishes between banks of different nationalities. This could help put an end

to the situation in which a bank which finds itself at a competitive disadvantage in its traditional markets, owing to a relatively high capital requirement, may feel compelled to take on higher-margin and hence riskier business in order to survive.

Some concerns have been voiced:

Although the basic rationale for the convergence agreement has been widely accepted, a number of concerns have been voiced. These are: that the agreement will increase the costs of bank intermediation, thereby putting banks at a competitive disadvantage vis-à-vis non-bank intermediaries; that, through the use of a set of published risk weights, it will result in a system of official credit allocation; and that it will increase rather than decrease risk-taking by banks.

increase in banks' financing costs

One consequence of explicit or implicit governmental support to banks is to make debt a particularly attractive form of finance for them. This is because creditors do not require banks to compensate them for the part of their risk which is assumed by the government. Since a higher capital ratio reduces the extent to which a bank can rely on debt finance, the argument that the convergence agreement will tend to increase bank costs is well-founded. However, the resulting competitive position of the banking industry may well be more in line with that which would exist if government intervention, in the form of prudential regulation and the safety net, were not necessary.

risk of credit allocation

The new system of risk asset weights is indeed likely to have a significant impact on banks' portfolio decisions (see also Chapter V). However, it is surely less distortionary than a simple leverage ratio that applies equal risk weights to all exposures. In addition, the convergence agreement merely seeks to establish minimum standards of capital adequacy, while the system of risk asset weights is to serve as only one of the tools that supervisors will use to control and respond to changes in bank portfolio risk. Thus a bank which attempts to exploit the simplicity of the weighting system by systematically choosing assets with high risk return characteristics but low capital weights is likely to find at least in some countries that its local supervisor will require it to maintain a capital ratio higher than the minimum stipulated by the convergence agreement. Provided supervisors are careful not to rely too heavily on the new system's ability to respond automatically to changes in banks' risk-taking behaviour, and provided banks fully understand the way in which the system is designed to work, the risk that a system of official credit allocation will emerge would seem to be modest.

and impact on banks' risk-taking

A priori, one cannot be certain what effect the convergence agreement will have on a bank's risk-taking behaviour. This will depend on a variety of factors, such as the bank's size, the objectives of its management and shareholders, the nature of the official safety net and of the regulatory system that applied before the agreement was implemented, the terms on which the bank can obtain access to new capital and its comparative advantage in financial intermediation vis-à-vis non-banks. One concern is that, by increasing the costs of bank intermediation, higher capital standards may encourage the trend towards the securitisation of financial assets. Since high-quality assets tend to be the most amenable to securitisation, a reduction in the average quality of bank assets could potentially result. Nonetheless, the earlier discussion of the

expected effects of the convergence agreement established some strong arguments to the effect that banks' incentives to take on risk would generally be reduced by an increase in capital standards.

The US thrift industry crisis

In 1988 the problems of the US savings and loan ("thrift") industry became a matter of general concern. The savings and loan industry, which specialises in mortgage lending, primarily for residential housing, is made up of roughly 3,000 institutions with assets of $1,300 billion, or about 30% of the assets of all US depository institutions. At the beginning of 1988 515 savings and loan associations, with almost one-sixth of the industry's assets, were insolvent. In the course of 1988 the Federal Savings and Loan Insurance Corporation (FSLIC) incurred liabilities valued at roughly $40 billion in closing or subsidising the sale of over 200 failed institutions whose liabilities were backed by FSLIC deposit insurance. Despite this, in early 1989 the Federal Home Loan Bank Board (FHLBB), the principal regulatory agency for the savings and loan industry, estimated that an additional 580 institutions would require Federal financial assistance costing about $38 billion.

Magnitude of the thrift industry problem

The incoming Administration faced two problems in this area. Firstly, funding had to be provided for both the liabilities that the FSLIC had incurred in 1988 and for those that would be incurred in dealing with the remaining thrifts in difficulties. The Administration has therefore proposed a $90 billion refinancing package for the FSLIC to meet these needs.

Administration's proposal for reform

Secondly, adequate safeguards had to be put in place to avoid a repetition of the crisis. The performance of savings and loan associations over the last eight years has revealed a variety of weaknesses in the industry's regulatory framework and, in response, the Administration has proposed major modifications. The responsibility for managing the provision of deposit insurance for thrifts would be transferred to the Federal Deposit Insurance Corporation (FDIC), the independent agency that provides deposit insurance for US commercial banks. The insurance funds for commercial banks and savings and loan associations would remain separate, however. The independence of thrift regulators would be curtailed by placing the FHLBB under the supervision of the US Treasury in the exercise of its remaining responsibilities. In addition, thrifts would be made subject to a system of risk-based capital standards comparable with those applicable to commercial banks. At the time of writing, Congress seems likely to accept the basic proposals but to moderate the tightening of capital standards.

The performance of the industry prior to the 1980s was satisfactory. The total losses of the FSLIC during the period 1934–79 were only slightly more than $300 million. By contrast, its losses in the 1980s are likely to be more than 200 times that amount. Significant problems for the industry first emerged in 1980. Since at that time 80% of its assets were fixed rate mortgages, while its liabilities were primarily short-term deposits, the unprecedented increase in nominal interest rates generated tremendous losses. As interest rates declined from 1982 onwards, much of the industry recovered,

Historical causes of the crisis:

interest rate shock

but a significant number of institutions remained both insolvent and unprofitable.

Insolvent thrifts could continue to attract deposits because of their access to deposit insurance. The number of insolvent, but open, institutions increased from eighty-five at the end of 1981 to 237 at the end of 1982 and to 445 at the end of 1984. But while the regulators closed sixty-three institutions in 1982, only thirty-six were closed in 1983 and twenty-two in 1984.

There were two main reasons why regulators adopted a policy of forbearance, i.e. of allowing insolvent institutions to continue to operate, during this period. Firstly, the funds available in the insurance fund probably would not have been sufficient to cover the liabilities that would have been incurred by closing all insolvent thrifts. At the end of 1982 the FSLIC had total reserves of $6.3 billion. At that time 237 institutions were insolvent according to the Generally Accepted Accounting Practices (GAAP), with GAAP net worth of −$2.2 billion, over $6 billion in non-performing assets and an estimated market value of some −$11 billion. Secondly, as the performance of the industry as a whole was improving, regulators were encouraged to believe that by allowing marginal institutions to continue to operate the problems would diminish.

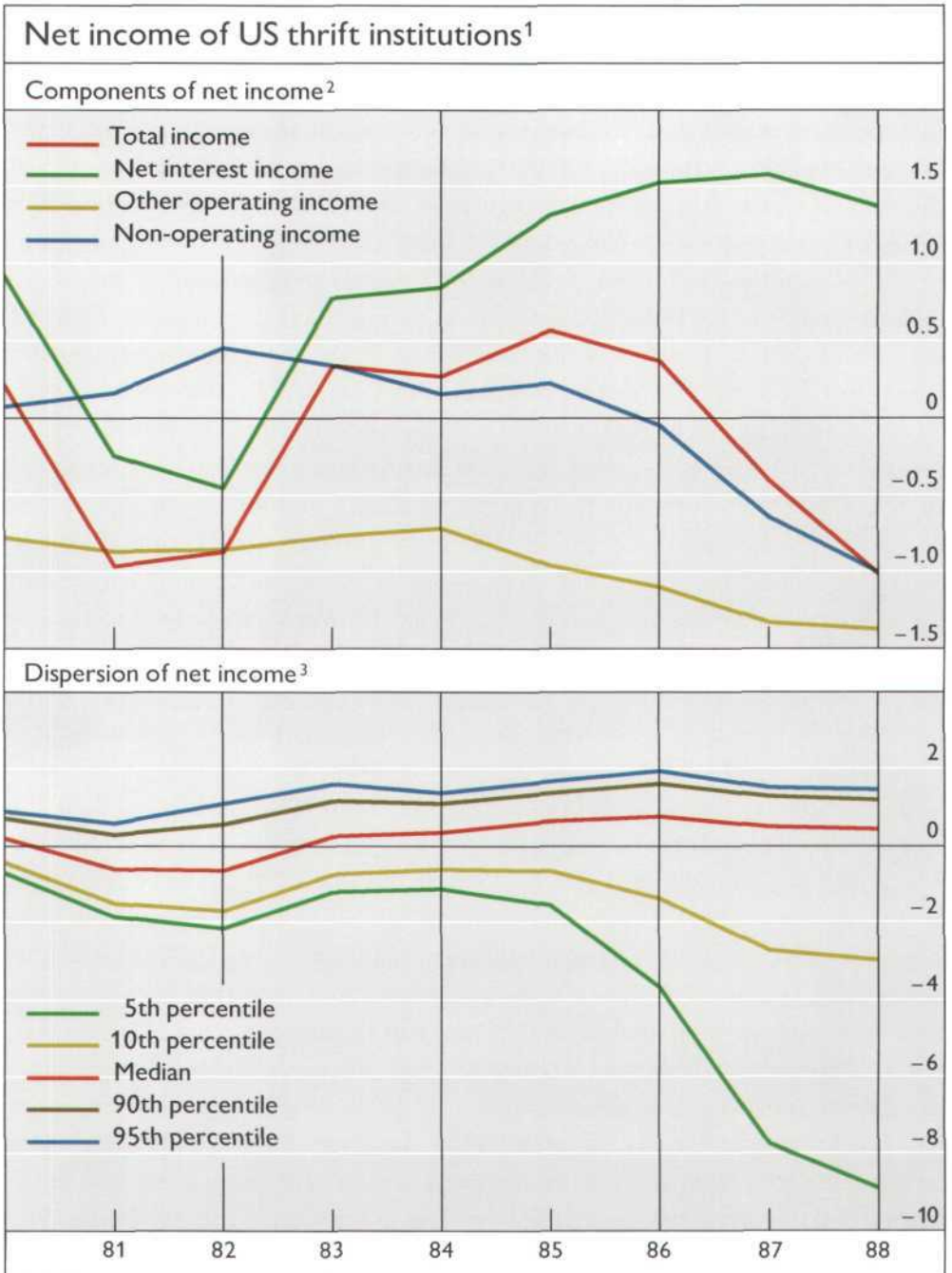
failure to close insolvent thrifts

Instead, they only worsened. Although the profitability of the industry as a whole improved further up to the end of 1985, the number of insolvent institutions increased steadily, reaching 470 at the end of 1985 and 515 at the end of 1987. The share of assets held by insolvent institutions rose from over 9% at the end of 1982 to close to 15% at the end of 1987. In addition, the profitability of marginal thrifts deteriorated sharply from 1986 onwards. The lower panel of the graph overleaf indicates that at the end of 1986 the worst-performing 5% of thrifts were making losses at an annual rate exceeding 2% of their assets, while by mid-1988 that rate had risen to over 8%. By contrast, the median performance for the industry was relatively stable, with earnings being positive throughout this period.

Unlike the situation in the early 1980s, however, the large losses incurred by thrifts since 1985 were caused almost exclusively by a decline in asset quality. As shown in the upper panel of the graph, while the 1981 and 1982 losses stemmed from a shortfall in net interest income, reflecting the interest spread problems associated with the sharp increases in thrifts' cost of funds, more recently they have resulted primarily from a decline in net non-operating income, reflecting almost exclusively credit losses.

By the beginning of 1988 it had become increasingly obvious that the failure to close insolvent institutions was actually increasing the losses that the insurance fund would have to cover. In addition, past reliance on historic cost accounting had led to a significant underestimation of the asset quality problem. In response, regulators dramatically stepped up thrift closures in 1988. In that year 205 institutions were closed and another eighteen were given assistance at a total cost of $38 billion. This expenditure was financed almost entirely by the issuance of a variety of FSLIC liabilities.

There are three main reasons for the decline in quality of the assets of US savings and loan associations in the second half of the 1980s. Firstly, in 1983



[1] All FSLIC-insured institutions. [2] Annual income as a percentage of average assets; 1988 data are the first two quarters at an annual rate. [3] Fourth-quarter income at an annual rate as a percentage of average assets; for 1988, second-quarter data.

and 1984 a number of institutions attempted to restore their profitability by rapidly expanding their balance sheet and increasing the expected rate of return on their assets. In these two years the assets of the industry grew by 40%, or roughly double the rate of growth of both commercial bank assets and nominal GNP over the same period. In order to achieve this rapid growth in assets, however, it was necessary in many cases to lower underwriting standards significantly.

unsound growth policies

Secondly, declines in agricultural land prices associated with the moderation of inflation in the early 1980s and the significant fall in oil prices in late 1985 caused severe economic problems in the south-western part of the

adverse economic shocks

United States. These regional economic problems had a considerable impact on savings and loan associations and banks in that area because restrictions on interstate banking made it difficult to diversify assets regionally.

fraud

Finally, fraud was widespread among thrifts in difficulties. Much of the alleged fraud is related to the excessive concentration of lending to borrowers who were, in some way, connected with the management of troubled institutions. A study of thrifts closed in 1988 indicated that there had been significant violations of restrictions on loans to one borrower and on self-dealing in about half of the cases that generated the largest losses for the FSLIC.

The excessive risk-taking in the US savings and loan industry during the 1980s is a clear example of the moral hazard problem that is generated by government support for depository institutions. Given the losses they had already incurred, after 1982 the owners of some thrifts believed that there

moral hazard

was little hope of restoring the profitability of their institutions by following conservative banking practices. Undertaking high-risk projects and rapid growth by, in effect, leveraging the market value of deposit insurance appeared to be the only strategy that offered any hope of obtaining a positive return on their previous investments. Those responsible for supervising and regulating the industry failed to restrain this activity, either by closing insolvent institutions or by using their authority to limit risk-taking.

To a significant degree, this failure can be attributed to a certain incompatibility between the objectives of government intervention in the industry and to the concentration of the responsibility for implementing that intervention in

and flaws in the regulatory structure

a single independent agency, namely the FHLBB. The FHLBB has three sets of responsibilities: it is the principal regulator and supervisor; it administers the provision of deposit insurance through its oversight of the FSLIC; and it manages the provision of subsidised credit to thrifts through the Home Loan Bank System. Thus, while the principal function of the Home Loan Bank System is to promote the industry, one of the FSLIC's main objectives should be to limit excessive risk-taking. The dual responsibilities of promoting and restraining the savings and loan industry mean that the FHLBB does not have a clear institutional objective to guide its actions.

The experience of the US savings and loan industry over the last eight years has also brought to light other flaws in the regulatory structure for the industry. Firstly, in the early 1980s access to thrift deposit insurance was expanded and capital standards were significantly lowered. These changes were intended to mitigate the severe, but temporary, profitability problems that virtually all thrifts were suffering at that time, but they made it possible for a small segment of the industry to pursue the high-risk strategies that resulted in many of the problems faced today.

Secondly, inadequate insurance premium levels and the absence of an alternative source of financial support for deposit insurance liabilities made it more difficult to resolve the industry's problems. When potential losses overwhelmed FSLIC reserves in the early 1980s, regulators could not easily find the funds that would have been needed to close all insolvent associations.

Thirdly, in order to maintain access to the benefits of a thrift charter, primarily preferential tax treatment, savings and loan associations must hold a

large proportion of their assets in the form of mortgages. The continuing preference of US mortgage borrowers for fixed rate loans complicates the management of the exposure to interest rate risk. Since the early 1980s regulatory changes and increased attention to the problem by thrift managements have diminished, but not eliminated, thrift exposure to interest rate risk. This suggests that the maintenance of a separate system of banking institutions dedicated to real estate lending may be a costly method of promoting housing finance. Finally, restrictions on interstate banking in the United States may increase solvency risk in the banking system by making it difficult for banks to diversify their assets regionally.

It is worth noting that although the scale of the problems of the US thrift industry is unique, their fundamental nature is not. For example, the French authorities faced similar issues last year in dealing with two failed banks. The problems of moral hazard arise whenever public attempts to ensure the viability of financial institutions encourage risk-taking activities whose potential costs are not fully borne by the institutions' creditors. Adequate supervision and capitalisation reduce the potential public cost of such behaviour.

Developments in London's securities markets since the "Big Bang"

Objectives of the "Big Bang"

The reform of the London Stock Exchange's membership rules and market-making practices, known as the "Big Bang", was completed in October 1986. Its main objective was to increase the level of competition in London's domestic markets for equities and government securities ("gilt-edged stock") in the expectation that this would lower intermediation costs, help check the growth of off-exchange trading, stimulate the development of UK-owned financial institutions and safeguard London's status as an international financial centre.

Considerable progress was achieved after one year...

By the summer of 1987 considerable progress appeared to have been made in attaining these goals. A number of indicators, such as turnover volumes, commission rates, dealing spreads and the number of market-makers per stock, suggested that the quality of equity and gilt markets had improved substantially. There had been a large influx of foreign-owned intermediaries both to the markets directly affected by the reform programme and to various other financial markets based in London, while several UK-owned integrated investment banks had taken shape. London had succeeded in attracting a significant proportion of the secondary market in certain equities and government securities issued in other parts of Europe. Indeed, back-office settlements were the only area in which progress did not appear to be satisfactory.

... but ground has been lost since the crash

However, developments since the October 1987 crash have called many of these achievements into question. In the equity markets the value of turnover has declined substantially and, according to some indicators, quality has deteriorated. At the same time, lower commission revenues and market-making losses have left firms with high fixed costs heavily exposed. According to one estimate, aggregate losses for equity market-makers were running at £500–600 million per annum at the start of 1989. In addition, partly as a result of difficult market conditions, gilt-edged market-makers had by the end of

1988 run up combined accumulated losses equivalent to 30% of their capitalisation in October 1986.

In response, some firms have withdrawn altogether from particular markets, while others have cut back the scale of their activities. There have also been calls for a reform of market practices with a view to increasing the underlying profitability of market-making. The Stock Exchange has reacted by removing the obligation on equity market-makers to deal with each other at their publicly quoted prices and by allowing large trades to be reported the following day rather than immediately. No changes have been made in the obligations of gilt-edged market-makers.

Three possible reasons for the deterioration in performance

One interpretation that can be put on these developments is that the London market is merely suffering from a worldwide retrenchment in securities markets triggered by the crash and reflecting over-expansion during the 1982–87 equity bull market. This view is supported by developments in the United States, where the securities industry has experienced substantial net job losses and some foreign intermediaries have withdrawn as primary dealers in US Treasury securities. Another possible interpretation is that the London market is experiencing unique external pressures such as the competitive consequences of the modernisation of securities markets in continental Europe and the side-effect on domestic markets of the long-expected retrenchment in the Euro-bond market.

Finally, it could be argued that the Big Bang method of liberalisation would have generated a pattern of rapid expansion in the London securities markets followed by a shake-out even in the absence of the crash or other external pressures. The Big Bang approach contrasts with other liberalisation strategies, notably that adopted in Japan, where each step is graduated so as to minimise the disruption caused to the competitive standing of different types of intermediary. On the one hand, the Big Bang approach has the advantage that it allows market forces to determine the number and composition of intermediaries in each market and may enable the authorities to focus more clearly on establishing high standards for the functioning of markets. On the other hand, there is a risk that the losses incurred by intermediaries during the adjustment process could result in fewer market-making resources being available once the equilibrium market structure is finally established than would have been the case with a more graduated approach to liberalisation. This danger is exacerbated by the possibility that the authorities may initially underestimate the costs to practitioners of maintaining certain standards of transparency and liquidity.

The single European market in financial services

The programme to create a single market within the European Community by the end of 1992 comprises some 300 detailed and wide-ranging regulatory measures designed to facilitate the free flow of goods, services, labour and capital within the twelve member countries of the Community and thereby realise the economic benefits of greater competition, economies of scale and economies of scope. Over half of the proposed reforms have already

been agreed upon. However, many of the most difficult issues remain to be settled.

Financial services are a key element in the single market programme

The financial services sector, comprising banking, insurance and investment services, may prove to be one of the most important elements of the single market programme. It has been estimated that the medium-term benefits of the reforms in this sector could amount to 1.5% of Community GDP, one-third of the total expected benefits from the programme.

The proposed single market measures relevant to financial services can be grouped under four headings: prudential supervision, capital movements, merger policy and taxation. The various draft directives on prudential supervision are at an advanced stage of development, while the directive on capital movements setting down a timetable for the complete abolition of exchange controls in most member countries was agreed upon in June 1988. By contrast, the likely shape of future agreements on merger policy and the harmonisation of taxes (notably VAT, profits tax, withholding tax and turnover tax) is still uncertain. Monetary control instruments, such as reserve requirements, are not covered by the single market legislation.

The new system for prudential supervision

The draft Second Banking Directive, which sets out the proposed system of banking supervision, is based on three concepts: firstly, "home country control" implemented through a single Community-wide "passport" enabling banks licensed in any one member country to establish branches and provide services in all member countries; secondly, a broad list of banking activities (excluding, however, insurance) to which the passport will apply; and, thirdly, the harmonisation of "essential" supervisory standards, notably the definition of capital and application of minimum capital adequacy ratios. The draft Investment Services Directive, whose main function is to provide for the supervision of non-bank securities firms, follows similar principles (though responsibility for administering conduct of business rules in securities markets is left with host country authorities). By contrast, the single passport concept applies to the insurance industry only in the case of large-scale business carried out across borders. The establishment of branches and the cross-border insurance of small-scale risks is still subject to authorisation by individual member countries.

Some likely consequences

The system of supervision described above is designed to improve access for financial institutions to individual national markets by eliminating the need for multiple authorisations and minimising the regulatory overlap between national supervisors. The fact that significant differences between member countries' regulatory practices will remain is in line with the methodology underlying the whole single market programme and reflects a deliberate policy. However, it is recognised that further harmonisation may be necessary if such differences lead to serious market distortions.

The proposed framework for prudential supervision is likely to act as a catalyst in the process of structural change in European financial markets. For example, universal banks authorised to conduct securities underwriting or leasing business in their home country will, under the terms of the single licence, be able to carry out such activities in all other member countries, even those which at present do not allow their own banks to engage in them.

Consequently, it seems likely that the unified market will tend to converge on the universal banking model. However, this trend may not extend to the holding of long-term participations by banks in non-financial enterprises, since the draft legislation limits individual holdings to 10%, and combined holdings to 50%, of a bank's capital.

More generally, the establishment of new cross-border links between EC banks based on mutual shareholdings has already emerged as a possible trend, as has the establishment of new links between banks and insurance companies. However, the potential for outright acquisitions appears to be rather limited. It has been estimated that only one in eight of the top 162 banks in Europe are potential acquisition targets.

The external dimension

Considerable controversy has surrounded the external dimension of the European single market. Non-EC countries and enterprises have expressed the fear that liberalisation within the Community might be accompanied by an increase in trade barriers vis-à-vis the rest of the world, a view that has been firmly rejected by both the Commission and the EC member countries. Financial services in general, and the Second Banking Directive in particular, have had a central position in this debate because the draft directive was the first single market proposal to incorporate a reciprocity clause.

The proposed banking reciprocity clause ...

Under the Commission's most recent proposal, the Second Banking Directive's reciprocity clause would give the Commission the power to limit or suspend the establishment or acquisition in the Community of new banking subsidiaries by non-EC parent institutions if it was not satisfied that Community banks enjoyed "genuine national treatment" in the home country of the parent institution – that is, the same treatment as domestic banks. Where national treatment was granted, but in the Commission's view this did not provide the same market access and competitive opportunities as granted by the Community to non-EC banks, the Commission might seek to initiate negotiations with the country concerned. The Commission has also indicated that the reciprocity clause would not be applied retroactively to non-EC subsidiaries established before 1993, nor would it be used to force other countries to adopt a financial structure similar to that of the Community. At the time of writing, the member countries have not yet decided on the form the reciprocity clause should take, or whether a clause of this kind should be incorporated in the Directive at all.

... is a source of controversy

Almost all EC countries currently have some reciprocity powers in the field of financial services (though in some cases these relate only to insurance business). Such powers are also to be found in Canada, Switzerland, Japan and in some states of the United States, though at the federal level the United States applies a policy of unconditional national treatment for foreign-owned banks. The establishment of reciprocity powers at the Community level can to some extent be seen as maintaining the status quo, since the availability of the single European passport to non-EC-owned banking subsidiaries will greatly weaken the effectiveness of reciprocity policies maintained by individual member countries. On the other hand, there could be risks involved in the establishment of any new reciprocity powers at the Community level, even when the underlying intention is to further the process of international

financial liberalisation. Other countries may retaliate, while, if either side were to take action in a specific case, a vicious circle could be triggered entailing progressive restriction of market access.

A possible solution to this problem may emerge from the current round of negotiations within the GATT, which is seeking to establish a multilateral framework covering trade in financial services. If successful, this may reduce the scope for bilateral reciprocity negotiations. In addition, independent reforms in major financial markets outside the European Community, such as the gradual elimination of restrictions on interstate branching in the United States and the possible further relaxation of restrictions on banks' securities powers in the United States and Japan, may help reduce the potential for policy conflicts as the process of global financial integration continues.

V. International financial markets

Highlights

Although the stock market crash was widely believed to presage a stagnation of the international financial markets, these expectations did not materialise. After the slump in the final months of 1987, issue activity in the international bond market surged again to high levels in 1988. The growth of international bank lending slowed down somewhat from the unusually rapid pace recorded in 1987 but remained strong by any standard. Excluding exchange rate effects, double-counting and redemptions, the total amount of new credit intermediated by the international financial markets can be estimated at $315 billion. This was $65 billion less than the growth recorded in 1987, but well above the average of the preceding years.

A number of general factors and some specific influences shaped the growth of the international financial markets in 1988. The broad and unexpected upswing in world economic activity and the related expansion of trade flows sustained international credit demand in spite of the sharp rise in short-term interest rates. The recovery of stock markets, the exuberance of merger and acquisition activity and the banks' demand for capital resources in response to the new international supervisory guidelines also boosted borrowing demands. In addition, uncertainties surrounding regulatory and tax provisions contributed to large shifts of business from the domestic to the international markets. On the other hand, in contrast to 1987 the financing of the current-account imbalances amongst the major industrial countries largely bypassed the international banking and bond markets.

In some respects activity last year was less buoyant than suggested by the gross credit aggregates. Trading volumes in the secondary market for international securities declined sharply, in spite of the rebound of new issues. Final lending was heavily concentrated on particular groups of borrowers. Against the background of the ongoing transformation of the character of financial services, changes in the regulatory and tax environment and low profitability in many areas of financial intermediation, banks and other financial institutions reassessed their commitment to the various markets. Particularly in the international banking sector, growth was almost entirely accounted for by Japanese institutions, whereas there was much retrenchment elsewhere.

From the point of view of the international debt situation, 1988 was an eventful but also somewhat disappointing year. Despite an unusually favourable international environment, the economic condition of many debtor countries, notably in Latin America and sub-Saharan Africa, continued to deteriorate. In several of these countries inflation accelerated and per capita incomes declined further. Worsening terms of trade and the sharp rise in dollar interest rates

added to the real weight of the debt service burdens. Investment activity has stagnated and the prospect of the heavily indebted countries growing out of their problems has become more remote. As a result, discussions have increasingly focused on outright debt relief. At first debt reductions were mainly an element in banks' negotiations with debtor countries and were largely based on market incentives. More recently an initiative of the Secretary of the US Treasury proposed the use of IMF and World Bank resources for encouraging and financing such deals. Although the exact outline of this new strategy is not yet clear, it has set the official seal on debt relief and boosted the expectations of the debtor countries. Whatever the details of its implementation, this new initiative is bound to have a profound impact on the future topography of the international debt situation.

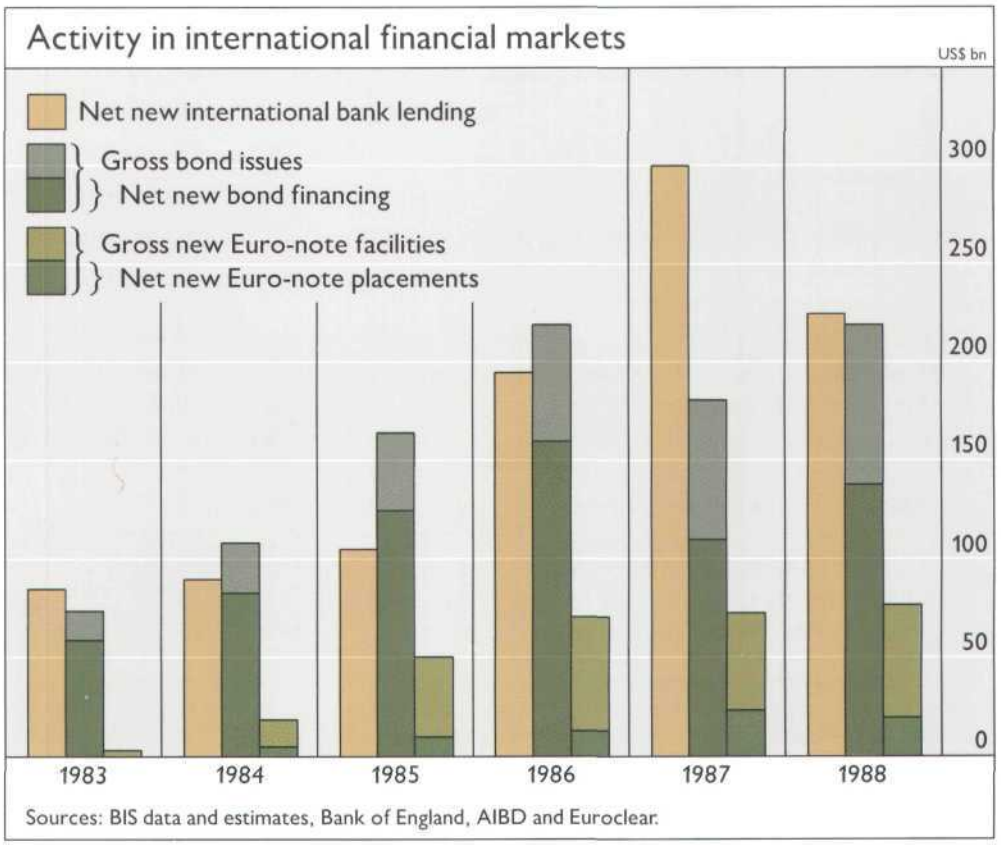
International financial intermediation in a period of flux

Last year the international financial markets continued to expand rapidly, although the total volume of new lending was somewhat lower than in 1987. In the international banking sector cross-border claims plus local claims in foreign currencies rose by 10%, whereas in the previous year the rate of expansion had amounted to 17%. This slowdown was due in large measure to developments in the interbank market, where activity had expanded extremely rapidly in 1986 and 1987 but was significantly less buoyant last year. The opening of the Japan Offshore Market in December 1986 had sparked off vast flows of new funds between banks in Japan and other major financial centres. By the beginning of 1988 this adjustment appeared to have run its course, although arbitrage between the domestic and Euro-yen markets at times strongly boosted interbank activity last year. Another, more general, factor was the coming into force of the new international capital adequacy guidelines, which acted as an incentive for the banks to trim the size of their balance sheets. The reduced scope for interest rate position-taking following the flattening of yield curves, the greater stability of the exchange markets and a smaller volume of official dollar accruals invested through the international banking system also appear to have contributed to the fall-off in interbank activity.

More restrained growth of international bank activity owing largely to developments in the interbank market

Excluding the double-counting resulting from interbank operations, the total amount of credit intermediated by the international banking system, which had soared by $300 billion in 1987, may be estimated to have expanded by $225 billion last year. This slowdown in credit growth from an unusually rapid pace in 1987 occurred in spite of a strong investment-led upsurge in the world economy. Ample corporate liquidity and competition from the domestic and international securities markets were the main reasons for the somewhat smaller intermediary role played by the international banking sector. Another important factor was that in 1987 borrowing demands had been driven to a considerable extent by the speculative strategies pursued in the securities and money markets by Japanese entities, which had accounted for nearly 50% of total direct borrowing by non-banks within the reporting area. This activity seems to have become less attractive last year because of the rise in short-term interest rates. Another element dampening the growth of final credit was the continued slowdown in new lending to countries outside the reporting

Developments in banks' final lending



area. The large debt conversion programmes undertaken by several major debtors resulted in a sharp contraction of banks' claims on these countries. In addition, a number of Asian countries which recorded sizable trade surpluses reduced their outstanding bank borrowings.

In contrast to the more moderate growth of the overall gross and net credit aggregates, certain areas of banks' international business showed a strong expansion. In particular, the volume of newly announced syndicated credit facilities continued to rise and returned to the record levels of the early 1980s. The provision of financial backing for corporate takeover and restructuring activity was the main driving force behind this development.

Buoyant issuing activity in the international bond markets

New issues of securities in the international bond markets, which had come to a near standstill in the wake of the stock market crash in the last months of 1987, staged a remarkable comeback last year. In the face of steeply rising short-term interest rates, announced new issues, at $225 billion, even slightly exceeded their record 1986 level. However, owing to the pronounced upward trend of scheduled repayments and early redemptions, net credit flows channelled through the international bond market remained somewhat below their earlier peak. The increase in activity was broadly based in terms of instruments and currencies, although in some instances, such as equity-related bonds, new issues tended to depend heavily on Japanese borrowers. Once again swaps played a major role in support of issuing activity, and the majority of new issues were apparently swap-driven. At the shorter end of the securities markets, net new issues of Euro-notes fell off from $23 billion in 1987 to $19 billion, or from 17 to 12% of total net international securities financing. However, in

Estimated net lending in international markets

	Stocks at end-1983	Changes[1]					Stocks at end-1988
		1984	1985	1986	1987	1988	
	in billions of US dollars						
Total cross-border claims of reporting banks[2]	2,107.7	124.7	232.0	510.3	597.5	419.4	4,485.3
Local claims in foreign currency	450.6	27.5	63.4	147.7	162.6	75.0	1,019.7
minus: double-counting due to redepositing among the reporting banks	1,318.3	62.2	190.4	463.0	460.1	269.4	3,115.0
A = Net international bank lending[3]	1,240.0	90.0	105.0	195.0	300.0	225.0	2,390.0
B = Net new Euro-note placements	0.0	5.0	10.0	13.0	23.3	19.5	72.1
Total completed international bond issues		105.6	161.9	219.6	181.2	219.4	
minus: redemptions and repurchases		24.6	38.9	59.3	71.1	81.5	
C = Net international bond financing	320.0	81.0	123.0	160.3	110.1	137.9	1,085.4
D = (A + B + C) = Total international financing	1,560.0	176.0	238.0	368.3	433.4	382.4	3,547.5
minus: double-counting[4]	60.0	31.0	58.0	78.3	53.4	67.4	347.5
E = Total net international financing	1,500.0	145.0	180.0	290.0	380.0	315.0	3,200.0

[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; a deduction is made, however, in respect of working balances and similar items. [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.

spite of this slowdown the Euro-note market appeared to display underlying strength, with new facilities arranged continuing to expand at a very rapid pace.

Reduced role of Euro-markets in the financing of current-account imbalances

One salient feature last year was the reduced role of the international securities and banking markets in helping to finance current-account imbalances among the major industrial countries. In contrast to 1987, private capital inflows financed virtually the whole of the US current-account deficit, but mostly bypassed the international markets. US private entities which traditionally had raised a large net volume of funds in the Euro-bond market took up barely $8 billion, or 38% less than in 1987. Similarly, direct lending from banks abroad to US non-bank entities declined from $27 to 16 billion, and the US banking system borrowed only a net amount of $13.5 billion from non-residents in comparison with $48 billion in 1987. Among the major surplus countries, regulatory and tax biases contributed to two-way flows between the domestic and international markets. The "overfinancing" of the Japanese current-account surplus can be attributed in part to the intermediation of domestic credit flows through the international markets. Similarly, the weakness of the Deutsche Mark last year can be partly ascribed to the attraction of German investors to the high-interest, tax-free securities readily available in the international markets. By contrast, in the United Kingdom

short-term banking inflows were the major identified counterpart to the country's current-account deficits.

Regulatory and structural factors

In the period under review the international financial markets were influenced by developments which had been partly concealed in previous years by the buoyant level of activity and a relatively stable interest rate outlook. 1988 provided the first opportunity to assess more clearly, in a somewhat longer-term perspective, the repercussions of the unprecedented reshaping of numerous regulations, the changing character of some aspects of bank and bond intermediation and the resilience of a wide range of new instruments to a less propitious environment following the stock market crash and the more recent surge in short-term interest rates.

Impact of the new international capital convergence agreement

The most important regulatory change in recent years affecting the overall character of international financial intermediation has been the convergence agreement on standards of capital adequacy reached by the Committee on Banking Regulations and Supervisory Practices of the Group of Ten countries, which is discussed in Chapter IV. The new standards apply specifically to internationally active banks, although in practice they will affect a much wider range of institutions. One of their direct consequences is that a number of banks have been forced to raise a large volume of new risk capital. Since share issues often involve high direct costs and alter the existing structure of ownership, banks have issued a considerable volume of "hybrid securities" which have been recognised by the supervisors as part of the second of the two tiers of capital. In the second half of 1988 in the international markets alone such issues of subordinated debt instruments by the banks amounted to $5.5 billion, or 18% of their total bond issues. The need for more capital has also induced banks to try to improve their profitability in order to enhance their ability to raise such funds. In this respect the new capital guidelines are likely to dampen the overall rate of expansion of banks' balance sheets, and in particular of those activities with traditionally low margins. The slowdown in final lending and interbank business recorded last year is probably indicative of such a development.

Implications for banks' balance sheets

Another change in behaviour concerns the effect which the varying risk weights on different types of activity might have on the composition of banks' portfolios. A growing amount of evidence suggests that banks have sought to readjust their portfolios from high to low-weight assets, to acquire assets with greater profitability and to widen their earnings margins on existing business. For example, the expansion of off-balance-sheet transactions and the removal of assets from balance sheets through securitisation have continued and even accelerated. Asset-backed securities carrying lower risk weightings in the supervisory guidelines, which were formerly confined to the United States, have sprung up in other countries, including Japan, France and the United Kingdom. In the international markets a number of FRN issues last year were backed by mortgages extended by specialised institutions in the United Kingdom. The new capital standards may also have encouraged banks' participation in the syndication of $27 billion of international credit facilities for the purpose of financing mergers and acquisitions, which carry higher spreads than traditional loans. Currency swaps, which attract a relatively high weighting

under the new guidelines, are also reported to have been repriced, and information available on volumes outstanding suggests that banks have been more eager to intermediate interest swaps instead.

Other regulatory and fiscal influences

The continuing changes in financial regulation in Japan also exerted a powerful influence on the international markets. Last year, as short-term interest rates in the Euro-yen markets rose above those on the domestic interbank markets, yen funds flowed out of Japan, with interbank activity shifting partly to the Euro-yen market. In November, following the introduction of new operating procedures in the domestic money markets by the Bank of Japan, this business was largely repatriated. In the international securities markets new issue activity for bonds with equity warrants was influenced by the regulations affecting the domestic issuing of these securities.

In Germany, as discussed at length below, the introduction of a withholding tax in January 1989 (subsequently repealed) prompted a number of German companies to issue Deutsche Mark securities through their foreign subsidiaries. In Italy, following further liberalisation of exchange controls, non-bank residents became large borrowers of foreign currency funds from domestic banks.

Factors behind the slower growth of the interbank market

Whilst changes in regulations have had an impact on overall international financial activity, other factors have influenced the development of individual market sectors. In the international interbank market, excluding business involving Japan and the foreign affiliates of Japanese banks, the growth of activity, which had temporarily picked up in 1985 and 1986, has slowed down markedly during the last two years and in 1988 was almost entirely limited to inter-office operations. This slowdown can be ascribed to three sets of influences. Firstly, the earlier decline in syndicated lending in conjunction with the international debt crisis and the virtual demise of the market for floating rate notes, of which the banks had been large purchasers, have reduced the demand for LIBOR-based funding in the interbank market. At the same time, the revival of the syndicated credit market since 1987 has been associated with a much wider range of borrowing options, including at times the issuance of marketable securities. Secondly, in contrast to the early 1980s, banks have employed a wider spectrum of financial instruments, booked largely off the balance sheet, in their asset/liability management. Last year open interest positions on the Euro-dollar futures contract traded on the Chicago Mercantile Exchange, the instrument most widely used by banks for covering their interest rate mismatches, expanded by 80% to $529 billion. The market for interest rate options on Euro-dollar futures appears to have taken off, and forward rate agreements have reportedly expanded. Finally, changes in regulations have also contributed to the slow growth of interbank activity. Although the new international capital guidelines attach only a relatively small weight to interbank assets, banks appear to have been more reluctant than before to enter this market in view of its low profitability.

The international bond markets in the aftermath of the stock market crash

The international securities markets were severely affected by the stock market crash. The flight to quality was initially reflected in the high volume of government securities purchased by foreign investors and the tiering of interest rates between the Euro-markets and the government securities

sector. Concerns regarding credit quality gradually eased, but trading volume in secondary markets continued to suffer from a lack of investor interest. However, it is difficult to judge whether this represented a shift in behaviour in reaction to the stock market crisis and longer-term structural factors or whether it was merely the outcome of macro-economic influences such as the flattening of the yield curves. Firstly, professional trading was curtailed following sizable losses incurred by many banks in the aftermath of the stock market crash. Secondly, as already mentioned, securities issued by Japanese entities, which were the largest borrowers in 1988, tended to flow back to Japan and were not actively traded thereafter in the international markets. Thirdly, private placements, which are tailored to specific investors and have a very limited secondary market, are estimated to have accounted for more than 20% of total issues in 1988. Finally, the type of security issued in the international markets has changed very markedly. FRNs, which were used as a money market instrument and therefore had a relatively high turnover, have been supplanted since 1987 by short-term commercial paper placed with final investors and not traded actively.

Reasons for the contraction in secondary trading

The decline in secondary market turnover had a major impact on the profitability of banks and securities companies last year. Over-capacity in some sectors forced several financial institutions to withdraw from market-making, and a number of firms underwent significant restructuring, including large-scale dismissal of employees. In the primary market lead managers reviewed the underwriting procedures for Euro-bonds in an attempt to reduce excessive competition and restore profitability.

Reduced role of financial innovation

In the aftermath of the stock market crash financial innovation in the sense of the creation of broad markets for new instruments was not particularly prominent. Owing to the premium attached to liquidity by many investors, certain types of security carrying special features, which had traded at sizable discounts during the latter part of 1987, fell out of favour. Nevertheless, many of the new instruments which had sprung up at the beginning of the 1980s continued to prosper. The market for interest and currency swaps remained buoyant and witnessed a number of minor innovations. As already mentioned, the Euro-dollar futures contract expanded markedly; in addition, futures contracts tied to instruments issued on domestic markets, such as the contract on German government bonds introduced in September 1988 on the London LIFFE exchange, met with considerable success.

The international banking sector

The development of the overall aggregates

Slower growth of international banking aggregates

After two years of exceptional growth, international bank activity in 1988 settled down to a more moderate pace of expansion. In current dollar terms, the cross-border assets of reporting banks rose by $290 billion to reach a total of $4,485 billion at the end of the year. In 1987 the increase had amounted to no less than $927 billion. However, the difference in growth performance between the two years is exaggerated by changes in the size of the yardstick used. In 1987 the ongoing depreciation of the dollar had boosted the dollar

Selected features of international banking activity

Items	Stocks at end-1985	Changes, excluding exchange rate effects							Stocks at end-1988
		1986	1987	1988					
				Year	Q I	Q II	Q III	Q IV	
	in billions of US dollars								
A. Cross-border transactions:									
Total claims	2,574.2	510.3	597.5	419.4	76.7	94.9	212.5	35.3	4,485.3
of which: interbank claims within the reporting area	*1,527.0*	*443.9*	*496.0*	*350.7*	*62.6*	*73.6*	*200.2*	*14.2*	*3,068.1*
claims on non-banks within the reporting area	*356.9*	*39.7*	*78.5*	*60.1*	*17.5*	*19.2*	*9.8*	*13.7*	*594.9*
Total liabilities	2,537.7	535.4	686.5	510.7	85.9	144.0	216.3	64.5	4,620.5
of which: vis-à-vis non-banks within the reporting area	*351.7*	*71.9*	*50.0*	*43.9*	*3.5*	*17.7*	*7.6*	*15.1*	*551.2*
of which: deposits received from official monetary institutions	*145.2*	*−12.8*	*44.3*	*9.0*	*−2.9*	*13.5*	*−0.9*	*− 0.7*	*204.8*
B. Local transactions in foreign currency:[1]									
Total domestic claims	562.8	147.7	162.6	75.0	41.1	−45.3	76.6	2.6	1,019.7
of which: claims on domestic non-bank entities	*212.2*	*68.4*	*100.2*	*68.1*	*22.4*	*− 0.2*	*21.3*	*24.6*	*477.9*
Total domestic liabilities	477.1	112.9	119.3	33.7	32.2	−62.3	84.1	−20.3	798.1
of which: liabilities to domestic non-bank entities[2]	*67.9*	*17.3*	*20.4*	*22.1*	*5.8*	*3.8*	*2.5*	*10.0*	*137.5*
Memorandum item:									
Total announced syndicated credits		29.9	88.7	103.8	24.6	22.6	26.5	30.2	

[1] For banks in Europe, Canada and Japan only. [2] Excludes positions of banks in Japan.

value of the banks' positions denominated in other currencies, whereas its recovery in 1988 had the opposite impact. Excluding these valuation effects resulting from exchange rate changes, the slowdown in the growth of the reporting banks' cross-border assets was much less pronounced, namely from $597 billion in 1987 to $419 billion.

As in the two preceding years, the cross-border liabilities of the reporting banks showed a considerably stronger increase than their external assets. The resultant $91 billion expansion in their external net liability positions meant that the reporting banks, on balance, used a very substantial amount of external funds for domestic lending, either in foreign or in domestic currency. In fact, their foreign currency claims on domestic non-bank entities showed another very substantial increase ($68 billion, or 17%) last year, whereas identified foreign currency deposits received locally from non-bank residents rose by only $22 billion.

Uneven growth of the interbank market

The more moderate expansion of the banks' cross-border assets last year was due largely to a slowdown in the growth of interbank activity within the reporting area, from $496 billion in 1987 to $351 billion. Operations involving banks in Japan, as either suppliers or takers of funds, accounted for the bulk of this expansion and increased by one-third, whereas the growth of interbank business between other reporting banks fell off drastically to only 2%. Direct cross-border claims on non-bank entities within the reporting area continued to expand quite strongly, by 11%. By contrast, new credit to countries outside the reporting area slowed down further, with their increase amounting to only 1%.

All in all, excluding the double-counting resulting from the redepositing of funds between the reporting banks, but allowing for the banks' own use of international funds for domestic lending, the amount of new credit outstanding intermediated through the international banking market may be estimated to have expanded by around 10% last year.

Inside-area sources and uses of international banking funds

Final lending almost entirely focused on the reporting area

Virtually all new international bank credit last year ($216 billion, or 96%) can be identified as having been absorbed within the reporting area itself. Direct lending to non-banks amounted to $128 billion, with entities in Japan ($47 billion), the United Kingdom ($17 billion), the United States ($16 billion), Italy ($12 billion) and the Netherlands ($10 billion) being the largest borrowers. In the case of Japanese and UK residents, most of these funds were obtained in the form of foreign currency loans from banks at home and may have been used in large measure for the financing of purchases of international securities.

The banks' own use of international funds for local lending in domestic currency may be estimated at $88 billion, with banks in the United States

Estimated sources and uses of international banking funds

	Changes, excluding exchange rate effects								Stocks at end-1988
	1981	1982	1983	1984	1985	1986	1987	1988	
	in billions of US dollars								
Uses									
Reporting area	92	42	52	77	77	168	277	216	1,568
Outside area	66	39	28	13	24	14	11	7	720
Unallocated	7	14	5	0	4	13	12	2	102
Total	165	95	85	90	105	195	300	225	2,390
Sources									
Reporting area	137	93	81	60	85	166	217	153	1,655
Outside area	17	−12	1	31	18	− 2	49	40	518
Unallocated	11	14	3	− 1	2	31	34	32	217
Total	165	95	85	90	105	195	300	225	2,390
Net									
Reporting area	−45	−51	−29	17	−8	2	60	63	− 87
Outside area	49	51	27	−18	6	16	−38	−33	202
Unallocated	− 4	0	2	1	2	−18	−22	−30	−115

($22 billion), the United Kingdom ($20 billion) and Japan ($17 billion) being the largest net takers of external funds.

On the liabilities side of the banks' balance sheets, $153 billion, or about two-thirds, of the new funds in the market were provided from within the reporting area. In addition, the bulk of the $32 billion increase in the unallocated item, which results in large measure from the banks' own issuance of securities (the buyers of which cannot usually be identified), was presumably accounted for by investors from the reporting area. Direct identified deposits by non-banks amounted to $66 billion, with entities from the Netherlands ($13 billion), the United States ($10 billion) and Belgium-Luxembourg ($8 billion) being the largest sources. In addition, nearly $28 billion seems to have been channelled into the market via trustee accounts of banks in Switzerland. The important role of Dutch non-bank entities both on the sources and uses side of the international banking market is largely explained by the frequent choice of the Netherlands as a domicile for the financing vehicles of international corporations. Banks' supply of domestic funds for international lending may be estimated at close to $60 billion, but this figure also includes a certain amount of central bank deposits.

Important supplies of new funds from inside the reporting area

Business with countries outside the reporting area

The increase in identified claims on countries outside the reporting area slowed down further to a mere trickle of $6.8 billion last year. At the same time, the flow of new funds from these countries to the banks continued at a relatively rapid pace, totalling $39.5 billion. The main providers of these new deposits were non-OPEC developing countries excluding Taiwan ($19.2 billion), developed countries outside the reporting area ($12.7 billion) and OPEC countries ($11 billion). By contrast, Taiwan, which had added significantly to its deposits with the reporting banks in recent years, drew them down by nearly $8 billion in 1988.

Outside area a net supplier of funds to reporting banks

The slow overall pace of new lending to outside-area countries was due essentially to developments in Latin America. After a $3.9 billion decrease in 1987, the identified claims of reporting banks on Latin American countries recorded another absolute contraction of $10.8 billion, or nearly 5%, last year. This decline was more than accounted for by three countries, namely Mexico (−$5.8 billion), Brazil (−$3.9 billion) and Chile (−$1.7 billion) (see the table on page 132). Banks provided $5.6 billion of new money under restructuring packages (of which $4 billion to Brazil, $1.1 billion to Mexico and $0.5 billion to Argentina), but these flows of new credits were more than offset by the fall in outstanding claims resulting from debt conversion schemes, asset sales at a discount to face value, write-offs and the exercise of guarantees. On the deposits side, Mexico, which suffered large foreign exchange reserve losses last year, drew down its deposits by $5.2 billion, after having built them up by $6.5 billion in 1987. Most other Latin American countries, notably Brazil ($2.7 billion) and Argentina ($1.6 billion), added to their balances with the reporting banks.

Accelerated decline in reported claims on Latin America

In Asia, by far the largest borrower was China ($7.2 billion), which also built up its deposits with the reporting banks ($5.1 billion). On the other hand,

BIS reporting banks' business with countries outside the reporting area

	Changes, excluding exchange rate effects								Stocks at end-1988
	1981	1982	1983	1984[1]	1985	1986	1987	1988	
	in billions of US dollars								
Borrowing from reporting banks									
Non-reporting developed countries	16.8	16.0	7.2	5.3	6.9	6.7	5.1	2.5	130.2
Eastern Europe	4.8	− 4.6	− 1.1	−0.1	5.7	3.7	2.3	8.0	87.0
OPEC[2]	4.2	8.2	9.8	−2.1	0.2	0.4	2.0	5.2	129.0
Non-OPEC LDCs (excluding Taiwan)	39.4	20.0	13.1	10.6	11.6	− 0.9	−6.4	− 7.2	357.4
of which: Latin America[3]	*30.5*	*12.1*	*8.3*	*5.3*	*1.7*	*1.6*	*−3.9*	*−10.8*	*214.9*
China	*−0.4*	*− 0.6*	*0.4*	*1.4*	*4.9*	*0.7*	*4.8*	*7.2*	*23.7*
Other Asia	*5.0*	*5.1*	*3.5*	*4.2*	*4.0*	*− 2.2*	*−5.6*	*− 1.8*	*80.7*
Africa	*2.0*	*1.7*	*0.6*	*0.1*	*0.9*	*− 0.2*	*−0.6*	*− 1.0*	*22.7*
Middle East	*2.3*	*1.7*	*0.3*	*−0.4*	*0.2*	*− 0.8*	*−1.1*	*− 0.7*	*15.4*
Taiwan	0.5	− 0.2	− 0.5	−0.8	−0.6	4.0	8.3	− 1.7	16.3
Total borrowing	65.7	39.4	28.5	12.9	23.8	13.8	11.2	6.8	719.9
Memorandum item: fourteen heavily indebted countries[4]	*33.5*	*16.5*	*8.5*	*2.4*	*0.7*	*2.0*	*−5.9*	*−14.2*	*265.0*
Deposits with reporting banks									
Non-reporting developed countries	3.8	− 0.1	1.3	3.1	3.3	7.2	6.3	12.7	68.3
Eastern Europe	0.1	2.0	2.7	4.3	2.8	0.2	−0.7	4.4	34.7
OPEC[2]	3.2	−18.2	−13.0	4.2	6.6	−22.1	19.3	11.0	178.5
Non-OPEC LDCs (excluding Taiwan)	8.3	3.4	8.3	13.9	−1.0	− 1.5	17.5	19.2	199.4
of which: Latin America[3]	*4.7*	*− 1.9*	*5.8*	*10.1*	*0.4*	*0.8*	*6.7*	*2.3*	*80.7*
China	*2.3*	*2.9*	*1.3*	*1.3*	*−5.3*	*− 0.9*	*5.3*	*5.1*	*22.0*
Other Asia	*−0.7*	*1.4*	*1.9*	*3.1*	*1.0*	*− 0.3*	*2.1*	*10.3*	*55.2*
Africa	*0.5*	*− 0.8*	*0.2*	*1.0*	*1.4*	*− 0.1*	*1.6*	*1.5*	*16.7*
Middle East	*1.5*	*1.8*	*− 0.9*	*−1.7*	*1.5*	*− 1.0*	*1.9*	*− 0.1*	*24.7*
Taiwan	1.2	1.2	2.1	5.4	6.7	14.4	6.5	− 7.9	37.5
Total deposits	16.6	−11.7	1.4	30.9	18.3	− 1.8	48.8	39.5	518.3
Memorandum item: fourteen heavily indebted countries[4]	*2.5*	*− 9.5*	*7.0*	*13.4*	*2.6*	*− 4.7*	*7.1*	*1.5*	*97.0*

[1] As from 1984 the coverage of the figures has been enlarged to include changes in the positions of banks in Finland, Norway, Spain, Bahrain and the Netherlands Antilles, as well as all banks in the Bahamas, the Cayman Islands, Hong Kong and Singapore. [2] Includes, in addition, Brunei, Oman and Trinidad and Tobago, but excludes Bahrain as from 1984. [3] Includes those countries in the Caribbean area which are not classified as offshore banking centres. [4] Baker countries excluding Yugoslavia.

several Asian countries made substantial debt repayments to the reporting banks, notably South Korea and the Philippines ($1.9 billion each), Taiwan ($1.7 billion) and Malaysia ($1.3 billion). Further modest declines occurred in reporting banks' claims on non-OPEC developing countries in Africa and the Middle East.

There were two groups of outside-area countries with which the reporting banks' credit business accelerated last year, namely eastern Europe and the OPEC countries. New credits to OPEC countries amounted to $5.2 billion, with the United Arab Emirates ($2.1 billion), Libya and Saudi Arabia ($0.8 billion each) being the largest borrowers. By contrast, claims on Nigeria recorded a further decrease of $1.3 billion. Saudi Arabia ($10.6 billion) and the United Arab Emirates ($5.4 billion) were the principal depositors of new funds, whereas most other countries in this group drew down their deposits with the reporting banks. Libya's deposits, in particular, declined by $1.8 billion, or 26%.

Increased lending to eastern Europe and OPEC countries

New lending to eastern European countries picked up markedly from $2.3 billion in 1987 to $8 billion, nearly matching the previous record level. However, after some drawdowns in 1987, these countries also added $4.4 billion to their deposits with the reporting banks. As usual, the Soviet Union was the largest borrower ($5.5 billion) and depositor of new funds ($1.7 billion). Other major borrowers were the German Democratic Republic ($2.5 billion) and Bulgaria ($1.8 billion), both of which also added substantially to their deposits with the reporting banks (namely by $1.6 and 0.7 billion respectively).

Developments in individual market centres

The more modest expansion of international banking business last year was not evenly shared amongst the various banking centres. In Europe and the offshore centres the growth of activity slowed down sharply. By contrast, the cross-border assets of banks in Japan continued to expand at a rapid pace, namely by 29%, and accounted for two-fifths of the total growth of reporting banks' external assets. Unlike in 1987, this expansion was mainly in foreign currency and was booked primarily through the Japan Offshore Market (JOM). As a result, in the first two years of its existence the external assets of banks in the JOM surged to $331 billion, thereby overtaking the International Banking Facilities in the United States (which were established as long ago as December 1981) by about $22 billion. On a net basis, and despite continuing foreign lending in yen, the Japanese banking system was again an importer of external funds to the tune of $23 billion. After the banks in Japan, banks in the Asian offshore centres recorded the highest rates of growth of external assets last year, although at 17% the expansion was only half that recorded in 1987. By contrast, the increase of external assets of the banks in the Caribbean centres slowed down drastically to only 2%.

Continued rapid growth in the external positions of banks in Japan

The growth of the external assets of banks in the United States picked up to 9% last year, whereas the expansion of their liabilities slowed down from 17% in 1987 to 11%. As already explained on page 106, this meant that the banks in the United States played a much smaller role in the financing of the country's current-account deficit than in 1987. A notable feature in the United States was once more the relatively strong growth in banks' external assets and liabilities in foreign currency. Although these non-dollar positions are still much smaller than those in dollars, they have more than doubled in the space of two years.

Smaller net external borrowing by banks in the United States

Developments in individual banking centres

External positions of banks in:	Changes, excluding exchange rate effects								Stocks at end-1988	
	Gross assets				Net assets				Gross assets	Net assets
	1985	1986	1987	1988	1985	1986	1987	1988		
	in billions of US dollars									
United Kingdom	30.7	87.5	89.1	34.0	−15.1	− 9.6	− 6.2	−27.7	883.6	− 78.4
France	7.4	14.9	37.9	23.3	2.7	1.1	1.6	− 9.9	275.9	− 16.3
Germany	19.4	38.8	17.0	17.4	13.0	27.7	4.1	8.8	206.0	76.2
Luxembourg	9.6	15.2	19.0	19.5	0.1	− 1.4	1.1	4.6	188.6	17.1
Belgium	16.1	18.7	16.5	1.3	− 0.7	− 1.1	− 2.7	− 2.6	142.8	− 24.7
Netherlands	5.2	5.9	12.5	15.1	0.9	− 3.8	0.9	2.9	122.3	8.2
Switzerland	9.1	10.3	16.4	0.0	1.0	0.7	4.7	− 3.8	117.0	37.2
Italy	8.7	3.8	−1.5	2.7	3.0	− 4.7	− 5.1	− 7.5	62.8	− 35.2
Austria	5.2	6.1	1.6	−0.6	− 0.4	− 0.7	− 1.9	− 1.3	50.3	− 6.2
Spain	1.8	2.9	−0.1	−0.4	3.1	− 1.6	− 5.2	− 5.3	24.3	− 11.0
Denmark	4.1	−1.2	4.0	3.6	− 0.7	− 0.3	0.6	0.9	19.8	1.0
Sweden	1.5	1.2	2.9	0.5	− 1.4	− 2.3	− 5.7	− 9.9	14.9	− 29.0
Finland	−0.2	1.7	0.3	0.6	− 1.6	− 0.8	− 5.8	− 4.1	9.2	− 16.7
Ireland	0.3	0.5	1.2	0.1	0.1	− 0.5	0.0	− 0.8	5.3	− 6.0
Norway	1.3	1.3	0.7	−1.3	− 1.9	− 2.6	− 2.6	0.0	5.1	− 13.1
Total European reporting countries	120.2	207.4	217.6	115.7	2.0	0.3	−21.9	−55.8	2,128.0	− 97.0
United States	3.0	50.3	31.4	46.5	−35.3	−23.6	−48.0	−13.5	555.8	− 34.5
of which: IBFs	*11.8*	*35.7*	*31.5*	*32.0*	*− 4.4*	*−17.2*	*−18.8*	*1.3*	*309.4*	*− 26.5*
Japan	53.4	126.6	166.5	166.7	12.0	−21.1	−24.5	−23.2	733.7	− 38.7
of which: Offshore Market		*88.7*	*89.9*	*138.5*		*0.7*	*− 0.2*	*2.7*	*331.0*	*3.0*
Canada	1.2	6.8	−0.4	−6.5	− 0.4	2.9	− 2.7	− 3.2	48.0	− 23.3
Asian market centres*	29.7	85.6	135.7	88.7	3.4	11.9	9.2	8.1	598.3	43.1
Caribbean market centres	24.5	33.6	46.7	8.3	10.1	4.5	− 1.1	− 3.6	421.4	15.2
Total	232.0	510.3	597.5	419.4	− 8.1	−25.1	−89.0	−91.3	4,485.3	−135.2

* Including Bahrain.

Deceleration of external banking activity in Europe

In Europe the deceleration in cross-border lending between 1987 and 1988 was particularly significant in the case of banks in the United Kingdom (from 11 to 4%), Belgium (from 12 to 1%) and Switzerland (from 14% to nil), but activity in the Netherlands, Luxembourg, France and Germany continued to expand fairly briskly. With the exception of Germany, Luxembourg, the Netherlands and Denmark, banks in European reporting countries were net importers of external funds. This was particularly true of banks in the United Kingdom ($27.7 billion), France, Sweden (nearly $10 billion each) and Italy ($7.5 billion).

Currency composition of international banking activity and growth of the ECU market

Declining share of the dollar in external assets

The share of the dollar in the growth of the external assets of banks in the industrial reporting countries contracted from 48% in 1987 to 38%. Cross-border liabilities in dollars showed a much stronger expansion, which meant that the banks' external net debtor position in dollars widened by nearly

$80 billion. This reflected in large measure the banks' net use of external dollar funds for domestic purposes. An important additional factor, however, was that despite the exchange risks depositors were attracted by the high dollar interest rates, while borrowers preferred to incur debt in the low-interest currencies.

Strong growth of yen assets

Apart from the dollar, the largest growth was recorded for yen assets ($75.9 billion). The bulk of this increase represented external yen lending by banks in Japan. Considering only positions in foreign currency, the expansion in non-dollar cross-border assets was largest in Deutsche Mark, sterling and ECUs, with the yen taking only fourth place. However, the yen figures are strongly understated, since a currency breakdown is not available for the positions of banks in the Asian offshore centres. In terms of growth rates, the expansion of nearly 50% in Euro-sterling assets was especially pronounced. By contrast, Swiss franc positions declined last year. The reporting banks' external liabilities in that currency, in particular, contracted by over 10% – the first major decline yet recorded – and Euro-Swiss franc liabilities are now smaller than those in yen.

Pick-up of ECU business

After two years of relatively sluggish growth the banks' ECU business picked up in 1988. Including positions vis-à-vis residents, the expansion in ECU assets accelerated from $11.1 billion in 1987 to $23.9 billion. However, this faster growth was due solely to a revival of interbank business, whereas new lending to non-bank entities slowed down from $5.2 billion in 1987 to $4.6 billion. Deposits by non-bank entities, which had on balance shown no increase over the preceding two years, expanded slightly (+$1.6 billion), but remained small in relation to the total size of the market.

The currency composition of reporting banks' cross-border positions[1]

Currencies		Changes, excluding exchange rate effects								Stocks at end-1988	
		Assets				Liabilities				Assets	Liabilities
		1985	1986	1987	1988	1985	1986	1987	1988		
		in billions of US dollars									
US dollar	A	52.9	188.7	184.3	93.6	41.2	209.8	193.4	161.0	1,328.3	1,535.5
	B	1.4	43.1	15.1	29.9	33.5	63.1	63.4	41.9	489.7	519.3
Other	A	77.9	69.2	101.4	115.6	90.6	106.8	130.8	123.3	920.2	1,018.4
	B	45.6	90.1	114.3	83.4	34.0	53.0	124.7	92.0	727.3	585.8
of which: [2]											
Deutsche Mark	A	13.4	0.3	31.9	31.2	15.9	28.0	41.5	41.5	293.0	340.2
	B	15.5	26.4	4.0	13.3	3.0	2.3	4.4	8.0	145.4	79.6
Swiss franc	A	15.3	7.9	−1.5	−4.8	18.9	17.5	10.5	−16.1	113.9	138.8
	B	2.8	3.3	3.5	−0.7	2.4	1.4	4.7	− 0.6	55.0	20.9
Japanese yen	A	21.0	20.8	30.8	14.0	19.4	21.3	23.8	7.5	159.3	141.3
	B	22.1	43.9	92.5	61.9	17.9	29.4	89.9	46.5	344.4	268.8
Sterling	A	4.8	8.5	5.2	22.8	7.1	10.1	13.9	21.7	69.1	86.3
	B	2.3	8.8	8.3	6.8	5.6	9.4	15.6	24.7	77.0	117.3
ECU	A	14.3	6.2	8.4	16.1	12.8	2.7	5.9	17.2	86.0	76.9

Note: A = Euro-currency positions; B = external positions in domestic currency.

[1] Positions of banks in industrial reporting countries only. [2] Excluding positions of banks in the United States.

The structure of the ECU banking market

	Assets				Liabilities			
	Changes, excluding exchange rate effects			Stocks at end-	Changes, excluding exchange rate effects			Stocks at end-
	1986	1987	1988	1988	1986	1987	1988	1988
	in billions of US dollars							
Positions vis-à-vis non-banks:								
Domestic	0.0	3.0	2.4	12.4	−0.5	0.1	1.0	4.8
Cross-border within the Community	0.7	1.2	1.6	9.5	−0.4	0.2	0.0	2.4
Cross-border with non-EC residents	0.9	0.2	−0.1	2.5	0.0	0.2	0.4	1.3
Unallocated*	0.3	0.8	0.7	4.0	0.0	0.2	0.2	1.2
Total positions vis-à-vis non-banks	1.9	5.2	4.6	28.4	−0.9	0.7	1.6	9.7
Positions vis-à-vis banks:								
Domestic	0.0	−0.2	5.4	20.2	−0.2	0.2	7.9	22.3
Cross-border within the Community	0.6	2.2	9.8	46.7	1.7	1.9	9.8	48.0
Cross-border with non-EC residents	1.0	1.3	1.2	8.1	0.4	2.2	2.6	11.1
Unallocated*	2.7	2.6	2.9	15.1	1.0	1.1	4.2	13.0
Total interbank positions	4.3	5.9	19.3	90.1	2.9	5.4	24.5	94.4
Total	6.2	11.1	23.9	118.5	2.0	6.1	26.2	104.1

* Includes international institutions other than the BIS.

The nationality structure of international bank lending

The table overleaf shows the development of international banking activity (defined as cross-border business, plus local business in foreign currency except with affiliated banks) according to the nationality of ownership of the reporting banks. Unfortunately, the flow figures in this table cannot be given net of valuation effects resulting from exchange rate changes. This means that in view of the appreciation of the dollar last year in relation to other internationally used currencies, notably the Deutsche Mark and the Swiss franc, the 1988 changes understate the actual volume increases. This effect was particularly pronounced for continental European banks.

Increasing dominance of Japanese banks

Developments during 1988 were characterised by three main features. The most pervasive of these was the dominant role of Japanese banks (i.e. domestically owned banks in Japan plus their affiliates in other reporting countries). They accounted for almost 90% of the growth of international business of reporting banks in the industrial countries, compared with somewhat under 50% in 1987. As a result, the share of Japanese banks in total international assets expanded further, from 36% at the end of 1987 to 38%. The international assets of other reporting banks increased by less than 1% in 1988. Absolute declines in the dollar value of outstanding claims were actually recorded for Canadian (−18%), Belgian (−12%), Austrian (−9%), Swiss (−7%) and UK banks (−6%), although in the case of the European banks these decreases were largely due to exchange rate effects. Net of inter-office business, an absolute contraction in international bank assets was also recorded for the US banks. However, the decline in the relative importance of US banks

Types of international bank assets and liabilities, by nationality of banks[1]

	Change in current dollars during 1988						Total stocks	
	Related offices	Other banks	Official monetary institutions	Non-banks	Securities[2]	Total	end-1985	end-1988
	in billions of US dollars							
Japanese banks								
Assets	110.7	59.0	1.2	33.1	–	204.0	706.2	1,756.4
Liabilities	121.1	65.2	4.4	12.4	8.8	211.9	671.6	1,706.3
US banks								
Assets	40.0	−13.4	−0.2	−0.4	–	26.0	590.2	675.2
Liabilities	49.2	−11.3	−4.6	6.8	−3.8	36.3	552.3	688.9
French banks								
Assets	13.4	− 3.0	−0.1	−2.9	–	7.4	244.0	384.1
Liabilities	16.0	4.5	−2.7	5.4	4.7	27.9	248.7	400.4
German banks								
Assets	1.3	7.7	−0.1	−2.0	–	6.9	191.2	353.8
Liabilities	4.6	0.5	−3.6	10.1	−1.2	10.4	157.6	275.0
UK banks								
Assets	−1.9	−12.3	1.4	−2.3	–	−15.1	192.8	238.6
Liabilities	−2.1	− 3.8	0.4	3.5	−0.1	− 2.1	203.0	266.8
Other								
Assets	−9.5	−16.3	1.1	23.7	–	− 1.0	789.1	1,190.1
Liabilities	−0.9	−15.5	6.9	18.9	8.8	18.2	781.6	1,226.8
Total								
Assets	154.0	21.7	3.3	49.2	–	228.2	2,713.5	4,598.2
Liabilities	187.9	39.6	0.8	57.1	17.2	302.6	2,614.8	4,564.2

[1] This table shows the international assets and liabilities, i.e. 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 of 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. [2] Liabilities arising from banks' issues of CDs and other securities. The banks' holdings of securities are not reported as a separate item but are included in the other asset categories.

in recent years has been overstated to the extent that they engage in a higher volume of off-balance-sheet business than other banks.

Pronounced expansion of inter-office business

The second salient feature last year was the strong growth of cross-border business between related offices of the same bank, which accounted for two-thirds of the total increase in reporting banks' international assets. Genuine interbank lending expanded by $59 billion in the case of Japanese banks, but showed on balance a $37 billion contraction as far as the other reporting banks were concerned – though here again exchange rate effects would seem to have contributed strongly to the decline. The current dollar value of direct claims on non-banks rose by $49 billion, or 4%, with Japanese banks alone accounting for two-thirds of this increase.

Thirdly, among the larger banking nationalities the Japanese banks were the only net lenders to the non-bank sector, the increase in their credits to

non-bank entities exceeding that in their deposit liabilities by nearly $21 billion. The Japanese banks funded this net lending largely in the interbank market (including borrowing from related banks outside the reporting area) and through securities issues. The other major banking nationalities received substantial deposits from non-banks, whereas the dollar value of their claims on non-banks declined. This suggests either a dearth of profitable lending outlets or conservative growth strategies.

The syndicated loan market

Large new facilities arranged for corporate borrowers partly in the context of merger and takeover activity

Last year witnessed a further pronounced expansion in the syndicated loan market, with arrangements of new borrowing facilities exceeding $100 billion, a level comparable with that recorded at the beginning of the decade. However, many credits were precautionary or replaced existing lines and did not involve new drawdowns of funds. Unlike the late 1970s and early 1980s, when borrowings by governments – particularly from less developed countries – had provided the main impetus to the market, the lion's share of new facilities in 1988 was arranged for non-bank corporate customers in industrial countries. The process of financial restructuring under way in some countries (see Chapter IV) and efforts by companies to diversify their sources of funding constituted the principal factors behind this development. At the same time, ample liquidity and the desire to diversify their loan portfolios meant that banks were quite eager to accommodate companies' borrowing demands, with the strong competition for mandates resulting in declining fees and margins. Syndicated credits arranged for the financing of mergers and acquisitions accounted for roughly one-quarter of total new facilities and for more than the whole of the 1988 increase. The desire for flexibility was reflected in the arrangement of a considerable volume of multiple-option facilities, which allow borrowers to raise funds through short-term securities as well as through bank loans.

Prominence of UK borrowers

UK non-bank corporate entities were the largest borrowers in the syndicated credit markets ($35.6 billion) and utilised a significant volume of these funds to finance mergers and acquisitions, especially of companies in the United States. Furthermore, a very significant share (22%) of new credits was denominated in sterling. Sizable facilities were also arranged for US ($12.6 billion), French ($9.9 billion) and Australian ($6.8 billion) borrowers.

The international securities market

The Euro-note market

Overall expansion of activity...

The market for short and medium-term international securities (Euro-commercial paper, underwritten Euro-notes and medium-term notes) witnessed a further expansion last year. The total volume of such paper outstanding grew by $19.5 billion to $72 billion, while announced new programmes for the issuance of such securities accelerated further to $77 billion (see the table on the following page). Although there is significant under-utilisation of many large programmes, the rapid pace at which new facilities continue to be arranged underscores the growing potential for borrowings in this market. Euro-commercial paper remained the most buoyant sector,

Main features of the Euro-note market

	Years			1988				Stocks at end-1988
	1986	1987	1988	Q I	Q II	Q III	Q IV	
	in billions of US dollars							
New facilities announced								
Underwritten facilities	15.0	3.9	3.7	1.0	1.0	1.6	0.1	
Euro-commercial paper	50.3	56.9	58.1	16.6	13.0	15.1	13.4	
Medium-term notes*	5.5	12.1	15.1	5.8	1.2	6.9	1.2	
Total	70.8	72.9	76.9	23.4	15.2	23.6	14.7	
Net new issues								
Underwritten Euro-notes		1.7	−3.3	−0.8	−1.4	−0.5	−0.7	13.6
Euro-commercial paper		19.4	19.8	9.8	5.4	5.8	−1.2	52.8
Medium-term notes		2.2	3.1	0.4	0.5	0.8	1.4	5.7
Total	13.0	23.3	19.5	9.4	4.5	6.1	−0.5	72.1

* Includes Euro-commercial paper programmes with the option to issue medium-term notes.

Sources: Bank of England and Euroclear.

... but further decline in underwritten facilities

whereas less than 5% of new facilities took the form of underwritten programmes. These facilities, which are currently viewed as too expensive and cumbersome by prime borrowers, had accounted for a large proportion of the market up to 1985. In fact, the outstanding amount of underwritten Euro-notes actually declined by 20% last year. At the same time, the market for medium-term notes, which bridges the maturity gap between Euro-commercial paper and longer-term bonds, expanded strongly. Nearly 20% of new facilities allowed for the issuance of such paper, and the outstanding volume more than doubled to $5.7 billion.

In contrast to earlier years, changes in placement techniques and instruments tended to be of minor importance in 1988. Moreover, low profitability, which characterised many areas of the securities markets, resulted in a further contraction in the number of active intermediaries. One of the most salient developments – the opening in October 1988 of an ECU-denominated Treasury bill market by the UK Government, targeted at international investors, and the expansion of ECU issues by the Italian Treasury – actually took place outside the Euro-note market. By end-March 1989 the outstanding volume of such paper had reached $10 billion. As a result, the range of short-term instruments available in ECUs has been widened and new interest rate bench-marks for this currency sector have been provided.

Nationality of borrowers

As regards the nationality of issuers, the Euro-note market remained heavily focused on developed countries. The largest placements of notes in 1988 were made for borrowers from the United Kingdom ($5.5 billion), Australia ($3.6 billion) and the United States ($3.1 billion). In terms of new facilities, the largest programmes were arranged for entities from the United Kingdom ($10.9 billion), the United States ($9.8 billion) and Sweden ($8.9 billion).

Role of Euro-notes in international financial market activity...

The Euro-note market has played a significant role in the recent evolution of international financial market activity, despite its relatively modest size. Firstly, for borrowers Euro-commercial paper in particular has provided a cheaper source of short-term international finance than bank credits, while for

investors it has come to represent a truly international money market instrument. In this respect the Euro-note market has complemented the longer-term international bond market. Secondly, on account of the flexibility with regard to the terms of new issues – interest rates can be adjusted according to market conditions and the current credit-standing of the borrower – Euro-commercial paper has contributed to the demise of the floating rate note (FRN) market in the form in which it had evolved in the early 1980s. Thirdly, the Euro-note market has promoted the closer international integration of national markets. This has been most evident in the case of the dollar market, where a growing number of US and UK issuers have set up programmes for issuing simultaneously domestic and Euro-commercial paper. This development has promoted the growing convergence of interest rates between the domestic and international markets.

... and their interaction with the development of the domestic commercial paper market

Finally, the expansion of Euro-notes has coincided with the opening of domestic commercial paper markets in several countries. In Japan, where issues were first allowed in November 1987, commercial paper accounted for 12% of total corporate borrowings in 1988, and by the end of the year the outstanding amount of such securities reached $74 billion. This growth is likely to continue, since further deregulation measures have increased the number of eligible domestic companies, allowed issuing by foreign entities and widened the range of permissible maturities. The growth of domestic markets has also been significant during recent years in Canada, France, Spain and Sweden. In the United Kingdom, where the expansion of the domestic commercial paper market has been slow since its opening in 1986, the latest budget gave access to a much broader group of potential borrowers and permitted a wider spectrum of maturities.

Changes in the currency structure of the Euro-note market

The growth of domestic commercial paper markets and their internationalisation could conceivably affect the currency composition of the market for Euro-notes. At present roughly 90% of Euro-notes are denominated in US dollars. However, an increasing number of issuers have swapped their debt obligations into other currencies, and 40% of new facilities in 1988 included a multi-currency option allowing for issues in non-dollar currencies. The markets for Euro-yen and Euro-sterling commercial paper are also likely to expand following recent deregulation. Nevertheless, dollar issues will probably remain preponderant. This reflects in large measure the importance of the domestic US commercial paper market, which dwarfs all other short-term markets and offers ample arbitrage opportunities with the international markets. In addition, regulatory and tax factors will probably continue to limit the scope for issuing domestic and Euro-commercial paper in other major currencies such as the Deutsche Mark and Swiss franc.

The further expansion of domestic commercial paper markets raises the question of whether they will crowd out the international markets for short-term securities. The continued growth of the Euro-note market will clearly depend on the factors which have favoured financial intermediation through the Euro-markets generally: on the one hand, flexible organisation, efficient issuing and trading techniques, and convenient terms of settlement; and, on the other, regulations and tax laws governing transactions by domestic and foreign

market participants. For example, if credit ratings were to become an accepted practice in the international markets and standardised worldwide, borrowers who had previously refrained from issuing in domestic markets because of the need to apply for a credit rating might revise their strategies. Last year the spread of credit ratings in the Euro-markets may indirectly have contributed to the $10 billion, or nearly 25%, increase in the volume of commercial paper issued in the United States by foreign borrowers. Similarly, if domestic and international clearing arrangements become more closely integrated, the need for a separate market for international investors could become less compelling.

Blurring of borderlines between domestic and international short-term securities markets

The international bond market

Contrary to widespread fears of major cutbacks in new issue activity at the beginning of the year, the primary market for international bonds during 1988 was very buoyant. At $225 billion, the volume of announced new issues was 27% higher than in 1987 and roughly equal to the peak recorded in 1986. The pick-up in issue activity was particularly pronounced in the first half of the year, following the sharp slowdown in the last months of 1987 in conjunction with the stock market crash. Last year also witnessed an increasing volume of retirements of outstanding bonds, which reflected the growing number of issues scheduled for repayment and the continuing high volume of calls, redemptions and conversions. As a result, the net volume of funds raised through the international bond markets, at $138 billion, though 25% higher than in 1987, remained below the record level of $160 billion reached in 1986.

Revival of activity after the stock market crash

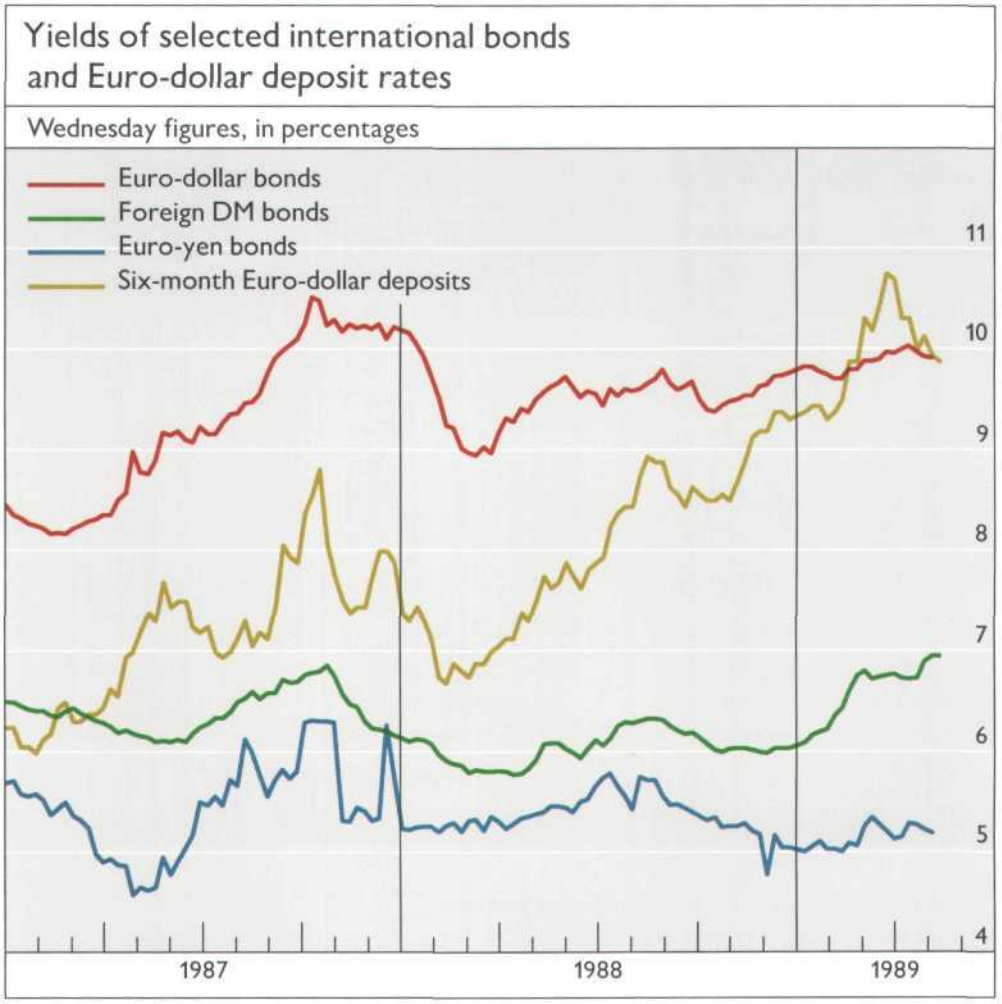
Several factors interacted with one another to promote the resurgence

Main features of international bond market activity

	Years			1987	1988				Stocks at end-1988
	1986	1987	1988	Q IV	Q I	Q II	Q III	Q IV	
	in billions of US dollars								
Total announced gross new issues[1]	221.7	177.1	225.4	28.1	59.7	62.5	56.4	46.7	
of which:									
straight fixed rate issues	*146.6*	*121.3*	*160.8*	*20.5*	*48.9*	*41.5*	*35.7*	*34.7*	
floating rate notes	*47.7*	*12.1*	*22.4*	*5.0*	*2.7*	*6.1*	*6.8*	*6.7*	
equity-related issues[2]	*27.3*	*43.7*	*42.1*	*2.6*	*8.0*	*14.9*	*14.0*	*5.2*	
Total completed gross new issues[3]	219.6	181.2	219.4	35.0	47.5	56.9	61.3	53.6	
minus: scheduled repayments	22.8	34.7	41.2	8.7	11.8	7.9	7.2	14.0	
minus: early repayments	36.5	36.4	40.3	11.9	9.2	10.3	10.1	10.8	
= Total net new issues	160.3	110.1	137.9	14.4	26.5	38.7	44.0	28.8	1,085.4
of which:									
straight fixed rate issues	*109.0*	*71.4*	*100.1*	*7.8*	*21.5*	*29.6*	*23.3*	*25.7*	*777.8*
floating rate notes	*28.9*	*0.4*	*3.7*	*3.0*	*0.3*	*1.0*	*4.5*	*−2.1*	*158.8*
equity-related issues[2]	*22.4*	*38.2*	*34.1*	*3.5*	*4.7*	*8.1*	*16.2*	*5.1*	*148.7*

[1] Non-dollar bonds converted into dollars at exchange rates prevailing on announcement dates. [2] Convertible bonds and bonds with equity warrants. [3] Converted at exchange rates prevailing at the time of issue.

Sources: Bank of England, AIBD and BIS.

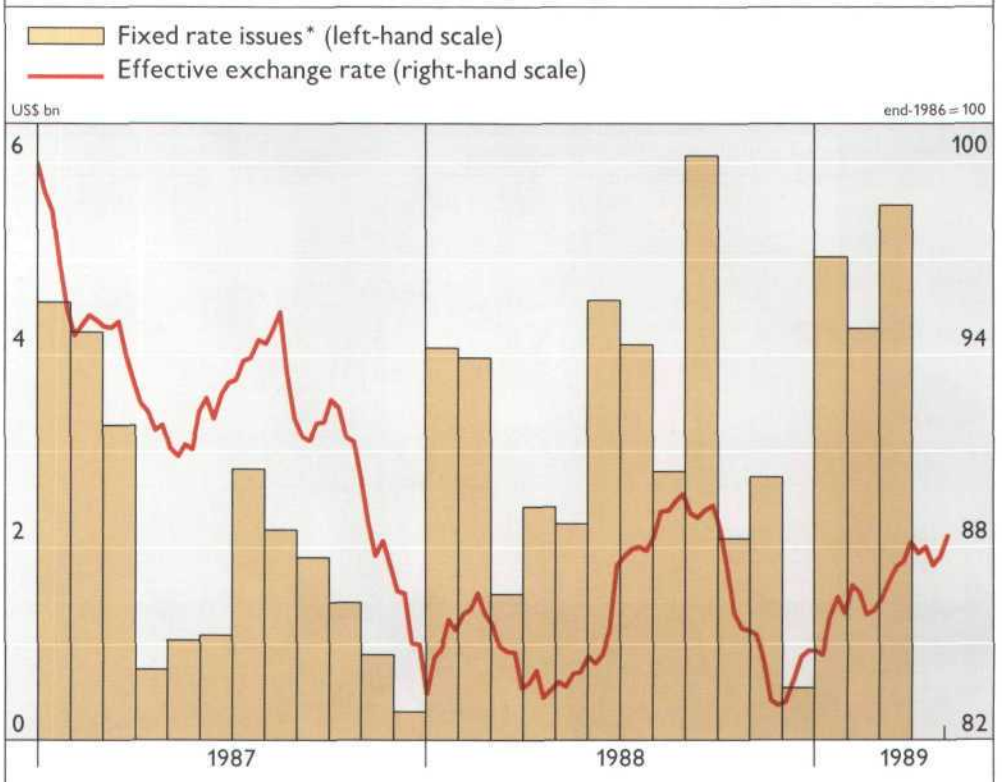


Factors behind expansion of new issuing activity

of international bond market activity. Firstly, national regulatory biases and tax provisions encouraged borrowers to shift their issuing activity offshore, although the ultimate buyers of the paper were in large measure residents of the same countries as the borrowers. These influences help to explain the sizable volume of equity-related issues by Japanese entities, the record issue volume in sterling and the exuberance of the foreign Deutsche Mark bond market. Secondly, the more stable exchange market outlook for the dollar contributed to a pick-up of activity in this sector, which, in terms of its depth and liquidity, is still unrivalled by any other currency sector. Thirdly, the use of a wider spectrum of smaller currencies, together with the continuing expansion of the swap market, also provided support to issuing activity. Indeed, the share in total announced new issues of bonds denominated in currencies other than the US dollar, Deutsche Mark, Swiss franc and yen, which had already expanded from 17% in 1986 to 28% in 1987, rose further to 32%. Fourthly, the international bond markets may have temporarily benefited from investor disenchantment with shares following the late-1987 stock market crisis. Finally, gross issuing activity was underpinned by the increasing reflow of funds stemming from redemptions of outstanding bonds.

Straight fixed rate bonds. In spite of the steep upward trend of short-term interest rates and flattening yield curves, announced new issues of straight fixed rate bonds expanded sharply from $121.3 billion in 1987 to

Issuing activity in the Euro-dollar bond market and the US dollar effective exchange rate



* On an announcement basis; excluding equity-related bonds.

Source for bond issue data: Bank of England.

$160.8 billion. Investors were particularly sensitive to developments on the exchange market. As a result, there were sharp swings in issuing activity in particular currency sectors whenever favourable borrowing opportunities opened up, a development which went hand in hand with the expansion of swap-driven business.

Buoyancy of straight fixed rate dollar bond issues

The share of dollar-denominated bonds in total announced straight fixed rate issues rose from 25% in 1987 to 29%, a level still well below that of earlier years. In spite of a sharp recovery in the immediate aftermath of the stock market crisis, new issue activity during the first half of 1988 remained affected by the flight to quality. Spreads between Euro-dollar and US Treasury bonds remained unusually high, and the average size of new issues was particularly large in order to satisfy investors' preference for liquidity. As the dollar strengthened in the course of the summer, US corporate borrowers returned to the international market and dollar issues surged. However, during the fourth quarter, following the announcement of unprecedented takeover bids in the United States (see Chapter IV) and the subsequent downgrading of the credit-standing of many US companies, the prices of outstanding Euro-dollar bonds issued by US companies fell sharply and new issue activity by US corporations came to a virtual halt. The temporary weakening of the dollar in the course of the fourth quarter also contributed to a slowdown in dollar issues.

Effects of the German withholding tax

The proposed introduction of a withholding tax on interest income in Germany played a considerable role in boosting international Deutsche Mark

issues to record levels, from $12.9 billion in 1987 to $21.2 billion. Many investors shifted out of domestic Deutsche Mark bonds with the consequence that foreign issuers, including the subsidiaries of German companies, were in some instances able to borrow on more favourable terms in the international bond market than the German Federal Government on the domestic market. New straight fixed rate issues in Swiss francs rose sharply during the first half of 1988. However, as long-term interest yields remained below those available in other currencies and the Swiss franc continued to show signs of weakness, it became increasingly difficult to place new issues. At the same time, a substantial volume of outstanding Swiss franc paper was redeemed, and, despite the pick-up in gross issues, net new Swiss franc borrowing declined from $2.4 billion to $1 billion.

Stagnation of yen issues

The yen was the only major currency in which issue activity contracted last year, namely in the case of straight fixed rate bonds, from $21.9 billion in 1987 to $18.8 billion. In terms of net new funds raised, the decline was particularly pronounced, from $18.5 to 11.6 billion. The lack of swap opportunities, low interest yields and the perception by some investors that the yen had peaked against the dollar, were probably the principal factors behind this slowdown. Under these circumstances new yen borrowing was often in the form of special issues linked to the performance of the Tokyo stock market.

Prominence of issues in currencies with high interest yield

A salient feature of 1987 and 1988 was the popularity with investors of bonds carrying a relatively high coupon, such as those denominated in sterling, the Canadian dollar, the Australian dollar and, in some respects, the ECU. New straight fixed rate issues in sterling rose from $9.2 billion in 1987 to $11.7

Currency structure of the international bond market

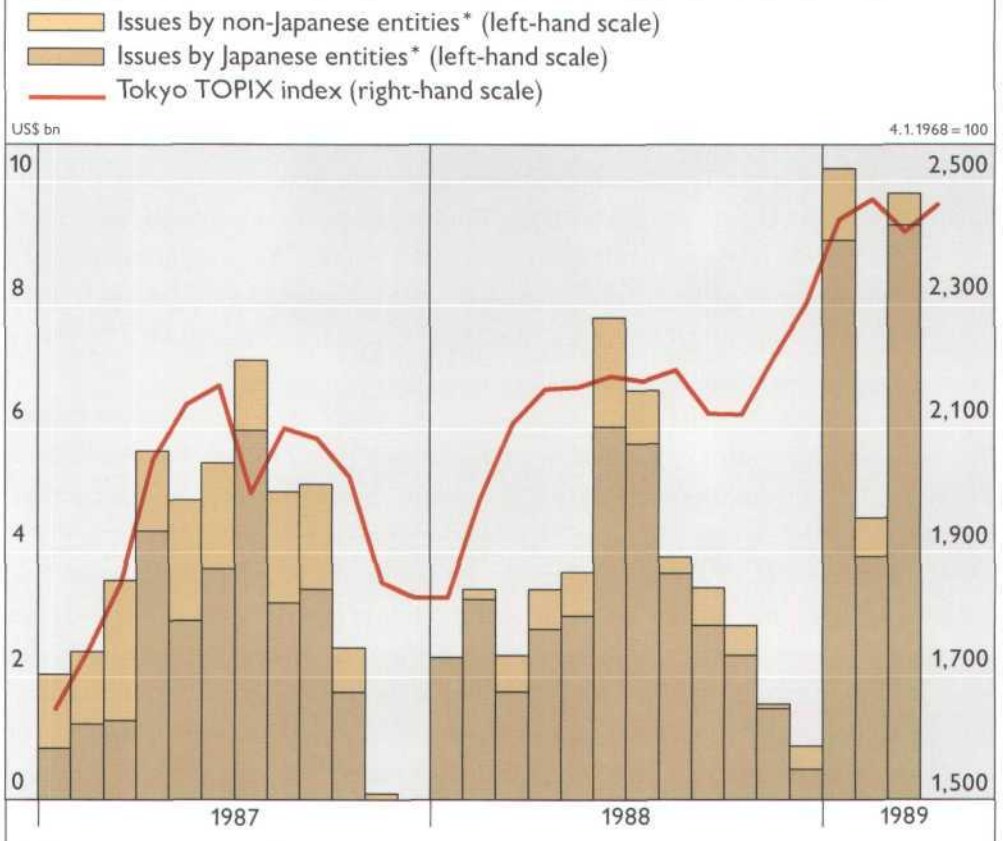
		New issues				Stocks			
		1985	1986	1987	1988	1982	1985	1987	1988
		in billions of US dollars							
Total new issues	A	163.8	221.7	177.1	225.4				
	B	123.0	160.3	110.1	137.9	259.1	556.7	990.8	1,085.4
US dollar	A	98.6	121.6	63.3	83.0				
	B		79.7	31.0	44.6	145.5	314.8	425.8	469.9
Swiss franc	A	14.6	23.1	24.1	26.7				
	B		15.4	7.9	5.0	42.6	78.6	157.8	139.3
Japanese yen	A	12.3	22.3	24.8	20.4				
	B		19.7	21.3	12.7	16.5	42.8	122.2	132.7
Deutsche Mark	A	11.3	16.3	15.3	23.6				
	B		11.5	4.3	16.0	31.4	50.6	99.2	103.7
Sterling	A	6.4	11.4	15.2	23.4				
	B		10.9	13.9	20.4	4.6	19.1	54.8	73.4
ECU*	A	7.5	7.0	7.6	11.3				
	B		5.9	7.5	9.7	3.2	16.5	41.0	46.5
Other	A	13.1	20.0	26.8	37.0				
	B		17.2	24.2	29.5	15.3	34.3	90.0	119.9

Note: A = announced gross new issues; B = completed new issues, net of repayments.

* Excludes bonds issued in borrowers' national markets.

Sources: Bank of England, AIBD and BIS.

Issuing activity in the equity-related bond market



* On an announcement basis.

Source for bond issue data: Bank of England.

billion. A strengthening exchange rate and declining interest rates contributed to a large volume of activity during the first half of 1988. Although this favourable combination of factors disappeared in late spring, activity was to some extent supported by a shortage of long-term sterling paper following the withdrawal of the UK Government from borrowing in the domestic gilt-edged market as a large surplus emerged in the public sector. As a result, a substantial proportion of the sterling paper issued on the international market found its way into the portfolios of UK institutional investors. Issues in Canadian dollars amounted to $13.2 billion, or 8% of total straight fixed rate issues in 1988. However, new issue activity was intermittent and concentrated on specific time periods when the swap market was accommodating. Activity in Australian dollars, which had been particularly buoyant in 1987, fell off somewhat. New issues in ECUs contracted markedly during the summer of 1988 but, as expectations of an EMS realignment receded, accelerated sharply towards the end of the year, with the total volume of straight fixed rate issues rising from $7.2 billion in 1987 to $10.7 billion.

Recovery of equity-related issues

Equity-related bonds. Following the setback in the aftermath of the stock market crash, equity-related issues recovered sharply in the first half of the year, and, at $42.1 billion, announced new issues for the year as a whole were only $1.6 billion lower than in 1987. Japanese borrowers alone accounted for nearly 85% of total announced new issues and for an even larger share of net

new funds raised in this market. Bonds with equity warrants, mostly denominated in US dollars, represented the bulk of new paper. Activity was particularly buoyant in the second and third quarters, whereas, owing to market saturation during the last quarter of 1988, new issues of bonds with warrants by Japanese companies fell off sharply in spite of the buoyancy of the Tokyo stock exchange. Almost 60% of new convertible bonds were denominated in Swiss francs, nearly all of which on behalf of Japanese borrowers.

Changing structure of the FRN market

Floating rate notes. After falling to a low of $12.1 billion in 1987, announced new FRN issues recovered to $22.4 billion last year. However, the structure of activity was quite different from the heyday of 1984–86. In the dollar sector, business remained sluggish and turnover on the secondary market declined further as the climate continued to be affected by the earlier collapse of the perpetual FRN sector and its repercussions on the market for dated FRNs owed by banks. Shrinking borrowing requirements on the part of governments, as well as the more favourable terms available on swapped fixed rate issues or on short-term paper, also depressed issuing activity. These influences were reflected in an unusually large volume of redemptions of outstanding FRNs denominated in dollars ($15.8 billion), and in the sizable share of new issues taking the form of private placements. On the other hand, FRN issues by UK borrowers in the Euro-sterling market accelerated from $1.5 to 9.8 billion. A very significant share of this borrowing was by specialised mortgage institutions or building societies and was backed by mortgages.

The FRN market in 1988 also witnessed the appearance of some new instruments. In particular, there was a significant volume of issues of variable rate notes ($1.9 billion), which, in contrast to traditional FRNs, allow for the margin over reference interest rates, such as LIBOR, to be reset for each coupon period to take account of changes in the credit-standing of the issuer or in the spreads on the market. In addition, in order to comply with the new supervisory guidelines, a number of banks issued subordinated capital notes.

Shift in sectoral composition of borrowers

The *sectoral composition* of overall international bond borrowing last year continued to move away from governments and international institutions to private sector entities. In terms of net new issues, the share of governments in total international bond borrowing contracted sharply, from 17% as recently as 1986 to only 6% in 1988. This can be attributed to smaller budget deficits in countries where governments have been traditionally large borrowers in the international markets and to a shift to other markets, such as that for Euro-notes, where funding was available on cheaper terms. In 1988 this movement away from borrowing in the international bond markets was reflected, in particular, in $8 billion of early repayments by governments of outstanding FRN issues. The decline in the share of international institutions has been more gradual and reflected a fairly stable volume of borrowing in the face of a growing market.

Issuing activity by banks and other financial institutions rose quite strongly last year, with their combined share in net new borrowing expanding from 37% in 1987 to 45%. This was partly a result of the new international capital guidelines, but other regulatory factors such as the proposed introduction of a withholding tax in Germany, which induced German banks to raise funds

through their foreign subsidiaries, also contributed to this growth. The share of total net issues accounted for by non-financial companies, which had risen markedly in 1987, decreased marginally last year. This was the net outcome of a sharp decline in borrowing by US corporations and the expansion of issues by Japanese companies. All in all, net issues by Japanese corporate business enterprises on the international bond markets accounted for 10% of their total domestic and international borrowings in 1988.

Nationality of issuers

With regard to the *geographical composition* of issuers, Japanese entities in 1988 were by far the largest takers of funds on the international bond markets, with equity-related issues accounting for three-quarters of their $40 billion of net new borrowings. Entities from the United Kingdom more than doubled their net take-up of funds, from $9.5 billion in 1987 to $19.2 billion. French, Canadian and Austrian entities also sharply stepped up their recourse to the international bond markets. US net borrowing, which some years ago had still been quite a dominant factor, shrank further to $6.6 billion and accounted for barely 5% of net new issuing activity.

Developments in early 1989

During the *first quarter of 1989* announced new issues of international bonds surged to a record level of $79.1 billion. Equity-related activity was the

Nationality of international bond issuers

Issuers		New issues				Stocks			
		1985	1986	1987	1988	1982	1985	1987	1988
		in billions of US dollars							
Japan	A	20.2	31.8	42.7	50.8				
	B		27.0	36.8	40.1	17.7	63.7	152.8	183.4
United States	A	40.2	41.7	22.6	17.1				
	B		33.9	12.2	6.6	36.0	98.5	160.8	163.7
Canada	A	8.8	17.0	9.0	12.9				
	B		13.0	3.0	6.4	41.4	56.9	81.5	86.9
United Kingdom	A	14.4	20.2	11.1	25.9				
	B		17.5	9.5	19.2	11.1	29.8	64.2	81.8
France	A	11.9	13.4	8.5	16.4				
	B		5.6	3.3	10.1	18.4	39.0	57.9	65.4
Other developed countries[1]	A	43.0	74.9	60.5	76.8				
	B		53.6	36.6	47.9	67.3	150.0	294.6	328.1
Developing countries[2]	A	6.2	3.0	2.2	3.7				
	B		0.5	−0.9	−1.1	18.0	27.9	34.0	31.9
Eastern Europe	A	0.4	0.6	0.6	1.2				
	B		0.6	0.5	1.2	0.6	1.0	2.4	3.5
International institutions	A	18.7	19.1	19.9	20.4				
	B		8.5	9.1	7.4	48.8	89.9	142.8	140.6
Total	A	163.8	221.7	177.1	225.4				
	B	123.0	160.3	110.1	137.9	259.1	556.7	990.8	1,085.4

Note: A = announced gross new issues; B = completed new issues, net of repayments.

[1] Other BIS reporting countries plus non-reporting developed countries. [2] OPEC and non-OPEC developing countries.

Sources: Bank of England, AIBD and BIS.

Huge volume of equity-related issues

most buoyant, with new issues soaring from $5.2 billion in the fourth quarter of 1988 to $24.6 billion, by far the highest quarterly level ever. Japanese issuers who benefited from the remarkable strength of the Tokyo stock market, dominated the picture. In the straight fixed rate sector, where new issues expanded to $51.2 billion, activity was strongly affected by exchange rate and interest rate expectations. The strength of the dollar and swap opportunities boosted new issues in US dollars from $8.4 billion in the fourth quarter to $19.3 billion; however, owing to interest rate uncertainties and the yield curve inversion, borrowing was heavily concentrated on the short end of the maturity spectrum. Amongst other currencies, a pronounced upswing in issues of straight fixed rate bonds was recorded in yen, sterling, Canadian dollars and Australian dollars, whereas Swiss franc and ECU borrowing fell off sharply. Another salient feature of the first quarter was the large share of fixed rate issues (about 20%) carrying non-equity options, particularly in the form of call provisions, which had been quite uncommon in recent years.

The international debt situation

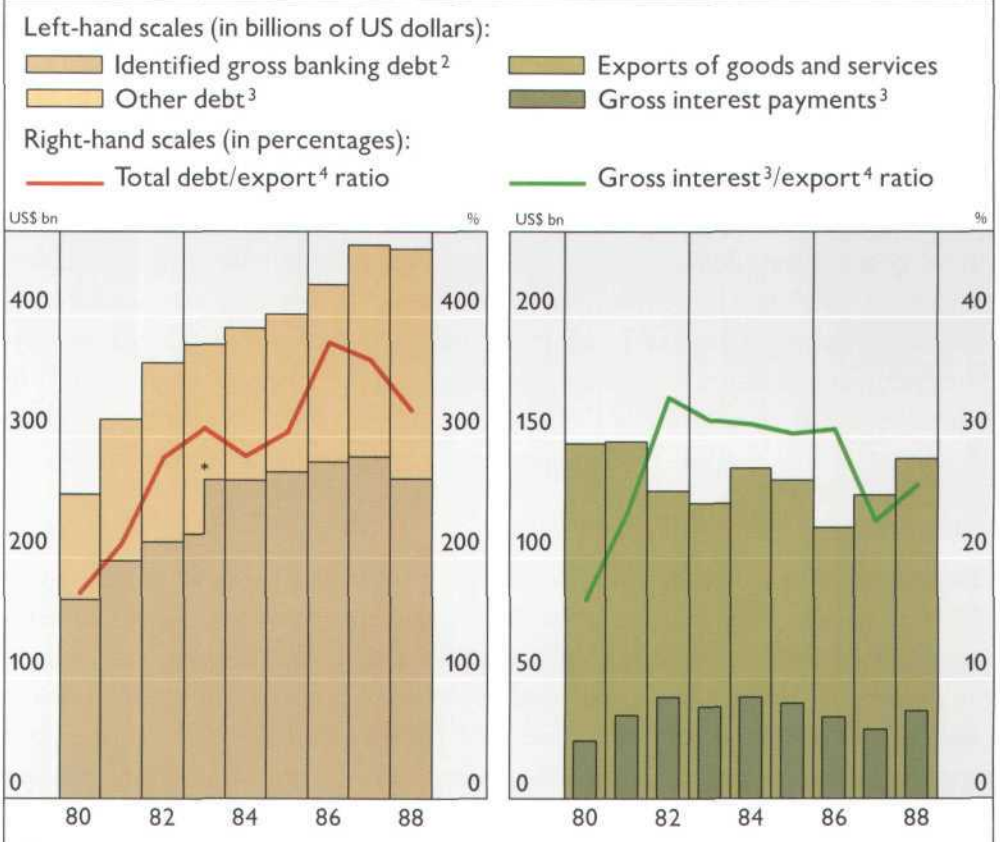
Continuing problems in the heavily indebted countries

Despite continued retrenchment, repeated efforts at structural reform and a highly propitious international cyclical environment, the developing countries struggling with serious debt problems experienced several setbacks last year. In the fourteen heavily indebted middle-income countries (i.e. the Baker countries excluding Yugoslavia) economic growth slowed down further, per capita incomes declined and unemployment rose. At the same time, inflation accelerated for the second year in succession to record levels of well over 200%. Except for lower inflation rates, the situation was equally bleak in sub-Saharan African countries, where rapid population growth was reflected in a particularly pronounced fall in per capita incomes. Moreover, as discussed in previous chapters, the ratio of gross investment to GDP in both groups of countries remains far below the pre-1982 levels, and in some cases is barely sufficient to maintain the existing capital stock. This casts serious doubts on the prospects for a longer-term resolution of the international debt problem through greater economic growth.

Recovery of exports and some debt reduction in the Baker countries

In certain important areas, such as export performance and debt reduction, the deeply indebted middle-income countries were able to make some headway last year. Thanks to boom conditions in the industrial world, their export volumes rose by 12%, a rate of growth not experienced since the advent of the debt crisis, though part of the gain was eaten up by a further deterioration in terms of trade. The total debt of the heavily indebted middle-income countries fell for the first time in the current decade. Although the decline amounted to less than 1%, the strong expansion in export receipts helped to reduce the ratio of total debt to exports from 364% in 1987 to 323% in 1988, a figure still 50% above its level on the eve of the debt crisis (see the graph on the following page). On the other hand, the strong upturn in short-term dollar interest rates last year contributed to a rebound in the ratio of interest service to exports from 23 to 26%. The discount at which the debt of these countries is traded in secondary markets, and which had already risen sharply in 1987, increased further.

Evolution of major debtor countries' external indebtedness and debt service[1]



* Break in series due to the broadening of the coverage of the BIS international banking statistics.

[1] The countries in question are those covered by the Baker initiative, with the exception of Yugoslavia. [2] Vis-à-vis banks located in BIS reporting countries, at current exchange rates. [3] Estimates based on IMF data, at current exchange rates. [4] Goods and services.

In sub-Saharan Africa trade and debt developments offered little solace. Export volumes actually decreased by 0.5% in 1988, after rising handsomely in the two preceding years. This decline was exacerbated by a 2% worsening in these countries' terms of trade, which followed upon a deterioration of over 8% one year earlier. Moreover, unlike the heavily indebted middle-income countries, sub-Saharan Africa saw its total external indebtedness rise by nearly 5% to $97 billion, but this was exclusively the result of an expansion in liabilities to official and private non-bank creditors. Debt to BIS reporting banks, which accounts for less than a sixth of these countries' total indebtedness, contracted by $1.7 billion to stand at $14.9 billion. As a result of these developments, the ratio of total external debt to exports in sub-Saharan Africa continued to rise, reaching 331%, compared with 179% in 1981.

Export stagnation and increasing debt burdens in sub-Saharan Africa

The 1988 reduction in the total external debt of the heavily indebted middle-income countries was concentrated on liabilities to BIS reporting banks, which declined by $19 billion, or nearly 7%, to $265 billion. Part of this contraction was, however, due to the appreciation of the US dollar. If exchange rate effects are excluded, the drop was $14 billion, or 5%, with most of it being accounted for by Mexico and Brazil. One reason for the fall was the marked increase in debt conversions. The nominal amount of debt

Decline in banking debts heavily concentrated on a few large countries

converted more than doubled to $21 billion. Since some operations, such as debt-for-debt swaps, reduce rather than eliminate the debt, the net decrease in indebtedness attributable to conversions was somewhat smaller. The transactions were highly concentrated on four countries, Mexico, Brazil, Chile and Argentina, which accounted for over 90% of the total. Nevertheless, in other countries, notably Nigeria and several smaller ones, debt conversion programmes have recently been instituted.

Further easing of terms in rescheduling agreements

The number of rescheduling agreements signed with commercial banks plummeted from seventeen in 1987 to eight last year. However, because of the large amounts involved in the Brazilian operation, the amount of debt rescheduled declined by only $10 billion to $83 billion, whereas disbursements of new money under concerted lending arrangements rose to around $6 billion. At the same time, the easing of the terms in the rescheduling packages that has been evident in the past few years continued. The average maturity of rescheduled debt increased by four years to nineteen years, and the margin over LIBOR continued to fall, dropping to 0.8% from about 1% in 1987.

The Brazilian package ...

The agreement reached in June 1988 between Brazil and its commercial bank creditors was the first major rescheduling package to be negotiated in the wake of the widespread and substantial increase in country risk provisioning by banks in the United States, the United Kingdom and Canada that had followed upon Citicorp's well-publicised decision in May 1987 to build up its loan loss reserves for LDC exposures by $3 billion. The Brazilian package agreement denoted a further evolution in the relationship between the heavily indebted middle-income countries and their bank creditors. It provided for the rescheduling of $61 billion in outstanding medium and long-term commercial bank credits, $5.2 billion in fresh medium-term money, and about $15 billion in short-term interbank lines and trade-related credit facilities. In addition, it recognised the need to provide greater incentives for bank participation, and it explicitly took into account the changes in individual banks' exposures that had occurred since 1982. The main innovation in the Brazilian package was its extensive use of attractive debt conversion options. For example, more than 100 of Brazil's 700 creditor banks exchanged over $1 billion in debt for exit bonds bearing interest at 6% that could be converted at full face value into inflation-indexed cruzado Treasury obligations which can be sold freely within Brazil. About fifty smaller banks converted all of their medium and long-term claims on Brazil through this operation. These exit features, and the choice of a March 1987 base date for determining contributions to the new money package, altered the shares of banks from different countries, with the share of Japanese banks rising.

... and its exit features

Official debt relief for sub-Saharan Africa

A second significant event in 1988 was the announcement at the summit in Toronto of the intention of the Group of Seven to provide debt relief for the poorest countries in sub-Saharan Africa. Although the plan provides for only a modest reduction in the debt burden of these countries, the Toronto declaration marked a watershed in the sense that it represented the first jointly agreed inter-governmental scheme for providing relief on debt owed to governments by a whole group of countries. Here, as in commercial bank negotiations, a range of options was offered to the creditors. Individual

External debt of selected developing countries

	Stocks					Changes, excluding exchange rate effects	
	1983	1985	1986	1987	1988	1987	1988
	in billions of US dollars						
Brazil							
Total debt	97.5	106.5	112.8	123.9	120.1		
of which: to banks	*71.3*	*76.9*	*81.1*	*81.0*	*75.9*	*−2.8*	*−3.9*
Claims on banks	11.4	16.6	16.8	13.5	16.2	−3.4	2.7
Mexico							
Total debt	93.1	96.9	101.1	107.9	106.2		
of which: to banks	*72.1*	*74.5*	*74.2*	*75.8*	*69.3*	*−0.5*	*−5.8*
Claims on banks	18.0	21.9	23.0	30.1	24.5	6.5	−5.2
Argentina							
Total debt	45.9	49.3	49.7	56.8	59.6		
of which: to banks	*27.4*	*28.9*	*32.4*	*35.3*	*35.1*	*1.6*	*0.4*
Claims on banks	8.7	9.2	8.5	10.2	11.7	1.5	1.6
Chile							
Total debt	18.1	20.4	20.2	21.2	20.7		
of which: to banks	*13.1*	*14.3*	*14.0*	*12.9*	*11.0*	*−1.6*	*−1.7*
Claims on banks	3.7	3.4	3.1	3.5	4.3	0.4	0.8
Venezuela							
Total debt	37.4	34.7	34.7	36.5	35.0		
of which: to banks	*28.3*	*25.8*	*25.1*	*25.0*	*25.5*	*−0.5*	*0.7*
Claims on banks	17.1	22.0	16.6	16.2	15.9	−0.6	−0.2
Nigeria							
Total debt	18.6	19.5	24.5	28.7	28.5		
of which: to banks	*9.3*	*9.1*	*10.0*	*10.7*	*8.9*	*−0.5*	*−1.3*
Claims on banks	1.4	1.9	2.4	3.7	3.0	1.0	−0.6
Philippines							
Total debt	24.1	26.2	28.9	30.0	29.9		
of which: to banks	*13.7*	*13.4*	*14.1*	*14.4*	*12.3*	*−0.4*	*−1.9*
Claims on banks	2.4	3.1	3.3	4.3	4.0	0.7	−0.2

Note: The term "banks" refers only to those covered by the BIS reporting system.
Sources: BIS and World Bank.

governments can write off part of the debt service, extend the maturities and lower the rates of interest charged on their non-concessional official bilateral claims.

Considerable changes in attitudes and conditions have occurred in the years since the then Secretary of the US Treasury, James Baker, articulated a strategy for resolving the debt crisis based in part on the further extension of commercial bank credit to the troubled debtors. For their part, commercial banks have become increasingly reluctant to lend to these countries, since the assumption on which this new lending was originally based, namely that it would improve the quality of their outstanding claims, in many cases does not seem to have been borne out by subsequent developments. Apart from some of the larger international banks with long-term commitments to the developing countries, commercial banks have, consequently, preferred to cut their exposure to the heavily indebted countries. In addition, increased provisions

Increased reluctance of banks to commit new funds

and higher capital levels have reduced the vulnerability of the banks and have put them in a better position to resist requests for more funds from the debtor countries. As a result, the additional bank lending envisaged by the Baker Plan has not, on balance, been forthcoming.

Adjustment impasses in the debtor countries

The capacity of the developing countries to build up and service still more debt has also been called into question. Many of these countries have made major adjustment efforts since 1982 and, essentially by compressing imports and investment, have achieved large trade surpluses. Excluding payments of interest, the cumulative current-account surplus of the fourteen middle-income debtors since the eruption of the debt crisis amounted to $155 billion by the end of 1988, which is equivalent to half of their total debt at the end of 1981. Interest payments, however, have more than absorbed these earnings and the countries have seen their debt rise steadily, whereas the investment needed to boost economic growth and trade performance has not been forthcoming. A larger volume of external borrowing might, in the short run, ease some of the policy constraints, but, unless accompanied by fundamental structural reforms, it is by no means sure whether it would augment the growth of export capacity enough to justify the concomitant further increase in debt service burdens.

Opposition within debtor countries to a maintenance of full debt service is not difficult to understand. The costs are high, immediate and obvious to all, while the rewards seem to be somewhat remote. There is also a widespread perception that many of the benefits of domestic economic reforms will accrue to foreign creditors through increased net transfers abroad. Declining standards of living and growing social and political unrest in reaction to adjustment measures suggest that the scope for the necessary fundamental policy changes has become more limited. A symptom of the desperate situation of some of the debtor countries and the related deterioration of debt service morale is the considerable build-up of arrears, which has not been confined solely to debts to governments and commercial banks. Although the number of delinquent countries declined, arrears of principal and interest owed to the IMF rose significantly last year, to about 10% of Fund credit outstanding.

Brady proposal for a modification of the current debt strategy

Following an announcement by President Bush of a major review of the strategy for tackling the debt problems of the developing countries, Nicholas Brady, the Secretary of the US Treasury, presented several ideas for supplementing and modifying the current approach. Many of the ideas, which built upon earlier Japanese and French proposals, were subsequently endorsed by the major industrial countries at a meeting in Washington. The centrepiece of this new approach is the use, on a case-by-case basis, of debt and debt service reduction along with new lending as a means of providing financial support to individual debtor countries undertaking fundamental and convincing economic reforms. The principal difference between it and the ad hoc debt reduction operations that have taken place up till now is the proposed use of IMF and World Bank funds for such purposes. In addition, to facilitate debt reduction, it was recommended that waivers of clauses in existing loan agreements impeding debt and debt service reduction programmes be negotiated for a limited period. The governments of the large industrial countries also

undertook to review regulatory, tax and accounting practices which might unnecessarily impede the banks' ability to grant debt and debt service relief.

Because many details have yet to be worked out, and also because the plan calls for voluntary negotiations between sovereign debtors and their commercial bank creditors on a case-by-case basis, the total amount of debt and debt service relief that could be achieved cannot be determined with precision. A US Treasury estimate suggests that the debt of thirty-nine countries which since 1982 have rescheduled their commercial bank debt could be cut by about $70 billion, or 20%, over a span of three years and that their interest payments could be reduced by $20 billion. These figures depend critically on assumptions about the discounts at which the debt reduction operations would take place and the amount of money that the multilateral institutions would devote to debt and debt service reduction. The US Treasury has suggested that between $20 and 25 billion of the lending of the IMF and World Bank over a three-year period could be used for this purpose. Japan repeated its earlier offer to provide concessional funds in parallel with those extended by the international institutions.

Conceivable dimensions of debt relief

The Bretton Woods institutions could use their resources in a variety of ways to reduce debt burdens and to encourage bank participation in restructuring operations. They could finance buy-backs at substantial discounts, which would lower both debt and debt service obligations. Alternatively, the proceeds of their loans could be used to purchase collateral for new debt instruments with a smaller face value than the old ones, or for guaranteeing reduced interest payments on unchanged debts. Similar techniques could be employed to support additional loans from commercial banks.

Role of Bretton Woods institutions

In line with suggestions made by the Secretary of the US Treasury, the IMF is reconsidering its policy with respect to the relationship between its own lending and commercial bank restructuring agreements. In the past the IMF was unwilling to commit funds until a "critical mass" for the financing of the anticipated shortfall in the borrower's balance of payments was assured. In practice this meant that Fund programmes were not finalised until bank debt restructuring agreements were largely in place. However, in April 1989, before Mexico had even begun formal negotiations with its commercial bank creditors, the IMF indicated that it would lend $3.6 billion to that country. Mexico's letter of intent included assumptions regarding the level, but not the form, of refinancing that it expected to negotiate with the commercial banks. The rationale for this new approach is to avoid costly delays in the implementation of the necessary adjustment programmes in debtor countries, the implicit assumption being that the commercial banks will subsequently come up with equivalent concessions.

Changes in Fund lending strategy

Officially supported debt relief is bound to affect the willingness of commercial banks to lend additional funds to the problem debtors. To the extent that it improves the developing countries' ability to meet their obligations and prevents the build-up of arrears, debt relief will tend to lessen banks' reluctance to increase their exposure. However, it seems more likely that debt relief granted by the banks on the initiative of their own governments may make them even more hesitant to lend additional funds without explicit official

Possible implications of new strategy on bank behaviour

guarantees. How could bank managements justify to their shareholders the extension of new credits at essentially unchanged terms when identical claims can be bought in the secondary market at a substantial discount?

The advantages ...

By lowering debt and debt service obligations, the new strategy could provide debtor countries with the breathing space needed for carrying out the kind of growth-oriented policy adjustments which otherwise would have been too painful to be politically acceptable. Moreover, if successfully implemented, it should help to avoid the disorderly build-up of arrears and the disruptions and climate of confrontation usually associated with it.

... and dangers of debt relief

On the other hand, the new proposals for easing debt burdens entail certain dangers. By generating excessive expectations they may delay the conclusion of agreements and persuade governments to suspend their present debt conversion programmes. Moreover, general debt reduction schemes based on secondary market values may easily create perverse incentives. Rather than implementing necessary reforms, countries may be tempted to try to drive down the market value of their debt so that they can extract the greatest benefits from the relief schemes. Finally, a strategy that provides relief only to problem countries runs the risk of being considered unfair to those countries that have carried out quite onerous and ultimately successful adjustment programmes and have serviced their debts in full.

Need for continued conditionality

The crux of the problem is how to promote the necessary growth-oriented reforms and macro-economic policies. Until now the process of repeated rescheduling has ensured continuous monitoring by the IMF and the World Bank. Debt reduction, which is a once-for-all operation, does not lend itself to such monitoring unless it takes place in steps. Moreover, in order to achieve a sustainable increase in the net resource flows to the debtor countries it will have to be backed up by new lending.

The role of "flight capital"

An additional and potentially very large source of capital for the troubled countries that underlines the utmost importance of sound policies is the large amount of assets held abroad by their residents. Accurate data are not available on these holdings, but, as the table overleaf suggests, their increase in a number of Latin American countries over the ten years up to and including 1987 may have amounted to a very large proportion of, or even exceeded, their present debts to commercial banks.

However, the bulk of such assets are owned by the private sector, and residents are unlikely under present conditions to be more willing to invest in their home countries than foreign commercial banks or other creditors. Repatriation of "flight capital" tends to be more a consequence of fundamental improvements in conditions at home than a means of bringing them about. It may even be that some of the devices for achieving debt reduction, for example debt conversion programmes that in effect provide subsidies for capital imports, induce temporary capital outflows as residents seek to benefit from the preferential exchange rates often used in connection with debt conversion arrangements.

In brief, there can be little doubt that debt relief, if properly implemented, can make a decisive contribution towards solving the problems of the heavily indebted countries. Debt service reduction, accompanied by additional

Cumulative changes in external positions of selected developing countries, 1978–87

	Cumulated current account (1)	Net direct investment plus change in reserves (2)	Change in total external debt[1] (3)	Balancing item[2] (4) = (1)+(2)+(3)	Liabilities to BIS reporting banks at end-1988 (5)
	in billions of US dollars				
Argentina	−23.5	9.5	45.4	31.4	35.1
Bolivia	− 2.8	0.3	3.8	1.3	0.4
Brazil	−71.4	21.0	82.5	32.1	75.9
Chile	−17.7	0.8	15.4	−1.5	11.0
Colombia	−10.1	2.2	12.0	4.1	6.9
Costa Rica	− 3.7	0.3	3.4	0.0	0.9
Ecuador	− 6.0	1.2	8.1	3.3	4.9
Mexico	−28.8	8.2	76.7	56.1	69.3
Peru	− 6.5	0.2	8.9	2.6	4.6
Uruguay	− 2.2	0.6	3.1	1.5	2.0
Venezuela	9.2	3.7	25.8	38.7	25.5

[1] Current dollar change in external debt plus the use of IMF credit. [2] Since the current account equals the change in the net foreign asset position, this column represents the change in the stock of external assets and liabilities not included in the second and third columns. The main missing item is the build-up of private assets abroad. Capital outflows via the under-invoicing of exports and the over-invoicing of imports, a common phenomenon in some of these countries, are not captured by this balancing item.

Sources: IMF and World Bank.

Crucial importance of linking debt relief with fundamental economic reforms

lending and a return of "flight capital", could materially improve the net resource flows and permit a return to higher investment ratios and more satisfactory rates of economic growth. However, spontaneous new commercial bank lending and the repatriation of "flight capital" will occur only when there are clear prospects of a permanent recovery of the economic health of the countries concerned. A lasting solution to the problems of the debtor countries can be achieved only when the breathing space provided by debt relief is used to create stable macro-economic conditions and to implement the necessary growth-oriented structural reforms. In this sense the basic ideas of the Baker Plan are as valid as ever.

VI. Monetary developments and policy

Highlights

Faced with last year's unexpected acceleration in economic growth, monetary policy in many of the industrial countries increasingly had to take account of the risk of strains on productive resources. Short-term interest rates in the largest countries continued to decline in early 1988, when the economic outlook was still clouded by the stock market crash and dollar weakness, but thereafter money market rates edged up progressively. In contrast to 1987, long-term interest rates rose little or remained stable for most of 1988, with the result that the term structure of interest rates became flat or inverted.

Partly because official exchange rate commitments came to be regarded in the market as increasingly convincing, private capital flowed on a very large scale to countries with relatively high nominal interest rates. As the Federal Reserve sought to slow the rapid pace of domestic economic expansion, rises in short-term interest rates in the United States added to upward pressures on the US dollar vis-à-vis other major currencies. In Japan, where the price level remained virtually stable, monetary policy continued to be geared to fostering the international current-account adjustment process, and short-term interest rates rose very little. By contrast, exchange market and short-term interest rate policy in Germany took account of the depreciation of the Deutsche Mark, which threatened domestic price level stability, as well as the emerging pressures on productive capacity.

Capital flows, which weakened the Deutsche Mark against the US dollar, helped to stabilise exchange rates within the exchange rate mechanism of the European Monetary System once the authorities succeeded in convincing the market that a realignment of central exchange rates was not under consideration. France, Belgium and the Netherlands shared in last year's quickening of the pace of economic expansion and accepted rises in short-term interest rates which seemed appropriate on domestic grounds. In Italy, where economic growth was relatively strong, capital inflows hindered efforts to achieve an appropriate degree of monetary restraint. Capital flows exerted upward pressure on the currencies of many other countries with relatively high inflation rates and weak external current-account positions as they tightened monetary policy to counter a build-up of inflationary pressures. Situations of this kind were experienced at times in the United Kingdom, Canada, Spain, Portugal, Sweden, Norway, Finland and Australia.

With the relationships between the growth of the money stock, economic activity and inflation rates influenced in large measure by exchange rate changes and special factors, monetary policy in the major countries was not closely geared to controlling the growth rates of monetary aggregates.

Responding strongly to interest rate movements, the growth of key monetary aggregates slowed down in the United States but continued at a rapid pace in Japan and Germany last year. The rate of monetary growth accelerated in the United Kingdom and Canada. In the absence of reliance on a money stock anchor, monetary authorities in the larger countries were guided by a variety of indicators of developments in the financial markets and in the economy in attempting to judge the appropriate stance of monetary policy.

While inflation remained generally moderate in 1988 and the policies followed contributed to allaying market concerns about inflation, it is uncertain at present whether the changes in monetary policies which have occurred will bring about a sufficient slowdown in the pace of economic expansion to counter the build-up of inflation which has been taking place.

Monetary policy in the major industrial countries

Domestic and external considerations in monetary policy

Generalised rise in short-term interest rates

Monetary authorities in the largest industrial countries induced a rise in money market interest rates as from the spring of last year in response to indications of increasing strength in economic activity and, in many cases, signs of a faster rise in production costs which might herald an acceleration in underlying rates of consumer price inflation. In contrast to 1987, unfavourable reactions in the bond and share markets to rises in short-term interest rates did not occur – indeed the flattening or inversion of the yield curve which became evident during the summer and autumn was widely interpreted as a sign of market confidence that timely monetary policy restraint would succeed in keeping inflation in check.

Capital flows to countries with relatively high interest rates

In a changed climate of exchange rate expectations, which may have partly reflected the greater credibility of official commitment to resisting a further decline of the dollar as well as an improvement in the US trade balance, private capital flows to the United States increased strongly. Large-scale purchases of dollars by monetary authorities in support of the US currency were no longer necessary. Indeed, German official external reserves fell substantially last year, mainly as a result of exchange market intervention to moderate the rise in the US dollar. The response of international capital flows to relatively high nominal interest rates posed acute dilemmas at times for the monetary authorities in the United Kingdom, Canada and Italy. To achieve the degree of monetary restraint which seemed to be called for in these countries it appeared necessary to permit the domestic currency to appreciate. Exchange rate appreciation would directly contribute to moderating rises in cost and demand pressures, albeit at the cost of a further deterioration in the external current account. However, especially if some rise in the underlying rate of inflation could not be avoided, a higher exchange rate might well prove unsustainable in the medium term.

Monetary authorities' responses in situations of this kind depended on the importance they attached to exchange rate stability as an anchor for monetary policy and inflation expectations in the longer run. While a realignment of central exchange rates within the exchange rate mechanism of the European

Monetary System was avoided, in a wider context there was a clear shift in many countries last year towards giving increased priority in monetary policy to attempting to avoid overheating of the domestic economy and a resurgence of inflation. This need not be interpreted as implying a retreat from international co-operation, which was evident in joint intervention to limit the rise of the dollar and in continuing consultations. The absence of severe strains in the financial and exchange markets seems to testify to the enhanced credibility of policy co-operation in exchange market management. But as economic expansion strengthened and spread to countries where previously growth had been sluggish, conflicts between domestic and external objectives tended to disappear, and the inflation risk came to be generally recognised as the most pressing consideration.

Increased priority given to avoiding an acceleration of inflation

In the United States the Federal funds rate rose steadily between March and August 1988 as the Federal Reserve responded to increasing evidence of strong growth in the economy by tightening bank reserve positions. Concern that failure to tighten monetary policy might permit inflation to accelerate led to the acceptance of some appreciation of the US dollar. It could reasonably be argued, of course, that allowing US prices and costs to move out of line with those abroad would hinder current-account adjustment in the longer run. For a time in the autumn the pace of economic growth seemed to be easing and bond yields actually fell. In the late autumn, however, the Federal Reserve saw evidence of continuing inflation momentum and as from November brought about a further rise in short-term interest rates. To signal the thrust of monetary policy the Federal Reserve discount rate was increased in August 1988 and was raised further in February 1989.

Monetary restraint in the United States and appreciation of the US dollar

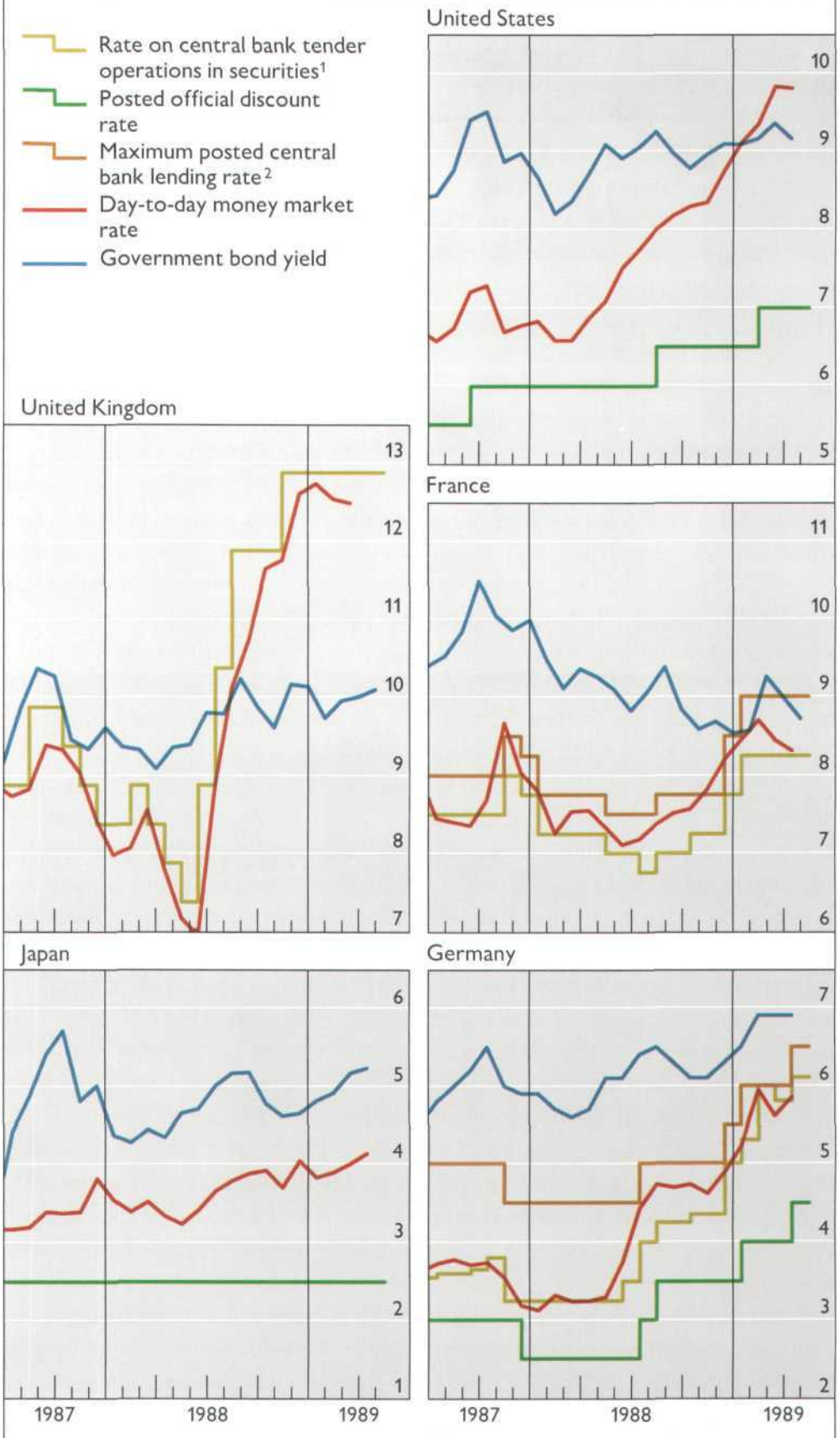
Although economic expansion in Japan continued to be very robust, cost and import competition effects deriving from the earlier large appreciation of the yen and a strong supply response in the economy contributed to keeping consumer prices stable in 1988, while wholesale prices actually fell. Downward pressure on the yen in the spring and summer remained modest and was not resisted by official exchange market intervention. Some firming of short-term interest rates was accepted, but the rise was far less than that recorded in other major countries. That the yen's earlier fall against the US dollar was largely reversed after October argued against a more pronounced tightening of monetary policy, and the Bank of Japan's discount rate was kept unchanged.

Limited tightening in Japan

By contrast, in Germany, where output moved close to potential, the Deutsche Mark's depreciation against the US dollar, by over 20% in the period from January to August 1988, and its weakness against a number of non-EMS currencies contributed to upward pressures on the domestic price level. Between June and August, in a context of large-scale exchange market intervention, the Bundesbank gradually raised the rates applied in tenders for supplying bank reserves and also increased its discount and lombard lending rates. Short-term market rates rose steeply in this period and went up further as from December, in line with the rates applied in the Bundesbank's tender operations. By this time a strong economic expansion was clearly under way in Germany and also in most of its partner countries in the EMS exchange rate mechanism. Between December 1988 and April 1989 the central banks of

Response to Deutsche Mark weakness and strong economic expansion in Germany

Official and market interest rates



[1] For the United Kingdom, purchases of very short-term bank bills. [2] For Germany, lombard rate; for France, standing securities sale and repurchase facility.

Belgium, the Netherlands, Switzerland and Austria joined the Bundesbank in raising official posted rates in several stages. As in Japan, bond yields also rose in late 1988 and early 1989.

Return to monetary restraint also in France

In France the decline in market interest rates from the high levels reached in late 1987 continued until June 1988, with the French franc even rising slightly in the EMS band. Although inflationary pressures were not expected to become unduly strong, provided that wage developments remained moderate, the small external current-account deficit was thought to call for levels of interest rates which would encourage domestic private saving. As from August increases in the Bank of France's tender rate underpinned progressive rises in short-term money market rates, and in early 1989 bond yields also rose sharply.

Policy dilemmas in the United Kingdom ...

In the United Kingdom a situation that was diagnosed in the late spring of 1988 as a classic case of excess demand spilling over into a balance-of-payments deficit and rising wage pressures was attributed to an excessively low level of short-term interest rates implied by the earlier policy of preventing a rise in sterling vis-à-vis the Deutsche Mark. However, the competitiveness of British industry had been a major consideration in the selection of the informal exchange rate objective, and a number of financial and economic indicators had been pointing to the need to tighten monetary policy for some time. After the exchange rate cap was abandoned, short-term interest rates were encouraged to rise in stages between May and August and to increase much further in October. Long-term interest rates displayed remarkably little response. It is difficult to assess how much influence was exerted – in addition to capital inflows – by the Government's funding policy. This now took the form of substantial net repurchases of government debt by the authorities on a scale broadly matching the central government's surplus, which came to nearly £7 billion in the financial year ending in March 1989, compared with a net borrowing requirement of £0.9 billion in 1987–88.

... Italy ...

In Italy strong demand pressures, fuelled by the large budget deficit, and increases in production costs were reflected in a marked acceleration of consumer prices by the end of last year. From July short-term interest rates, which were already at a relatively high level, rose further and the lira gradually appreciated in its broad EMS band. In February 1989, against the background of a sharp expansion in bank lending to the economy, and especially in foreign currency lending financed from abroad, reserve requirements were extended to banks' net foreign currency liabilities. With the intention of giving a strong signal, the Bank of Italy raised its official discount rate by a full percentage point in March.

... and Canada

Although forecasts of the strength of economic activity in Canada were gradually revised upwards in the course of the year, it was clear by the end of 1988 that demand and cost pressures had been consistently underestimated. Both short and long-term interest rates rose progressively to an extent which roughly preserved their margin over the corresponding US rates.

The framework of monetary targeting

Monetary policy in the industrial countries last year was again not closely

Monetary and credit aggregates: Objectives and rates of expansion

Countries and aggregates[1]		Objective[2] for			Monetary or credit expansion			
					Target period[4]		Change over four quarters[5]	
		1987[3]	1988[3]	1989[3]	1987	1988	1988Q1	1989Q1
		in percentages						
United States	M_2	5½–8½	4–8	3–7	4.2	5.2	4.2	4.1
	M_3	5½–8½	4–8	3½–7½	5.7	6.3	5.8	5.5
	TDND	8–11	7–11	6½–10½	9.8	8.7	9.1	8.8
Japan	M_2 + CDs	11–12	10–11	10–11	11.8	10.6	12.0	10.3
Germany	CBM	3–6	–	–	8.0	8.5	8.3	9.2
	M_3	–	3–6	about 5	6.0	6.8	6.0	6.8
France	M_2	4–6	4–6	4–6	4.0	3.9	3.0	3.8
	M_3	3–5	–	–	9.1	6.9	8.2	7.3
United Kingdom	M0	2–6	1–5	1–5	5.8[6]	6.2[6]	5.2	6.7
Italy	CPS	5–9	6–10	7–10	10.3	15.7	9.4	18.1
	M_2	6–9	6–9	6–9	8.3	8.4	7.1	9.1
Spain	ALP	6½–9½	8–11	6½–9½	14.0	11.1	13.8	11.4
Switzerland	CBMA	2	3	2	3.0	−3.9	1.3	n.a.
Portugal	L–	–	10–13	7½–10½	16.8	14.8	17.6	n.a.
Greece	M_3	–	14–16	18–20	25.2	22.4	25.3	n.a.

[1] TDND = total domestic debt of non-financial sectors; CBM = central bank money; M0 = wide monetary base; CPS = credit to non-state sector; ALP = liquid assets in the hands of the public; CBMA = adjusted monetary base; L– = total liquidity held by non-financial residents. [2] For TDND in the United States, monitoring range only; for M_2 + CDs in Japan, projection only. [3] Periods running from the fourth quarter to the fourth quarter for the United States, Japan (except 1989, second quarter to second quarter), Germany and France. From December to December for Italy, Spain, Greece and Portugal. For the United Kingdom, twelve-month periods ending in March. Annual averages for Switzerland (for 1989 average annualised seasonally adjusted growth from the fourth quarter of 1988). [4] Calculated on the same basis as the objective. [5] Based on quarterly averages. [6] Twelve months to March 1988 and 1989.

Sources: National data.

Policy not closely geared to monetary aggregates

geared to controlling the money stock, but the argument that the absence of inflationary pressures rendered this unnecessary lost more and more of its force. The idea that rates of monetary expansion in the longer run tend to be reflected in inflation rates still led to the publication of annual norms for the growth rates of representative monetary aggregates in many countries. They are generally based on the estimated rise in productive potential at current prices and the trend change in income velocity or on normative forecasts of output growth and short-run inflation performance. However, for several reasons such norms have not, in practice, served as the main guides in the conduct of monetary policy in the last few years.

Impact on velocity of disturbances and structural financial change

The income velocity of some aggregates was clearly affected last year by unpredictable disturbances or by structural financial change whose impact was difficult to foresee. An example of the former could be seen in Germany, where a sharp acceleration in the growth of currency in circulation, partly related to uncertainties associated with the planned introduction of a withholding tax on interest income, had to be accommodated. In France and Italy structural changes in the financial system contributed to strong rises in

non-bank holdings of market instruments which are included in M_3 but not in the targeted aggregates. In Switzerland changes in the interbank clearing arrangements and in the system of reserve requirements permitted banks to economise on the holding of balances at the National Bank to an unexpectedly large extent.

In the United Kingdom, on the other hand, the impact on M_3 of competition between the banks and building societies led to the abandonment of targets for the broad aggregates some years ago but the upsurge in M0 and M_4 recorded last year might have been interpreted as indicating a need for greater monetary restraint. Fast rates of monetary expansion in relation to the objectives in Portugal and Greece last year served to confirm the need for tighter monetary policies.

Interest rate effects

Other large changes in velocity primarily reflected interest rate effects. In particular, a strong expansionary influence on rates of monetary growth again came from the historically low levels of short-term interest rates still prevailing at the beginning of the year in Japan and Germany, but rises in interest rates exerted a moderating influence on monetary expansion in the course of the year, particularly in the United States and to a lesser extent in the United Kingdom, Japan and France. On the other hand, expectations of further rises in interest rates on long-term instruments tended to stimulate the demand for monetary assets at times in Germany, France and Italy. Of course, the level of short-term interest rates reflected policy choices which were influenced, particularly in Germany, by awareness of the direct effect of exchange rate developments on economic activity and on the general price level. The strong short-run responses of M_1 and, to a lesser extent, M_2 in the United States to changes in the relationship between money market interest rates and the less flexible interest rates offered on deposits with banks and thrift institutions are also by now familiar and to a large extent predictable. However, the slowdown in M_2 growth last year in response to rises in money market interest rates made it difficult to express the need for monetary restraint in terms of the current behaviour of the aggregates.

Difficulties due to financial innovation often surmountable

While the sensitivity of money demand to the level of interest rates has clearly changed at times as a result of increased substitutability between new interest-bearing deposit instruments and marketable financial assets, the difficulties in interpreting developments in the monetary aggregates due to financial innovation are normally not insurmountable. Many of the changes are evolutionary; others cause only a once-for-all shift in the demand for money. In the United States, where the focus is now mainly on broader measures of money comparable with those long used in Japan and Germany, deregulation may have enhanced the usefulness of the monetary aggregates as long-run policy guides. Although it has increased their short-run interest elasticity, it seems to have reduced their response to interest rate movements in the longer run and the incentive to financial innovation that would facilitate economising on holdings of monetary assets. The main reason for this is that the own rates of return on most types of money balances can be expected to adjust to the level of market rates in the longer run. In Canada, where the targeting of M_1 was abandoned in 1982, a relationship between developments in the broader aggregates M_2

and M_2+ and nominal spending over periods of one to two years has re-emerged. Though these aggregates cannot be controlled closely, it has been found helpful in explaining monetary policy to indicate to the public that the acceleration in the growth of M_2 and M_2+ to rates consistently in excess of 10% last year should be regarded as a matter for concern.

Changes extending over several years in the relationships between developments in the monetary aggregates and in the economy, such as those that seem to have been brought about in Japan and Germany by the large swings in exchange rates, clearly jeopardise the credibility of the targeting process. However, developments of this kind may ultimately prove consistent with the view that account should be taken of long and variable lags in the process through which monetary developments influence economic activity and inflation.

Risks implied in strong monetary expansion in recent years

Monetary authorities have continued to point to the risks entailed in the strong monetary expansion which has occurred in many countries in recent years. It is clearly reflected in the rise in asset prices over a period of several years. This may have contributed, together with the further lowering of short-term interest rates in many countries in late 1987 and early 1988, to last year's strong upswing in economic activity. Inflation has so far been held at bay mainly by moderate developments in wages, but there are now signs of an increase in the level of wage settlements in some countries and a risk of it in others. Should a significant rise in the underlying inflation rate come to be reflected in an upsurge of inflationary expectations, it could be difficult to prevent the money balances which have been built up in recent years being activated to reinforce a wage/price spiral.

Targeting strategies continued

Symbolising the desire of monetary authorities to avoid accommodating a rise in the inflation rate, the monetary objectives set for this year in the United Kingdom, France and Italy were similar to those of last year. In Germany, where monetary expansion had exceeded the upper limit of the Bundesbank's target range in three consecutive years, a single target figure was set. In the United States, Spain and Portugal the limits of all the target ranges published for 1989 were lower than those for 1988. In Greece the targets are considerably lower than the actual rates of monetary expansion recorded in 1988. In Switzerland the change to a fourth-quarter reference period for measuring monetary expansion in 1989 implied that a reversal of the fall in the central bank money stock in 1988 was not envisaged.

Other indicators of monetary conditions

Credit aggregates

Although in recent years published monetary policy objectives have generally been expressed in terms of monetary aggregates and exchange rates, norms for credit aggregates have been announced in some countries. More generally, monetary authorities have always viewed developments in credit as an important element of the monetary policy transmission mechanism and as useful indicators of monetary conditions.

Strong rises in bank credit to private sector

The strong rise in bank credit to the private sector recorded last year in most industrial countries is clearly related to the strength of economic activity. In many countries it followed large increases in 1987 which in some cases had

been viewed as foreshadowing a need for a tightening of monetary policy. Housing or consumer credit was one of the strongest components of credit demand; particularly sharp rises in credit to households were recorded last year in the United Kingdom, Canada, France, Italy, the Netherlands and Sweden. Although a strong profit position contributed to the internal financing capacity of the business sector, a rise in non-residential fixed investment was also supported by a quickening in the pace of bank lending to enterprises in many countries. In the United States issues of securities on a large scale helped to moderate the demand for bank loans, though bank credit was used to a considerable extent to finance corporate takeover and leveraged buy-out activity. In many countries bank credit to the public authorities grew very moderately or declined last year either because banks cut back their accumulation of government securities or because the government took action to reduce its borrowing requirement and/or to limit its recourse to the credit system in financing the deficit.

Difficulties in interpreting credit developments

Some of these developments draw attention to difficulties, similar to those encountered with monetary aggregates, which may arise in interpreting movements in credit in a context of deregulation and financial innovation. In Italy, for instance, the credit ceilings which had been imposed to deal with the 1987 exchange market crisis were removed early last year. In France, the United Kingdom and Sweden large rises in housing or short-term consumer credit were mainly due to the effect of deregulation or to intensified competition between financial institutions in increasing the personal sector's access to credit. It was difficult to judge their likely contribution to economic activity: in some cases these rises had a counterpart in a faster accumulation of money balances in the economy; in others they were associated with slow growth of bank lending to the government or the business sector. Nevertheless, personal sector borrowing contributed to increases in consumption and residential construction in the three countries.

Broad credit aggregates

Norms for broad credit aggregates which include certain types of securities financing of non-banks as well as loans from the credit institutions have been published in the United States and Italy and a broad credit aggregate is now also monitored in France. In the United States the previously very stable income velocity of the broad credit aggregate has fallen sharply in the 1980s in a context of very large-scale government and private borrowing. Last year the growth rate of the US broad credit aggregate slowed but remained in excess of that of nominal GNP. In France the growth of total credit quickened slightly. In Italy credit to the Government, which cannot be controlled by monetary policy, is excluded from the targeted aggregate. The overshooting of credit to the non-state sector, though influenced by a reduction in bank portfolios of Treasury securities, pointed to the need for a monetary policy correction.

Domestic credit and international capital flows

In a context of managed exchange rates, domestic credit expansion may result in a balance-of-payments deficit on current account or capital outflows of the non-monetary sector (i.e. a deterioration in the external position of the banking system) and therefore not be reflected in the money stock. Last year, however, effects of this kind which might have been associated with current-account deficits were counteracted by the tendency of private capital to flow

Contributions of selected counterparts to changes in the broad money stock

Countries	1982–85	1986	1987	1988	1982–85	1986	1987	1988
	December-to-December change as a percentage of the broad money stock							
	Credit to private sector[1]				Credit to public authorities[2]			
United States	7.5	9.4	7.5	7.6	2.1	−0.1	0.1	−0.5
Japan	9.2	9.6	11.3	11.1	0.7	1.3	0.0	1.4
Germany	9.7	7.5	5.8	8.6	2.8	0.8	2.5	3.8
France	13.4	9.6	14.9	13.6	3.2	1.2	−0.7	0.8
United Kingdom	17.0	20.9	20.4	27.0	−0.6	−1.6	−2.2	−2.8
Italy	6.1	5.3	4.2	7.5	12.7	5.6	10.3	9.5
Canada	2.9	5.0	13.6	14.5	1.0	1.4	0.5	3.4
Spain	8.7	8.4	11.1	12.5	8.0	6.5	4.7	4.0
Netherlands	7.0	13.7	6.5	15.5	5.2	4.5	1.0	2.0
Belgium	2.7	5.7	6.8	10.3	18.9	16.5	11.6	7.2
Sweden	6.1	12.1	8.5	17.4	1.3	1.7	−3.0	−3.4
	Net foreign assets[3]				Broad money stock[4]			
United States	−0.8	−2.2	−2.5	−2.0	9.4	9.2	5.2	6.5
Japan	−0.6	−2.3	−0.9	−0.5	7.8	9.2	10.8	10.2
Germany	1.0	5.7	5.1	−0.5	5.5	6.7	5.8	6.8
France	−1.1	2.3	−0.5	−1.4	9.6	4.7	9.0	7.0
United Kingdom	−1.7	−1.3	0.9	−2.6	12.8	15.4	16.3	17.5
Italy	−0.4	−0.5	0.2	0.1	13.4	9.4	8.3	8.4
Canada	0.6	1.1	−5.1	−0.9	7.3	9.6	6.2	11.7
Spain	1.3	0.9	2.9	0.9	14.7	12.2	13.6	10.3
Netherlands	4.2	−5.6	1.9	4.6	9.2	5.1	6.0	13.0
Belgium	−7.2	−4.6	−5.2	−7.5	6.6	12.8	10.1	6.6
Sweden	1.7	−1.2	−0.9	−2.2	5.6	10.9	4.0	5.3

[1] For the United States, commercial bank and savings institution credit excluding Treasury and tax-exempt securities; for the United Kingdom, sterling lending by banks and building societies; for Canada, chartered bank call and short loans and less liquid Canadian dollar assets excluding claims on provinces and municipalities; for Sweden, domestic currency lending. [2] For the United States, Federal Reserve, commercial bank and savings institution acquisitions of Treasury and tax-exempt securities; for France and Sweden, central government only; for Canada, Bank of Canada and chartered bank holdings of government securities and claims on provinces and municipalities. [3] Banking system; for the United States, includes US official reserve assets and liabilities to foreign official institutions plus other net bank-reported claims on non-residents; for Canada, chartered bank net foreign currency assets. [4] For Japan, M_2 + CDs; for the United Kingdom, M_4; for Italy, Canada and the Netherlands, M_2; for Spain, ALP; for Belgium, M_2 (European Communities concept); for other countries, M_3.

Sources: National data.

to countries where the pressure of aggregate demand was strongest and where nominal interest rates were relatively high. In this context, rates of domestic credit expansion may have been lower than they might otherwise have been in countries such as Italy and Spain and higher than might otherwise have been the case in Germany and Japan. In some countries the relationship between developments in bank credit and the broad money stock may be influenced to a significant extent by changes in the rate of expansion of banks' non-monetary liabilities (not shown in the table). In Germany the growth of long-term bank liabilities slowed down markedly last year under the influence

of investors' expectations of rises in interest rates and the introduction of the withholding tax on interest income.

Interest rates

Short-term interest rates, which are the principal instrument of monetary policy, are often compared with the current inflation rate in an effort to assess the stance of policy. In some countries the acceleration in consumer price inflation recorded last year was largely attributable to such transitory factors as changes in indirect taxation and increases in mortgage interest rates. Even so, it may be noted that in real terms the rise in short-term interest rates in the United States, Canada, the United Kingdom and Italy was considerably less than it was in nominal terms. Moreover, it is often surmised that, at least in the United States, deregulation and financial innovation in recent years have changed the relationships between interest rates, output and demand in the economy to such an extent that a higher level of nominal and real interest rates may now be required to achieve the same restraint as in the past.

Difficulties in assessing short-term interest rate levels

Over the last two years, however, increasing attention has been paid to the proposition that monetary authorities might obtain useful guidance in judging the appropriateness of policy from the relationship between money market interest rates which they influence closely and market-determined rates at the longer end of the maturity spectrum. In fact, the underlying arbitrage relationships between long-term interest rates, current and future expected short rates or between short rates and holding-period returns on long-term securities vary over time in ways which are difficult to explain. Volatility and medium-term swings in the bond, equity and foreign exchange markets have cast increasing doubt on the assumption that markets do not make systematic forecasting errors. It has been suggested that changes in risk assessments in these markets may be related in complex ways. A shift in investor preferences away from shares may have exerted downward pressure on bond yields last year, and a reduction in the supply of long-term government bonds occurred, or is in prospect, in several key countries as a result of budgetary retrenchment or debt management policy. International capital flows must also have contributed to downward pressure on long-term interest rates in some countries, including the United States, but may have had less impact on yields in capital-exporting countries. The flattening or inversion of the yield curve could also to some extent have reflected expectations that the pace of economic activity would slow down and even that monetary policy would be eased following a reduction in inflationary pressures.

Different interpretations of the term structure

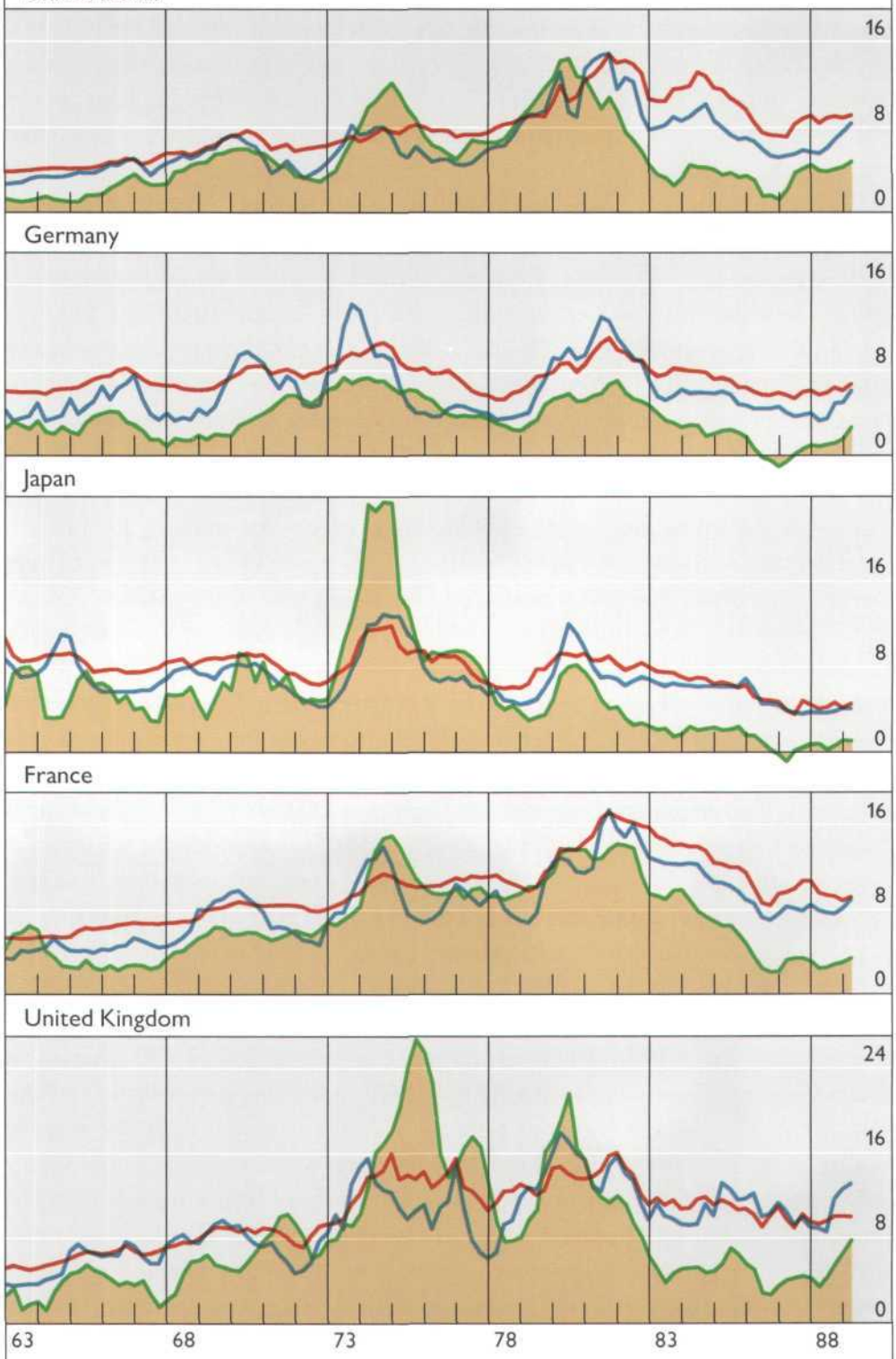
While long-term interest rates have tended to follow movements in short-term rates more closely during the 1980s, a flattening or inversion of the yield curve such as has occurred recently was not uncommon in the past, as can be seen from the graph. During the last two or three decades monetary policy in Germany, in particular, seems to have been consistently tightened at times when inflation appeared to be creeping up. Short-term interest rates regularly rose sharply and went well above long-term rates, while bond yields remained consistently at levels above the inflation rate. The recent behaviour of the term structure in Germany as short-term interest rates rose seems to be broadly in line with previous experience. In the case of Japan, relatively moderate rates of inflation in the last decade must help to explain why both

Interest rates and inflation in a long-term perspective

Long and short-term interest rates and inflation*

Quarterly averages, in percentages

Long-term interest rate
Short-term interest rate
Consumer price inflation



* Representative long-term bond yields and money market rates; inflation measured as percentage changes in consumer prices over four quarters.

short and long-term interest rates have remained at remarkably low levels. In other countries a flattening of the yield curve has often been observed at times when inflation was accelerating. Short-term rates responded more sharply than bond yields but rates of price increase surged up to levels which far exceeded those of both short and long-term interest rates. Though the oil price rises in 1974 and 1978–79 may have been difficult to predict, it seems clear that the acceleration in inflation rates has not always been correctly anticipated by the markets. This experience may be part of the reason why long-term interest rates have remained relatively high in relation to current rates of inflation in many countries in the 1980s even at times when short-term rates fell. Recent efforts in a wide range of countries, including the United States, to avoid letting short-term interest rates become negative in real terms may have helped to check inflation expectations for some time. But long-term interest rates in the United States and many continental European countries moved up sharply in early 1989.

Commodity prices:

Monetary policy in most countries has long had to take into account developments in the prices of oil and other commodities which have a strong influence on the level of consumer prices. However, leaving aside proposals for gold and general commodity standards, recent interest in commodity price indices, as evidenced, for instance, by their inclusion among the indicators used in consultations among the Group of Seven countries, has mainly focused on their potential usefulness as leading indicators of demand pressures and consumer price inflation in the world economy as a whole. Although the prices of many commodities directly affect only a small proportion of production costs, spot and future quotations are available on a timely basis in auction markets which respond quickly to changes in demand and supply conditions. To a degree they could, therefore, reflect expectations of demand pressures in the international economy. On the other hand, commodity prices can also react quickly to changes in short-term interest rates, which affect carrying costs, while other prices in the economy respond more slowly to a tightening or easing of monetary policy.

their advantages and shortcomings as indicators of demand pressures and consumer price inflation

In addition, commodity price indices often display very volatile responses to expectations of changes in the supply and demand conditions for individual components or in market structures. Longer-term trends and medium-term cycles in commodity prices have differed markedly from those in consumer prices and, although there is some evidence that changes in the prices of particular types of commodities such as industrial materials often precede changes in the general price level, this relationship is not reliable. Nevertheless, while they are not likely to be adopted as the principal guide for monetary policy, commodity prices may at times usefully complement other indicators used in assessing demand conditions in the world economy. Though supply influences have played a role and prices have started rising from a historically low level, the pronounced but irregular rise in non-oil commodity prices since mid-1987 might to some extent be interpreted as pointing to the strengthening of aggregate world demand and perhaps also to potential pressures on output prices. However, the prices of non-oil commodities have generally had much less influence on the general price level than movements in oil prices, which

helps to explain why consumer price inflation performance until recently was better than might otherwise have been expected, given the strength of the upswing in economic activity. Between December 1988 and late April 1989, however, oil prices rose progressively as the OPEC cartel succeeded in reasserting its influence over deterioriating supply conditions in the markets.

Indicators of ongoing developments in the economy

The formulation and implementation of monetary policy in the larger industrial countries has always been discretionary, but it has clearly become more judgemental in the recent period of moderate inflation when intermediate targets for the monetary aggregates were not considered to be providing reliable guidance for the setting of policy instruments. In the context of large imbalances in the world economy and large swings in exchange rates, monetary policy has been guided more by current and prospective developments in the economy. The process through which monetary policy influences inflation may not be stable over time and still involves long delays. Even if market expectations of developments in output and inflation could be correctly discerned from the available indicators of financial conditions it is questionable how much reliance should be placed on them in judging the appropriate stance of policy. Various forward indicators of developments in output, prices and wages can also be used, but it is generally not possible to place much confidence in the reliability of the signals given by the individual measures. The inherent risk in paying too much attention to developments in output in relation to productive capacity may also have increased in recent years as a result of uncertainties about whether the growth of aggregate supply potential has increased. The fairly general move towards higher short-term interest rates last year indicates that monetary authorities remain alert to these risks, even though they have to make do without reliable anchors for inflation forecasts, which implies that action may be inadequate in timing as well as in magnitude.

Risks entailed in the lack of reliable guides

Monetary policy in small and medium-sized industrial countries

Countries participating in the EMS exchange rate mechanism (ERM)

Co-ordination of interest rate policy in ERM countries

Short-term interest rate increases in ERM countries after mid-1988 were closely co-ordinated, though differentials between money market rates in Germany and those in the other countries tended to narrow. Upward adjustments of the Bank of France's money market intervention rates were frequently synchronised with rises in rates for the Bundesbank's repurchase operations, as were increases in the Netherlands Bank's special loan rate and the key three-month Treasury bill rate set by the National Bank of Belgium. Though the risk of a resurgence of inflation was increasingly recognised in all four countries, in France the main concern was still the potential constraint implied by the lack of a strong external current-account position, while in Belgium policy-makers continued to express a desire to promote domestic economic activity as far as possible. In Italy, where demand pressures were stronger than in the other ERM countries and the underlying external current-account position weaker, the dilemma was more acute. A comparatively steep rise in money market rates was encouraged by the Bank of Italy's reversible transactions in Treasury bills. Some insulation from capital inflows was achieved

by official exchange rate intervention, by permitting the lira to drift upwards into the narrow EMS band and by the extension of reserve requirements to banking inflows from abroad in early 1989, after which the lira moved down a little. In Denmark and Ireland, on the other hand, economic activity remained relatively weak last year, partly as a result of the strong efforts that had been made in recent years to consolidate the government budgetary position. In the case of Denmark monetary policy had also been cautious for some time in view of the weak external current-account position. In the circumstances, these countries were reluctant to accept rises in money market rates as large as those taking place in other ERM countries. In Ireland short-term interest rates were raised sufficiently to keep the Irish pound near the top of the EMS band, which helped to counteract the effect of the appreciation of sterling on the effective exchange rate. The Danish krone was permitted to move down in the band in early 1989 but Denmark joined other ERM countries in increasing short-term interest rates in April.

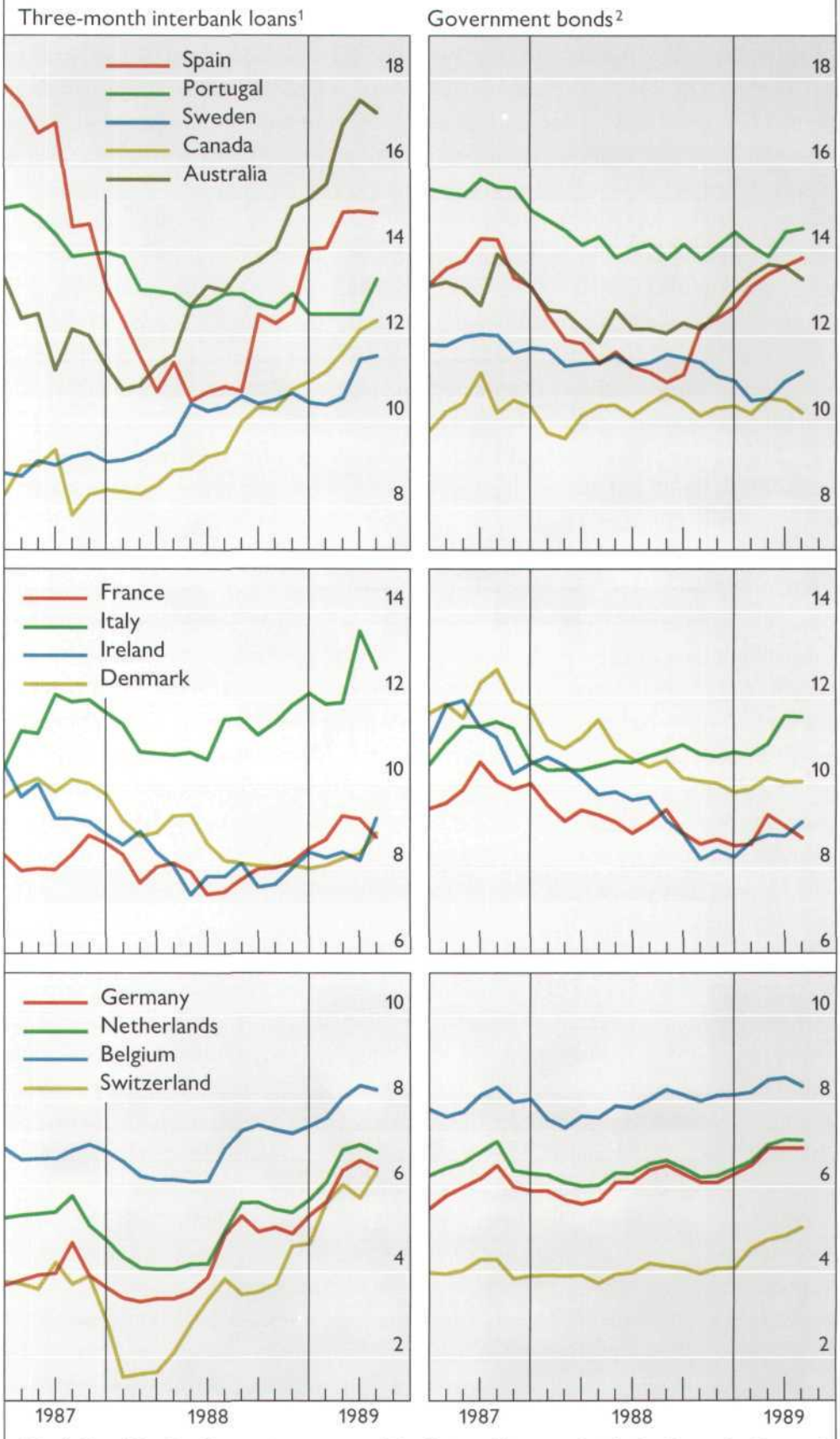
Long-term interest rates in ERM countries converged further in 1988 and early 1989. One contributing factor was, of course, the relatively steep rise in bond yields in Germany, which partly reflected the uncertainties related to the introduction of a withholding tax on interest income. Though domestic saving/investment imbalances do not seem to have had a major direct influence on bond yields in individual countries in recent years, structural budget imbalances may influence market confidence in the exchange rate commitments in the longer run. The declines in long-term interest rates last year, in Ireland in particular, may be partly attributable to progress made in correcting the government budget deficit, though in the Netherlands and Belgium full advantage was not taken of the opportunity afforded by the strengthening of the economic expansion for a further reduction of the large deficits. In Italy the disappointing failure to achieve the expected improvement in the public finances may have contributed to the comparatively large rise in long-term interest rates.

Influences on long-term interest rates

Although realignments took place quite frequently during the early years of the operation of the ERM, the intervals between them subsequently became remarkably long. In recent years the increased credibility of the exchange rate commitments has contributed to stabilising market expectations. In some technical respects the system has not functioned as expected at its inception: attention has always focused on the position of currencies in the band around the bilateral parities; the ECU has played only a limited role in the operating mechanisms of the EMS; exchange market interventions have generally been carried out before currencies reached their intervention limits; and the credit mechanisms available to individual central banks have scarcely been used. Intervention obligations have not in themselves exerted a binding constraint on any individual central bank's domestic money market policy. However, the framework for central bank co-operation has undoubtedly contributed to the political acceptability of the exchange rate commitments, which have served as a linchpin for monetary policy in individual member countries and have permitted the large regional component of their international trade to be shielded from exchange rate volatility. There is a widespread conviction in the

Experience of the functioning of the EMS

Interest rates in selected countries



[1] For Italy and Sweden, Treasury instruments. [2] For Spain, public sector bonds; for Denmark, all quoted bonds.

countries participating in the exchange rate mechanism that other EC countries would benefit from becoming full members of the system and accepting the obligations implied.

Issues raised by the prospect of increased financial integration

The implementation of the European Communities' programme for creating a unified financial area by 1993 and the decision to proceed with the liberalisation of capital movements by 1990 have raised the question as to whether new monetary arrangements will be needed to facilitate central bank co-operation in the Community. While views on this differ, there is general agreement that credible domestic policies will continue to be needed to convince markets that steps towards the liberalisation of capital movements are irreversible.

Various issues have been raised in the discussion of the future design of monetary co-operation in a financially integrated Europe. A question which has frequently been debated in an EMS context is whether future arrangements should be more symmetrical, in the sense that both weak and strong-currency countries should share the burden of adjustment. Increased acceptance of the need to focus monetary policy primarily on price stability may have contributed to the recognition that arrangements which imply a reduction in the anti-inflationary discipline of the exchange rate commitments might not be in the interest of individual countries or of the group of EC countries as a whole. Another question is how price stability can best be guaranteed if more permanently fixed exchange rates significantly reduce the autonomy of national monetary policy in most participating countries. To the extent that a need for more centralised monetary policy decision-making is seen to call for new institutional arrangements, efforts would have to be made to ensure that the conduct of monetary policy is as free as possible from near-sighted political influences. An equally important question is whether any moves towards monetary union can be envisaged without closer co-ordination in other areas, especially that of budgetary policy.

At present the conditions for rapid moves towards economic and monetary union are far from being fulfilled. Continuing interest rate differentials between ERM countries despite a relatively long period of central exchange rate stability in the system implies that the realisation of monetary union would not be an easy step even in these countries. Inflation rates in EC countries still differ widely and may diverge further in the course of 1989. Achievements so far in the consolidation of government budgetary positions also differ considerably from country to country. Current-account imbalances continued to worsen last year, even if allowance is made for the element in the German surplus related to the European investment boom. It is questionable whether the present degree of goods and labour market integration is sufficient to permit current-account imbalances to be reduced to sustainable levels without recourse to exchange rate changes. Although, in principle, fiscal policy or differential wage or productivity developments can serve as an alternative to exchange rate changes, the contribution of budgetary and structural policies to the external adjustment process in the short run will no doubt be limited.

Continuing differences between developments in EC countries

Monetary policy in other industrial countries

Exchange rate commitment in Austria

Last year Austria experienced a balanced economic expansion under the "hard-currency" policy which has in recent years held the schilling more stable in relation to the Deutsche Mark than any EMS currency by keeping money market operations closely geared to the unilateral exchange rate commitment. In Switzerland, where a policy oriented towards the central bank money stock has in recent years generally implied monetary and economic developments broadly comparable with those in Germany and a fairly stable Deutsche Mark/Swiss franc exchange rate, difficulties in estimating appropriate operating objectives for bank reserves when bank demand for liquidity shifted last year (see page 159) resulted in levels of short-term interest rates well below those prevailing in Germany. The subsequent weakening of the Swiss franc seems to have contributed to the relatively strong demand pressures experienced in the economy.

Domestic operating objectives in Switzerland

Dilemmas caused by capital inflows ...

In most other European countries the effective exchange rate plays a role in anchoring monetary policy, though their currencies have tended to depreciate on balance vis-à-vis the Deutsche Mark. Last year, however, many of these countries experienced upward pressures on their currencies when they attempted to tighten monetary policy. In many cases the external current-account position was in deficit or had started to worsen under the influence of strong domestic demand pressures.

... in Sweden, Finland and Norway...

In Sweden and Finland, where the effective exchange rate standards used to underpin monetary policy had earlier been influenced by the depreciation of the US dollar components, the currency was allowed to strengthen within the published fluctuation band in 1988 and early 1989 as monetary policy sought to prevent an acceleration in inflation. In Finland the limits of the band were adjusted in November 1988 and March 1989 so as to increase the scope for appreciation of the markka. In Norway, where the external current account was affected by the weakening of oil prices, monetary policy was intended to be generally restrictive but advantage was taken of periods in which the currency was relatively strong to lower interest rate differentials vis-à-vis the country's major trading partners.

... Spain ...

In Spain the efforts made in 1987 to limit rises in the exchange rate of the peseta vis-à-vis a trade-weighted basket of EC currencies eventually led, despite large-scale exchange market intervention and tighter exchange controls, to a pronounced decline in interest rates. By contrast, a sharp appreciation of the currency was accepted last year so as to permit a marked increase in short-term interest rates, to which consistent monetary and debt management policies contributed. To a degree capital inflows and a relatively high growth rate could be welcomed, but the acceleration in inflation and the prospect of difficult wage negotiations clearly threatened to make the economic expansion unsustainable and the objective of bringing the inflation rate more into line with those of other EC countries more remote. In Portugal, where the capital markets are much less open, reliance was placed mainly on a lowering of the credit ceilings in late 1988 and early 1989 and a reinforcement of the credit control procedures for counteracting domestic

... Portugal ...

demand pressures. The interest rate instrument was scarcely used, though the official discount rate was raised in March 1989. Over a number of years a controlled progressive depreciation of the escudo has broadly compensated for the inflation differential between Portugal and other countries. Last year, with the inflation differential increasing, the previous practice of gradually reducing the rate of depreciation of the escudo was suspended.

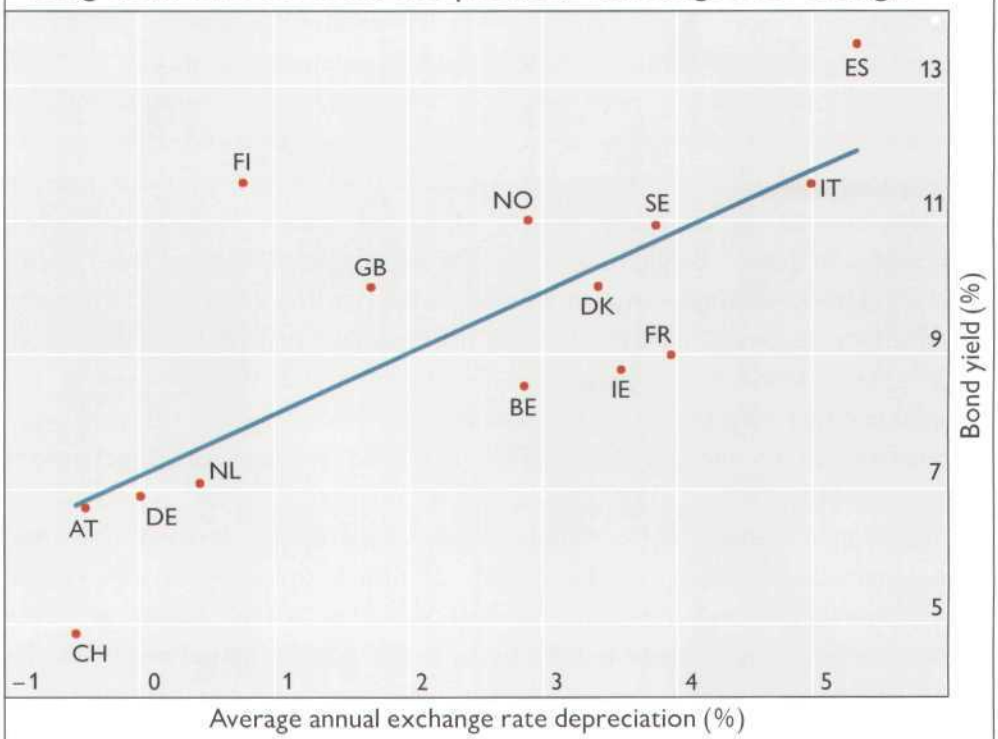
... and Australia

In Australia monetary policy has been guided by a check-list of indicators since effective exchange rate and money stock objectives were abandoned some years ago. Having fluctuated over a wide range in recent years in response, inter alia, to market judgements about the effect of changes in commodity prices on the balance of payments and the economy, the exchange rate of the Australian dollar appreciated strongly in 1988 under the influence of a tightening of monetary policy before undergoing a sharp but limited fall in early 1989. Although the public sector borrowing requirement had fallen sharply, demand pressures became very strong and there was a clear risk that the rate of consumer price inflation, still about 7%, would again increase. By early 1989 three-month money market rates stood at around 17% and were tending to rise in response to an unexpectedly large increase in the external current-account deficit.

Long-term interest rates and the credibility of monetary policy

As in the largest countries, developments in long-term interest rates in many small and medium-sized countries were quite different from those in short-term interest rates last year. Long-term interest rates still reflected to a

Long-term interest rates and previous exchange rate changes



AT: Austria; BE: Belgium; CH: Switzerland; DE: Germany; DK: Denmark; ES: Spain; FI: Finland; FR: France; GB: United Kingdom; IE: Ireland; IT: Italy; NL: Netherlands; NO: Norway; SE: Sweden.

Note: The curve is obtained by regressing representative government or public sector bond yields in March 1989 on the average annual depreciation of nominal bilateral exchange rates vis-à-vis the Deutsche Mark over the period March 1979 to March 1989.

large extent the previous history of exchange rate depreciation. It is to be expected, of course, that markets will take a long-term view when assessing the credibility of monetary policies in individual countries and the long-term outlook for exchange rate movements. As can be seen from the graph, differences in the levels of bond yields in individual countries seem to be closely related to the depreciation of their currencies vis-à-vis the Deutsche Mark over the past ten years. Reflecting the increased credibility of their exchange rate commitments, long-term interest rates in all ERM countries and Austria are below the line which indicates the estimated average relationship between long-term interest rates and previous changes in exchange rates, while rates in most other European countries are above it.

Changes in the implementation of monetary policy and in the transmission mechanism

Last year many central banks again had to rely on flexible money market operations for offsetting the effect of foreign exchange market intervention on bank reserve positions. The emerging need for greater monetary restraint stimulated the further development of central bank instruments and operating procedures which make use of market mechanisms for guiding interest rates. An underlying influence on these changes is the increasing integration of the financial markets, domestically and internationally.

Central bank money market operations

The impact on central bank operations of the substantial change in the pattern of international capital flows last year was felt chiefly in countries which had accumulated large amounts of official foreign exchange reserves in 1987. Domestic money market operations conducted by the central bank bore the main burden of adjustment to a huge decline in official external reserves in Germany and to a much smaller increase than in the previous year in the Netherlands. In Germany banks' rediscount quotas were increased in November. In Japan, Belgium and the United Kingdom, where the rate of official reserve accumulation also slowed down markedly last year, swings in the Treasury accounts, partly reflecting debt management policies, helped to insulate bank reserves. In Japan and Germany further strong rises in the demand for currency and increases in bank holdings of required reserves were accommodated at interest rates which reflected the overall objectives of monetary policy.

Offsetting the effects of exchange market intervention on bank reserves

In France central bank money market operations formed the main counterpart to the change in the balance of official foreign exchange operations following the large net sales of foreign exchange in 1987. However, in the major countries which recorded increases in the balance-of-payments surplus on an official settlements basis last year any impact on the central bank's balance sheet was only a minor consideration in the conduct of money market policy. In Italy the net accumulation of official external reserves remained fairly modest in relation to the absolute size and growth during the year of the central bank money stock, which includes a far larger compulsory reserve requirement component than in the case of any of the other countries. Bank

Even large-scale intervention small in relation to bank reserves in some countries

Influences on the central bank money stock

Countries	Central bank money stock[1]		Central bank net foreign assets[2]		Central bank loans, market operations[3]		Other domestic influences[4]	
	1987	1988	1987	1988	1987	1988	1987	1988
	December-to-December change as a percentage of central bank money stock[5]							
United States	7.6	6.3	− 3.5	0.4	8.1	5.8	3.0	0.2
Japan	9.1	13.7	18.4	1.8	3.0	7.9	−12.3	4.0
Germany	12.5	9.8	23.1	−16.2	− 5.8	28.3	− 4.8	− 2.3
France	8.1	4.7	−20.7	1.8	29.2	0.2	− 0.4	2.7
United Kingdom	4.2	8.5	75.6	24.1	−48.9	− 6.0	−22.5	− 9.6
Italy	9.9	8.4	4.9	7.2	− 3.5	− 0.7	8.6	2.0
Canada	9.2	4.2	26.2	53.1	9.3	4.0	−26.3	−53.0
Netherlands	11.9	4.1	16.9	8.5	− 9.6	− 1.0	4.5	− 3.4
Belgium	2.6	1.1	19.5	4.4	− 0.4	0.1	−16.5	− 3.4
Sweden	2.9	11.0	16.1	24.6	13.8	2.9	−27.2	−16.6
Switzerland	6.0	−14.2	− 1.7	− 4.3	0.7	−14.4	6.9	4.4

[1] For Germany, at current reserve ratios but excluding the effects of changes in the ratios; for the United Kingdom, M0; for other countries, currency and bank reserves. [2] Excluding foreign exchange swaps used for the purpose of influencing bank liquidity. For the United States, Treasury and Federal Reserve foreign exchange operations. For Japan, the United Kingdom and Canada, operations of the government foreign exchange fund. [3] Lombard and (except for Germany) discount credit; outright open market purchases and sales of bills and securities, special loans at market interest rates, foreign exchange swaps and government deposits transferred to the market. [4] Includes movements in the government accounts and, in the case of Germany, the effect of changes in reserve requirements and rediscount quotas. [5] Flows net of valuation changes, partly estimated by the BIS. For the United States, Germany, France, Canada and the Netherlands, based on monthly averages of daily or weekly data; for other countries, month-end data.

Sources: National data.

of Italy credit to the Government, normally the major asset counterpart to the growth of central bank money, was kept reasonably well in check last year as a result of favourable conditions for Treasury bill sales. In Canada the official exchange reserves are held in a Treasury foreign exchange fund, and increases were as usual mainly financed by Treasury borrowing outside the Bank of Canada. In the United States the Federal Reserve foreign exchange transactions are very small in relation to the System's domestic operations, and the fraction of foreign central bank reserves which is held with the Federal Reserve is also extremely small and stable. Observers in such countries where domestic influences on bank reserves are dominant often fail to appreciate that in other countries official external movements are frequently very large in relation to the central bank money stock and to the small response of the demand for central bank money to changes in interest rates. In these circumstances the impact of exchange market intervention on bank reserves has to be offset even over periods of a year or more.

Larger rises in interest rates on official market operations than in posted rates

While encouraging a firming of market interest rates in supplying bank reserves, central banks in many countries last year generally increased their official posted discount and secured lending rates only at times when a clear signal was judged to be appropriate. In the United States the unusually large margin which emerged between the official discount rate and the Federal funds rate tended to weaken the relationship between these rates and borrowed

bank reserves. Under the Federal Reserve operating procedures in use since 1982 this relationship has been the basis of the mechanism which normally ensures that action to meet operating objectives for borrowed reserves has a fairly predictable effect on money market interest rates. Last year the relationship seems also to have been affected by the difficulties experienced by the savings industry. Deposit-taking institutions seem to have been unusually reluctant to use Federal Reserve credit, either because they wished to conserve future borrowing rights or because they were concerned that recourse to the Federal Reserve, should it become known in the market, could be interpreted as a sign of financial weakness of the borrower. In these circumstances the Federal Reserve paid increased attention to developments in the funds rate in conducting open market operations.

Related changes in operating procedures in the United States ...

An important change in the Bank of Japan's money market operating procedures took place in November, following a period in which interest rates in the Euro-currency and domestic money markets open to non-banks had risen well above interest rates in the interbank call money and bill markets, with the relative size of the interbank markets tending to decline. The interest rates on certain maturities in the bill markets which were closely influenced by the Bank of Japan had come to be viewed as indicating the stance of monetary policy and could not be changed flexibly. To strengthen the Bank of Japan's influence on rate setting in the open market, the commercial bill markets were extended to shorter maturities, so as to establish trading in one and two-week maturities in which official operations would take place. At the same time the maximum maturity in the collateralised call-money market was lowered to six days and the longest maturity traded in the uncollateralised call-money market was increased from three weeks to six months. In early 1989 trading in bills and uncollateralised call money was extended to twelve-month maturities, and to facilitate arbitrage between different sections of the money markets restrictions on banks' activities, such as ceilings on their holdings of CDs, were eased. The Ministry of Finance plans to begin public issues of three-month Treasury bonds in the financial year ending in March 1990 (in addition to six-month bonds, which have been issued since 1986). This should provide an instrument particularly suited for use in central bank market operations.

... Japan ...

In Germany the Bundesbank introduced a new type of interest rate tender with "American" allocation procedures for providing bank reserves for two months under securities purchase and resale contracts in September 1988. Under these arrangements, which were extended to transactions with the standard one-month maturity in October, successful bids are accepted at the interest rate indicated in the application instead of at a uniform price as had previously been the practice. In a period in which market interest rates had generally been high in relation to the uniform tender rate, banks had had an incentive to bid for very large amounts. More importantly, the replacement of the single fixed rate by a range of rates quoted by banks potentially implied a reduction in the prominence of the charges applied in central bank operations. At times when clear official guidance of interest rate setting in the market seemed appropriate, particularly in the light of exchange market developments, the Bundesbank continued to use "volume" tenders, for which it

... and Germany

quotes a fixed interest rate at which it is prepared to accept bids, allocating the total amount on which it decides by scaling down individual applications. In November the Bundesbank added to its range of fine-tuning techniques a new kind of "quick tender", which is primarily directed at active money market banks and can be used for supplying reserves for periods as short as a few days.

Changes in money market operating procedures and in systems of reserve requirements in Belgium ...

In Belgium the National Bank introduced tender procedures for supplying bank reserves for periods of fifteen days in early 1989. In December 1988 new legislation providing for the establishment of a system of reserve requirements (which previously could be introduced only on an emergency basis under special conditions) had been approved. In the longer run the implementation of these changes could tend to bring the procedures used by the National Bank for influencing money market rates more into line with those used in Germany, France and the Netherlands.

... Italy ...

In October 1988 the Bank of Italy announced proposals to permit a degree of averaging of reserve balances over the month in measuring banks' compliance with the reserve requirements, to curtail banks' ordinary central bank credit lines and to change the official rates for its fixed-term advances more frequently so as to keep them above short-term market rates in normal circumstances. Such changes could also bring official money market operating procedures in Italy more into line with those of other countries adhering to the EMS exchange rate mechanism. In particular, averaging provisions in reserve requirements, which are in effect in most of the Group of Ten countries, generally help to avoid disruptive swings in short-term money

... Switzerland ...

market rates during the reserve-holding period. A striking illustration of this can be seen in the virtual disappearance of the frequent month-end upsurges in short-term money market rates that were previously so characteristic of the Swiss market following the introduction at the beginning of 1988 of a new bank liquidity requirement with averaging provisions. In contrast to the reserve requirement arrangements in effect in many other countries, however, the new Swiss prudential liquidity arrangements call for levels of balances at the National Bank which are so low that most banks normally need to hold excess reserves for clearing purposes. Bank demand for reserves fell much more than had been expected in 1988, but the National Bank is hopeful that it will remain stable in the future.

... Canada ...

In Canada, where the Government intends to abolish the existing system of bank reserve requirements, recently published proposals provide, inter alia, for changes in the system of charges for Bank of Canada accommodation. These are designed to provide a wider range of clearing institutions with incentives to manage their positions vis-à-vis the Bank of Canada during the week in a way which should contribute towards stabilising short-term interest rates. In

... and the Netherlands ...

the Netherlands, where the averaging provisions in the quota arrangements for central bank credit help to smooth money market rates, the Netherlands Bank announced in March 1989 that it would commence operations in government securities designed to raise long-term interest rates selectively.

... increasing the focus on interest rates as operating variables

While most of these changes are contributing towards convergence in central bank operating procedures in different countries, they tend in most cases to increase the focus on domestic interest rates as policy variables and

are not aimed in the first instance at stabilising exchange rates. Sweden is the only Group of Ten country which has introduced arrangements, including a graduated scale of charges for central bank credit, which could be used to let the effect on bank reserves of changes in the official foreign exchange reserves move money market interest rates in a direction conducive to stabilising the exchange rate in the absence of explicit action by the central bank. In early 1988 the graduated rate structure was divided into smaller bands.

Uncertainties in the monetary policy transmission mechanism

In many countries the impact of monetary policy on the economy has in recent years come to rely less on credit-rationing and liquidity constraints and more on interest rate mechanisms. In a context of increased international financial integration exchange rate effects have gained in importance, especially in the larger countries. Last year experience again showed that the response of market interest rates and exchange rates to monetary policy can be strongly conditioned by expectational factors and by foreign as well as domestic influences. Changes in the transmission mechanism have been greater in some countries than in others and need not imply that monetary policy has become generally less effective in controlling inflation in the longer run. However, in many cases they have increased the uncertainty about the short-run impact of policy, making it more difficult to assess the stance of monetary policy in the light of current developments in the economy.

Effect of increasing integration of markets

Changes in the monetary policy transmission mechanism have been most evident in Japan and in European countries where credit and/or exchange controls have been removed in recent years. However, the abolition of interest rate controls in the United States in the early 1980s and the development of new financial instruments and secondary markets in various countries have contributed to an erosion of liquidity constraints and credit-rationing effects. Information and transactions technology has permitted enterprises to economise on low-yielding transactions balances, and in an increasing number of countries new types of deposit or money market funds are providing small savers with greater opportunities to earn market rates of return and to adjust their portfolios at lower transactions costs. In many European countries specialised credit institutions have been allowed to diversify their activities and to penetrate other markets. Increased competition has helped to break down conventional constraints on the availability of credit to households (for example, in France, the United Kingdom and Sweden) and to corporations with less than prime credit-standing (in the United States in particular).

Erosion of credit-rationing and liquidity constraints

In some countries traditional interest rate transmission mechanisms have been significantly influenced in recent years by changes in the interest rate setting practices of financial institutions. In Japan last year the setting of bank prime lending rates was made more flexible by the introduction of arrangements linking them to market rates instead of to the Bank of Japan's discount rate. Changes of this kind, which have also been made in other countries in recent years, help to speed the transmission of monetary policy impulses

Changes in interest rate transmission mechanisms

throughout the financial system. However, experience last year showed that the delays with which financial institutions increase variable lending rates on housing loans, in particular, may still be very long in some cases.

Uncertainties related to expectational effects

It has become increasingly evident that the responses of market interest rates can be strongly conditioned by expectational effects. Uncertainty caused by the volatility of market expectations has made it more difficult to predict the impact of changes in short-term interest rates on long-term interest rates. Moreover, international capital flows, influenced by expectations held both at home and abroad, may have helped to reduce the sensitivity of bond yields to changes in domestic money market rates in individual countries. Last year the limited response of long-term interest rates to rises in short rates may have been encouraging to the extent that it reflected a stabilisation of inflation expectations, but it has raised questions about the ability of monetary policy to bring about a significant slowdown in economic activity.

Some of the wealth, substitution and income effects of interest rates on the economy have become more difficult to forecast. Experience since the stock market collapse suggests that the wealth impact of changes in asset prices on consumer spending and asset valuation effects on corporate investment may be less powerful than was previously thought. Yet rises in the prices of equities, housing and other assets over a longer period must have been an influence on the upsurge in economic activity last year. In some countries rises in interest rates do not appear to have been very effective in curbing strong demand for credit to finance leveraged buy-outs or consumer spending, but the resulting indebtedness of parts of the corporate sector in the United States and of the household sector in the United Kingdom, in particular, may suggest that interest rates could have powerful income and liquidity effects in the future. The sword could, of course, prove to be double-edged, should fragile financial positions or political pressures against interest rate rises prove to be a constraint on the conduct of monetary policy.

Implications of increased indebtedness

Problems related to exchange rate effects

The increasing influence of the exchange rate on economic developments may tend to strengthen the monetary policy transmission mechanism. In tightening domestic monetary conditions last year, the authorities in a number of countries seemed to be taking advantage of the effect of currency appreciation in moderating rises in import costs and in increasing competitive pressures on the export and import-competing industries. However, exchange rate movements tend to redistribute inflationary pressures between countries. Moreover, it could be expected that exchange rates would in time again come to be influenced more by non-monetary factors, including relative balance-of-payments positions.

The risks inherent in the present situation

Impact of monetary tightening remains to be seen

Last year monetary policy in most industrial countries had to shift from seeking to sustain economic activity to attempting to prevent a build-up of inflation. Inflation expectations in the financial markets may have been held in check, but economic activity seems to have been slow to respond to the efforts to tighten monetary policy. In the spring of 1989 monetary authorities, still hoping to achieve a "soft landing", were awaiting effects of tightening measures.

Meanwhile signs of price and wage tensions had become clearer, and it remains to be seen how effective policy will be in controlling inflation.

Demand pressures were strong last year in many countries with weak underlying external current-account positions and movements in exchange rates which seemed unsuited to the structure of these countries' balances of payments had to be accepted as a consequence of an indispensable tightening of monetary conditions, although they risked storing up problems for the future. An underlying problem here is saving/investment imbalances, in which, although they may be the outcome of many different factors, government budgetary deficits play a part in many cases. In a context of robust growth in the world economy, efforts to reduce large budget deficits in the medium term clearly need to be continued for domestic reasons even in countries with large external current-account surpluses. In other countries more immediate action is needed. To a considerable extent upward pressures on the US dollar, which have contributed to slowing the international adjustment process, may be attributable to the increased burden placed on monetary policy by lack of progress in reducing the Federal Government budget deficit in the United States as the economy approached full capacity. Failure to effect fiscal adjustments remains a source of pressure on exchange rates and makes it more difficult for countries to pursue policies which ensure stable monetary conditions.

Need for support from budgetary corrections

VII. The international monetary system

Highlights

Despite the persistence of large current-account imbalances, the situation on the exchange markets changed markedly last year. Impressed by the substantial dollar depreciation that had already occurred and the official action to prevent a further decline, the markets became less and less concerned about the danger of continuing weakness of the US currency. Consequently, the wide interest rate differentials in its favour began to reassert their full influence on international capital flows. The massive downward pressures that had been an outstanding feature of 1986 and 1987 gradually subsided and intermittently gave way to pronounced dollar buoyancy. Spontaneous capital inflows at times exceeded the US current-account deficit, and the authorities repeatedly undertook concerted interventions to prevent an excessive rebound of the dollar. On the other hand, there were still periods last year when the dollar was weak and given considerable official support. The gross volume of intervention sales and purchases of dollars by Group of Ten countries, though smaller than in 1987, was larger than in preceding years.

The more balanced exchange market outlook not only underpinned the dollar but also boosted the currencies of a number of other countries with high interest and inflation rates and large or rising current-account deficits. On the other hand, the currencies of some countries with traditionally modest inflation rates and relatively low nominal interest rates, notably Germany and Switzerland, came under considerable downward pressure.

For the European Monetary System 1988 and early 1989 was a period of relative stability. Despite widening trade imbalances between member countries, the stronger dollar and the continued narrowing of inflation differentials helped to prevent the emergence of major exchange market unrest.

The firmer dollar, higher interest rates and confidence in the authorities' determination to keep inflation under control tended to rob gold of much of its attraction last year. In May 1989 the dollar price of gold fell to its lowest level since summer 1986.

The growth of global reserves, which had been exceptionally large in 1987, slowed down sharply. Official efforts in countries other than the United States to moderate the depreciation of their currencies against the dollar led at times to a substantial drawdown of official dollar balances, while reserves held in the form of other currencies expanded strongly. The amount of outstanding International Monetary Fund credit continued to contract last year as a result of repayments of loans granted in the earlier years of the debt crisis. This caused a decline in the IMF reserve positions of those industrial countries whose currencies were used for these repayments.

Exchange markets

Developments in the US dollar market

Basic change in market situation

The period under review saw a pronounced turn-round in exchange market trends. After nearly three years of steep decline and a particularly sharp dip towards the end of 1987, the dollar gradually began to recover. Not only was official intervention in its support required less frequently, but in certain periods the authorities sold large amounts of dollars in order to limit the strong rebound of its exchange rate that was considered untimely in view of the continuing large US current-account deficit and the need for further adjustment.

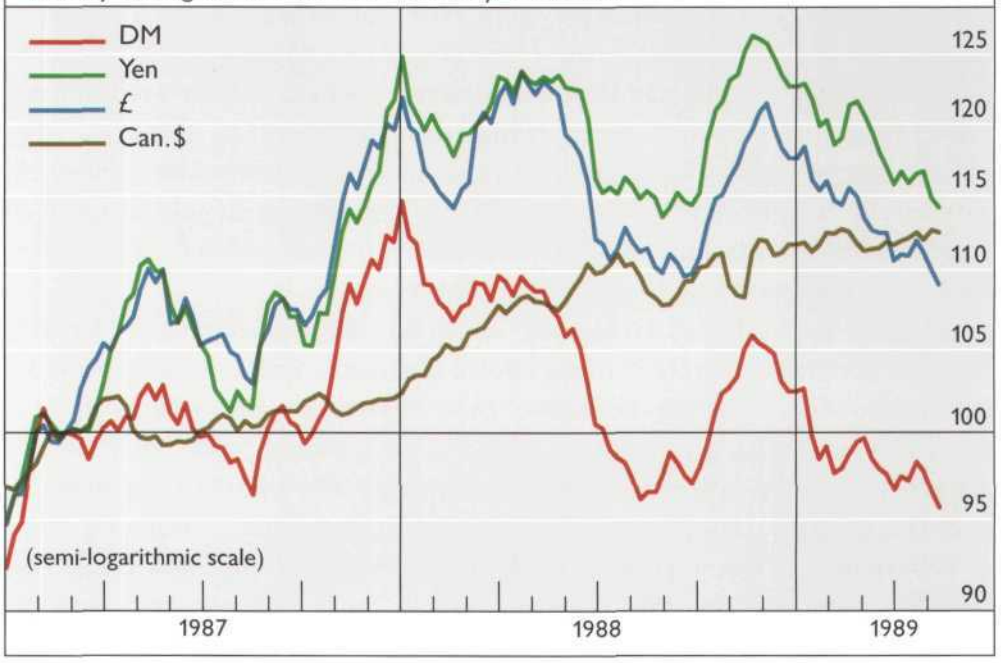
Developments in the early part of 1988, when well-timed official dollar support and signs of a significant reduction in the US trade deficit had brought about a considerable improvement in market sentiment towards the dollar, were already described in last year's Annual Report. In the course of March 1988, however, confidence began to wane once more as evidence of greater-than-anticipated vigour of the US economy seemed to limit the scope for a further improvement in the US trade balance. Despite a substantial widening of interest rate differentials in favour of the United States and another set of favourable US trade figures, the yen/dollar rate, which had recovered from a historical low of less than Yen 122 at the beginning of the year to a peak of Yen 131 in mid-February, fell back below Yen 125 by the end of March.

Dollar weakness in early spring 1988 ...

However, concerted official support in late March and mid-April helped to restore confidence in the dollar, and the large interest rate differentials in its favour began increasingly to reassert their influence on international capital

Bilateral exchange rates of selected currencies against the US dollar

Weekly averages, third week of February 1987=100



flows. As a result, the dollar began to rise again, albeit at first hesitantly and only vis-à-vis the European currencies. Around mid-June the publication for the second successive month of US trade figures suggesting that a decisive improvement in the US current-account balance was under way gave a strong boost to the dollar. Moreover, later in the month the text of the official declaration following the Toronto Economic Summit seemed to persuade the markets that the Group of Seven countries might accept a further moderate dollar appreciation.

... followed by pronounced dollar strength during the summer

The combination of a favourable exchange rate outlook for the dollar and large interest rate differentials in its favour proved irresistible to investors. As a result the Deutsche Mark/dollar rate, which had already recovered from around DM 1.66 in late March to DM 1.75 by mid-June, rose above its pre-Louvre Accord level of DM 1.83 around mid-July and reached a peak of DM 1.92 in the second week of August in the aftermath of a US discount rate increase prompted by the vigour of the domestic economy and related fears of inflation. At this point the dollar stood 21.5% above its end-1987 low against the Deutsche Mark. Notwithstanding the publication in mid-August of a disappointing set of US trade figures and a concerted round of official interest rate increases by European central banks on 26th August, the dollar's strength lasted well into September.

Official efforts to prevent an excessive rebound of the dollar

The dollar's rise occurred despite heavy official support of the Deutsche Mark. US official intervention purchases of Deutsche Mark in the period from late June to late September amounted to $5 billion, while German official exchange reserves declined by $10.6 billion in the four-month period from June to September. Moreover, the Deutsche Bundesbank, which was concerned about the large expansion of the domestic monetary aggregates, reacted to the stronger dollar by bringing about a sharp rise in short-term interest rates from less than 3.5% in late May to over 5% in early August, the official discount rate being raised by 0.5 percentage points at the beginning of July and again in late August.

Over this period the dollar also appreciated against the Japanese yen, although by much less than vis-à-vis the Deutsche Mark; at no point did it come close to the level prevailing at the time of the Louvre Accord and no official interventions to moderate its rise were reported.

During September the dollar remained for the most part firm, particularly following the publication of another set of positive trade figures and, later in the month, a Group of Seven statement which was once more interpreted by the markets as leaving scope for further dollar appreciation. However, in the course of October enthusiasm for the US currency began to wane. The official efforts to prevent an excessive rebound of the dollar had finally made an impression on the markets. At the same time, poorer US trade figures and statistical evidence from the surplus countries seemed to suggest that the current-account adjustment process was faltering. The dollar began to weaken and the downward pressures intensified in November, when, in the aftermath of the US presidential election, the markets were uncertain about the new Administration's determination to act decisively on the budget deficit. The depreciation was especially pronounced vis-à-vis the Japanese yen, with

Temporary dollar weakness in autumn

the yen/dollar rate falling in late November to the new post-war low of Yen 121.

Official dollar support operations

As on earlier occasions, excessive exchange rate pressures were countered by concerted official intervention – this time of course in favour of the dollar. Between late October and early December the Federal Reserve, for example, supported the dollar to the extent of nearly $2 billion against the yen and $630 million against the Deutsche Mark. Moreover, as the US economy somewhat unexpectedly showed renewed signs of exuberance, in November the US authorities induced a marked increase in interest rates. Nevertheless, with market sentiment dominated by dollar fears, its interest rate attractions were for the time being of little avail.

Renewed dollar strength in late 1988 and early 1989

However, the persistent presence of the central banks in the exchange markets and expectations of a further tightening of US monetary policy eventually had an impact. Although in mid-December the Deutsche Bundesbank and a number of other European central banks raised their official lending rates for domestic reasons, the dollar recovered steadily throughout the rest of the month. In January its upward movement gathered further strength, despite persistent concerted official intervention in support of the Deutsche Mark, disappointing US trade figures and a pronounced narrowing of interest rate differentials. Even a further round of increases in official lending rates by the Deutsche Bundesbank and a number of other European central banks – this time prompted largely by exchange rate considerations – failed to restore a two-way market, and the dollar appreciated to a peak of DM 1.88 in early February, nearly 10% above its late-November lows.

Short period of stability

In the second week of February the upward pressures on the dollar temporarily subsided. Once more increasingly aggressive concerted official interventions had left their imprint on the markets. Moreover, there was growing evidence of a further widening of the German current-account surplus and of the continuing strength of the German economy. Dollar quotations eased, and in late February the Federal Reserve was able to raise the discount rate without upsetting the markets.

In early March the Deutsche Bundesbank surprised the markets by signalling a reduction in its lending rates without immediately causing major negative exchange rate reactions. However, a few days later statistical evidence of an acceleration of US inflation and related expectations of a further rise in US interest rates led to a renewed strengthening of the dollar. Despite repeated concerted US and European interventions, the dollar continued to firm during the rest of March. It was only in early April, after the announcement by the Group of Seven countries of their strong opposition to a further dollar rise and after some official dollar sales by the Bank of Japan – the first such intervention since late 1985 – that the dollar showed some downward reaction. In the course of April Germany and a number of other European countries raised official lending rates. Nevertheless, towards the end of the month the upward pressures on the dollar resumed with renewed vigour. Despite sustained official intervention and narrowing interest rate differentials, the dollar, following the release of unexpectedly good US trade figures, went above DM 2.00 and Yen 140 in the fourth week of May.

Persistent dollar strength in the face of concerted official interventions

Buoyancy of the Canadian dollar

Canada was the only Group of Ten country whose currency strengthened markedly vis-à-vis the US dollar in the period under review. A very robust economy and a firm monetary policy kept Canadian interest rates substantially higher than those in the United States. At the same time market sentiment with respect to the Canadian dollar was favourably affected by the prospect of the free trade agreement with the United States as well as by commodity price trends and the resultant improvement in the country's terms of trade. This combination of very high nominal interest rates and a favourable exchange rate outlook produced a volume of capital inflows that exceeded the country's widening current-account deficit. Consequently, the Canadian currency strengthened against the US dollar during most of 1988 and by mid-May 1989 had appreciated from its end-1987 level by 9% vis-à-vis the US dollar and by 34% vis-à-vis the Deutsche Mark.

Developments in other currency sectors

The yen's marked appreciation vis-à-vis the Deutsche Mark ...

An outstanding feature of exchange market developments last year was the pronounced movements in exchange rates between currencies other than the US dollar, notably the particularly important cross rate between the Japanese yen and the Deutsche Mark. The decline of the Deutsche Mark during periods of dollar strength exceeded that of the yen, while during periods of dollar weakness the yen recovered more of the ground lost than the Deutsche Mark. As a result, by mid-February 1989 the yen had appreciated against the Deutsche Mark by 22% since the Louvre Accord, although it subsequently lost some ground.

... difficult to explain in terms of fundamental factors

It is not easy to explain the divergent behaviour of these two major currencies in terms of fundamental factors. Expressed in relation to GNP, the German current-account surplus is now considerably higher than that of Japan. Moreover, the scope for further import penetration is probably still greater in Japan than in Germany. Interest rate levels, both nominal and real, short-term and long-term, are higher in Germany and, given the strong German economic outlook, are not on the verge of falling. Also, the prospect of 1992 would seem to augur well for the Deutsche Mark. Moreover, given the different geographical composition of Japanese and German trade, the huge depreciation of the dollar since 1985 has entailed a much steeper appreciation of the effective exchange rate for the yen than for the Deutsche Mark.

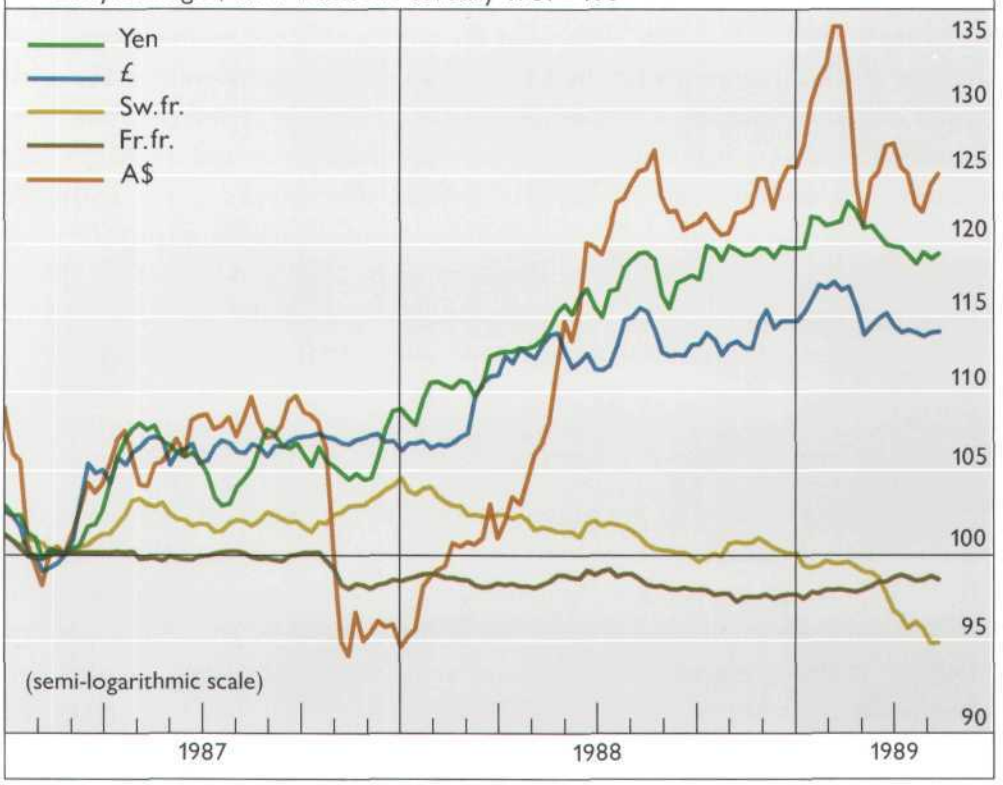
One of the main factors in the weaker performance of the Deutsche Mark during 1988 was probably the proposed introduction in Germany of a 10% withholding tax on interest income. This led to a surge in capital outflows which at times far exceeded the country's current-account surplus.

Pronounced sterling strength and official policy dilemmas

While the higher German interest rates failed to sustain the Deutsche Mark vis-à-vis the yen, the even higher interest levels in the United Kingdom were a key factor in the Deutsche Mark's weakness vis-à-vis the pound sterling, despite the more pronounced UK inflation rate and a rapidly widening UK current-account deficit. The large capital inflows attracted by the high UK nominal interest rates and the resultant upward pressure on sterling placed the UK authorities before some difficult policy choices. On the one hand, there

Bilateral exchange rates of selected currencies against the Deutsche Mark

Weekly averages, third week of February 1987=100



was the danger of excessive appreciation, while, on the other, there loomed the threat of economic overheating and a resurgence of inflation.

Temporary sterling weakness and official policy reactions

After the UK authorities had permitted sterling to rise above its informal ceiling of DM 3.00 in early March 1988, it gradually appreciated to DM 3.19 by mid-May, while, in view of the deflationary influence exerted by the higher exchange rate itself, the Bank of England signalled a cut in commercial bank base rates in three steps from 9% in mid-March to 7.5% around mid-May. However, from late May onwards sterling became progressively weaker. This was largely the result of the stronger US dollar, the sharp deterioration of the UK current-account balance and the tightening of monetary policy in Germany. The Bank of England reacted by guiding base rates up in eight steps from 7.5% in early June to 12% in late August. Although the short-term interest premium vis-à-vis the dollar widened sharply, sterling declined from a peak of $1.89 in mid-May to a low of $1.66 in late September, whereas against the Deutsche Mark it eased to around DM 3.14.

The subsequent period of dollar weakness saw a sharp appreciation of sterling vis-à-vis the dollar and to some extent also vis-à-vis the Deutsche Mark. Although in December and January sterling participated in the general downward trend against the dollar, it continued to strengthen against the Deutsche Mark and at the end of January touched a new peak of over DM 3.28. However, in the course of February sterling began to be affected by the general disenchantment with high-yielding currencies sparked off by the sharp decline of the Australian dollar. Against the background of worsening trade and

inflation figures, it fell to a low of DM 3.16 in early March and continued to weaken against the US dollar despite repeated support by the Bank of England.

The rise and fall of the Australian dollar

The Australian dollar, with long-term interest yields of around 12% and an appreciation of roughly 25% vis-à-vis the US dollar and the Deutsche Mark between mid-1987 and early February 1989, for a long time looked like the investors' key to paradise – provided they were willing to ignore the underlying exchange risks. In February 1989, however, under the impact of disappointing current-account figures, the Australian dollar plunged by around 10% within the space of two weeks against the US dollar and the Deutsche Mark.

Unusual weakness of the Swiss franc

The Swiss franc, by contrast, was in very much the same boat as the Deutsche Mark. With an inflation rate slightly higher than that in Germany but substantially lower long-term interest rates, it came under strong downward pressure and was one of the few currencies that even lost ground against the currencies participating in the EMS exchange rate mechanism. Despite a pronounced upward adjustment in the country's interest rate level, the Swiss franc in mid-May 1989 stood about 10% below its end-1987 exchange rate against the Deutsche Mark and was down by 27% against the US dollar.

Developments in effective exchange rates

The graph on the following page illustrates recent developments in the exchange rates of selected currencies, weighted according to the export and import shares of twenty-one industrial countries, and also taking into account export competition in third markets.

Dominant influence of nominal interest rate differentials on exchange rate movements

It can be seen that 1988 was the year of the currencies with high interest yields. This is particularly evident in the right-hand section of the graph, which shows the exchange rate indices adjusted for differential developments in unit labour costs in manufacturing. Although labour costs are admittedly only a very imperfect indicator of final costs, exchange rate indices computed in this way provide a more realistic picture of developments in international competitiveness than nominal effective exchange rates or real effective rates based on consumer price indices.

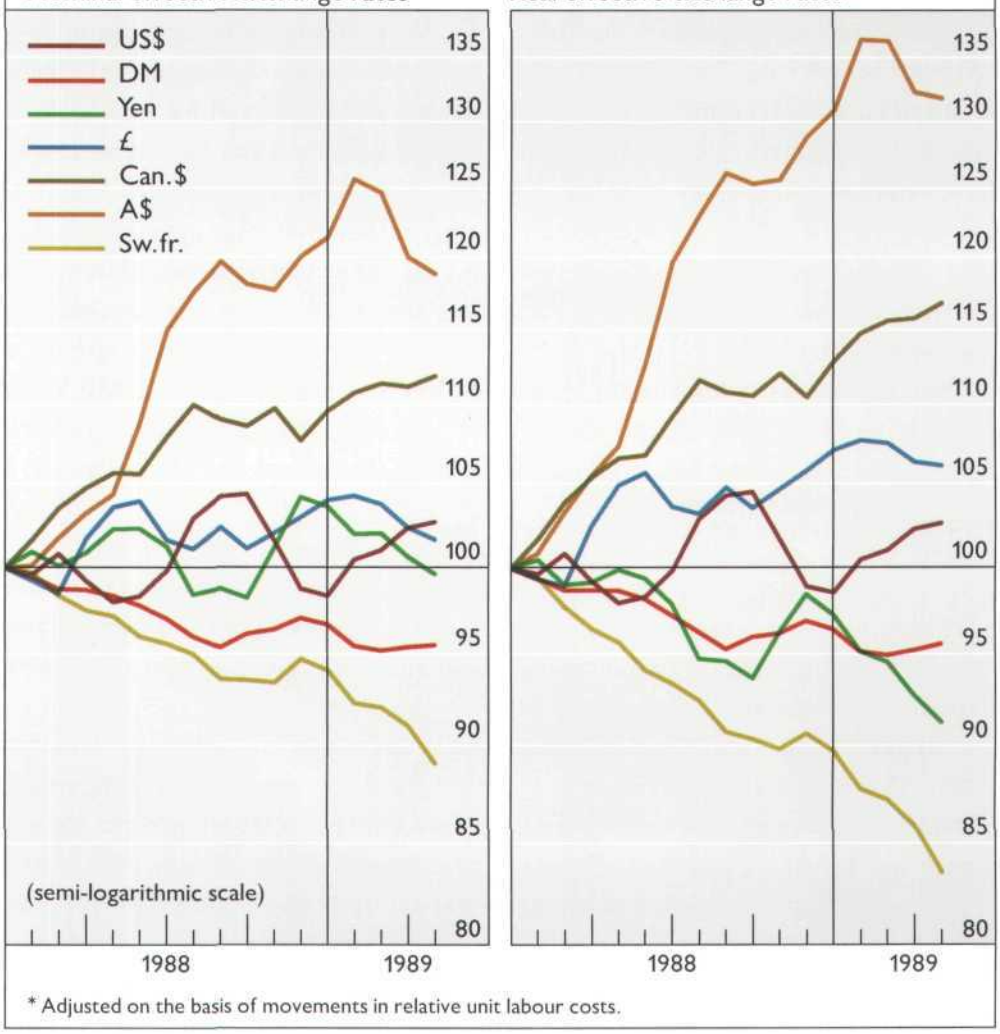
On this basis the Deutsche Mark and the yen depreciated in 1988 and the first four months of 1989 by 4 and 9%. An even larger decline of about 16% was recorded by the Swiss franc. Over the same sixteen-month period the US dollar appreciated by 3% in real terms. The largest appreciations were, however, registered by the currencies with the highest nominal interest rates, namely the Australian dollar (36% prior to its sharp drop in February 1989), the Canadian dollar (17%) and the pound sterling (6%). All the countries concerned experienced relatively high, and in some cases accelerating, inflation rates and large or even widening current-account deficits. Unless these currencies were originally undervalued, this would suggest that their exchange rates were being pushed away from their longer-term equilibrium level by excessive capital inflows.

Longer-term perspectives

The graph on page 171 looks at the real exchange rate developments of four major currencies over the ten-year period since March 1979, when the

Nominal and real effective exchange rates of selected currencies

Monthly averages, December 1987=100



* Adjusted on the basis of movements in relative unit labour costs.

European Monetary System was set up. Any choice of a base date is inevitably somewhat arbitrary, but the spring of 1979 is not a bad reference point for exchange rate comparisons. The UK and US current accounts were at that time in near balance. Sterling was about half-way on its long march from its 1976 low to its 1981 high. The Deutsche Mark and the Japanese yen had fallen back somewhat from their previous peaks vis-à-vis the US dollar and, partly as a result of their earlier strong appreciation, the current-account balances of Germany and Japan were moving into sizable deficit.

Movements in real exchange rates over a ten-year period

It can be seen that the huge real appreciation of the US dollar up to early 1985 had been fully reversed by 1987 and that in April 1989 the dollar stood about 11% below its level of ten years earlier. There were a number of changes in the fundamentals which may help to explain this depreciation of the dollar's real weighted exchange rate compared with early 1979. They include the increasing dependence of the United States on oil imports; the international debt crisis, which resulted in the stagnation of one of the most important US

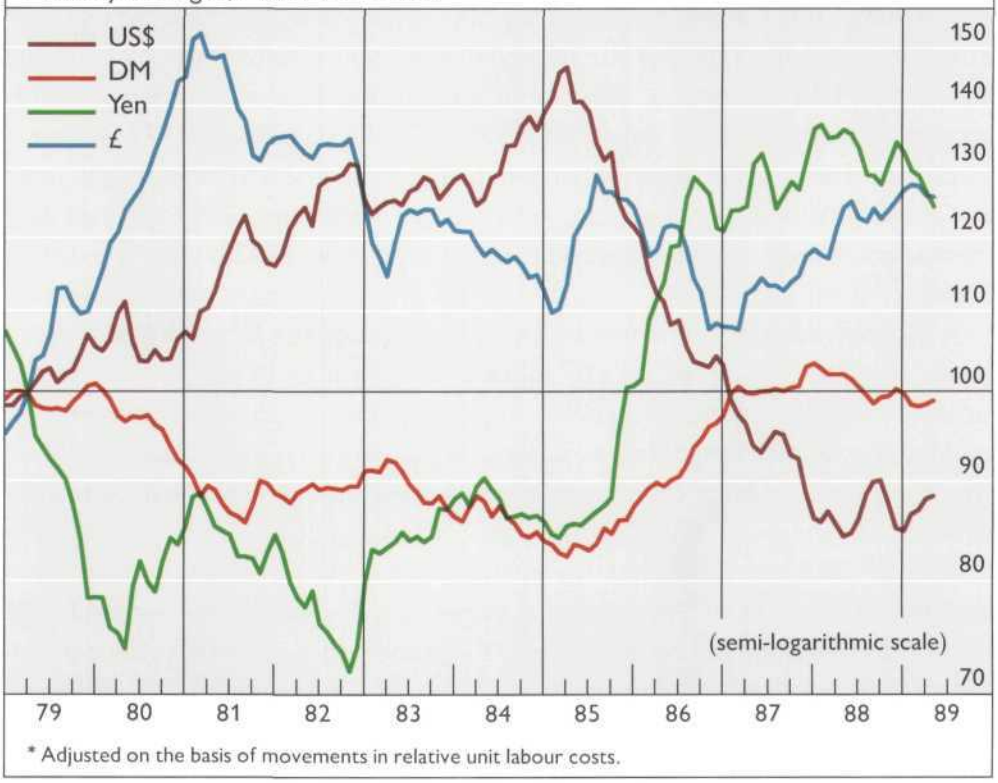
Longer-term dollar depreciation and the fundamentals behind it

export markets, Latin America; and the enormous industrial progress of countries on the Pacific rim, which has dulled the competitive edge of US industry in terms of innovativeness and new products. Moreover, the impact of the second and third of these factors was temporarily enhanced by the steep appreciation of the US dollar until early 1985, which seems to have had a negative impact on some sectors of US industry that could not be readily reversed by the subsequent depreciation.

The upshot of these developments was the emergence of the huge US

Real effective exchange rates of major currencies, 1979–89*

Monthly averages, March 1979 = 100



* Adjusted on the basis of movements in relative unit labour costs.

current-account deficit. The massive depreciation of the dollar from early 1985 onwards contributed to a sizable reduction in this deficit between the third quarters of 1987 and 1988, but since then the adjustment has slowed down markedly. This has led some observers to conclude that in the absence of some further dollar depreciation the deficit may begin to widen again in the not-too-distant future. However, in parallel with the sharp deterioration in the US current-account balance, some fundamental changes have taken place in the factors which determine the international pattern of capital flows. Largely as a result of the international debt crisis, non-OPEC developing countries are now no longer major net capital importers. At the same time, Germany, Japan and some smaller industrial countries have developed large structural savings surpluses. The United States, with its well-developed financial markets, a very low private savings ratio, a substantial Federal budget deficit, strong growth orientation of its economy and correspondingly high interest rate levels, attracted a large share of the surplus savings available in the world economy.

As a result, one of the wealthiest nations is in the process of becoming the principal debtor in the international economy – quite a contrast to the classical model which sees capital flowing to those countries with a plentiful labour supply but poor capital endowment, i.e. essentially the developing world.

Has the dollar depreciation gone far enough?

In view of these offsetting influences on the US balance of payments, it is not easy to say what the appropriate exchange rate for the US dollar would be. However, there can be little doubt that the existence of a huge current-account deficit justifies a substantially lower level than that of ten years ago. Advocates of further dollar depreciation usually point to the longer-term external debt and international portfolio implications of a continuation of the US current-account deficit at, or even somewhat below, its present level.

Longer-term stability of the Deutsche Mark

Among the currencies shown in the graph, the only one whose real effective exchange rate has not changed significantly since early 1979 is the Deutsche Mark, despite a very large turn-round in the German current-account position from a deficit of about 1.75% of GNP in 1979–80 to a surplus of 4% in 1988. One important factor behind this steadiness has been the stability of real exchange rate relationships within the EMS exchange rate mechanism, whose members account for a large share of Germany's external trade.

Longer-term appreciation of the yen and sterling

By contrast, the real effective exchange rates of the Japanese yen and the pound sterling have appreciated by about 25% each since March 1979. Whereas Japan's current-account balance has improved dramatically over this period, that of the United Kingdom has deteriorated markedly. This helps to explain why the time profile of the appreciation of the two currencies has been very different. In the case of the Japanese yen, after significant depreciation in the course of 1979, the real effective exchange rate did not show a clear trend until the second half of 1985, when it began to rise steeply. The real exchange rate of sterling, buoyed by the United Kingdom's role as an oil producer and the cyclical weakness of import demand, soared in the course of 1980 and early 1981 to 50% above its March 1979 level but lost most of this gain over the following six years. Since 1987, however, large capital inflows have pushed up sterling's real exchange rate once more, by about 16%, despite a sharp shift in the UK current-account balance into deficit.

Experience with official exchange rate management

In the past two years international co-operation in managing exchange rates has been successful in putting a floor under the US dollar. From the Louvre Accord up to 22nd May 1989 changes in the exchange rates of the principal currencies vis-à-vis the dollar have on balance remained quite moderate: a 9% depreciation of the Deutsche Mark and an appreciation of the Japanese yen and the pound sterling by 9% and 3% respectively. Nevertheless, experience with official exchange rate management has not been entirely free of problems. It was characterised by huge swings in international capital flows that gave rise to severe exchange rate pressures and called for frequent and massive official presence in the exchange markets. In fact, in both 1987 and 1988 official intervention purchases and sales of dollars by Group of Ten countries were larger than in the preceding years.

Role of large international interest rate differentials

The main problem seems to be the wide international nominal interest rate differentials which largely reflect differences in the perceived inflation-

proneness of individual currencies. When the authorities succeed in persuading the markets of their determination and ability to defend the existing nominal exchange rate structure, the nominal interest rate differentials, as during large stretches of 1988 and 1989, tend to become a dominant influence on international capital flows. As a result, the countries with the higher inflation and interest rate levels may experience excessive capital inflows, which exert undesirable upward pressures on their exchange rates. Conversely, in the low-inflation countries large-scale capital outflows will tend to lead to exchange rate depreciation. The policy signals and forces generated by these market trends will not always be very helpful. They will tend to exert pressure in the direction of unduly accommodative policies in the countries with higher *inflation rates and undesirably tight policies in the low-inflation countries*.

Danger of over-correction

Conversely, there is the danger that, once these destabilising capital flows have driven exchange rates sufficiently out of line with fundamentals, market sentiment may suddenly turn round. As a result, nominal interest rate differentials will lose their grip on international capital flows, exchange rate expectations will take over, and capital will flood back to the countries with low inflation and low nominal interest rates. Although the exchange rate pressures and policy signals will, at least initially, point in the right direction there will now, given the high degree of global integration of financial markets and the resultant scale of international capital flows, be a danger of exchange market turmoil and over-correction.

Allowance in exchange rate targets for inflation differentials

This alternation between nominal international interest rate differentials, on the one hand, and exchange rate fears, on the other, as the dominant influence on international capital flows may mean that there is most of the time a problem of either "too much or too little", i.e. a tendency for capital flows either to over or under-finance the current-account imbalances. Perhaps one way to deal with this problem would be to introduce more flexibility in official exchange rate arrangements. The official nominal exchange rate targets could make some explicit allowance for the possibility of their gradual adjustment in line with inflation differentials. Although such adjustments should not be applied in a rigid and automatic way, the possibility of their occurring would tend to reduce the overwhelming influence of nominal interest rate differentials and thereby also the artificial incentives for the massive and destabilising shift in capital flows that have characterised the international monetary scene in recent years.

No realistic alternative to internationally co-ordinated exchange rate management

The alternative to co-ordinated international efforts to stabilise exchange rates, namely an official "hands-off" policy towards the exchange markets, would under present circumstances hardly appear to be a meaningful or even feasible strategy. The high degree of global integration of national financial markets means that even relatively small modifications of domestic monetary policies or regulations may have a stronger impact on exchange rate behaviour than outright official exchange market intervention. This implies that the only available choice is between co-ordinated international exchange rate management and haphazard national interference with exchange rate behaviour, leaving it to the markets to make sense of the often contradictory policy signals.

Vital role of stable exchange rate expectations

The satisfactory functioning of a floating rate system depends crucially on market participants' ability to form fairly stable and realistic views about the longer-term equilibrium level or trend of exchange rates, so that when prevailing exchange rates diverge too far from this level or path the necessary stabilising position-taking will take place. Without such an anchor of firm and realistic exchange rate expectations there is a danger that exchange rate movements will become self-perpetuating and acquire a life of their own. In that case they will no longer perform their balancing role but will themselves become a source of disequilibria and distortions.

Difficulty of evaluating realism of exchange rates and the need for official guidance

Unfortunately, in today's world the appropriateness of exchange rate levels has become very difficult for market participants to evaluate. In a context of rapid technological, demographic and social change, purchasing power parity is a very limited guide for finding the "right" exchange rate level. Moreover, with a very high degree of international financial integration, even large temporary current-account surpluses or deficits are not necessarily a sign of fundamental disequilibrium. Finally, the various policies adopted by individual countries and their international interaction are themselves an extremely important determinant of sustainable exchange rate levels. All this amounts to saying that without substantial official guidance it will be virtually impossible for exchange market participants to form those stable and firm exchange rate expectations that are vital as an equilibrating mechanism for the satisfactory performance of a floating rate system.

It is often argued that the case for the authorities' playing an active role in the exchange markets depends on their ability to outperform the markets in estimating equilibrium exchange rates (the implication usually being that market participants are rather better at the job, if only because they have to put their money where their mouth is). This, however, is beside the point. There is no single, predetermined, equilibrium level or path for the exchange rate. Given that national economic policies have a very important bearing on exchange rate levels, there is a fairly broad range of exchange rates that are sustainable – provided they are backed up by the right kind of economic policies.

This, of course, is not to say that the authorities are completely free with regard to the choice of the exchange rate levels they seek to support. There are obviously exchange rates – such as that of the dollar in the mid-1980s – which, given the stickiness of factor prices, could put a country virtually out of business. More generally, an exchange rate whose defence would be too costly economically and would not muster the necessary policy support should not be considered an equilibrium rate.

International policy co-ordination – a prerequisite for reasonable exchange rate behaviour

Nevertheless, despite the risk of policy slippages, there is in a world of global financial markets no attractive alternative to co-operative exchange rate management backed up with an appropriate degree of international policy co-ordination. Given the pervasive role of exchange rates as an allocative mechanism, their influence on the economic performance of individual countries and the importance of a reasonably stable exchange market outlook for investment decisions, the cost of large, erratic fluctuations in real exchange rates is too high.

Developments within the EMS

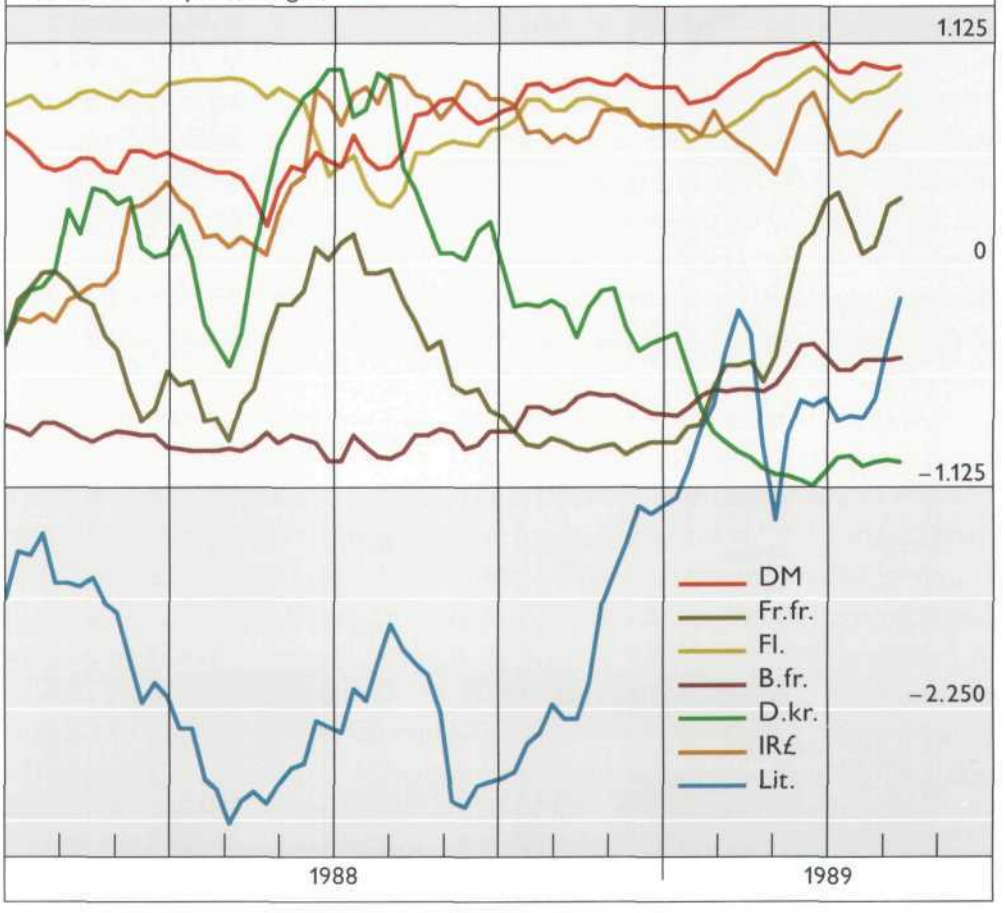
A period of relative calm and stability

Despite Germany's growing trade surplus with other EMS member countries (see Chapter III) and further liberalisation of exchange controls, 1988 and the early part of 1989 was a period of relative calm for the European Monetary System. This was due above all to continued progress in the convergence of economic policies, with inflation differentials between member countries showing a further decline. While Germany's monetary policy was geared primarily to containing domestic inflationary pressures and preventing an excessive weakening of the Deutsche Mark against the dollar, concern for EMS stability played a significant role in the monetary policy conduct of other member countries. A second factor in the near-absence of centrifugal forces within the system was exchange market developments outside. In the past dollar weakness usually tended to put disproportionate upward pressure on the Deutsche Mark. For most of the period under review, however, the dollar was strong. Moreover, the fact that the Deutsche Mark lost ground not only against the dollar but also against sterling and some other non-EMS currencies may have helped to reduce its strength within the system.

In the first two months of 1988, when the dollar had recovered from its late-1987 attack of weakness, conditions in the EMS were fairly quiet. However, in March there were signs of nervousness in connection with the French

Positions of member currencies in the EMS exchange rate band

Weekly averages of deviations from the central rates of the participating currencies, in percentages



elections, and for a few days in early March and early May the French franc replaced the Belgian franc at the bottom of the narrow EMS exchange rate band. However, as confidence was restored, the French authorities were able to lower official lending rates by 0.25% in late May and by a further 0.25% in early July. Meanwhile, the Italian lira, after drifting well into the lower half of its wider exchange rate band by early May, was bolstered by major foreign investment in Italian government securities, particularly those denominated in ECUs, and began to rise in line with the French franc.

Some nervousness in spring

From early summer onwards European countries began to tighten their monetary policy stances, largely in response to the stronger dollar. The central banks of Belgium, Germany, the Netherlands and a number of European countries outside the EMS raised their official lending rates in several steps between late June and late August. Amid these concerted rounds of interest rate increases – the last one was also joined by the Bank of France and the Bank of Italy – the exchange rate configuration within the EMS changed markedly. As a result of the narrowing of its interest rate differentials against the Deutsche Mark, the French franc drifted into the lower half of the EMS band from mid-July onwards, whereas the Deutsche Mark strengthened. In this context there were two occasions when tensions resurfaced within the EMS and the French franc came under considerable pressure. The first was in late August, when the Deutsche Mark replaced the Irish pound at the top of the band. The second episode occurred in mid-October, when the French franc was allowed to drop to the lowest position in the EMS band, while the Deutsche Mark became the strongest currency again. Faced with expectations of a realignment, the Bank of France intervened heavily in the exchange markets and raised domestic interest rates. Moreover, the French Finance Minister repeatedly ruled out the possibility of a devaluation of the French franc. Although pressures subsequently subsided, the French franc was permitted to continue at the bottom of the band throughout the rest of the year in order to limit the scope for speculative gains that might conceivably be derived from going short on francs. The favourable performance of the domestic economy caused the franc to strengthen in early 1989, and, following the announcement of a further relaxation of official exchange controls, it moved into the upper half of the EMS exchange rate band during March.

Temporary weakness of the French franc ...

... and its recovery in early 1989

Another feature of the second half of 1988 and the early months of 1989 was the marked weakness of the Danish krone. After occupying the top position in late June and part of July, the krone progressively declined. As from mid-January 1989 it replaced the French franc as the weakest currency and in March touched the bottom of the narrow EMS exchange rate band. This development was related to a sharp narrowing of the interest rate differentials in favour of the krone, official interest rates in Denmark having been kept unchanged as a result of the weakness of the Danish economy. At the same time, in view of the renewed strength of the dollar and the threat of a resurfacing of domestic inflationary pressures, other EMS central banks, under the leadership of the Bundesbank, had recourse to concerted rounds of interest rate increases in late August and mid-December 1988 and around mid-January and in late April 1989.

Buoyancy of the lira

In contrast to the Danish krone, the Italian lira has shown remarkable strength since early September 1988. It benefited not only from the interest rate differentials in its favour but also from the abolition of exchange controls on capital movements on 1st October, which led to a substantial increase in foreign currency borrowing by Italian residents via the domestic banking sector. As a result, between early September and mid-February the lira appreciated by 2.5 percentage points to near the centre of the EMS band. In the second half of February 1989, however, the imposition of a 25% reserve requirement on increases in banks' net foreign currency borrowing resulted in some weakening of the lira. This prompted the Italian authorities, who were concerned about the excessive strength of the domestic economy, to raise the official discount rate by a full percentage point in early March.

Further liberalisation of capital flows

In a broader context than the EMS, an important step was taken last year towards a further liberalisation of capital flows within Europe. In June the EC countries reached agreement on the complete liberalisation of capital movements within the Community by mid-1990, with extensions of this deadline being granted to Greece, Ireland, Portugal and Spain. Belgium and Luxembourg committed themselves to abolishing their dual exchange market by the end of 1992. At the same time the EC countries agreed to set up a new medium-term balance-of-payments support facility under which funds will be provided either directly from the reserves of other member states or through the Community loan mechanism.

Ten years of the EMS

In March 1989 the EMS celebrated the tenth anniversary of its founding. The official purpose of the system was to "create a zone of monetary stability in Europe". Basically, this meant two things: insulation of the exchange rate relationships between member currencies from the fluctuations of the dollar; and the downward convergence of member countries' inflation rates.

The EMS quite successful in attaining its goals despite an initially very difficult world economic environment

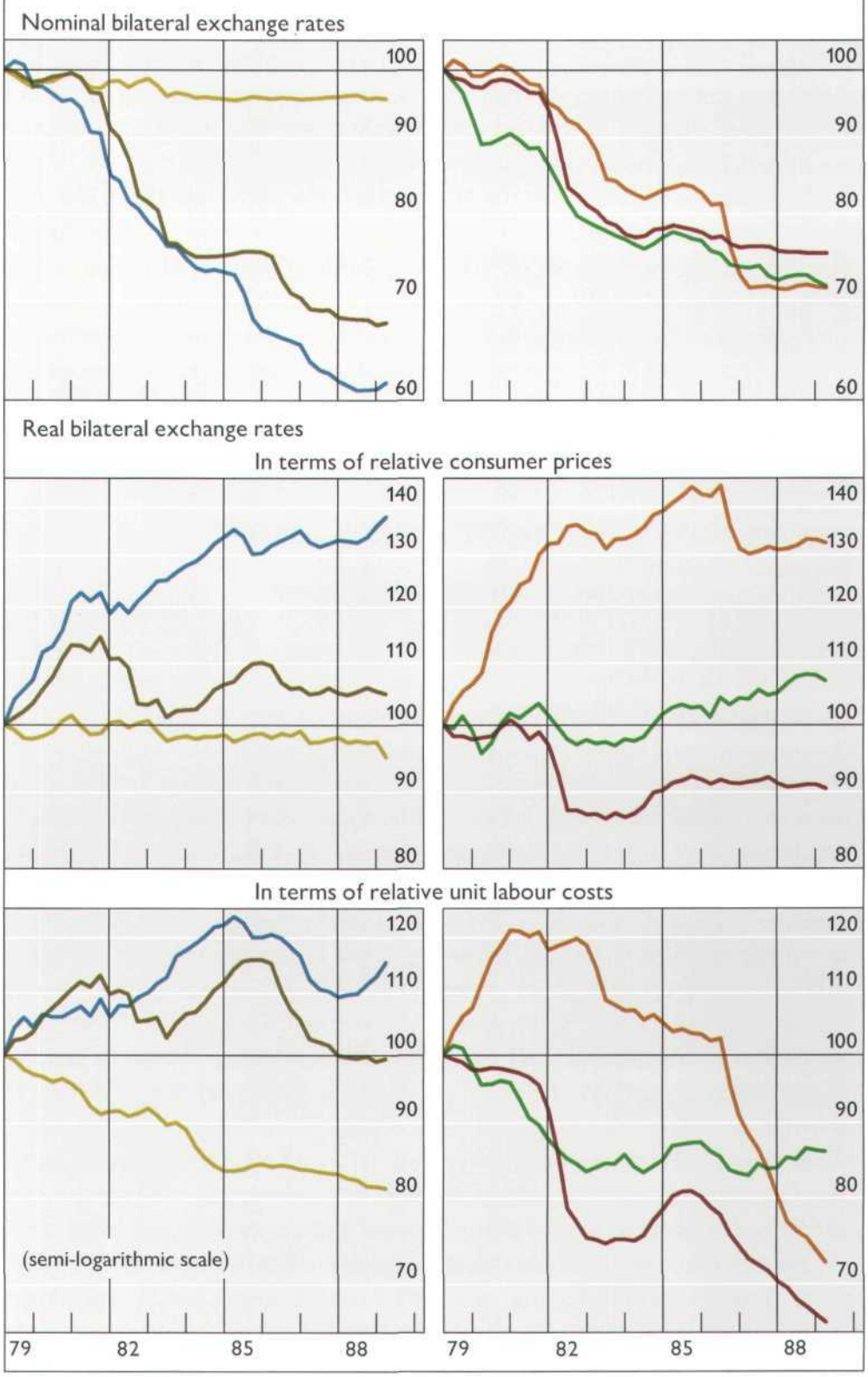
The EMS has been quite successful in attaining the goals it set for itself. Given the initially very large inflation differentials, there have still had to be considerable exchange rate adjustments over the past ten years. For example, the nominal exchange rate of the lira has fallen by nearly 40% against the Deutsche Mark since March 1979 and the French franc by over 30%. However, these adjustments have been made gradually and smoothly (see the graph on the following page), in sharp contrast to the large fluctuations in exchange rates in relation to and between currencies outside the system that have characterised the international monetary system during the past decade. Moreover, particularly in the early years of its existence, the EMS had to survive in an extremely difficult world economic environment: the second oil shock, an unusually strong inflationary bout followed by a drastic tightening of monetary policies; and, as a result of all these, unprecedented interest rate fluctuations, a huge increase in unemployment and the international debt crisis.

Notwithstanding some very dire predictions of an "inflation community" at the time of its introduction, the EMS has also succeeded in fostering a remarkable downward convergence of inflation rates between member countries. The average rate of consumer price increases in the member

Nominal and real bilateral exchange rates of EMS currencies against the Deutsche Mark

Quarterly averages, first quarter 1979 = 100

Fr.fr.
Lit.
Fl.
B.fr.
D.kr.
IR£



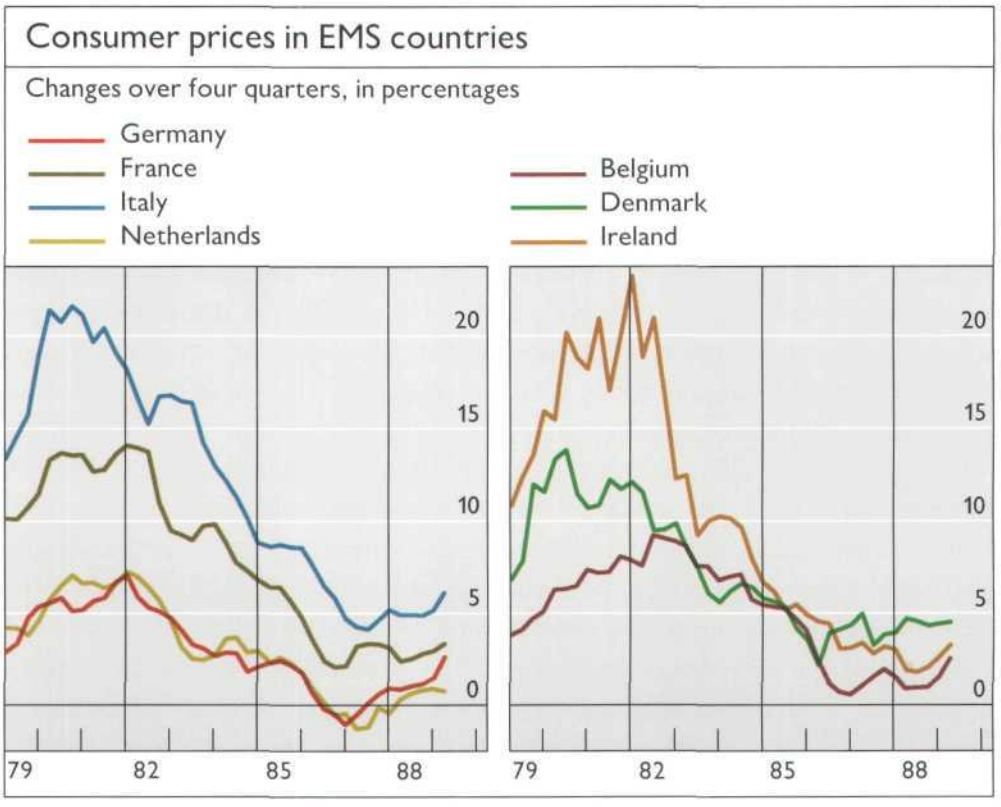
Remarkable convergence towards lower inflation rates

countries has come down sharply, and the inflation differentials are now only a fraction of what they were in the early years of the system. As a result, the downward movement of the exchange rates of the other member currencies vis-à-vis the Deutsche Mark has slowed substantially since 1983. There have been a total of eleven realignments since the birth of the system, but they have become less and less frequent and smaller in size, offering little incentive to speculators. With the most recent realignment having taken place in January 1987, the EMS is now experiencing its longest period without central rate adjustment, although this stability is based on substantial nominal interest rate differentials.

Reasonable behaviour of real exchange rates

Despite the increasing steadiness of nominal exchange rate relationships, the EMS on balance does not seem to have led to major distortions of competitive positions in favour of the Deutsche Mark. It is admittedly part of the anti-inflationary discipline of the system that in the countries with higher inflation rates the depreciations should offset the inflation differentials only with some reluctance. This is in fact what has happened. As can be seen from the graph on the facing page, the real exchange rate of the Deutsche Mark, adjusted for the relative development of consumer prices, has depreciated vis-à-vis all member currencies except the Belgian franc and the Dutch guilder. However, from the point of view of international competitiveness, consumer price indices are of only limited relevance.

In rapidly growing countries with large productivity gains in industry the services sector cannot normally absorb the same rate of wage increases without passing on part of the cost to the consumer. As a result, such countries tend to record higher rates of consumer price increases, without



necessarily suffering a major competitive handicap in their internationally traded goods sector. A more relevant indicator of international competitiveness, therefore, is the development of exchange rates adjusted for unit labour costs in manufacturing. It can be seen from the graph on page 178 that, measured on this basis, the German economy does not on the whole seem to have derived a competitive advantage from EMS membership. The real exchange rate of the Deutsche Mark has appreciated markedly against the Belgian franc, the Irish pound, the Dutch guilder and the Danish krone, while it has on balance remained unchanged against the French franc. The only member currency against which the real exchange rate of the Deutsche Mark has depreciated (by nearly 15%) is the lira, i.e. the currency of one of the most dynamic countries within the system, where non-price factors may play a certain role. It should, moreover, be noted that in the past three to four years Germany's competitive position, in terms of unit labour costs, has deteriorated significantly compared with a number of countries, namely Belgium, France, Ireland and, up to 1987, Italy. This might suggest that the recent increase in Germany's bilateral trade surpluses with other member countries (see Chapter III) is due in large measure to cyclical or structural factors – such as the buoyant international demand for capital goods, the production of which is one of German industry's main strengths.

Broader macro-economic consequences of the EMS not certain...

Lower, more convergent rates of price increase are not only ends in themselves; they are also worth striving for because of the longer-term benefits they should confer in terms of employment and economic growth. From this point of view the statistical evidence in favour of the EMS is less clear. Economic growth in member countries has been, if anything, lower than in other industrial countries, and unemployment has been more persistent. Contrary to what one might have expected from the greater anti-inflationary discipline, real long-term interest rates (measured on the basis of current inflation rates) of other member countries have not declined, but have in nearly all cases increased in relation to those prevailing in Germany, although this may be partly a measurement problem since inflationary expectations, which cannot be accurately gauged, are slow to die.

... nevertheless they are likely to be beneficial

It is very difficult to tell what the economic performance of member countries would have been in the absence of the EMS. The experience of other industrial countries does not provide conclusive evidence in this respect, since there are too many other variables involved. However, on a priori grounds there are several considerations that would seem to argue in favour of the EMS. Firstly, the advantages of greater price stability become apparent only in the longer run and the successes in the fight against inflation are probably still of too recent origin to show up fully in economic performances. Secondly, there can be little doubt that a greater degree of stability and predictability of exchange rate relationships between member countries is conducive to investment. Finally, true to the intentions of its founding fathers, the increased policy convergence and economic integration fostered by the EMS have helped to prepare the ground for further initiatives such as the study of concrete steps towards European economic and monetary union launched by the European Heads of State and Government in mid-1988.

The Report on Economic and Monetary Union in the European Community ("Delors Report")

Background

At its meeting in Hanover on 27th–28th June 1988, the European Council "confirmed the objective of progressive realisation of economic and monetary union" and entrusted to a Committee, chaired by M. Delors, President of the European Commission, "the task of studying and proposing concrete stages leading towards this union". The Committee completed its work in mid-April 1989 and the "Report on Economic and Monetary Union in the European Community" was made public shortly afterwards. After the Werner Report, prepared in 1970, this marked the second attempt to draw up a plan for the attainment of economic and monetary union.

Part I of Report: review of past and current developments in the field of European economic and monetary integration

The Report is divided into three main parts. The first one briefly reviews past and present developments in economic and monetary integration in the Community. It notes that considerable progress has been made in this respect in recent years, both within the framework of the EMS and in connection with the internal market programme which calls for the creation of a market without internal frontiers by the end of 1992. It argues, however, that the EMS has not yet fulfilled its full potential and that there is a need for a greater convergence of economic performance. The realisation of economic and monetary union would require further major steps in all areas of policy-making and presupposes a high degree of economic integration, a common monetary policy and consistent economic policies. These policies should be geared to price stability, balanced growth, converging standards of living, high employment and external equilibrium.

Part II: principal prerequisites, features and consequences of economic and monetary union

Part II of the Report outlines the principal features and implications of an economic and monetary union. It emphasises that the realisation of such a union would involve a transfer of the necessary monetary and economic decision-making power from member states to the Community and that the existing EC Treaties would have to be amended. The conditions for a monetary union, as defined already in the Werner Report, are: total and irreversible convertibility of currencies; complete freedom of capital movements and full integration of financial markets; and irrevocably locked exchange rates without any margin of fluctuation. Once these conditions were fulfilled, a further development – not strictly necessary, but desirable for economic as well as psychological and political reasons – might be the adoption of a single currency. The Committee felt that the ECU had the potential to be developed into a future common currency, but it firmly rejected proposals for using a parallel currency as a means of accelerating monetary union.

Need for a common monetary policy

The most important implication of a monetary union is the need for a common monetary policy, the responsibility for which would have to be vested in a new institution, which might be called a European System of Central Banks (ESCB). This new System would have to have a federative structure, and would consist of a central institution and the national central banks; it would be independent of instructions from national governments and Community authorities and it would be committed to the maintenance of price stability.

The principal features of an economic union are: a single market within

which persons, goods, services and capital can move freely; common competition policies; common structural and regional policies; and effectively co-ordinated macro-economic policies, including binding rules for national budgetary policies. These policy requirements are essential both in order to deal with possible economic imbalances in a situation where exchange rate changes are no longer available as an instrument of adjustment among member countries and in order to enable the Community to conduct a coherent fiscal/monetary policy mix directed towards internal and external goals. Monetary policy alone cannot perform all these functions.

Part III: a three-stage approach to economic and monetary union

Part III of the Report sets out the principles for a step-by-step approach to economic and monetary union, divided into three main stages. It stresses that, although each stage is separate, the creation of the union must be viewed as a single process and that the decision to enter upon the first stage should be a decision to embark on the entire process. The new arrangements coming into effect at the beginning of each stage would gradually pave the way for the next stage. In each stage there would have to be broadly parallel developments on the economic and monetary fronts. While the Report deliberately refrains from laying down a precise timetable, it suggests that the first stage should start no later than 1st July 1990, when the Directive for the full liberalisation of capital movements comes into force.

Greater policy co-ordination

The principal steps in stage one would aim at a greater convergence of economic performance through the strengthening of economic and monetary policy co-ordination within the existing institutional framework. During this stage it would also be necessary to prepare and ratify the change in the Treaty of Rome.

New institutions and organs

Stage two could not begin until the Treaty change had come into force, allowing the establishment of the basic organs and structure of the economic and monetary union. Within this new framework a training process would be set in motion which would gradually lead to collective decision-making. The ultimate responsibility for policy decisions would, however, remain with the national authorities.

Centralised decision-making and common currency

The final stage would commence with the irrevocable locking of exchange rates and full transfer of the necessary decision-making power to Community institutions. In particular, this would involve giving the Community authority to impose constraints on national budgets, and the European System of Central Banks would assume the full responsibility for monetary policy. The national currencies would be replaced as soon as possible by a single currency.

The Committee took the view that if the European Council endorsed its Report, the Council of Ministers and the Committee of Governors should be invited to take the necessary decisions to implement stage one and that preparatory work for the negotiations on the new Treaty should start immediately.

Gold production and the gold market

Bearish market conditions

In the period under review gold shared the fate of the currencies with low interest yields. Despite a decline in the total amount coming onto the market (a fall of 140 tons to 1,705 tons in 1988), the price of gold displayed

Estimated market sources and uses of gold					
Items	1984	1985	1986	1987	1988
	in metric tons				
Production	1,160	1,230	1,290	1,380	1,535
Estimated net sales by communist countries[1]	150	250	400	300	260
Estimated changes in official gold stocks through market transactions[2] (− = increase)	20	−165	−10	95	−240
Net new gold loans				70	150
Total (= estimated non-monetary absorption)	1,330	1,315	1,680	1,845	1,705

[1] Excluding European IMF members. [2] Changes in South Africa's gold reserves have been excluded from the movements of official gold stocks in this table, since they are believed to have largely reflected the execution or unwinding of gold swaps between the South African Reserve Bank and commercial banks in other countries.

considerable weakness throughout most of the year and in early 1989. Total production by western countries was higher than in 1987, but sales by communist countries contracted somewhat and, in sharp contrast to 1987, the official sector was a substantial net buyer of gold.

Continuing rise in production

The 1988 increase in the output of western mines was broadly based, as mines exploited capacity created in response to the high prices of the early 1980s. Total production rose by 155 tons to 1,535 tons. South Africa marginally increased its output for the first time in four years, following changes in taxation which encouraged greater production. In the United States output jumped by nearly one-third, or 50 tons. In Australia the 41 ton rise was equivalent to an expansion of 37%. Substantial increases also occurred in Brazil (16 tons) and Canada (12 tons).

Some decrease in communist supplies

Communist countries are estimated to have sold around 260 tons in western markets, about 40 tons less than in 1987. Soviet sales of gold did not increase in 1988, despite a poor harvest in the Soviet Union and weak prices for oil. One reason for this may have been that the Soviet Union has been meeting part of its need for foreign currency by borrowing in the Euro-markets. Net supplies of gold from China, the other major communist producer, appear to have contracted, in part because domestic demand has picked up as inflation has accelerated, and in part because of domestic production shortfalls.

Substantial absorption by official holders

Last year's identified increase of 240 tons in official gold holdings was in large measure accounted for by international institutions, notably the European Monetary Co-operation Fund. Countries' gold holdings expanded by only 82 tons, an increase which was the net outcome of substantial movements in opposite directions. Amongst the Group of Ten only two countries showed any changes in 1988. The United States used 16 tons from its official gold stock to mint coin, while Canada continued its earlier policy of gradually reducing its official stocks and disposed of a further 43 tons. A noteworthy development, though without consequence for the 1988 data, was that in the first quarter of 1989 the Belgian National Bank sold 127 tons. This reduced Belgium's gold stock by about 10% and brought the share of gold in its total monetary reserves roughly into line with that in neighbouring European countries.

World gold production

Countries	1953	1970	1980	1984	1985	1986	1987	1988
	in metric tons							
South Africa	371	1,000	675	683	672	640	607	621
Share of world gold production	*49.1*	*78.6*	*70.4*	*58.8*	*54.5*	*49.5*	*43.9*	*40.4*
United States	61	54	31	66	80	118	155	205
Australia	33	20	17	39	59	75	111	152
Canada	126	75	52	86	90	106	117	129
Brazil	4	9	35	62	72	67	84	100
Philippines	15	19	22	34	37	39	40	43
Colombia	14	7	17	21	26	27	33	33
Papua New Guinea	0	1	14	19	31	36	34	33
Chile	4	2	7	18	18	19	20	23
Venezuela	1	1	1	10	12	15	16	16
Zimbabwe	16	15	11	15	15	15	15	15
Japan	7	8	7	7	9	14	14	14
Other countries	103	62	70	102	112	122	136	153
World total[1]	755	1,273	959	1,162	1,233	1,293	1,382	1,537
Memorandum items:	annual averages, in US dollars per ounce							
Market price of gold								
in current US dollars	*35.00*	*35.94*	*612.76*	*360.45*	*317.30*	*367.59*	*446.63*	*437.09*
in constant US dollars[2]	*35.00*	*24.78*	*199.03*	*92.87*	*78.96*	*89.77*	*105.21*	*98.93*

[1] Excluding the USSR, other eastern European countries, China and North Korea. [2] Deflated by the US consumer price index (1953 = 100).

Source: Consolidated Gold Fields PLC (London).

Elsewhere in the developed world, Portugal reported a decline of 124 tons in its gold reserves. However, since this was the counterpart of swaps against ECUs associated with the country's accession to the European Monetary Co-operation Fund, this operation did not affect market supplies of gold. Spain, which had transferred gold to the EMCF in 1987, added 66 tons to its own holdings.

Larger Taiwanese purchases

By far the largest official gold purchases took place in the Far East, where Taiwan acquired 181 tons. Valued at average market prices for the year, this increase of $2.5 billion virtually offset last year's decline in the country's foreign exchange reserves. Moreover, many of the purchases were made in the United States, which made Taiwan's bilateral trade surplus with that country appear to be smaller.

In Latin America several major debtor countries recorded changes in their gold reserves. Brazil sold 15 tons of gold in the first quarter of 1988, but subsequently replenished its holdings to some extent. Colombia and Peru added 13 tons and 7 tons respectively to their reserves.

Increasing role of gold loans

A final factor affecting the amount of gold coming onto the market was the increasing recourse to gold loans, particularly in the first half of the year. It has been conservatively estimated that, net of repayments of earlier gold loans, around 150 tons of gold was lent in 1988. These low-interest gold loans are mostly extended to mining companies, which sell the gold spot and repay the loans out of future production. The gold employed in these loans largely

comes out of official gold stocks, which would otherwise have remained unused. These transactions are usually not reported as a decline in official gold reserves since the central banks continue to have a gold claim.

The attraction for the mining companies of borrowing gold is that the costs are lower than on conventional loans, provided that the gold price does not go up over the life of the loan by more than the interest saved. It is, therefore, not too surprising in view of the bearish outlook for the gold price that both the demand for these loans and the interest rates charged on them have gone up strongly. It appears that by early May 1989 most final borrowers, owing to the strong rise in interbank gold deposit rates, could no longer obtain fixed interest rate loans and had to pay nearly twice as much as in early 1987, namely around 3%. However, even this somewhat higher interest cost still leaves scope for a substantial rise in the gold price. On the other hand, a pessimistic outlook for the gold price will tend to reduce borrowing for purposes of expanding mining capacity.

Buoyant fabrication demand

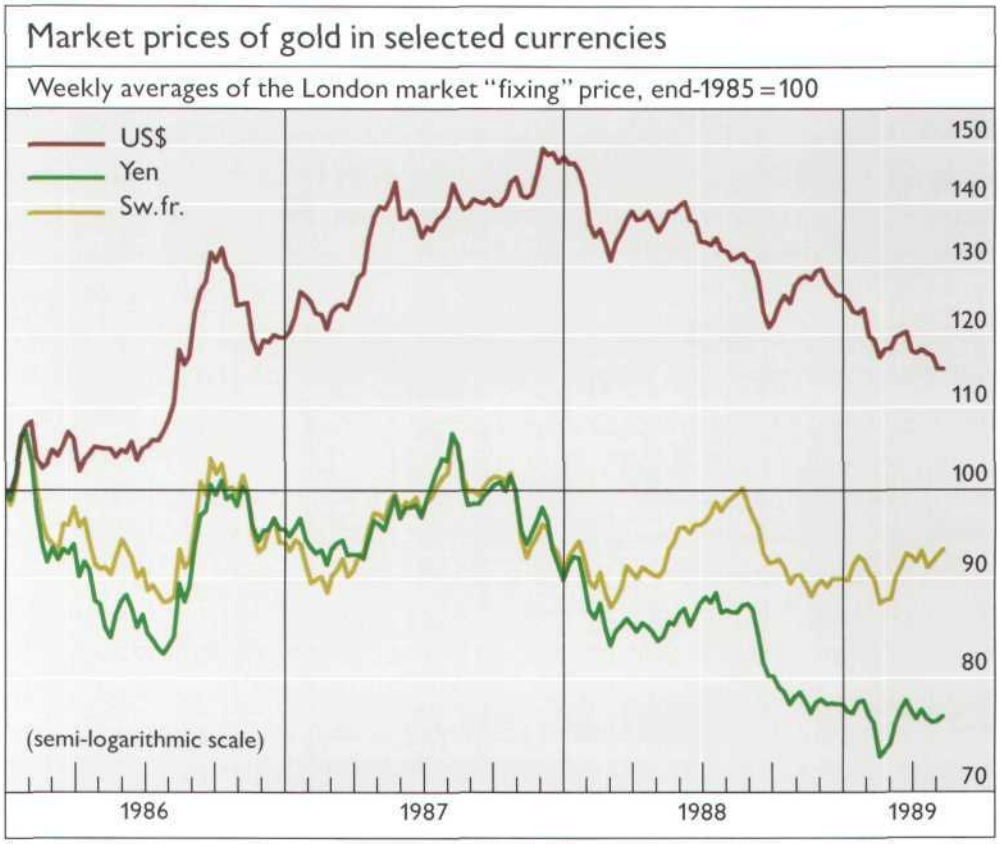
Last year the prosperous state of large parts of the world economy, together with declining gold prices, stimulated fabrication demand, which is estimated to have risen by 330 tons to 1,520 tons (excluding the use of scrap). The jewellery industry, which alone accounts for about 80% of the industrial demand for gold, took an additional 350 tons. On the other hand, there was a pronounced drop in the use of gold for official coinage, which reflected a return to more normal patterns following two somewhat exceptional years: in 1986 and 1987 Japan had bought considerable amounts of gold for the Hirohito commemorative coin. Moreover, the fall in the stock market in October 1987, while not producing a generalised shift into gold, had caused small savers to purchase coins in unusually large quantities.

Strongly increasing private gold holdings in the Far East

Although gold hoarding in the aggregate appears to have fallen off sharply, private holdings expanded markedly in some Far Eastern countries. In Taiwan declared imports of gold for purposes other than adding to official reserves amounted to roughly 170 tons, but it is widely believed that the true figure was much larger. Imports into Japan for investment purposes may be estimated at around 150 tons. In view of the fact that in recent years the drop in gold prices has been quite pronounced in terms of yen, it would seem that Japanese private investors are taking a long view or are motivated by portfolio diversification considerations. Accurate data are not available for other regions, where a sharp distinction between hoarding and jewellery uses is not always possible. However, favourable economic conditions would seem to have increased demand for gold in South-East Asia and the Indian subcontinent, while elsewhere there was presumably substantial dishoarding.

Gold price trends

For most of 1988 and early 1989, the dollar price of gold tended to weaken. In the wake of a stronger dollar and reports of exceptionally large gold loans to mining companies, quotations dropped from a five-year high of over $500 in December 1987 to $424 on the last day of February 1988. In March 1988 dollar weakness, expectations of higher oil prices and renewed fears of inflation led to a temporary rally and, in tandem with other precious metal prices, quotations rose to a peak of $465 in early June. In the shadow of the strengthening dollar, prices drifted downwards to about $420 over the



following months before plummeting to under $390 in the last week of September, as falling oil prices dampened inflationary expectations. The subsequent recovery to an early December peak of $430, which occurred in parallel with temporary dollar weakness, turned out to be short-lived, and the price eased back below $400 in late January 1989. It traded in the $380-400 range up to the end of April, before dropping to a 33-month low of $359 on 22nd May in parallel with a sharp rise of the dollar.

In recent years the gold price has shown a tendency to react more to movements in exchange rates than to any other single macro-economic influence. For that reason it is perhaps not surprising that in the period under review spells of dollar strength were accompanied by declining gold prices. Nonetheless, the failure of the gold price to respond to the modest but broad-based acceleration in inflation last year is worthy of note, particularly as gold and other commodity prices are often considered to be a bell-wether of expectations and to presage or at least move in tandem with inflation. Perhaps this immunity of the gold price to signs of inflation reflects the markets' belief that this time the increase in price pressures is merely transitory and that the authorities will be successful in choking off any material threat to price stability. The inversion of yield curves and the relative stability of long-term interest rates in 1988 have been interpreted in the same way.

International liquidity

Two distinct features marked the development of international liquidity in 1988. Firstly, after the record increase registered in 1987 there was a further modest rise in official non-gold reserves. Secondly, a marked shift occurred in

the currency pattern of the growth in foreign exchange reserves. Official dollar holdings seem to have declined, whereas other currency assets continued to expand.

Drastic slowdown in official reserve growth

In 1988 the current dollar value of official international reserves other than gold increased by only $10.6 billion, or 1.5%, to $724 billion, whereas in the preceding year it had surged by over 40%, a rate of growth unprecedented since the abandonment of the Bretton Woods system of fixed parities. However, the slow growth last year was partly the result of dollar appreciation. When the effects of exchange rate changes are eliminated, the deceleration in the growth of non-gold reserves, from about 20% in 1987 to just over 5% one year later, was less dramatic, while in SDR terms the expansion amounted to 7% last year.

There was only a very marginal increase in countries' reported official gold holdings in 1988, while the 16% decline in the price of this metal in the course of the year reduced the market value of their gold reserves by about $72 billion.

Private capital flows to the United States obviate the need for official dollar purchases

The principal reason for the pronounced slowdown in the growth of non-gold reserves last year was the turn-round of the dollar due to a resurgence of private capital flows to the United States. As a result, dollar support operations of the kind undertaken on an exceptionally large scale by Group of Ten countries in 1987 were no longer called for. If account is taken of indirect flows of official funds to the United States via the Euro-market, in 1987 over three-quarters of the $154 billion US current-account deficit had been financed by the accumulation of foreign official dollar balances. By contrast, in 1988 private net capital inflows appear to have fully financed the US deficit, which narrowed to $135 billion.

Other factors affecting official reserve growth

A second reason for the slowdown in reserve growth was the decline in the free market price of gold. This not only affected the value of gold held by central banks, but also reduced the amount of ECUs created against gold on the basis of a market-related gold price. Finally, the further repayment of credits granted by the IMF in the early years of the international debt crisis reduced the reserve positions of the member countries whose currencies had been used for these operations.

There were, however, some factors that tended to offset these contractionary influences on international liquidity. Firstly, the United States intervened on both sides of the currency market, but on balance purchased more foreign exchange than it sold, thereby largely replenishing the reserve holdings it had drawn down in 1987. Secondly, there was substantial reserve accumulation in currencies other than the dollar, which tended to boost the dollar accruals or reduce the dollar losses of the countries of issue of these secondary reserve currencies. Thirdly, the rise in short-term interest rates in the course of the year tended to boost official foreign exchange incomes, which are quite often added to reserves.

Reserve growth centred on foreign exchange assets

In 1988 reserve accruals were more sharply focused on foreign exchange assets than in recent years. Indeed, the increase in official foreign exchange holdings, after the exclusion of dollars swapped against ECUs, totalled over $31 billion, which was three times as large as the aggregate growth of non-gold

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							
1986	−1.0	46.7	38.4	0.3	2.9	7.9	49.5
1987	−1.4	69.7	93.0	0.2	3.2	21.8	118.2
1988	−1.9	−56.9	19.5	−3.0	0.4	−15.3	1.6
Amounts outstanding[2]	733.3	300.8	270.3	23.1	21.2	54.6	369.2
Other developed countries[3]							
1986	−0.8	5.1	6.1	0.2	0.4	-	6.7
1987	−1.9	7.0	27.9	0.6	0.5	5.0	34.0
1988	−4.1	− 7.9	13.0	0.2	−0.1	2.6	15.7
Amounts outstanding[2]	77.0	31.6	96.7	3.2	2.4	8.4	110.7
Developing countries							
1986	2.1	8.6	10.0	0.2	0.5		10.7
1987	−0.6	11.5	52.0	0.6	1.1		53.7
1988	6.3	− 6.8	−1.1	−3.8	−1.8		−6.7
Amounts outstanding[2]	129.2	52.9	228.9	11.8	3.5		244.2
of which:							
Major debtor countries[4]							
1986	*0.7*	*2.4*	*−7.3*	*-*	*0.3*		*−7.0*
1987	*−1.5*	*2.5*	*4.0*	*−0.1*	*0.9*		*4.8*
1988	*0.6*	*− 2.2*	*−6.2*	*−0.6*	*−1.0*		*−7.8*
Amounts outstanding[2]	*33.3*	*13.6*	*27.6*	*0.1*	*0.7*		*28.4*
Middle Eastern oil exporters[5]							
1986	*−0.1*	*1.4*	*−6.5*	*0.1*	*-*		*−6.4*
1987	*−0.1*	*2.1*	*3.9*	*0.6*	*0.3*		*4.8*
1988	*0.1*	*− 1.7*	*−3.8*	*−3.0*	*−0.3*		*−7.1*
Amounts outstanding[2]	*22.8*	*9.4*	*35.1*	*9.7*	*1.4*		*46.2*
Total[3]							
1986	0.3	60.4	54.5	0.7	3.8	7.9	66.9
1987	−3.9	88.2	172.9	1.4	4.8	26.8	205.9
1988	0.3	−71.6	31.4	−6.6	−1.5	−12.7	10.6
Amounts outstanding[2]	939.5	385.3	595.9	38.1	27.1	63.0	724.1

[1] Gold reserves valued at market prices. [2] At end-1988. [3] Excluding eastern European countries. [4] Baker countries excluding Yugoslavia. [5] Iran, Iraq, Kuwait, Libya, Oman, Qatar, Saudi Arabia and the United Arab Emirates.

reserves. In constant dollar terms, and including dollars swapped against ECUs, the expansion amounted to even more, namely about $40 billion.

Decline in IMF credit

Reserve positions in the Fund, by contrast, shrank by $6.6 billion, $2.3 billion of which resulted from valuation effects. IMF credits outstanding declined for the third year in succession as repayments of loans (SDR 6.7 billion) continued to exceed new disbursements (SDR 3.1 billion). Some

countries, such as Argentina and Brazil, received new credits in 1988, after repaying loans drawn in 1981–84. Since 1986 the IMF has also been granting structural adjustment credits to low-income member countries implementing medium-term macro-economic and structural adjustment programmes. Last year the first disbursements (SDR 0.1 billion) were made under the Enhanced Structural Adjustment Facility. Altogether, a total of SDR 0.4 billion in structural adjustment loans was drawn in 1988, the same as one year earlier. Last year also saw a $1.5 billion contraction in the dollar value of countries' official SDR holdings, which was, however, almost entirely accounted for by valuation effects.

The $12.7 billion decline in official ECU holdings recorded last year can be attributed to the repayment of credits granted earlier by the European Monetary Co-operation Fund under the very short-term financing facility and to the way official reserve ECU assets are maintained by rolling over gold swaps. As already mentioned, the fall in the price of gold led to a decrease in the amount of official ECUs created against gold.

Geographical distribution of reserve growth

In 1988 notable changes occurred in the geographical pattern of reserve accumulation. There was only a very slight increase in the aggregate reserves of the Group of Ten countries, whereas the other developed countries and the developing countries without debt service problems, particularly those in Asia, recorded substantial increases.

Substantial reserve accruals in some Group of Ten countries largely offset by declines elsewhere in the Group

The aggregate expansion of the non-gold reserves of the Group of Ten countries amounted to a mere $1.6 billion, or to about $22 billion if exchange rate effects are excluded. Substantial reserve accruals by some countries, notably Japan, Canada and Italy, were largely offset by the run-down of reserves by others, mainly Germany, France and Switzerland. Canada, which was the only Group of Ten country to see its currency appreciate against the strengthening US dollar, more than doubled its international reserve holdings by $8.1 to 15.4 billion in current dollar terms. Although both the yen and the pound sterling declined somewhat against the dollar, they appreciated against most other Group of Ten currencies, and the non-gold reserves of Japan and the United Kingdom grew by $15.8 and 2.4 billion respectively. Similarly, the Italian lira strengthened against other currencies in the European exchange rate mechanism and the Italian authorities added $4.5 billion to their international reserves. US official reserve assets rose by $2 billion, a $4.3 billion increase in the dollar value of the country's exchange reserves being partly offset by a contraction in its IMF and SDR positions. On the other hand, countries whose currencies weakened the most drew on their exchange reserves to prevent a still greater drop. In particular, Germany and Switzerland, despite large current-account surpluses, experienced declines in their reserve holdings by $20.3 and 3.3 billion respectively. France, which made substantial repayments to the European Monetary Co-operation Fund and supported the franc against the dollar and EMS currencies, saw the dollar value of its non-gold reserves decline by $7.6 billion.

The official reserves of other developed countries grew very considerably, namely by $15.7 billion, or over 16%, owing mainly to the expansion in the international asset holdings of Spain ($6.4 billion), Australia ($4.8 billion),

Changes in individual countries' official non-gold reserves*

Countries	Amounts outstanding at end-1983	Changes					Amounts outstanding at end-1988
		1984	1985	1986	1987	1988	
	in billions of US dollars						
United States	22.6	1.2	8.3	5.3	−2.7	2.0	36.7
Other Group of Ten countries	156.5	−3.3	14.6	44.2	120.9	− 0.4	332.5
Japan	24.6	1.8	0.3	15.5	38.7	15.8	96.7
Germany	42.6	−2.4	4.1	7.4	26.9	−20.3	58.3
United Kingdom	11.3	−1.9	3.4	5.6	23.3	2.4	44.1
Italy	20.0	0.8	−5.3	4.4	10.2	4.5	34.6
France	20.6	0.3	5.7	4.8	1.6	− 7.6	25.4
Switzerland	15.0	0.3	2.7	3.8	5.7	− 3.3	24.2
Netherlands	10.2	−0.9	1.5	0.4	4.8	0.0	16.0
Canada	3.5	−1.0	0.0	0.8	4.0	8.1	15.4
Belgium	4.7	−0.1	0.2	0.7	4.1	− 0.3	9.3
Sweden	4.0	−0.2	2.0	0.8	1.6	0.3	8.5
Other developed countries	40.3	6.9	7.1	6.7	34.0	15.7	110.7
Spain	7.4	4.6	−0.8	3.6	15.9	6.4	37.1
Australia	9.0	−1.5	−1.7	1.5	1.5	4.8	13.6
Portugal	0.4	0.1	0.9	0.0	1.9	1.8	5.1
Yugoslavia	1.0	0.2	−0.1	0.4	−0.8	1.6	2.3
Other	22.5	3.5	8.8	1.2	15.5	1.1	52.6
Developing countries	157.1	13.8	15.6	10.7	53.7	− 6.7	244.2
Taiwan	11.9	3.8	6.9	23.7	30.4	− 2.8	73.9
China	15.0	2.4	−4.6	−1.3	4.9	2.2	18.6
Singapore	9.3	1.1	2.4	0.1	2.3	1.9	17.1
Korea	2.4	0.4	0.1	0.4	0.3	8.8	12.4
Brazil	4.4	7.1	−0.9	−4.8	0.5	0.2	6.5
Thailand	1.6	0.3	0.3	0.6	1.2	2.1	6.1
Mexico	3.9	3.4	−2.4	0.8	6.8	− 7.2	5.3
Venezuela	7.6	1.3	1.4	−3.8	−0.5	− 2.9	3.1
Other	101.0	−6.0	12.4	−5.0	7.8	− 9.0	101.2
Total	376.5	18.6	45.6	66.9	205.9	10.6	724.1

* Including ECU positions.

Portugal ($1.8 billion) and Yugoslavia ($1.6 billion). Here again, the increases were considerably larger if exchange rate effects are excluded.

Declines in reserves in certain groups of developing countries

The $6.7 billion decline in the aggregate international reserves of the developing countries during 1988 masks a diversity of experience among various country groupings. Firstly, the non-oil-exporting countries recorded an increase of $5.1 billion in their reserves, whereas the Middle Eastern oil exporters drew down their reserves by $7.1 billion, or 13%. Even within the non-oil-exporting developing countries, there were wide differences. The middle-income countries facing debt servicing problems drew on their reserves in order to finance imports, to pay interest and to convert debt obligations.

The total international assets of the fourteen heavily indebted countries other than Yugoslavia fell by $7.8 billion, or over 20%, with those of Mexico and Venezuela contracting the most (by $7.2 and 2.9 billion respectively). On the other hand, developing countries in Asia, notably Korea ($8.8 billion), China ($2.2 billion) and Thailand ($2.1 billion) substantially increased their holdings of non-gold reserves.

Shifts in the currency pattern of exchange reserve growth

With regard to the deployment of official reserve accruals, 1988 saw a pronounced shift in the currency pattern of the growth of exchange reserves away from the dollar to other currencies. However, the exact magnitude of this shift cannot be determined. Expressed in constant dollars, countries' identified non-dollar exchange reserves expanded by $54 billion, or almost one-third, last year, with $48 billion of this increase being accounted for by countries other than the United States. Since total official exchange reserve holdings of these other countries are reported to have grown only by about $35 billion, it appears that their dollar reserves declined by around $10 billion last year.

Decline in official dollar holdings

In fact, after growing by $22 billion in 1987, identified dollar deposits held by official monetary authorities with banks in the Euro-market were drawn down by $9 billion. On the other hand, the $39 billion increase in identified *official dollar assets held in the United States shown in the US balance-of-payments statistics* for 1988 was nearly as large as the corresponding 1987 figure of $45 billion. This would seem to suggest that there was a further strong increase in official dollar holdings last year. However, the US balance-of-payments statistics cannot be used to draw such a conclusion. They identify only official funds placed directly in the United States. It appears that in 1987 there had been very large unidentified inflows of official funds into the United States via banks and securities houses abroad and that these inflows were to a large extent reversed in 1988. This seems to have been the main reason for the massive $105 billion turn-round, from +$61.3 billion in 1987 to −$43.4 billion in 1988, in the unallocated item shown in the table on the following page. A second reason for the large 1988 decline in this item might be some unidentified official withdrawals of deposits from the Euro-dollar market and official sales of Euro-dollar securities. A conceivable third explanation – unidentified draw-downs of official non-dollar assets – seems less plausible in view of the strong general upward trend of such non-dollar holdings last year.

Strong expansion in official Deutsche Mark holdings

In constant dollar terms, Deutsche Mark assets alone accounted for well over half of the identified $54 billion volume expansion in countries' official exchange reserves denominated in currencies other than the dollar. The identified $4.8 billion volume increase in official yen assets was not much larger than that in French francs ($4.5 billion), but probably understates the true increase. The strong growth in official Deutsche Mark reserves was only partly the result of official support purchases by the United States and EMS member countries; it also reflected the efforts of other countries to diversify their exchange reserve holdings.

Global reserve data are not yet available for the first quarter of 1989. However, in the Group of Ten countries non-gold reserves contracted marginally, by $2.5 billion. This decline was more than accounted for by the

First-quarter 1989 developments in Group of Ten countries' official reserves

further appreciation of the US dollar, which reduced the dollar value of assets denominated in other currencies by about $9.5 billion and also entailed decreases in the dollar value of Group of Ten countries' official ECU assets, SDR holdings and IMF reserve positions. In the case of foreign exchange reserves, however, substantial volume gains more than offset the negative exchange rate effects. On balance, the dollar value of Group of Ten countries' official exchange assets showed an increase of $4.3 billion. The dollar value of US exchange reserves alone rose by $2.9 billion in the wake of massive US official support purchases of other currencies against dollars. Official dollar sales were also reflected in declines in Swiss, UK and German exchange reserves of $2.2, 1.6 and 1.4 billion respectively. On the other hand, Japan's exchange reserves expanded by $2.3 billion as a result of interest receipts. Substantial exchange reserve gains in an EMS context were recorded by Italy ($3 billion) and France ($0.8 billion). The $1.3 billion expansion recorded in Belgium's foreign exchange reserves was essentially the consequence of official gold sales (see page 183 above).

Limited macro-economic significance of sharp fluctuations in official reserve growth

In recent years there have been sharp fluctuations in the relationship between the expansion of international liquidity and the growth of world trade. In 1987 the 40% increase in global reserves had dwarfed the expansion of total exports and imports. In 1988 this pattern was reversed, with the percentage increase in international liquidity amounting to only a fraction of the simultaneous 14% rise in the dollar value of world merchandise trade. What significance can be ascribed to such large swings in reserve growth? It

US current-account balance and estimated changes in foreign exchange reserves (excluding valuation effects[1])

Items	1984	1985	1986	1987	1988
	in billions of US dollars				
US current-account deficit	107.1	115.1	138.3	154.0	135.3
Changes in US non-gold reserves	1.2	8.3	5.4	−2.7	2.0
of which:					
Foreign exchange reserves	1.1	4.5	1.1	−8.6	5.6
Changes in foreign exchange reserves of countries other than the United States[2]	32.0	11.7	31.4	166.9	34.7
of which:					
Identified official assets held in the United States[3]	2.4	−2.0	33.5	45.0	39.0
Dollar reserves held outside the United States[4]	9.8	−4.7	− 1.2	21.9	− 8.9
Non-dollar reserves[5]	16.1	2.3	−15.0	38.7	48.0
Unallocated[6]	3.7	16.1	14.1	61.3	−43.4

[1] Changes computed at constant (end-of-period) exchange rates. [2] Includes dollars swapped against ECUs. [3] As recorded in the US balance-of-payments statistics. [4] Deposits by official monetary institutions with Euro-banks reporting to the BIS. Includes all deposits with these banks by China. [5] Estimates from IMF and BIS sources. [6] Total increase in non-US exchange reserves minus increase in non-dollar exchange reserves of countries other than the United States, minus increase in their dollar reserves held outside the United States, minus increase in their dollar reserves held in the United States as reported in the US balance-of-payments statistics.

would require considerable boldness to draw far-reaching conclusions. The growth in global reserves is more the adventitious outcome of national decisions regarding interest rates, exchange rates and general economic policy than the result of explicit reserve strategies. For the countries accounting for the lion's share of world trade, reserve adequacy is not an issue. Their credit-standing assures them that liquid resources can be obtained by borrowing in the international financial markets if the need arises. To be sure, a considerable number of developing countries suffer from reserve inadequacy, which may limit their ability to engage in debt reduction programmes or may compel them to take sub-optimal steps with regard to economic policy. But even in these countries reserve inadequacy is more a symptom of a deeper malaise than a fundamental cause in its own right.

VIII. Activities of the Bank

1. Development of co-operation between central banks and international organisations

During the past year the Bank has continued to play its traditional role in fostering international monetary co-operation.

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 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 statistical 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 has continued to organise periodic meetings of central bank officials on a variety of subjects. It has also, as in the past, provided the Secretariat for various committees and groups of experts.

The Euro-currency Standing Committee continued to monitor regularly international banking and capital market developments. In particular it discussed issues relating to the international debt situation and recent developments in offshore banking centres. Moreover, a working party set up by the Committee examined certain banking and other financial issues arising out of the introduction of the single European financial market. The Bank also continued to assemble, survey and publish statistical data on developments in the international banking and capital markets.

The Committee on Banking Regulations and Supervisory Practices (the "Basle Supervisors' Committee") continued its work of encouraging co-operation in the prudential supervision of international banking. The proposals on capital adequacy released for comment in December 1987 were, with the endorsement of central bank Governors, issued in final form in July 1988 in a document entitled "International Convergence of Capital Measurement and Capital Standards". Since then member countries have been adapting their own domestic supervisory arrangements to conform with the standards. In many countries, including those of the European Community, these standards will be applied to all credit institutions. In October, at the 5th International Conference of Banking Supervisors held in Tokyo, the standards were commended to the hundred or so countries represented there, and many

other countries with major international banks have already indicated a desire to ensure that their own supervisory arrangements are in line with the new standards, which now have worldwide recognition. Meanwhile, the Committee has been considering issues relating to the prudential treatment of foreign exchange, interest rate and certain other position risks. In January 1989 the Committee authorised the issue by its members of a Statement of Principles on the prevention of criminal use of the banking system, which has been widely circulated to banks throughout the world.

The Group of Experts on Payment Systems continued its regular exchange of information on developments in each of the Group of Ten countries. It also completed the third edition of its book on "Payment Systems in Eleven Developed Countries", which, compared with its predecessors, contains a much enlarged selection of statistical data. In addition, the Group undertook a study, which was published in February 1989, of various kinds of netting arrangements for cross-border financial transactions as a first attempt to assess how far existing or planned arrangements are likely to contribute to the efficiency of international financial markets and payment systems and what effect they might have on credit and liquidity risks.

In the course of its regular meetings the Group of Computer Experts paid attention in particular to security issues and to preparing the ground for an analysis of the changes being brought about within the central banks by the adoption of the personal computer as an everyday working tool, especially as regards the organisation of work, the distribution of responsibilities and overall control. In addition, the Group devoted a number of special meetings to questions relating to the quality of data processing in central banks.

The Group of Experts on Monetary and Economic Data Bank Questions focused its attention on the further development of the data bank service for the central banks of the Group of Ten countries and the BIS. Participating institutions took additional measures to improve the timeliness of their reporting to the Data Bank, and preparations were begun at the BIS for a gradual expansion of the number of data series to meet the needs of the Group's economists and statisticians. In order to keep pace with advances in technology at the central banks, a number of steps were taken towards upgrading the telecommunication facilities at the BIS which support the computer links to the Data Bank.

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 groups of experts continued to meet in Basle. The sub-committees and groups include in particular: the Committee of Governors' Alternates, which systematically prepares the groundwork for the meetings of the Governors; a group specialising in matters relating to the foreign exchange markets and intervention policies on these markets; and a group commissioned to examine periodically the monetary policies pursued by member states, their co-ordination and the implications of developments in public finance.

In the financial year 1988–89 a major part of the activity of the Committee of Governors, and consequently of its sub-committees and groups

of experts, was concerned with the functioning of the EMS and monetary policy co-ordination. The Committee has implemented the improved procedure for joint monitoring of short-term economic and monetary developments and policies, in line with the Basle/Nyborg Agreement;[1] this procedure is designed to permit common assessments of both the prevailing economic situation and appropriate responses in terms of exchange rate, intervention and interest rate policies. In addition, this joint monitoring (which is focused essentially on the short-term aspects) has been supplemented by in-depth analyses of the formulation and conduct of monetary policies within the Community. These analyses are aimed at achieving a co-ordinated approach that could assist in reducing the divergences between Community countries as regards prices and external positions.

The Board of Governors of the EMCF received applications from the Swiss National Bank and the Central Bank of Malta to be granted the status of Other Holder of official ECUs; these two applications were approved by the Board of Governors of the EMCF at its meetings in February and March 1989 respectively. The designation of these two central banks brings the number of Other Holders of official ECUs to three, the BIS having obtained this status in January 1986.

Between July 1988 and April 1989 the Committee for the Study of Economic and Monetary Union in the European Community held all but one of its meetings at the Bank. Set up by the European Council in June 1988, the Committee was chaired by M. Jacques Delors, President of the Commission of the European Communities, and its seventeen members also included all the Governors of the EC central banks (who took part in their personal capacities) and five other persons, one of whom was the General Manager of the BIS. A brief summary of the report produced by the Committee is given in Chapter VII.

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.[2] 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 1988 to 31st March 1989 interventions carried out by EMS central banks in other member countries' currencies did

[1] For a description of the content of this Agreement, see the fifty-eighth Annual Report, page 196.
[2] For a description of the structure and functions of the Fund, see the fifty-fourth Annual Report, pages 162–164.

not give rise to any financing or settlement operations through the intermediary of the EMCF.

The volume of ECUs issued by the EMCF through quarterly swap operations with each of the EC central banks fell from ECU 54.6 billion at 1st April 1988 to ECU 52.7 billion at 31st March 1989. This decrease of almost ECU 2 billion over the year was mainly due to the fall in the price of gold expressed in ECUs, whereas the decline in EC central banks' US dollar contributions was almost fully offset by the rise in the exchange rate of the US dollar vis-à-vis the ECU. The Luxembourg Monetary Institute has participated in the mechanism for the creation of ECUs since January 1989.

Transfers of ECUs between the EC central banks' "ECU reserves" accounts totalled approximately ECU 0.6 billion during the period under review. They related mainly to a repurchase of ECUs effected by a central bank with a view to settling its net debtor position in ECUs; the remaining ECU transfers consisted of interest payments on net ECU positions.

As regards the Community borrowing and lending operations referred to in Council Regulation (EEC) No. 1969/88,[1] particulars of which were given in the fifty-sixth and fifty-seventh Annual Reports on pages 171 and 183 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. It also carried out the financial transactions relating to the repayment in full, at the final maturity date of 29th August 1988, of the US$ 240 million Community loan – in the form of bearer notes 1985–88 at 9¼% per annum – and of the corresponding credit granted to France.

The following table shows, as at 31st March 1989, the total of outstanding Community borrowing and lending operations.

Outstanding Community loans as at 31st March 1989

Borrowing countries	US dollars	Deutsche Mark	Swiss francs	Yen	ECUs
	in millions				
France	350				70
Greece	400	830	227	25,000	700
Total	750	830	227	25,000	770

(b) Agent for the private ECU clearing and settlement system

Throughout the year the Bank continued to perform its functions as Agent for the private ECU clearing and settlement system in accordance with the provisions of the Agreement concluded on 30th April 1987 with the ECU Banking Association (EBA).[2]

[1] 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.

[2] For a description of the structure and operation of the clearing system, see the fifty-sixth Annual Report, page 172.

As from May 1987, the system was opened to new member banks of the EBA which, following their formal application, were granted the status of clearing bank by the Association. These new banks joined the system at a rate of about three each month from July 1987 until March 1988, and three more banks joined in November 1988, bringing the number of participating banks to thirty-three as at 31st March 1989, compared with seven at the outset in 1986.

3. Financial assistance to central banks

In addition to its normal banking operations, the Bank was involved in three publicly announced bridging loans during the year under review:

(a) In June 1988 the BIS participated in a US$250 million bridging facility in favour of the National Bank of Yugoslavia. The BIS share in the facility amounted to US$200 million and was backed by eleven member central banks; the balance of US$50 million was provided through a parallel arrangement granted by the US Treasury. The facility was due to mature at the end of November 1988.

In setting up this facility, account was taken of financing to be provided under a Standby Arrangement with the IMF and under a Structural Adjustment Loan from the World Bank.

The whole amount of the facility was drawn on 15th June 1988. A first repayment was received at the beginning of July; the balance was repaid at the end of September, and the facility was terminated at the request of the National Bank of Yugoslavia two months ahead of its original maturity date.

(b) In July 1988 short-term credit facilities totalling US$500 million were established in favour of the Banco Central do Brasil in order to provide bridging finance linked to expected drawings under a Standby Arrangement with the IMF. The financing was provided by the BIS and the US Treasury in equal shares of US$250 million each, the BIS facility having the backing of ten member central banks.

An amount of US$465 million was drawn, in equal shares, on the BIS facility and on the US facility on 29th July 1988 and was fully repaid on 26th August 1988. No further drawing was made under either of the facilities, which terminated on 30th December 1988.

(c) In October 1988 short-term credit support was arranged in favour of the Banco Central de la República Argentina amounting to US$500 million; a total of US$190.5 million was provided by the BIS, with the backing of ten member central banks, US$265 million by the US Treasury and US$44.5 million by the Kreditanstalt für Wiederaufbau of the Federal Republic of Germany. This bridging finance was to be made available in a number of tranches in order to prefinance US$500 million under two World Bank Sectoral Loans which were expected to be disbursed in separate tranches on or before 28th February 1989. The first tranche of the bridging loans, amounting to US$150 million, was made available on 22nd November 1988. Repayment started on the following

day in conjunction with the first of the World Bank disbursements. The other tranches were not drawn and the facilities expired, with all drawings repaid, on 28th February 1989.

4. Operations of the Banking Department

The Balance Sheet of the Bank and the Profit and Loss Account at 31st March 1989, certified by the auditors, are reproduced at the end of this Report; they are expressed in gold francs.*

At the end of the financial year 1988–89, on 31st March 1989, the balance-sheet total amounted to GF 42,233,811,401

On 31st March 1988 it had stood at GF 38,150,580,292

The increase thus came to GF 4,083,231,109

or 11%, but it would have been appreciably larger had it not been for the depreciation, in gold franc terms, of currencies other than the US dollar. The rise in the Bank's balance-sheet total was therefore entirely due to a further increase in resources – in currencies for the most part, but also in gold. This rise brought the balance-sheet total on 31st March 1989 to the highest figure ever recorded at the end of a financial year.

BIS: Development of the balance-sheet total over the past five financial years

Financial years ended 31st March	Total of Balance Sheet	Movement over the year	
	in millions of gold francs		in percentages
1985	22,852	+ 1,576	+ 7
1986	26,558	+ 3,706	+ 16
1987	29,944	+ 3,386	+ 13
1988	38,151	+ 8,207	+ 27
1989	42,234	+ 4,083	+ 11

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 under earmark held by the Bank for the account of various depositors; on 31st March 1989 this item amounted to the equivalent of 1,238 million gold francs and was thus slightly larger than at the end of the preceding financial year, when it had stood at 1,225 million gold francs.

* 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			
1985	1,143	21,323	386	22,852
1986	1,204	24,684	670	26,558
1987	1,270	27,626	1,048	29,944
1988	1,335	35,658	1,158	38,151
1989	1,404	39,875	955	42,234

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 upon 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 1988–89 GF 600,816,157

This compares with 576.3 million gold francs on 31st March 1988; the difference of 24.5 million represents the amount it is proposed to allocate to the Fund from the net profit. The proposed increase in this Reserve Fund is in conformity with the provisions of Article 51(3) of the Statutes.

(3) Special Dividend Reserve Fund
after allocation of the net profit for 1988–89 GF 35,530,055

This compares with 31.5 million gold francs on 31st March 1988. In accordance with the provisions of Article 51(4) of the Statutes it has been proposed that an amount of 4 million gold francs be transferred to this Fund from the net profit.

(4) Free Reserve Fund
after allocation of the net profit for 1988–89 GF 442,066,872

This compares with 401.5 million gold francs on 31st March 1988. It has been recommended that an amount of 40.5 million gold francs be transferred to this Fund, also from the net profit.

The total of the Bank's reserves, after allocation of the net profit for 1988–89, thus amounts to GF 1,108,483,397

They had risen to 1,039.5 million at the end of the preceding financial year and thus show an increase of 69 million.

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
	1988	1989	
	in millions of gold francs		
Deposits of central banks	34,507	38,385	+ 3,878
Deposits of other depositors	1,151	1,490	+ 339
Total	35,658	39,875	+ 4,217

The rise in resources is attributable for the most part to a further increase – of 11.2% – in the volume of "Deposits of central banks"; it should, however, be noted that this item had recorded an even greater rise in the financial year 1987–88, when it increased by 31.6%.

After declining in the preceding year, "Deposits of other depositors" also increased. This rise reflected new deposits received from various international organisations.

"Deposits of central banks" represented 96.3% of total borrowed resources, whereas those of other depositors accounted for only 3.7%. On 31st March 1988 the corresponding percentages had been 96.8 and 3.2% respectively.

BIS: Borrowed funds, by nature and term to maturity

Term	Deposits in gold			Deposits in currencies			Total		
	Financial years ended 31st March		Movement	Financial years ended 31st March		Movement	Financial years ended 31st March		Movement
	1988	1989		1988	1989		1988	1989	
	in millions of gold francs								
Sight	4,466	4,654	+ 188	2,240	2,885	+ 645	6,706	7,539	+ 833
Not exceeding 3 months	8	21	+ 13	27,125	30,523	+ 3,398	27,133	30,544	+ 3,411
Over 3 months	–	–	–	1,819	1,792	– 27	1,819	1,792	– 27
Total	4,474	4,675	+ 201	31,184	35,200	+ 4,016	35,658	39,875	+ 4,217

Both resources in gold and those in currencies increased during the past financial year. Examination of the different categories shows that the increase in gold resources mainly involved sight deposits, whereas in the case of currency deposits the most marked movement was recorded by those with a residual maturity not exceeding three months.

As a proportion of total borrowed funds, however, the share of deposits in gold decreased to 11.7% from 12.5% on 31st March 1988, while the share of deposits in currencies rose to 88.3% from 87.5%.

Examined in terms of their maturity, sight deposits made up 18.9% of all deposits, compared with 18.8% on 31st March 1988, while deposits with a maximum maturity of three months represented 76.6%, compared with 76.1%; deposits with a maturity of over three months, for their part, accounted for only 4.5%, compared with 5.1%. There was therefore a slight tendency towards a shortening of the maturities of deposits received.

(a) Deposits in gold GF 4,674,850,242

This compares with a figure of 4,474 million gold francs at the end of the financial year 1987–88, representing an increase of 201 million, which was mainly accounted for by an increase in sight deposits in gold.

(b) Deposits in currencies GF 35,199,968,115

This compares with 31,184 million gold francs at the end of the previous financial year. The rise of 4,016 million gold francs – or 12.9% – corresponds in large part to the increase in resources in Deutsche Mark and US dollars; it was entirely accounted for by sight deposits and deposits with a maximum maturity of three months, whereas deposits with a longer maturity recorded a slight decline.

C. Other liabilities

(a) Staff pension scheme GF 106,004,887

This compares with 116 million gold francs on 31st March 1988. The amount of Swiss francs held in this item, which represents the Bank's liability in respect of staff pensions, was increased during the financial year. The gold franc equivalent decreased, however, as a result of exchange rate fluctuations.

(b) The item *"Miscellaneous"* stood at GF 822,916,020

against 1,011 million gold francs on 31st March 1988.

The decrease under this heading also reflects the fall in the gold franc value of component items denominated in currencies other than the US dollar.

(c) Dividend payable on 1st July 1989 GF 25,885,615

It has been recommended that this sum be set aside out of the net profit for 1988–89 in respect of the dividend of 175 Swiss francs per share (the same as in 1988). The sum of 25.9 million gold francs compares with that of 30.9 million transferred in 1988 from the net profit for the financial year 1987–88 in respect of the dividend paid on 1st July 1988. The reduction of 5 million gold francs is solely due to the depreciation of the Swiss franc in terms of gold francs.

The Profit and Loss Account for the financial year 1988–89, before allocation, shows a net surplus of 94,885,615 gold francs. Details of the proposed allocation of this amount, in accordance with the provisions of Article 51 of the Statutes, are given in Section 5 below.

Assets (employment of resources)

The following table gives a breakdown of the main items of the assets according to their nature.

BIS: Development of investments and other assets

Nature	Financial years ended 31st March				Movement	
	1988		1989			
	in millions of gold francs					
Sight assets						
Gold	4,981		5,175		+ 194	
Currencies	15	4,996	15	5,190	–	+ 194
Treasury bills		1,952		2,057		+ 105
Time deposits and advances						
Gold	145		210		+ 65	
Currencies	26,888	27,033	29,824	30,034	+ 2,936	+ 3,001
Government and other securities at term		4,165		4,938		+ 773
Miscellaneous		5		15		+ 10
Total						
Gold	5,126		5,385		+ 259	
Currencies	33,025	38,151	36,849	42,234	+ 3,824	+ 4,083

(a) Gold GF 5,175,422,171

This compares with 4,981 million gold francs on 31st March 1988. The rise of 194 million gold francs represents the difference between the new resources in gold received from central banks and the increase in investments in gold made on the market.

(b) Cash on hand and on sight account with banks GF 14,942,077

This item shows virtually no change from the preceding financial year.

(c) Treasury bills GF 2,056,603,526

This compares with 1,952 million gold francs on 31st March 1988.

This portfolio increased slightly in the financial year 1988–89; its structure was modified as a result of purchases and sales of Treasury bills made on various markets.

(d) Time deposits and advances GF 30,033,872,116

This compares with a figure of 27,033 million gold francs at the end of the preceding financial year, giving a rise of 3,001 million gold francs. It is chiefly in the movement in this item that the increase in resources in currencies is reflected. As at the end of the preceding financial year, these investments were predominantly in US dollars and Deutsche Mark.

It should be mentioned that during the early months of the financial year the International Monetary Fund repaid the balance of the facility of SDR 2,505 million which the Bank had granted to it in 1984.

(e) Government and other securities at term GF 4,937,840,670

This compares with 4,165 million gold francs on 31st March 1988, giving a rise of 773 million. This portfolio consists of public and private sector securities purchased on various markets.

A breakdown according to residual term to maturity of investments in time deposits and advances (in currencies and gold) and in government and other securities at term is given in the following table.

BIS: Time deposits and advances and government and other securities at term, by term to maturity

Term	Financial years ended 31st March		Movement
	1988	1989	
	in millions of gold francs		
Not exceeding 3 months	26,385	29,886	+ 3,501
Over 3 months	4,813	5,086	+ 273
Total	31,198	34,972	+ 3,774

The share of investments with maturities not exceeding three months increased slightly to 85.5% from 84.6% on 31st March 1988, while investments with maturities of over three months declined to only 14.5% compared with 15.4% at the end of the previous financial year.

(f) Miscellaneous GF 15,130,841

This compares with a figure of 5 million gold francs on 31st March 1988.

Forward gold operations

These operations, which are mentioned in Note 2 to the Balance Sheet, resulted in a negative balance of GF 48,252,871 compared with a positive balance of 10 million gold francs at the end of the preceding financial year.

The reversal of this position was due to the conclusion of new transactions involving a repayment of gold by the Bank at maturity.

5. Net profits and their distribution

The accounts for the fifty-ninth financial year ended 31st March 1989 show a net operating surplus of 106,213,792 gold francs, compared with 118,901,393 gold francs for the preceding financial year. The principal factors underlying the decrease in the surplus for the year under review were a narrowing of the Bank's intermediation margins on borrowed funds and the absence of capital gains from trading in securities.

The net operating surplus is shown after deduction of 30,135,891 gold francs in respect of costs of administration, the moderate increase over the previous year's figure of 28,821,525 gold francs reflecting the fall during the year in the gold franc value of the Swiss franc, in which currency most of the Bank's expenditure is incurred; in terms of Swiss francs the total administrative costs actually rose by almost 11%.

The Board of Directors has decided to transfer 828,177 gold francs to the Provision for Exceptional Costs of Administration, and to supplement – by means of a further transfer of 10,500,000 gold francs – the Provision for Modernisation of Premises and Renewal of Equipment, the main purpose of which is to cover the cost of the ongoing series of projects involving investment expenditure. As a result of these two transfers, the net profit amounts to 94,885,615 gold francs, against 95,937,052 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 94,885,615 gold francs be applied by the General Meeting in the following manner:

– an amount of 25,885,615 gold francs in payment of a dividend of 175 Swiss francs per share;

– an amount of 24,463,364 gold francs to be transferred to the General Reserve Fund;*

– an amount of 4,000,000 gold francs to be transferred to the Special Dividend Reserve Fund; and

– an amount of 40,536,636 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 1989 to the shareholders whose names are contained in the Bank's share register on 20th June 1989.

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 Messrs. Price Waterhouse & Co., Zurich, 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 1989 and of its profit for the year ended on that date. Messrs. Price Waterhouse & Co.'s report is appended at the foot of the Balance Sheet.

* The amount to be transferred to the General Reserve Fund is in conformity with the provisions of Article 51(3) of the Statutes, which require an appropriation of 40% of the yearly net profits remaining after payment of the dividend until the General Reserve Fund equals twice the paid-up capital, and thereafter 30% of the net profits until the General Reserve Fund equals three times the paid-up capital.

6. Changes in the Board of Directors and in the Management

At the meeting of the Board held on 13th September 1988 the Chairman announced that Lord Richardson of Duntisbourne had decided to relinquish his position as Vice-Chairman of the Board on 27th November 1988, when his three-year term of office expired. The Chairman expressed the Board's deep gratitude for Lord Richardson's invaluable co-operation and wise counsel during this period. At the same meeting Prof. Paolo Baffi was elected Vice-Chairman of the Board for a period of three years ending on 27th November 1991.

Also at that meeting the Chairman noted that M. Georges Janson would shortly be retiring from the National Bank of Belgium and therefore relinquishing his appointment as Alternate to M. Godeaux, Governor of the National Bank of Belgium. The Chairman expressed the Bank's appreciation of the very valuable services rendered by M. Janson during a record term of office of seventeen and a half years.

At its next meeting, held on 8th November 1988, the Chairman informed the Board that M. Godeaux had appointed M. Jean-Jacques Rey to act as his Alternate in place of M. Janson.

At the same meeting M. Bernard Clappier, whose mandate as a member of the Board was due to expire on 27th November 1988, was re-appointed under Article 27(2) of the Statutes by M. de Larosière, Governor of the Bank of France, for a further period of three years ending on 27th November 1991.

Also at that meeting the Chairman informed the Board that Dr. Ciampi, Governor of the Bank of Italy, had appointed Dr. Carlo Santini to replace Dr. Masera as his Alternate in the absence of Dr. Dini. The Chairman expressed the Bank's appreciation of Dr. Masera's valuable services.

At its meeting on 14th February 1989 the Chairman informed the Board that Mr. Leigh-Pemberton, Governor of the Bank of England, had appointed Mr. A.D. Crockett to act as his Alternate in place of Mr. Loehnis. The Chairman thanked Mr. Loehnis for his eminent services during a period of nine years.

Dr. Markus Lusser, Chairman of the Governing Board of the Swiss National Bank, whose mandate as a member of the Board was due to expire on 31st March 1989, was re-elected under Article 27(3) of the Statutes at the meeting of the Board held on 14th March 1989 for a further period of three years ending on 31st March 1992.

Dr. J.B. Schöllhorn relinquished his directorship at the end of April 1989. At the meeting of the Board held on 11th April 1989 the Chairman paid a warm tribute to him for the notable services he had rendered to the Bank over a period of more than thirteen years.

At the same meeting the Chairman announced that Herr Pöhl, President of the Deutsche Bundesbank, had appointed Prof. Dr. Leonhard Gleske as a member of the Board to succeed Dr. Schöllhorn as from 1st May 1989. This appointment was made under Articles 27(2) and 28 of the Statutes for the unexpired period of Dr. Schöllhorn's term of office ending on 31st December 1990. Also at that meeting the Chairman informed the Board that Herr Pöhl

had appointed Dr. Wolfgang Rieke to act as his Alternate in place of Prof. Gleske as from 1st May 1989.

On 31st July 1988 Herr J. Mix, Deputy Manager in the Banking Department, and on 28th February 1989 Mr. K. J. Kearney, Assistant Manager in the General Secretariat, retired, after almost twenty-two and more than seventeen years respectively of valuable service.

At the meeting of the Board on 14th March 1989 the Chairman announced that the Bank had decided to promote as from 1st April 1989 Prof. Dr. Mario Giovanoli to the rank of Deputy Manager and M. Jean-Marc Andreoli to that of Assistant Manager. Prof. Giovanoli was also appointed Legal Adviser as from the same date.

The Bank learned with deep regret of the death of M. Guillaume Guindey on 11th March 1989. M. Guindey had been General Manager of the Bank from October 1958 until April 1963.

Conclusion

In a number of areas which have been analysed in this Report the outlook has recently become somewhat clouded. This is apparent from the fact that developments in 1988 as a whole were more encouraging than in the second half of the year alone, and in particular than in the first quarter of 1989. That is certainly true with regard to price performance almost everywhere; and it is also true to some extent with respect to the adjustment process among the major industrial countries. Whether international policy co-ordination efforts and the common strategy concerning the exchange rate structure should be viewed in the same light is less clear. The outlook on these interrelated questions needs a concluding evaluation here, as does the debt problem, where a ray of hope can be glimpsed but concerted action is now essential if any headway is to be made.

Since the spring of 1988 short-term interest rates in the seven largest industrial countries have been raised by up to 5 percentage points, the most recent action having been taken in Germany in April 1989. It is evident that the monetary authorities in many countries at present face a difficult, and critical, choice between further tightening and waiting to see how effective their earlier action will be. On the one hand, there is the danger of overkill, of suffocating an upswing that shows signs of continued vigour now that the main driving force has at long last shifted to business investment (the best ingredient a growth process can have), which last year increased by over 10% in real terms. On the other hand, desiring to avoid the mistake of over-reaction in both the expansionary and the contractionary phase of the cycle, which was typical of "stop-go" fine-tuning policies, policy-makers could hope that this time they have not delayed too long before tightening policy and that they can therefore safely wait for the effects to materialise with the usual "long and variable" lags.

What risks are incurred by erring in one direction or the other? The danger of overkill depends to a large extent on the underlying health of the industrial economies. In a number of countries the indications are that this health has improved: profitability has been restored on the whole to levels last seen in the early 1970s; some structural adjustments have been achieved; lower inflation rates have increased the efficiency of market mechanisms. One can hope that all this will cause prices to respond more flexibly to restraint and thus reduce the danger of overkill in real terms. In any event, it would seem that the time dimension of the risks – and this may be a crucial point – is different. Should policy-makers adopt a "wait and see" attitude and prove to be wrong, the achievement of bringing inflation down to levels not seen for twenty years will be jeopardised. This was an achievement which few people had continued

to hope for and which might not have been accomplished had it not been for certain fortuitous circumstances. There have been nagging doubts in many minds as to whether it could be preserved. But if it is lost, it may be a long time before there is another chance of restoring the same degree of price stability.

To describe the present inflation problem in such strong terms may appear to be over-dramatising it. After all, the acceleration in prices has so far been modest – less than one percentage point between the end of 1987 and the first quarter of this year – and not all recent news has been bad. There is almost certainly no inflationary wave about to engulf the industrial countries, nor are these countries about to sink back into the doldrums of the 1970s. The question, however, is: where are we heading? The warning signals are plain to see everywhere, perhaps with the exception of Japan (unless prices in asset markets are included in this category). All the industrial countries know from experience how slippery the slope is onto which they may be stepping. The benefits of price stability in terms of growth and employment are considerable and so are the costs of disinflation. The only way of enjoying the benefits without incurring the costs is to maintain price stability once it has been achieved.

Is this asking too much from monetary policy under present conditions? Not only have authorities had problems with monetary indicators as a result of the globalisation of financial markets, innovation and deregulation, they have also, in small and some not so small countries, been preoccupied with meeting exchange rate objectives, particularly within the EMS. Let us examine these problems in turn.

Firstly, the seriousness of the indicator problem seems to have diminished, as in most countries the different indicators are now tending to point in a similar direction and the distortions resulting from shifts between assets because of financial innovation have become less pronounced. Moreover, strong rates of monetary expansion in many countries were in fact followed by stronger economic growth and ultimately by an increase in inflation. Much has been made recently of the fact that rises in interest rates are themselves reflected in consumer price inflation rates as measured in some countries and that raising interest rates can therefore appear to be counter-productive as a tool for fighting inflation – at least in the short run. But there is no way of tightening monetary policy other than by pushing up short-term interest rates to levels which affect behaviour, regardless of what intermediate target the authorities may be using to guide their action and to judge the appropriateness of their policy stance. If central banks come to the conclusion that they have to do more than they have done already, they have only this tool available.

With regard to the second of the two problems referred to, namely the apparent preoccupation of monetary policy, in some countries at least, with defending exchange rates, there are at present few indications that this is bringing the authorities into conflict with their domestic goal of keeping inflationary pressures at bay. Where a conflict exists it is rather the reverse: the anti-inflationary stance, as expressed in high interest rates, as well as dampening domestic monetary growth, has helped to move the exchange rate in ways which reinforce the anti-inflationary effect, as can be seen most clearly

in a number of European countries. However, the resulting exchange rate structure may cause problems for the restoration of external balance in the countries concerned.

In a wider context similar problems have emerged with regard to the continuation of the international adjustment process. On the face of it, international policy co-ordination has achieved what it set out to achieve. The common goal since the Louvre Accord of February 1987, reaffirmed in December 1987 and again at every Group of Seven meeting since, has been to stabilise nominal exchange rates around current levels. This has been attained to a remarkable extent, although the recent strength of the dollar does give rise to concern. The day-to-day volatility of exchange rates has subsided. Even more striking is the degree to which the range of exchange rate fluctuations has narrowed.

The stabilisation of nominal exchange rates through exchange market intervention and co-ordination of macro-economic policies was, however, intended to be part of a broader strategy aimed at reducing the huge current-account imbalances between the large industrial countries. There was concern that, unless these imbalances were soon scaled down significantly, they might have undesirable repercussions not only on trade policies but also on financial markets, which might not be willing or able to digest the cumulative effects of sustained creditor and debtor positions. There had after all been financial market upheavals before whose genesis had fitted this description. While the strategy of pursuing greater exchange rate stability could be termed a success, the same claim clearly cannot be made for the broader strategy of which it was a part. The adjustment process, which seemed to be firmly under way during the first half of 1988 when US exports were growing rapidly, has faltered over a period of no less than three quarters. This raises the question of whether the common strategies have to be reappraised or whether there are grounds for qualifying the earlier concerns about the imbalances.

What are the arguments of those who contend that even large current-account imbalances require little or no attention from policy-makers? There is first the argument that to the extent that capital flows cause current-account deficits a financing question does not arise. However, the interaction of the current and capital accounts does determine the exchange rate level at which the balance-of-payments identity is established, and capital flows can change much more quickly than the current account; the corresponding effects on exchange markets may trigger official intervention. In fact, the accounting identity between the current and the capital accounts applies only if the latter is defined to include movements in official exchange reserves. The contrast between 1988 and 1987 in this respect demonstrates how quickly the situation can change.

A second argument used to assert that persistent imbalances should not cause too much concern is that there may be perfectly "legitimate" reasons why some countries should have current-account surpluses and others deficits. As nobody claims that it would be ideal if all surpluses and deficits were eliminated, it is indeed necessary to take the forces underlying the external position into account. The main surplus countries, Japan and Germany, are faced with

demographic developments which in part explain, and in a limited way may justify, the accumulation of sizable foreign assets. In the case of the United States the current-account deficit has often been linked to the existence of better investment opportunities there than in competitor countries.

In an increasingly integrated world economy there is no reason why private savings, reflecting the intertemporal choices of individuals, should not be invested on a global basis. It is, however, the case that the specific decision as to where to invest financial savings is often governed more by short-term return considerations than by an assessment of long-term investment opportunities. But structural differences in private saving and investment behaviour between countries cannot fully explain the persistence of present imbalances. In the surplus countries the imbalances widened during the years 1983 to 1987 more quickly than changes in private saving behaviour would have suggested. Similarly, the sharp turn-round in the US external position between 1981 and 1984 took place at a time when private saving (as a percentage of GNP) varied by little more than ½ percentage point – pointing to the crucial role that the US Federal budget deficit played in this process. Since then the deterioration in the US external position has mirrored the decline in US private saving, but the persistently high fiscal deficit has nonetheless remained the most important counterpart to the US current-account deficit.

These arguments, then, do not point to any need for a fundamental reassessment of the problems posed by the current-account imbalances among major industrial countries. Apart from domestic distortions, which are not only reflected in the external imbalances but also aggravated by their persistence, the concern had always been the risks that might be entailed: a "crash-landing" or severe exchange rate misalignments, and the dangers for financial market stability and for free trade. These risks were very much in everybody's mind shortly after the stock market crash. They attract less attention now, but that does not mean that they no longer exist. On the contrary, it can be argued that the risks must become greater because of the cumulative effects on the stocks both of claims and of liabilities. At some stage threshold effects will come into play, though it is impossible to predict when and where.

At present there is widespread confidence in many countries that if short-term interest rates are pushed up sufficiently capital flows can be generated to sustain almost any level of current-account deficit. The accompanying effects on exchange rates and on inflation are welcomed. Any adverse effects on real activity do not for the present receive much attention since domestic demand is strong in most of these countries and growth buoyant, high interest rates notwithstanding. Such a strategy for dealing with current-account deficits is being used quite deliberately in a number of countries. While this is certainly not true in the same sense for the United States, US policies have nevertheless also been leading to the same result. All round, there has been a policy of *sustaining* rather than of *reducing* current-account imbalances. Adjustment has not been a pressing issue.

The conclusion to be drawn from this experience by policy-makers seems inevitable: the adjustment process has to be given new momentum. But how? Do we need another Plaza Agreement aimed at a major realignment of the

exchange rate structure among the large industrial countries? Presumably not, certainly nothing on the scale of September 1985. The mere fact that high current-account imbalances persist is no proof that exchange rates are in urgent need of further adjustment. Such a conclusion would only be valid if it had to be accepted that no other room for policy manoeuvre existed, in particular if demand management had to be ruled out as a possible means of setting the adjustment in motion again. There are many in the United States – and their view is shared by the overwhelming majority of policy-makers and observers outside that country – who argue forcibly that with a relatively moderate rise in taxes the US Administration could substantially reduce the Federal deficit and thus improve the saving and investment imbalance in the United States, which is the domestic side of the current-account imbalance.

Two arguments are frequently put forward in this connection. Firstly, it is pointed out that experience in many countries, most prominently at present the United Kingdom, demonstrates that the "twin deficits" are in fact not twins, that a substantial current-account deficit can co-exist with a fiscal surplus, and vice versa. That is indeed true, but only if private net saving, which makes up the balance, conforms; but this is not the case in the United States. There, a significant correction of the saving/investment imbalance requires decisive action on the fiscal deficit. The second argument, which one encounters regularly at this point in the debate, is that action on the fiscal front must be symmetrical, that the surplus countries must compensate through fiscal expansion for what the United States wipes out through fiscal retrenchment. This argument had a certain validity a few years ago, but no longer. Domestic demand in Japan grew by 7¾% in 1988 and has outpaced output growth by 2 percentage points. In Germany capacity utilisation in manufacturing already exceeds the peak of the early 1970s, when inflationary pressures were exceedingly strong. Symmetrical action is no longer required; a substantial unilateral reduction of domestic demand in the United States through fiscal action could give the adjustment process the required stimulus.

Those who, on the contrary, argue in favour of a substantially lower dollar as a necessary precondition for a further reduction in the US current-account deficit have failed to demonstrate that such an incentive would indeed boost exports, in other words that the capacity reserves exist. Without such reserves, which are vital if export volumes are to respond quickly, a dollar depreciation would do little to reduce the current-account deficit in the near term, but could push up inflation rates in the United States because of the effect on import prices. This tendency would be exacerbated by the effects of monetary policy, as only by bringing down US short-term interest rates – with a corresponding tightening in the two main surplus countries, Japan and Germany – could the dollar depreciation be engineered. With accelerating inflation in the United States, the likelihood is great that a vicious circle would be set in motion, nullifying also any medium or long-term effects of the currency depreciation on the current-account balance. It follows from this reasoning that demand management or, to be more precise, fiscal tightening in the United States has to take the lead in new efforts to substantially reduce the current-account imbalances among the large industrial countries. Only in this

way could it be seen what change in the structure of real exchange rates among the major currencies might be warranted. But what can already safely be said now is that the pendulum has swung too far in the direction of pursuing nominal exchange rate stability. Focusing on nominal exchange rate stability at a time when differentials in inflation and productivity growth persist at best opens the door to *real* exchange rate changes *in the wrong direction,* to the erosion of competitiveness in some countries and to the aggravation of external imbalances; at worst it leads to an irresistible appreciation of the "wrong" currencies with high interest rates and to even worse effects on the imbalances.

Imbalances of a somewhat different nature, though also with a strong external component, have afflicted large areas of the world in a perhaps even more serious manner. The debt problems of developing countries do not only entail economic risks – with some differences of judgement about how grave they are. Here, the seriousness of the situation, the human misery involved and its disruptive character for the political system are plain for all to see. What erupted in 1982 as a debt crisis has in the course of nearly seven years evolved into a chronic disease which has been largely contained but which has defied the different cures that have so far been tried. We are now about to enter a new phase in this area, but as yet it is difficult to say how much progress it will bring.

The speech delivered by Mr. Brady, the US Treasury Secretary, on 10th March 1989 acknowledged that a further element has to be added to the case-by-case approach. There had already been some debt reduction operations on a voluntary basis. Now it is proposed that the IMF and the World Bank should make resources available for that purpose within the framework of their existing lending facilities, as a complement to the other elements of the debt strategy, namely rescheduling, the provision of new money and determined adjustment efforts in the debtor countries themselves.

These last three elements combined had been strongly emphasised in the Baker initiative of October 1985. Belt-tightening, while indispensable as a first step, was recognised to have reached its limits; it could not on its own restore creditworthiness. Debtor countries had to adopt policies which would improve growth prospects, remove distortions and bring market incentives into play. The multinational institutions and the commercial banks were urged to provide the resources needed to allow growth in these countries to be resumed. They could, it was argued, grow out of their debt problems if they adopted the right policies and were supported by their creditors. In addition, they had to keep domestic capital in the country and attract back capital that had fled abroad. Capital flight was in fact seen as the litmus-test for assessing debtor countries' policies, for how could a government gain the confidence of new foreign creditors if it could not retain the confidence of its own people? It should, however, be borne in mind that some of the middle-income debtor countries do allow free capital movements or have done so in the past, so that the line between "legitimate portfolio diversification" and "capital flight" is not always easy to draw.

Over the years since Mr. Baker launched his initiative it had become clear

that, while its various elements were quite valid and were also accepted as such by a number of debtor countries, little progress was being made towards restoring normal creditor/debtor relations. Some debtor countries had made valiant efforts to improve economic policy, but much remained to be done in that respect. At the same time, the bank lending which had been envisaged under the Baker initiative and which was essential for stimulating growth and promoting investment in the debtor countries was not forthcoming. The multinational institutions were quite active within the limits set by their statutes and the rules of conditionality. But the commercial banks were torn between the role they were assigned as providers of new money and the need to make large provisions against their existing claims on the same countries. There were good reasons for some of them to provide new money as long as this allowed them to pretend that – apart from some liquidity problems – their debtors were solvent and their claims therefore unimpaired. When in 1987 it was generally accepted that this had been an illusion, only a long-term strategy of maintaining a stake in the countries concerned could induce commercial banks to continue to play the role that had been allotted to them. And it was generally only larger banks with the largest claims that did so. For smaller banks the temptation was great to cut their losses and to consider it none of their business to find a solution to the debt problem.

At this stage it became evident that the Baker initiative, with its three-year time-horizon, would have to be supplemented by a more fundamental attempt to square what the debtor countries were committed to paying on their debt with what they could be expected to pay on a continuous basis without relinquishing all prospect of economic recovery. This presupposed some reduction in the amount of debt to be serviced and/or in the interest charges on the debt. The fact that banks had been prepared to sell claims at a considerable discount was evidence of their readiness to accept a reduction in nominal claims of doubtful value in exchange for an asset of lower nominal value but higher quality. In order to achieve some debt reduction through this mechanism, somebody had to help to upgrade the reduced claims. Different solutions have been suggested by President Mitterrand, by the former Japanese Finance Minister, Mr. Miyazawa, and now by Mr. Brady. The first linked this process to a distribution of SDRs which the developed countries would place in a fund administered by the IMF, the second to funds from the debtor countries themselves, the third also to funds from the debtor countries though not directly out of existing reserves but out of loans made to them for that specific purpose by the IMF and the World Bank. Whether the amounts that could be made available in this way could provide a sufficient basis for achieving the objective is not yet clear. But just as each of the different steps since 1982 covered only a certain amount of ground, the step now envisaged cannot be expected to go all the way. One or two countries will presumably make a start and their experience will determine how many will follow. Now that the need for debt reduction programmes has been publicly acknowledged, it is essential for progress to be achieved so that the high hopes raised by Mr. Brady are not disappointed. The problem is still far too big for a grand solution, but part of the stumbling-block could be chipped away.

The moral hazard problem remains, namely that the largest debtors should not in effect receive preferential treatment from creditor banks and creditor governments compared with those which have pursued more prudent policies. Greater generosity will be required of the richer countries, but it should be directed towards those who are in greatest need and often patently unable to help themselves. The middle-income countries are not in that category; many of their citizens may be, but that is not a problem with which the debt strategy per se can be concerned.

In summing up, a short reminder may be in order concerning the specific role that central banks can play in tackling the series of problems discussed in this Conclusion, namely the inflationary threat in the industrial countries, the stalling of the adjustment process and the need for a country-by-country resolution, rather than just a general containment, of the debt problem. These problems pose serious challenges for all policy-makers. Central banks can play an effective, although by no means autonomous, part in dealing with the first two, but only a limited one in helping to solve the last.

Indeed, the contribution of central banks to a lasting resolution of the debt problem can only be marginal. What debtor countries now need is not short-term liquidity support of the bridging type, the usefulness of which has been eroded over time. They need a variety of debt burden reduction programmes that offer a reasonable choice to lenders, tackle the problem of "free riders" and at the same time promote domestic adjustment. In the implementation of such programmes the part central banks have to play (particularly those which have supervisory responsibilities) is to safeguard the orthodoxy underlying their prudential regulations, while ensuring that they do not impair the banks' freedom of choice.

By contrast, the contribution of central banks to fighting the threat of inflation has been, and will probably continue to be, a decisive one. There is no doubt that an appropriately restrictive monetary policy is capable of preventing the resurgence of inflation. But the recent strength of the dollar has become a severe constraint on the efficient, yet prudent, implementation of such a policy, for it obliges central banks to pay increasing attention to the stalling of the external adjustment process.

When the dollar is rising, balance-of-payments adjustment requires that monetary policy should exert downward pressure on the dollar by reducing the interest rate differential in its favour. To achieve this through a relaxation of US monetary policy at a time when, despite some encouraging signs, it is still uncertain what will happen to domestic demand in the United States would entail a twofold danger: it might be counter-productive to the adjustment process itself and, at the same time, jeopardise the hitherto successful efforts of the US monetary authorities to defuse inflationary expectations. On the other hand, without a decline in US interest rates, the reduction of the interest rate differential might well necessitate interest rate increases in Japan and Germany of a size that might also be detrimental to the adjustment process by reining in domestic demand in the surplus countries and, by the same token, might expose the world to the risk of a synchronised cyclical downturn.

This dilemma would, of course, become less acute if the weakening of final domestic demand in the United States were to receive further confirmation in the coming months and/or if the foreign exchange markets were to revise their bullish views about the dollar. Failing this, fiscal restraint in the United States constitutes the only rational response. It is, moreover, necessary in a longer-term perspective, not least for the United States itself. We thus find ourselves in an exceptional situation in which a major shift in fiscal policy in the largest economy would unambiguously and simultaneously serve the interests of both domestic and external adjustment in the greater part of the world.

Basle, 22nd May 1989

ALEXANDRE LAMFALUSSY
General Manager

Balance Sheet and Profit and Loss Account

at 31st March 1989

Balance Sheet at 31st March 1989

(in gold francs - see Note 1)

Assets		
Gold		5 175 422 171
Cash on hand and on sight account with banks		14 942 077
Treasury bills		2 056 603 526
Time deposits and advances		
Gold		
Not exceeding 3 months	147 517 312	
Over 3 months	62 051 222	
Currencies		
Not exceeding 3 months	26 382 812 921	
Over 3 months	3 441 490 661	
		30 033 872 116
Government and other securities at term		
Not exceeding 3 months	3 356 048 988	
Over 3 months	1 581 791 682	
		4 937 840 670
Miscellaneous		15 130 840
Land, buildings and equipment		1
		42 233 811 401

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 1989, gold payable against currencies on forward contracts amounted to 48 252 871 gold francs.

		Before allocation of the year's Net Profit	After
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	576 352 793		*600 816 157*
Special Dividend Reserve Fund	31 530 055		*35 530 055*
Free Reserve Fund	401 530 236		*442 066 872*
		1 039 483 397	*1 108 483 397*
Deposits (gold)			
Central banks			
Sight	4 654 224 109		
Not exceeding 3 months	20 625 734		
Other depositors			
Sight	399		
		4 674 850 242	*4 674 850 242*
Deposits (currencies)			
Central banks			
Sight	2 856 540 363		
Not exceeding 3 months	29 061 832 092		
Over 3 months	1 791 849 724		
Other depositors			
Sight	28 226 623		
Not exceeding 3 months	1 461 519 313		
		35 199 968 115	*35 199 968 115*
Staff Pension Scheme		106 004 887	*106 004 887*
Miscellaneous		822 916 020	*822 916 020*
Profit and Loss Account		94 885 615	—
Dividend payable on 1st July 1989		—	*25 885 615*
		42 233 811 401	*42 233 811 401*

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 1989 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.

Zurich, 28th April 1989 *PRICE WATERHOUSE & CO.*

Profit and Loss Account

for the financial year ended 31st March 1989
(in gold francs)

Net interest and other operating income		136 349 683
Less: Costs of administration		
Board of Directors	352 168	
Management and Staff	21 489 551	
Office and other expenses	8 294 172	30 135 891
Net operating surplus		106 213 792
Less: Amounts transferred to		
Provision for Exceptional Costs of Administration	828 177	
Provision for Modernisation of Premises and Renewal of Equipment	10 500 000	11 328 177
Net Profit for the financial year ended 31st March 1989		94 885 615

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: 175 Swiss francs per share on 473 125 shares		25 885 615
		69 000 000
Transfer to General Reserve Fund		24 463 364
		44 536 636
Transfer to Special Dividend Reserve Fund		4 000 000
		40 536 636
Transfer to Free Reserve Fund		40 536 636
		—

Movements in the Bank's reserves

during the financial year ended 31st March 1989
(in gold francs)

I. Development of the Reserve Funds resulting from allocations for the financial year 1988–89

	Legal Reserve Fund	General Reserve Fund	Special Dividend Reserve Fund	Free Reserve Fund
Balances at 1st April 1988, after allocation of Net Profit for the financial year 1987–88	30 070 313	576 352 793	31 530 055	401 530 236
Add: Allocations for the financial year 1988–89	—	24 463 364	4 000 000	40 536 636
Balances at 31st March 1989 as per Balance Sheet	30 070 313	600 816 157	35 530 055	442 066 872

II. Paid-up Capital and Reserve Funds at 31st March 1989 (after allocation) were represented by:

	Paid-up Capital	Reserves	Total
Net assets in			
Gold	295 703 125	366 184 467	661 887 592
Currencies	—	742 298 930	742 298 930
	295 703 125	1 108 483 397	1 404 186 522

Board of Directors

Dr. W.F. Duisenberg, Amsterdam
Chairman of the Board of Directors,
President of the Bank

Prof. Paolo Baffi, Rome
Vice-Chairman

Dr. Carlo Azeglio Ciampi, Rome
Bernard Clappier, Paris
Bengt Dennis, Stockholm
Prof. Dr. Leonhard Gleske, Frankfurt a/M.
Jean Godeaux, Brussels
Jacques de Larosière, Paris
The Rt.Hon. Robert Leigh-Pemberton, London
Dr. Markus Lusser, Zurich
Karl Otto Pöhl, Frankfurt a/M.
The Rt.Hon. Lord Richardson of Duntisbourne, London
Baron de Strycker, Brussels

Alternates

A. D. Crockett, London, or
L. D. D. Price, London
Dr. Lamberto Dini, Rome, or
Dr. Carlo Santini, Rome
Jean-Jacques Rey, Brussels
Dr. Wolfgang Rieke, Frankfurt a/M.
Jacques Waitzenegger, Paris, or
Francis Cappanera, Paris

Management

Alexandre Lamfalussy	General Manager
R.T.P. Hall	Assistant General Manager
Dr. Giampietro Morelli	Secretary General, Head of Department
Rémi Gros	Head of the Banking Department
Dr. Horst Bockelmann	Economic Adviser, Head of the Monetary and Economic Department
M.G. Dealtry	Deputy Head of the Monetary and Economic Department, Manager
Marten de Boer	Manager, Banking Department

Jean Vallet	Deputy Secretary General
André Bascoul	Deputy Manager, Secretariat of EEC Governors
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
Dr. Gunter Baer	Assistant Manager, Monetary and Economic Department
Jean-Claude Dagassan	Assistant Manager, EMCF Agent
P.C. Bridge	Assistant Manager, Banking Department
Tullio Pollonio	Assistant Manager, General Secretariat
Jean-Marc Andreoli	Assistant Manager, General Secretariat