BANK FOR INTERNATIONAL SETTLEMENTS

60th ANNUAL REPORT

1st APRIL 1989–31st MARCH 1990 BASLE, 11th JUNE 1990

Bank for International Settlements

60th Annual Report

1st April 1989–31st March 1990 Basle, 11th June 1990

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60th Annual Report

submitted to the Annual General Meeting of the Bank for International Settlements held in Basle on 11th June 1990

Ladies and Gentlemen,

I have the honour to submit herewith the sixtieth Annual Report of the Bank for International Settlements for the financial year which began on 1st April 1989 and ended on 31st March 1990.

The net profit for the year amounted to 104,330,524 gold francs, after transfer of 9,014,556 gold francs to the Provision for Exceptional Costs of Administration, 5,000,000 gold francs to the Provision for Building Purposes and 8,500,000 gold francs to the Provision for Modernisation of Premises and Renewal of Equipment. This compares with a net profit for the preceding year of 94,885,615 gold francs.

The Board of Directors recommends that, in application of Article 51 of the Bank's Statutes, the present General Meeting should apply the sum of 32,330,524 gold francs in payment of a dividend of 200 Swiss francs per share.

The Board further recommends that 21,600,000 gold francs be transferred to the General Reserve Fund, 4,000,000 gold francs to the Special Dividend Reserve Fund and the remainder of 46,400,000 gold francs to the Free Reserve Fund.

If these proposals are approved, the Bank's dividend for the financial year 1989–90 will be payable to shareholders on 1st July 1990.

I. A year of dramatic changes

1989 will be remembered above all as the year of dramatic changes in a number of centrally planned economies in eastern Europe. While these changes have so far been primarily of a political nature and reflect a widespread desire for democratic freedoms, they were brought about by a number of factors, among which the failure of centrally planned economies to "deliver the goods" ranked very high. Given that the century-old arguments about the merits and demerits of different ways of organising economic activity have always been largely ideological and little influenced by empirical evidence, recent developments in eastern Europe have a significance far beyond the boundaries of the countries in which they occurred. It is no exaggeration to say that the very basis for the discussion of alternative economic systems has been transformed.

This is also likely to have a bearing on discussions of specific economic policy measures in non-socialist countries. The manifest shortcomings of systems relying wholly on government directives cannot fail to influence policy choices in specific areas between market-oriented and interventionist approaches. Even before the recent events a greater inclination to rely on market solutions could be detected in a number of countries, including countries in the Third World. This tendency will no doubt now be given a strong boost as the full implications of the simultaneous collapse of the eastern European socialist regimes become clear.

After some forty years, the collapse came not as a result of external shocks but as a result of the accumulation of problems to which central planning combined with state ownership was unable to pay sufficient attention or devote the necessary resources. Ultimately it was not just a question of being unable to invest in modern equipment or of keeping the existing capital stock in working order; even the current supply of consumer goods could not be maintained at the modest level which people had come to expect. The stark contrast with the renewed dynamism of western economies seems, in some socialist countries at least, to have robbed those in power of any remaining confidence in their ability to pull their economies out of the doldrums. In turn, this apparently undermined their will to hold on to political power. They recognised clearly that the system itself was to blame and that a complete break with the past was required. Once the winds of change had gathered momentum they swept across other countries in a similar plight. Even so, an essential factor at the political level was that the Soviet Union accepted liberalisation in these countries – at a time when it was itself grappling with similar problems and had also embarked on a process of political and economic restructuring, though a less radical one.

The shift to new economic policy mechanisms will, however, be a very difficult task which will require enormous patience, good judgement, determination and perseverance from the new leaders and from those who put them in power. There are no blueprints available for the transformation, and many of the steps required are interdependent; ideally they should be undertaken simultaneously, but that is easier said than done. A social element has long been emphasised in a number of western countries as a necessary ingredient of a modern market economy, but for the moment that will have to be balanced against the need to set market forces free and to get the economies moving. It would be an illusion to expect the transition to be smooth and fast. Differences in this respect will no doubt be considerable from one country to another.

These developments will not be without consequences for the non-socialist industrialised countries, which are able and willing to assist the process of transformation in eastern Europe in many ways, bilaterally and through various multilateral organisations. The fact that economic conditions in most western European countries were quite favourable in 1989 and continue to be so should provide a propitious external environment; successful transformation of the formerly socialist economies should feed back to other countries, change the structure of capital flows and create new and stronger trade links. The country likely to be most affected in this context is the Federal Republic of Germany, which stands prepared for swift union with the German Democratic Republic – economic, monetary and finally political. This creates a new environment for the process under way in western Europe towards a single market and monetary union. While it was feared that there might now be a delay because of a preoccupation with settling intra-German issues, this seems to have been outweighed by an even stronger political determination to push ahead, even towards political union, within western Europe.

The dramatic changes in eastern Europe have occupied centre stage in economic policy discussions for the last few months to such an extent that other developments have tended to receive less attention than they would otherwise have done. Most remarkable among these is the fact that economic growth has remained so strong over such a long period in many western industrial countries, again exceeding already optimistic forecasts. In Germany, Belgium and the Netherlands real output growth reached 4–4¼%, making 1989 their best year in the 1980s. A second, rather heterogeneous group of countries, including Japan, France, Italy, Australia, Austria, Spain and Switzerland, registered growth rates of 3–5%; they had in common the fact that these rates were equal to or not far below levels attained in 1988 or 1987. A third group, however, comprising the United States, the United Kingdom and Canada, experienced a marked slowdown to 2¼–3%, which was in fact what their policies had aimed for in view of clear indications of excess demand. The slowdown in these countries, together with some moderation of growth in India, China and the dynamic East Asian economies, accounts for the fact that world output growth, at 3½%, was almost 1 percentage point lower than in 1988.

Inflation has been on a rising trend since its low point in 1986 and was appreciably – on average 1.2 percentage points – higher in 1989 than in 1988 in all industrial countries. In some of them the upward trend may now have been broken. A reversal, however, is not in sight, in spite of the fact that monetary policy was tighter everywhere in 1989. Without exception short-term interest rates, which reflect the policy stance most clearly, were higher on average than in the previous year, the rise ranging from only 1¼% in the United States, where a peak was reached as early as March 1989, and in Japan to almost 4% in the United Kingdom and Switzerland. In some of the major countries monetary expansion did in fact show signs of slowing down, but in many countries it continued unabated.

Long-term interest rates did not immediately follow the rise in short-term rates and actually fell in the United States, Canada and France, which was widely interpreted as an indication of market confidence in the authorities' ability to cope with the increased inflationary pressures. More recently, however, and particularly in the early months of 1990, long-term rates have been catching up with short-term rates to some extent. This has added to the widespread unease about what are perceived as excessively high levels of real interest rates. Some take a sanguine view and see the rise in real long-term interest rates simply as a natural reflection of a higher marginal efficiency of capital, now that high-yielding investment opportunities are opening up in former "eastern-bloc" countries. The same point can be put less positively by noting that the global relationship between saving and investment has worsened. There can be little doubt, however, that higher long-term real interest rates – calculated in the conventional way by subtracting current inflation rates from nominal interest rates – also reflect an awareness of increased inflation risks, tighter monetary policy and greater uncertainty, especially in Germany.

The global rise in long-term interest rates has called into question the high level of asset prices in certain markets. "Asset price inflation" has received increasing attention as an indication of excess liquidity and an early warning sign of inflationary pressures still in the pipeline. The concept itself is somewhat ambiguous. The distinction between changes in the general price level on the one hand and changes in relative prices on the other would suggest that the term "inflation" should be used only in respect of the first and not in respect of the second. But rising aggregate demand, whether stimulated by excess liquidity or by rising real incomes, will no doubt have its first and strongest price effects in areas where supply is inelastic. This is particularly obvious in the case of real estate in a densely populated country like Japan, where the situation is aggravated by various restrictions and tax arrangements which discourage landowners from selling their land in response to sharp rises in land prices. While underlying conditions such as these explain medium and long-term relative price trends, short-term developments may well be dominated by monetary factors; in other words, asset prices may indeed already signal inflationary dangers at a time when the general price level – known to be a lagging indicator – reveals no such risks. Finally, wherever rapid price rises occur one has to allow for the possibility of speculative bubbles on top of everything else.

Other perennial policy problems – such as excessive levels of external debt in middle-income developing countries, unemployment, large current-account imbalances and financial market instabilities, to mention just some of them – have also received less than their normal share of attention recently. Indeed, a number of the countries affected by some of these problems have voiced concern about being given a lower priority on international policy agendas. A first, somewhat cursory glance through the list of the problems in question reveals, however, that in fact some progress has been made in respect of most of them, though nowhere has it been particularly impressive.

To begin with the *debt problem,* the Brady Initiative launched in March 1989 has enabled certain problem debtor countries, notably Mexico, to negotiate some debt and debt service reduction against a background of increased confidence in their policies on the part of international and domestic investors. However, while the momentum of the initiative has not been lost, other major debtor countries, such as Argentina and Brazil, which together account for almost one-third of the total external debt of middle-income problem debtor countries, are still no nearer a solution or even any marked improvement with regard to their external debt than they were a year ago. The readiness of commercial banks to provide new money is now at a very low ebb.

Next on the list of perennial problems, a hard core of relatively *high structural unemployment* has persisted in a number of industrial countries even though the continuation of the upswing has brought some progress in labour markets. In many cases employment rose more quickly than unemployment declined, with migration and participation rates taking over from other demographic factors as the main causes of labour force growth. Even so, present unemployment figures are well below peak levels almost everywhere and in many countries are the lowest for close to a decade. For the OECD area as a whole the unemployment rate in 1989 was 6.4%, compared with a peak of 8.7% in 1983.

The problem of the *large current-account imbalances* among the major industrial countries continued to ease somewhat, although Germany's overall current-account surplus increased to almost 4½% of GNP as imbalances within Europe grew. Among the smaller economies, Australia's current-account deficit now stands at over 5½% of GNP, the highest ratio of any industrial country. A number of deficit countries have initiated programmes to promote private saving, which – if successful – could help to reduce existing external imbalances and raise overall levels of saving, with consequences for the level of long-term interest rates. The countries concerned are fully aware of the rather limited success such programmes have had elsewhere, tending to reward actions which would have been undertaken anyhow without having much effect on actual spending decisions. It is very difficult to design a structure of incentives which avoids this. The safer and faster method of raising the level of domestic saving is to increase public sector saving, or, where relevant, to reduce public dissaving.

In fact, considerable progress was made with *fiscal consolidation* in 1989, in part as a result of the good economic performance which acted as a built-in stabiliser and tended to ease the tensions which were building up. The exceptions among the major countries were Italy and Canada. Public debt/GNP ratios improved moderately in most countries, but the range remains very wide, from 133 and 126% in Belgium and Ireland respectively to below 30% in Finland, Australia and Switzerland.

Foreign exchange markets became somewhat calmer towards the end of 1989 and in early 1990, but volatility remained high and official exchange market intervention was substantial. The pronounced weakness of the Japanese yen, which persisted into the early part of May 1990, represented a new and serious exchange rate misalignment which might threaten a return to higher Japanese trade surpluses. Exchange market participants were obviously not wholly convinced of the strength of the commitment to policy co-ordination among the major industrial countries, in spite of their reaffirmation of such a commitment at the Group of Seven meetings in April and May. Nevertheless, as this Report was being finalised, the yen had started to experience some relief from the pressures to which it had earlier been subject.

Financial markets remained highly sensitive in 1989, with strong movements in equity prices in both directions. However, price falls did not raise fears of adverse repercussions on the real economy as had been the case in 1987, presumably because these fears had proved unfounded. In early 1990 the Tokyo stock market went into a sharp decline, without meeting strong immediate resistance as on previous occasions but without the kind of contagious effect on the stock markets of other countries that had been such a marked feature of events in October 1987. The junk bond market experienced some nasty moments but sent no immediate shock waves into other market segments. The crisis in the US thrift industry assumed even larger dimensions and tended also to affect confidence in other financial institutions. The sudden drop in bond prices in a number of countries, most notably in Germany in February 1990, was another indication of underlying nervousness in financial markets during the period under review.

The one "perennial" problem in respect of which there was no progress, only a further deterioration, was the plight of the poorest countries, primarily the countries in Sub-Saharan Africa. A number of them now have per capita incomes *below* the levels of the mid-1960s. Modified and more promising policy approaches – such as more realistic exchange rate policies – are pursued in some of these countries from time to time, which gives rise to new hope. But with rapid population growth and severely limited administrative skills, not to mention more general problems in the domestic political process, their ability to implement programmes that will turn the tide is seriously restricted.

This is undoubtedly the darkest spot in the relatively bright picture of the world economy presented in this Report. Nonetheless, difficult policy choices and the need to consider new approaches are not confined to this one field, even though it must be singled out as presenting the gravest problems. Policy aspects will be taken up in the Conclusion. The structure of the Report will be familiar to the regular reader: broadly speaking, it moves from the sphere of real economic activity to financial markets and on to policy issues, in each case with predominantly domestic aspects in one chapter followed by international aspects in a second chapter. A more detailed discussion of eastern European policy problems has been incorporated in Chapter II.

II. General economic developments in 1989

Highlights

Growth in the world economy remained fairly high but decelerated last year to 3½% from a rapid 4¼% in 1988. The slowdown was centred on the large industrial economies, eastern Europe and the developing countries, whereas in the smaller industrial economies the rate of expansion edged upwards. The regional distribution of growth among the industrial countries changed in 1989 as continental Europe outpaced North America, while economic activity remained strong in Japan. Continental Europe had lagged behind North America and Japan in the early years of the economic upswing, but in 1988–89 its growth was very dynamic, led by a surge in exports and buoyant business investment. A recovery in business profitability based in part on moderate real wage increases underlay this development. The present pace of growth in activity is close to the limits set by output potential in most countries, as idle capacity has gradually been absorbed in the course of seven years of economic expansion.

As capacity limits were approached and labour market conditions became tighter, associated price and cost pressures also increased. Inflation rose in most industrial countries in the latter part of 1988 and the early months of 1989, owing in part to the rebound in oil prices. Even if allowance is made for the one-off effects of energy and agricultural price fluctuations, however, inflation rates in most industrial countries rose in 1988–89 in tandem with generally higher labour costs, some slackening of productivity growth and, particularly in continental Europe, higher profit margins. Monetary conditions were tightened in response to inflationary pressures in 1988 and again last year, except in the United States, where interest rates already peaked in the spring and were eased subsequently in the light of weakness in the economy. The deceleration in activity helped to contain the rise in inflation, which had been particularly evident in the earlier part of 1989.

External imbalances narrowed in the United States and Japan in 1989, although more slowly than in 1988 in real (volume) terms. By contrast, Germany's already large external surplus widened on a year-on-year basis, particularly vis-à-vis several other EC countries. Exchange rate developments were not always helpful from the point of view of external adjustment. Real effective exchange rate depreciation in the course of the year in Japan and a roughly unchanged year-on-year average real effective rate in Germany contrasted with large external surpluses.

Progress in fiscal consolidation continued in most of the industrial countries in 1989, so that public debt/GNP ratios stabilised and in some cases edged downwards after a decade of rapid escalation. However, recent progress on this front in a number of countries has resulted in large measure from strong economic activity and not from explicit changes in expenditure policies.

Growth in the developing countries also decelerated last year, to 3¼% from 4¾% in 1988, as a result of some slackening of the rapid pace of economic activity in Asia. At more than 5%, the rate of growth in the Asian economies was still by far the fastest among the developing countries, but was nonetheless the slowest since 1982. Economic activity in Latin America remained stagnant under the twin burden of high levels of foreign debt and sky-rocketing inflation. Slightly more encouraging signs were evident in the Middle East owing to large terms-of-trade gains. Elsewhere external conditions were less favourable. Export growth weakened despite booming conditions in the industrial countries and non-oil commodity prices fell sharply in the course of last year. The external price fall was particularly steep in Sub-Saharan Africa and once again rapid population growth led to a fall in per capita income.

Dramatic developments occurred in eastern European countries, most of which are currently undergoing a radical political and economic transformation. Having rejected centrally planned economic systems, the majority of these countries are attempting to develop market economies. Although economic conditions and reform strategies differ considerably from one country to another, they all face a similar set of fundamental problems in transforming their economic structure into a decentralised,

World output growth[1]

Country groups and regions	1987 GDP			1978–84 average	1985	1986	1987	1988	1989
	in billions of US dollars	as % of total, based on							
		current US dollars	PPPs[2]	percentage changes in real GDP					
Seven major countries	10,682	64.6	47.1	2.5	3.6	2.7	3.6	4.5	3.5
Other industrial countries[3]	1,903	11.4	9.8	2.0	3.0	2.6	3.0	3.3	3.6
Developing countries	2,615	15.8	29.8	3.9	4.1	4.6	4.5	4.7	3.2
Major oil producers[4]	759	4.5	6.5	2.4	0.2	0.4	1.0	1.8	1.7
Other developing countries	1,856	11.3	23.3	4.6	5.6	6.3	6.1	5.9	3.6
Africa and Middle East	196	1.2	2.1	4.1	4.0	2.5	0.9	4.3	3.1
Asia	1,073	6.5	15.1	6.2	6.4	7.0	8.3	9.5	5.2
of which: NIEs[5]	293	1.8	2.1	7.4	3.7	10.6	12.1	9.2	6.3
Latin America	587	3.6	6.1	1.8	4.7	6.3	3.7	−0.4	1.0
Eastern Europe[6]	1,347	8.2	13.3	3.0	3.5	2.9	1.9	3.9	1.8
World[7]	16,547	100.0	100.0	2.7	3.6	3.1	3.6	4.3	3.4

[1] Group averages are calculated using 1987 GDP weights and exchange rates, including all countries with 1987 GDP of at least US$ 0.1 billion. [2] Purchasing power parities, based on data by A. Heston and R. Summers, University of Pennsylvania. [3] Including the countries listed in the table on page 23, Iceland and Luxembourg. [4] OPEC members, Bahrain, Oman, Mexico and Trinidad and Tobago. [5] The newly industrialising economies: Hong Kong, Singapore, South Korea and Taiwan. [6] Net material product or GDP converted at non-commercial exchange rates. [7] Calculated using current US dollar weights. The use of PPP weights caused only marginal changes.

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

profit-oriented system. These issues are discussed in a broad context at the end of this chapter.

The industrial countries

Growth continued strong in continental Europe and Japan but slowed in North America

The centre of growth among the industrial economies shifted in 1989 from North America to continental Europe, while strong economic activity continued in Japan. Growth in the United States and Canada slackened, particularly in manufacturing industry, while the level of economic activity in Germany, France and a number of smaller European countries remained robust, fuelled by exports and business fixed investment.

Most industrial countries were faced with very high rates of capacity utilisation and firming labour market conditions in 1989. Vacancy rates generally increased last year, and, as shown in the graph overleaf, unemployment rates fell in most countries, in some cases to the lowest levels for more than a decade. Business profitability rose significantly in Europe, in parallel with an export boom, while some decline in profitability in North America was associated with the weakness of manufacturing activity. The rise in general profitability in Europe and North America in the 1980s, following a period of profit compression during the 1970s, has been a significant factor in the strength and duration of the economic recovery, particularly with its emphasis on business investment. Moderate real wage growth, the decline in real oil prices and a rebound in productivity growth in the 1980s contributed to the rise in profitability (see the section on prices, costs and profit shares later in this chapter).

Increased business profits

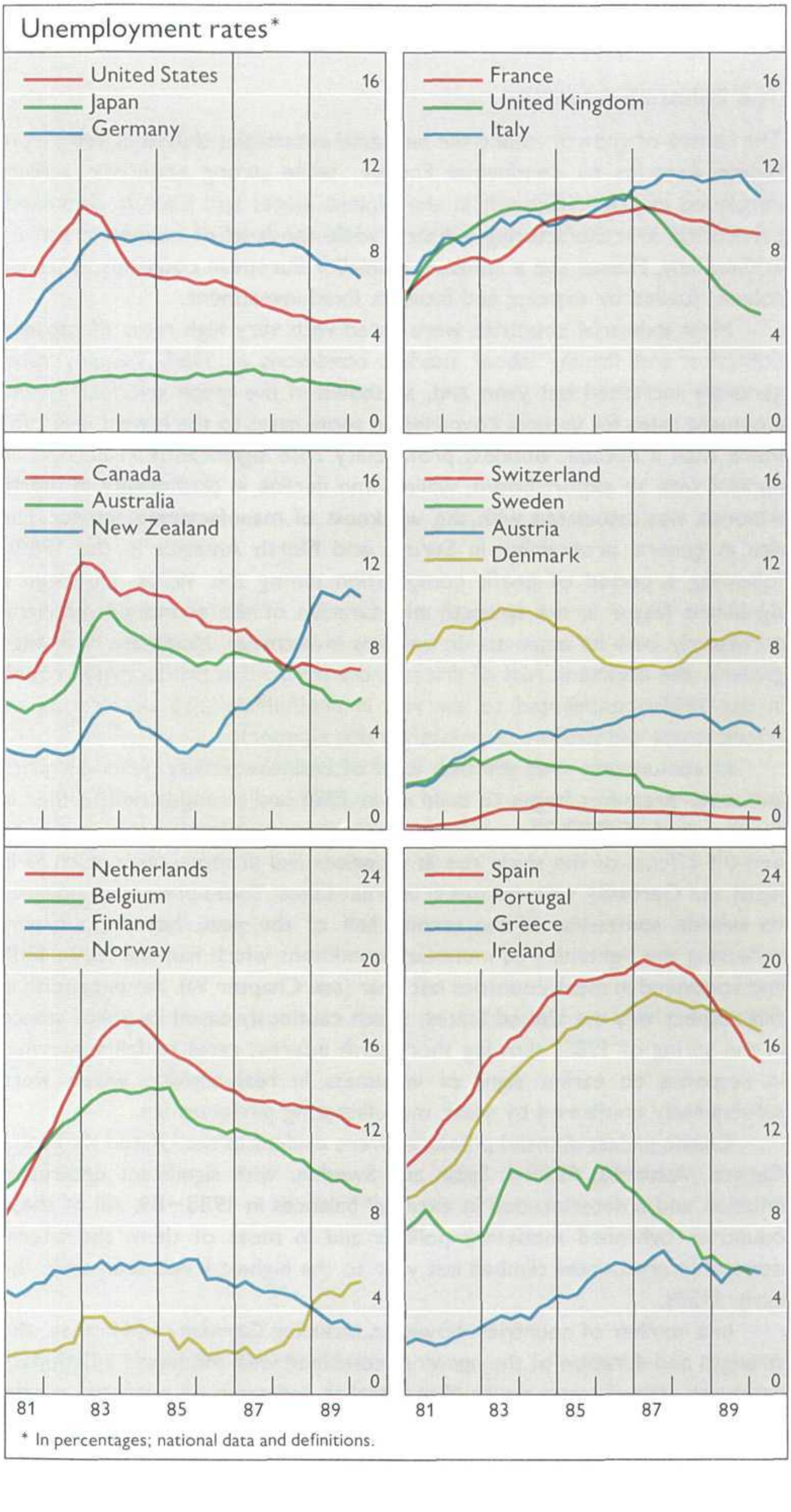
In conjunction with the high level of business activity generally, price and wage pressures began to build up in 1988 and strengthened further in the first half of 1989. The acceleration in prices was attributable in part to one-off effects of the sharp rise in oil prices and in some cases, such as in Japan and Germany, to increases in indirect taxes. These pressures appeared to subside somewhat in the second half of the year, however, in part reflecting the tightening of monetary conditions which had started in 1988 and continued in most countries last year (see Chapter VI). An exception in this respect was the United States, which cautiously eased its policy stance in the spring of 1989, allowing short-term interest rates to fall somewhat in response to earlier signs of weakness in real activity, which were subsequently confirmed by weak manufacturing performance.

Price and wage pressures

Monetary conditions were tightened further

Classic excess demand pressures were evident in the United Kingdom, Canada, Australia, Finland, Spain and Sweden, with significant upturns in inflation and a deterioration in external balances in 1988–89. All of these countries tightened monetary policies and in most of them short-term nominal interest rates climbed last year to the highest levels seen since the early 1980s.

In a number of countries, however, including Germany and France, the strength and duration of the upswing, combined with moderate inflationary pressures, raised some doubt about earlier estimates of potential output levels. Despite the high rates of capacity utilisation experienced recently and declining levels of unemployment, output growth has generally been



* In percentages; national data and definitions.

Capacity limits are being reached

stronger than expected, while price and wage pressures have until recently grown moderately. Nonetheless, increasing signs of shortages of skilled labour in a number of industries and associated wage pressures, as well as the recent slowdown in activity in some countries with relatively low unemployment rates such as the United States and Sweden, indicate that capacity limits are being reached, and in some cases exceeded, and highlight the threat of further inflationary pressures.

Government budget positions

Government budget deficits continued to decline in most of the industrial countries last year. The table below shows the improvement in government financial positions. The general government balance in Germany moved into surplus for the first time in almost two decades, while the surplus widened in Japan, the United Kingdom, Australia, Finland and Sweden. Although significant progress has been made since 1986, reduction of the US federal government budget deficit was impeded last year by unexpected additional borrowing requirements in connection with the restructuring of the thrift industry.

General government budget balances[1]

Countries	1973	1980–84 average	1985	1986	1987	1988	1989[2]
	as a percentage of GNP/GDP						
United States	0.6	−2.5	−3.3	−3.4	−2.4	−2.0	−2.0
Japan[3]	0.5	−3.5	−0.8	−0.9	0.6	2.1	2.7
	−2.7	*−6.7*	*−4.2*	*−4.2*	*−1.4*	*0.6*	*1.3*
Germany	1.2	−2.9	−1.1	−1.3	−1.8	−2.1	0.2
France	0.9	−2.1	−2.9	−2.7	−2.0	−1.8	−1.4
United Kingdom	−2.6	−3.1	−2.7	−2.3	−1.3	1.0	1.1
Italy	−8.0	−12.0	−13.6	−12.3	−11.7	−11.6	−11.3
Canada	0.9	−4.7	−6.8	−5.5	−4.4	−2.6	−3.4
Australia[4]	0.1	−1.7	−3.1	−2.7	−1.5	0.3	2.0
Austria	1.3	−2.7	−2.5	−3.7	−4.3	−3.1	−2.8
Belgium	−3.5	−11.1	−8.9	−9.0	−7.4	−7.1	−6.5
Denmark	5.3	−6.1	−2.1	3.4	2.6	0.3	−1.7
Finland	5.8	−0.1	0.1	0.8	−1.1	1.4	2.7
Greece	−1.4	−7.9	−14.0	−12.7	−12.0	−14.5	−17.6
Ireland[5]	−3.8	−14.5	−12.8	−12.8	−9.9	−3.3	−2.4
Netherlands[6]	1.9	−5.7	−4.4	−5.0	−4.9	−4.3	−3.9
New Zealand[4, 7]	−2.5	−7.3	−7.2	−4.2	−3.7	0.8	2.7
Norway	5.8	5.3	10.4	5.8	4.8	3.1	0.9
Portugal	1.4	−10.0[8]	−10.1	−7.2	−6.9	−6.5	−5.3
South Africa[7]	−1.1	−3.4	−3.1	−4.3	−5.4	−4.4	−5.0
Spain	1.1	−4.5	−7.0	−6.1	−3.6	−3.1	−2.2
Sweden	4.1	−4.8	−3.8	−1.3	4.2	3.4	5.3
Switzerland[6]	−1.1	−0.5	−0.1	1.1	0.8	0.7	0.2
Turkey	−1.8	−3.1	−2.9	−3.6	−4.5	−4.0	−3.8

[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] Fiscal years, ending in the year indicated. [5] Exchequer borrowing requirement. [6] Excluding social security. [7] Central government only. [8] 1981–84.

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

As can be seen from the graph opposite, most industrial countries in recent years have succeeded in stabilising or reducing public debt/GNP ratios following their earlier rapid growth in the 1970s and early 1980s. All of the seven largest countries except Italy have stabilised or reduced their public debt ratios. The United Kingdom's public debt ratio has fallen sharply since the early 1970s, initially as a consequence of double-digit inflation, but later owing to the medium-term budget and privatisation strategies introduced more than a decade ago. Nonetheless, a number of industrial countries face a significant budgetary problem, with rising debt service costs compounded by the general rise in interest rates since mid-1988. Both Belgium and Ireland, with two of the highest public debt ratios at 133% and 126% of GDP respectively, have managed to stabilise their positions despite rising debt service costs by running large surpluses (over 3% of GDP in 1989) on their general government primary budgets (before interest payments).

Public debt/GNP ratios declined

Part of the progress in fiscal consolidation has been associated with implementation of explicit medium-term deficit reduction strategies – Ireland, the United Kingdom and Australia are especially noteworthy. However, the "budgetary bonus" attributable to the strength of economic activity, and not to explicit changes in expenditure policies, has also contributed to fiscal consolidation and to reversing the "snowball" effect of debt accumulation (i.e. issuing debt to cover interest payments). Good economic performance has led to a large increase in revenues and reduced demands on government expenditure in certain areas, such as unemployment compensation. A modest downturn could reverse some of these gains.

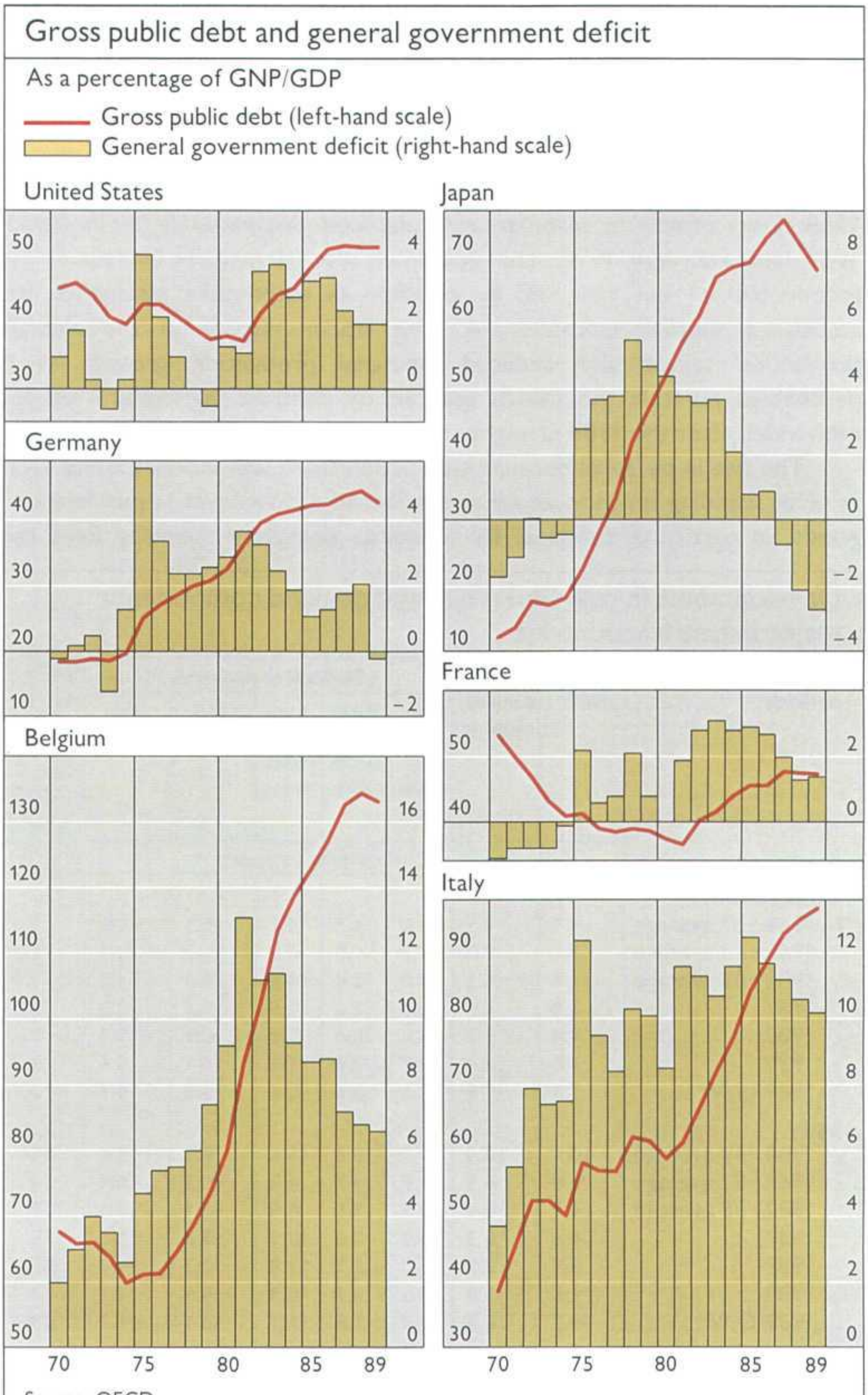
Many industrial countries have in recent years restructured tax codes and offered supply-side incentives so as to increase economic efficiency. The focus on the supply side of the economy and on designing institutional arrangements which promote private initiative is unmistakable. The United States introduced a major tax reform in 1986, broadening the personal and corporate tax bases and substantially lowering tax rates. Japan recently reduced marginal income tax rates and partly made up for lost revenues with a consumption tax introduced last year. In a three-stage reform process Germany simplified the income tax schedule and reduced marginal income tax rates in 1988, increased indirect taxes in 1989 and implemented a large income tax reduction at the beginning of this year. Other countries which have recently introduced or plan to implement tax reforms include France, Canada and a number of smaller countries such as Austria, Denmark, Finland, Portugal and Sweden.

Tax code restructuring and supply-side incentives

The three largest economies

With an increase in GNP of 3% last year, the *United States* recorded its seventh consecutive year of growth – making this the longest business cycle expansion since the 1960s. Although the rate of growth was considerably slower than in the preceding two years, it is closer to the estimated longer-term growth potential of the economy. After falling each year in 1983–88,

Real GNP growth slowed in the United States



Source: OECD.

the rate of unemployment held steady at 5¼% for much of 1989 and into the early months of 1990. Signs of weakness led to some cautious easing of monetary policy in the spring of 1989, allowing interest rates to edge downwards. Approximately 2% real GNP growth in the first quarter of 1990, together with last year's decline in interest rates and a reasonable balance between production and sales, makes the slowdown in the United States in the second half of 1989 resemble the earlier pause in the upswing in 1986.

Weakness in manufacturing

Weakness last year was concentrated in the industrial sector of the economy and was reflected in a fall in profit shares. Manufacturing output rose by only 1½% during 1989, compared with more than 5% during 1988. Employment in manufacturing declined progressively from March 1989 until February 1990. The slowdown was particularly evident in the second half of last year, led by cutbacks in automobile assemblies and associated supplier industries. A long labour dispute in the aircraft production sector also reduced industrial production growth by 1 percentage point in the fourth quarter. By contrast, agricultural output rebounded after the 1988 drought and the services sector remained robust.

The rise in personal consumption expenditure was moderate last year, as brisk spending on services counterbalanced a slowdown in purchases of goods, in particular durables. Nonetheless, consumer spending kept the

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

Countries and periods	GNP/GDP[1]	Total domestic demand	Demand components: Personal consumption	Public consumption	Total fixed investment	Stock changes[2]	Net exports[2]	Memo: Private non-residential fixed investment[3]
	percentage changes							
United States								
1960–69 average	4.3	4.5	4.2	4.7	4.7	0.1	−0.2	5.6
1969–82 average	2.1	2.0	2.7	1.0	0.9	−0.2	0.1	1.4
1982–88 average	4.1	4.5	4.0	3.4	6.5	0.3	−0.5	5.1
1987	3.8	3.2	2.8	2.6	2.5	0.5	0.3	3.9
1988	4.4	3.3	3.4	0.4	5.8	0.1	1.1	8.4
1989	3.0	2.4	2.7	2.7	1.6	−0.1	0.6	3.3
1989 Q IV[4]	2.6	1.9	2.5	0.5	0.6	0.2	0.7	3.7
Japan								
1960–69 average	10.4	10.3	9.2	5.8	15.6	0.3	−0.6	15.1
1969–82 average	4.9	4.5	4.7	4.7	4.2	−0.1	0.4	4.7
1982–88 average	4.2	4.4	3.5	2.5	6.5	0.1	−0.1	9.3
1987	4.6	5.3	4.2	−0.6	10.2	−0.3	−0.6	8.2
1988	5.8	7.7	5.2	2.2	12.8	0.3	−1.7	15.5
1989	4.8	5.8	3.5	2.1	10.9	−0.1	−1.1	17.7
1989 Q IV[4]	4.7	6.5	4.0	1.9	11.7	−0.1	−1.7	18.4
Germany								
1960–69 average	4.4	4.5	4.8	4.4	3.9	0.1	0.0	4.8
1969–82 average	2.4	2.4	3.0	3.1	1.0	−0.3	0.3	1.2
1982–88 average	2.4	2.5	2.4	1.8	2.5	0.3	0.0	4.5
1987	1.8	2.9	3.5	1.5	2.1	0.1	−1.1	4.2
1988	3.7	3.7	2.7	2.2	6.0	0.4	0.0	7.3
1989	4.0	2.7	1.7	−0.8	7.2	0.4	1.3	8.6
1989 Q IV[4]	3.7	3.6	1.9	−2.2	7.1	1.4	0.1	11.1

For footnotes see the table on page 21.

economy moving when weakness appeared in other sectors in the second half of the year. A fall in overall demand growth was evident in exports and fixed investment. The downturn in real business fixed investment reflected a deceleration in spending on producers' durable equipment and continued weakness in non-residential construction. Although an increase in the pace of new "capital widening" investment in the form of industrial plant construction was recorded, this was more than offset by a decline in the commercial and office construction sector. The 7% decline in real private residential fixed investment between the fourth quarter of 1988 and the fourth quarter of 1989 also contributed to weaker GNP growth, reflecting relatively high mortgage interest rates early in the year. Sales of new single-family homes declined by 3.8% between 1988 and 1989. In response to lower sales, housing starts tumbled from their recent peak of 1.81 million units in 1986 to about 1.39 million units in 1989, the lowest level since 1982.

Services and agriculture were robust

Progress in reducing the federal budget deficit slowed

Over the last few years fiscal policy in the United States has been guided by the targets laid down by the Gramm-Rudman-Hollings (GRH) legislation, which are designed to gradually eliminate the federal budget deficit on a unified budget basis. Although not as effective as originally intended, partly because the targets only apply to budget forecasts, the GRH legislation has exerted a restraining influence on the budgetary process. From a peak of $221 billion in 1986, the federal budget deficit declined to $152 billion in the fiscal year 1989 (which ended on 30th September). However, the deficit last year was well above the $136 billion target and close to the 1988 deficit. Progress in budget deficit reduction last year was hindered by more than $10 billion of additional spending associated with the restructuring of thrift institutions. The new government agency for this purpose, the Resolution Trust Corporation, is to spend $19 billion "on-budget" and borrow an additional $30 billion "off-budget" over a period of several years (see Chapter IV).

More recently, after an initial political impasse which triggered across-the-board spending cuts ("sequestration"), a reconciliation budget bill for fiscal 1990 was finally adopted which maintained broad-based "sequestration" spending reductions lasting several months (equally divided between defence and discretionary domestic programmes) and is supplemented by several other smaller cost-saving measures. The 1991 draft budget continues this medium-term consolidation strategy, with projected revenues growing by 9% and expenditures only by 3%, and may even be supported by further reductions in defence spending in light of the relaxation of political tensions with the Soviet Union.

Japanese economic activity remained strong ...

The *Japanese* economy continued its strong expansion last year, with real GNP growth approaching 5%. Led by buoyant corporate investment, the upswing is accompanied at this stage by very tight goods and labour markets. Industrial production and employment in manufacturing continued to climb in 1989, though slowing from the rapid pace of 1987–88, with the rate of capacity utilisation in manufacturing reaching a fifteen-year high last August. By December the unemployment rate had fallen to 2.1%, the lowest level for almost a decade. Favourable business conditions and capacity constraints spurred private non-residential fixed investment to grow by almost 18% last year, the highest among the major industrial economies and oriented towards both capacity expansion and labour-saving improvements. Housing investment, by contrast, decelerated last year and the number of housing starts was below the peak reached in the fourth quarter of 1987. Personal consumption growth was also moderate in 1989, and its pattern over the year was quite uneven. The introduction of a 3% general consumption tax on 1st April shifted some personal consumption expenditure to the first and third quarters and was the major factor behind the absolute decline in real GNP and consumption in the second quarter.

... leading to tight labour markets ...

Owing largely to rapid aggregate demand growth and increasing capacity constraints on domestic supply, the real net export surplus again narrowed last year, but at a slower rate than in 1988. Despite the large gains in Japanese international competitiveness in 1989 (see the table on page 30), the process of external adjustment continued, in part reflecting the effects of the earlier appreciation of the yen in 1985–88.

... and a narrowing of the net export surplus

In an attempt to halt the weakening of the yen on foreign exchange markets and curb incipient price and wage pressures, monetary conditions were tightened somewhat, leading to a rise in interest rates in the course of the year. On the fiscal side, Japan has pursued a policy of budgetary consolidation since the early 1980s. This has been reflected in a marked improvement in the government's financial balance, with modest declines in the public debt/GNP ratio towards the end of the decade. The official objective of discontinuing issues of "deficit financing bonds" set almost a decade ago was achieved in this year's initial budget plan. Given the revenue increases associated with the robust economy, a broadly neutral overall fiscal stance last year was consistent with further improvement in the budgetary position.

Monetary policy was tightened

German economic growth was unexpectedly vigorous during 1988–89, averaging almost 4% per annum – the largest gains since the second oil shock. Rapid GNP growth owes much to the strength of exports, which in turn has been fuelled by buoyant European economic activity. An additional stimulus to exports came from the depreciation of the exchange rate in the first half of last year. German investment growth had been moderate in the early stages of the upturn, but advanced sharply in 1988–89. Last year private non-residential fixed investment spending grew by almost 9% in real terms. Recently the strength of investment has been associated with the rise in capacity utilisation rates, booming export demand and very strong growth of business profitability.

German GNP growth was unexpectedly strong

Despite the buoyancy of investment, overall domestic demand growth in Germany slowed considerably last year as a result of the weakness of personal and public consumption. The slowdown in the growth of personal consumption from 2.7% in 1988 to 1.7% in 1989 was partly attributable to high and rising interest rates, in turn associated with efforts initiated by the Deutsche Bundesbank in the spring of 1988 to curb rising inflation and support the exchange rate. The weakening of consumption growth led to slower overall domestic demand growth and contributed to the rise in the real external surplus, largely reflecting a widening of the bilateral imbalances with Italy, France and Spain.

The three-stage tax reform programme

Fiscal policy was tightened in Germany last year following restraint in public consumption and a rise in excise duties, notably on energy products. Together with larger-than-expected gains from the "growth dividend" – lower unemployment payments, fewer persons on other income support programmes and swelling tax revenues and social security contributions – this resulted in a general government surplus for the first time for almost two decades. The increase in indirect taxes is one element of the three-stage tax reform programme designed to create a less distorting tax system. Income taxes were reduced in 1988 as part of the reform – contributing to fiscal expansion at that time – and the last and largest tranche of the reform was implemented at the beginning of this year with net tax relief estimated at 1¼% of GNP. The timing of this tax reduction may prove problematic, however, given its potentially stimulative impact on the economy at a time when capacity constraints are clearly in evidence. Moreover, additional fiscal stimulus could be provided by the supplementary budget for 1990, raising federal spending growth from 3% to almost 6%, with most of the new funds earmarked for aid to the German Democratic Republic. On the other hand, to the extent that imports rise in response to buoyant demand conditions, the external adjustment process should also benefit.

Other large industrial economies

Strong exports and investment spending in France

The *French* economy grew at a rate of nearly 3½% in 1989 for the second year running, led by strong export growth and corporate investment. This brought a further modest decline in unemployment, a welcome departure from the steady rise recorded from the time of the first oil shock up to 1987. Spending on plant and equipment slowed considerably from the double-digit rate of 1988, the highest since the late 1960s, but still remained a key element in the recovery. The revenue gains induced by high income growth in recent years, together with measures to reduce expenditure as a percentage of GDP, have led to a gradual reduction in the general government financial deficit from a peak of around 3% to approximately 1½% of GDP last year.

Price and wage pressures moderate

Despite a high rate of capacity utilisation, price and wage pressures in France have remained low, partly owing to the discipline imposed by participation in the ERM and the Government's commitment to exchange rate stability. The moderate rate of wage growth in France in recent years, as shown in the table on page 30, stands in sharp contrast to the 1970s and early 1980s. Moderate nominal wage gains and stronger productivity growth recently, together with the 1986 fall in oil prices, have helped boost profits substantially. The rise in net profits in France in recent years has been among the largest in the industrial countries. Although developments were generally favourable in 1989, there were also several problems: a bout of labour unrest in the autumn, especially in the public sector;

a continued high level of unemployment, despite a substantial rise in employment; and a deterioration in the balance on trade in manufactured goods.

Economic activity slowed in the United Kingdom ...

Following very rapid growth in 1987–88, economic activity slowed considerably in the *United Kingdom* last year. The earlier pace of expansion had reflected booming investment and consumer demand, supported by brisk private borrowing, especially in consumer and mortgage credit. Employment growth was again strong in 1989, the unemployment rate declined to 5.7% by the end of the year and wage increases accelerated to almost 9%. The overheating of the UK economy has been characterised by sharp increases in unit labour costs, rising inflation and, initially, a marked widening of the net export deficit.

... but signs of overheating persisted

In an attempt to curb these pressures, monetary policy was tightened in 1988 and 1989. Together with a cautious fiscal stance, higher interest rates contributed to a slowdown in domestic demand and real GDP growth last year to 3¼% and 2¼% respectively. The decline in domestic demand growth was particularly evident in the second half of the year, marked by a cutback in private non-residential fixed investment and a slowdown in personal consumption growth. These developments pushed down the rate of capacity utilisation and stabilised the rate of price inflation by the end of 1989. Nonetheless, labour market conditions continued to tighten, so that some uncertainty remains as to whether wage and labour cost pressures will be contained.

Continued buoyant growth in Italy

In line with developments in continental Europe generally, economic activity in *Italy* remained buoyant in 1989, with GDP growing at 3¼%. Output growth was led by fixed investment and exports. By the end of 1989 unemployment had fallen slightly below previous year-end levels, capacity utilisation rates were higher and industrial production had climbed. However, the overall positive direction of economic developments did not include substantive progress in reducing the general government financial deficit. The brisk pace of economic activity also contributed to wage and price pressures, despite a continuing high level of unemployment and a substantial increase in interest rates in the course of the year. Unfavourable labour cost developments relative to Italy's major trading partners contributed to a sharp deterioration in the country's international competitiveness and impeded any substantial correction of the net export deficit.

Canadian growth slowed ...

Canadian economic growth slowed in 1989 as signs of overheating emerged after six years of robust economic activity and the attainment of very high levels of resource utilisation. At 7.3% in mid-1989, unemployment was the lowest recorded since the early 1980s, and increasing price and wage pressures were evident in the first half of the year. Domestic demand growth outstripped supply by a substantial margin, leading to a sharp deterioration in the net external balance. To counter the threat of accelerating inflation, the restrictive stance of monetary policy was maintained during the year. As a consequence aggregate demand growth slowed considerably in the second half of the year, unemployment edged upwards, and capacity utilisation rates fell. The slowdown in activity was

... as policy was tightened to contain rising inflation

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

Countries and periods	GNP/ GDP[1]	Total domestic demand	Demand components: Per-sonal con-sump-tion	Public con-sump-tion	Total fixed invest-ment	Stock changes[2]	Net exports[2]	Memo: Private non-resi-dential fixed invest-ment[3]
	percentage changes							
France								
1960–69 average	5.5	5.8	5.5	4.1	8.2	0.8	−0.8	8.5
1969–82 average	3.3	2.6	3.4	3.4	2.0	−0.5	0.3	2.3
1982–88 average	1.9	2.2	2.3	2.1	1.9	0.0	−0.3	2.7
1987	1.9	3.0	2.7	3.0	3.7	0.1	−1.1	4.5
1988	3.4	3.8	2.8	2.3	7.7	0.2	−0.5	10.4
1989	3.4	3.1	2.9	2.2	4.0	0.2	0.2	4.6
1989 Q IV[4]	3.7	3.1	2.7	4.0	3.6	0.1	0.5	3.7
United Kingdom								
1960–69 average	2.9	2.8	2.3	2.1	5.5	−0.1	0.1	5.1
1969–82 average	1.7	1.6	2.0	2.1	0.1	−0.2	0.3	0.6
1982–88 average	3.6	4.5	4.7	1.0	6.9	0.3	−1.1	9.9
1987	4.8	5.5	6.1	1.1	8.6	0.1	−0.7	14.4
1988	4.1	7.6	7.0	0.4	13.6	0.7	−3.5	19.7
1989	2.2	3.2	3.8	0.5	4.9	−0.2	−1.1	6.4
1989 Q IV[4]	1.9	−0.4	2.5	0.7	1.6	−2.5	2.3	−1.9
Italy								
1960–69 average	5.8	5.4	6.3	4.1	5.3	−0.2	−0.2	4.1
1969–82 average	3.4	3.2	4.0	3.0	1.2	0.1	0.3	2.7
1982–88 average	2.7	3.1	2.9	3.1	3.0	0.2	−0.5	5.3
1987	3.0	4.6	3.9	3.6	6.8	0.2	−1.8	14.1
1988	3.9	4.3	3.8	3.0	4.9	0.5	−0.6	6.0
1989	3.2	3.3	3.8	0.5	5.1	−0.2	−0.3	6.7
1989 Q IV[4]	2.8	1.8	3.1	0.0	4.1	−1.0	0.9	n.a.
Canada								
1960–69 average	5.5	5.2	4.6	6.3	5.3	0.1	0.4	5.4
1969–82 average	3.7	3.8	3.9	3.9	4.7	−0.3	0.2	5.7
1982–88 average	4.5	4.9	4.4	1.9	6.8	0.4	−0.4	6.2
1987	4.5	4.9	4.9	0.7	11.6	−0.6	−0.5	11.1
1988	5.0	5.8	4.3	3.1	13.3	−0.4	−1.1	18.9
1989	2.9	5.5	4.0	2.2	7.0	1.0	−2.6	8.2
1989 Q IV[4]	2.4	4.8	3.6	2.1	6.2	0.8	−2.4	5.9
Seven major countries[5]								
1960–69 average	5.8	5.9	5.4	4.6	8.4	0.2	−0.3	8.6
1969–82 average	3.0	2.8	3.3	2.3	2.1	−0.2	0.3	2.7
1982–88 average	3.7	4.0	3.6	2.6	5.5	0.2	−0.3	6.5
1987	3.6	3.9	3.5	2.0	5.9	0.2	−0.4	6.9
1988	4.5	4.8	4.0	1.3	8.8	0.2	−0.3	11.5
1989	3.5	3.5	2.9	1.9	5.9	0.0	−0.1	9.0
1989 Q IV[4]	3.2	3.2	2.9	0.7	5.5	0.0	0.0	9.0

[1] GNP for the United States, Japan and Germany. [2] Percentage point contribution to GNP/GDP growth. [3] Machinery and equipment for Germany (fourth quarter 1989) and Italy. [4] Fourth quarter to fourth quarter. [5] Weights proportional to 1987 GDP and demand components.

Sources: OECD and national data.

concentrated in interest-sensitive categories of consumer goods spending and expenditure on machinery and equipment. A sharp decline in real export growth, in part reflecting the slowdown in the US market and a real appreciation of the exchange rate, also contributed to weaker real GDP growth in Canada.

Other industrial countries

Led by fixed investment, real growth attains 4–5% in many countries ...

Real output growth in other industrial countries averaged 3½% last year, which was a small rise compared with 1988 (see the table on page 23). In seven countries GDP expanded by 4–5%, and a notable feature in most of them was that the strongest demand component was fixed investment, with growth rates ranging from 4½% in the Netherlands to 14½% in Belgium. Given the typically high import content of capital goods, the investment boom was accompanied by faster import growth. Hence despite favourable export conditions, changes in net exports made a negative contribution to output growth. Indeed in Australia this amounted to more than 3%. A second feature common to several countries in this group was that they were forced to tighten policies to prevent a further deterioration in their current external accounts and/or an acceleration in the rate of inflation. This was the case in Spain, which on two occasions tightened domestic lending policies and took steps to reduce capital inflows. Australia, Finland and Portugal also resorted to tight monetary policies, and in the first two countries short-term real interest rates were in the 5–6% range for most of last year. However, since financial markets typically react with a shorter lag than output markets, the measures taken seem, in most cases, to have influenced the nominal exchange rate more than domestic demand, with the result that currency appreciation further aggravated the external imbalances.

... but inflationary pressures also rise ...

... and keep some countries on a low growth path

Inflationary pressures and concern about the external account were not confined to countries with high growth rates. Problems in balancing the current account have forced the Danish authorities to maintain a restrictive policy stance for several years. The moderate growth recorded last year was almost entirely due to changes in net exports, whereas fixed investment fell to 18% of GDP, though remaining above the level of previous cyclical troughs. Israel has attempted to curb inflation by raising income taxes and stabilising the exchange rate against the US dollar. However, the rate of inflation has remained near 20%, and on two occasions the authorities resorted to devaluation to restore competitiveness. Turkey has relied mainly on budgetary policies in its attempt to reduce inflation and has also endeavoured to cut back monetary financing of the government borrowing requirement. This year, for the first time, the central bank announced monetary growth targets. In Sweden excess demand conditions were accompanied by accelerating inflation and a widening balance-of-payments deficit, despite a growing fiscal surplus. In February this year the Swedish Government proposed a series of measures to break the inflationary spiral, but the version adopted by Parliament was much watered down. A second package of austerity measures was

Changes in real GDP and fixed investment in other industrial countries

Countries	1987 GDP in billions of US dollars	Real GDP				Gross fixed investment			
		1980–86	1987	1988	1989[1]	1980–86	1987	1988	1989[1]
		percentage changes							
Australia	196	3.0	4.1	3.7	4.9	2.4	3.5	9.6	9.4
Austria	117	1.3	1.9	4.2	3.8	−0.0	2.9	5.8	4.6
Belgium	139	0.8	2.0	4.3	4.2	−2.9	5.2	16.0	14.3
Denmark	101	2.8	−0.6	−0.2	1.1	4.5	−7.4	−4.8	−1.1
Finland	89	2.8	4.0	5.2	5.0	1.9	5.4	9.8	12.6
Greece	46	1.3	−0.1	4.0	2.3	−3.0	−7.9	9.0	8.4
Ireland	30	2.0	4.9	3.7	5.0	−2.8	−1.9	−1.7	10.5
Israel	36	2.8	5.2	1.6	1.0	1.6	3.3	−2.1	−3.0
Netherlands	213	1.2	1.2	2.8	4.1	1.0	0.6	9.8	4.5
New Zealand[2]	35	2.5	1.4	0.1	−1.2	6.2	−7.4	6.5	−5.9
Norway	84	3.5	2.0	0.1	2.3	4.7	−2.1	0.7	−4.3
Portugal	37	1.4	4.6	4.2	5.4	−2.0	15.0	16.0	9.5
South Africa	83	1.0	2.1	3.7	2.1	−4.5	−2.5	8.6	4.0
Spain	289	1.7	5.5	5.3	5.2	0.4	14.6	14.0	13.6
Sweden	161	1.9	2.9	2.3	2.1	1.5	7.6	6.4	9.5
Switzerland	171	1.6	2.0	3.2	3.1	3.7	7.6	7.0	5.1
Turkey	68	5.4	7.4	3.4	1.9	5.9	5.6	−1.3	−3.0
Average[3]	–	2.0	3.0	3.3	3.5	1.2	4.4	8.1	7.0

[1] Preliminary. [2] Fiscal year, ending in March. [3] Calculated using 1987 GDP weights and exchange rates.

Sources: OECD National Accounts, IMF International Financial Statistics and national data.

proposed in early April, following a jump in the rate of inflation to more than 11%. Greece experienced a decline in output growth to 2¼% and an increase in the public sector borrowing requirement to more than 20% of GDP, while the external deficit rose to almost 5%. Output growth also fell in South Africa – especially in the non-agricultural sectors – as the authorities tightened fiscal and monetary policies with a view to strengthening the external account and reducing the rate of inflation. Capacity limits and a tight labour market kept the rise in GDP to 3% in Switzerland, while monetary policy was tightened sharply to prevent a further depreciation of the Swiss franc. Finally, output growth rose somewhat in Norway, helped by favourable terms-of-trade developments but also by some relaxation of policies, as inflation declined and the current account improved in response to earlier measures.

Prices, costs and profit shares

Higher price inflation in early 1989 ...

The rate of consumer price inflation increased in virtually all industrial countries in 1989, with a particularly sharp acceleration during the first half of the year, when the twelve-month rate of increase rose to one percentage point above that of end-1988 (see the table overleaf). Changes in indirect taxes accounted for a large part of the acceleration in Japan and Germany, but had a dampening impact on inflation in France, Italy and the

Consumer prices

Countries	1987	1988	1989				1990
			March	June	Sept.	Dec.	March
	percentage changes over twelve months to end of period[1]						
United States	4.4	4.4	5.0	5.2	4.3	4.6	5.2
Japan	0.8	1.0	1.1	3.0	2.6	2.6	3.5
Germany	1.0	1.8	2.6	2.9	2.9	3.0	2.7
France	3.1	3.1	3.4	3.6	3.4	3.6	3.4
United Kingdom	3.7	6.8	7.9	8.3	7.6	7.7	8.1
Italy	5.1	5.5	6.4	7.0	6.6	6.5	6.1
Canada	4.2	4.0	4.6	5.4	5.2	5.1	5.3
Australia[2]	7.1	7.7	6.8	7.6	8.0	7.8	8.6
Austria	1.7	1.9	2.2	2.5	2.5	2.9	3.1
Belgium	1.4	1.9	2.8	3.0	3.5	3.6	3.4
Denmark	4.1	4.5	4.7	4.5	4.7	4.8	3.0
Finland	4.2	6.5	6.6	6.8	6.7	6.6	6.5
Greece	15.7	14.0	13.5	13.4	14.3	14.8	17.8
Ireland	3.1	2.7	3.3	3.8	4.5	4.7	4.2
Israel	16.1	16.4	19.5	20.1	21.0	20.7	16.1
Netherlands	−0.5	1.2	0.8	1.0	1.3	1.3	2.2
New Zealand	9.6	4.7	4.0	4.4	7.2	7.2	7.0
Norway	7.4	5.6	4.3	4.7	4.2	4.2	4.5
Portugal	8.9	11.7	12.4	13.2	12.7	11.6	12.8
South Africa	14.7	12.5	13.8	15.7	14.9	15.3	14.9
Spain	4.6	5.9	6.0	7.1	6.8	6.9	7.0
Sweden	5.2	6.0	6.3	6.6	6.4	6.6	11.2
Switzerland	1.9	1.9	2.3	3.0	3.4	5.0	5.0
Turkey[2]	55.1	75.2	64.5	67.7	73.1	68.8	62.8
Average[3]	3.6	4.1	4.5	5.2	4.8	4.9	5.3
	(4.9)	*(5.6)*	*(5.9)*	*(6.5)*	*(6.2)*	*(6.3)*	*(6.5)*

[1] Quarterly figures for Australia, Ireland and New Zealand. [2] New series from 1989 for Australia and from 1990 for Turkey. [3] Calculated using 1987 GDP weights and exchange rates. Figures in italics are based on PPP consumption weights.

Source: National data.

Netherlands. Moreover, higher US dollar prices for oil and non-oil commodities tended to raise import prices, particularly in countries whose currencies depreciated vis-à-vis the US dollar. The high rates of capacity utilisation and buoyant demand conditions also enabled firms to raise profit margins. This was especially evident in Europe, whereas Japanese firms seem to have reduced their margins (see below).

... and renewed acceleration this year

While the tighter monetary policies introduced in 1988 and maintained through 1989 helped to dampen price trends in the second half of 1989, a renewed acceleration could be observed early this year. Unfavourable weather conditions were responsible for much of the rise in the United States and in other countries higher oil and other import prices pushed up retail prices. It cannot be excluded, however, that the one-off price increases in early 1989 may have left a permanent effect on underlying cost increases.

The table overleaf shows developments in prices and costs, focusing on their contribution to changes in profits, which, particularly in the European countries, have a significant influence on firms' investment plans. All components are measured per unit of total sales in constant prices and imports are regarded as an input along with labour and capital. On this broad definition the share of profits depends not only on gross output prices relative to unit labour costs but also on import prices and the share of imports in total sales. Moreover, since profits are measured net of depreciation and indirect taxes less subsidies, the profit share declines when gross output prices are only partly adjusted to increases in these cost components. On the other hand, to ensure comparability across countries the measure used is gross of interest and company tax payments.

Strong profit share gains in the 1980s...

In five of the seven countries included in the table the share of profits rose during the 1980s, with particularly large increases being recorded in Germany, France and the United Kingdom. In both Germany and France the 1986 fall in oil prices gave a large boost to profits and more recently moderate nominal wage gains and faster productivity growth have contributed to a further rise. German enterprises have also benefited from strong demand for investment goods and, in conditions of high capacity utilisation rates (the highest since 1973), were able to raise profit margins both domestically and in foreign markets. Capacity utilisation rose in France as well, but the most remarkable feature has been the slowdown in the growth of labour costs compared with the early 1980s. In the United Kingdom most of the improvement in profits occurred prior to 1986, whereas the last three years have seen a steady rise in labour cost pressures, reflecting the joint effect of higher nominal wage gains and slower productivity growth. Imports also contributed to stronger cost pressures last year, owing to the depreciation of the pound as well as a marked rise in the import share in output. At the same time, higher oil prices combined with the depreciation allowed exporters to raise margins.

In the United States the improvement in the profit share was also largely confined to the early 1980s. Since 1985 wider margins on exported goods have boosted overall profit margins and despite the depreciation of the dollar and a higher import share in output, the cost pressure emanating from imports has been surprisingly modest. Unit labour cost increases, however, have accelerated since 1986, though mainly reflecting developments in the services sector. Thus the small fall in the profit share recorded last year was to a large extent the result of a 1½ percentage point acceleration in unit labour costs. Italy, like the other continental European countries, also experienced a marked profit improvement in 1986, but since then the profit share has stagnated or fallen. One reason for this deterioration has been rising import cost pressures, but it also appears that firms have held back from raising prices in line with costs, possibly reflecting the effect of a firmer exchange rate policy. Labour cost increases have fallen substantially since the early 1980s, but seem to have become "stuck" at around 5% a year, which is well above those of Italy's major trading partners.

Developments in prices, costs and profit margins[1]					
Countries and items	1980–85	1986	1987	1988	1989[2]
	percentage changes, annual rates				
United States					
Prices, total sales	4.6	2.2	3.0	3.2	3.8
Prices, exports	−2.6	6.2	9.3	16.9	10.5
Costs, total	4.1	2.6	2.9	2.9	4.1
Wages	4.2	2.3	2.8	2.5	3.8
Imports	3.4	6.5	7.8	3.8	4.8
Net profits	6.8	0.6	3.3	5.3	2.7
Profit share[3]	16.1	17.6	17.6	18.0	17.8
Japan					
Prices, total sales	1.3	− 1.8	−0.6	−0.2	1.4
Prices, exports	3.3	−19.9	−9.0	1.1	11.7
Costs, total	1.5	− 2.4	0.4	0.6	2.4
Wages	1.3	1.4	−0.5	−2.1	−0.9
Imports	−3.3	−32.1	−2.7	13.7	23.2
Net profits	0.6	1.1	−3.8	−2.2	−2.2
Profit share[3]	23.5	23.4	22.6	22.2	21.6
Germany					
Prices, total sales	3.4	− 0.3	0.6	1.4	2.8
Prices, exports	7.4	− 4.5	−2.9	3.2	8.4
Costs, total	3.0	− 1.8	0.4	0.6	2.5
Wages	2.1	2.3	1.5	−0.4	−0.1
Imports	4.4	−11.3	−3.0	3.1	7.7
Net profits	5.7	7.0	1.5	4.5	4.9
Profit share[3]	15.9	19.0	19.2	19.8	20.2
France					
Prices, total sales	9.4	1.6	2.2	2.9	4.0
Prices, exports	11.5	− 7.4	−0.3	5.6	10.3
Costs, total	9.2	− 0.8	2.0	2.4	3.8
Wages	8.6	1.3	0.6	0.2	1.5
Imports	9.8	− 9.4	3.9	5.9	11.6
Net profits	10.6	14.0	3.0	5.2	4.8
Profit share[3]	15.3	18.2	18.3	18.7	18.8
United Kingdom					
Prices, total sales	6.9	1.8	4.3	4.9	6.4
Prices, exports	7.7	− 7.9	3.2	−4.4	9.7
Costs, total	6.2	2.8	3.4	5.0	7.2
Wages	5.5	3.6	3.3	4.5	8.0
Imports	8.7	− 1.8	5.0	5.2	9.6
Net profits	11.6	− 3.7	9.8	4.2	1.1
Profit share[3]	11.8	13.8	14.5	14.4	13.8
Italy					
Prices, total sales	13.8	3.2	4.8	5.5	6.6
Prices, exports	14.9	− 4.5	0.9	5.1	10.3
Costs, total	13.5	0.6	5.9	6.9	6.8
Wages	13.7	5.0	5.0	5.2	4.5
Imports	12.7	−13.2	5.5	7.1	13.4
Net profits	14.2	9.1	2.4	2.7	6.2
Profit share[3]	29.0	31.2	30.5	29.7	29.6

Developments in prices, costs and profit margins[1] (continued)					
Countries and items	1980–85	1986	1987	1988	1989[2]
	percentage changes, annual rates				
Canada					
Prices, total sales	5.5	2.0	2.5	2.4	3.3
Prices, exports	5.6	1.9	0.4	1.8	−2.5
Costs, total	5.5	3.8	1.8	1.9	4.0
Wages	5.1	2.1	3.2	1.7	4.8
Imports	5.0	3.8	−0.6	2.9	1.4
Net profits	5.5	−5.5	6.2	4.9	−0.2
Profit share[3]	18.9	17.6	18.1	18.7	18.0

[1] Total sales comprise domestic demand plus exports, and all price, cost and profit components are measured per unit of total sales in constant prices. Consequently, the annual changes in export prices are affected by shifts in the share of exports in total sales, and those of the cost components by shifts in their cost shares. Total costs also include depreciation and indirect taxes less subsidies, and wages as well as profits have been adjusted for changes in the ratio of employees to total employment. [2] Partly estimated. [3] In percentages; first column 1980.

Sources: OECD, National Accounts and national data.

... though with some exceptions

Both Canada and Japan saw declining profit shares during the 1980s. Canadian firms have faced problems in maintaining margins on exported goods, in part owing to weak world demand for oil and non-oil raw materials, which in 1988 accounted for some 20% of total merchandise exports. Labour cost increases have been relatively moderate, but contributed to a fall in profit margins last year, primarily due to a marked decline in productivity growth. Japan shows the largest profit share decline of all the countries included in the table. Even though the profit share in 1980 at 23.5%, was exceeded only by that of Italy, this development is surprising, given the performance of Japanese firms in world markets and the recent investment boom. Several factors were responsible. Firstly, Japanese firms have faced problems in maintaining margins on exported goods, especially in 1986–87 when the real effective exchange rate appreciated by almost 45%. Secondly, in 1988–89, when a weaker yen allowed higher margins on exports, import prices pushed up costs and some enterprises, especially public utility firms, faced constraints in passing the higher costs on to prices. Thirdly, other indicators which give a more favourable picture of recent profit developments relate to large enterprises in the corporate sector, whereas in the non-corporate sector, which includes a large number of sub-contracting firms and accounts for some 50% of total output, profit margins have been squeezed. Finally, and perhaps most importantly, in a period of stable and even falling prices fixed costs tend to become more burdensome. During 1980–89, when gross output prices rose by only 0.6% a year (and actually fell in the last four years), depreciation per unit of gross output increased by 3% a year and indirect taxes less subsidies by 5%. Since the fixed cost components account for almost 25% of total costs in Japan, this development explains why total costs rose by 1% a year during the 1980s, despite moderate labour cost increases and falling import costs.

Wages, productivity and core inflation

Continuing the longest sustained expansion since the 1960s, the unexpectedly strong pace of economic activity in 1989 brought with it a firming of labour market conditions in most industrial countries. Employment growth was strong in the industrial countries at approximately 1.8% and, in conjunction with a moderate 1.3% growth in the labour force, led to falling unemployment rates. Particularly significant declines were recorded in the course of 1989 in several European countries, namely Germany, the United Kingdom, Spain and Belgium, although in many cases the high level of structural unemployment remains a major concern. Only modest declines were observed last year in the United States and Japan, however, owing to already tight conditions in labour markets, labour force expansion and some slowing of economic activity, particularly in the manufacturing sector. The recent declines in unemployment rates are particularly encouraging when viewed in the light of the cyclical troughs reached in the early 1980s. From that vantage point, unemployment rates in the United States and the United Kingdom have fallen by almost one-half or more; large decreases have also been recorded in a number of other western European countries.

Labour markets tightened last year ...

... and unemployment rates declined

Firming conditions in the labour market are also reflected in increases in overtime work, higher vacancy rates and reduced short-time work. The number of workers on short time in the United States declined by almost 10% in 1989. In Japan the "job open ratio", which measures the number of openings for every job applicant, was 1.3 during the second half of 1989 (it rose above unity in 1988 for the first time in fourteen years). Similarly, the number of job vacancies reported in Germany grew by more than 50% in the course of the year, approaching a peak last reached in December 1979, and in France the number of job vacancies grew by more than 18%.

Labour force growth tends to vary widely among individual countries, reflecting differences in underlying population trends and age-profile demographics as well as varying responses to favourable employment opportunities. Strong growth rates of 1.8% and 1.7% were recorded last year in the United States and Japan respectively as a result of increases in the working-age population and higher participation rates. By contrast, the labour force grew by only 0.5% in the European Community in 1989 owing to a continued slowdown in the growth of the working-age population. Germany was a special case, with a 0.6% increase in the labour force driven by 720,000 immigrants from eastern Europe. Estimates indicate that just over half of these immigrants entered the work-force immediately, and most are relatively young – only about 8% are over sixty years of age, compared with 22% of the existing population of the Federal Republic.

Wage growth rose in most countries last year owing primarily to an acceleration of wage costs in the services sector. In the major industrial countries wage gains in manufacturing were fairly steady at about 5.0% in both 1988 and 1989. However, this is more than 1 percentage point higher

Wage growth rose and ...

than the 1987 rate of wage increase (see the table on page 31). Particularly rapid wage growth was recorded last year in the United Kingdom, Australia, Sweden, Finland and Greece. Several recent wage agreements, aggressive employee stances on shorter working hours and an increase in labour disputes suggest that this pattern may continue.

... productivity growth slowed last year

Moreover, unit labour costs were pushed up further in many instances as a result of a general slowdown in manufacturing productivity growth last year, following its rapid rise in 1988. Among the larger industrial countries, large unit labour cost increases in manufacturing were registered in the United Kingdom, Italy and Canada, largely owing to sharp declines in productivity growth. By contrast, very favourable cost developments were evident in Japan owing to continued strong productivity growth in 1989, though smaller than the extraordinary increase observed in 1988, and in France and the Netherlands owing to wage restraint.

The rise in wage inflation, if it continues unabated, could pose a problem in a number of countries, given the traditional linkages between wage increases and underlying inflation rates. Moreover, the "asset price inflation" experienced in Japan, the United Kingdom, Sweden and elsewhere in recent years could exert more pressure on wages as workers attempt to maintain living standards in the face of rapidly escalating land and housing prices (see Chapter IV).

Core inflation and unit labour costs

The graph on page 32 shows the pattern of "core inflation", which is a measure of underlying domestic inflation pressures calculated as the percentage change in the consumer price index for all items except food and energy, plotted together with unit labour costs for the whole economy since 1965. The adjustment for energy prices in consumer price inflation is particularly important owing to large swings in oil prices.

Upturn in prices and unit labour costs

The graph illustrates that the rates of increase in unit labour costs and domestic inflation move closely together in most periods. An upturn in core inflation during the past three years is apparent for most countries. Although the general strengthening of profit margins in most industrial countries since 1982 suggests that firms may be able and willing to absorb cost increases for a limited period, longer-term price stability ultimately depends on compensation per employee rising roughly in line with productivity gains.

Productivity growth has improved since the early 1980s

Positive features of the 1982–89 upturn have included the partial recovery of productivity growth in manufacturing, to an average of 4.5% a year, and a sharp decline in the rate of wage increases. The combination of the two has led to a moderation of unit wage cost increases over the past seven years, to an average of less than 1% a year in the manufacturing sector in the major industrial economies, which helped lay the foundations for a sustained period of economic expansion consistent with moderate inflation pressures. Wage restraint was an essential part of the "disinflationary" process in the early and mid-1980s, and continued moderation in real wage growth in most countries occurred despite tightening labour market conditions. Wage restraint was attributable to a number of factors, including the less aggressive stance of trade unions in

Unit labour costs and productivity in manufacturing[1]

Countries and periods	Relative unit labour costs[2]	Domestic conditions: Unit labour costs (ULCs)	of which plus: wage costs	of which less: productivity growth	External conditions: Foreign unit labour costs (national currency)	External conditions: Nominal effective exchange rate
	percentage changes					
United States						
1961–69 average	− 0.7	1.6	4.7	3.1	2.7	0.5
1969–82 average	− 1.9	6.4	8.8	2.3	8.0	− 0.3
1982–89 average	− 4.6	−0.3	3.7	4.0	1.4	− 2.9
1987	−13.5	−1.0	2.6	3.7	1.2	−11.2
1988	− 7.2	0.9	3.6	2.7	1.2	− 6.8
1989	3.8	1.5	4.3	2.8	1.6	3.8
Japan						
1961–69 average	0.5	1.8	10.9[3]	9.0	1.7	0.4
1969–82 average	1.7	6.5	13.3	6.4	7.8	3.0
1982–89 average	6.7	−0.7	5.2	6.0	1.3	8.6
1987	7.6	−2.8	2.6	5.8	−1.0	9.5
1988	3.8	−4.3	6.8	11.5	1.7	10.0
1989	− 8.7	−0.5	5.7	6.3	3.1	− 5.0
Germany						
1962–69 average	0.2	2.3	8.3	5.7	3.0	0.8
1969–82 average	1.6	5.8	9.8	3.8	8.4	4.2
1982–89 average	1.6	0.9	4.3	3.3	1.8	2.4
1987	9.2	2.9	4.6	1.7	0.4	6.6
1988	0.0	−0.5	3.6	4.1	−1.3	− 0.7
1989	− 1.8	0.9	4.2	3.2	1.7	− 1.2
France						
1963–69 average	1.4	4.2	8.4	3.9	2.3	− 0.5
1969–82 average	− 1.0	9.8	14.5	4.4	8.9	− 1.8
1982–89 average	− 0.6	1.9	6.1	4.2	1.5	− 1.0
1987	0.0	1.2	5.0	3.7	1.8	0.8
1988	− 4.3	−3.2	3.5	7.1	−1.0	− 2.1
1989	− 4.0	0.1	4.0	4.0	2.9	− 1.2
United Kingdom						
1963–69 average	− 2.7	3.2	6.7	3.4	3.6	− 2.2
1969–82 average	1.7	12.6	14.7	1.8	8.3	− 2.6
1982–89 average	− 1.2	3.1	8.5	5.3	2.0	− 2.5
1987	− 2.6	1.4	8.1	6.6	2.3	− 1.5
1988	8.3	3.0	8.4	5.3	0.4	6.0
1989	− 0.5	4.5	8.8	4.1	2.0	− 3.0
Italy						
1965–69 average	− 1.9	0.7	9.0	8.2	3.3	0.6
1969–82 average	− 0.9	14.5	19.8	4.7	8.9	− 6.5
1982–89 average	2.6	5.7	10.6	4.6	1.3	− 1.7
1987	0.9	3.3	8.4	4.9	2.8	0.4
1988	− 0.5	3.6	8.0	4.2	0.9	− 3.2
1989	5.5	5.9	8.1	2.1	1.1	0.6

Unit labour costs and productivity in manufacturing[1] (continued)						
Countries and periods	Relative unit labour costs[2]	Domestic conditions			External conditions	
		Unit labour costs (ULCs)	of which		Foreign unit labour costs (national currency)	Nominal effective exchange rate
			plus: wage costs	less: productivity growth		
	percentage changes					
Canada						
1961–69 average	–1.6	0.9	5.4	4.4	1.8	–0.6
1969–82 average	–0.1	8.4	10.4	1.9	7.2	–1.2
1982–89 average	1.6	1.8	6.7	4.9	–0.1	–0.2
1987	5.0	2.9	6.2	3.2	–0.9	1.3
1988	8.9	3.0	8.0	4.9	0.1	6.1
1989	9.5	5.8	7.3	1.5	1.8	5.6
Seven major countries[4]						
1965–69 average		2.6	8.1	5.4		
1969–82 average		7.7	11.6	3.7		
1982–89 average		0.6	5.2	4.5		
1987		–0.2	3.9	4.2		
1988		–0.3	5.1	5.5		
1989		1.5	5.2	3.7		

Note: Components may not add up to totals owing to rounding.

[1] For Germany, mining and manufacturing; for Italy, industry excluding construction. [2] Relative ULCs equal domestic ULCs less foreign ULCs plus nominal effective exchange rates. [3] Earnings, all industries. [4] Calculated using 1987 GDP weights and exchange rates.

Sources: National data, OECD, and BIS estimates.

Wage restraint has also helped contain inflation

contract negotiation following the severe recession in the early 1980s and a continuation of persistently high levels of unemployment in many countries, particularly in Europe. Also, real wage compression in some countries, such as the United States, was concentrated in low-skill jobs, perhaps owing to greater international competition from newly industrialising and developing countries. Highly skilled, highly educated workers fared better.

The recent upturn in inflation could feed through to wage demands

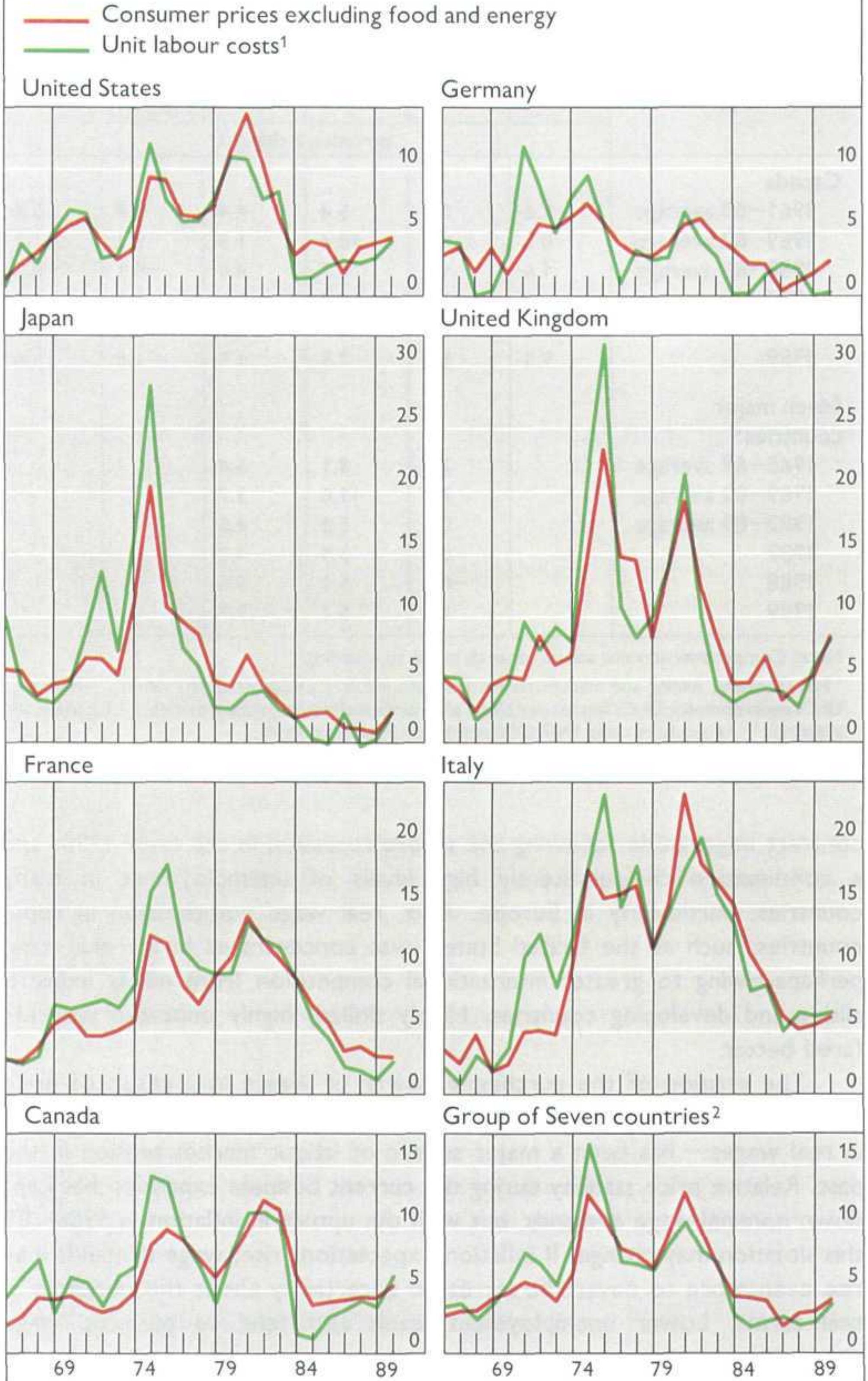
The erosion of the purchasing power of wages as a result of price inflation – leading in a number of instances even to an absolute decline in real wages – has been a major source of labour market tension in the past. Relative price stability during the current business expansion has kept down nominal wage demands, but with the upturn in inflation in 1988–89 this situation may change. If inflation expectations rise, wage demands may rise even more to cover the increased uncertainty about the outcome in real terms. Lower unemployment levels also tend to push up wage demands.

Firming labour markets

Substantial efforts have been made to determine empirically the level of unemployment at which wage growth might be kept stable. This is termed the "non-accelerating-wages rate of unemployment" (NAWRU). The NAWRU itself is not stable over time. Institutional labour market

Core inflation and unit labour costs

Annual changes, in percentages



[1] Ratio of compensation per employee to output per person employed in the whole economy.
[2] Weighted averages, calculated using 1987 private consumption expenditure weights and exchange rates.

Sources: OECD and national data.

characteristics with effects on the NAWRU include, among other things, labour force demographics, the share of long-term unemployment, the regional/sectoral distribution of unemployment and the degree of centralised wage bargaining. In the United States some evidence suggests that the NAWRU rose in the 1970s, partly as a result of changing trends in work-force composition and partly on account of the slowdown in productivity growth. Workers were initially reluctant to accept less than the "3% plus COLA" (cost-of-living adjustment) wage settlements which had become the norm with the productivity gains experienced in the 1960s. A gradual recognition of changing economic conditions, and some rebound in productivity growth, has apparently reduced the NAWRU in the United States since the mid-1980s.

In Europe a common view is that the existing high levels of unemployment compared with the early 1970s are largely the result of a structural mismatch between the supply of and demand for different labour skills. Not only has new technology raised required skill levels, greater international competition from low-wage countries has also increased the relative demand for more highly skilled workers in Europe. This shift, combined with narrow and rigid wage differentials between regions and occupations compared with earlier periods and other parts of the world, has contributed to the rise in the average level of unemployment. Moreover, incomes policies, minimum wage legislation, the financing of social security and the activities of trade unions seem to have squeezed wage differentials since the early 1970s.

Rise in wage inflation

At all events, most estimates indicate that NAWRUs generally have risen since the early 1970s, particularly in continental Europe, and that current rates of unemployment in many countries may be close to or even below the NAWRU level. This draws attention to the rise in price and wage inflation last year and highlights the difficulty of containing or averting further cost pressures while at the same time maintaining strong economic activity.

Another important issue concerning cost developments in labour markets is the extent to which they diverge between countries and affect international competitiveness. In five of the seven major industrial countries exchange rate movements in 1989 amplified the divergences in international competitiveness arising from national differences in labour costs and productivity growth. This may be seen by comparing the difference between changes in domestic and foreign unit labour costs (in national currencies) with the changes in relative unit labour costs shown in the first column in the table on pages 30–31. This has led some to question whether exchange markets provide an effective adjustment mechanism for external imbalances. Japan, for example, experienced a fall of 0.5% in its manufacturing unit labour costs in 1989, while its trading partners experienced increases of more than 3% on average. In spite of this divergence, the trade-weighted value of the yen depreciated by more than 5% and was the single largest component of the sharp rise (of almost 9%) in Japanese international competitiveness. Further weakness of the yen exchange rate

Exchange rates amplified the divergences in national unit labour costs last year in the spring of this year in spite of a large external surplus and tighter monetary conditions heightens this concern.

Over longer periods, however, exchange rate changes have generally narrowed or reversed differences in unit labour cost trends between countries. In the 1969–82 and 1982–89 periods, during which exchange rate swings were substantial, currency movements followed this pattern in all of the major industrial countries except the United States. The trade-weighted value of the US dollar depreciated on average during these periods even though unit labour costs in the United States were rising at a somewhat slower rate than in many other countries, partly owing to structural factors. The general trend among the major industrial countries in the 1970s and 1980s, however, was that currency depreciation was experienced in countries with relatively high unit labour cost increases (France, the United Kingdom, Italy and Canada) and appreciation in countries with low unit labour cost increases (Germany and Japan). For example, the table shows that relatively low unit labour cost growth in Japan in the 1969–82 and 1982–89 periods was more than offset by yen appreciation, leading to a decline in Japan's international competitive position measured on this basis.

Developments in less developed countries

Output and real income growth

Sharp decline in real output growth in Asia ...

Two features characterised output and real income developments in the LDCs last year (see the table opposite): firstly, overall output growth fell compared with 1988, but entirely owing to a slowdown in the Asian countries; secondly, external factors were generally less favourable than in 1988 as international interest rates rose, and the growth of export volumes declined (see the table on page 36). Moreover, favourable terms-of-trade changes were largely confined to the oil-exporting countries, whereas exporters of non-oil primary products experienced a deterioration and exporters of manufactured goods only a small gain. The slowdown in export volume growth was especially marked in the Middle East and Latin America, while the African countries experienced the fastest volume growth since 1984.

... is primarily caused by developments in China and India ...

The slowdown in real output growth in *Asia* – the first since 1985 – was dominated by developments in China and India, which accounted for more than 80% of the overall decline. Following an average expansion of more than 11% over the previous five years and faced with growing inflationary pressures and a widening external deficit, the Chinese authorities curbed credit growth and raised interest rates to more than 10% in real terms. As a result, private demand weakened and GDP growth was reduced to 4%, with the slowdown having a particular impact on rural private enterprises and the number of unemployed and underemployed workers, which rose to an estimated 13½% of the labour force. Early this year, however, the austerity programme was eased, especially for rural industries. In India last year's developments mainly reflected weaker industrial growth, while agricultural output set a new record. Nonetheless, there was no relief from inflationary pressures, and the budget deficit, at 8½% of GNP, was 50% higher than expected. Moreover, despite a vigorous rise in exports, the ratio of foreign debt to GNP increased to almost 25%, compared with only 12% in 1980.

... and in the NIEs

A second centre of the slowdown in Asia was the NIEs, where most of the fall in output growth was due to developments in South Korea. Undermined by a 21% rise in nominal wages, shorter working hours and an appreciating exchange rate, international competitiveness fell sharply and the contribution of net exports to real output growth declined to −6½%. Nonetheless, as a result of buoyant domestic demand, led by private consumption and business fixed investment, GDP growth, at 6½%, exceeded the average for Asia but was down sharply from the 11½% rate recorded for the previous three years. Slower export growth also contributed to some cooling-off in Singapore and Hong Kong. In Taiwan changes in net exports provided a negative contribution for the second consecutive year. However, due to a fall in the national saving rate to 31½% (still one of the highest in the world), consumption grew strongly. Boosted also by fixed investment, GDP growth, at 7½%, was slightly

GDP growth in developing countries

Countries and country groups	1987 GDP in billions of US$	1978–84 average	1985	1986	1987	1988	1989	Per capita 1980–89 average
		percentage changes						
Africa	224	3.4	3.9	2.3	0.9	3.3	3.2	−0.2
Nigeria	24	−1.8	7.9	3.2	1.8	4.2	4.0	−3.0
Sub-Saharan countries	112	2.3	2.8	2.3	0.7	2.6	3.0	−0.4
Middle East	465	1.8	−1.2	−0.2	0.0	1.1	2.0	−2.3
Egypt	33	7.3	6.7	2.7	2.5	5.9	5.0	3.8
Asia	1,138	6.2	6.2	6.9	8.3	9.4	5.2	5.3
China	297	8.3	13.1	8.3	10.6	11.2	3.9	7.7
India	256	3.8	5.1	4.0	3.6	10.4	4.5	3.3
Indonesia	65	6.2	2.5	5.9	4.8	5.7	6.2	2.7
Thailand	47	5.8	3.5	4.5	8.0	13.2	11.0	5.0
NIEs	293	7.4	3.7	10.6	12.1	9.2	6.3	6.9
Latin America	788	2.0	4.1	4.5	3.1	0.4	0.7	−0.5
Brazil	315	2.4	8.3	7.6	3.6	0.0	3.6	−0.0
Mexico	140	4.1	2.7	−3.8	1.5	1.1	3.0	−1.0
Argentina	77	0.3	−4.4	5.5	1.9	−3.1	−5.5	−2.9
Chile	17	2.2	2.4	5.7	5.7	7.4	9.3	0.9
Peru	44	0.6	1.9	9.5	6.9	−8.8	−12.2	−3.6
Venezuela	48	−1.2	1.3	6.8	3.0	5.7	−8.1	−2.6
All developing countries*	2,615	3.9	4.1	4.6	4.5	4.7	3.2	1.8

* Calculated using 1987 GDP weights and exchange rates.

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

higher than in 1988. At the same time, helped by booming domestic demand in the NIEs, a marked rise in foreign direct investment and a continued expansion of the non-oil sectors, Indonesia recorded a second year of nearly 6% growth, and in Thailand real GDP increased by around 11% for the third consecutive year, confounding earlier and lower estimates of potential output, but also creating bottlenecks in the market for skilled labour.

Continued stagnation in Latin America

In *Latin America* average GDP growth was slightly higher than in 1988, but not enough to prevent a further decline in per capita income to 8% below its 1980 peak. The decline was most pronounced in countries with hyperinflation (Argentina and Peru) or undertaking anti-inflationary programmes. Among the latter the downturn was especially marked in Venezuela, which was forced to reverse its earlier policy of supporting domestic demand by running down foreign exchange reserves while keeping the exchange rate at an unsustainable level. Output picked up somewhat in Brazil despite a sharply accelerating rate of inflation. This was partly the result of advance purchases in anticipation of future price increases, but also reflected some positive effects of a stabilisation programme introduced early in 1989 (the "Summer Plan"). Towards the end of last year output was falling. By contrast, in Mexico output growth rose in the course of the year as the stabilisation programme strengthened confidence and capital inflows stimulated business fixed investment. In Chile GDP growth exceeded 9%, reflecting expansionary policies and improved confidence in the private sector.

Some upturn in the Middle East ...

... but a bleak picture in Sub-Saharan Africa

While the growth performance of the oil-exporting *Middle Eastern* countries was boosted by higher oil prices and a rise in world demand for oil, unfavourable terms-of-trade developments – mainly due to falling prices for tropical beverages – had a negative effect on real income growth in the *Sub-Saharan African* countries. Moreover, rapid population growth caused a further fall in per capita income to a level below that of the mid-1960s. Last year's outcome can thus be seen as the latest episode in a long period of declining economic performance which can primarily be ascribed to: (i) a

External influences on output developments

By region	Terms of trade				Export volumes			
	1981–86 average	1987	1988	1989	1981–86 average	1987	1988	1989
	percentage changes							
Africa	– 7.8	2.1	– 5.5	–0.7	3.5	0.2	2.1	6.1
Middle East	–13.0	8.6	–19.2	8.0	–5.7	3.1	15.3	7.0
Asia	0.1	2.8	0.8	1.1	8.3	19.9	13.0	10.0
Latin America	– 4.7	–2.0	– 2.2	1.3	2.5	7.8	10.4	2.9
All developing countries*	– 3.8	3.0	– 3.9	2.3	4.2	13.0	12.0	7.9

* Calculated using 1987 export weights and exchange rates.

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

falling investment share in output, caused by high capital and operating costs and low saving and compounded in the 1980s by a decline in the return on investment to only 2.5%, compared with more than 20% in other LDCs with similar per capita income levels; (ii) an incentive structure biased against agriculture, owing to overvalued exchange rates and price regulation; together with the lack of a diversified export base, but also influenced by poor harvests following severe droughts, this has contributed to low growth of exports and a declining share of world trade, even in markets for non-oil commodities; (iii) frequent terms-of-trade shocks which, though in the long run quantitatively less important than the poor export performance, have created an environment of uncertainty; (iv) overstaffed public sectors, which have distorted the price/wage structure through trade taxes, subsidies and, until recently, high real wages for civil servants; furthermore, price and wage regulation and inefficient public enterprises have biased growth in favour of the urban sectors and encouraged the development of an "informal sector" of smaller enterprises which are more responsive to market signals but produce mainly services and other non-tradables; (v) a growing external debt and a debt service/ export ratio of nearly 50% (though effectively only around 25% because of arrears); and (vi) high rates of population growth, aggravating the dependence on food imports and reducing saving and investment.

Inflation in the developing countries

Countries and country groups	1978–83 average	1984	1985	1986	1987	1988	1989
	percentage changes in consumer prices						
Africa and Middle East	14.0	14.0	7.0	11.5	17.0	18.5	17.0
Egypt	14.4	17.0	12.1	23.9	19.7	17.7	21.3
Nigeria	14.7	39.6	5.5	5.4	10.2	38.7	42.5[1]
Asia	8.2	7.0	7.3	9.4	9.7	14.5	12.0
China	3.2	2.7	11.9	7.0	8.8	20.7	19.0
India	10.2	8.3	5.6	8.7	8.8	9.4	8.4
Philippines	13.8	50.3	23.1	0.8	3.8	8.8	10.5
South Korea	15.8	2.3	2.5	2.8	3.0	7.1	5.8
Latin America	71.5	133.5	145.0	88.0	131.0	286.0	531.0
Argentina	174.7	626.7	672.1	90.1	131.3	343.0	3,096
Brazil	96.2	197.0	227.0	150.0	219.0	582.0	1,325
Mexico	46.6	65.5	57.7	86.2	131.8	114.2	19.7
Peru	75.4	110.2	163.4	77.9	85.8	669.0	3,388
All developing countries[2]	29.0	47.0	48.5	33.5	48.0	97.0	170.0

[1] Estimated. [2] Calculated using 1987 GDP weights and exchange rates.
Sources: IMF International Financial Statistics, World Economic Outlook and national data.

Inflation

Accelerating inflation in Latin America ...

The price performance of LDCs last year was dominated by developments in Latin America (see the table above), where in three of the largest countries (Brazil, Peru and Argentina) the rise in consumer prices attained four-digit rates. Several countries with relatively favourable inflation records (Venezuela, Chile and Paraguay) also experienced a worsening in price performance. The rise in inflation had several causes. Excess demand pressures developed in Chile, while in Venezuela the acceleration was the result of the reversal of policies mentioned above. Moreover, higher tariffs and lower subsidies contributed to price inflation in countries attempting to reduce their fiscal imbalances. However, the most important cause last year, especially evident in the three countries with hyperinflation, was the loss of confidence in the authorities' ability to correct past policy mistakes and implement stabilisation programmes. Thus signs of accelerating inflationary expectations were evident in sharp jumps in nominal interest rates and widening gaps between official and unofficial exchange rates.

... but progress made in some countries

At the same time, some countries made impressive progress in curbing inflation. Bolivia and Ecuador managed to reduce price inflation through restrictive demand policies. In Mexico the extension of the stabilisation programme introduced in December 1987 helped to bring down the rate of price inflation to only 20% last year, even though minimum wages and public tariffs were raised and the peso allowed to fall against the US dollar. In March this year the new Government of Brazil introduced an anti-inflationary plan designed to break the inflationary cycle at its source and including as the main ingredients a thirty-day price and wage freeze (to be followed by controls), a severe liquidity squeeze with an eighteen-month freeze of most savings and financial assets and various measures to reduce the public sector deficit. Outside Latin America, inflation rose in Nigeria and the Philippines due to higher oil prices and depreciating exchange rates, while in South Korea and China the rate of price increase started to come down as a result of tighter monetary policies and curbs on nominal wage growth.

Resource transfers and adjustment patterns

The external and internal transfer problem

One of the most serious problems facing many – though not all – developing countries in the 1980s has been the fall in net capital inflows (see Chapter V), coinciding with higher net interest payments. In the 1970s most LDCs financed their saving shortfalls through capital inflows, but as this proved unsustainable and their creditworthiness deteriorated they had to take corrective measures in order to balance their current accounts. Adjustment to this new situation required policies aimed at boosting exports and reducing imports, complemented by measures to stimulate national saving relative to investment. Moreover, because governments or public enterprises owed a major part of the external debt, the rise in debt servicing costs increased public sector borrowing requirements. To consolidate the current external account and prevent inflationary pressures it was, therefore, also necessary to raise private net financial saving and reduce the primary budget deficits (i.e. the deficits before interest payments).

Developments since 1980 ...

In the 1980s LDCs have thus faced two interrelated transfer or adjustment problems; the table opposite illustrates how these problems evolved during three phases:

... in all LDCs ...

– the years up to 1982, marked by increasing net interest payments and lower exports, in part also reflecting the recession in the industrialised world. On the domestic side, the rise in net interest payments led to higher government deficits, and despite some improvement in the financial balance of the private sector, national saving fell sharply;

– a second phase up to 1986–87, when the current account was gradually brought close to balance, but primarily through import compression. On the domestic side, the import compression was accompanied by a reduction in capital formation, while the adjustment of financial balances was confined to the private sector. Indeed, by 1987 central government borrowing requirements were higher than in 1982;

– the recent phase, characterised by higher exports but an even stronger

Net resource transfers and changes in financial balances

Country groups and years	Ex	Im	Int	BoP	I	S	S_p-I_p	S_g-I_g
	as a percentage of GNP/GDP							
All LDCs[1]								
1980	19.9	20.6	−2.3	−3.0	26.6	23.6	−0.5	−2.5
1982	19.2	20.4	−3.3	−4.5	24.5	20.0	0.5	−5.0
1986	18.8	18.2	−3.0	−2.4	23.9	21.5	3.6	−6.0
1987	20.3	18.4	−2.7	−0.8	24.7	23.9	5.3	−6.1
1988	19.6	17.9	−2.7	−1.0	25.1	24.1	5.1	−6.1
1989	21.1	20.0	−2.8	−1.7	24.2	22.5	5.4	−7.1
Latin America								
1980	17.9	18.8	−3.5	−4.4	23.4	19.0	−2.2	−2.2
1984	20.7	15.4	−5.5	−0.2	16.6	16.4	4.7	−4.9
1987	16.4	14.0	−3.8	−1.4	19.8	18.4	7.9	−9.3
1988	15.7	13.1	−3.8	−1.2	20.8	19.6	8.1	−9.3
1989	17.2	14.6	−3.9	−1.3	19.6	18.3	11.5	−12.8
Asia								
1980	25.8	26.6	−1.2	−2.0	29.0	27.0	1.3	−3.3
1982	27.1	27.5	−1.7	−2.1	27.1	25.0	2.1	−4.2
1986	32.0	29.5	−2.0	0.5	29.0	29.5	4.4	−3.9
1987	37.1	33.0	−1.8	2.3	29.2	31.5	5.9	−3.6
1988	38.6	36.0	−1.7	0.9	29.2	30.1	4.4	−3.5
1989	41.0	39.1	−1.7	0.2	28.7	28.9	3.7	−3.5
Sub-Saharan Africa[2]								
1980	29.7	36.0	−2.2	−8.5	19.8	11.3	−1.0	−7.5
1981	27.9	34.9	−2.8	−9.8	20.9	11.1	−2.9	−6.9
1985	28.2	28.9	−2.9	−3.6	18.4	14.8	1.7	−5.3
1988	26.2	31.0	−2.5	−7.3	18.0	10.7	−0.7	−6.6
1989	29.1	33.2	−3.0	−7.1	17.6	10.5	−0.8	−6.3

Note: Calculated using the national income accounting identity expressed as a percentage of GNP/GDP:
$Ex-Im-Int \equiv BoP \equiv S-I \equiv (S_p-I_p)+(S_g-I_g)$
where Ex = exports of goods and services, Int = net interest payments, BoP = balance on current external account, S = national saving, I = total investment, (S_g-I_g) = central government net lending. To ensure consistency, Im = imports of goods and services measured as Ex−Int−BoP, and (S_p-I_p) = private sector net lending as BoP−(S_g-I_g).

[1] World Bank definition excluding European countries. [2] Excluding Nigeria.

Sources: World Bank World Debt Tables and IMF World Economic Outlook.

rise in imports resulting in a larger current-account deficit. This deterioration in the current external account has not been associated with higher investment but with weaker national saving, with government borrowing requirements showing a further rise.

... Latin America ...

Looking at different regions, *Latin America* faced the steepest rise in net interest payments, which reached 5½% of GNP in 1984, or 2 percentage points more than in 1980. However, through a combination of severe import compression and some rise in exports the current-account deficit was almost eliminated. On the domestic side, the public sector borrowing requirement rose and the national saving rate declined, so that a lower rate of capital formation was the principal domestic counterpart to reducing the external imbalance. The next five years marked a period of stagnation or even worsening on the external side, while domestically the investment ratio and the national saving rate returned to levels of 19–20% of GNP, which could be sufficient to ensure output growth of around 4% per year. However, the public sector borrowing requirement has increased to almost 13% of GNP and a growing share is being financed domestically at very short maturities, fuelling inflation. Imports have stabilised, but exports have weakened and this has offset the fall in net interest payments, which was, moreover, partly the result of growing arrears and/or debt rescheduling.

... Asia ...

In *Asia* the deterioration in the current account during the initial phase was small and mainly due to higher imports. In the course of 1982–86 the current-account balance was turned into a surplus, thanks to a sharp rise in exports. Supported also by a higher national saving rate – primarily in the private sector – the Asian countries were able to raise investment and create the capacity for further expansion. The rise in exports was also high during the recent phase, but was exceeded by that of imports, as in a number of countries export-led growth gave way to domestic demand-led growth. This was also reflected in some weakening of the private and national saving rates, whereas the public sector borrowing requirement was limited to 3.5% of GNP.

... and Sub-Saharan Africa

A major feature of developments in *Sub-Saharan Africa* has been the failure to generate a domestic adjustment which would consolidate initial progress on the external side. The current external deficit fell by as much as 6% of GNP between 1981 and 1985, but this was achieved in conditions of weak output growth and mainly by compressing imports and investment. The absence of a more fundamental domestic adjustment became more evident in the 1985–89 period as both public and private financial balances declined and the national saving rate fell to only 10½% of GNP. During this period imports started to rise, but, against the background of stagnant investment, the increase mainly reflects a failure to expand output sufficiently to satisfy current consumption needs.

Adjustment patterns and country cases

Typical patterns

The differences in external and internal changes discussed above may be illustrated by grouping indebted countries according to four adjustment patterns.

(i) neither external nor internal adjustment;

A *first group* characterised by difficulties both in balancing the current external account and in controlling the fiscal deficit. Many Sub-Saharan countries are in this group and, as noted above, the external and internal imbalances can be related to low output growth and falling saving and investment ratios, whereas in most cases the rate of inflation has been relatively moderate. This group also comprises countries such as *Peru* and *Argentina*, where the clearest sign of the adjustment failure is a vicious circle of accelerating inflation and falling real growth. Growing monetary financing of the public sector deficit has been a primary source of inflation and, combined with attempts to maintain fixed parities, has generated a real appreciation. Eventually the authorities were forced to devalue the exchange rate, which, in turn, triggered a new round of price and wage increases. In such conditions, saving and investment incentives tend to weaken, with further adverse consequences for real growth.

(ii) external adjustment, but no domestic counterpart;

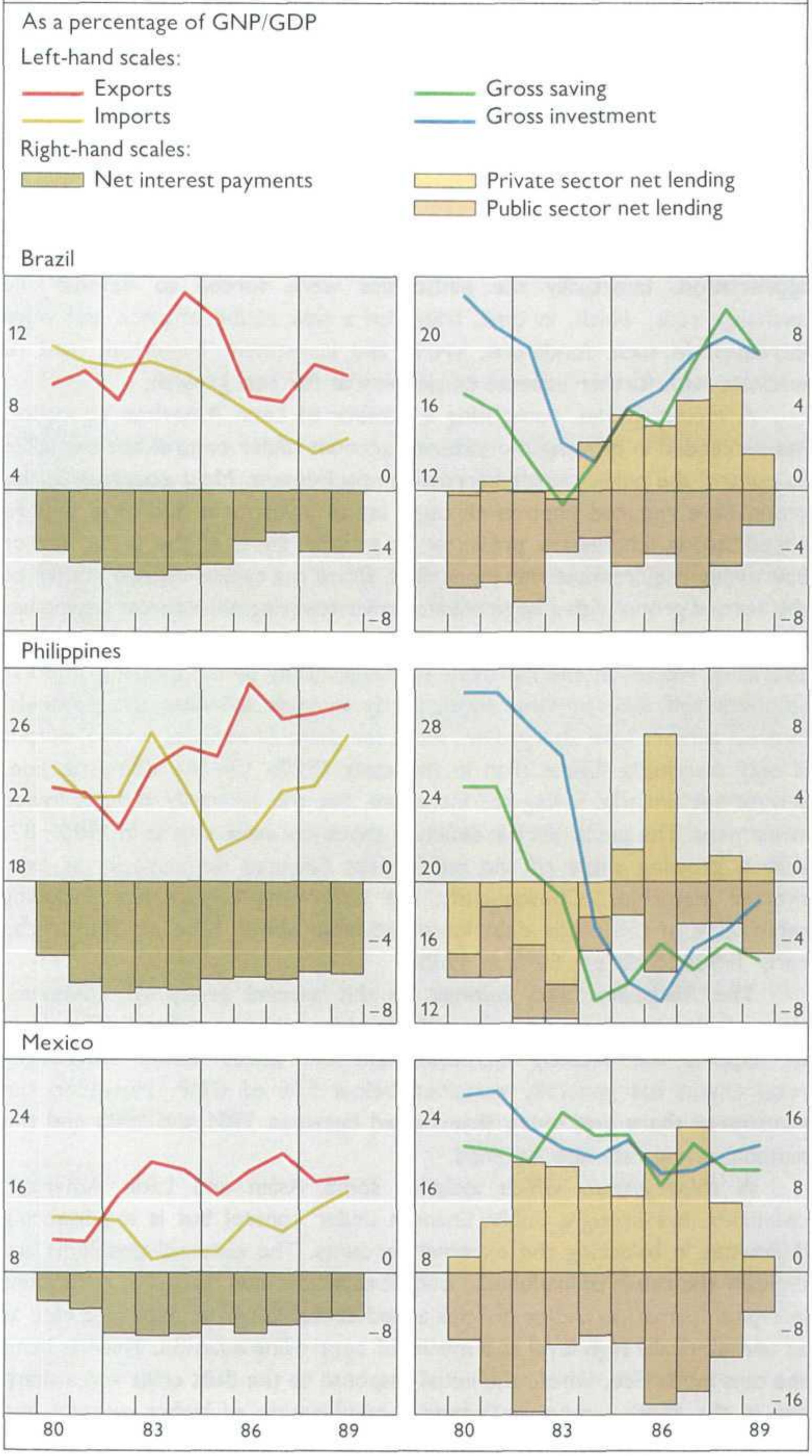
A *second group*, comprising a number of Latin American countries, has succeeded in bringing the external account under control but has failed to control the public sector borrowing requirement. Most countries in this group have reduced imports through lower investment and have experienced strong inflationary pressures as a rising share of the public sector borrowing requirement was monetised. *Brazil* is a typical representative of this second group with a large trade surplus covering net interest payments, in sharp contrast to the situation prior to the debt crisis (see the graph overleaf). However, this has been achieved mainly by compressing imports to about half their previous level, partly through administrative controls. Interest arrears have also grown, while the share of exports in total output is only marginally higher than in the early 1980s. On the domestic side, private net financial saving has increased, but this primarily reflects lower investment. The public sector deficit is about the same size as in 1980–82, with a growing share of the public debt financed domestically at ever shorter maturities. Consequently, the borrowing requirement including refinancing of the public debt increased from about 12% of GNP in the early 1980s to almost 50% in 1988.

The *Philippines* also belongs to this second group of countries, although developments there have differed from those of Brazil. The share of exports has steadily increased and the public sector borrowing requirement has generally remained below 5% of GNP. However, the investment share was more than halved between 1981 and 1985 and the national saving rate also declined.

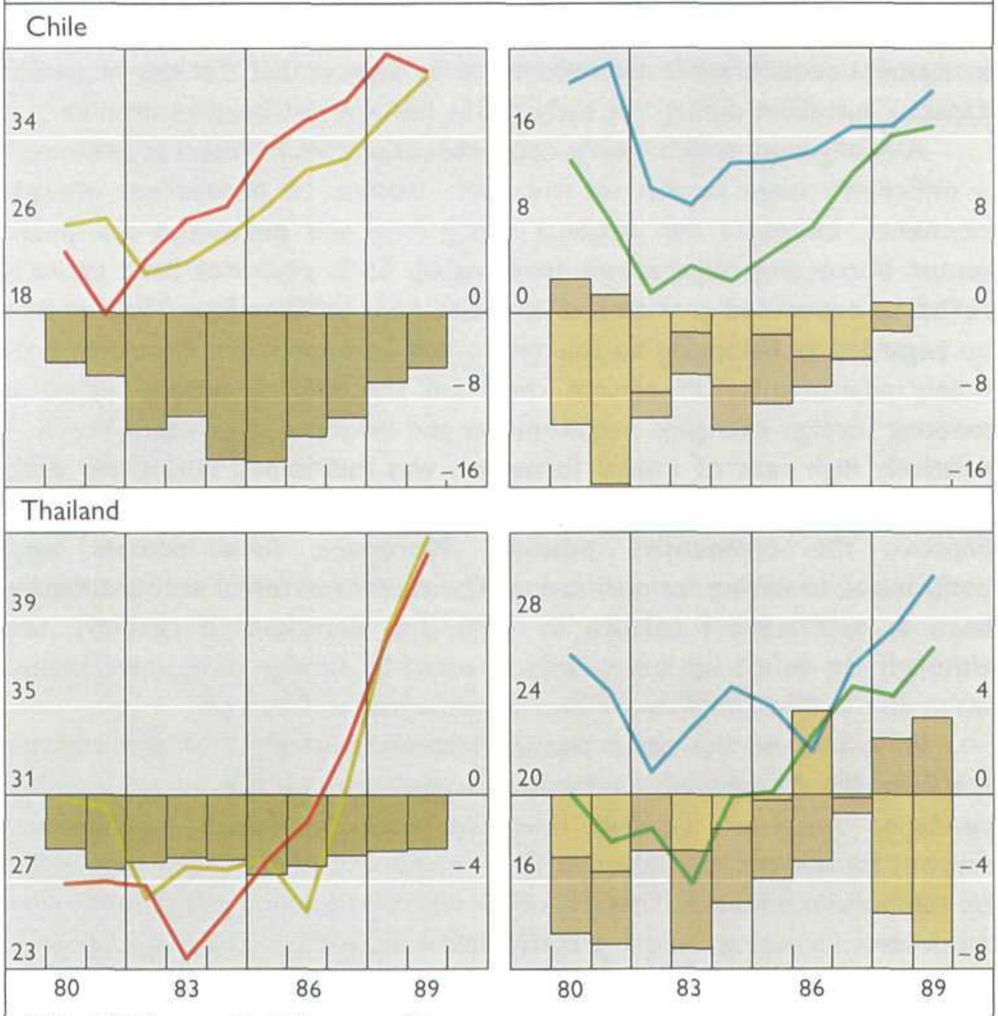
(iii) domestic adjustment, but fragile external balance; and ...

A *third group*, which includes some Asian and Latin American countries, has brought public finances under control but is experiencing difficulties in balancing the external accounts. The external problems are typically the result of inadequate output capacities due to earlier reductions in capital formation and/or policies aimed at stabilising the exchange rate at an unrealistically high level as a means of controlling inflation. This has been the case in *Mexico*, where the initial response to the debt crisis was a sharp rise in the trade surplus, reflecting a combination of higher exports and import compression. Since then the trade balance has weakened. One

Net resource transfers and changes in financial balances*



Net resource transfers and changes in financial balances* (continued)



* For definitions see the table on page 39.

Sources: World Bank World Debt Tables, IMF International Financial Statistics, Inter-American Development Bank and national data.

reason, of course, has been the decline in oil revenues, but, in addition, imports have been liberalised and attempts to stabilise the nominal exchange rate as part of a broad incomes policy agreement have been accompanied by some appreciation of the real exchange rate. There are also signs that the domestic adjustment remains fragile. The national saving rate has not increased sufficiently to offset the rise in net interest payments, though this may be due in part to the fall in per capita real income (15% since 1981). Moreover, despite a more restrictive fiscal policy and a surplus on the primary budget, the public sector borrowing requirement is still almost 6% of GNP, as efforts to reverse the flight of capital by increasing real interest rates also raised the interest burden on the domestically held part of the public debt.

Chile can also be included in this group, even though the adjustment patterns have differed considerably from those observed in other Latin American countries. The export share fell sharply in the early 1980s, but has increased since then, though not sufficiently to meet net interest payments. The domestic adjustment clearly reflects the steep fall in real incomes in the early 1980s, when the national saving rate declined to less than 2%. Despite a subsequent recovery, saving is still low relative to investment requirements and recent trends suggest that the loss of output capacity sustained during the early 1980s has not yet been recovered.

... (iv) both external and internal adjustment

A *final group*, which mainly comprises countries in Asia, has generated a sufficiently large surplus on the trade balance to finance net interest payments, increased the national saving rate and prevented the public sector borrowing requirement from rising. Such countries have typically relied on export-led growth and have also kept inflation low. *Thailand* may be regarded as belonging to this group and its experience illustrates how timely adjustments can obviate the need for policies directly aimed at meeting foreign exchange requirements and involving large social costs. A relatively high rate of capital formation was maintained during the early 1980s and a stable monetary policy has helped to keep inflation low and improve the competitive position. Moreover, fiscal policies have contributed to raising national saving. The current external account, having been in approximate balance in 1986, has deteriorated recently, and although the deficit has been easily financed by foreign direct investment, some rise in household saving may nonetheless be required.

In several of the cases discussed above the origin of the transfer problem can be related to factors largely beyond the control of the countries concerned. Typically, however, success or failure in achieving a smooth adjustment has depended less on the size of the initial shock than on the policies adopted. Thus countries which responded quickly and relied on policies favouring export growth have managed to "grow out of" their debt and transfer problems. By contrast, in countries which have failed to adopt adjustment policies, both the external and the internal problems have tended to become more burdensome over time.

Eastern European economies: the process of economic reform

A general move towards market economies

All eastern European countries are currently undergoing a radical transformation in every area of political, social and economic life. Most of these countries have now committed themselves to moving away from the socialist economic system and developing market economies similar to those in western industrial countries. Although economic conditions and reform strategies differ considerably from one country to another, they all share the legacy of central planning and therefore face the same set of fundamental issues and challenges.

The purpose of this section of the Report is to discuss these issues and challenges in a broader context, taking into account both some aspects of economic performance in eastern Europe and the rules and structures that have evolved in these countries under a regime of central planning. Indeed, without such a review it is difficult to understand the immense complexity of the task facing them, which involves not only reforming the economic system but also changing attitudes and economic behaviour.

The twin problems of supply inefficiency and macro-economic imbalances

Statistical and conceptual factors ...

An analysis of the economic performance of eastern European countries is greatly hampered by two factors. Firstly, there are various statistical problems arising from the lack of data and the use of statistical concepts which are not easily comparable with those in western countries. Secondly, under a system of central planning, where prices are regulated, full employment is ensured and external transactions are firmly controlled, there are no "visible" statistical indicators of macro-economic disequilibria. Instead, imbalances are reflected in such phenomena as supply shortages, queues and black markets for foreign exchange and high-quality imports which usually elude precise measurement.

... render it difficult to compare economic performances in the East and West

Indeed, in most of the eastern European countries the available official statistical information does not provide a realistic picture of the economic situation. In particular, national data on output growth offer no explanation for the evident shortfalls in supply and the gap in the standard of living vis-à-vis western industrial countries. Although output growth has slowed down considerably in recent years, between 1960 and 1989 the combined output of all eastern European countries is reported to have risen at an average annual rate of 5%, compared with only 3.3% in the countries of the European Community (see the table below). The divergence is even more striking over the longer term: for example, since 1950, when per capita income in the German Democratic Republic may have been no more than 20% lower than that in the Federal Republic of Germany, the growth of overall output or of the output of major sectors (which are directly comparable) in the Federal Republic has been much slower than that reported for the German Democratic Republic. By contrast, some broad indicators of consumption suggest that the relative standard of living – especially if the significant quality differences are taken into account – must have moved in the opposite direction (see the table on page 46).

Reported output growth in eastern and western Europe

Items	1960–70	1970–75	1975–80	1980–85	1985–89	1960–89
	percentage changes, annual rates					
Output growth:*						
Eastern Europe	6.8	6.1	4.3	2.8	2.6	5.0
European Community	4.8	2.9	2.9	1.5	3.1	3.3

* Net material product for eastern Europe (Bulgaria, Czechoslovakia, the German Democratic Republic, Hungary, Poland, Romania and the Soviet Union) and GNP/GDP for the twelve countries of the European Community.

Sources: UN Economic Commission for Europe, The Vienna Institute for Comparative Economic Studies and European Community.

There are several reasons why output measures in eastern Europe overstate real economic performance. The concept of net material product (NMP) used in a centrally planned economic system indicates only the value of physical production and of services related to the delivery of

Economic indicators reported by the Federal Republic of Germany and the German Democratic Republic		
Items	Federal Republic of Germany	German Democratic Republic
GNP per capita, 1950 (in national currency):	2,100	1,675
Average annual output growth, 1950–88 (in percentages):		
GNP/NMP	5.0	5.9
Agriculture	1.8	2.2
Construction	3.4	7.0
Mining and energy	2.5	7.3
Manufacturing	5.1	
Indicators of standard of living (1988):		
Passenger car[1]	97	52
Colour television[1]	94	52
Telephone[1]	98	16
Living space[2]	33	27

[1] Percentage of households. [2] Per person in square metres.

Sources: Statistisches Jahrbuch für die Bundesrepublik Deutschland and Statistisches Jahrbuch der Deutschen Demokratischen Republik.

goods. It excludes "non-material" services, such as health, education and banking, which form part of GDP but which have remained relatively underdeveloped in eastern Europe. More importantly, the measurement of production is also greatly affected by the distorted price structure. New products, especially durable consumer goods, the output of which tends to grow rapidly, are assigned high relative prices in eastern European countries and therefore have an excessive weight in production indices. At the same time, it is a widespread practice among eastern European enterprises to make slight modifications in the design of existing products in order to be able to raise prices. This is an easy way of increasing the value of output and fulfilling plan targets without actually expanding production or improving its quality. As the price changes are not taken into account in consumer price indices or output deflators, the substitution of new products for old ones results in exaggerated output growth figures.

Reasons for overstated output growth ...

Indeed, several factors suggest that production in eastern Europe is much less efficient than in western industrial countries. For example, the available evidence indicates that during the 1980s stockbuilding averaged 2–3% of annual output in eastern European countries, a much higher proportion than in market economies; fixed investment, which constitutes a larger share of total output than in western countries, appears to be misdirected towards less productive areas – an impression confirmed by the disappointing results of hard-currency-financed investment undertaken by a number of countries in the 1970s; and total energy consumption per capita appears to considerably exceed that in the West, pointing to far more energy-intensive production methods.

... and factors indicating supply inefficiencies

The weakness of the supply side of eastern European countries is also reflected in their trade performance. Convertible currency exports of

Savings and wages in eastern and western Europe

Countries	1973			1988		
	Savings deposits per capita[1]	Average monthly wages[1]	Ratio	Savings deposits per capita[1]	Average monthly wages[1]	Ratio
Bulgaria	700	140	5	1,900[2]	235[2]	8[2]
Czechoslovakia	6,650	2,160	3	17,000	3,050	5½
German Democratic Republic	3,930	835	4½	9,090	1,280	7
Hungary	5,940	2,510	2½	31,900	8,800	3½
Poland	6,100	2,800	2	96,800	51,800	2
Romania	1,700	1,390	1	7,300[3]	2,860[3]	2½[3]
Soviet Union	275	135	2	1,040	215	5
Germany	6,830	1,560	4½	20,120	3,170	6½
France	8,620	2,140	4	47,300	9,790	5
United Kingdom	940[4]	260[4]	3½[4]	4,940	820	6
Italy	921,580	206,220	4½	9,004,500	1,815,000	5
Spain	69,100	17,350	4	751,820	135,200	5½

[1] In national currency units. [2] 1987. [3] 1986. [4] 1975.

Sources: UN Economic Commission for Europe and national data.

manufactured goods from these countries rose by 16% between 1981 and 1987, less than half the rate of growth in world trade in manufacturing during the same period. This development is especially striking in view of the growing debt problems faced by several countries during this period, since these problems might have been expected to encourage planners to divert resources to the export sector.

The inflexibility of the supply side is the principal cause of low standards of living and growing macro-economic imbalances. In a market economy such imbalances are revealed by price, interest rate, employment and balance-of-payments developments, which in turn set in motion equilibrating adjustments in demand and supply. No such mechanisms exist in a centrally planned system, where – with public consumption and the bulk of investment spending being controlled by the plan – disequilibria develop primarily in the consumer market. Adjustments to mismatches between demand and supply in the consumer goods markets have often been slow or non-existent, resulting on the one hand in the extension of credit and growing subsidy payments to unprofitable enterprises and, on the other, rising inventories of unsold output, a proliferation of black markets and a build-up of excess demand in the form of "involuntary" holdings of currency and savings deposits.

Macro-economic imbalances reflected in …

Although it is difficult to gauge the extent and severity of macro-economic imbalances in eastern European countries, there can be little doubt that owing to the lack of financial discipline at the micro and macro-economic levels a monetary overhang has developed in most countries. The impression that excess demand is widespread is, for example, supported by the sharp price rises which occurred in the wake of market liberalisation. In Hungary, where price reforms have been undertaken gradually, inflation accelerated from 5.3% in 1986 to 17% in 1989 and in Poland, where the liberalisation was rather abrupt, hyperinflation emerged during the final months of 1989.

... a monetary overhang ...

The table on page 47, which relates per capita savings to average monthly wages, attempts to give some broad indication of the reservoir of purchasing power accumulated by the population in individual eastern European countries. Perhaps somewhat surprisingly, with the exception of Bulgaria and the German Democratic Republic, these balances do not appear abnormally high when compared with household savings in western European countries. However, in assessing the potential excess demand several factors have to be taken into consideration. A significant part of total liquid balances is likely to be held in the form of cash, but data on the public's currency holdings are not available for all countries. Moreover, the underlying motives of saving behaviour are of critical importance. On the one hand, if savings balances reflect mainly the lack of alternative financial assets, their size would not necessarily point to the existence of a monetary overhang in eastern Europe. On the other hand, as the return on savings deposits is usually very low, the balances may not be the result of a rational choice between present and future consumption but simply a reflection of supply shortages. In that case it would seem doubtful that large savings balances would be maintained once the availability of supplies was no longer constrained by price controls.

... and weak external positions and foreign indebtedness

Finally, the existence of imbalances is also indicated by the weakness of the external positions and the high levels of foreign indebtedness of most eastern European countries. However, in most cases the emergence of current-account deficits in convertible currencies owed much to deliberate, large-scale imports of machinery and equipment in an effort to modernise

Estimated current-account balances and external debt in convertible currencies

Countries and country groups	Current-account balance							External debt			
	1970–75	1976–80	1981–85	1986	1987	1988	1989	1980	1985	1988	1989
	in billions of US dollars										
Bulgaria	− 1.1	1.1	2.4	−0.9	0.0	−0.7	−0.8	3.5	4.0	7.7	10.8
Czechoslovakia	− 0.9	− 2.7	1.8	0.2	−0.3	−0.4	−0.3	4.9	4.6	6.7	7.9
German Democratic Republic[1]	− 2.6	− 6.3	3.7	0.8	0.7	0.6	−0.2	14.4	13.2	19.8	20.6
Hungary	− 1.4	− 3.6	−0.7	−1.4	−0.9	−0.8	−1.4	9.1	14.0	19.6	20.2
Poland[2]	− 6.4	−15.3	−7.3	−0.6	−0.4	−0.6	−1.8	24.1	29.3	39.2	41.4
Romania	− 1.5	− 5.3	3.1	1.3	1.9	2.2	2.0	9.6	6.6	2.9	0.3
Soviet Union	− 0.8	6.9	14.9	1.0	4.0	3.1	−1.0	27.5	25.2	46.8	49.2
Eastern Europe	−14.7	−25.2	17.9	0.4	5.0	3.4	−3.5	93.1	96.9	142.7	150.4
European Community[3]	*6.3*	*−40.0*	*−4.0*	*51.5*	*34.9*	*16.1*	*2.4*	..	..	..	..

[1] Includes transactions with the Federal Republic of Germany. [2] Current-account estimates include interest due, whether paid or not. For example, cumulative interest actually paid in the three years from 1987 to 1989 totalled $3 billion, with arrears and relief on interest payments amounting to about $6½ billion. [3] The present twelve member countries.

Sources: IMF, UN, OECD, The Vienna Institute for Comparative Economic Studies and national data.

the industrial sector and, to that extent, cannot be viewed as a spillover of excess demand pressure into the external accounts.

The principal features of a centrally planned economy

In the immediate post-war period all eastern European countries adopted a system of central planning closely modelled on that of the Soviet Union. Although attempts at reform have been made in a number of countries in the past, until recently the economies continued to operate largely within the broad framework of the original model.

The central role of the plan ...

The most important features of a centrally planned economy are that most means of production are state-owned and that decisions on what to produce, how to divide the social product between consumption and investment and how to allocate inputs are made in the context of a comprehensive plan. The plan is executed on the basis of directives which specify the allocation of resources, i.e. through a system of "material balancing" under which quantities of inputs are made available to enterprises on the basis of estimated needs for fulfilling production targets. The plan is thus both a document stating the authorities' policy objectives and an instrument for realising them.

... and consequences for prices and money

The emphasis on material balancing has two crucial implications. Firstly, there is no need either for a mechanism to bring about equilibrium between the demand for and the supply of inputs in the process of production, or for information to assess opportunity costs of production. Prices are not expected to clear markets and are thus fixed administratively, held constant over prolonged periods, and essentially serve only accounting purposes. Secondly, money does not represent an unequivocal claim on real resources. While physical movements of goods and services have counterpart payments passing through the banking system, these financial transactions are not permitted to interfere with plan fulfilment. Financial balances accumulated by enterprises cannot be used freely for purchases of inputs (which are only available upon authorisation from the planning authorities) and, conversely, financial shortfalls impose no constraint on the supply of inputs foreseen under the plan.

However, the principle of planning finds practical limits in the distribution of goods and services to the household sector. For this reason all centrally planned economies rely to some extent on market mechanisms in the allocation of consumer goods, attempting to maintain overall market balance by matching the planned supply of consumer goods, at administratively set prices, with the total wage and transfer payments envisaged under the plan.

Central planning requires an extensive bureaucracy ...

The operation of a regime of central planning requires an extensive administrative capacity to handle the formulation and execution of the plan at all stages of production. This tends to create a large and powerful bureaucracy, with responsibilities for economic management being shared in a hierarchical structure of state planning commission, branch ministries and state enterprises. In principle, decisions about resource allocation are highly centralised. However, because plan formulation requires that account be taken of technical production possibilities, enterprises have considerable scope for influencing the plan by negotiating specific output quotas, supplies of inputs and allowances for wage payments. There are strong incentives for enterprises to bargain for undemanding plan targets and, in order to guard against possible supply bottlenecks, to hoard labour and inputs. By contrast, households have virtually no direct influence on the plan. Although they are free to exercise choice in how to spend their income, mismatches between supply and demand normally have no impact on the allocation of resources, which is the prerogative of the planner.

...and strict control over external transactions

Centrally planned economies need to insulate themselves from external influences which could limit the scope for setting prices and undermine planners' decisions by offering enterprises alternative ways of acquiring resources. So that foreign trade can be kept under close control, it is typically centralised under the direction of the ministry for foreign trade, which has the sole authority to determine the commodity composition and the geographical distribution of exports and imports. Enterprises and households are barred from trading directly with foreign residents and external trade is usually managed through specialised foreign trade organisations. The monopoly position of the state is reinforced by the inconvertibility of the national currency and by prohibiting enterprises and individuals from holding, or dealing in, foreign currency. Foreign and domestic prices of traded goods are kept strictly apart by various price equalisation schemes which result in an extensive system of multiple exchange rates.

A rudimentary financial sector

Given the dominant role of the plan, centrally planned economies have little or no use for classical monetary and fiscal policy instruments. Money and credit play a passive role in the sense that payments are expected only to validate the plan directives. The financial sector is rudimentary and consists normally of a state bank which acts as both the central bank and the commercial bank for most enterprise operations, a few specialised banks financing sectoral activities, including foreign trade, and savings institutions which provide the outlet for the cash holdings of the public. The banking system plays practically no part in the intermediation of savings and investment – which is carried out essentially through a large-scale redistribution of income via the state budget – but serves primarily to monitor compliance with the physical plan.

This description of the basic characteristics of a centrally planned economy inevitably represents an over-simplification of what was in reality a very complex arrangement. In fact, soon after its inception all countries made efforts to reduce the rigidities of the system of planning and to adapt it to changing conditions and requirements.

Experiments with reform programmes in the past

Efforts to reform the regime of central planning have a long history. At first their goal was simply to improve the accuracy and effectiveness of the planning process by strengthening the institutional structure, defining tasks more clearly and refining the instruments of administrative control.

Recognition of limitations to central planning

It soon became evident, however, that this approach to reform could do little to relieve the growing economic strains reflected in shortages in the consumer market, the poor quality of output, the lack of technological progress and the waste of resources. In particular, two considerations pointed to a need for greater flexibility in the economic system. Firstly, it was recognised that the authorities could never have sufficient information at their disposal to enable them to take all the necessary micro-economic decisions. Enterprises therefore needed to be involved more directly in the formulation and execution of the plan. Secondly, for enterprises to be able to plan and to utilise available resources in an efficient way, managers needed greater authority and responsibility and their decisions would have to take into account information provided by market signals.

Reform attempts failed because ...

These considerations formed the basis of various reform programmes under which certain elements of a market economy were incorporated into the system of central planning. For example, enterprises were granted more autonomy, the price system was revised and exchange rates were unified, the concept of profitability was introduced and, most importantly, the allocation of resources in physical terms was abolished and replaced by a system of indirect economic management based on the use of taxes and subsidies.

All eastern European countries have experimented with these market elements, although the extent and the timing of reforms and the circumstances in which they were carried out have varied greatly. In practice, the reforms met with relatively little success in terms of improved economic efficiency and some of them may in fact have exacerbated macro-economic imbalances. In retrospect, the failure of the reform attempts can be traced to two factors.

... they did not succeed in reducing central control over economic management ...

Firstly, the reform programmes did not call into question the ideological postulate of socialism: state ownership of the means of production and the dominant position of the national plan. Their principal aim was rather to ensure more efficient implementation of the plan. Accordingly, the national plan continued to play a pivotal role in economic management and, when there were signs that decentralised decisions or market developments threatened to produce results inconsistent with plan objectives, the authorities quickly reverted to price controls, administered interest rates and preferential allocation of credits and inputs. Indeed, the role of market mechanisms in the allocation of resources remained unclear and the interrelationship between profitability, prices, money and financial constraints was never fully recognised.

The unwillingness to relinquish control over economic management was most clearly evident when the authorities moved from rigid, quantitative directives to the use of indirect policy instruments. Taxes and subsidies were not applied uniformly and transparently but were tailored in such a way that the authorities could steer production, income and price results to conform with plan objectives. This procedure opened the door to negotiations which enabled unprofitable enterprises to bargain for tax relief and direct subsidies in exchange for compliance with the planners' wishes. The possibility of easily negotiating financial concessions meant that enterprises did not face financial constraints, which, together with the lack of reliable indicators of the market value of production and investment, rendered the concept of profitability meaningless.

Secondly, the reforms gave surprisingly little consideration to the necessary changes in the economies' institutional structure. Both the liberalisation of the external sector and the establishment of an independent financial sector were neglected for a long time, and only recently have they become part of reform programmes. While considerable progress has lately been made in breaking up the monopoly of foreign trade organisations and in extending free-trading rights to individual enterprises, the reform of the financial system is still in its infancy. But even where certain structural changes were made, as in the organisation of economic decision-making, they were not adequately supported by institutional reforms. The extent and the meaning of enterprise autonomy remained ambiguous, not least because the existing bureaucracy was not dismantled or its capacity to influence micro-economic decisions reduced. As a result, there was no clearly defined division of responsibility between planners and managers. In addition, few measures were taken to strengthen competition by reducing the degree of monopolisation in the industrial sector and encouraging private sector activity.

... and gave too little consideration to institutional changes

The main aspects of reform

In designing programmes to change their economies into market economies the authorities of eastern European countries are faced with three main issues: what are the basic requirements of a market economy? What is the most appropriate approach? What are the major risks and problems that have to be expected during the transition period? While the answers may differ to some extent in the light of each country's particular circumstances, the experience of past reform efforts and the broad similarity of problems encountered by all eastern European economies point to some general observations of relevance to all of them.

Three fundamental issues

The basic requirements. The successful transformation of eastern European centrally planned economies into market economies presupposes two fundamental changes: the establishment of markets for goods and services, financial assets and labour; and the development of a set of new instruments for macro-economic policy. Both changes require far-reaching reforms in each country's economic, financial and institutional structures.

Establishment of markets and indirect policy instruments

The creation of markets lays the micro-economic foundations for allocating resources in accordance with relative scarcities and in response to society's priorities. Markets generate and disseminate information on relative prices and costs and thereby provide criteria on which to base decisions on what to produce, which inputs to use, where to invest and how to assess economic performance.

For markets to play these roles it is essential that market participants are autonomous in their economic decision-making, that prices are allowed to reach market-clearing levels, that financial constraints are effective and that markets operate in a competitive environment. In practice these conditions imply action on several fronts. Firstly, the eastern European countries have to abandon controls over prices, wages and interest rates, decentralise decision-making, review ownership laws and eliminate restrictions on private sector activity. Secondly, particular emphasis needs to be given to the creation of a financial market as the principal conduit for intermediation between savings and investment. This necessitates the establishment of freedom to acquire and dispose of financial assets and the creation of an independent banking sector which will assume the task of controlling the soundness of business operations by actively seeking lending outlets in new and promising business ventures and penalising loss-making enterprises. Thirdly, the legal and institutional framework needs to be reformed with a view to introducing clear rules and regulations governing the conduct of business and setting minimum standards for the protection of consumers, savers and workers. Finally, particular attention must be given to measures to promote competition, both among domestic suppliers and between domestic and foreign producers.

The need for competition, both within the domestic economy ...

In order to expose state enterprises to greater competition, it is necessary to break up the monopolistic structures which were created in all eastern European countries as a means of facilitating the planning process. In addition, existing restrictions on private sector and state enterprise activity must be removed, allowing all firms, irrespective of their ownership status, to compete freely and on an equal footing. In this context it will also be necessary to address the issue of property rights, especially with a view to determining to whom state enterprise managers are ultimately responsible and how the state as the owner of means of production should ensure that its assets are not wasted. Experiments in self-management and workers' councils have proved unsatisfactory and serious consideration should be given to the privatisation of a large part of the state-owned sector. However, the transfer of state enterprises to the private sector poses very difficult questions as to the most efficient, equitable and administratively feasible method. In practice it may be achieved only slowly.

... and in external trading relations

In order to facilitate the creation of a competitive environment, it is essential to open up the domestic economy to foreign competition. Trade liberalisation, covering all imports and not just complementary products, will greatly assist in eliminating price distortions by linking domestic and foreign prices of tradable goods and will promote a reallocation of resources in accordance with the economy's comparative advantage. Liberal foreign trade, however, presupposes the adoption of a unified and realistic exchange rate and – at least limited – convertibility of the domestic currency. The integration of eastern European countries into the western trading system should be accompanied by a revision of the rules which govern intra-eastern European trade. While some time will probably be needed to adjust the trading relationships that have evolved under the arrangements of the Council for Mutual Economic Assistance, the effectiveness of liberalisation measures would be greatly impaired if a significant part of external trade continued to be conducted within the framework of intra-governmental trade agreements and at negotiated trade prices. Opening up the domestic economy to foreign competition also means a liberal policy towards foreign investment, which through inflows of financial resources and imports of technological and managerial skills could make a significant contribution to the domestic supply side.

As these micro-economic changes shift the responsibility for resource allocation to the market-place, the authorities will lose the ability to correct macro-economic imbalances by directly influencing the level and composition of output. As a result they will have to develop a new system of indirect economic management which relies on monetary, fiscal and exchange rate policy. To this end, the practice of using discretionary and highly differentiated taxes and subsidies must give way to a transparent and rational system of direct and indirect taxes. The functions of the central bank must be separated from those of commercial banks and other financial institutions, and direct credit allocation and the administrative setting of interest rates must be abolished and be replaced by the use of indirect instruments of monetary control – with allocation of credit being determined by the market participants.

Risks of a gradual reform approach

The speed of reform. The transition to a market economy will inevitably entail major adjustment shocks. This would seem to militate in favour of a reform process in which adjustment is phased in gently and the economy is allowed to adapt slowly to a new setting. However, a strategy aimed at gradually changing the structure of the economy – either by introducing only a limited number of liberalisation measures or by confining the reform to certain sectors – could be fraught with considerable risks. Firstly, past experience of reform programmes suggests that partial reforms are likely to meet with only partial success and that, in particular, attempts to introduce only some market elements will fall short of creating real markets. A step-by-step approach tends to disregard the close interaction between price liberalisation, decentralisation of decision-making, financial discipline and indirect economic management. However, these reform elements are complementary, reinforce each other and thus form part of a single programme. Secondly, only if market forces are permitted to make themselves felt quickly will it be possible to overcome bureaucratic inertia and to implement the necessary institutional reforms. Thirdly, the urgent need to proceed with reforms on all major fronts is heightened by the existence of large macro-economic imbalances. Even limited steps towards liberalisation will immediately produce major adjustment problems and mounting resistance to further reform measures could jeopardise the entire reform process. For these reasons it would seem more advisable to pursue a strategy under which the move to a market economy is based on a comprehensive plan, with all principal reform steps preferably being taken as soon as possible but with due regard to the political and economic risks involved in this process. However, rather than trying to mitigate unavoidable friction during the transition by suppressing or tempering market signals and thereby slowing down the pace of reform, adjustment shocks should be alleviated by social policies which are compatible with the institution of a market economy.

Risks and problems during the transition period. The most serious problem facing the authorities during the first stages of the reform process will be the threat of declining production in combination with strong inflationary pressures, and much of the success in restructuring the economy will hinge on the speed with which output growth recovers. While in most eastern European countries a relatively skilled labour force and a strong resource base point to favourable growth prospects in the longer run, the initial supply response to the reform measures is likely to be weak or even negative. Adjustments of relative prices together with higher interest rates, cuts in subsidies and a realistic exchange rate will quickly expose inefficient enterprises and exert pressure to restructure or to close down unprofitable operations. At the same time, the introduction of new production techniques and the reallocation of labour will tend to proceed slowly, especially as the shift to new productive activities will be hampered by deeply ingrained habits formed under a system of central commands, the suspicion of private sector initiative and the lack of entrepreneurial skills and technical and management know-how. These domestic supply-side difficulties will, to varying degrees, be exacerbated by external constraints, affording most eastern European countries little scope for easing adjustment problems by importing foreign resources.

The danger of declining output and inflationary pressures highlights ...

... the need for accompanying social measures

The likelihood of recessionary developments in the initial stage of reform underlines the importance of flanking social measures. Transitional unemployment and declining real wages are difficult to accept in societies where for many years the population has been accustomed to full employment, economic security and low and stable prices for basic goods and services – even if the price paid for these social guarantees was economic inefficiency and low standards of living. The creation of a new social safety net, including unemployment insurance programmes and officially supported retraining schemes, will be an indispensable element of the reform process.

Strict financial discipline necessary at micro and macro-economic levels

The lagging response of output in the early stage of the reform will inevitably leave the authorities with little choice but to pursue tight demand management policies. The main reason for this is the threat of inflationary pressures surfacing in the wake of domestic price liberalisation. Even if in the process of eliminating price distortions not all prices are allowed to reach market-clearing levels immediately, it is highly unlikely that price revision will take place without a significant rise in the price level. This tendency will be exacerbated in those countries where a monetary overhang reflecting excess demand pressures has accumulated. If the price adjustment cannot be limited to a one-off rise in the price level, there is a serious danger that continuing inflation could undermine the reform process. An inflationary environment clouds price signals, generates excessive wage pressure and tends to encourage speculative activities, diverting savings into foreign assets, stockbuilding and real estate.

Macro-economic policies aimed at containing inflationary pressures, however, are not only important for the development of markets but are also an indispensable element in enforcing financial discipline at the micro-economic level. The pursuit of sufficiently restrictive monetary and fiscal policies implies in practice the maintenance of positive real interest rates and tight budgetary controls, leaving no room for large subsidy payments or new measures to support financially troubled enterprises. Only under these conditions will state enterprises, which have operated for many years under lax financial constraints, come to accept financial performance as the decisive criterion for evaluating the efficiency of resource utilisation.

Supportive measures by western industrial countries

While the creation of market economies in eastern European countries ultimately rests on their willingness and determination to adopt the necessary reform measures, the speed of progress and the extent to which adjustment problems can be alleviated will depend significantly on western countries' contributions to the reform process. Such contributions should take two main forms. Firstly, as eastern European countries open up their economies to foreign competition, trade restrictions on their exports to western markets, as well as the existing limitations on purchases of high-technology products from the West, should be lifted. The continuation of trade restrictions would not only severely hamper eastern Europe's integration in the world economy and render the liberalisation of the domestic economies much more difficult, but would also constitute a serious barrier to foreign direct investment and impede the badly needed inflow of technological and managerial know-how. Secondly, given the existing constraints on access to foreign savings and the limited scope for generating domestic savings, the transfer of resources that will be required to restructure the industrial sector and modernise the infrastructure in eastern European countries will hardly be possible without adequate financial support from western countries through both private and official channels.

The current state of reform

While recent political developments together with rapidly deteriorating economic performances have given additional impetus to the reform process, the actual progress made in designing approaches and implementing reform measures differs greatly among individual eastern European countries.

Far-reaching reforms in Poland and Hungary ...

Only two have so far undertaken far-reaching reforms and are clearly on a path to a market economy. At the beginning of this year *Poland* adopted a comprehensive programme directed at restoring equilibrium in the domestic economy and transforming the economic system. During a short initial stabilisation phase, the programme involves restrictive demand management policies, large cuts in price subsidies and the decontrol of most prices, wage restraint – implying marked reductions in real incomes – and, in combination with trade liberalisation, the move to partial convertibility of the zloty. In a second phase, to last several years, emphasis will be placed on completing the restructuring of the economy. This will involve the abolition of remaining controls on prices and trade, the introduction of a new tax system and, most importantly, the privatisation of state-owned enterprises. By early April there were some encouraging signs of success: the exchange rate had been stabilised without recourse to a $1 billion stabilisation fund provided by various western countries, and the rate of price increase had fallen from hyperinflation to a monthly rate of 4% in March. At the same time, real output had contracted by 20–30% and unemployment, though still low by western standards, was on a steep upward trend, demonstrating the short-term costs of adjustment. In *Hungary,* too, a wide range of measures have been implemented during the past two years to increase the flexibility of the economy and considerable progress has been made in transforming the economy. Prices and trade have been liberalised to a significant extent, the tax system has been reformed, a two-tier banking system has been set up and efforts are now being made to accelerate the privatisation of state property. However, the liberalisation measures were not backed by sufficiently strict financial discipline, and excessive wage pressures, rising domestic inflation and a widening current-account deficit point to an urgent need for more restrictive income, monetary and fiscal policies.

... but in other countries the debate concerning the reform strategy not yet concluded

In the other eastern European countries the debate concerning the nature and speed of reform has not yet been concluded. With the exception of Romania and the German Democratic Republic, all of these countries have been experimenting since 1987 with measures designed to increase the autonomy of state enterprises, to ease restrictions on private sector activity and to enhance the role of the financial sector. But on the whole these limited reform efforts have tended to weaken the controls and the effectiveness of the existing economic system without constituting a significant move towards a market economy. This has been most evident in the *Soviet Union*, where greater independence of state enterprises, the promotion of a co-operative sector and a banking reform have had little impact on real output but have resulted in substantial wage increases, larger subsidies and a growing budget deficit financed by money creation. While the authorities have recognised the importance of short-term stabilisation measures and have acted to reduce wage growth and the fiscal deficit, the future course of a more profound restructuring of the Soviet economy is still under discussion. In *Czechoslovakia,* where a reform programme adopted in 1987 aimed at combining the use of market mechanisms with strengthening the role of the centre, the new Government has not yet decided on an overall reform strategy but has brought forward some of the market-oriented measures envisaged under the old programme. At the beginning of this year a two-tier banking system was established, the currency was devalued, wholesale prices were partly adjusted and foreign trade was liberalised somewhat. Particular emphasis is now being placed on the promotion of competition and legislation is being drafted to set out the rules for privatisation and the operations of privately owned companies. In *Bulgaria* new legislation has been enacted in the past two years to stimulate competition, make enterprises more profit-oriented and foster some private sector initiative. However, the implementation of these measures has been slow and the recent economic situation has been dominated by growing internal and external imbalances. In contrast with these three countries, *Romania* had refrained from any reform measures since the mid-1980s, when the priority of economic policy shifted towards the repayment of external debt and a system of strict central planning was used to enforce a drastic cut in domestic demand. Recently some very limited first steps were taken to relax the system of planning, to ease some of the restrictions on small-scale industry and agriculture in order to revive domestic production and to overcome the country's isolation from the outside world.

The German Democratic Republic: a special case

The *German Democratic Republic,* where virtually no systemic changes were made in the 1980s, represents a special case, as the speed and character of reform will be determined in the context of economic and political union with the Federal Republic of Germany. There is political agreement to form an economic and monetary union between the two German states at an early stage. The necessary wide-ranging structural changes will undoubtedly require substantial support from the Federal Republic. However, as a rapid adjustment of the economic system and the introduction of the Deutsche Mark will greatly enhance the country's attractiveness to western investors, there would seem to be good prospects for large-scale transfers of private capital and technical and managerial know-how and, in comparison with other eastern European countries, the process of restructuring may be relatively fast and the cost of adjustment relatively low.

III. International trade and payments

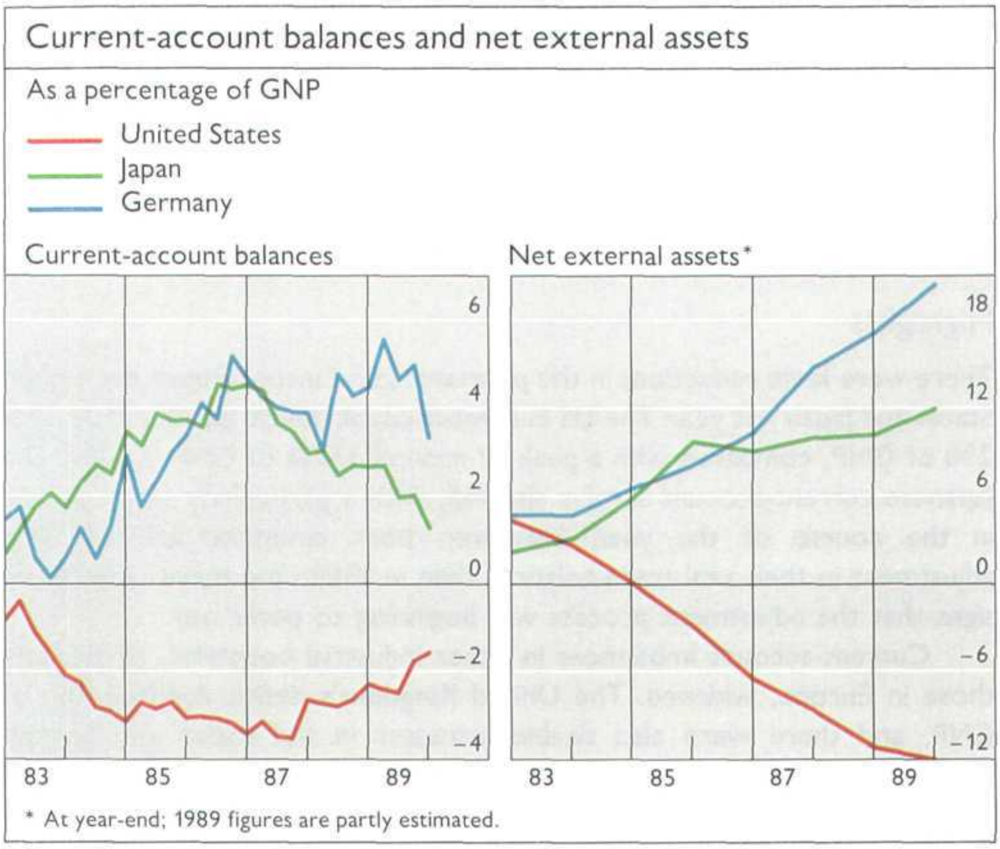
Highlights

There were large reductions in the payments imbalances of both the United States and Japan last year. The US current-account deficit fell to a little over 2% of GNP, compared with a peak of around 3¼% of GNP in 1987. The Japanese current-account surplus also fell, with a particularly steep decline in the course of the year. However, both countries achieved less adjustment in their real trade balances than in 1988, and there were some signs that the adjustment process was beginning to peter out.

Current-account imbalances in other industrial countries, particularly those in Europe, widened. The United Kingdom's deficit reached 4% of GNP, and there were also sizable increases in the Italian and Spanish deficits. At the same time, Germany's surplus rose to almost 4½% of GNP. However, trends emerging in the course of the year suggested that both the German surplus and the UK deficit had finally begun to decline in response to divergent movements in domestic demand. Outside Europe, the already large Australian and Canadian deficits rose further.

The volume of private capital flows – direct as well as portfolio investment – rose considerably in 1989. In a number of industrial countries net non-official capital inflows exceeded even large current-account deficits, leading to currency appreciation and, where the authorities intervened, to significant reserve accumulation. Conversely, non-official outflows from the major surplus countries (Japan and Germany) exceeded their current-account surpluses, leading to downward exchange rate pressure. As this was resisted by the authorities, the net reserve position of both countries deteriorated. The decline was particularly marked in Japan, where capital outflows ran well above the current-account surplus for much of the year, leading to a steep drop in the yen.

In the developing world, higher oil prices and the increased dependence of industrial countries on imported oil greatly improved the current-account position of the major fuel exporters in 1989. But oil prices remained highly volatile, dropping steeply in the first few months of 1990. The large surplus of the Asian newly industrialising economies (NIEs) declined somewhat, but only because of a sharp fall in the South Korean surplus. The aggregate current-account deficit of the rest of the developing world rose. In particular, the heavily indebted countries were unable to achieve any external adjustment, mainly because they failed to benefit from the strong expansion in world trade, with the volume of their exports rising at less than half the rate of world trade growth. The financing of the continuing current-account deficit of this group of countries remained



difficult: there was a further accumulation of interest arrears and reliance on official sources of finance increased.

World trade

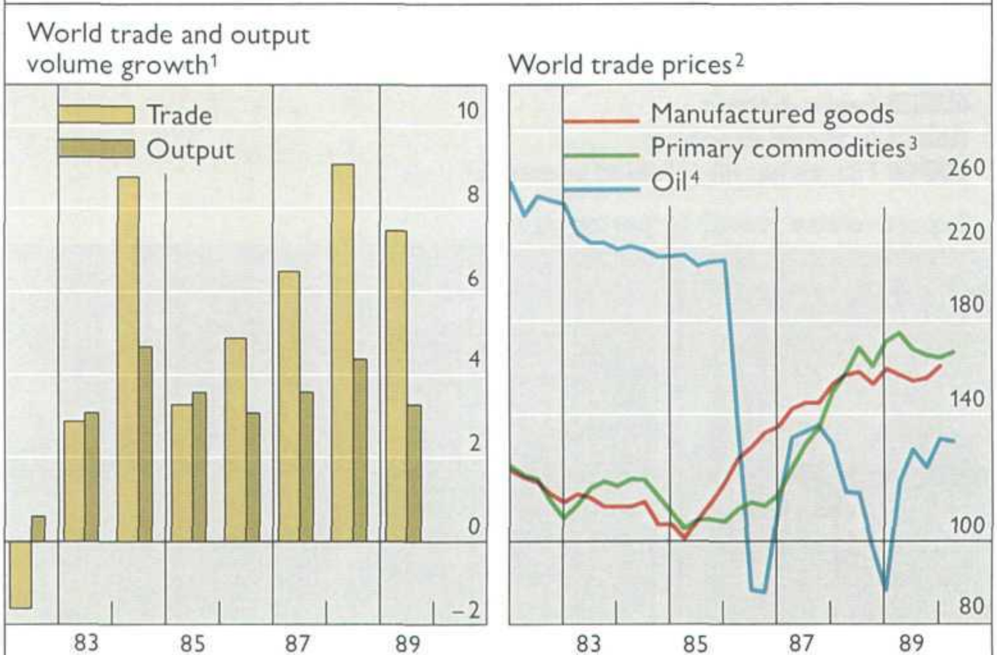
World trade growth decelerates

Mainly as a result of continued economic expansion in the industrial countries, the volume of world trade increased by 7½% last year – a little less than in 1988 but still more than twice as fast as output growth. The average dollar prices of traded goods changed little during the year. However, as the dollar appreciated, the local currency prices of industrial countries' exports rose on average by around 5½%, compared with about 2% in 1988. For the first time for a number of years, the industrial countries' local currency export prices rose significantly faster than their average GDP deflator. The appreciation of the dollar enabled some non-US exporters to increase profitability: as capacity shortages have emerged in a number of countries and as Japanese exports remained constrained by various arrangements, price competition in international markets may have become less intense.

Oil prices rise but other commodity prices weaken

Higher oil prices led to a deterioration in the industrial countries' terms of trade with the developing world. Excluding energy, the prices of industrial raw materials, which had risen sharply in 1988 and early 1989, fell back during much of last year; year-on-year there was little change. By contrast, agricultural prices declined, with cocoa and coffee prices dropping steeply as some major producers, in the absence of agreement on quotas and other price support measures, dumped excess supplies on world markets.

Indicators of world trade



[1] Output growth as measured by percentage changes in real GDP. [2] Indices (1978 = 100) based on prices in US dollars (semi-logarithmic scale). [3] HWWA index, industrial raw materials, excluding energy. [4] Saudi Arabian light crude.

Sources: GATT, IMF, UN, HWWA and national data.

Exports from developing countries slow

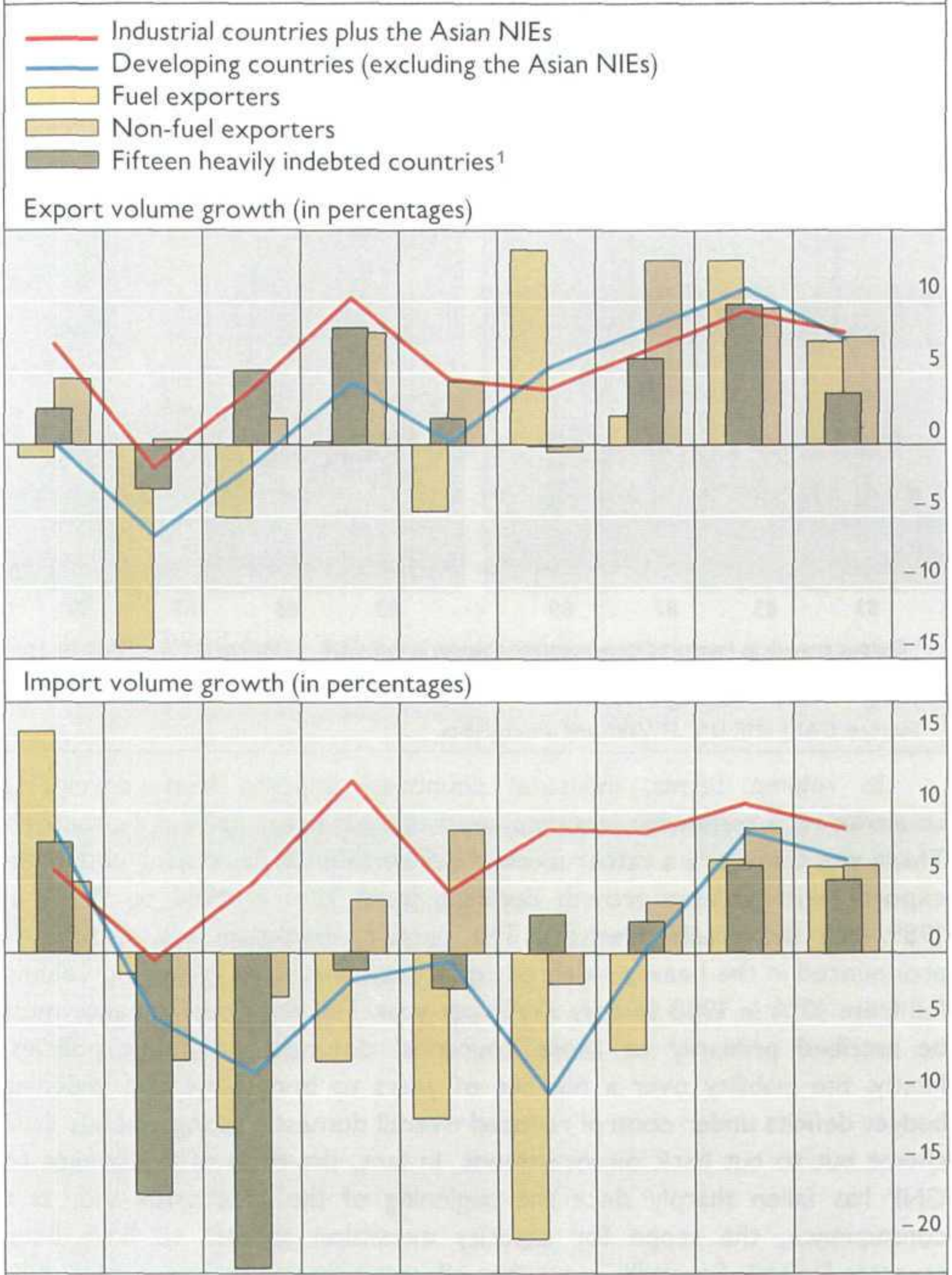
In volume terms, industrial countries' imports from developing countries rose somewhat less than imports from other industrial countries. There was therefore a rather marked deceleration in developing countries' exports, with volume growth declining from 11% in 1988 to 7½% in 1989 (see the graph overleaf). The export slowdown was particularly pronounced in the heavily indebted countries, where the growth in volume fell from 10% in 1988 to only 3½% last year. This poor performance must be ascribed primarily to these countries' domestic economic policies. Firstly, the inability over a number of years to bring large and widening budget deficits under control reduced overall domestic saving and left little choice but to cut back on investment. In fact, the ratio of investment to GNP has fallen sharply since the beginning of the debt crisis and, as a consequence, the scope for capacity expansion appears to have been severely limited. Secondly, a number of countries in this group saw their real exchange rate appreciate over the past two years as nominal rates were not adjusted enough to offset extremely high rates of inflation.

Two medium-term trends are likely to be of increasing importance for international trade developments in the years ahead. One is the industrial countries' increased dependence on OPEC for oil supplies; the other is the growing significance of service transactions (notably investment income payments and tourism) in current-account developments.

Increased dependence on OPEC ...

Net OPEC oil exports increased from 17.4 million barrels per day in 1988 to 19.5 million barrels per day in 1989, which was about 40% higher than in 1985. Heavier reliance on OPEC supplies has been brought about by the lower oil prices prevailing in the second half of the 1980s. Not only has

Growth of world trade by main groups of countries



[1] Argentina, Bolivia, Brazil, Chile, Colombia, Côte d'Ivoire, Ecuador, Mexico, Morocco, Nigeria, Peru, Philippines, Uruguay, Venezuela and Yugoslavia. [2] Average annual rate.

this tended to increase demand, but it has also depressed the supply of oil from industrial countries, where, in general, production costs are much higher than in OPEC countries.

... as oil demand rises worldwide ...

Overall, world oil consumption (outside eastern Europe) has grown by about 3% annually since 1985, after contracting during the first half of the 1980s. The ratio of oil consumption to GNP in the industrial countries as a whole, which fell by more than one-quarter in the first half of the decade, continued to decline last year, but much less than earlier in the decade. As modest economies in energy use have been offset by the strong expansion in activity, total oil consumption in the industrial countries has increased. Moreover, demand has risen more rapidly in the developing countries, largely because of urbanisation and industrialisation, notably in South-East Asia.

... and oil production falls in industrial countries

At the same time, oil production in industrial countries has been flat or falling in recent years. In 1989 there was a decline of about 4%. The largest absolute contraction was in the United States. Because lower oil prices have sharply reduced energy exploration and development expenditure, US oil production has declined each year since 1985, causing a cumulative decline by 1989 of 15%. The consequence of this, together with increased energy consumption, was that the volume of US oil imports in 1989 was more than 50% higher than in 1985. In addition, accident-related production difficulties further depressed industrial countries' output last year.

The changing balance between oil demand and supply in the industrial countries contributed to a rise of around 20% in the annual average price of oil last year. Nevertheless, supply uncertainties have made oil prices volatile and highly sensitive to short-term demand fluctuations. Firstly, the combined production of Iran and Iraq – both with strong pent-up demand for foreign currency – overtook that of Saudi Arabia in 1989. Secondly, oil production in the Soviet Union has recently declined and there is considerable uncertainty about future supply. World oil prices were particularly unstable in the first few months of 1990, when they fell steeply.

World trade in goods and services[1]

Items	1975	1980	1985	1988	1989[2]
	in billions of US dollars				
Total	970	2,544	2,688	3,992	4,350
Merchandise	720	1,822	1,899	2,785	3,010
Services	250	722	789	1,207	1,340
Shares in total trade in goods and services (in percentages)					
Services	*25.8*	*28.4*	*29.4*	*30.2*	*31*
of which: Transport	*7.0*	*6.2*	*5.3*	*4.9*	*n.a.*
Tourism	*4.4*	*4.0*	*3.6*	*4.6*	*n.a.*
Investment income	*7.2*	*11.3*	*13.5*	*13.9*	*n.a.*

[1] Average of credits and debits. [2] Preliminary estimates.
Sources: IMF Balance of Payments Yearbook and World Economic Outlook.

Rising share of tourism and net investment income payments ...

The other medium-term trend of interest was the increased importance of certain international transactions in services. Tourism and investment income payments accounted for around 18½% of total transactions in goods and services in 1988, compared with only 11½% in 1975 (see the table above).

The steep rise in investment income reflects the integration and globalisation of financial markets. In most industrial countries international capital movements are now subject to few restrictions – a radical change from the situation prevailing even as recently as the late 1970s. At the same time, a wide range of financial instruments has been developed to reduce risk and manage currency exposure. Cross-border borrowing and lending flows have therefore increased for reasons that are quite independent of current-account financing, a trend further examined below. Although data on investment income flows are among the weakest of balance-of-payments statistics (reported aggregate world payments exceeded receipts by more than $50 billion in 1988, the latest year for which comprehensive data are available), there is no doubt about the broad magnitude of this change.

... but relative decline of other service transactions

By contrast, the share of services other than investment income and tourism has actually declined despite the greater service-orientation of most mature industrial economies. Part of the explanation for this may be that increased efficiency in transport and the shift in goods trade from heavy industry to relatively light, high-value products (notably electronics) have reduced transport costs. The share of transport services has indeed declined in recent years (see the table on page 63). Another explanation may be that many payments for financial services are included in investment income flows. But it is also possible that various restrictions on trade in services, as well as the absence of agreed rules, may have impeded the internationalisation of services. It is perhaps significant that the category of service transactions subject to the fewest restrictions – foreign travel and tourism – has grown relatively rapidly in recent years.

The Uruguay Round ...

Developing a multilateral framework for trade in services is one of the major issues being addressed in the current Uruguay Round of GATT negotiations. Others include bringing trade in textiles back into the GATT framework; addressing agricultural trade; and developing more explicit, internationally agreed rules to govern the GATT's traditional "safeguard" provisions permitting temporary protection for a domestic industry. The deadline for reaching agreement on this comprehensive and ambitious agenda is the end of this year.

... should tackle trade discrimination and the abuse of "temporary" protection

Two recent tendencies merit particular attention: the more frequent resort to bilateral restrictions on trade and the increasingly common practice of "temporary" measures providing semi-permanent protection for certain domestic industries. The "Super" Section 301 provisions of the US Omnibus Trade and Competitiveness Act (allowing retaliatory trade restrictions to be imposed bilaterally), recent anti-dumping measures imposed by the European Community and a number of voluntary export restraint arrangements all tend to discriminate among foreign suppliers. Settling trade disputes bilaterally also inevitably undermines GATT procedures and thus risks weakening the multilateral trading system. Secondly, many of the trade-restricting measures that have been introduced in recent years appear to have become almost permanent features of international trade, and not just temporary remedies to cushion short-run adjustment. According to the GATT, more than 60% of the 249 discriminatory export restraint type of arrangements in force at the end of 1989 had no explicit expiration date. In the interests of strengthening the free trade system, it is therefore to be hoped that the Uruguay Round concludes with a far-reaching and effective agreement that reverses the recent drift away from non-discrimination among foreign suppliers as a key principle of international trade and prevents temporary protective measures from becoming permanent.

Narrowing US and Japanese imbalances

The current-account imbalances of the United States and Japan have narrowed much more rapidly than expected earlier. Excluding exchange rate related valuation effects on direct investment, the US current-account deficit fell from a peak of $160 billion in 1987 to under $104 billion in 1989 (see the table on page 67); the reduction in the Japanese surplus over this period was about $30 billion.

Relative demand and competitiveness conducive to adjustment

The traditional determinants of the trade balance, relative domestic demand and competitiveness as reflected in real effective exchange rates (shown in the graph overleaf), continued to contribute to the narrowing of the US and Japanese imbalances last year. Domestic demand grew much faster in Japan than in most other industrial countries while its growth in the United States was well below the general average. Secondly, the real effective exchange rate of the dollar was at its lowest, and that of the yen at its highest, towards the end of 1987 and in early 1988. As changes in competitiveness affect trade volumes with a lag of up to two years, it is likely that the impact of the decline in the dollar (and of the rise in the yen) up to early 1988 was still being felt on trade volumes in 1989. Finally, the appreciation of the dollar and the depreciation of the yen in 1989 tended to reduce the dollar value of the US and Japanese imbalances. In the United States, the non-oil import price deflator actually fell in dollar terms. This to some extent offset the impact of significantly higher oil prices on the US terms of trade, which deteriorated only slightly. As a result, most of the improvement in trade volumes was reflected in dollar values. Also, a terms-of-trade loss for Japan accentuated the reduction in the dollar value of the Japanese surplus.

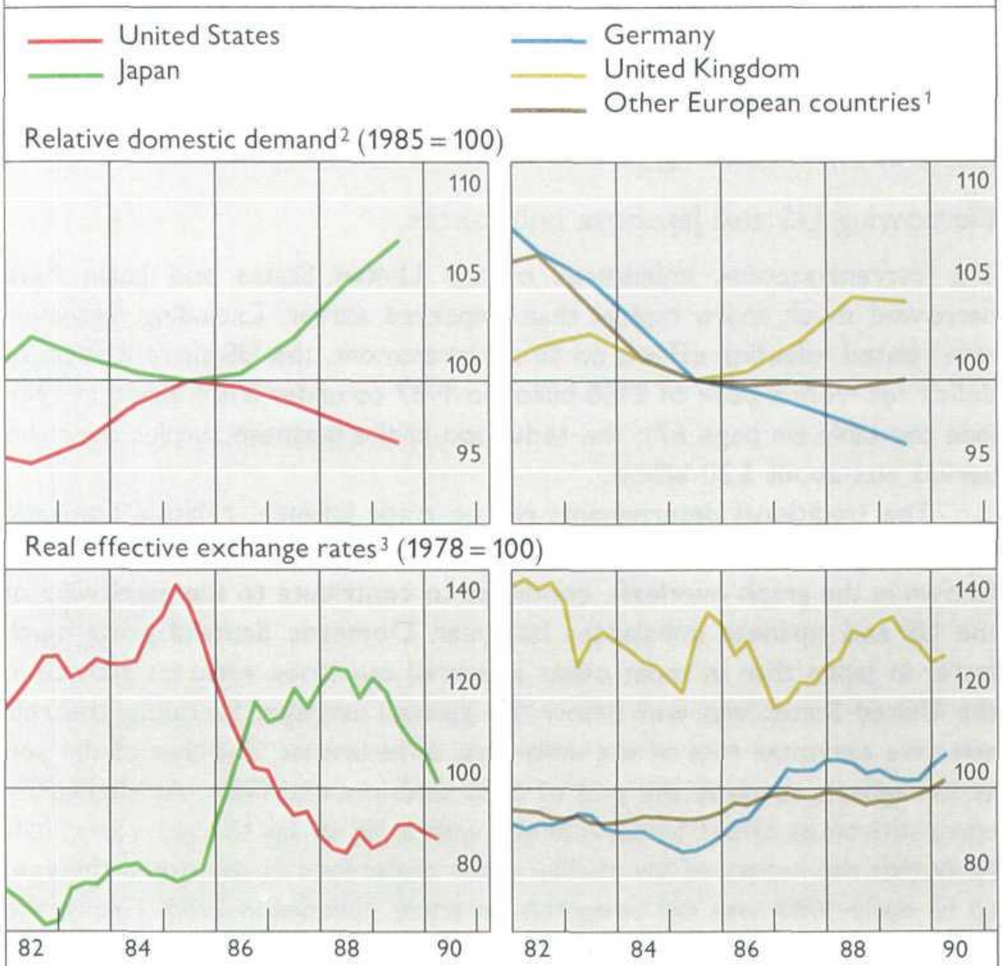
US export volumes expand strongly ...

Most of the reduction in the US current-account deficit in 1989 reflected the narrowing of the trade deficit, which declined to its lowest level since 1984. While the oil deficit widened by about $10 billion, the non-oil deficit contracted by almost $24 billion. This was largely the result of the rapid growth in the volume of exports in the first half of the year, when real non-agricultural exports rose at an annual rate of almost 16%. Although there was some deceleration in the second half, the year-on-year growth of about 12½% was still much faster than the growth in world trade. But US gains of market share were smaller than in 1987 and 1988, suggesting that the impact of the steep decline in the dollar during the period 1985–87 (which was partly reversed over the last eighteen months) may be coming to an end.

... though imports also rise

The volume of merchandise imports grew only a little less than in 1988 despite the much slower growth of domestic demand. The buoyancy of

Relative domestic demand and real effective exchange rates



Note: Averages have been calculated using 1987 GDP weights and exchange rates.

[1] Austria, Belgium, Denmark, Finland, France, Greece, Ireland, Italy, the Netherlands, Portugal, Spain, Sweden and Switzerland. [2] Final domestic demand relative to the average in OECD countries. [3] Nominal effective exchange rates adjusted for movements in relative unit labour costs.

imports was only partly due to the continued strength of energy imports, since the volume of non-oil imports also rose by over 5%. The net effect of these volume trends was to cut the real non-oil trade deficit by almost \$20 billion, compared with a decline of over \$40 billion in 1988.

The underlying strength of US import demand was reflected in a 16% increase in the volume of imports of capital goods. This rate of growth was about three times as large as that of total investment in machinery and equipment, suggesting an increased dependence on foreign capital goods. On the other hand, imports of passenger cars – about one-fifth of total non-oil imports – actually fell by more than 4% in volume terms, largely because the increased supply from Japanese subsidiaries producing in the United States displaced direct imports.

US surplus on non-factor services rises ...

The US invisibles balance improved by over \$6 billion. The main change was in services other than investment income: the surplus on this account rose by \$7½ billion, largely because of higher tourist receipts and earnings from other private services. Excluding valuation effects on direct invest-

... while net investment income is unchanged

ment, the surplus on net investment income was maintained at $3.2 billion. Given the size of the current-account deficit, and thus of the annual addition to net external liabilities, the lack of any deterioration in the net investment income position requires some explanation. Two factors were

The US current account

Items	1985	1986	1987	1988	1989 year	1989 fourth quarter[1]
	in billions of US dollars					
Current account	−112.7	−133.3	−143.7	−126.5	−105.9	− 82.3[2]
Trade balance	−122.1	−145.1	−159.5	−127.2	−113.2	−115.2[2]
Net investment income	25.9	21.6	22.3	2.2	1.0	27.0[2]
Other services	− 1.0	5.9	7.7	13.1	20.6	23.8[2]
Transfers	− 15.5	− 15.7	− 14.2	− 14.6	− 14.3	− 17.9[2]
Memorandum items:						
Excluding valuation changes:						
Current account	*−119.5*	*−143.9*	*−160.2*	*−125.5*	*−103.7*	*− 96.6*
Net investment income	*19.1*	*11.0*	*5.7*	*3.2*	*3.2*	*13.7*
Non-oil trade balance[3]	*− 81.5*	*− 95.5*	*− 79.5*	*− 38.2*	*− 17.8*	*− 20.6*[2]
	percentage changes					
Export volumes	*3.6*	*6.2*	*16.2*	*20.5*	*12.4*	*10.8*[2,4]
Import volumes	*4.8*	*12.4*	*6.5*	*6.1*	*5.8*	*5.1*[2,4]
Terms of trade	*− 0.1*	*3.0*	*− 6.2*	*2.1*	*− 1.9*	*− 4.0*[2,4]

Note: At present, US balance-of-payments accounts treat as investment income the fluctuations in the dollar value of US direct investment assets and liabilities that result from exchange rate changes. Because of this practice, the net balance on investment income declines when the dollar appreciates and vice versa.

[1] At an annual rate. [2] Seasonally adjusted. [3] At constant 1982 trade unit values. [4] Change over fourth quarter 1988.

mainly responsible. The first was an improvement of almost $6 billion in net earnings (before exchange rate related capital losses) from direct investment as a result of a combination of growth in the profits of US subsidiaries abroad and an apparent decline in foreigners' earnings on direct investment in the United States. Secondly, the nature of US external liabilities – mainly dollar-denominated and relatively long-term – meant that interest payments abroad were partly insulated from the significant rise in short-term interest rates on other currencies seen last year. Even so, the deficit on portfolio income rose by $5.8 billion.

Japan's surplus declines ...

Japan's current-account surplus for 1989 as a whole was $57 billion, more than $22 billion below its 1988 level. This result masks the sharp decline that occurred in the course of the year. At a seasonally adjusted annual rate, the surplus fell from more than $80 billion in the first quarter – about as large as in 1987 and 1988 – to less than $40 billion by the fourth quarter before rebounding to about $60 billion in the first quarter of 1990.

The lower surplus in 1989 mainly reflected a reduction in the trade imbalance that arose from a continued decline in net exports in volume terms and from a significant deterioration in the terms of trade. The earlier appreciation of the yen may have continued to limit exports: the volume of exports rose by less than 4% in 1989 and weakened during the year. Another factor – perhaps of greater long-run significance – is that expanding production by Japanese subsidiaries overseas is displacing direct exports, as can be seen in the continued decline in the number of motor vehicles exported: 6.2 million cars were exported last year, compared with 7.2 million at the peak in 1985. At the same time, the growth of imports of manufactured goods continued, but at a slower pace than over the three years 1986–88, suggesting that the effects of earlier yen appreciation and of import liberalisation are beginning to wear off. Nevertheless, the volume of manufactured imports still rose twice as fast as domestic demand last year. The value of total imports of manufactured consumer goods reached almost $30 billion, compared with under $10 billion as recently as 1986. The net effect of these volume trends was that the real non-oil trade surplus continued to decline in 1989, but by much less than in the previous three years.

... as export growth remains weak ...

... and as imports rise strongly

In addition, the depreciation of the yen and the higher dollar price of oil contributed to a deterioration in the terms of trade of a little over 4% – the first such worsening since 1980. Given the magnitude of the yen depreciation last year, this terms-of-trade loss was relatively small. This is mainly because Japan's exports tend to be priced in foreign currency, which meant that yen-based export unit values (which had declined at an average annual rate of more than 8% from 1985 to 1988) rose by almost 7% in 1989. Nevertheless, the year-on-year terms-of-trade loss built up in the course of the year, reaching almost 8% by the final quarter of 1989.

The Japanese current account

Items	1985	1986	1987	1988	1989	
					year	fourth quarter[1]
	in billions of US dollars					
Current account	49.2	85.8	87.0	79.6	57.2	36.8[2]
Trade balance	56.0	92.8	96.4	95.0	76.9	56.0[2]
Net investment income	6.8	9.5	16.7	21.0	23.4	27.0
Other services	−12.0	−14.4	−22.4	−32.3	−38.9	−41.5[2]
Transfers	− 1.6	− 2.1	− 3.7	− 4.1	− 4.2	− 4.7[2]
Memorandum items:						
Non-oil trade balance[3]	*86.7*	*74.0*	*63.0*	*49.0*	*44.8*	*43.0*
	percentage changes					
Export volumes	*4.6*	*− 0.6*	*0.3*	*5.1*	*3.8*	*− 0.1*[4]
Import volumes	*0.4*	*9.5*	*9.3*	*16.7*	*7.8*	*9.0*[4]
Terms of trade	*3.8*	*33.6*	*2.2*	*2.3*	*− 4.2*	*− 7.9*[4]

[1] At an annual rate. [2] Seasonally adjusted. [3] At constant 1985 trade unit values. [4] Change over fourth quarter 1988.

Yen depreciation makes exporting more profitable

The rebound in yen export prices after six years of decline implies that the profitability of exporting has greatly improved (see the table on page 26), raising the possibility of another surge of Japanese exports on world markets. Recent surveys indicate that domestic investment in manufacturing rose by a total of 60% in the 1988 and 1989 fiscal years. Although the latest survey (in February 1990) found that manufacturers still expected domestic demand to rise faster than exports – suggesting that the investment boom is oriented primarily towards the home market – any further depreciation of the yen could well alter this prospect.

Rising Japanese net investment income

The rise in net investment income receipts amounted to less than \$2½ billion, rather modest in the light of the size of the current-account surplus and the fact that interest rates were much higher in 1989 than in 1988. The main explanation is that Japan has a net short-term liability position, but is a creditor in terms of long-term assets. The rise in short-term dollar interest rates from early 1988 up to early 1989 therefore tended to increase payments on Japan's liabilities rather more than receipts from the country's assets. As short-term dollar rates fell from March 1989 to the end of the year, while other interest rates tended to rise, net investment income increased from an annual rate of around \$21 billion in the first half of 1989 to \$27 billion by the last quarter. The deficit on non-factor services widened by much less than in 1988, largely because the rate of increase in Japanese expenditure on foreign travel slowed down. Even so, Japanese tourists spent more than \$22 billion abroad last year, three times as much as in 1986.

Slower adjustment in real terms in both the United States and Japan

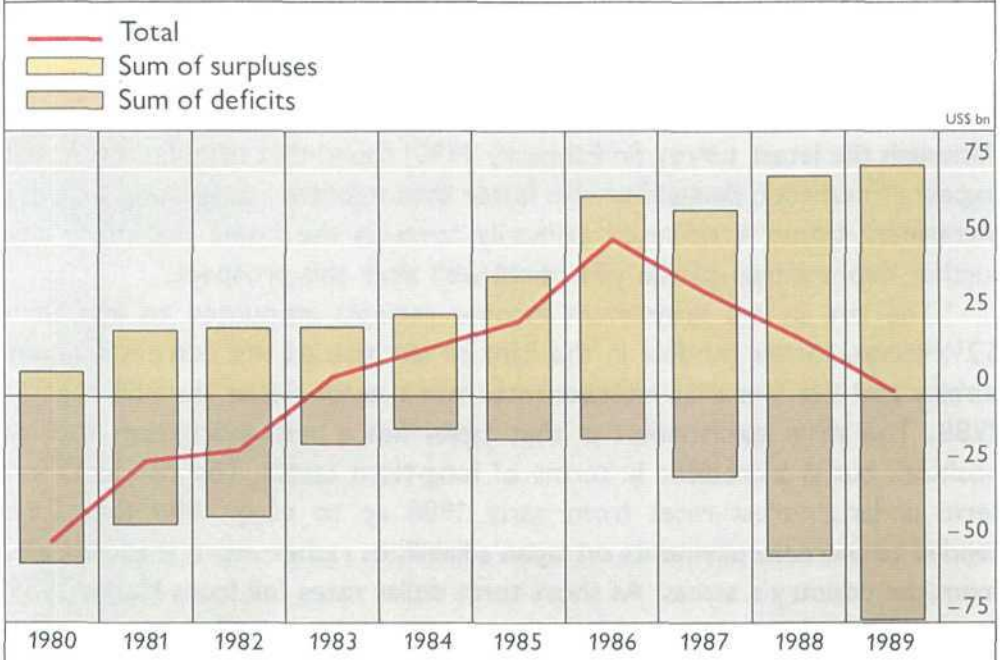
To conclude, perhaps the salient feature of the continued adjustment of US and Japanese imbalances is that less adjustment in real terms – measured by the difference between the growth of import and export volumes – was achieved in 1989 than in 1988. One important reason for this is that the effects of the adjustment-enhancing decline of the dollar and rise of the yen that took place from 1985 to late 1987 probably faded during 1989 – as, indeed, most econometric estimates suggest. Throughout much of 1989 exchange rates moved in a direction that would, if sustained, eventually work against further adjustment. This has been particularly true for Japan. Furthermore, it would not be realistic to count on real domestic demand in Japan continuing to expand annually by about 3 percentage points faster than in other industrial countries – as it did in 1988 and 1989.

Widening European imbalances

Elimination of the overall surplus ...

Western Europe's aggregate current-account position, still in surplus of some \$50 billion in 1986, deteriorated by a further \$17½ billion in 1989 to virtual balance. But this apparent movement towards a correction of external imbalances on a global scale masked a considerable widening of imbalances within Europe. As the graph overleaf shows, the elimination of western Europe's aggregate surplus occurred through a combination of widening surpluses in a number of countries and a significant deterioration in the current-account position of countries already in deficit. The current-account deficits of Finland, Italy, Spain, Sweden and the United Kingdom

Current-account imbalances in Europe



Source: National data.

widened by a total of about $25 billion in 1989, while the combined surplus of the Belgium-Luxembourg Economic Union (BLEU), Germany and the Netherlands rose by $7 billion.

... but widening imbalances among individual countries ...

Three factors have contributed to the widening of current-account imbalances in Europe. Most important would seem to be the sizable differentials in the growth of domestic demand within Europe in recent years. A second factor is that imbalances have not, in general, triggered corrective movements in real exchange rates. On the contrary, a number of the countries running current-account deficits have also been those with higher inflation, resulting in significant real appreciations of their currencies. Thirdly, the cumulative impact of persistent and, in some cases, growing current-account imbalances on net international investment positions, and thus on net investment income flows, has itself tended to add to the existing imbalances. A further potential factor is that the rather high investment content of recent growth may have put those countries which are dependent on imported capital goods at a disadvantage. However, the evidence, limited as it is, suggests that differences in the shares of consumer and capital goods have not played a major role.

... explained by three factors

The graph on page 72 shows how far the external trade performance of most countries has been associated with the relative strength of their domestic demand over the last two years.

Well above average rates of domestic demand growth in Finland, Portugal, Spain and the United Kingdom over the last two years led to a sizable deterioration in their real trade balances. The United Kingdom remained the European country with the largest trade deficit. But at $38 billion it was only $1 billion higher than in 1988 and showed signs of reversing during the year as domestic demand growth slowed appreciably.

More rapid expansion of domestic demand in deficit countries ...

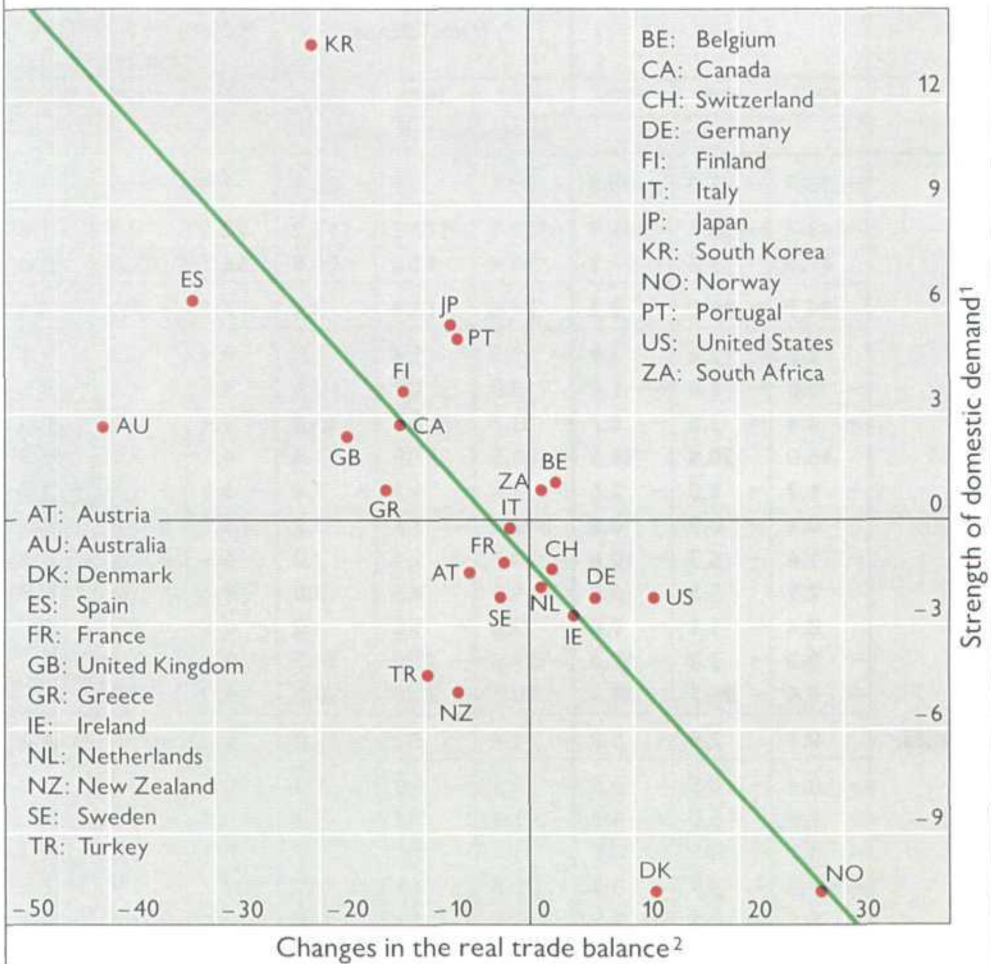
Current-account balances of the industrial countries and the Asian NIEs									
Countries and areas	Current-account balance			Of which:					
				Trade balance			Balance on investment income		
	1987	1988	1989	1987	1988	1989	1987	1988	1989
	in billions of US dollars								
Industrial countries	– 36.4	– 45.9	– 80.0	– 28.1	– 7.9	– 36.3	7.8	–10.6	–14.7
United States	–143.7	–126.5	–105.9	–159.5	–127.2	–113.2	22.3	2.2	1.0
Japan	87.0	79.6	57.2	96.4	95.0	76.9	16.7	21.0	23.4
European Community	34.7	16.0	2.3	27.6	17.4	3.4	– 7.7	– 7.0	– 4.4
BLEU*	2.8	3.6	3.9	– 0.2	1.4	1.3	0.4	0.3	1.1
Denmark	– 3.0	– 1.8	– 1.4	0.8	1.9	2.4	– 4.1	– 4.3	– 4.5
France	– 4.4	– 3.5	– 3.7	– 8.7	– 8.1	– 10.3	– 0.4	0.1	– 0.5
Germany	46.0	50.4	55.5	68.3	77.9	75.4	4.1	5.1	11.8
Greece	– 1.2	– 1.0	– 2.6	– 5.5	– 6.1	– 7.4	– 1.4	– 1.5	– 1.5
Ireland	0.4	0.7	0.6	2.6	3.8	3.7	– 3.1	– 4.0	– 4.0
Italy	– 1.6	– 6.3	– 10.6	– 0.1	– 1.4	– 2.0	– 6.6	– 7.1	– 8.3
Netherlands	2.9	5.5	6.9	5.1	8.5	8.0	0.2	– 0.7	0.9
Portugal	0.4	– 1.1	– 0.6	– 3.6	– 5.5	– 5.2	– 0.9	– 0.9	– 0.8
Spain	– 0.2	– 3.8	– 11.6	– 13.0	– 18.0	– 24.5	– 2.8	– 3.5	– 3.6
United Kingdom	– 7.4	– 26.7	– 34.1	– 18.1	– 37.0	– 38.0	6.9	9.5	5.0
Other European countries	0.1	2.9	– 0.8	– 8.4	– 7.2	– 10.0	0.2	1.1	– 1.0
Austria	– 0.4	– 0.5	– 0.2	– 5.1	– 6.3	– 5.9	– 0.9	– 0.9	– 0.8
Finland	– 1.8	– 3.0	– 4.9	1.4	1.1	– 0.2	– 1.7	– 1.9	– 2.2
Iceland	– 0.2	– 0.2	– 0.1	– 0.1	0.0	0.1	– 0.2	– 0.2	– 0.2
Norway	– 4.2	– 3.7	0.3	– 0.8	– 0.1	3.9	– 1.2	– 1.9	– 2.5
Sweden	– 1.1	– 2.1	– 5.2	4.5	4.9	3.5	– 2.6	– 3.1	– 4.1
Switzerland	7.6	8.4	5.9	– 5.2	– 5.6	– 6.7	10.5	13.0	12.0
Turkey	– 1.0	1.5	1.0	– 3.2	– 1.8	– 4.5	– 2.0	– 2.1	– 1.7
Yugoslavia	1.2	2.5	2.4	0.1	0.6	– 0.2	– 1.7	– 1.8	– 1.5
Other industrial countries	– 14.5	– 17.9	– 32.8	15.8	14.1	6.6	–23.7	–27.9	–33.7
Australia	– 8.6	– 10.1	– 15.7	– 0.5	– 1.1	– 3.7	– 6.6	– 8.1	–10.1
Canada	– 7.1	– 8.3	– 16.6	8.6	8.0	3.9	–12.5	–15.0	–18.9
New Zealand	– 1.8	– 0.8	– 2.1	0.5	2.0	0.8	– 2.1	– 2.5	– 2.3
South Africa	3.0	1.3	1.6	7.2	5.2	5.6	– 2.5	– 2.3	– 2.4
Four Asian NIEs	31.4	28.9	23.5	25.1	21.8	18.8	1.4	4.0	5.5
Hong Kong	2.9	2.8	5.0	– 0.3	– 1.0	0.7	n.a.	n.a.	n.a.
Singapore	0.6	1.7	2.3	– 2.6	– 2.6	– 2.8	0.8	0.9	1.0
South Korea	9.9	14.2	5.1	7.7	11.6	4.5	– 2.8	– 2.0	– 1.2
Taiwan	18.0	10.2	11.1	20.3	13.8	16.4	2.3	3.4	3.9

* Belgium-Luxembourg Economic Union.

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

The volume of manufactured goods imports (seasonally adjusted and excluding erratic items) grew by about 3% in the year to the fourth quarter of 1989, a marked slowdown from previous periods. Over the same period, the volume of manufactured goods exports (again seasonally adjusted and excluding erratic items) rose by over 14%. As a result, the non-oil trade deficit fell. One temporary factor increasing the UK trade

Domestic demand growth and changes in real trade balances from 1987 to 1989



Note: The line shows the regression of changes in the real trade balance on domestic demand growth (excluding primary commodity exporters: Australia, New Zealand and South Africa).

[1] Measured as the percentage change in real final domestic demand, less the average growth of domestic demand (7.9%). [2] The change in the trade balance between 1987 and 1989, measured at constant 1987 prices and expressed as a percentage of average 1987 merchandise exports and imports.

Source: National data.

deficit was that a series of accidents and serious production difficulties in the North Sea halved the UK oil surplus to about $2½ billion in 1989.

Domestic demand growth remained very strong in Spain in 1989, increasing the volume of non-energy imports by 17.5% and bringing the cumulative increase since 1985 to 125%, well above the expansion in the volume of Spain's exports. As a result, Spain's trade deficit rose by more than $6 billion to about $24½ billion in 1989.

... than in Germany

In the major surplus country, Germany, domestic demand has, until recently, expanded at less than the average of other industrial countries. By 1989, final domestic demand in Germany had risen only about 12% above its 1985 level: in the rest of Europe the expansion was about 18%. The volume of German exports again grew faster than that of imports in 1989 – indeed, the differential widened somewhat from 1988. As Germany's terms of trade deteriorated by almost 3% because of higher oil prices and a depreciation of the Deutsche Mark against the US dollar, the increase in the real trade balance was translated into a marginal reduction of the trade surplus measured in dollars. However, the pattern of trade volume changes was reversed in the course of the year as the volume of imports expanded in the year to the fourth quarter of 1989 by almost 4 percentage points more than the volume of exports (see the table below). This was due to a strong recovery in German domestic demand towards the end of 1989 and slower demand growth abroad, most notably in the United States and the United Kingdom.

In two European countries, Denmark and Norway, the improvement in the real trade balance over the last two years exceeded that in Germany. This was mainly attributable to declines in final domestic demand during 1988 and 1989, which held the growth rate of their imports well below the European average. Higher oil prices helped Norway's trade balance to move decisively into surplus in 1989, for the first time in four years.

Changes in real exchange rates ...

The second important feature of European imbalances is that, in general, real exchange rates have not risen in countries with current-account surpluses nor fallen in countries with deficits. This behaviour stands in marked contrast to the large changes in the real effective exchange rates of the US dollar and of the Japanese yen. In particular, several years of large surpluses have not led to a major real appreciation of the Deutsche Mark, unlike earlier periods of mounting German surpluses. Indeed, the real effective exchange rate of the Deutsche Mark has been fairly stable since the beginning of 1987 (see the graph on page 66). Even in the case of the United Kingdom, where real exchange rate fluctuations have been much more marked, the changes that occurred during most of the 1980s do not seem to have been sustained for very long. Real exchange rates of the major European countries have not, then, moved to counteract growing

The German current account

Items	1985	1986	1987	1988	1989 year	1989 fourth quarter[1]
	in billions of US dollars					
Current account	17.1	40.1	46.0	50.4	55.5	42.0[2]
Trade balance	27.8	54.6	68.3	77.9	75.4	68.0[2]
Net investment income	3.3	4.2	4.1	5.1	11.8	13.2
Other services	− 1.3	− 3.4	− 6.7	− 9.8	− 7.9	−12.4[2]
Transfers	−12.7	−15.3	−19.7	−22.8	−23.8	−26.8[2]
Memorandum items:						
Non-oil trade balance[3]	*68.3*	*61.0*	*55.1*	*58.1*	*60.9*	*52.6*
	percentage changes					
Export volumes	*6.6*	*1.1*	*2.4*	*6.5*	*8.8*	*2.8*[2,4]
Import volumes	*4.7*	*5.7*	*5.1*	*6.0*	*7.8*	*6.4*[2,4]
Terms of trade	*1.4*	*15.3*	*3.7*	*− 0.1*	*− 2.7*	*−3.0*[2,4]

[1] At an annual rate. [2] Seasonally adjusted. [3] At constant 1980 trade unit values. [4] Change over fourth quarter 1988.

imbalances. By contrast, the substantial appreciation of most European currencies against the US dollar has helped to reduce Europe's trade surplus with the United States. One consequence of this is that trade surpluses or deficits in European countries are increasingly taking the form of trade imbalances with other European countries. For example, Germany's trade surplus now reflects almost entirely net exports to other European countries as its trade surplus with other industrial countries has been eliminated. Between 1987 and 1989, Germany's trade surplus with the United States fell by about $9 billion to about $4½ billion.

... with significant real appreciations in deficit countries aggravating trade imbalances ...

Moreover, European imbalances have been made worse by a significant loss of price competitiveness in a number of European countries in current-account deficit. Some simple comparisons of changes in consumer prices, expressed in a common currency, suggest that prices in deficit countries have risen faster than prices in surplus countries – in some cases by a wide margin (see the table opposite). The quite pronounced deterioration in Spain's and Sweden's real trade balances resulted in part from the significant real appreciation of their currencies.

... and affecting tourism

Changes in price competitiveness also help to explain the widely differing fortunes of the tourism sector in various countries. As the real effective exchange rates, based on relative consumer prices, of the drachma, lira and peseta have appreciated since 1987, the net foreign earnings from tourism of Greece, Italy and Spain have been adversely affected. As recently as 1985, for instance, Italian travellers abroad spent only about one-fifth of what foreign visitors spent in Italy; by 1989 this ratio was over one-half. This rise was an important reason for the widening of Italy's current-account deficit to nearly $11 billion. By contrast, relatively good price competitiveness performance in Austria and France (thanks to low inflation) helped to produce a sharp increase in these countries' tourism revenues. Higher earnings from foreign tourism held the French current-account deficit to $3.7 billion, despite a continued deterioration in its manufactured goods trade balance. Relative price factors also played a part in holding the increase in total German tourist spending abroad to 3½%, compared with a 9½% rise in foreign visitors' spending in Germany (in Deutsche Mark terms).

Changes in net investment income

The third factor contributing to growing European imbalances consisted of changes in the net investment income balances in deficit and surplus countries. The growth in the stock of net foreign assets of Germany (and also of smaller economies, such as the BLEU and the Netherlands) provided a powerful boost to net investment income receipts in 1989, thereby increasing already large surpluses. In Germany net investment income receipts more than doubled to $11¾ billion last year, reflecting not only its large net foreign asset position but also higher short-term interest rates (given the relatively large weight of shorter-term maturities in its foreign assets). Conversely, in Switzerland net investment income receipts fell last year for the first time in the 1980s, as Swiss interest rates rose significantly during the year relative to those abroad.

Net investment income flows also aggravated the growing imbalances

Relative consumer prices in selected European countries in a common currency											
Years	Surplus countries*					Deficit countries*					
	Belgium	Germany	Nether-lands	Switzer-land	Average	France	Italy	Spain	Sweden	United Kingdom	Average
	in Deutsche Mark, 1987 = 100										
1988	100.4	101.3	100.9	101.4	101.0	101.3	102.2	108.5	107.0	111.5	106.1
1989	103.4	104.1	101.7	100.1	102.3	104.8	110.6	122.0	115.8	118.4	114.3
1990 Q I	105.9	106.0	102.9	101.4	104.1	106.8	113.0	124.4	117.0	112.6	114.8

* According to current-account position in 1987–89.

on other transactions in most deficit countries. In the United Kingdom net investment income receipts dropped by $4.5 billion in 1989 as larger earnings on direct investment in the United Kingdom and higher interest charges on rapidly rising shorter-term foreign liabilities increased interest, profit and dividend payments. The growing net foreign liability positions of Italy and Sweden raised their net investment income payments by about $1 billion in 1989. The increase was much smaller in Spain, because the growing importance of its non-interest-yielding foreign liabilities (notably direct investment) tended to shield investment income payments from the rise in international interest rates.

Assessing the role of the investment boom ...

Finally, a factor considered by some to have a bearing on European imbalances relates to the pattern of trade and the composition of demand. As described in Chapter II, the most recent surge in domestic demand in many industrial countries, particularly in Europe, owed much to rapid increases in fixed capital spending. This has increased the importance of trade in capital goods, relative to consumer goods. Although the statistics on the composition of trade are incomplete and not uniform across countries, it does appear that trade in capital goods has expanded at a much faster rate than trade in consumer goods in the last two years. This is the reverse of the pattern seen from 1980 to 1987 (see the table overleaf).

However, it is unclear whether this development has contributed to the widening of deficits in capital-goods-importing countries or surpluses in capital-goods-exporting countries. Most advanced industrial countries for which data are available have a higher share of capital goods in their exports of finished manufactured goods than in their imports. Italy and Spain are the only countries where the share of capital goods in total finished manufactured goods is greater for imports than for exports, and whose trade performance might therefore have suffered from the recent growth bias in favour of fixed capital spending.

The potential impact of differences in the commodity composition of trade is illustrated by the graph overleaf, which shows the contribution of trade in capital goods to growth in exports and imports of finished manufactured goods for various countries during the 1980s. With the exception of Spain, most European countries do not appear to differ much from each other. By contrast, the trade pattern of some non-European countries is distinctly different: while the United States and Japan are capital goods exporters, South Korea is a capital goods importer and consumer goods

Trade in capital and consumer goods in selected industrial countries[1]

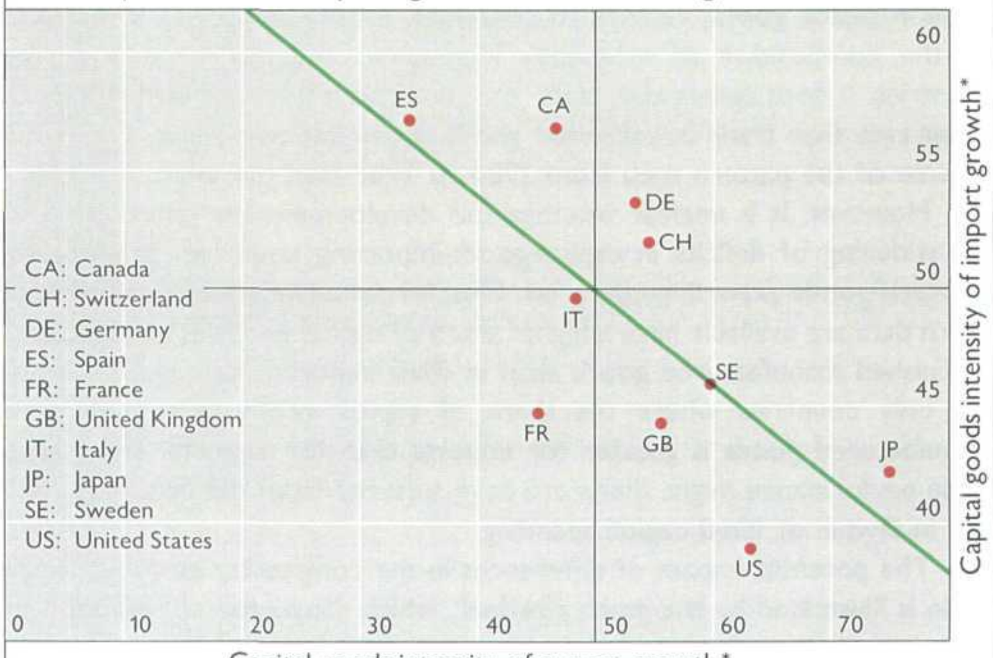
Periods	Average annual growth in: Capital goods		Consumer goods		Share of capital goods in total finished manufactured goods trade[2]	
	Exports	Imports	Exports	Imports	Exports	Imports
	in percentages					
1981–87	6.2	9.6	7.3	11.0	56.6	42.7
1988–89	13.5	15.2	8.5	8.8	58.8	45.6

[1] Aggregate dollar value of imports and exports of Canada, Germany, France, Italy, Japan, Spain, Sweden, Switzerland, the United Kingdom and the United States. [2] In the last year of each period, i.e. 1987 and 1989.

exporter. Compared with other countries, France also has a lower-than-average share of capital goods in exports. Yet there is no marked difference between the share of capital goods in imports and in exports. Even Germany, which is a large exporter of capital goods, does not show a concentration on capital goods exports that is out of line with other European countries and deviates little from the average when imports are considered. There therefore appears to be little evidence that the recent boom in capital spending in Europe has been a central reason for Germany's large external surplus.

Rather, Germany's trade structure is mainly distinguished by the large

The importance of capital goods in trade during the 1980s



Capital goods intensity of export growth*

Note: The line shows the correlation between the degrees of capital goods intensity of export and import growth.

* Change in the value of imports/exports of capital goods as a percentage of the change in total imports/exports of capital and consumer goods between 1980 and 1989.

Source: National data.

... and differences in structural trade balances in manufactured goods

structural surplus on trade in finished manufactured goods – consumer and capital goods alike. In 1989 German exports of such goods were two-thirds higher than imports, so that any strong rise in trade in finished manufactured goods – caused, for instance, by a consumer durables boom or a cyclical upturn in investment – tends to increase the German surplus. Italy also enjoys a marked surplus. On the other hand, France and the United Kingdom have large deficits on trade in finished manufactures, and this structure accounts for part of the widening trade deficits seen in both countries.

Other industrial countries and the Asian NIEs

One significant feature of the pattern of international trade and payments last year was the deterioration of about $20 billion in the external balances of the other non-European industrial countries and the Asian NIEs (see the table on page 71).

Higher deficits in Australia, Canada ...

Even though world prices for their commodity exports remained relatively high, the current-account deficits of *Australia* and *Canada* increased by $5.6 and 8.3 billion, reaching the equivalent of 5½% and 3% of their respective GNPs. Both countries have benefited from significant terms-of-trade gains, with Australia's terms of trade improving by about one-quarter during the last three years and Canada's by just 8½% over the same period. There are three reasons why these terms-of-trade improvements did not lower the current-account deficits. Firstly, domestic demand rose much more strongly than in the rest of the world on average (see the graph on page 72). As in many other countries, private non-residential investment grew particularly rapidly in the last two years, leading to increased imports of capital goods. Secondly, both countries have seen significant real appreciation of their currencies because of the rise in commodity prices and high nominal domestic interest rates. The volume of Canadian goods exports fell slightly last year, one symptom of declining competitiveness, although the weakness of US demand also played a role. Finally, both countries have large external debts: with net liabilities growing as deficits accumulate and with interest rates rising, the deterioration in their net investment income balances last year was particularly large. Net investment income paid abroad amounted to 3½% of GNP in both countries last year.

... and New Zealand

New Zealand also benefited from terms-of-trade gains in 1987 and 1988 but domestic demand was very weak, leading to a sizable reduction in the current external deficit in 1988. Preliminary figures for 1989, however, suggest a sharp increase in the volume of imports: import liberalisation and a strong rebound in investment appear to be the main factors. As the volume of exports has weakened (partly because of special factors, including a drought), the current-account deficit is estimated to have widened to about 5% of GDP.

South African exports strong

South Africa's current-account surplus increased slightly despite a marked deterioration in the terms of trade: the volume of exports (excluding gold) rose by over 16%, while import volumes stagnated as total domestic demand declined. The surplus permitted a further reduction in the country's external debt; however, net investment income paid abroad, which had fallen from 3.7% of GDP in 1985 to 2.5% in 1988, rose slightly as a percentage of GDP in 1989.

South Korea's surplus falls ...

The combined current-account surplus of the Asian NIEs fell by about \$5½ billion to \$23½ billion. This overall movement reflected a decline of more than \$9 billion in South Korea's external surplus and somewhat higher surpluses of the other Asian NIEs. In *South Korea* large increases in nominal wages in 1988 and 1989 (the cumulative increase over the two years was about 50%) provided a powerful stimulus to domestic demand and, together with substantial exchange rate appreciation up to early 1989, led to a considerable loss in international competitiveness. Moreover, production was disrupted by widespread strikes. A marked reduction in the real trade balance resulted as the volume of exports fell by 5% while import volumes rose by 14%, almost exactly in line with the growth in domestic demand. In addition, South Korea's large surplus on non-factor services in 1988 – which in part reflected exceptional tourist receipts during the Olympic Games – virtually disappeared in 1989. *Taiwan's* current-account surplus, which had narrowed significantly in 1988, widened to \$11 billion (7.5% of GNP) as export volume growth recovered and as the impact of exceptional gold imports in 1988 disappeared. Finally, both *Hong Kong* and *Singapore* recorded larger current-account surpluses.

... but the surpluses of other Asian NIEs rise

Deficits widen in eastern Europe ...

There appears to have been a major deterioration in eastern European countries' aggregate current-account balance in convertible currencies last year, perhaps of as much as \$7 billion, or about one-sixth of the value of their merchandise exports to industrial countries (see the table on page 48). The *Soviet Union's* current-account position is subject to much uncertainty but appears to have deteriorated significantly in 1989. Imports of western consumer goods rose, while hard-currency earnings from oil exports appear to have been broadly unchanged as a decline in the volume of Soviet oil exports to the West offset the impact of higher oil prices. *Poland's* trade surplus narrowed from around \$1 billion in 1988 to \$¼ billion in 1989: the dollar value of convertible currency imports rose by some 16% while that of exports rose by only 4%. Most of this deterioration, however, occurred in the first three quarters of the year, before the introduction of the October 1989 reforms. Since then hard-currency exports are estimated to have risen significantly, while imports have fallen steeply in the wake of a severe compression of domestic demand. The current-account deficit (including interest payments due) amounted to \$1.8 billion (about 3% of GDP). However, excluding arrears and debt relief on interest obligations (which rose by \$2.4 billion), there was a surplus of some \$0.6 billion. Imports also rose strongly in *Hungary* despite a fall in domestic demand in 1989. The tourism account also moved sharply into deficit as Hungarian citizens took advantage of the greater freedom to travel. With interest rates rising and external debt accumulating, there was a further increase in net interest payments abroad. Exports from *Czechoslovakia* grew substantially in 1989, largely because enterprises were allowed to retain a portion of their foreign exchange earnings; the current-account deficit therefore appears to have stabilised.

... where the underlying external position is fragile

The underlying external position of most eastern European countries is probably even more fragile than the size of their 1989 current-account deficits would suggest. Traditionally, a significant amount of their trade essentially took the form of bilateral barter under which, on balance, the Soviet Union exchanged raw materials (notably energy products) for manufactured goods from eastern Europe. The terms on which eastern European countries could import raw materials under these arrangements were much more favourable than they could have obtained on world markets. In addition, a guaranteed market was provided for eastern European exports of manufactured goods. This bilateral barter system is under review at present, and reform is likely to involve movement towards settlement in convertible currencies and away from preferential trading patterns. While these changes are obviously consistent with the new market-oriented policies now being adopted, the short-run balance-of-payments costs for eastern European countries (other than the Soviet Union) are likely to be heavy.

International imbalances and saving and investment

In order to put persistent international imbalances into a longer-term perspective, it is of interest to review – especially in the light of the lower global propensity to save observed in the 1980s – how they have reflected different saving and investment behaviour in surplus and deficit countries.

Decline in savings in deficit countries ...

Over the 1980s as a whole, the share of gross saving in GNP (see the graph overleaf) rose by about 4–5 percentage points in Japan and in other surplus countries but fell in the United States and other deficit countries. The decline in US saving was particularly steep. The share of investment fell in both surplus and deficit countries until the middle of the decade and rose sharply thereafter, the main exception to this pattern being the United States.

... larger rise in investment in surplus countries

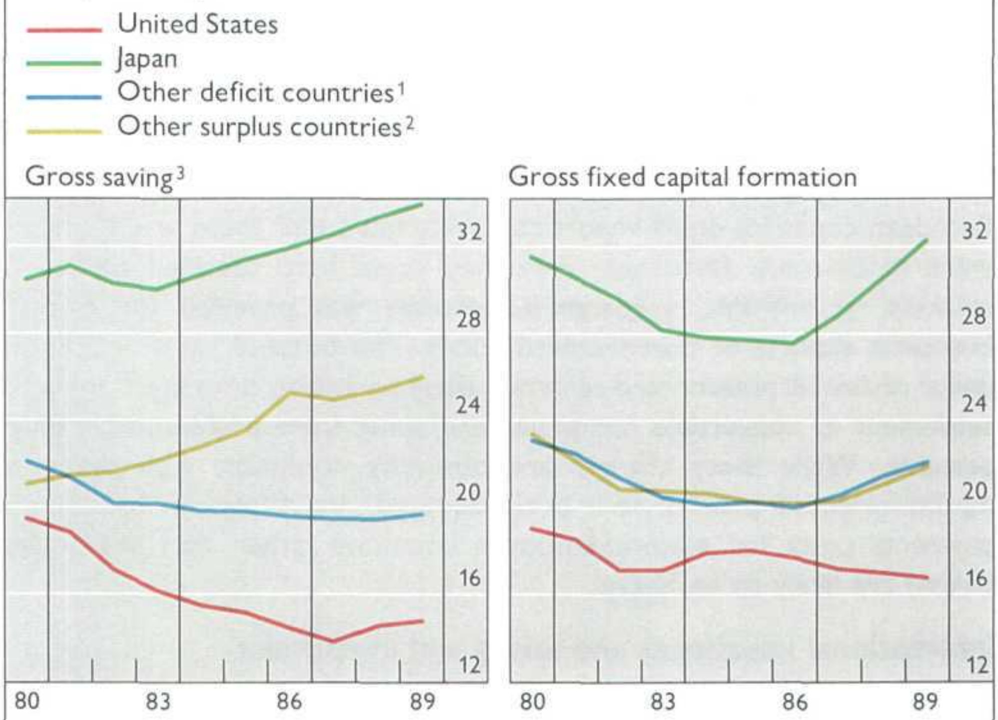
Much has been made of the role played by greater investment in enlarging the current-account deficits in a number of industrial countries. It is indeed true that, in many instances, the widening of deficits over the last two to three years owed more to a rise in the ratio of fixed investment to GNP than to a decline in the saving rate. But the investment share rose faster in the surplus countries than in the deficit countries and was financed by domestic saving. Indeed, the share of saving in GNP has risen so much in surplus countries that they have been able to finance both the boom in domestic investment and a significant increase in net external assets: their current-account surplus has averaged around 4½% of GNP since 1986. In deficit countries, by contrast, the share of saving has merely stabilised at a rather low level after having fallen for much of the decade. In this sense, it is divergent saving trends that account for widening imbalances.

Much-increased saving and investment in Japan ...

The reduction of the US and Japanese imbalances during the past two to three years has, by contrast, owed rather more to divergent investment trends. On the one hand, the decline in the Japanese surplus has been

Saving and investment in selected deficit and surplus countries

As a percentage of GNP/GDP



Note: Averages have been calculated using 1987 GDP weights and exchange rates.

[1] Countries in current-account deficit in 1989: Australia, Canada, France, Italy, Spain, Sweden and the United Kingdom. [2] Countries in current-account surplus in 1989: Belgium, Germany, the Netherlands, South Korea, Switzerland and Taiwan. [3] Excluding inventory investment.

associated with an increase in the share of investment in GNP (up by more than 4½ percentage points since 1986) which exceeded the rise in the saving rate (see the graph above). In the process of adjustment, therefore, Japan has managed to increase its high saving rate while investing more in domestic assets and less in foreign assets. On the other hand, the adjustment process in the United States has been hindered by only a small rise in the national saving rate, which remains well below even the depressed levels prevailing earlier in the decade. At the same time, the lower share of investment spending in GNP reflected a fall in the relative price of investment goods – mainly because of declines in the prices of computers; at constant prices, the investment share actually rose.

... but not in the United States

Trends in capital movements

Increasing capital mobility

A number of countries took further measures last year to liberalise international capital movements. Private residents of all major and most smaller industrial countries now enjoy almost complete freedom to acquire foreign assets; the main exception is that non-bank financial institutions' investment abroad remains regulated in a number of countries. Indeed, one of the striking features of the international economy in recent years is the much-increased international mobility of capital; the volume of capital movements rose particularly sharply last year. Not only did direct investment flows rise significantly in 1989 (continuing a trend evident since

1985), but the volume of securities transactions also increased strongly as the shadow cast by the stock market break of October 1987, which had temporarily checked the growth in international transactions in securities, disappeared. Direct investment and portfolio outflows and inflows for the thirteen larger industrial countries over the period since 1975 are summarised in the table overleaf.

Factors behind the strength of foreign direct investment

Foreign direct investment flows continued to grow strongly during 1989: aggregate inflows for the countries shown in the table are estimated to have increased by about $17 billion. Since the first half of the 1980s, inward and outward flows have risen about fourfold. However, measured outflows persistently exceed measured inflows, partly because of net outflows to countries not included in the table. But a more important reason for the discrepancy is the use of different definitions and accounting standards by the reporting countries – the treatment of reinvested earnings and the threshold beyond which the acquisition of equities counts as direct, not equity, investment are two important areas where conventions differ. Nevertheless, the broad trends in direct investment activity are revealed by both inflows and outflows.

Foreign direct investment flows appear to be strongly pro-cyclical, varying more than proportionately with economic activity. Part of the strong rise since the mid-1980s, therefore, can be attributed to recovery from a recession that depressed foreign direct investment. Secondly, a wave of cross-border mergers and acquisitions has increased foreign direct investment flows. Thirdly, substantial changes in real exchange rates in the mid-1980s prompted a number of enterprises to relocate production to areas where labour costs were lower. The fear of protectionism also encouraged exporting enterprises to establish production units in export markets. A fourth influence has been the international boom in property prices (discussed in Chapter IV), which has increased the value of direct investment in real estate. Also, the rapid rise in property prices in some countries (notably Japan and the United Kingdom) may have led to capital outflows to countries where property was perceived as being relatively "undervalued".

More direct investment in the EC

The most significant change in foreign direct investment inflows during 1989 was the large rise in investment in the countries of the European Community: total inflows into the member states included in the table overleaf amounted to $63 billion in 1989, compared with $47 billion in 1988. The prospect of a large unified European market was probably the most important factor behind this development. However, inflows remained unevenly distributed among EC countries. Foreign direct investment in Germany amounted to about $6 billion, while the total in the United Kingdom reached $26 billion and that in Spain exceeded $5 billion. A relatively favourable climate for foreign investors and a permissive attitude to takeovers probably account for much of the attractiveness of the United Kingdom. Spanish capital inflows can be attributed to relatively low wage costs, extensive tax incentives and a large domestic market.

By contrast with Europe, direct investment in the other industrial countries fell (Canada) or remained broadly unchanged (United States and Australia). There was net disinvestment in Japan, where foreign direct investment has typically been very small. Finally, the United States still accounted for almost half of the total inflows into the industrial countries.

Japan the largest foreign direct investor

With total direct investment outflows rising to $175 billion, Japan displaced the United Kingdom as the largest provider of capital, investing about $44 billion abroad. About one-half of foreign direct investment has in recent periods gone to the United States.

Capital movements in thirteen industrial countries

Items	1975–79	1980–84	1985–89	1986	1987	1988	1989
	in billions of US dollars, annual averages						
Portfolio investment							
Total outflows[1]	17.6	46.9	177.5	180.3	122.8	194.6	269.2
United States	5.8	5.7	9.5	4.3	5.3	7.8	22.5
Japan	2.6	13.8	90.0	102.0	87.7	86.9	113.3
Germany	1.5	4.3	20.5	9.7	13.7	41.5	26.4
United Kingdom	0.8	10.9	26.3	34.0	−6.7	17.8	61.5
Others[2]	6.9	12.2	31.2	30.3	22.8	40.6	45.6
Total inflows[3]	19.8	57.7	165.6	164.4	99.7	147.5	271.2
United States[4]	4.6	16.7	59.4	74.8	34.5	46.6	69.7
Japan	3.0	11.9	23.3	0.5	−6.1	20.3	85.1
Germany[5]	2.0	9.1	15.0	31.7	11.1	−2.3	22.2
United Kingdom	1.7	1.6	17.7	13.7	23.0	20.8	19.5
Others[2]	8.5	18.4	50.2	43.7	37.2	62.1	74.7
Direct investment							
Total outflows[1]	34.0	39.5	117.3	83.6	124.2	151.3	174.5
United States[6]	15.9	9.6	21.8	17.7	28.0	17.7	32.6
Japan	2.1	4.3	23.7	14.5	19.5	34.2	44.1
Germany	3.0	3.6	9.8	10.0	9.1	11.3	13.5
United Kingdom	6.2	9.4	25.6	17.2	31.1	37.1	31.7
Others[2]	6.8	12.6	36.4	24.2	36.5	51.0	52.6
Total inflows[3]	18.3	34.3	87.4	60.4	91.2	116.3	133.6
United States[6]	6.1	18.3	44.2	36.1	47.3	57.6	59.5
Japan	0.1	0.3	0.1	0.2	1.2	−0.5	−1.1
Germany	1.3	0.8	2.2	1.1	1.9	1.3	6.0
United Kingdom	4.2	5.3	13.7	7.2	14.1	16.0	26.2
Others[2]	6.6	9.6	27.2	15.9	26.7	41.9	43.0
Memorandum item: Direct investment inflows into the EC[7]	*10.5*	*13.2*	*37.8*	*17.0*	*34.1*	*47.3*	*63.2*

[1] Increase in residents' assets. [2] Other Group of Ten countries plus Spain and Australia. [3] Increase in non-residents' assets. [4] Including US Treasury securities. [5] Including official domestic borrowers' notes. [6] Excluding exchange rate related valuation effects. [7] BLEU, France, Germany, Italy, the Netherlands, Spain and the United Kingdom.

Sources: National data, IMF Balance of Payments Statistics and World Economic Outlook.

The strong expansion of activity and the prospects for faster growth abroad than in the United States led in 1989 to greater reinvestment overseas of the earnings of US subsidiaries. In addition, US acquisitions of foreign companies increased significantly.

Increasing portfolio flows and the role of financial institutions ...

The volume of international transactions in securities continued to rise sharply in 1989. Aggregate flows of portfolio capital – inward and outward – reached about $270 billion, compared with less than $20 billion in the late 1970s. This trend, which became apparent in the mid-1980s, owed much to increased institutional investment in foreign securities. A large proportion of the funds invested internationally has come from non-bank financial institutions – insurance companies, pension funds and unit trusts. Liberalisation in financial markets and, in some cases, official incentives for individuals to provide for their own pensions have led to a large increase in the funds at the disposal of institutional investors. But not all countries permit domestic institutions to invest freely in foreign securities, and such differences in official policy have influenced the pattern of capital movements.

... in Japan ...

Japanese financial institutions' appetite for foreign securities is one important reason for *Japan's* dominance in portfolio investment flows. Since the mid-1980s the progressive relaxation of restrictions on Japanese institutions' investment has permitted a substantial build-up of foreign assets. Although Japanese life insurance companies' holdings of foreign securities have hovered around 30–35% of their total securities holdings since 1987, suggesting that the phase of radical diversification into foreign assets is over, the rapid expansion of their total assets (which rose by 20% last year) continues to support a strong demand for foreign securities. Over the last five years, Japanese purchases of foreign securities have averaged $90 billion annually, about half of the total outflows identified in the table opposite.

... and the United Kingdom ...

Heavy outflows from the *United Kingdom* also reflect strong institutional demand for foreign financial assets: the net acquisition of foreign financial assets by pension funds, insurance companies and unit trusts has risen sharply in recent years, amounting to around $28 billion in 1989. As in the case of Japan, the investible funds of these institutions are expanding rapidly.

... which contrasts with that in Germany and the United States

By contrast, portfolio outflows from *Germany* and the *United States,* though rising appreciably in recent years, have remained relatively moderate given the size of these economies. In Germany the organisation of company pension schemes (where assets are often held within the company, and not placed in open financial markets) and restrictions on foreign investment by insurance companies have traditionally limited institutions' portfolio outflows. In the United States, too, institutional investment in foreign financial assets has remained low.

Heavy international borrowing by Japanese corporations

Japan has also come to dominate aggregate portfolio inflows. One somewhat paradoxical reason for this is the continuation of some residual official restrictions in domestic capital markets. The steep rise in capital inflows to Japan in the last two years (and particularly in 1989) reflected a big increase in bonds issued abroad by Japanese companies. Net issues of external bonds, less than $8 billion annually before 1985, have risen rapidly in recent years, reaching $35 billion in 1988 and $75 billion last year. A significant part of issues abroad took the form of foreign currency denominated equity-related bonds that could not be issued in Tokyo. Typically the equity warrants were detached from the bonds soon after issue; some of these warrants and "stripped" bonds were then sold separately to Japanese residents, thus giving rise to a capital outflow (resident purchase of foreign-owned equities and bonds). Partly because the value of equity warrants increased sharply in a rising stock market, this capital outflow offset part of the inflow recorded at issue.

Ease of financing current-account imbalances

In conclusion, one important implication of the greater international mobility of capital in the 1980s is that capital flows (other than official financing) were often driven by certain deep-seated factors that proved capable of sustaining net capital movements in the same direction for many years. As a result, current-account imbalances have been more persistent than in earlier decades, when deficits would often provoke heavy outflows of short-term capital and so intensify pressures to reduce imbalances. The ease of financing of current-account deficits (and, conversely, of recycling of surpluses) was again much in evidence last year.

The financing of current-account imbalances in the industrial countries

Indeed, non-official inflows in 1989 over-financed large current-account deficits in the *United States, Italy* and *Spain*. Of the major deficit countries only the *United Kingdom* faced an appreciable loss of reserves. Similarly, non-official capital outflows more than recycled the surpluses of *Japan* and *Germany* so that official monetary assets fell substantially in both countries (see the table opposite). At times exchange market intervention was particularly heavy, with Japan, the major surplus country, being confronted with exceptionally strong and persistent downward pressure on its currency. The pattern of intervention during the year is discussed more fully in Chapter VII.

Unprecedented build-up of US reserves

The net official reserve position of the *United States* improved by about $18 billion in 1989 as a whole, after three years of decline. One new feature was the scale of US acquisition of foreign currency reserves. Because of the reserve currency status of the dollar, US official holdings of foreign currencies have generally been relatively small, amounting to $17.4 billion at the end of 1988. But during 1989 such reserves rose by over $25 billion, significantly exceeding the $7.4 billion increase in foreign official assets placed in the United States. The pattern of non-official flows also changed a good deal in 1989. Net portfolio inflows into the United States accounted for almost one-half of total net private inflows; in addition, the statistical discrepancy, which rose to $35 billion last year, may have reflected unrecorded inflows from the Euro-market. According to BIS banking statistics (shown in Chapter V), the net capital inflow from banks abroad to US non-bank entities amounted to $50 billion in 1989. By contrast, net direct investment inflows declined appreciably.

Financing of major current-account imbalances in industrial countries

Items	1986	1987	1988	1989
	in billions of US dollars			
United States				
Capital account	110.1	103.3	88.9	121.7
of which: Direct investment[1]	*18.4*	*19.3*	*39.9*	*26.9*
Securities[2]	*70.5*	*29.2*	*38.7*	*47.1*
Banks, other than above	*19.8*	*46.9*	*14.3*	*10.8*
Statistical discrepancy	*11.3*	*1.9*	*−10.6*	*34.9*
Changes in the net official monetary position[3]	33.8	56.9	36.6	−18.0
Japan				
Capital account	− 72.1	−44.7	−64.1	−81.9
of which: Direct investment	*− 14.3*	*−18.4*	*−34.7*	*−45.2*
Securities	*−101.4*	*−93.8*	*−66.6*	*−28.1*
Banks, other than above	*58.5*	*71.8*	*44.5*	*8.6*
Statistical discrepancy	*2.5*	*− 3.9*	*2.8*	*−22.0*
Changes in the net official monetary position[3]	− 13.7	−42.3	−15.5	24.7
Germany				
Capital account	− 37.0	−22.6	−69.6	−65.5
of which: Direct investment	*− 8.9*	*− 7.2*	*−10.0*	*− 7.5*
Securities[4]	*22.0*	*− 2.6*	*−43.8*	*− 4.2*
Banks, short-term	*− 27.9*	*− 3.9*	*−10.3*	*−30.3*
Other private, short-term	*− 25.1*	*− 5.5*	*−12.8*	*−23.5*
Changes in the net official monetary position[3]	− 3.1	−23.4	19.2	10.0
United Kingdom				
Capital account	4.4	20.5	27.7	23.7
of which: Direct investment	*− 10.0*	*−17.0*	*−21.1*	*− 5.5*
Securities	*− 20.3*	*29.7*	*3.0*	*−42.0*
Banks, other than above	*15.0*	*− 1.1*	*22.8*	*21.6*
Statistical discrepancy	*14.9*	*12.5*	*17.9*	*26.6*
Changes in the net official monetary position[3]	− 4.3	−13.1	− 1.0	10.4

Note: The capital account includes the statistical discrepancy, negligible in Germany for all years shown.

[1] Excluding exchange rate related valuation effects. [2] Including US Treasury securities. [3] The net official monetary position is gold and foreign exchange reserves less liabilities to foreign monetary authorities. Valuation adjustments are excluded. A minus sign indicates an increase in official assets. [4] Including official domestic borrowers' notes.

Japanese reserves decline ...

Net official reserve assets in *Japan* declined by about $25 billion in 1989. The change in the composition of Japan's non-official capital outflows was the reverse of the US pattern as net direct investment outflows became more, and net portfolio investment less, important. However, the emergence of a large statistical discrepancy in the balance-of-payments accounts indicates the need for caution in drawing firm conclusions.

... and German net official position deteriorates

The decline in the *German* net official monetary position took the form of increased liabilities to foreign monetary authorities. Actual reserves showed a small increase after the large decline seen in 1988. In marked contrast with Japan, long-term capital flows recycled only a small proportion of Germany's current surplus: net direct and portfolio investment abroad amounted to less than $12 billion in 1989. Short-term outflows through the banking system were instead the main financing vehicle.

UK reserves fall ...

While net direct investment and portfolio flows both went in the direction of financing current-account imbalances in the three largest economies, the *United Kingdom* was confronted with a large current-account deficit and sizable outflows on both direct investment and securities accounts. While balance-of-payments statistics may exaggerate the size of net portfolio outflows (because the large statistical discrepancy probably reflects to an important extent unrecorded non-resident purchases of UK securities), there is little doubt about the direction of capital movements. The current-account deficit and portfolio and direct investment overseas were essentially financed by substantial inflows through UK banks. In the first three quarters of the year bank inflows denominated in sterling amounted to over $20 billion at an annual rate as progressively higher short-term interest rates attracted large inflows of funds into sterling deposits. Such inflows virtually dried up in the fourth quarter as confidence in sterling weakened and high interest rates failed to prevent a significant loss of reserves.

... while other countries with deficits add to their reserves

Unlike the United Kingdom, a number of other countries with growing current-account deficits experienced significant reserve growth. Capital inflows into countries with higher-than-average inflation and interest rates led to upward pressure on the exchange rate, which the authorities resisted with large-scale intervention. Official reserves in *Italy* and *Spain* both rose substantially (by $11 and 5 billion respectively) as current-account deficits of about $11 billion were more than offset by foreign purchases of high-yielding government paper and, in the case of Spain, by substantial foreign direct investment.

Current-account developments in developing countries

Developing countries' trade surplus rises while their investment income deficit widens

The combined current-account deficit of all developing countries other than the Asian NIEs fell from $50 billion in 1988 to $42½ billion in 1989 (see the table opposite). The improvement in the trade balance was much larger, as the surplus on merchandise transactions rose by $13 billion to about $23 billion last year, but the invisibles balance moved deeper into deficit, mainly because of an $8 billion rise in interest payments due. At just over $82 billion, these payment obligations implied an increase in the effective rate of interest on outstanding debt from a little over 7% in 1988 to 8% in 1989. This increase reflected to a large extent the average rise in international interest rates last year, but it might also have been related to the expiry in 1989 of grace periods on interest payments agreed under the extensive debt rescheduling operations of recent years. Nevertheless, actual interest payments last year fell short of interest due, as there was a renewed build-up of interest arrears, estimated at around $14 billion, or 18% of total interest due.

Structural differences again produced markedly different current-account developments in 1989 for the various groups of developing countries. The countries depending mainly on fuel exports recorded a very sizable improvement in their current-account position, which almost completely reversed the deterioration experienced in 1988. The improvement in this group actually more than fully accounted for the current-account improvement of all developing countries combined, as those dependent on exports of non-fuel commodities and manufactured goods saw their current-account deficit, which had stabilised the year before, widen by $9 billion in 1989.

Fuel exporters increase their trade surplus ...

Favourable external conditions allowed the fuel-exporting countries to increase their trade surplus by nearly $20 billion to $50 billion last year. As described in the section on world trade above, oil prices rose by over 20% in dollar terms and the demand for oil in industrial countries and in some developing countries continued to grow briskly. Export earnings were thus boosted by both price and volume developments (see the table on page 89). Nonetheless, as domestic economic activity remained relatively strong, import volumes also rose appreciably, particularly when seen against their substantial drop throughout most of the 1980s.

... while other groups experience a deterioration

In the non-fuel-exporting countries the aggregate trade deficit grew by $6 billion to nearly $27 billion in 1989. This result was primarily attributable to a small terms-of-trade deterioration for this group as a whole, with particularly large losses being incurred by producers of a number of commodities (notably coffee, cocoa, nickel and copper), the

International current-account balances

Country groups	Current-account balance			Of which: Trade balance			Of which: Balance on investment income		
	1987	1988	1989	1987	1988	1989	1987	1988	1989
	in billions of US dollars								
Industrial countries	−36.4	−45.9	−80.0	−28.1	− 7.9	−36.3	7.8	−10.6	−14.7
Eastern European countries[1]	5.0	3.4	− 3.5	..	..	..	− 6.4	− 7.3	− 8.2
Asian NIEs	31.4	28.9	23.5	25.1	21.8	18.8	1.4	4.0	5.5
Developing countries[2]	−33.2	−49.8	−42.7	23.6	10.1	23.2	−32.1	−36.1	−41.7
Fuel exporters[3]	− 3.7	−20.4	− 4.5	48.1	30.9	50.0	1.7	1.5	− 0.9
Non-fuel exporters	−29.5	−29.4	−38.2	−24.5	−20.8	−26.8	−33.8	−37.6	−40.8
Exporters of manufactured goods[3]	− 9.5	−10.0	−14.0	− 2.5	− 0.6	− 4.4	−14.1	−15.7	−16.6
Exporters of primary products[3]	−15.7	−14.0	−14.2	− 1.9	0.9	2.3	−13.0	−14.4	−16.1
Others	− 4.3	− 5.4	−10.0	−20.1	−21.1	−24.7	− 6.7	− 7.5	− 8.1
Total[4]	−33.2	−63.4	−102.7	..	..	..	−29.3	−50.0	−59.1
Memorandum item:									
Heavily indebted countries	*− 9.1*	*− 9.0*	*−10.7*	*27.1*	*31.3*	*34.0*	*−32.5*	*−35.4*	*−39.5*

[1] Balances in convertible currencies of Bulgaria, Czechoslovakia, the German Democratic Republic, Hungary, Poland, Romania and the Soviet Union. [2] Other than the Asian NIEs. [3] Countries whose exports of fuel, manufactured goods and primary products respectively accounted in 1985–87 for over 50% of their exports of goods and services. [4] Equals the world current-account discrepancy.

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

prices of which declined sharply because of over-supply on world markets (sometimes due to the breakdown of agreements on price support measures). At the same time, volume developments did not fully compensate for the terms-of-trade deterioration.

Export performance of non-fuel exporters weakens ...

The export performance of the non-fuel exporters – which had been quite strong in 1987 and 1988 – showed signs of weakening. For the first time since 1986 the volume growth of exports, slowing from 9½% in 1988 to just 7½% last year, fell short of that of aggregate import demand in their main markets in the industrial countries. Performance, however, differed widely among countries. Argentina, Brazil, Chile and the Philippines did particularly badly, recording only negligible rates of export growth, whereas others, such as Thailand and Malaysia, maintained rapid export growth.

Moreover, the volume of imports grew much more rapidly than GDP, implying a further increase in the ratio of import to GDP growth. This ratio, which had been very low if not negative during most of the 1980s, reached 2, the highest level for many years. The average figures masked, however, striking differences among countries. Reflecting rapid GDP growth as well as the progressive shift towards more domestic-demand-led policies in some countries, the volume of imports in many Asian non-fuel-exporting countries increased by over 10%. Even higher rates of over 15% were recorded for a number of Latin American countries, such as Brazil, Chile and Mexico. By contrast, a major slump in import demand was observed in Argentina, Peru and Venezuela, while import growth of the African primary commodity producers was sluggish, as activity remained depressed.

The combined trade surplus of the group of heavily indebted countries widened by close to $3 billion last year, but, given external indebtedness of over 2½ times their exports of goods and services, this improvement was overshadowed by the impact of rising interest rates on external debt. The current-account deficit of this group accordingly rose to close to $11 billion from around $9 billion in both 1987 and 1988.

Notwithstanding the small improvement in the combined trade surplus of the heavily indebted countries in 1989, the underlying trade performance in volume terms showed signs of increasing strain. In fact, the trade surplus improvement in 1989 was entirely attributable to a small terms-of-trade gain, as volume developments had an adverse impact on the trade account.

... with heavily indebted countries faring particularly badly ...

Exports from the heavily indebted countries neither kept up with the growth of world trade nor matched the export growth of the developing world as a whole. This had already been the case in 1988, but the situation worsened considerably last year, when export volume growth slumped to just 3½%, less than half the average for the developing world. Import volume growth also slowed to 5% in 1989, but was still four to five times faster than sluggish GDP growth in this group of countries. Strong import growth recorded in some of the heavily indebted countries was often the direct consequence of looser fiscal and monetary policies. This was, for instance, the case in Brazil, where imports were further stimulated by

Indicators of foreign trade: selected groups of developing countries

Country groups	Period	GDP	Import volume	Export volume	Terms of trade
	percentage changes, annual averages				
All developing countries*	1982–85	3.6	– 3.7	–0.8	– 1.9
	1986–87	3.6	– 6.0	6.7	–10.8
	1988	4.1	8.5	11.0	– 7.1
	1989	2.8	6.1	7.4	3.2
Fuel exporters	1982–85	1.5	– 8.3	–6.1	– 3.5
	1986–87	0.7	–13.7	7.6	–23.3
	1988	1.8	6.5	12.8	–18.6
	1989	1.7	6.0	7.2	9.3
Non-fuel exporters	1982–85	4.6	0.2	3.6	– 0.6
	1986–87	5.2	0.6	5.9	– 0.3
	1988	5.3	8.5	9.5	2.7
	1989	3.1	6.1	7.5	– 2.0
of which: Exporters of manufactured goods	1982–85	6.4	5.9	6.1	– 0.6
	1986–87	6.5	– 0.7	3.3	4.3
	1988	5.9	12.3	12.5	2.5
	1989	3.5	8.1	9.3	– 1.3
Exporters of primary goods	1982–85	0.3	– 7.5	1.6	– 1.0
	1986–87	4.0	6.3	5.8	– 6.3
	1988	0.9	1.8	2.3	5.4
	1989	–0.3	1.3	5.1	– 1.4
Memorandum items:					
Heavily indebted countries	*1982–85*	*0.9*	*–11.1*	*2.9*	*– 3.0*
	1986–87	*3.7*	*2.4*	*2.9*	*– 7.5*
	1988	*0.7*	*6.1*	*9.8*	*– 2.8*
	1989	*1.1*	*5.1*	*3.6*	*1.5*
Asian NIEs	*1982–85*	*6.5*	*5.3*	*9.2*	*1.5*
	1986–87	*11.3*	*17.5*	*21.9*	*0.0*
	1988	*9.2*	*20.6*	*14.1*	*0.7*
	1989	*6.3*	*15.7*	*9.5*	*2.6*

* Not including the Asian NIEs.
Sources: IMF World Economic Outlook and national data.

import liberalisation measures. In Mexico, too, imports surged, largely because fixed investment, financed from domestic as well as foreign sources, was boosted by structural reforms. Recent trade liberalisation initiatives also played a role. At the other end of the spectrum, a number of heavily indebted countries cut the volume of their imports by over 15% in 1989, either because of severe economic instability (Argentina and Peru) or because a rigorous adjustment programme restrained imports (Venezuela).

... mainly because of real exchange rate appreciation ...

The marked differences in trade performance between the heavily indebted countries and some of the more dynamic economies in the developing world can be related to two factors. Firstly, many heavily indebted countries have allowed a rather severe erosion of competitiveness since the end of 1987. In Latin America, where most heavily indebted countries are located, real effective exchange rates, based on relative consumer prices, rose by about 20% in the two years to end-1989, after having fallen by more than one-third between 1981 and 1987. To a large extent, the loss of competitiveness in recent years was caused by insufficient adjustment of exchange rates to accelerating inflation. By contrast, in Asia, where the most dynamic developing countries are to be found, competitiveness did not deteriorate over the last two years (except in the Asian NIEs).

... and fiscal and monetary laxity

The second factor behind poor external adjustment in major heavily indebted countries, most notably Brazil, Argentina and Peru, has been their inability to promote fiscal and monetary discipline since the early 1980s, thereby eroding saving and investment incentives. As discussed in greater detail in Chapter II, sustaining growth given the external financing constraints of the 1980s required policies to increase domestic saving in order to support investment. However, in many heavily indebted countries, particularly those which failed to control public sector deficits, earlier adjustment towards better internal and external balance took the form of a reduction in fixed capital spending accompanied by a severe compression of imports. On average, the investment share in the group of heavily indebted countries dropped from 22½% of GDP in 1981 to under 17% in the mid-1980s and has only partly recovered since then. At the same time, the volume of their imports was scaled back by an average 11% per annum between 1981 and 1985. Depressed investment in the early 1980s is now tending to limit the production and export capacities of the countries in which these trends have been most marked. Indeed, whereas they still succeeded in increasing their export volumes at appreciable rates in the first half of the 1980s, they achieved only low export volume growth thereafter, even though world trade recovered strongly and produced an equally strong export response in most other developing countries.

Some signs of reform

There are, however, encouraging signs that an increasing number of heavily indebted countries are adopting more growth-oriented policies based on deregulation and the restructuring and reorganisation of the public sector. For some years now, Chile and Mexico have directed their policies towards achieving structural reform, while more recently Venezuela and Nigeria have intensified their efforts in this direction. Indebted countries' ability to create and sustain a policy climate significantly more propitious to renewed growth is likely to be an important factor in determining whether and when international credit markets will again become accessible to them.

External financing of the developing countries

External financing remains difficult ...

The difficulties of financing the external deficit of the net debtor developing countries (i.e. excluding the Asian NIEs and the major Middle Eastern fuel exporters) were again evident last year. As arrears on interest payments continued to accumulate, new bank financing declined and reliance on official sources of finance increased. More positive developments last year were a decline in net repayments due on IMF loans as well as the gain in official reserves recorded in a number of countries.

... with heavier reliance on official creditors ...

Borrowing from official creditors rose to $30 billion, meeting nearly 60% of the external financing requirements, compared with about one-half in 1987 and 1988. Net additions to interest arrears (counted as external borrowing in balance-of-payments statistics) of the net debtor developing countries amounted to an estimated $14 billion last year, about 90% of which was accounted for by the group of heavily indebted countries. Given continued arrears of this size and doubts about the viability of policies pursued in a number of countries, commercial banks have remained reluctant to undertake new lending to indebted developing countries (see also the discussion of the international debt situation in Chapter V). With more realistic reserve provisions for bad debts now made, banks had little incentive to extend loans merely to cover interest payments on existing loans, which had been an important feature in the earlier phases of the debt crisis. Furthermore, the long process of reaching agreement on officially sponsored plans to reduce the developing countries' debt burden may have

... as commercial banks avoid new lending ...

Developing countries: estimated external financing of current-account deficits[1]

Items	Net debtor developing countries[2]			Of which: Heavily indebted countries		
	1987	1988	1989	1987	1988	1989
	in billions of US dollars					
Current-account balance	−33	−47	−49	− 9	− 9	−11
Changes in foreign assets (− = increase)	−21	− 9	− 6	−10	− 4	− 3
Official reserves	*−15*	*5*	*− 9*	*− 3*	*6*	*− 4*
Other assets	*− 6*	*−14*	*3*	*− 7*	*−10*	*1*
External financing[3]	54	56	55	19	13	14
Borrowing from official creditors	24	22	30	13	10	11
Borrowing from private creditors	17	19	13	− 1	− 5	− 2
of which: Increase in interest arrears[4]	*9*	*6*	*14*	*7*	*2*	*13*
IMF credit	− 3	− 3	− 1	− 1	− 1	− 1
Other	16	18	14	7	10	6
of which: Direct investment[5]	*12*	*17*	*16*	*5*	*9*	*7*
Memorandum item:						
Change in BIS reporting banks' claims[6]	*− 1*	*− 4*	*−21*	*− 7*	*−15*	*−23*

Note: The figures shown in this table are estimates that indicate broad orders of magnitude only.

[1] Totals may not add up owing to rounding. [2] Excluding the Asian NIEs 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] Interest arrears are calculated as the difference between estimated interest payment obligations and actual payments made. [5] Residually calculated by eliminating from net non-debt-creating inflows those flows related to SDR allocations, gold monetisation and estimated valuation changes. [6] Excluding bank lending to offshore centres.

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

delayed new loan commitments, while officially encouraged debt relief included in these plans may have increased commercial banks' opposition to new lending. Finally, trade-related bank credits have come to depend increasingly on official backing: BIS/OECD statistics suggest that government-sponsored trade credit (either by official agencies or by the private sector with official guarantees) rose by over $7 billion in the first half of 1989 after having fallen in 1988.

The dollar value of commercial banks' claims on developing countries, adjusted for exchange rate induced valuation changes, fell sharply during the year. Claims of BIS reporting banks, which had already fallen by $4 billion in 1988, were reduced by a further $21 billion in 1989. The drop partly reflected reductions in the balance-sheet value of debt. Also some claims held by banks were sold (in the secondary market for developing country debt) to the non-bank sector.

... and as foreign direct investment falls

Foreign direct investment inflows into developing countries slowed somewhat in 1989 and remained well below the levels recorded in the 1970s. Although the increased use of debt/equity conversion schemes has tended to increase direct investment in countries such as Chile and Mexico, the scope for foreign investment covering more of developing countries' financing needs at present remains limited. Greater foreign direct investment depends crucially on the creation of a favourable investment climate in the recipient countries, a condition that is not satisfied in some of the major debtor countries. Indeed, with increasing competition for scarce financial resources globally, the record of individual countries in implementing appropriate adjustment policies will decide the direction and size not only of direct investment flows but also of all private financing flows in general. In this respect, it is significant to note that the pace of lending by BIS reporting banks to developing countries such as Indonesia and Thailand, which have relied on export-led growth and policies that sustain high levels of saving and investment, picked up significantly over the last three years, while banking claims on the heavily indebted countries dropped sharply, mainly as a reflection of debt write-offs.

Finally, a number of countries were able to increase their reserves, which had fallen to very low levels in 1988. This was particularly true of net debtor fuel exporters: after falling by $12 billion in 1988, their reserves rose by $3½ billion last year. In this group of countries the build-up of reserves was greatly facilitated by some repatriation of private residents' foreign assets. For the first time in the 1980s, resident transactions in this group of countries resulted in a net sale of foreign assets (of some $4 billion). In the case of Mexico, the sale of gold reserves for foreign currencies also served to stabilise measured official reserves.

IV. Domestic financial markets

Highlights

Following a long period of relative calm after the turbulence caused by the October 1987 stock market crash, financial markets have shown some signs of renewed tension since the autumn of 1989. The steady recovery of equity prices from their post-crash lows was first briefly interrupted by a global mini-crash in October and later partly reversed when long-term interest rates started to rise in early 1990. A sharp drop occurred in the Japanese stock market, whose remarkable boom had barely been affected by previous worldwide corrections. While for much of 1989 bond yields tended to fall in the United States and followed a gentle upward path in Europe and Japan, they afterwards increased significantly everywhere, particularly during the first quarter of 1990. The contrasting paths of bond yields in 1989 were primarily associated with the relative weakness of the US economy and the consequent easing of monetary policy. The global rise in 1990 appeared to reflect reactions to the uncertainty surrounding plans for currency union between the two German states, monetary tightening in both Germany and Japan and persistent inflationary expectations in many countries.

The buoyancy of equity and bond prices which characterised much of the 1980s was accompanied, especially in the second half of the decade, by rising property values in many countries. A number of factors appear to underlie the increases in property prices: rapidly growing income and wealth, the relaxation of credit constraints, the strong expansion of the financial industry and, in some cases, declining inflation-adjusted interest rates and an easing of monetary policy. Where the simultaneous rise in real estate and equity prices was especially fast and asset values reached unprecedented levels, as in Japan, questions were raised about "asset price inflation", particularly in terms of its implications for price inflation in goods and services. In several countries where increasing private sector indebtedness, particularly that of households, has accompanied the boom, attention has focused on the vulnerability of borrowers to higher interest rates or an economic downturn. More recently, in the light of weakening prices in some market segments, in at least two countries, the United States and the United Kingdom, the focus of attention has shifted to the impact of falling property values on the financial strength of lenders.

The greater availability of credit has not only contributed to the buoyancy of property prices, it has also been a motive force behind the wave of highly leveraged transactions (HLTs) which gathered momentum in the second half of the 1980s, leading to sharp increases in the prices paid for corporations. The HLT wave, part of the generalised boom in mergers and acquisitions, has been concentrated in the United States, sustained by the development of the non-investment-grade ("junk") bond market. In the period under review the growing difficulties faced by restructured corporations in servicing their debts and the related slump in the junk bond market contributed to a softening of the stock market and heightened concerns about the financial vulnerability of both corporations and lenders. Last year's Annual Report looked at the characteristics and implications of the HLT wave with reference to corporations; this Report considers the process from the standpoint of banks, whose involvement has attracted growing attention from supervisors.

Further efforts have been made to strengthen the prudential regulation and supervision of financial activity while encouraging greater competition. In the United States new legislation has set the basis for the overhaul of the thrift industry. In the European Community the contours of the single market have been sharpened by the passage of the Second Banking Directive and related legislation. In a number of international forums, including the International Organisation of Securities Commissions and the Basle Committee on Banking Supervision, work has been stepped up on the co-ordination of capital adequacy standards for securities business. This work has highlighted the difficulties in reconciling widely differing regulatory approaches, particularly as between bank and non-bank supervisors, and in adapting the supervisory framework to the growth of financial conglomerates, both within and across national borders.

Financial asset prices

Interest rates

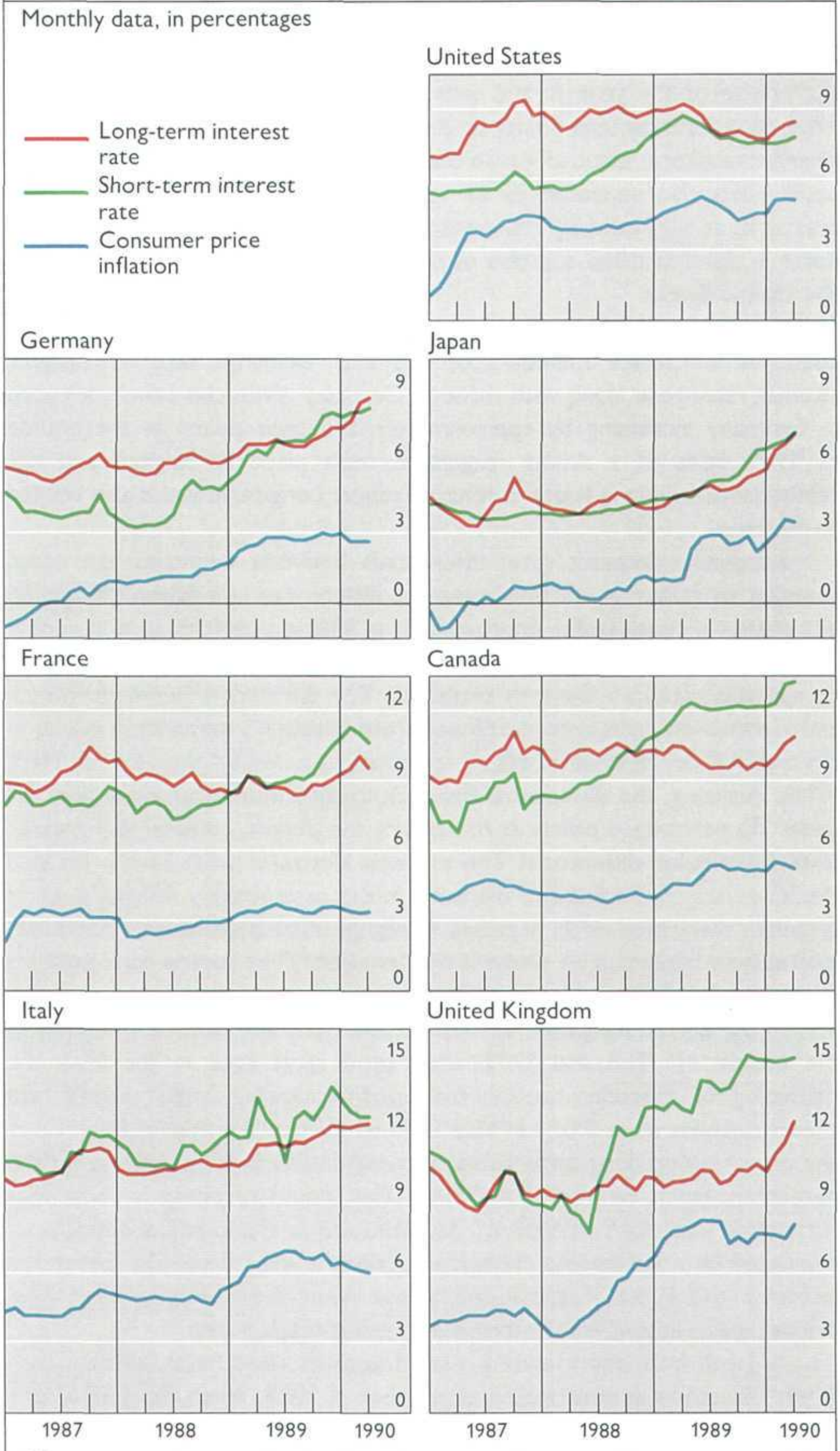
Contrasting interest rate movements in 1989:

In 1989 interest rate movements diverged significantly between the major economies (see the graph opposite). While in Europe and Japan, albeit with some interruptions, both short and long-term rates rose in the course of the year, they declined in the United States. In response to signs of labour and capacity constraints and incipient inflationary pressures monetary policy was tightened in Europe and, later on, in Japan. In Europe this represented the continuation of a policy which had been embarked upon in the spring or autumn of 1988; in Japan it marked a significant change. Partly in sympathy with short-term rate movements and in anticipation of further inflation and strong growth, long-term rates tended to drift upwards, though to a smaller extent than short-term rates. By contrast, in the United States emerging signs of weakening real economic growth in the spring led to a cautious easing of monetary policy and a decline in long-term rates. As a result of these movements, by the end of the year interest rate differentials between the major economies were considerably smaller than twelve months earlier, while yield curves had flattened or become further inverted.

Inflation risks had been discerned in Germany as early as mid-1988, in view of rapid monetary growth and very buoyant aggregate demand. The

Nominal interest rates and inflation*

Monthly data, in percentages



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

"anticipatory approach" to monetary policy, with the central bank tightening money market conditions in anticipation of future price pressures, continued in 1989. Reflecting both higher short-term interest rates and expected inflation, long-term rates rose by approximately 80 basis points in the course of the year. In the event, consumer price inflation did rise in 1989, by 1.2 percentage points to 3.0% by year-end. Part of this rise was clearly transitory, induced by an increase in indirect taxation. However, bond yields also appeared to be responding to longer-term inflationary concerns, as suggested by the weakness of the Deutsche Mark against the dollar in the first three quarters of the year despite declining bond yields in the United States.

rates rose in Germany ...

In other continental European financial markets, particularly in the countries which are members of the EMS exchange rate mechanism, interest rates rose along with those in Germany. With the call-money rate in Germany increasing by approximately 275 basis points in the course of 1989, rises of a similar magnitude took place in Belgium and the Netherlands, and to a lesser extent in France. Long-term yields also tended to increase.

... in continental Europe ...

Long-term interest rate differentials between countries are often assumed to reflect in no small measure differences in inflation prospects. Yet despite a considerable improvement in inflation performance in recent years, long-term rates in France, for instance, have continued to exceed comparable rates on German securities. The differential between French and German inflation rates narrowed from about 1½ percentage points in the autumn of 1988 to about ½ percentage point by the end of 1989. While declining, the differential between long-term interest rates was still some 1½ percentage points at the end of the period, considerably greater than the inflation differential. This example illustrates what has been called the long memory of financial markets, in this case possibly reflecting a risk premium associated with previous exchange rate experience. It demonstrates how important an element the "credibility" of central bank policy is in the determination of interest rates.

In the United Kingdom, as inflation and the trade balance worsened in the course of 1988 and 1989, short-term rates rose in line with the tightening of monetary policy, the London clearing banks' prime rate almost doubling from 8½% in May 1988 to 16% by the end of 1989. Over the same period long-term rates also increased, but by only around 1 percentage point to close to 10½%. This muted response is somewhat surprising in the light of signs of deterioration in the inflation outlook, as evidenced by a weakening currency, aggressive wage demands, excise tax increases and a rise in the inflation rate from about 4% to over 5%, excluding the impact of the increase in the mortgage rate.

... in the United Kingdom ...

In Japan both short and long-term interest rates rose significantly in 1989. This stood in contrast to experience in 1988, when there had been little change in short-term rates. Three upward adjustments in the discount rate signalled major concerns about a weakening currency, potential domestic inflation risks and the unprecedented levels reached by some real

... and in Japan ...

and financial asset prices, particularly of real estate. Although inflation rates remained relatively low until the end of 1989, clear signs of latent price pressures did emerge, including labour shortages, rising labour costs and increasing import prices. In addition, the previous rapid growth in Japanese monetary aggregates, even after allowing for the effects of financial liberalisation, raised the question of possible excess liquidity in the system. In the course of the year long-term rates rose from over 4% to around 6%, broadly shadowing the increase in short-term rates and reaching levels not seen since 1985.

... but fell in the United States

In contrast to the rise in interest rates in Europe and Japan, both short and long-term rates fell in the United States throughout much of 1989. The declines reflected the cautious easing of policy by the Federal Reserve which began in the spring amidst emerging signs of a slowing economy. As it turned out, even with sizable employment cutbacks in the manufacturing sector, only the fourth quarter recorded real growth significantly below potential. Nonetheless, business capital spending and residential construction remained weak. By year-end, long-term rates had declined by over 1 percentage point to below 8%, exceeding somewhat the fall in short-term rates.

The global increase in bond yields in 1990 ...

Bond markets underwent a major and sudden downward correction in early 1990. In contrast to previous interrelated bond market adjustments, this time the source of the "shock" was not the United States but Germany and Japan. German long-term government bond rates jumped from 7½% at the close of 1989 to over 9% by early March 1990, and have declined only slightly since then. In the light of the rapid and unexpected progress of plans for monetary unification with the German Democratic Republic, the market appeared concerned about prospects of larger government financing requirements and inflation in the Federal Republic. In Japan the rise in long-term bond rates seemed to be associated with the tightening of monetary policy, underlined by a further discount rate increase in March 1990. This move was clearly motivated by concern about the continued weakness of the yen. The rises in long-term bond rates in Japan and Germany had significant spillover effects on other bond markets, large and small. As can be seen from the graph on page 95, long-term interest rates in the United States, Canada, the United Kingdom and other European countries rose by between 50 and over 200 basis points in the first few months of 1990.

... did not stop the narrowing of interest rate differentials

Interest rate differentials between the United States, on the one hand, and Germany and Japan, on the other, narrowed considerably across the maturity spectrum in the period under review (see the table overleaf). At the long end, for instance, between the first quarters of 1989 and 1990 the differential between the United States and Japan shrank from over 450 to around 150 basis points and that between the United States and Germany fell to zero. And even though inflation was higher in the United States than in either Japan or Germany, over the period as a whole the US dollar appreciated against the Japanese yen and, until the autumn, also against the Deutsche Mark.

Premium on dollar instruments:
short-term interest rates and government bond yields*

Years	Japan		Germany	
	Short	Long	Short	Long
1986	0.98	2.74	1.34	1.46
1987	1.90	4.17	1.74	2.04
1988	2.61	4.57	2.34	2.27
1989 Q I	3.97	4.66	2.27	2.33
Q II	3.45	3.78	1.57	1.75
Q III	2.41	3.10	0.65	1.18
Q IV	1.19	2.24	−0.52	0.48
1990 Q I	0.66	1.45	−0.60	−0.02

* Interest rates in the United States less corresponding rates in Japan and Germany, in percentage points.

Equity prices

Equity markets were generally buoyant in 1989. In many of the larger markets price gains exceeded 20%, among the highest in the 1980s. In most countries equity prices had by the end of the year reached levels higher than or broadly comparable with those attained before the October 1987 crash (see the table below and the graph opposite). By contrast, markets were generally lack-lustre in the early months of 1990, with some recording sizable losses. A major downward correction took place in Japan,

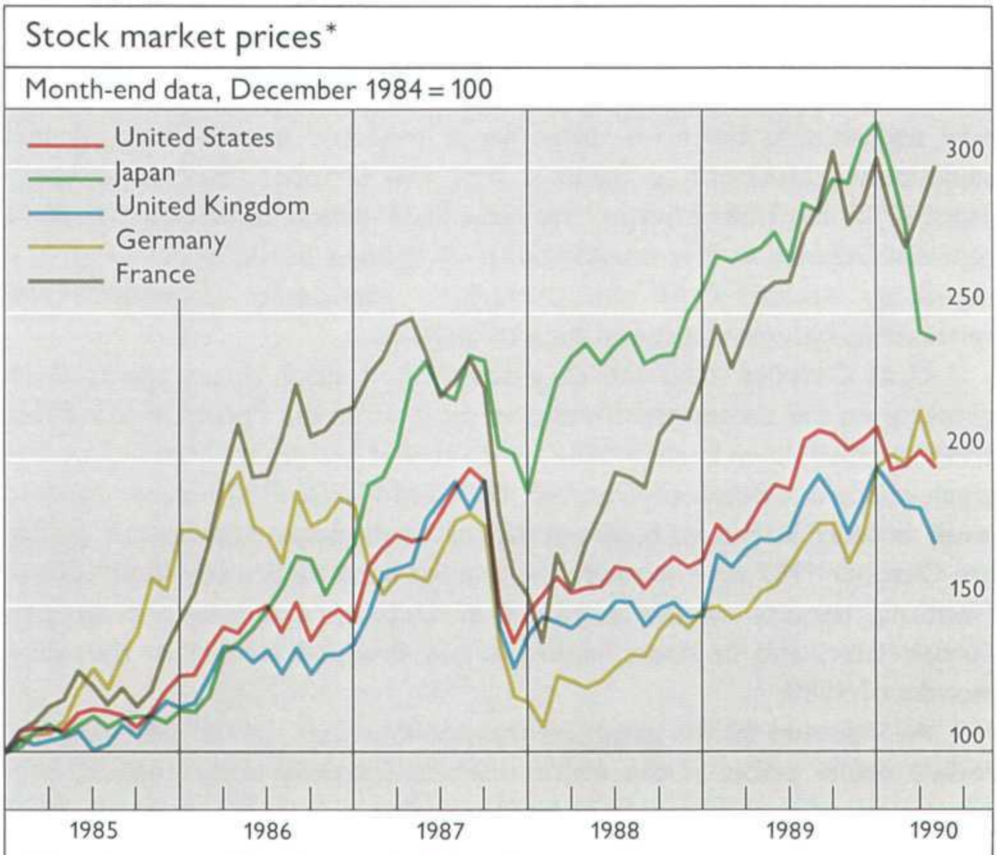
Equity prices were buoyant in 1989 but not in early 1990

Stock market prices and the October 1989 mini-crash[1]

Countries	Pre-1987 crash high	Post-1987 crash low	End-1989	10th May 1990	October 1989 mini-crash 13th	16th	17th
	end-1988 = 100				percentage changes		
United States	121.3	80.6	127.3	123.8	−6.1	2.8	−0.5
Japan	95.8	71.7	122.2	98.1	0.9	− 1.7	1.6
United Kingdom	136.3	87.3	135.1	120.3	−0.2	− 3.2	−1.3
Canada	122.0	84.2	116.6	103.4	−3.5	1.5	−0.6
Germany	124.7	73.1	132.6	140.0	−0.7	−13.5	6.9
France	110.8	60.5	133.3	133.5	1.0	− 5.4	0.6
Italy	130.1	71.8	116.6	119.0	−0.6	− 7.1	3.9
Switzerland	120.8	74.7	126.0	128.1	−0.2	− 9.0	3.7
Netherlands	101.7	54.9	116.4	114.9	−0.2	− 7.8	2.7
Sweden	98.4	60.0	124.5	118.3	0.1	− 7.5	3.7
Spain	118.6	73.2	108.1	102.5	−0.2	− 6.5	2.8
Belgium	97.2	63.0	116.4	109.3	−0.7	− 1.5	−3.0[2]
Australia	155.0	77.4	110.8	99.1	0.7	− 8.1	4.0
Hong Kong	146.9	70.5	105.5	111.1	−0.4	− 6.5	3.6
Singapore	144.9	67.4	142.6	146.7	−0.3	−10.2	4.7
Taiwan	91.3	44.9	169.3	164.6	−0.2	− 5.7	4.2
South Korea	59.7	51.8	103.5	87.8	0.3	− 0.6	0.1

[1] 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, Frankfurt; for France, CAC general index; for other countries, representative indices. [2] 18th October.

Sources: National stock exchanges.



* For a description of the indices used, see the table opposite.

where by early April the market had lost over a quarter of its value at the beginning of the year.

Despite the strength of equity prices for the year as a whole, there was a sharp though short-lived break in October. Because of its speed and global extension, the break was reminiscent of the crash of 1987. On Friday, 13th October, in the last hour of trading alone, the Dow Jones index dropped by around 5% in heavy volume. When markets reopened, prices fell abruptly worldwide – except in Japan – and some markets recorded even larger one-day losses than in October 1987 (see the table opposite). As in 1987, both the initial plunge and the subsequent partial rally originated in the United States, with most markets appearing to react to US developments. Again as in 1987, a flight to quality took place, as investors moved away from equities into safer assets such as government securities; and, to varying degrees, the potential for market disruption prompted a response by the securities exchanges and monetary authorities.

The October mini-crash ...

In the event, the plunge was shorter-lived, cumulatively smaller and accompanied by a more moderate increase in trading volume than in 1987. In the United States the specific trigger was the failure to complete a leveraged buy-out, which precipitated downward revisions of the prices of acquisition targets. With portfolio insurance strategies practically absent, computerised index arbitrage between the futures and cash markets was singled out by some as a contributory factor in the short-run volatility, but the evidence remains inconclusive. Particularly difficult to understand are the reasons for the major falls outside the United States, not least because compared with 1987 there was little perception of generalised over-valuation. One partial clue may be that, in contrast to 1987, sales appeared to come primarily from individual rather than institutional investors. This may suggest that the price drops partly reflected over-reaction by less sophisticated investors to parallels with the October 1987 experience. Especially in the United States, this episode of market turbulence has given renewed impetus to the consideration of changes in the organisation and regulatory structure of the exchanges, particularly as regards the relationship between cash and futures markets.

... signalled a new rise in volatility

Until October 1989 the daily volatility of stock prices appeared to continue on the downward trend that set in after the ripples of the global crash had died down in early 1988. Since then it has generally risen (see the graph opposite). Between October 1989 and March 1990 volatility was at levels broadly in line with, if not higher than, those experienced in the pre-October 1987 crash period. The rise has been particularly noticeable in Germany, because of the sharp fall in October and events in eastern Europe later, and in Japan, where prices dropped steeply in the early months of 1990.

As indicated by the graph on the previous page, in the period under review equity prices in the major markets followed similar trends. This contrasted with movements in interest rates, which for most of 1989 diverged significantly between North America, on the one hand, and Europe and Japan, on the other. Indeed, in 1989 it was precisely in some of the countries where interest rates tended to rise, such as Germany and France, that the increase in equity prices was relatively greater.

Much of this pattern of asset price movements may be explained by divergent expectations with regard to growth rates and corporate profitability. Corporate profits appeared to stagnate in the United States and Canada as early as in the second quarter of 1989, while those in several European countries and Japan continued to grow throughout the year. In addition, the longer-term outlook for European economies, particularly that of Germany, was brightened by the growth potential perceived in connection with political and economic reforms in eastern Europe. By contrast, in early 1990 it was the generalised rise in interest rates that seemed to lie behind the relative weakness of most markets. The German market, however, remained strong.

Japanese stock prices have dropped sharply ...

Within this broad picture, the performance of the Japanese stock market stands out. In early 1990 the market suffered the sharpest break since the beginning of its remarkable recent boom – a boom which, in contrast to experience in other countries, was only briefly affected by the crash of October 1987. The loss of over 25% in the first three and a half months of the year was about twice that recorded in October 1987 and more than offset the price gains accumulated in the course of 1989. The magnitude and speed of the fall, the absence of signs of ripple effects in other countries despite the size of the Japanese economy and indications that prices fell furthest in those sectors where they had been highest relative to enterprise earnings are all features in principle consistent with

* Variability calculated monthly as the standard deviation of daily percentage changes in stock market price indices. The green line represents the mean variability for the period January 1984 to September 1987. For a description of the indices used, see the table on page 98.

the view that the market may have been out of line with the long-run earning potential of corporations.

To what extent the market was indeed overvalued is difficult to say. For similar reasons, it is not easy to judge its present level in relation to long-run earnings potential. Despite the recent correction, the set of indicators commonly used to assess fundamental values do not point to a significantly different picture from that discernible a year ago (see last year's Annual Report). Primarily as a result of increases in long-term rates, since the first quarter of 1989 the gap between bond and dividend yields has in fact widened from about 4 to over 6 percentage points. It is unclear how much of this increase could be attributed to better prospects for nominal dividend growth and to a lower risk premium. In addition, the current price/earnings ratio, at around 60, is roughly the same as it was a year ago. Though indeed lower by about 10 points than before October 1987 or January 1990, it remains relatively high by historical standards. Because of the large land holdings of corporations, part of the steep rise in price/earnings ratios since 1985 may be attributed to unrealised capital gains associated with the boom in land prices during the period. There is a

... but may still be out of line with dividends and earnings question, however, about the extent to which that boom may in turn be consistent with the long-run earning potential of land.

Property markets

Property prices: trends and determinants

Property prices have been buoyant in the second half of the 1980s

Against the background of a sustained economic expansion but historically high real interest rates, the second half of the 1980s witnessed significant increases in real estate prices. The scarcity and limited reliability of data make it difficult to compare the behaviour of real estate prices geographically or over time (see the graph opposite). The available data suggest, however, that price increases have been particularly long-lived in some regions in the United States and in the United Kingdom, where they began roughly at the same time as the recovery in economic activity and stock markets. A boom started around 1986 in Japan, lagging somewhat behind the steep rise in equity prices. Continental European countries, Canada and Australia experienced price increases more recently and to varying degrees. Price rises have primarily been concentrated in the major cities, where both the housing and, above all, the commercial real estate segments of the market have been affected (see the table below). However, increases in housing prices have also occurred nationwide in Spain, Canada, Sweden and Australia and, to a lesser extent, in the Netherlands, Belgium and Italy. Lately there have been some signs of weakening price trends in the United States, the United Kingdom, Canada and Australia.

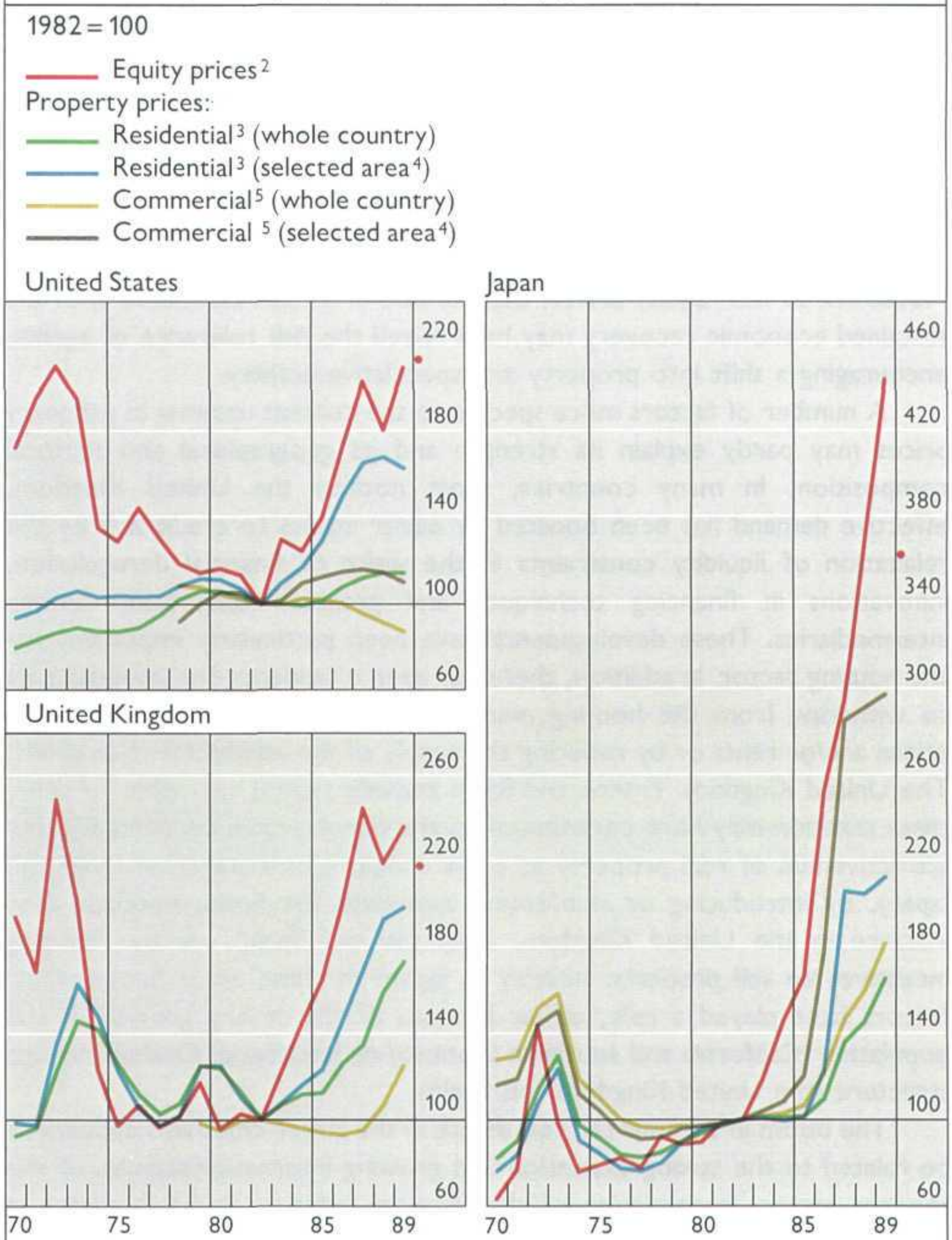
Inflation-adjusted housing prices in major cities[1]

Cities	1985	1986	1987	1988	1989	1980–84	1985–89
	percentage changes					cumulative	
New York	22.9	17.6	10.2	−3.8	− 5.6[2]	24.9[3]	44.7
Los Angeles	−2.0[4]	8.0	10.6	16.7	16.6[2]	− 9.4[3]	59.4
Tokyo	1.5	22.8	67.1	−0.7	3.4	11.9	114.0
London	6.2	19.7	15.5	12.2	1.8[2]	− 3.1	67.7
Paris	3.7	7.4	15.5	17.3	20.2	− 3.4[5]	81.5
Frankfurt[6]	−8.1	−11.3	5.4	12.5	− 2.4	19.8	−5.7
Milan	n.a.	− 2.7	3.8	7.9	25.2	n.a.	36.5[7]
Toronto	10.6	32.4	19.8	20.6	− 2.5	− 2.9[8]	106.1
Madrid	3.6	34.9	34.0	19.2	15.4[4]	−28.8	157.8
Brussels	−2.8	5.2	4.6	9.6	22.5	−36.8	43.6
Stockholm	−1.9	4.4	15.9	23.4	10.9[2]	−31.6	62.3
Sydney	5.1	3.7	13.1	48.0	−20.2	−10.6	45.6

[1] Deflated by nationwide consumer prices; national data and definitions. [2] January–September. [3] 1982–84. [4] Estimated. [5] 1981–84. [6] First quarter. [7] 1986–89. [8] 1983–84.

Sources: For the United States, National Association of Realtors and California Association of Realtors; for the United Kingdom, Building Societies Association and Department of the Environment; for France, Chambre Interdépartementale des Notaires de Paris; for Germany, Ring Deutscher Makler; for Italy, Associazione Italiana Consulenti Immobiliari; for Canada, Multiple Listing Service; for Spain, Directivos Construcción; for Belgium, AN-HYP s.a. Valeur Immobilière; for Australia, Real Estate Institute of Australia; for other countries, national sources.

Inflation-adjusted property and equity prices[1]



[1] Deflated by consumer prices. [2] The dot refers to end-March 1990. [3] For the United States and the United Kingdom, housing; for Japan, residential land. [4] For the United States, the North-East; for Japan, Tokyo; for the United Kingdom, Greater London. [5] For the United States and the United Kingdom, property; for Japan, commercial land.

Sources: For the United States, National Council of Real Estate Investment Fiduciaries; for Japan, National Land Bureau; for the United Kingdom, Richard Ellis Ltd.

Possible factors affecting prices:

Much like the price of any asset, that of real estate tends to reflect expectations of the future income stream associated with it, either rents or realisable capital gains. Over time, after proper adjustment for risk premiums, expected returns on real estate should tend to gravitate to levels broadly on a par with those on financial assets. The price of real estate, therefore, is sensitive both to changes in expectations about the future income stream and to yields on financial assets and hence interest rates. As with the price of other long-term assets, that of real estate is subject to greater fluctuations than those of goods and services. Since property is a real resource, its price, like that of equities, tends to move pro-cyclically. Because the supply of real estate is relatively fixed, particularly in the short term, fluctuations in the price primarily reflect demand factors.

income and wealth growth

In common with previous periods of increasing property prices, strong economic growth and the related rises in household incomes and profits have underlain the rise in the demand for housing and commercial property. Moreover, as with equity prices, the increase in wealth associated with the sustained economic recovery may have raised the risk tolerance of agents, encouraging a shift into property and speculative activity.

deregulation, taxation, demography

A number of factors more specific to the current upswing in property prices may partly explain its strength and its geographical and sectoral composition. In many countries, most notably the United Kingdom, effective demand has been boosted by easier access to credit and by the relaxation of liquidity constraints in the wake of financial deregulation, innovations in financing techniques and greater competition among intermediaries. These developments have been particularly important for the housing sector. In addition, there has been a tendency for governments to withdraw from the housing market, either by removing controls on prices and/or rents or by reducing the supply of the administered segment. The United Kingdom, France and Spain provide typical examples. In some cases taxation may have contributed to the rise in prices by increasing the attractiveness of real property as a tax shelter (for instance in Spain and Japan), by introducing or reinforcing incentives for house purchase (for instance in the United Kingdom, Australia and Spain), or by reducing incentives to sell property, notably in Japan. In some areas demographic factors have played a role, either because of the strong growth of the population (California and southern Ontario) or because of its changing age structure (the United Kingdom and Spain).

expansion and internationalisation of the services sector

The boom in commercial real estate in the larger cities also appears to be related to the strong expansion and growing internationalisation of the services sector, in particular of the financial industry. Rapid increases in office prices and rents have been associated with the "Big Bang" in London and the transformation of Tokyo into a major international financial centre. Similar increases have been evident in continental Europe, probably in anticipation of the creation of a single European market (see the table opposite). In the wake of these developments, prices of residential property in and around the major cities have also risen.

inflation-adjusted interest rates

In contrast to experience in the 1970s, the recent price increases do not seem to have been generally the result of relatively low inflation-adjusted returns on financial assets. Irrespective of the precise measures used, both long and short-term real interest rates have been higher in the 1980s than in the 1970s. At least in Japan, however, since the mid-1980s there has been a clear tendency for inflation-adjusted interest rates to decline.

Inflation-adjusted office rents in major cities*						
Cities	1985	1986	1987	1988	1989	1985–89
	percentage changes					cumulative
New York	−6.8	−5.8	−3.0	2.1	−4.4	−17.0
Tokyo	6.0	18.2	22.8	5.4	20.9	95.9
London	3.6	15.7	37.8	1.4	−7.2	55.5
Paris	12.4	10.6	5.6	9.6	9.9	58.1
Frankfurt	1.9	24.0	9.4	11.0	14.5	75.9
Milan	−3.2	5.6	13.8	23.7	18.7	70.9
Madrid	2.3	20.3	16.1	37.7	8.8	114.0
Amsterdam	−1.6	9.1	1.6	−0.2	11.1	20.9
Brussels	4.6	28.9	5.8	12.6	6.7	71.4
Stockholm	0.7	13.8	18.8	13.2	0.1	54.4
Lisbon	3.2	16.3	22.4	19.4	8.7	90.6
Sydney	1.1	6.4	4.7	6.0	6.8	27.4

* Deflated by nationwide consumer prices; national data and definitions.
Source: Richard Ellis Ltd. (United Kingdom).

and monetary policy

Assessing the role played by monetary policy in the recent property boom is not easy, as traditional benchmarks for evaluating the stance of policy have often given contrasting signals over the last decade. Relatively high real short-term interest rates may provide misleading indications of tightness in the context of significantly improved expectations of future income streams from physical assets, while the rapid growth of monetary and credit aggregates in the second half of the 1980s may well be taken as a sign of monetary ease. Japan and the United Kingdom are two typical examples. In addition, the general relaxation of policy in the wake of the stock market crash of 1987 may have fuelled the price increases experienced in some countries in 1988 and 1989.

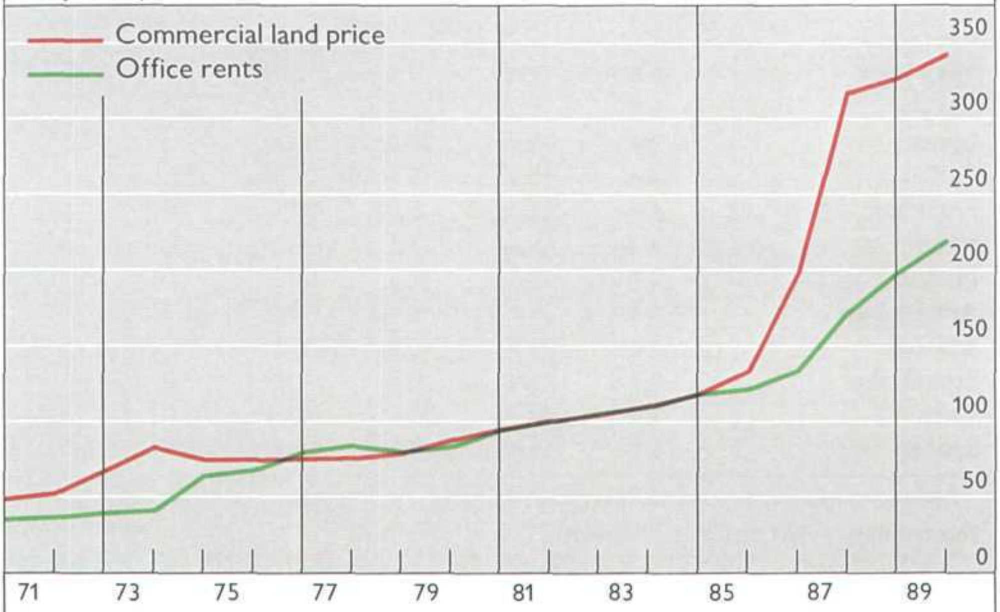
The case of Japan

It is the property boom in Japan which has received the greatest attention. A number of factors, such as population density, per capita income levels and the under-utilisation of land, may partly explain the high level of Japanese property prices by international standards. In no small measure, such under-utilisation stems from severe planning restrictions and tax arrangements which tend to favour property relative to financial investments and the use of urban land for farming. Nonetheless, the level of Japanese property prices is difficult to explain, and the sharp rise experienced since the mid-1980s has led to concern that present prices may be out of line with the long-run earning potential of the assets.

Since 1985 the increase in the price of commercial land in Tokyo has deviated markedly from that in office rents (see the graph overleaf). This pattern resembles that of the 1971–73 boom, which with hindsight has been recognised as having been out of line with fundamentals. Although the divergence observed could be consistent with expectations of more rapid future rent growth and the decline in real interest rates over the period, the possibility of overvaluation cannot be excluded. Price rises outside the Tokyo area, while smaller, also point to this possibility.

Commercial land price and office rents in Tokyo

1st January 1982 = 100



Sources: National Land Bureau and Tokyo Building Association.

Issues raised

The steep increase in both equity and property prices in Japan since 1985, sometimes referred to as "asset price inflation", has given rise to concerns about the possible impact on inflation of prices for goods and services. Similar questions have been raised in the United Kingdom in connection with the housing boom. These concerns are only partly related to the net wealth effects on spending associated with the increase in prices, which in the case of residential property can be largely redistributional, between landlords and tenants. By raising collateral values, higher property prices facilitate access to credit and hence spending. As workers tend to be tenants, higher housing prices lead to a more unequal distribution of income and may push up wage demands. To the extent that they also reduce labour mobility, they can contribute to labour shortages. By making foreign property relatively cheaper, higher property prices may lead to capital outflows and hence put downward pressure on the exchange rate. These effects are strengthened where, as in Japan, the close link between land and equity values can trigger a mutually reinforcing process. Given the sizable property holdings of corporations, increases in the price of property raise both equity prices and collateral values; this in turn eases financing constraints and may allow further speculative investments. Finally, particularly when decisions of economic agents are based on overly optimistic views of the long-run earnings of the assets, the potential for financial disruption caused by a sharp price reversal may have some weight in the determination of the monetary policy stance.

Asset price inflation

In many of those countries where developments in the housing market have been accompanied by sizable increases in households' indebtedness, Financial fragility of heavily indebted households

attention has focused on the potential financial vulnerability of borrowers. Typical examples are the United States, the United Kingdom and France. The risk is that in the wake of higher interest rates, a fall in incomes or a rise in unemployment, households may face serious difficulties in servicing their debts. This could in turn lead to or exacerbate an economic downturn. As a result of the innovations in financial practices and the relaxation of credit constraints which have gone hand in hand with the increase in indebtedness, traditional indicators of financial vulnerability have become more difficult to interpret. At the same time, there is a possibility that the less familiar financial environment and the prolonged expansion may have led some borrowers to over-extend themselves.

Concern about rising household indebtedness has been particularly prominent in the United Kingdom and France, for example, two of the countries where debt/disposable income ratios have reached historical highs. In the United Kingdom, according to some estimates, on mortgage credit alone the ratio of net payments to post-tax personal income increased from 20% to over 35% for first-time buyers between 1978 and 1989. In France in the mid-1980s many households which had taken on mortgages with progressively increasing payment schedules began facing repayment difficulties as disinflation raised the burden of existing commitments. A large number of these credits were renegotiated, partly owing to greater competitive pressures among financial intermediaries and government intervention. Looking ahead, a rising proportion of riskier, low-income households in the mortgage market since 1984 may point to potential difficulties.

Bank lending to the property markets:

Another issue which has recently received considerable attention is the involvement of financial institutions, particularly banks, in property markets. In Japan so far the focus has primarily been on the way in which large-scale lending by credit institutions may have added fuel to the property boom. In the United States and the United Kingdom, where signs of weakening prices and overbuilding have been apparent, it is the impact of falling property values on the financial strength of the lenders that has been highlighted.

in Japan

Between the end of 1985 and 1989 in Japan loans for construction and to real estate management firms grew at an annual rate of around 20% and their share in total lending climbed by around one-third to 17% (see the table overleaf). Moreover, there are several reasons why both the level of outstanding loans and their growth may be understated by these figures. Firstly, the above data exclude real estate loans in the form of overdrafts or made by foreign branches of domestic banks. Secondly, since 1985 loans to leasing and consumer credit companies have increased rapidly; a portion of these credits may indirectly finance lending for the acquisition of, or backed by, property. Finally, there is some evidence that part of bank lending finances non-financial corporations' subsidiaries specialising in real estate investment; as these loans are guaranteed by the parent company, they are not classified as real estate loans. While the authorities have exerted moral suasion on banks to reduce their property lending since the

Commercial bank real estate lending[1]							
Years	United States			United Kingdom			Japan
	Total	Residential	Commercial[2]	Total	Housing	Construction and property companies	Total[3]
	as a percentage of total loans outstanding						
1980	29	19	10	12	4	8	11
1985	29	16	13	19	12	7	13
1987	34	18	16	23	14	9	15
1989	37[4]	19[4]	18[4]	23[5]	12[5]	11[5]	17

[1] The data are not comparable across countries. [2] Including farms. [3] Construction and real estate management firms. [4] September. [5] Partly estimated.

Sources: Board of Governors of the Federal Reserve System, Bank of England, Bank of Japan and BIS estimates.

beginning of the price boom, in March 1990 their attitude stiffened further, and banks were required to limit the rate of growth of property lending to that of their total loans.

With the costs of the thrift industry crisis mounting, in the United States signs of weakness have now also appeared among commercial banks, not least in those regions which had previously experienced significant property price increases, such as the North-East. In that region non-performing real estate loans more than trebled between the fourth quarters of 1987 and 1989 from $2.6 billion to $9.1 billion, or 4.6% of total loans. A number of banks have suffered sizable losses, primarily on commercial real estate lending, adding to those already incurred by banks in the South-West. It is precisely commercial real estate lending, historically riskier than that for residential property, which accounts for practically the whole of the increase in the share of real estate loans in total loans of commercial banks since 1980. At close to 40%, this share now for the first time exceeds that of commercial and industrial loans. Against this background, a further deterioration in loan quality is suggested by high and rising office vacancy rates in many cities and, in some regions, by the overhang of properties acquired by the government in the process of liquidating failed thrift institutions.

in the United States

In early 1990 the Comptroller of the Currency pointed to several unsound lending practices which had contributed to some of the problems faced in connection with real estate loans: the deterioration of underwriting standards in pursuit of higher interest and fee income levels, of which a lack of borrower equity in real estate projects was a major example; poor credit screening; and window-dressing practices aimed at masking deteriorations in credit quality. Banks which failed to tighten lending practices could face lending restrictions and higher capital requirements.

In the United Kingdom, while there is as yet little evidence of actual losses, the rapidly rising exposure of banks to the property markets has occurred in a context of aggressive competition among institutions, overall in the United Kingdom

strong credit expansion, signs of an end to the real estate price boom and, more recently, monetary tightening. These developments have evoked parallels with the "secondary banking" crisis of the mid-1970s. Between 1980 and 1989 the share of real estate loans in total bank lending almost doubled to around one-quarter, with the bulk of the increase being accounted for by house mortgage loans. In 1988–89 loans for construction and to property companies rose at an annual rate of around 50%, or double that of total lending, and now comprise over 10% of the banks' portfolios. Meanwhile, office vacancy rates have climbed. In the wake of the contraction of the financial industry, partly the result of over-expansion in connection with the "Big Bang", vacancy rates in the City rose from 1% in 1987 to 10% in 1989 and are expected to increase further.

While the potential for difficulties does exist, there are several differences compared with the situation in the mid-1970s which should not be overlooked. The mid-1970s crisis occurred in an unsupervised and relatively undercapitalised segment of the banking industry, among so-called "secondary" or "fringe" banks, which had grown rapidly during the period when commercial banks were subject to credit constraints. No such supervisory gaps exist today and the institutions are better capitalised. Lending to property development companies, the main source of losses for fringe banks, has indeed increased; but the peak of 8% reached in May 1989 is still below the 10% attained in 1975, and its distribution among institutions appears less uneven. Much of the recent increase in banks' exposure has been accounted for by loans for the acquisition of residential property, historically less risky than lending for construction, particularly of commercial property. Not only is the value of the collateral easier to assess and not vulnerable to the possible failure of the borrower before the completion of the project; it also appears to be less variable when compared with that of commercial property, as the demand for housing tends to fluctuate less. The main risk on this form of lending is that, given the unprecedented levels of households' indebtedness, sufficiently widespread defaults may create liquidity problems for banks unable to sell property in a depressed market. There are some indications that the collateral cushion in house mortgage lending criteria has been declining, particularly as a result of greater competition between banks and building societies since the early 1980s. Between 1980 and 1987 the advance/price ratio for all borrowers rose from 57% to around 70%, and that for first-time buyers from 74% to 85%. Only recently have these ratios fallen again. But it is not clear how far these apparent signs of smaller security margins may signal future difficulties.

and in other countries

To varying degrees, an increase in banks' exposure to property markets has also taken place in many other countries (see the table overleaf). Canada and several European countries, with Germany as one exception, are examples. There are at least three reasons why such increases have attracted little attention with regard to the potential vulnerability of lenders. With the exception of Canada, there has as yet been little sign of weakening prices. Where exposure has risen, the increase has been primarily in lending for the acquisition of residential property. In some countries, such as France and Spain, part of the rise has occurred as a result of a reduction in the share of real estate lending accounted for by specialised credit institutions and may have been seen as leading to a wider spreading of the risk within the financial system.

Banks' real estate lending in selected countries[1]

Years	Spain	France	Germany	Portugal	Canada	Switzerland[2]
	as a percentage of loans to the private sector					
1982	19[3]	27	44	23	30	27
1985	19	28	46	27[4]	33	28
1987	20	29	45	33[4]	39	29
1989	24	31	44	37[5]	43[4]	33[6]

[1] The data are not comparable across countries. [2] As a percentage of total assets. [3] 1983. [4] September. [5] May. [6] Estimated.
Sources: National central banks.

Seen in a broader perspective, the difficulties faced by lenders to the property market in a number of countries may be viewed as symptoms of a more fundamental issue. They are partly the reflection of the greater potential for financial instability which exists in a more competitive and rapidly changing financial environment, where the evaluation of risks is more difficult and the incentive to take them may be greater. In the United States, but also in the United Kingdom and Japan, banks have lost some of their best corporate customers to the capital markets; in the United Kingdom in particular, competition among intermediaries, especially between banks and building societies, has intensified; in both the United Kingdom and Japan, structural changes and innovations in the financial system have complicated the assessment of both the risks taken on by economic agents and the stance of monetary policy, which may have allowed the expansion of overall credit to proceed too far.

Potential for financial instability in a competitive and rapidly changing environment

If the above analysis is correct, it points to the desirability of increased vigilance in those countries where the contours of the financial system are changing rapidly. It also underscores the importance of recent progress in strengthening the capital base of banks in line with the new internationally agreed standards. This progress should not be ignored when evaluating the potential vulnerability of the institutions to a deterioration in asset quality.

Banks' involvement in highly leveraged transactions

Banks' lending to the property markets has not been the only area which has attracted attention in the period under review. The same has been true of their involvement in so-called highly leveraged transactions (HLTs), i.e. financial restructurings of companies which raise their debt burdens substantially (leveraged buy-outs (LBOs), leveraged acquisitions and recapitalisations). Rising bank exposures, indications of deteriorating lending standards and growing signs of financial distress among restructured companies have all lent support to the view that the risks involved in the transactions may have been underestimated and/or the prices paid for the

Attention to banks' involvement in HLTs grows...

companies excessive. Although HLTs are essentially a US phenomenon, the growing participation of non-US banks in the financing of US deals has attracted the attention of supervisory authorities in other countries, notably Japan and the United Kingdom.

... as signs of stress in the market emerge

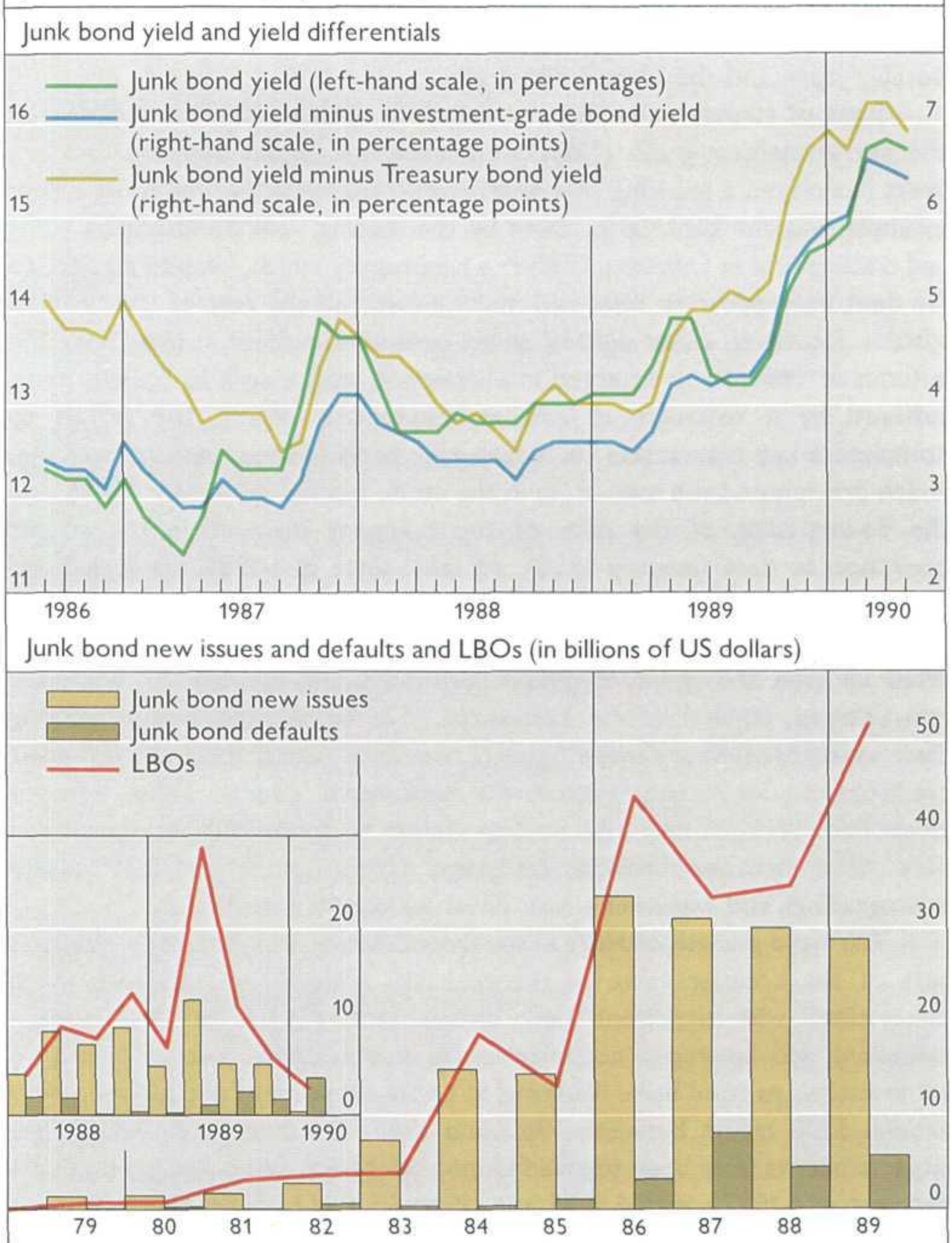
Signs of stress in the HLT market have been particularly apparent in the non-investment-grade ("junk") bond market, which over the last few years has played a growing role in leveraged transactions. The most salient example was the bankruptcy filing by the leading junk bond underwriting and trading firm in February 1990 – a bankruptcy which, despite its size, so far does not appear to have had much impact on the rest of the financial system. However, other signs of stress have been evident at least since the autumn of 1989. They emerged in connection with a serious liquidity crisis suffered by a restructured retailer (September 1989), the failure to complete a key transaction for which junk bond finance was not available, which precipitated the mini-crash in the stock market (October 1989), and the downgrading of the debt of the company involved in the largest operation to date (January 1990). At least since mid-1989 the junk bond yield differential vis-à-vis investment-grade bonds and default volumes have both risen sharply, and by the first quarter of 1990 new issues had almost dried up (see the graph overleaf). An increasing number of financially restructured, highly indebted companies have faced difficulties in meeting their commitments and have been forced into renegotiations with their creditors, so far mostly outside the bankruptcy courts. These signs of stress have brought new HLT activity almost to a standstill and have been part of a broader financial landscape characterised by debt quality downgradings and weakening cash flows and profit margins.

The rapid growth of HLTs in the United States since the early 1980s as part of the broader wave of mergers and acquisitions could only have materialised with significant bank involvement. Figures on total recapitalisations and leveraged acquisitions are not available, but according to some estimates total bank financing of LBOs alone may have amounted to around $100 billion between 1982 and 1989. Of that total, increasingly larger amounts have been supplied by non-US banks. Estimates indicate that between end-1987 and mid-1989 non-US banks may have provided over half of the total initial bank finance for the transactions. Japanese banks have been particularly active.

Banks become heavily involved ...

Estimates of the level of banks' exposure should be taken with great caution, not least because of problems of definition. Official survey evidence indicates that by the first quarter of 1989 total HLT loan exposure at banks located in the United States was probably of the order of $150 billion. Around 40% was in the form of firm commitments to lend. Other evidence suggests that by mid-1989 loan exposure at thirteen and fifty of the largest US bank holding companies respectively was around $65 billion and over $100 billion. The amounts at smaller institutions, particularly at those not originating deals, were probably lower on average, though there are some indications that they increased significantly in the course of 1989. More detailed estimates indicate that by mid-September 1989 the combined

Junk bonds and highly leveraged transactions



Note: A single LBO transaction, arranged in 1988 but completed in 1989, amounted to $25 billion and involved over $8 billion of straight junk bond issues.

Sources: Morgan Stanley & Co. Inc. and Investment Dealers Digest.

exposure of thirteen of the largest US bank holding companies averaged around 130% of equity (see the table opposite). That was over twice their average exposure to developing countries net of reserves. It represented a significant increase from the levels reached at the end of 1988, although part of this rise reflected a decline in equity capital associated with higher provisions against developing countries' debt. While the figures for average exposures at the end of 1989 are even higher, the increase appears to be related primarily to a recent broadening of the HLT definition in accordance with regulatory requirements.

Total HLT exposure at thirteen of the largest US bank holding companies[1]

Items	End-1988	Mid-1989[2]	September 1989	End-1989[2]
Percentage of shareholders' equity				
Average	81	114	130	140
Range	14–160	29–204	33–267	36–294
Number of banks in each percentage bracket				
Over 100%	5	8	9	10
Over 150%	2	5	6	6
Over 200%	0	1	2	4
Over 250%	0	0	1	2
Total exposure (in billions of US dollars)	42	64	64	73

[1] Loans, commitments to lend and investments in subordinated debt and equity. End-1989 figures are based on the HLT definition issued by US bank regulators in October 1989. Other figures relate to banks' own definitions, which vary considerably. As a result, the data are not fully comparable between banks or over time. [2] Partly estimated.

Sources: Thomson Bankwatch Inc., Keefe, Bruyette and Woods Inc. and BIS estimates.

Loans or firm commitments to lend account for the bulk of HLT exposure. Typically, a deal is syndicated by a number of banks which then sell part of their loans to other banks (primarily regional or foreign) and other financial institutions (see the table below). For some money centre banks loans extended for leveraged transactions are reported to account for up to 70% of their loan sale activity.

Characteristics of banks' commercial and industrial loan sales[1]

Items	Mid-1988	Mid-1989
	amounts outstanding as a percentage of sales	
By seller		
Merger-related	23	45
Money centre banks	63	71
By purchaser		
Domestic banks	34	34
of which:		
Large banks[2]	*27*	*31*
Foreign banks[3]	44	45
Other[4]	23	20
Memorandum item:		
Total sales (in billions of US dollars)	*53.1*	*72.2*

[1] Data derived from the Senior Loan Officer Opinion Survey on Bank Lending Practices covering the sixty largest domestic US banks. Call report data indicate that these banks accounted for over 90% of all loans sold by commercial banks in the second quarter of 1989. The number of respondents was almost the same in the two years. [2] Defined as banks with at least $2 billion in total assets. [3] Branches and agencies of foreign banks in the United States as well as their foreign offices. [4] Including mainly non-financial corporations, pension funds, mutual funds, bank trust departments, finance companies and insurance companies.

Source: Board of Governors of the Federal Reserve System.

At bank holding companies part of the exposure is in the form of subordinated debt, including junk bonds, and equity. At the most active banks, the evidence suggests that the amounts involved may exceed 10% of their HLT exposure. It has also been estimated that banks own around one-fifth of some of the largest equity LBO funds.

The typical motivation cited by bankers for their involvement in HLT business is the erosion of profitability in their traditional commercial lending operations under the pressure of greater competition from corporate clients and securities firms. As with commercial property lending, bankers have been forced to look for more profitable, but probably riskier activities. For the banks originating the deals, HLTs offered a number of advantages. By financing HLTs, they could retain part of their customer base; they could compete more effectively with securities firms in providing advisory services on mergers and, de facto, in the underwriting of part of companies' liabilities; and they could raise substantial fee revenue without tying up regulatory capital, particularly through loan sales. Between 1984 and 1988 the ratio of non-interest to interest income at money centre banks rose from 43 to 73%. For banks purchasing loans from the lead banks, HLTs held out the promise of high-yield assets obtained at lower resource costs in terms of information-gathering and processing.

... because of competitive pressures ...

... and attractive income prospects

The pricing of loans suggests that returns on HLTs can indeed be particularly high when compared with those on conventional loans to business firms. The rates charged typically range between 200 and 300 basis points over LIBOR. In addition, a variety of attractive fees normally amount to between 1½ and 3% of the commitments. How far the actual return will reflect these contractual terms, however, depends on the risks involved in the transactions.

Ultimately, the riskiness of HLT lending stems from the fact that as bank loans make up a larger share of a company's liabilities and the equity cushion declines, returns can be expected to become more variable. This is true whether the source of repayment is cash flow or asset sales. Studies indicate that in an LBO senior debt, the bulk of which is provided by banks, varies between 40 and 85% of the financing, the ranges for subordinated debt and equity being 10–40% and 1–20% respectively. The share of bank finance represents a significant increase over traditional corporate lending practices. As discussed in last year's Annual Report, there may indeed be good reasons for thinking that the new financial arrangements can raise the income stream associated with the targeted company's assets, primarily by restricting the managers' discretion to pursue non-profit-oriented goals. However, increased income need not provide a cushion for HLT lenders to the extent that it is anticipated by pre-existing company shareholders and reflected in the company's acquisition price.

High leverage increases risks

One feature of the transactions which points to the potential greater variability of returns on this type of lending is the particularly low coverage of the restructured companies, i.e. the ratio of their operating cash flow to interest payments. The coverage requirements have generally ranged between 1.5 and 1.0, with more recent deals tending to cluster towards the lower limit. In traditional corporate lending practices, by contrast, coverage requirements are often dispensed with altogether, as the cash-flow cushion for interest payments is normally much larger.

The potential greater variability of returns also adds to the underwriting risk which banks assume when temporarily committing more funds than their targeted final exposure in order to secure the deals and earn fee revenue. Even when the loans are not sold, the expectation is that part of them will be quickly repaid from funds raised by subordinated security issues. The risk is that the banks may be unable to reduce their exposure or may suffer heavy losses in the process, especially as a result of rapidly changing market conditions.

Risk management

Beyond a prudent and thorough assessment of a company's potential and its cyclical sensitivity, as well as a sound diversification strategy, banks can manage the economic risk inherent in HLTs in three ways. Firstly, they can insist that the company hedges part of its variable rate liabilities. It has been reported that bank agreements commonly require the hedging of 50% of a company's floating rate exposure for the initial two to three years after the transaction. A number of devices such as interest rate caps and swaps are used for this purpose. Secondly, banks can curtail the management's discretion over the use of the company's cash flow. Typical restrictions include minimum coverage requirements, limitations on new capital spending and on the issue of additional debt, a prohibition on paying common stock dividends in the early years and "recapture clauses", requiring that proceeds of asset sales be used to repay senior debt and possibly demanding early repayment of senior debt if the company's performance exceeds expectations. Thirdly, banks can ensure repayment priority ("seniority") of their claim over that of other debtors, both when the company is a going concern and in a liquidation. A number of restrictive covenants and clauses in the loan agreements are designed for this purpose. Moreover, the bulk of bank lending appears to be secured, i.e. collateralised, which would establish a priority claim on the borrower in the event of liquidation. The most common forms of collateral seem to be general liens on assets, the shares of subsidiaries of the target company and inventory and receivables.

Legal uncertainties

Owing to the novelty and complexity of the transactions, however, there are a number of legal uncertainties attaching to them. While potentially important, they defy quantification and are as yet largely untested in the courts. Under certain conditions the courts may not recognise the validity of banks' claims on collateral and may rank banks' claims on a par with those of junior creditors. One possible reason is that the senior lender may be found to exercise a significant measure of management control ("lender liability"). Bank holding companies owning direct or indirect equity stakes in restructured enterprises may be particularly affected ("equitable subordination"). Another possible reason is that the courts may find that the leveraged transaction has undermined the interests of previous unsecured creditors by raising the company's debt beyond its ability to pay (fraudulent conveyance laws). The test employed by the law is such that it imposes a major burden on the debtor and the lending banks when defending these actions. A further cloudy issue is that of ultimate legal liability in loan sales. As a result, the effective exposure of banks selling loans may be greater than is apparent from their books. The risk is particularly relevant for those agent banks originating the loans and then selling all or most of their exposure.

At least until the end of 1988, the quality of HLT loans, while deteriorating, appeared to be relatively good. Since then the deterioration has given some cause for concern. According to survey evidence reported by the Board of Governors of the Federal Reserve System, by 1989 about 40% of respondent banks had experienced higher charge-off rates on merger-related loans than on other commercial and industrial loans, compared with about one-quarter in 1988 and none in 1986. From the end of 1988 to mid-1989 the proportion of loans "criticised" by the Office of the Comptroller of the Currency at the top eleven multinational banks had almost doubled, from 9% to 17%. In the autumn the Comptroller pointed to a number of signs of potential weakness. Credit terms had been deteriorating, as prices paid for the companies had risen relative to earnings profiles and repayment periods had lengthened. The drying-up of the junk bond market was putting pressure on banks to take larger shares of overall HLT financing. Some agent banks were finding it increasingly difficult to sell their loans. Finally, the involvement of smaller banks with less sophisticated credit evaluation procedures and less expertise in the deals was growing.

The deterioration in loan quality ...

There is a risk that the quality of banks' exposure may deteriorate further. As suggested by trends in prices and financing terms, there are signs that over time competition has tended to erode the profit margins existing in the earlier stages of the HLT wave. Given the past growth of HLT volumes and the typical repayment schedules (50% repayment within five years), the real tests still lie ahead.

Thus, while the past showed how lucrative HLT involvement could be for banks, the future is more likely to clarify the longer-term risks that the institutions were incurring in the process. It is particularly hard to assess the likelihood of serious difficulties arising in the HLT portion of banks' portfolios and their consequences for the banking system. HLTs are by no means a homogeneous aggregate, as they include deals with significantly different characteristics in terms of leverage and coverage levels, financing structures and sensitivity to cyclical downturns. While the banking system's exposure will probably decline, legal uncertainties complicate the assessment of its distribution across banks and of recovery values in the event of liquidation. The practice of selling loans has probably permitted a better spreading of the risk in the financial sector. By the same token, however, it may have stored up significant difficulties for less benign times when the transactions may require renegotiation. Given the signs of a slowdown of economic activity in the United States and other sources of potential cyclical sensitivity in banks' portfolios, including commercial real estate, attention to banks' HLT involvement appears justified (see the table opposite). In response, supervisory authorities have stepped up their

... prompts a response by supervisors

Loan portfolio of US commercial banks at mid-1989[1]			
Items	In billions of US dollars	As a percentage of total loans	As a percentage of equity
Commercial and industrial	609	31	295
Real estate[2]	720	36	349
of which:			
Commercial and construction	*345*	*17*	*167*
Farm and residential	*375*	*19*	*182*
Individuals	376	19	182
Other	284	14	138
Total	1,989	100	964
Memorandum items:			
Highly leveraged transactions[3]	*60*	*3*	*29*
Developing countries	*71*	*4*	*34*

[1] Domestic and foreign offices of US commercial banks. The data do not cover branches and agencies of foreign banks in the United States. [2] The split between sub-categories of real estate lending is approximate. [3] Rough estimate referring only to loans outstanding and not to loan commitments, based on data from various official and unofficial sources.

Sources: Board of Governors of the Federal Reserve System and BIS estimates.

monitoring and co-ordination efforts, including the adoption of a common HLT definition in October 1989 by the three national US bank regulators.

Information about involvement in HLTs by non-US banks is not readily available and remains fragmentary. Although Japanese banks have been particularly active in financing US transactions, only one large bank has disclosed its HLT exposure, when its shares were first listed on the New York Stock Exchange in September 1989. Its exposure appeared significantly lower than that of typical large US banks. The Japanese authorities, however, have expressed some concern about Japanese banks' involvement, particularly that of smaller institutions. Estimates of UK banks' exposure to highly leveraged companies are also somewhat lower. At five of the largest lenders, total HLT loan exposure in 1989 was estimated to be over £10 billion, and in all cases well below 100% of the banks' equity. In at least one instance, however, the fact that some companies restructured by means of LBOs have gone into receivership has drawn attention to the exposure of the lending bank. The regulatory authorities have expressed little concern but are said to be monitoring HLT involvement closely.

Prudential regulation and supervision

In the period under review a number of steps were taken with a view to improving the framework of prudential regulation and supervision of financial market activity. One case, the restructuring of the regulation of thrift institutions in the United States, represented the authorities' response to a specific crisis. More generally, efforts have been guided by the need to adapt prudential arrangements to the rapidly changing organisation of the financial industry, as geographical and line-of-business barriers continue to be eroded worldwide. Two important examples are the work on defining the framework of the single European market in financial services and that on co-ordinating capital standards for securities business.

Reform of the thrift industry in the United States

In August 1989 the US Congress passed the Financial Institutions Reform, Recovery and Enforcement Act with a view to resolving the long-standing problems of the thrift industry (see last year's Annual Report). The legislation establishes a new government agency, the Resolution Trust Corporation, for the purpose of liquidating insolvent institutions, and overhauls the industry's regulatory framework. This overhaul comprises a number of measures: the transfer of the regulatory functions of the Federal Savings and Loan Insurance Corporation and Federal Home Loan Bank Board, both abolished, to, respectively, the Federal Deposit Insurance Corporation and the newly created Office of Thrift Supervision at the Department of the Treasury; stricter capital requirements, more in line with those for commercial banks; and the curtailment of lending and investment powers, including the obligation to sell off existing holdings of non-investment-grade bonds by mid-1994. As the law diminishes the advantages of being classified as a thrift institution, it will contribute to a major contraction in the industry over the next few years.

The thrift industry is overhauled ...

The costs of closing insolvent institutions, inclusive of interest payments, were originally estimated by the Administration at $166 billion over ten years. Estimates by Congress now put these costs at $243 billion and possibly considerably more. Recently, operating losses in the industry have risen, junk bond prices have slipped, further weakness has emerged in the real estate markets and the disposal of the assets is proving harder than anticipated. FDIC estimates of the number of institutions yet to be closed range from 225 to 295, accounting for some $160 to 200 billion of the industry's assets, to be added to the 250 or so already under the control of the authorities.

... as estimates of the costs mount

The single European market in financial services

The design of the single European financial market is founded on the principle of "mutual recognition" of national laws, regulations and practices, subject to the harmonisation of "essential" supervisory standards. This principle establishes the framework for cross-border financial activities and ultimately determines the scope for permissible competition not only in the provision of financial services but also between national regulatory arrangements. The principle is the basis for a number of specific directives, currently at different stages of development, defining the precise contours of the single market.

The Second Banking Directive, setting out the framework for banking supervision, was finally adopted in December 1989. Countries should comply with it by 1st January 1993 at the latest. The Directive defines a broad range of permissible activities for banks ("credit institutions"), The Second Banking Directive is adopted ...

including securities business, which correspond roughly to the concept of universal banking. Banks licensed in any one member state are allowed to engage in the permissible activities both directly and by establishing branches freely throughout the Community ("single passport"), subject only to the regulations of the home country ("home country control"). Minimum licensing standards involve an initial capital requirement (ecu 5 million) and the obligation to inform the authorities in the licensing state of the identity of shareholders with a significant degree of control (i.e. with "qualifying" holdings) so as to permit the refusal or withdrawal of the licence if these are deemed unfit.

The Directive does not set any limits to the participation of non-financial companies in banks' capital. By contrast, banks' individual and total "qualifying" holdings in non-financial companies are limited, respectively, to 15% and 60% of a bank's own funds. No such limits exist, however, for insurance business. In order to ease the transition for a number of banks, especially in Germany, a ten-year grace period is provided for.

The original draft of the Directive had caused considerable anxiety among non-EC countries. Its proposed reciprocity clause was interpreted as empowering the Commission to suspend the authorisation of foreign subsidiaries or the acquisition of participations in EC banks unless the Commission was satisfied that banks from the Community enjoyed "reciprocal treatment" in the non-member countries concerned, i.e., in effect, that they were allowed to engage in all those activities permissible in the Community. Fears of the restriction of access to EC markets were particularly rife in countries where commercial and investment banking activities are largely kept separate, notably the United States and Japan. The final text, however, has done much to allay such fears. Now the main criterion is "national treatment", i.e. non-discrimination in the non-member country between domestic and foreign institutions. Where such treatment is found not to be present, sanctions can only be decided by the Council of Ministers. They take the form of suspending authorisation decisions for up to three months, with the possibility of renewal. When "national treatment" is found to hold, but the non-member country is nevertheless considered not to provide "effective market access" comparable with that granted by the Community to non-EC institutions, the Commission can seek a mandate from the Council to start negotiations to remedy the situation, but no sanctions can be applied. These provisions do not apply retro-actively.

... and banks' capital standards are harmonised

The minimum harmonisation of bank capital standards is defined in two separate directives: the Own Funds Directive, adopted in April 1989, and the Solvency Ratio Directive, adopted in December. Except for minor discrepancies, the capital requirements conform to those for international banks agreed upon by the Basle Committee on Banking Supervision in 1988.

The two Directives regulating the activities of non-bank securities firms are still at an early procedural stage. The draft Investment Services Directive is based on the single EC passport and home country control principles, although conduct of business rules are primarily the responsibility of the host country's supervisory authorities. A Commission proposal for the Directive on the capital adequacy of investment firms formulates a common definition of own funds and a set of minimum capital requirements. The proposal covers position risk for both bank and non-bank institutions.

Supervision of securities firms and banks' position risk

Work on the international harmonisation of capital standards for securities firms is also being carried out by the Technical Committee of the International Organisation of Securities Commissions (IOSCO), a committee created in 1987 which brings together representatives of securities regulators in the major markets. At IOSCO's Annual Meeting held in September 1989 tentative agreement was reached on a common conceptual framework for a system resembling those already in operation in the United States, the United Kingdom and, since April 1990, in Japan. The system has encountered opposition, particularly in Germany, because it cannot be applied to universal banks, which mix securities business with banking business in the same corporate unit and are subject to quite different banking capital adequacy standards.

The harmonisation of capital standards for securities business raises difficult issues:

The Basle Committee on Banking Supervision has been studying ways of extending the Basle agreement on minimum capital standards to cover banks' market risks, including the position risk arising out of their securities business. This would complement existing standards, which focus only on credit risk.

These international regulatory efforts have highlighted the difficulties in co-ordinating the supervision of banks' and non-banks' securities business. There seems to be a broad consensus that some kind of "level playing-field" for the two forms of financial institution is called for, but as yet no agreement has been reached on how far it is feasible to pursue it without compromising supervisory standards for either.

co-ordination of bank and non-bank supervision

The difficulties arise in part from the two quite different approaches historically taken by securities and bank regulators. The bulk of the assets of a securities firm are marketable and hence subject to observable price fluctuations which result in similar fluctuations in a firm's net worth. As firms have to be able to meet losses quickly as they occur, securities regulators place considerable emphasis on liquidity, treating illiquid assets conservatively and often allowing certain forms of short-term subordinated financing to be counted as capital. By contrast, a major proportion of bank assets, such as loans, has traditionally been non-marketable. Bank supervisors have therefore tended to focus far less on liquidity and short-run changes in asset values and more on the long-run viability of the institution. Illiquid positions have not been penalised with higher capital requirements, and the regulatory definition of capital has only included financing instruments of a more permanent nature. Even in those countries where banks are allowed to engage actively in securities business, a specific treatment of securities activities has generally not been regarded as necessary. One reason is that, at least until recently, the securities activities of the major banks, while possibly large in absolute terms, have tended to be small in relation to the banks' total business.

level of consolidation

A second issue which has attracted considerable attention is whether supervision should be carried out on a consolidated basis. The question does not arise when the securities business is conducted in-house. When that is not the case, however, there is a risk that failure to consolidate may result in insufficient consideration being given to the interdependencies within the financial group and even in gaps in supervisory coverage. The recent bankruptcy of the largest junk bond market operator has, in part, illustrated some of these risks. And irrespective of the precise framework of supervision, questions also arise regarding the allocation of responsibilities between supervisors, both nationally and across national borders.

and allocation of supervisory responsibilities

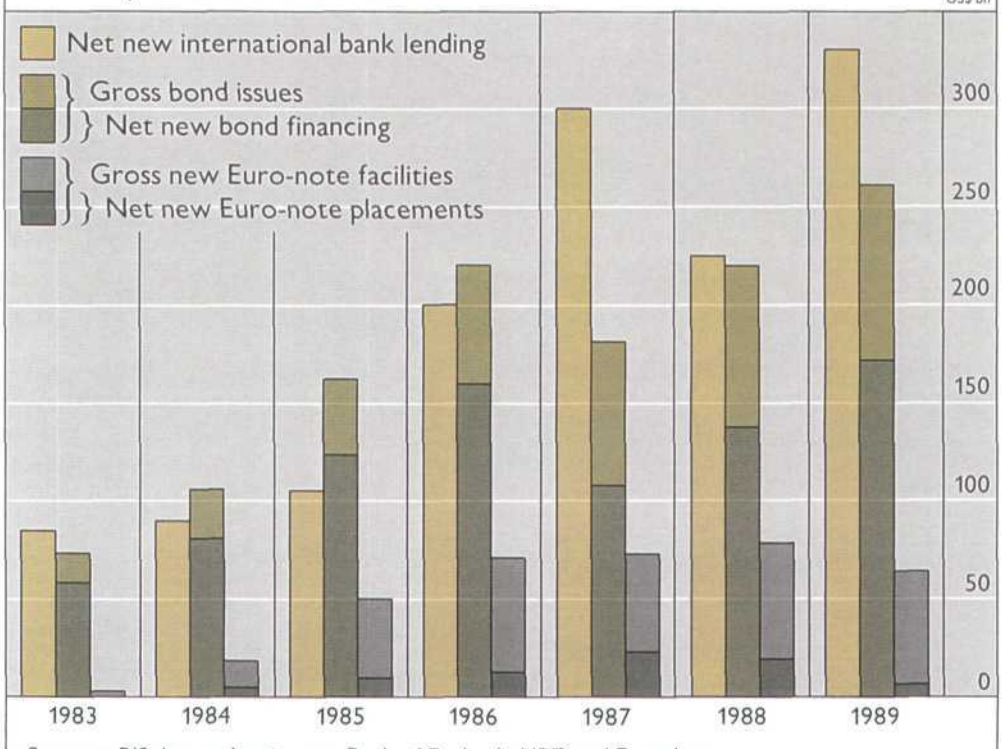
V. International financial markets

Highlights

In parallel with buoyant credit growth in most national markets, and continuing large international current-account imbalances, the volume of new funds channelled through the international banking and bond markets rose sharply last year.

In the international banking sector new lending was yet further concentrated in the industrial countries within the BIS reporting area. An important expansionary factor was the financial backing provided by banks for booming merger and acquisition activity. In a number of European countries the liberalisation of exchange controls permitted a further shift of business from the domestic to the international markets. In Japan a major influence was banks' channelling of domestic credit through their foreign affiliates. Finally, the international banking market continued to be used on a large scale for the financing and hedging of purchases of foreign securities. Outside the reporting area, eastern European countries were the only major group of borrowers, whereas identified claims on the heavily indebted countries in the Third World declined markedly.

Activity in international financial markets



Sources: BIS data and estimates, Bank of England, AIBD and Euroclear.

While Japanese institutions continued to play a pivotal role in the expansion of international banking activity, the international operations of US banks also revived in 1989 after years of near-stagnation, and particularly strong growth was reported by continental European banks.

In the long-term international securities market the outstanding feature was the surge in equity-related issues, which was based on the strength of the Tokyo stock market up to the end of the year. Another factor supporting activity in the first half of the year was the firmness of the US dollar, together with declining interest rates on that currency. On the other hand, later in the year increasing interest rate uncertainties, particularly with respect to other currencies, and changing perceptions about the credit-standing of some corporate borrowers were negative influences.

A sharp contraction was recorded last year in the short-term sector of the international securities market. Partly as a result of increasing competition from national markets and concerns about credit quality, net new Euro-commercial paper issues shrank to only a fraction of their former level.

One striking development in recent years, which gathered pace in 1989, has been the growth of the markets for derivative financial products. Activity in exchange-traded financial futures and options has soared and the swap markets have grown further in importance. This chapter examines recent changes in these markets and looks at some of their implications.

Finally, the chapter considers developments in the international debt situation. The heavily indebted countries failed on the whole to benefit from the favourable economic conditions in the industrial countries last year. Their export growth tended to slow down and at the same time higher interest rates pushed up their interest obligations again. Debt conversion packages negotiated on the basis of the Brady Initiative have alleviated the debt service burden of some countries, but the amount of official funds available under this scheme may not be sufficient to lay the foundations for the full restoration of the debt servicing capacity of all problem debtor countries willing to undertake fundamental economic reforms.

Overall international financial market activity

Pronounced expansion in final lending channelled through the international ...

The growth in the total volume of new funds channelled through the international financial markets accelerated markedly last year. Net of double-counting and overlaps between the different market sectors, the amount of credit outstanding may be estimated to have risen by $440 billion, or 14%, to a total of $3,530 billion. This was somewhat higher than the average rate of domestic credit growth in the major industrial countries and, if adjusted for the US domestic inflation rate, amounted to a real increase of 9%.

... banking sector ...

In absolute terms the largest contribution to the growth of the overall credit total came, as usual, from the international banking sector ($330 billion). Since the banks continued to be quite active as borrowers and investors in the securities markets, this figure includes an overlap of nearly $70 billion with the net volume of funds raised in the international bond

Estimated net lending in international markets

	Stocks at end-1984	Changes[1] 1985	1986	1987	1988	1989	Stocks at end-1989
	in billions of US dollars						
Total cross-border claims of reporting banks[2]	2,165.6	232.1	510.8	596.8	424.9	590.6	5,030.7
Local claims in foreign currency	464.3	63.4	147.7	162.8	75.5	113.1	1,132.9
minus double-counting due to redepositing among the reporting banks	1,344.9	190.5	458.5	459.6	275.4	373.7	3,523.6
A = Net international bank lending[3]	1,285.0	105.0	200.0	300.0	225.0	330.0	2,640.0
B = Net Euro-note placements	5.0	10.0	13.0	23.4	19.5	6.9	79.2
Total completed international bond issues		161.9	220.5	181.1	220.1	261.1	
minus redemptions and repurchases		38.9	60.9	73.3	82.9	89.5	
C = Net international bond financing	390.0	123.0	159.7	107.8	137.1	171.6	1,252.3
D = (A + B + C) = Total international financing	1,680.0	238.0	372.7	431.2	381.6	508.5	3,971.5
minus double-counting[4]	90.0	58.0	82.7	51.2	66.6	68.5	441.5
E = Total net international financing	1,590.0	180.0	290.0	380.0	315.0	440.0	3,530.0

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

market. Not directly reflected in the former figure is a record expansion of over 50% – to $152 billion – in announced new international syndicated credit facilities, which was related to the boom in merger and acquisition activity, notably in the United Kingdom and the United States.

... and bond markets

The volume of bond issues completed in 1989 amounted to $261 billion – a new peak. Although higher interest rates slowed down early retirements of bonds, the growing importance of scheduled repayments meant that total redemptions rose further to nearly $90 billion. At $172 billion, the actual amount of net new borrowing was 7.5% higher than the previous peak reached in 1986. A novel feature of the international bond market last year was that equity-related issues contributed nearly 45% to this net new financing. By contrast, in the international short-term securities market a sharp decline, to $7 billion, was recorded last year in net new Euro-note placements, down from $23 billion and nearly $20 billion in 1987 and 1988 respectively.

Surge in equity-related issues

The international banking sector

The development of the overall aggregates

After slackening somewhat in 1988, the growth of the international banking aggregates accelerated last year, without, however, attaining the high rates recorded in 1987. The reporting banks' cross-border claims plus their claims in foreign currency on their own residents expanded by $704 billion, or 13%, to a total of $6,164 billion (these figures somewhat understate the actual expansion owing to the lack of 1989 data for banks in Italy).

Yet further concentration of new lending in the reporting area

Even more so than in preceding years, new lending activity was concentrated in the reporting area itself. Net of double-counting, the increase in lending to this area may be estimated at around $320 billion, of which $184 billion represented direct credits to non-bank entities. Identified claims on outside-area countries declined marginally, the first reduction yet recorded. Geographically unallocated assets, which include certain securities holdings and claims on international institutions, increased by $12 billion.

The situation was different on the sources side of the reporting banks' balance sheets, with liabilities to countries outside the reporting area expanding by $51 billion. Given the decrease in the banks' claims on these countries, this implies that in 1989 the outside area was an important net

Main features of international banking activity

	Changes, excluding exchange rate effects				Stocks at end-1989
	1986	1987	1988	1989	
	in billions of US dollars				
Claims on outside-area countries	14.4	10.9	7.5	−1.0	719.3
International claims on entities within the reporting area	631.3	736.5	491.2	692.7	5,318.7
of which: Cross-border claims within the reporting area	*483.6*	*573.7*	*415.7*	*579.6*	*4,185.8*
Reporting banks' domestic claims in foreign currency	*147.7*	*162.8*	*75.5*	*113.1*	*1,132.9*
of which: Claims on non-banks	*108.7*	*177.7*	*128.9*	*183.8*	*1,255.3*
Banks' own use of international funds for domestic lending	*64.2*	*99.2*	*86.8*	*135.3*	*539.8*
Double-counting of interbank operations	*458.5*	*459.6*	*275.4*	*373.7*	*3,523.6*
Unallocated	12.7	12.2	1.8	11.9	125.6
Total gross international bank assets	658.5	759.6	500.4	703.7	6,163.6
Estimated net international bank credit	200.0	300.0	225.0	330.0	2,640.0
Liabilities to outside-area countries	−1.6	48.5	40.3	50.5	565.6
International liabilities to entities within the reporting area	618.6	722.3	478.0	600.7	5,230.3
of which: Cross-border liabilities within the reporting area	*505.7*	*603.0*	*443.8*	*517.7*	*4,350.6*
Reporting banks' domestic liabilities in foreign currency	*112.9*	*119.3*	*34.2*	*83.0*	*879.7*
of which: Liabilities to non-banks	*89.1*	*70.4*	*66.1*	*96.4*	*787.7*
*Banks' own supply of domestic funds for international lending**	*81.5*	*147.5*	*85.1*	*138.5*	*1,022.0*
Double-counting of interbank operations	*447.9*	*504.4*	*326.8*	*365.8*	*3,420.6*
Unallocated	31.0	33.6	33.5	44.6	264.7
Total gross international bank liabilities	647.9	804.4	551.8	695.8	6,060.6
Estimated net sources of international banking funds	200.0	300.0	225.0	330.0	2,640.0

* Including trustee funds channelled into the market via banks in Switzerland and deposits by official monetary institutions.

supplier of funds to the reporting banks. However, the $52 billion decline in the reporting banks' net creditor position vis-à-vis outside-area countries somewhat overstates the actual reflow of funds from these countries since it is inflated by banks' write-offs, sales and conversions of outstanding claims on heavily indebted developing countries. Liabilities to entities within the reporting area expanded by $600 billion, or by an estimated $235 billion if double-counting is excluded. The major part of the $45 billion increase in the geographically unallocated item, which largely comprises liabilities arising out of banks' own issues of international securities and liabilities to international institutions, can probably also be attributed to inside-area sources.

Major role of outside-area countries as net suppliers of new funds

As usual, the bulk of the increase in the banks' gross positions vis-à-vis the reporting area resulted from interbank transactions. Thus, nearly three-quarters, or $509 billion, of the expansion in inside-area claims was interbank, $472 billion of which represented cross-border operations. While Japanese banks, both head offices and their affiliates abroad, played a leading role in this expansion, the growth of their interbank activity appears to have slowed down markedly. The cross-border operations between banks in Japan and banks in other reporting countries, which had surged by $321 billion in 1988, increased by $256 billion. By contrast, there was a pronounced acceleration in interbank lending between banks in Europe from $39 billion in 1988 to $111 billion.

Strong growth in interbank operations within the reporting area

Excluding the double-counting resulting from the redepositing of funds, it may be estimated that the reporting banks' own use of international banking funds for local lending in domestic currency amounted to $135 billion last year, with banks in Japan and the United Kingdom being the largest takers of funds. At the same time, on the sources side of the market the banks may be estimated to have taken up $138 billion in domestic markets for funding their international lending activity. This latter figure includes about $40 billion of trustee funds channelled to the Euro-market via banks in Switzerland and some deposits received from official monetary institutions within the reporting area.

Developments in individual market centres

The acceleration in the growth of international banking activity last year occurred above all in the European market centres, where the banks' international assets expanded by $314 billion, or more than twice as much as in 1988. Banks in France and the United Kingdom reported the largest increase in cross-border assets in foreign currency, namely $50 billion each, or 21.5% and 6.2% respectively. The especially rapid growth of activity in France was the result of the liberalisation of exchange controls and the increasing presence of foreign banking establishments. An exceptional rate of expansion in total foreign currency assets (50%) was recorded by banks in Sweden, which also benefited from a liberalisation of foreign exchange controls, with the bulk of the $21 billion increase resulting from direct foreign currency lending to domestic non-bank entities. Banks in Germany reported unusually rapid growth in their external claims in both domestic

Buoyant activity in European market centres

Developments in individual market centres

Positions of banks in:		Changes, excluding exchange rate effects						Stocks at end-1989		
		1988			1989			External positions in:		Local positions in foreign currency
		External positions in:		Local positions in foreign currency	External positions in:		Local positions in foreign currency	domestic currency	foreign currency	
		domestic currency	foreign currency		domestic currency	foreign currency				
		in billions of US dollars								
United Kingdom	A	6.8	27.1	7.0	5.1	50.0	10.6	73.8	850.2	274.5
	L	24.7	37.0	−2.8	17.7	62.7	−8.3	122.1	905.8	233.0
France	A	1.4	21.8	0.5	4.3	50.1	3.5	51.0	283.4	74.1
	L	8.0	25.2	5.7	15.8	47.9	14.8	44.4	312.6	73.1
Germany	A	13.3	4.1	1.0	34.3	20.0	0.2	188.1	80.4	4.4
	L	8.0	0.6	0.6	12.1	13.1	1.3	96.7	63.0	6.7
Luxembourg	A	0.0	19.5	−0.2	0.2	36.3	4.4	3.3	225.7	39.3
	L	0.3	14.5	4.8	0.7	34.2	6.5	3.7	206.7	49.2
Belgium	A	0.7	0.6	0.8	0.5	19.3	1.8	10.1	151.9	46.8
	L	1.9	2.0	1.4	1.8	15.8	5.8	17.5	168.1	35.7
Netherlands	A	1.5	13.6	3.3	7.0	19.0	5.3	32.0	118.6	22.9
	L	−0.7	12.8	3.6	2.8	10.4	7.3	23.1	105.5	27.4
Switzerland	A	−1.3	1.2	0.8	−5.7	−0.3	3.6	58.4	65.1	19.4
	L	−0.6	4.4	−0.3	3.8	6.1	2.1	24.3	65.2	19.9
Sweden	A	−0.4	0.9	6.5	1.6	4.4	16.6	3.4	17.6	47.0
	L	1.0	9.5	0.0	0.2	18.4	0.7	4.1	59.2	7.5
Other European	A	0.9	4.6	15.7	3.0	8.7	10.2	27.0	163.5	104.1
countries	L	3.9	20.0	3.9	2.2	21.1	2.8	29.1	261.0	35.9
Total European										
reporting	A	22.9	93.4	35.4	50.3	207.5	56.2	447.1	1,956.4	632.5
countries	L	46.5	126.0	16.9	57.1	229.7	33.0	365.0	2,147.1	488.4
Japan: Offshore	A	61.4	77.1	25.4	69.0	46.0	26.0	183.0	246.0	67.0
market	L	52.9	82.9	9.0	19.7	38.0	35.0	117.0	254.0	60.0
Other	A	0.5	27.7	14.3	4.0	33.5	29.3	189.7	223.3	408.1
	L	−6.4	60.6	8.1	36.5	46.6	13.9	174.4	334.3	321.0
United States:										
IBFs	A	20.8	19.4	0.0	28.9	−0.5	0.0	289.6	53.3	0.0
	L	20.9	18.8	0.0	48.4	−1.8	0.0	334.0	55.5	0.0
Other	A	10.4	0.1	0.0	14.2	2.4	0.0	244.6	11.8	0.0
	L	21.6	3.0	0.0	12.3	−0.6	0.0	246.6	11.1	0.0
Canada	A	−2.0	−4.5	0.4	0.4	1.8	1.6	4.2	46.0	25.3
	L	−0.9	−2.3	0.3	2.1	0.1	1.1	9.3	64.4	10.4
Asian market	A	1.1[1]	87.6[2]	..	−1.1[1]	117.5[2]	..	4.7[1]	693.0[2]	..
centres	L	3.4[1]	77.2[2]	..	4.0[1]	109.2[2]	..	10.6[1]	638.5[2]	..
Caribbean	A	..	9.0	..	..	16.6	..	..	438.1	..
market centres	L	..	13.5	..	..	11.6	..	..	419.0	..
Total	A	115.2	309.8	75.5	165.7	424.9	113.1	1,362.8	3,668.0	1,132.9
	L	138.0	379.6	34.2	180.0	432.8	83.0	1,256.9	3,923.9	879.7

Note: A = assets; L = liabilities.

[1] Hong Kong only. [2] Including Bahrain.

and foreign currency, particularly in the last quarter of the year when there was strong foreign demand for Euro-Deutsche Mark funds for the financing of purchases of German shares and bonds.

Large net external borrowing by banks in the United Kingdom and Switzerland

Banks in the United Kingdom were large net importers of external funds ($ 25 billion), largely for the funding of domestic takeover and merger activity. In Switzerland, too, where credit was tightened markedly in the course of 1989, banks were substantial net borrowers of external funds, in striking contrast to the years before 1988. The $ 16 billion net capital inflow through the banks, together with the country's current-account surplus, helped to offset large outflows of non-bank funds from Switzerland. Banks in Germany and the Netherlands were large net suppliers of funds to the international markets in 1989, with their net external creditor positions increasing by $ 29 billion and nearly $ 13 billion respectively.

Continued strong growth of international activities of banks in Japan

As in preceding years, banks in Japan showed the largest expansion in their international assets, of $ 208 billion, although in percentage terms the increase of 19% was considerably lower than in 1988. Strong growth in external assets ($ 116 billion, or 20%) was, moreover, reported by banks in the Asian market centres, where the affiliates of Japanese banks play a prominent role.

Interaction between the JOM and the traditional onshore accounts

Within Japan developments differed sharply between banks' offshore accounts and their traditional onshore accounts. In the Japan Offshore Market (JOM) the banks built up their net external creditor position in yen by $ 49 billion, or nearly 300%. At the same time, through their onshore accounts, they were net importers of yen funds to the extent of $ 33 billion. The situation was similar with respect to foreign currency business: banks lent a net amount of $ 8 billion to non-residents through the JOM, but borrowed $ 13 billion abroad through their traditional accounts. These developments, which to some extent reflected a loosening of Japanese domestic regulations, permitting banks in Japan to become net lenders to the JOM, were influenced by two factors. Firstly, in order to circumvent domestic lending guidelines Japanese banks channelled a sizable volume of domestic credit through their foreign affiliates, which refinanced themselves in the JOM. Secondly, in view of a ban on direct borrowing in the JOM and despite the further liberalisation of the domestic money market in November 1988, a sizable volume of domestic interbank business continued to be channelled through the JOM by way of Japanese banks' foreign affiliates.

The expansion of the international positions of banks located in the United States slowed down last year. In particular, their cross-border assets and liabilities in foreign currency, which had both risen by about 40% in 1988, showed hardly any growth. As in preceding years, banks in the United States were substantial net importers of external funds ($ 13 billion).

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

The growth of the reporting banks' direct international business with non-bank entities within the reporting area accelerated considerably last year. On the uses side of the banks' balance sheets, cross-border credits and

Strong growth in direct lending to non-bank entities in Japan, the United Kingdom and the United States ...

local lending in foreign currency expanded by $184 billion, or 17% (see the table on page 130). The largest borrowers were non-bank entities in Japan, the United Kingdom and the United States. There was a particularly strong increase in cross-border credits to Japanese non-banks ($29 billion, or 53%). By contrast, local lending in foreign currency by banks in Japan ($11 billion) slowed down sharply last year, partly as a result of reduced hedging of foreign securities purchases by Japanese non-bank entities. The lending to UK and US non-banks ($38 and 22 billion respectively) was to a substantial extent connected with merger and acquisition activity.

... and in some continental European countries

Other large recipients of credits were non-bank entities in Sweden ($18 billion), the Netherlands ($12 billion) and Italy ($11 billion). The substantial borrowing by Swedish and Italian non-banks, largely in foreign currency, was facilitated by the removal of exchange controls and can be explained by the high level of domestic interest rates in combination with the absence of serious exchange rate fears for most of the year. The Italian figures include only cross-border lending; data on local lending in foreign currency by banks in Italy are not yet available for 1989. The Netherlands, like the United Kingdom, is an important domicile for the financing companies of international corporations.

Rapid expansion in non-bank deposits despite large withdrawals of funds by US non-banks

On the sources side of the reporting banks' balance sheets, new deposits received from non-bank entities within the reporting area amounted to $96 billion (+14%) last year. The increase would have been even greater had it not been for large-scale withdrawals of deposits from the international banking market by the US non-bank sector (−$28 billion), which in preceding years had usually been a major supplier of new funds. This pronounced turn-round reflected the narrowing of the differential between interest rates in the US domestic market and the Euro-markets, particularly between the Treasury bill rate and LIBOR. Combined with their substantial new borrowing, this meant that US non-bank entities obtained a net amount of nearly $50 billion from banks abroad in 1989 (against only $6 billion in 1988), a capital inflow which, together with the $13 billion imported by the banks, may help to explain the firmness of the dollar throughout most of 1989.

Factors accounting for the sharp increase in deposits from non-banks in Germany, Switzerland ...

Rigidities in domestic money markets, exchange rate expectations, changes in foreign exchange controls and tax factors help to explain the pronounced increase in external deposits by non-banks from several European countries.

In Germany and Switzerland tighter monetary conditions were rapidly reflected in Euro-Deutsche Mark and Euro-Swiss franc interest rates, whereas the upward movement in domestic rates followed with a lag. These developments, and a shift to the Euro-market to avoid domestic withholding tax during the first half of 1989, resulted in a $23 billion build-up of deposits by German non-bank entities with banks abroad. Similarly, Swiss non-bank entities added $8 billion to their international deposits and a further $15 billion was transferred abroad via trustee accounts. New reporting requirements imposed on the banks by the tax authorities in late 1988 may help to explain the very large supply of deposits from Dutch

Reporting banks' direct business with non-bank entities in the reporting area

Positions vis-à-vis non-bank entities in:		Changes, excluding exchange rate effects								Stocks at end-1989	
		Cross-border positions				Local positions in foreign currency				Cross-border positions	Local positions in foreign currency
		1986	1987	1988	1989	1986	1987	1988	1989		
		in billions of US dollars									
United Kingdom	A	7.0	0.9	5.5	8.0	11.1	14.4	12.2	29.7	39.1	117.6
	L	3.8	3.8	1.5	6.3	10.1	11.1	4.9	12.8	35.3	71.2
Italy	A	−0.4	1.1	5.3	11.2	3.0	6.5	6.5	..	44.1	33.9
	L	−0.1	1.1	−0.1	1.7	0.1	−0.4	0.9	..	8.2	2.4
Germany	A	−3.5	5.7	6.0	1.0	0.0	0.5	0.8	−0.2	67.7	2.8
	L	16.9	4.6	5.8	23.2	0.9	0.9	0.2	1.1	74.2	5.1
Sweden	A	0.0	0.7	−1.1	2.4	0.7	5.1	7.8	15.8	12.4	43.3
	L	0.4	0.5	0.5	0.6	0.2	0.7	1.7	−0.3	3.2	4.1
Belgium-	A	0.5	1.4	1.0	2.9	2.3	2.3	0.3	2.9	21.4	32.7
Luxembourg	L	3.1	−0.8	1.6	5.2	1.9	3.9	6.2	8.8	24.5	31.4
Netherlands	A	2.9	4.9	7.2	8.0	1.6	0.2	3.0	4.1	34.5	15.2
	L	2.7	4.1	10.4	9.9	1.5	1.0	2.9	6.5	43.1	19.7
France	A	−1.9	−1.3	−0.6	1.8	−0.6	7.9	−1.6	0.1	20.6	18.9
	L	1.8	1.6	0.9	4.4	0.8	1.3	4.1	9.3	17.5	19.4
Switzerland	A	1.8	0.4	1.1	3.7	2.0	0.4	0.5	2.3	18.3	10.8
	L	−0.4	3.2	1.4	6.0	1.5	1.3	0.3	2.1	40.5	11.1
Other European	A	−0.9	2.7	2.3	3.4	1.6	7.9	6.9	8.2	70.9	42.8
countries	L	1.8	0.9	1.4	3.4	0.0	0.1	0.8	2.7	18.7	9.3
Total European reporting	A	5.1	16.5	26.7	42.4	21.7	45.2	36.4	62.9	329.0	318.0
countries	L	30.0	19.0	23.4	60.7	17.0	19.9	22.0	43.0	265.2	173.7
Japan	A	4.6	26.8	14.9	29.2	47.6	56.7	31.6	11.4	84.5	214.3
	L	2.2	0.6	1.4	10.1	..	..	..	..	18.3	..
United States	A	20.3	27.2	15.6	21.6	0.0	0.0	0.0	0.0	179.4	0.0
	L	26.4	22.8	9.8	−27.7	0.0	0.0	0.0	0.0	203.8	0.0
Canada	A	2.1	2.7	−1.2	3.7	−0.9	−1.7	0.3	1.6	22.6	23.1
	L	1.5	−0.5	0.0	− 0.3	0.3	0.6	0.3	1.3	11.4	8.3
Asian market	A	1.1	−1.5	1.1	1.8	..	..	..	..	13.8	..
centres[1]	L	2.2	1.5	4.0	6.4	..	..	..	..	31.0	..
Caribbean and other market	A	7.1	5.7	3.5	9.3	..	..	..	..	70.6	..
centres[2]	L	9.5	6.6	5.3	3.0	..	..	..	..	76.0	..
Total	A	40.3	77.4	60.6	107.9	68.4	100.3	68.3	75.9	699.9	555.4
	L	71.8	50.0	43.9	52.2	17.3	20.4	22.2	44.2	605.7	182.0

Note: A = assets; L = liabilities.

[1] Including Bahrain. [2] Including non-reporting offshore centres: Barbados, Bermuda, Lebanon, Liberia, Vanuatu and British West Indies.

... and other European countries

non-bank entities to the international market ($16 billion, of which $10 billion was deposited with banks abroad). A $14 billion (or 59%) increase in deposits by French non-bank residents with banks abroad and in foreign currency with banks at home was made possible by the easing of French exchange controls. UK non-bank residents, largely non-bank financial institutions, supplied $19 billion to the international market, mainly in the form of foreign currency deposits with banks in London. Particularly noteworthy in 1989 was a $10 billion (123%) expansion in balances held by Japanese non-banks with banks abroad, but a large portion of this increase resulted from repurchase agreements with financial institutions in the United States which were subsequently unwound. No figures are available on foreign currency deposits by Japanese residents with banks at home.

Developments in business with outside-area countries

The marginal $1 billion reduction in banks' claims on countries outside the reporting area was the net result of fairly large offsetting movements. There was substantial new lending to eastern Europe ($9.5 billion) and, to a lesser extent, to OPEC countries and developed countries outside the reporting area ($4.1 and 3.2 billion respectively), whereas identified claims on non-OPEC developing countries declined by $17.7 billion (see the table on page 132). By contrast, on the sources side of the banks' balance sheets, non-OPEC developing countries accounted for nearly one-half of the $50.5 billion supply of new deposits from outside-area countries to the reporting banks. In addition, $15.5 billion of new deposits came from non-reporting developed countries and $11.2 billion was provided by OPEC countries.

Further contraction in reported claims on Latin America

In the developing world the reporting banks' claims on Latin American countries contracted by $15.2 billion, or 7%, largely as a result of debt conversion operations, asset sales and write-offs. The biggest decreases in claims were recorded vis-à-vis Brazil ($5 billion) and Argentina ($4.9 billion), despite the accumulation of large interest arrears by these countries and their decision to suspend official debt conversion programmes. At the same time, non-bank entities in these two countries built up their deposits with the reporting banks by $1.5 and 1.8 billion respectively, which suggests an acceleration of capital flight.

Elsewhere in Latin America, reported claims declined markedly vis-à-vis Mexico ($2.1 billion) and Chile ($1.8 billion), two countries which actively continued to pursue debt reduction strategies during 1989. At the same time Chile built up its deposits by $1.2 billion, thereby bringing down its remaining net debtor position vis-à-vis the reporting banks to only $3.5 billion. Mexico, on the other hand, withdrew $2.6 billion from its deposits with the reporting banks.

Reduction or elimination of net debtor positions of some major Asian countries

In Asia, the reporting banks' claims on China, which had been the largest borrower of new funds in 1988 ($7.2 billion), declined by $0.6 billion, following the temporary suspension of bank lending in the wake of political unrest. Moreover, China increased its deposits by $1.3 billion, thereby moving into a $0.4 billion net creditor position vis-à-vis the reporting banks. A further decrease of $2.3 billion, or nearly 20%, was reported in banks' identified claims on the Philippines, which also added $1.3 billion to its bank deposits. Malaysia, which had already repaid $4.6 billion over the preceding four years, reduced its banking debt by another $0.5 billion. Since it also added $1.4 billion to its deposits, its remaining net

BIS reporting banks' business with countries outside the reporting area

	Changes, excluding exchange rate effects								Stocks at end-1989
	1982	1983	1984[1]	1985	1986	1987	1988	1989	
	in billions of US dollars								
Borrowing from reporting banks									
Non-reporting developed countries	16.0	7.2	5.2	7.3	7.2	4.7	2.9	3.2	133.1
Eastern Europe	− 4.6	− 1.1	−0.1	5.7	3.7	2.3	8.0	9.5	97.6
OPEC[2]	8.2	9.8	−2.1	0.2	0.5	2.0	5.5	4.1	133.0
Non-OPEC LDCs	19.8	12.6	9.8	11.0	3.1	1.9	− 8.9	−17.7	355.6
of which: Latin America[3]	*12.1*	*8.3*	*5.3*	*1.7*	*1.5*	*−3.9*	*−11.1*	*−15.2*	*200.0*
China	*− 0.6*	*0.4*	*1.4*	*4.9*	*0.7*	*4.8*	*7.2*	*− 0.6*	*22.6*
Taiwan	*− 0.2*	*− 0.5*	*−0.8*	*−0.6*	*4.0*	*8.3*	*− 1.7*	*− 0.5*	*15.6*
Other Asia	*5.1*	*3.5*	*4.2*	*3.8*	*− 2.1*	*−5.5*	*− 1.8*	*1.6*	*81.1*
Africa	*1.7*	*0.6*	*0.1*	*0.9*	*− 0.2*	*−0.6*	*− 0.7*	*− 1.7*	*22.1*
Middle East	*1.7*	*0.3*	*−0.4*	*0.3*	*− 0.8*	*−1.1*	*− 0.7*	*− 1.4*	*14.3*
Total borrowing	39.4	28.5	12.8	24.1	14.4	10.9	7.5	− 1.0	719.3
Memorandum item: Fourteen heavily indebted countries[4]	*16.5*	*8.5*	*2.3*	*0.7*	*2.0*	*−5.9*	*−14.1*	*−21.4*	*245.2*
Deposits with reporting banks									
Non-reporting developed countries	− 0.1	1.3	2.7	3.5	7.4	6.1	13.5	15.5	84.1
Eastern Europe	2.0	2.7	4.3	2.8	0.2	−0.7	4.0	0.7	35.4
OPEC[2]	−18.2	−13.0	4.1	6.6	−22.1	19.1	11.1	11.2	187.9
Non-OPEC LDCs	4.6	10.4	19.4	5.7	12.9	24.1	11.7	23.0	258.2
of which: Latin America[3]	*− 1.9*	*5.8*	*10.1*	*0.4*	*0.7*	*6.7*	*2.8*	*2.4*	*83.4*
China	*2.9*	*1.3*	*1.3*	*−5.3*	*− 0.9*	*5.3*	*5.1*	*1.3*	*23.0*
Taiwan	*1.2*	*2.1*	*5.4*	*6.7*	*14.4*	*6.5*	*− 7.9*	*6.6*	*43.8*
Other Asia	*1.4*	*1.9*	*3.1*	*1.1*	*− 0.4*	*2.1*	*10.2*	*8.5*	*62.4*
Africa	*− 0.8*	*0.2*	*1.0*	*1.4*	*0.0*	*1.6*	*1.5*	*1.5*	*18.0*
Middle East	*1.8*	*− 0.9*	*−1.6*	*1.4*	*− 0.9*	*1.9*	*0.0*	*2.8*	*27.7*
Total deposits	−11.7	1.4	30.5	18.6	− 1.6	48.5	40.3	50.5	565.6
Memorandum item: Fourteen heavily indebted countries[4]	*− 9.5*	*7.0*	*13.5*	*2.6*	*− 4.6*	*7.1*	*1.9*	*4.9*	*102.6*

[1] As from 1984 the figures also 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] Including, in addition, Brunei, Oman and Trinidad and Tobago, but excluding Bahrain as from 1984. [3] Including those countries in the Caribbean area which are not classified as offshore banking centres. [4] Baker countries excluding Yugoslavia.

indebtedness to the reporting banks fell by 46%, to $2.2 billion. South Korea, by contrast, after repaying nearly $10 billion over the preceding three years, resumed its borrowing and received $1.2 billion in new credits from the reporting banks.

Substantial supplies of new funds from OPEC countries ...

OPEC countries, too, were substantial net suppliers of new funds to the reporting banks last year, with the largest identified increases in deposits coming from Saudi Arabia ($3.2 billion), Kuwait ($2 billion), Iran ($1.6 billion), Nigeria ($1.2 billion) and Iraq ($0.9 billion). Saudi Arabia was also the principal borrower, whereas the banks' identified claims on Venezuela and Nigeria declined by $1.7 and 1.6 billion respectively.

... and developed countries outside the reporting area

Developed countries outside the reporting area continued to reduce their net debtor position vis-à-vis the reporting banks, with the largest increases in deposits coming from Yugoslavia ($2.4 billion), Turkey ($2.2 billion), Portugal ($2.1 billion), Greece ($1.9 billion) and Australia ($1.7 billion). Yugoslavia, Turkey and Portugal succeeded in building up their official foreign exchange reserves substantially last year. Australia, Greece and Portugal were the major borrowers of new funds in this group ($2.9, 1.2 and 0.9 billion respectively), whereas the reporting banks' claims on Yugoslavia and South Africa declined by a further $1.5 and 0.8 billion respectively.

Major borrowing by eastern European countries

During 1989 eastern European countries were the main group of borrowers outside the BIS reporting area, with the Soviet Union ($7.1 billion), the German Democratic Republic ($1.2 billion), Bulgaria ($0.8 billion) and Czechoslovakia ($0.7 billion) the principal takers of new funds. Romania, by contrast, which had already made very large repayments over the preceding years, reduced its debts by a further $0.5 billion to leave a balance of only $0.3 billion. At the same time the country increased its deposits by $0.9 billion to a total of $1.7 billion, thereby becoming a net creditor vis-à-vis the reporting banks.

The currency composition of Euro-market activity and the ecu market

Rapid expansion in the Euro-yen and Euro-Deutsche Mark sectors ...

The more rapid expansion of reporting banks' international assets and liabilities last year was due in large measure to their lending and deposit-taking in foreign currencies. In the case of banks in the industrial reporting countries (no currency breakdown is available for the offshore centres), this acceleration was mainly accounted for by transactions in dollars, Deutsche Mark and yen. In particular Euro-yen assets, cross-border and local considered together, expanded by three times as much as in 1988, and in absolute terms their growth ($45 billion) slightly exceeded that in Euro-Deutsche Mark assets (see the table on page 134). A strong expansion was, however, recorded in foreign currency liabilities denominated in Deutsche Mark ($77 billion). On the other hand, Euro-Swiss franc assets, which had already fallen by $14 billion in 1988, declined by a further $9 billion, reflecting the ongoing reassessment of the international role of this currency. Somewhat slower growth was reported in Euro-sterling and ecu positions. By contrast, the role in the Euro-market of a number of currencies which had previously been used on only a very limited scale in international transactions increased significantly as a result of the dismantling of exchange controls. This applied above all to the lira and the French franc, with the banks' foreign currency assets denominated in these two currencies expanding by 55% and 28% respectively.

... and some smaller currency sectors

The slowdown in the reported growth of ecu assets, from $24 billion in 1988 to $18 billion, may have reflected the absence of data on the activities of banks in Italy, which appear to have been very buoyant. Identified direct claims on non-bank entities expanded by $4 billion, or

The currency composition of reporting banks' foreign currency positions[1]													
Currencies		Changes, excluding exchange rate effects								Stocks at end-1989	
		Cross-border positions				Local positions in foreign currency				Cross-border positions	Local positions in foreign currency
		1986	1987	1988	1989	1986	1987	1988	1989		
		in billions of US dollars									
US dollar	A	188.8	184.1	94.6	137.8	118.1	120.9	46.1	78.5	1,469.9	753.2
	L	209.7	192.4	161.4	137.4	88.1	93.8	1.6	54.1	1,675.2	579.9
Deutsche Mark[2]	A	0.9	31.1	31.3	29.5	4.6	20.4	8.9	14.5	341.9	128.2
	L	28.2	41.4	41.8	70.1	2.8	9.7	2.9	7.1	434.6	81.3
Japanese yen[2]	A	20.8	30.7	14.0	38.8	2.9	1.3	−0.5	6.0	177.4	40.4
	L	21.4	23.8	7.5	29.2	1.9	3.6	−2.7	3.2	151.8	35.6
Swiss franc[2]	A	7.9	−1.5	−4.8	2.7	9.6	4.0	−8.7	−11.3	113.8	57.3
	L	17.6	10.5	−16.1	4.5	4.7	0.0	2.9	−5.9	140.1	38.2
Ecu[2]	A	6.2	8.2	15.6	16.4	0.1	2.9	7.9	1.4	104.9	35.3
	L	2.2	6.1	16.8	16.8	−0.2	0.0	8.9	3.7	95.6	32.4
Pound sterling[2]	A	8.5	5.2	22.8	15.7	1.8	3.1	6.5	5.0	77.1	21.9
	L	10.1	13.9	21.7	13.4	3.3	2.4	5.5	4.0	90.1	19.7
Other	A	25.2	27.3	39.7	49.9	10.6	10.2	15.3	19.0	251.9	96.6
	L	27.4	35.1	55.8	40.6	12.3	9.8	15.1	16.8	279.0	92.6
Total	A	258.3	285.1	213.2	290.8	147.7	162.8	75.5	113.1	2,536.9	1,132.9
	L	316.6	323.2	288.9	312.0	112.9	119.3	34.2	83.0	2,866.4	879.7

Note: A = assets; L = liabilities.

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

13%, considerably less than in 1987 and 1988. On the other hand, ecu-denominated liabilities to non-banks, which had shown only moderate growth during recent years, rose by $5 billion, or as much as 43%, thereby considerably broadening the market's deposit base.

Strong increase in ecu deposits by non-banks

The nationality structure of international bank lending

Looking at international banking developments from the point of view of the nationality of the banks, a salient feature in 1989 was that the growth of activity was more evenly distributed than in recent years, when Japanese banks had been quite dominant. The Japanese banks still accounted for nearly two-fifths of the total increase in international bank assets and liabilities, but in terms of growth rates this was roughly in line with the 11.5% expansion in overall activity, and their share in total outstanding international bank assets, which had risen sharply over recent years, remained unchanged at 38%. On the other hand, there was some revival in the international activities of US banks, whose market share had declined as that of the Japanese banks rose; nevertheless, even in 1989 the expansion of US banks' international assets remained somewhat below the market average. The international balance sheets of continental European banks grew strongly last year, with their market share edging up from 35 to 36%. Among the major European banking groups the highest growth rate was recorded by German banks (23%), which by year-end ranked third after the Japanese and US banks in terms of the size of their international assets.

Stabilisation of market shares of Japanese and US banks

Growth in market share of continental European banks

The main reason for the more modest growth of Japanese banks' international banking operations was probably that, after years of extremely rapid expansion, they began to feel the impact of the new international capital guidelines, particularly towards the end of the year as the climate for new equity financing became less favourable. In addition, the sharp depreciation of the yen last year considerably increased the yen value of their assets denominated in foreign currencies.

A closer look at the statistics shows that the somewhat slower rate of expansion of the international activities of Japanese banks was due above all to slower growth of their inter-office positions, while the growth of their business with non-related banks accelerated. In particular their borrowing in the international interbank market, at $161 billion, was nearly two and a

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

	Change in current dollars during 1989						Total stocks	
	Related offices	Other banks	Official monetary institutions	Non-banks	Securities[2]	Total	end-1985	end-1989
	in billions of US dollars							
Japanese banks								
Assets	86.9	79.6	−0.5	35.8	–	201.8	707.0	1,967.2
Liabilities	41.6	161.0	−2.3	7.5	3.3	211.1	672.5	1,924.7
US banks								
Assets	44.9	2.3	0.2	13.2	–	60.6	593.3	727.4
Liabilities	44.5	7.6	1.0	18.7	−5.4	66.4	555.2	742.4
French banks								
Assets	3.5	25.1	0.0	16.1	–	44.7	245.2	432.1
Liabilities	−0.9	30.1	2.4	21.0	4.8	57.4	248.9	458.0
German banks								
Assets	18.8	51.0	4.4	7.6	–	81.8	191.0	435.8
Liabilities	14.9	6.8	0.1	30.0	2.6	54.4	157.4	329.3
UK banks								
Assets	7.5	−3.0	−1.9	5.5	–	8.1	191.0	247.3
Liabilities	6.0	−5.5	4.6	31.6	3.5	40.2	200.8	308.7
Other								
Assets	29.7	24.4	−3.9	73.6	–	123.8	786.2	1,329.4
Liabilities	9.1	56.8	−0.1	32.2	3.4	101.4	779.8	1,336.8
Total								
Assets	191.3	179.4	−1.7	151.8	–	520.8	2,713.7	5,139.2
Liabilities	115.2	256.8	5.7	141.0	12.2	530.9	2,614.6	5,099.9

[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 for US banks also include the cross-border positions reported by US banks' branches in the Bahamas, the Cayman Islands, Panama, Hong Kong and Singapore. The international assets and liabilities in this table are classified according to the nationality of ownership of the reporting banks. [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.

half times as large as in 1988. This points to a significant difference in the growth pattern of the international balance-sheet structures of Japanese and European banks. Whereas the Japanese banks continued to show by far the largest increase in direct credits to non-banks ($36 billion), their non-bank liabilities increased only moderately and they refinanced themselves in the international interbank market. Instead the largest accruals in non-bank deposits were recorded by UK and German banks ($32 and 30 billion respectively). The UK banks used these funds largely for lending in domestic markets, whereas the German banks deployed them mainly in the international interbank market, with their net creditor position vis-à-vis non-related banks increasing by nearly 45% last year.

Differences in funding patterns

The syndicated loan market

Syndicated credits boosted to record levels by merger and acquisition activity ...

Activity in the syndicated credit market surged to record levels last year. The volume of new facilities announced amounted to $152 billion, or 53% more than in 1988. Operations related to mergers and acquisitions (M & A) accounted for some $56 billion of this amount and for the two largest facilities ever assembled: one for $13.6 billion, and another for $11 billion. High fee incomes, together with opportunities to provide ancillary services and to sell the loans on the secondary market were the main incentives for banks' active participation in M & A operations (see Chapter IV). In particular, sizable sales of participations to smaller banks and to non-bank entities were reported. A significant volume of new facilities also related to real estate and airline financing. On the other hand, the arrangement of multiple option facilities and revolving credits declined considerably compared with 1988, as the most active prime names in the market had completed their borrowing programmes and banks became increasingly reluctant to engage in low-profit operations.

About 80% of syndicated credits were arranged for corporate borrowers, primarily US and UK entities, which accounted for $48.2 and 21.7 billion respectively of new facilities, $33.7 and 10.1 billion of which were in support of M & A operations. Moreover, M & A activities boosted borrowing by Canadian and Irish firms. The volume of new facilities arranged for entities in outside-area countries also rose substantially.

... but sharp slowdown in early 1990

Towards the end of the year some reappraisal of banks' involvement in corporate restructuring activity took place. This, together with the difficulties in the US junk bond and real estate markets, led to a sharp decline in the arrangement of new facilities. As a result, the volume of newly announced syndicated credits dropped from $51 billion in the fourth quarter of 1989 to $39 billion in the first three months of 1990.

The international securities markets

The Euro-note market

First setback in activity since the 1980s ...

In 1989 the Euro-note market experienced its first setback since its beginnings in the early 1980s. The volume of announced new facilities declined from a peak of $79 billion in 1988 to a four-year low of $66 billion. Similarly, the amount of Euro-notes outstanding increased by only

$6.9 billion, compared with a record expansion of $23.4 billion in 1987. The slowdown in placements of net new securities was particularly pronounced in the Euro-commercial paper (ECP) market, which had been the most buoyant sector in the preceding years, while short-term securities carrying an underwriting commitment by banks continued to be withdrawn from the market. By contrast, the outstanding volume of medium-term Euro-notes, which were first launched in 1986, grew at a rapid pace (71%), and by year-end reached nearly $10 billion.

Considering the Euro-note market as a whole, dollar-denominated securities accounted for nearly 85% of all paper outstanding at the end of 1989. However, numerous issues have been swapped into other currencies. As regards the nationality of borrowers, the main net takers of new funds were Australian ($4.4 billion) and US ($1.2 billion) entities, whereas the outstanding amount of securities issued by borrowers from Norway and New Zealand contracted markedly.

... but pick-up in net borrowing in the first quarter of 1990

In the first quarter of 1990 announced new facilities for the issuance of Euro-notes declined further to $16 billion. By contrast, following the seasonal contraction in December 1989, the volume of Euro-notes outstanding increased sharply, by over $9 billion to nearly $89 billion.

Growing competition from domestic commercial paper markets

The ECP market was subject to a number of negative influences last year. Prime borrowers, many of whom already had programmes in place, showed no interest in establishing new facilities, while high short-term interest rates deterred drawings on existing programmes. Domestic commercial paper (CP) markets, which continued to benefit from liberalisation measures in both Europe and Japan, also contributed to diverting business from the Euro-market. In 1989 the outstanding volume of commercial paper issued in domestic markets expanded by more than $100 billion to over $700 billion. In the United States alone borrowings by

Main features of the Euro-note market

	Years			1989				Stocks at end-1989
	1987	1988	1989	Q I	Q II	Q III	Q IV	
	in billions of US dollars							
New facilities announced								
Euro-commercial paper	46.1	52.5	47.9	7.8	14.3	10.8	15.0	
Other short-term Euro-notes	15.2	10.4	6.6	1.0	2.2	2.4	0.9	
of which: underwritten	*3.4*	*3.6*	*1.6*	*0.3*	*0.8*	*0.5*	*0.1*	
Medium-term notes*	12.0	16.1	12.0	4.0	3.4	0.7	3.9	
Total	73.4	79.0	66.4	12.9	19.9	13.9	19.8	
Net new issues								
Euro-commercial paper	19.4	19.9	5.3	3.7	0.4	4.6	−3.4	58.5
Other short-term Euro-notes	1.8	−3.4	−2.4	1.0	−1.4	−1.2	−0.8	11.1
Medium-term notes	2.2	3.0	4.0	0.8	0.9	1.3	1.0	9.6
Total	23.4	19.5	6.9	5.5	−0.1	4.7	−3.2	79.2

* Including Euro-commercial paper programmes with the option to issue medium-term notes.
Sources: Bank of England and Euroclear.

foreign issuers soared by $12 billion to $63 billion. Another influence affecting activity in the ECP market was the intense competition between dealers, which continued to erode the profit margins of intermediaries, with the result that several major ECP dealers withdrew from the market.

Increasing importance of credit ratings

The market for Euro-commercial paper was also severely shaken by a number of sudden defaults and by changing perceptions of the reliability of the credit back-ups. These developments led to a flight to quality by investors, and, following a reassessment of the pricing of credit and liquidity risks, resulted in a greater differentiation of interest rates. Investors in the ECP markets also appear to have become more attentive to credit ratings. Whereas in the US domestic CP market virtually all securities are rated and deteriorations in credit quality have at times been signalled well in advance of default, the majority of facilities in the ECP market had until recently not been assigned ratings. As a result, a number of lower-rated borrowers were attracted to the Euro-markets and were able to take up funds at rates which did not fully reflect their real credit-standing. However, it has been estimated that towards the end of 1989 the share of rated ECP outstanding had risen to nearly 50% and ECP dealers were reportedly urging unrated issuers to apply for credit ratings.

Favourable outlook for the medium-term Euro-note market

The market for medium-term Euro-notes (EMTNs) was only marginally influenced by developments affecting the issuance of short-term securities. The fee structure for intermediaries in the EMTN sector remained more profitable than that in the ECP market and there were no defaults amongst issuers. One feature of the EMTN sector has been the dominance of US borrowers who have exploited profitable arbitrage opportunities between the domestic and international markets.

There are several factors which suggest that the EMTN market will continue to expand and may possibly attract some business from the international bond market. Firstly, the issuance of medium-term notes intermediated by dealers permits more flexibility than the public offering of bond issues through a syndicate. The maturity of new issues in the EMTN market can be as short as nine months and, in theory, as long as desired by borrowers and investors. Moreover, the timing, size and currency of the drawings under a particular EMTN facility can be varied to accommodate the funding needs of issuers. Secondly, investors generally require that bond issues be of a minimum specified amount in order to guarantee liquidity. By contrast, in the EMTN market, dealers themselves provide liquidity to investors by standing ready to buy and sell securities. Finally, recent US experience suggests a shift of corporate borrowing from bonds to medium-term notes, which may spill over to the international markets. Excluding junk bonds and collateralised mortgage obligations, domestic issues of publicly placed bonds in the United States have declined continuously since the mid-1980s, whereas issues of medium-term notes have more than doubled and are now nearly as large as issues of corporate bonds.

The international bond market

There was further growth in the international bond market last year, with

Expansion in overall issuing activity ...

the volume of newly announced issues rising to $259 billion, or $33 billion more than in 1988. The increase was more than fully accounted for by equity-related bonds, the issuance of which surged to unprecedented levels in the first half of the year. Japanese borrowers, intermediaries and investors dominated this sector, reflecting the strength of the Tokyo stock market up to the end of 1989. Activity in other sectors was less buoyant. In the market for straight fixed rate bonds announced new issues in currencies other than the dollar declined from $114 billion in 1988 to $96 billion. Rising interest rates, especially during the second half of the year, exchange rate uncertainties and fiscal changes were among the major factors accounting for the slowdown. By contrast, the strengthening of the US dollar and declining longer-term interest rates in the first half of 1989 boosted the issuance of straight fixed rate dollar bonds by 15% to $55 billion. New issues of floating rate notes in 1989 were marginally higher than in the previous year but remained well below the levels recorded in the mid-1980s.

... but increasing volume of redemptions

Last year also witnessed a significant increase in scheduled redemptions of bonds, from $43 billion in 1988 to $58 billion. On the other hand, early repayments declined from $40 billion to $31.5 billion, owing to the higher level of interest rates. After allowing for redemptions, the volume of bonds outstanding in the international markets expanded by $172 billion last year, or by 16%, to just over $1,250 billion. This growth was accompanied by only a modest increase in secondary market turnover, which remained somewhat below the peak level recorded in 1987.

Syndication and issuance procedures in the international bond markets were the subject of some debate in 1989. The pressure for change originated in the erosion of underwriters' profit margins as a result of heightened competition for market shares, the increasing importance of

Main features of international bond market activity

	Years			1989				Stocks at end-1989
	1987	1988	1989	Q I	Q II	Q III	Q IV	
	in billions of US dollars							
Total announced gross new issues[1]	177.0	226.0	258.7	79.2	69.7	53.8	55.9	
of which: Straight fixed rate issues	*121.3*	*161.3*	*150.1*	*51.3*	*34.6*	*29.7*	*34.5*	
Floating rate notes	*12.1*	*22.6*	*23.4*	*3.4*	*7.5*	*6.9*	*5.5*	
Equity-related issues[2]	*43.7*	*42.1*	*85.2*	*24.6*	*27.5*	*17.2*	*15.9*	
Total completed gross new issues[3]	181.1	220.1	261.1	73.3	69.4	56.9	61.5	
minus scheduled repayments	36.7	42.8	58.0	12.3	14.1	15.8	15.9	
minus early repayments	36.6	40.1	31.5	8.1	8.0	6.7	8.7	
= Total net new issues	107.8	137.1	171.6	52.9	47.3	34.4	36.9	1,252.3
of which: Straight fixed rate issues	*68.9*	*99.4*	*89.0*	*35.0*	*19.1*	*16.2*	*18.8*	*864.0*
Floating rate notes	*0.5*	*3.6*	*7.8*	*1.7*	*−0.5*	*5.4*	*1.3*	*164.5*
Equity-related issues[2]	*38.3*	*34.1*	*74.7*	*16.3*	*28.7*	*12.9*	*16.8*	*223.8*

[1] Non-dollar bonds are 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.

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

Wednesday figures, in percentages

* Yields in annual terms for a sample of bonds with an average life of five years.

institutional investors and the competitive boost to domestic markets stemming from deregulation. The debate has centred mainly on the distribution of spreads between the lead managers, who organise issuance and bear responsibility for correctly pricing bonds and stabilising prices in the primary markets, and the other underwriting members. In particular, one of the major disputes has concerned the discount which is often granted by underwriters to large investors.

Changes in issuing procedures ...

In April new guidelines were released by the International Primary Dealers Association recommending a shorter allotment period for new issues and the abolition of deductions made for price stabilisation costs by lead managers. Moreover, later in the year a number of issues were brought to the market under a method based on underwriting procedures common in the US domestic markets, whereby all members of a small syndicate agree to sell bonds in the primary market at a fixed price. Whilst the nominal spreads under this "fixed price re-offering" technique are narrower than those under the traditional Euro-syndication procedures, each of the smaller number of participants receives a larger share of the income.

... and their implications

These new syndication procedures have several implications for the markets. Firstly, they represent a further narrowing of the divide between the domestic and international markets. Secondly, they entail a greater degree of concentration in underwriting business. Finally, because of the shorter placement periods, the syndicate members will probably focus even more than at present on institutional investors, with whom a sizable volume of securities can be placed quickly. Individuals will be increasingly relegated to purchasing securities in the secondary market.

Some decline in fixed rate issues, but strength of the dollar sector

Straight fixed rate bonds. New issuing activity in the straight fixed rate sector declined from an all-time record of $161 billion in 1988 to $150 billion last year. The peak was reached in the first quarter; thereafter activity was on average below that in 1988. In the dollar sector, interest rate and exchange rate developments, as well as swap rates, were favourable influences during the first half of the year. A subsequent turn in market sentiment was triggered by concern regarding "event risks" arising from the financial restructuring of companies in the United States and the United Kingdom as well as by adverse developments in the US junk bond market. However, the resulting decline in borrowing by US and UK corporate entities was partly offset by a number of large issues by other prime borrowers, including the global issue by the World Bank and the jumbo Euro-issue by the Republic of Italy ($1.5 billion each).

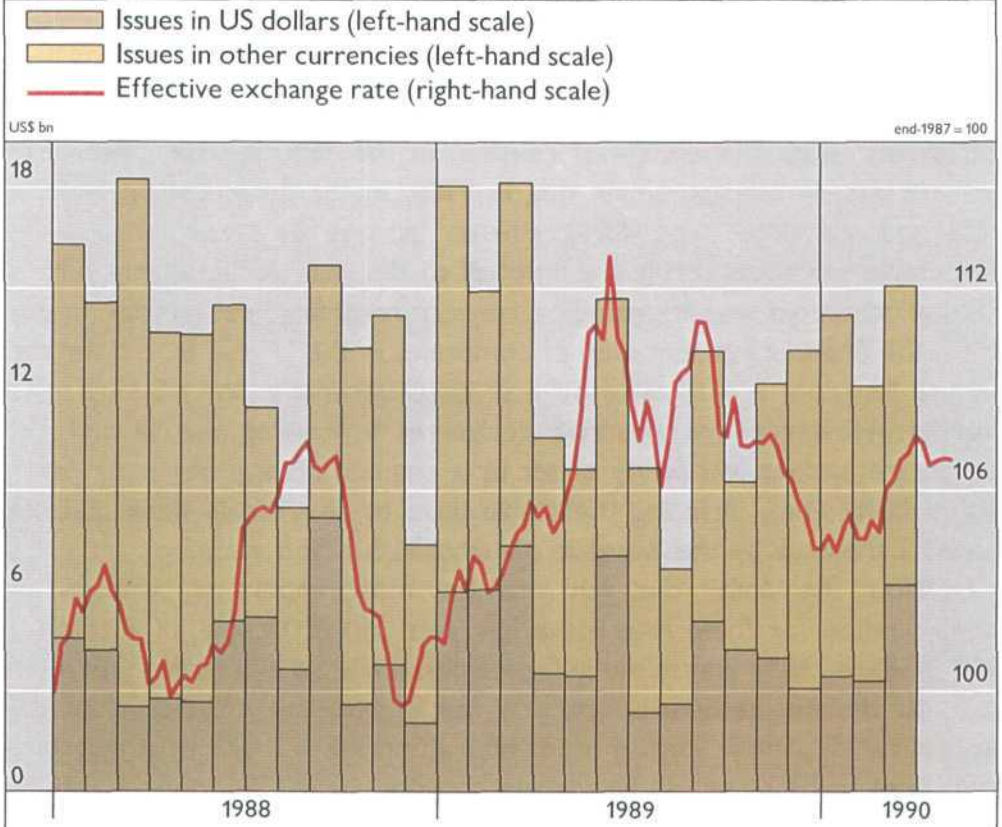
After the dollar the yen was the most important currency of denomination for fixed rate issues last year. However, out of a total of $22.3 billion, 25% was raised in December alone, when market sentiment towards the yen became temporarily less bearish and a flattening of the yield curve occurred. Sterling issues ranked third ($12.1 billion) as investors continued to be attracted by the high coupon yields. By contrast, issuing activity in Deutsche Mark and Swiss francs was depressed throughout most

Type and currency structure of international bond issues

	Announced gross new issues				Net new issues				Stocks at end-1989
	1986	1987	1988	1989	1986	1987	1988	1989	
	in billions of US dollars								
Straight fixed rate issues	147.4	121.3	161.3	150.1	108.6	68.9	99.4	89.0	864.0
of which: US dollar	*67.3*	*29.8*	*47.3*	*54.5*	*45.9*	*10.7*	*26.6*	*25.9*	*307.6*
Japanese yen	*21.4*	*21.9*	*19.0*	*22.3*	*18.9*	*18.4*	*11.9*	*14.5*	*125.0*
Swiss franc	*16.8*	*16.8*	*18.5*	*5.7*	*11.0*	*2.0*	*1.1*	*−3.9*	*97.7*
Deutsche Mark	*11.9*	*12.9*	*21.2*	*9.4*	*7.3*	*1.5*	*14.0*	*6.2*	*96.8*
*Ecu**	*5.7*	*7.2*	*10.8*	*11.7*	*4.7*	*7.2*	*9.5*	*7.4*	*51.4*
Pound sterling	*5.4*	*9.2*	*11.7*	*12.1*	*4.9*	*8.2*	*10.4*	*11.0*	*46.2*
Other	*18.9*	*23.5*	*32.8*	*34.4*	*15.9*	*20.9*	*25.9*	*27.9*	*139.3*
Floating rate notes	47.7	12.1	22.6	23.4	28.7	0.6	3.6	7.8	164.5
of which: US dollar	*38.2*	*3.9*	*6.6*	*8.1*	*19.0*	*−7.1*	*−10.2*	*−1.6*	*106.5*
Pound sterling	*5.4*	*2.2*	*10.2*	*7.3*	*5.5*	*2.2*	*8.7*	*5.4*	*27.8*
Other	*4.1*	*6.0*	*5.8*	*8.0*	*4.2*	*5.5*	*5.1*	*4.0*	*30.2*
Equity-related issues	27.4	43.7	42.1	85.2	22.4	38.3	34.1	74.7	223.8
of which: US dollar	*16.8*	*29.5*	*29.0*	*65.1*	*14.1*	*26.1*	*26.2*	*60.4*	*153.6*
Swiss franc	*6.0*	*7.1*	*8.3*	*13.6*	*4.5*	*5.4*	*4.3*	*8.8*	*42.0*
Other	*4.6*	*7.1*	*4.8*	*6.5*	*3.8*	*6.8*	*3.6*	*5.5*	*28.2*

* Excluding bonds issued in borrowers' national markets.
Sources: Bank of England, AIBD and BIS.

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



* Fixed rate issues, on an announcement basis; excluding equity-related bonds.
Source for bond issue data: Bank of England.

of the year. Deutsche Mark issues in the international market, which had been temporarily boosted by the announcement and subsequent introduction in Germany of a withholding tax on interest payments, fell back following the revocation of this levy in April 1989. The Swiss franc sector was handicapped by unusually pronounced interest and exchange rate uncertainties, and, after allowing for redemptions, the outstanding volume of Swiss franc bonds actually contracted.

Contraction in Deutsche Mark and Swiss franc issues

Newly announced ecu issues ($11.7 billion) benefited from the greater use of the ecu denomination by prime issuers in both domestic and international markets. In addition, attractive swap opportunities created by tax arbitrages led to a surge in corporate ecu borrowing. Issuing activity in Canadian and Australian dollars, although somewhat lower than in 1988, continued at high levels ($11 and 7.1 billion respectively). French franc, Italian lira and Spanish peseta bonds met with growing acceptance following the liberalisation of exchange controls and issuance procedures.

Equity-related issues. The market for equity-related issues was the most dynamic sector of the international bond market last year. In terms of announced new facilities, the volume of borrowing, at $85.2 billion, was twice as large as in 1988. Dollar issues, mostly with warrants attached, continued to account for the bulk (76%) of such paper, but activity in

Surge in equity-related issues as a result of ...

other currencies also expanded strongly. Swiss-franc-denominated issues, largely convertible bonds, increased by nearly two-thirds to $13.6 billion, while issues in Deutsche Mark surged from $1 to 4 billion.

... developments in Japan

As in earlier years, activity was dominated by Japanese borrowers (see graph on page 144). The continuing buoyancy of the Tokyo stock market and larger, and therefore more liquid, individual issues provided new opportunities for borrowers to reduce their coupons. At the same time, investors were attracted by the development in Japan of trading in detached warrants as well as by changes in Japanese accounting rules which made capital gains a more attractive source of revenue than coupons. Activity peaked in the second quarter and fell back significantly thereafter, partly because many borrowing programmes had been completed or reached the ceiling set by the Japanese regulations.

Unsettling influences from Japan

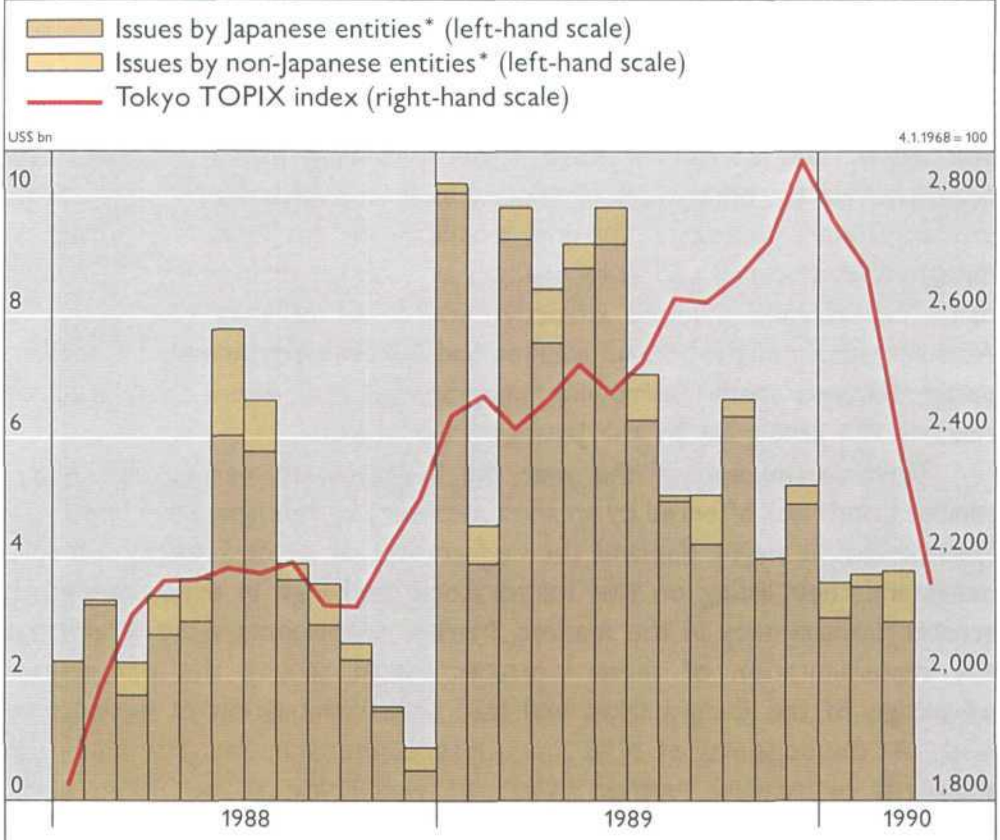
Towards the end of the year the international market for equity-related bonds was affected by an announcement by the Japanese Ministry of Finance that it might demand the registration of all new equity warrant issues and their listing on the Tokyo stock exchange in order to secure greater transparency in the market. Market participants were afraid that the implementation of these measures would reduce the competitive advantage of the Euro-market and lead to a repatriation of business to Japan. At the beginning of 1990 these uncertainties were heightened by the sharp rise in Japanese interest rates, the weakening of the Tokyo stock market, the further decline of the yen and growing competition from the newly liberalised domestic yen bond market. By the end of February the registration requirement had been introduced. At the end of March, following the stock market break in Tokyo, new issues of shares and equity-related bonds by Japanese entities were temporarily suspended by the major Japanese securities houses and in mid-May this moratorium was still in force.

Some pick-up in FRN issues accompanied by a broadening of currency denomination

Floating rate notes. New issues of FRNs in 1989 rose to $23.4 billion, slightly more than in 1988, but less than half the amount recorded before the crisis in the market for perpetual FRNs at the end of 1986. High short-term interest rates and competition from swapped fixed rate issues deterred borrowers. Dollar-denominated notes accounted for 35% of the total but, after allowing for repayments, there was a further decline in the volume of such paper outstanding. Activity in the sterling FRN sector, which had been boosted by UK mortgage companies and building societies in previous years, slackened following the sharp rise in sterling interest rates and the decline in the demand for mortgages. By contrast, new issuing activity in other currency sectors surged to record levels ($8 billion), with the largest volume of new issues being denominated in Deutsche Mark ($2.6 billion), Canadian dollars ($1.4 billion) and Italian lire ($1.2 billion).

An increasing number of FRNs took the form of variable rate notes. Banks and other financial institutions were by far the most active borrowers, using the market to increase their capital or to remove assets from their balance sheets by securitising loans. Redemptions of outstanding FRNs by governments exceeded new issues by a wide margin.

Issuing activity in the equity-related bond market



* On an announcement basis.
Source for bond issue data: Bank of England.

Nationality and sectoral composition of borrowers. Net new bond issues by Japanese entities, at $84 billion, accounted for nearly 50% of the new funds raised in the international bond markets last year. In fact, the contribution of borrowing in the international bond markets to the total volume of funds raised by Japanese non-bank corporate entities soared from roughly 10% in 1987 and 1988 to over 20% in the first half of 1989. UK entities remained the second-largest takers of new funds ($20.2 billion). In the case of some major borrowing countries a large part of the new issuing activity compensated for redemptions and repurchases of existing debt. In particular, the outstanding debt of US borrowers contracted by $2.9 billion. In eastern Europe, the Soviet Union took up $1 billion. The net volume of funds raised by international institutions rose from $7.7 billion in 1988 to $12.7 billion.

Predominance of Japanese borrowers

The further improvement in budgetary positions in a number of OECD countries was reflected in a fall in the net volume of funds raised in the international markets by government entities from $7.5 billion in 1988 to $3.5 billion. New issuing activity by banks was widespread and continued to be influenced by the need to raise capital in accordance with the international capital adequacy guidelines, with Japanese banks being by far the largest takers of new funds ($12.5 billion). By contrast, US banks redeemed $1.4 billion of their outstanding international bonds. As regards

Declining importance of governmental borrowings borrowing by private non-bank entities, concern over credit risk affected net issuing activity by US and UK companies.

During the first quarter of 1990 activity in the international bond market was buoyant, despite unsettled market conditions resulting from political uncertainties in Europe and Japan and a rise in long-term interest rates on several major currencies (the Deutsche Mark, Swiss franc and yen) to levels unprecedented in the 1980s. The volume of total announced new issues amounted to $62.1 billion, well above the levels recorded in the third and fourth quarters of 1989. In the straight fixed rate sector an unusually high share of borrowing was accounted for by government entities and international institutions. In terms of currency, there was, in particular, a pick-up in issuing activity in the Swiss franc, sterling, Deutsche Mark and ecu sectors. The sharp decline in the Tokyo stock market during the first quarter resulted in a further contraction in new issues of equity-related bonds, from $15.9 billion in the fourth quarter to $11.2 billion, before the moratorium on new issuing activity by Japanese entities. The uncertainty about the direction of interest rates contributed to a rise in the volume

Nationality of international bond issuers

Issuers		New issues				Stocks			
		1986	1987	1988	1989	1982	1987	1988	1989
		in billions of US dollars							
Japan	A	31.8	42.7	50.8	96.7				
	B	27.0	36.8	40.3	83.9	17.7	153.5	184.2	266.0
United States	A	41.6	22.5	16.6	16.4				
	B	32.6	11.4	5.4	−0.3	36.0	163.6	165.6	162.7
Canada	A	17.9	9.0	13.1	13.3				
	B	13.6	2.2	5.9	4.1	41.4	92.6	97.4	100.9
United Kingdom	A	20.2	11.2	26.3	23.0				
	B	17.5	9.5	19.6	20.2	11.1	64.3	82.4	96.5
France	A	13.4	8.5	16.5	13.5				
	B	5.7	3.1	10.1	9.4	18.4	58.3	65.8	74.5
Other developed	A	74.8	60.5	77.0	68.2				
countries[1]	B	53.5	36.3	47.9	40.7	67.3	295.2	329.1	364.7
Developing	A	3.0	2.2	3.9	2.6				
countries[2]	B	0.4	−0.9	−1.0	−1.0	18.0	34.1	32.2	29.9
Eastern Europe	A	0.6	0.6	1.2	2.0				
	B	0.6	0.5	1.2	1.9	0.6	2.0	3.2	5.2
International	A	19.1	19.9	20.6	23.1				
institutions	B	8.7	8.8	7.7	12.7	48.8	142.9	141.0	152.0
Total	A	222.4	177.0	226.0	258.7				
	B	159.7	107.8	137.1	171.6	259.1	1,006.6	1,101.0	1,252.3

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.

of announced floating rate note issues to $9.7 billion, the highest quarterly level since 1986. A salient feature was the record amount of FRN issues denominated in Deutsche Mark ($4.5 billion).

The markets for derivative financial instruments

Reasons for the rapid growth of derivative instruments

The remarkable expansion of markets for derivative products traded on organised exchanges or over the counter is perhaps the most striking development to have occurred in the financial markets during the 1980s. Although the characteristics of each individual instrument differ, all derivative financial products share the feature of not giving rise to an immediate flow of funds from one economic agent to another corresponding to the notional value of the contract. They have all been developed for the purpose of managing the risks associated with changes in asset prices, and the increase in volatility of interest rates, exchange rates and share indices in recent years is the factor which has contributed most to their success. But the scale and scope reached by these markets, particularly those in instruments with option-like features, would not have been possible without the changes in information and trading technology which have taken place since the beginning of the 1980s. Competition between markets for derivative products has intensified in recent years and has resulted indirectly in an increased volume of activity.

The expanding use of interest rate futures

Interest rate futures. Interest rate futures, which provide for the delivery of a specific standardised interest-bearing financial instrument at an agreed price on a future date and are traded on organised exchanges, are perhaps the most widely used derivative product. The number of contracts traded annually surged from 12 million to over 200 million between 1980 and 1989. Until 1982, when the London International Financial Futures Exchange (LIFFE) was opened and activity began to pick up on the Sydney Futures Exchange, virtually all trading took place in the United States, where futures on financial instruments were first introduced in the mid-1970s. Despite a threefold increase since 1982, the turnover on US exchanges had declined to just over 60% of worldwide trading by 1989.

The success of Euro-currency contracts

Of the contracts tied to short-term money market interest rates, futures on the three-month Euro-dollar time deposit, introduced in Chicago in December 1981 and currently also traded in Singapore, London and Tokyo, have been by far the most successful. In 1989 the average daily volume of trading in the Euro-dollar contract in terms of notional principal reached $160 billion in the United States and nearly $25 billion elsewhere. Short-term interest rate futures contracts in a number of other currencies have been introduced very recently and turnover in these instruments, whilst well below that in US dollar contracts, has expanded very rapidly. Trading in the Euro-yen contract, which was launched on the Tokyo International Financial Futures Exchange (TIFFE) at the end of June 1989, reached an average daily volume equivalent to over $25 billion during the first two months of 1990. The three-month sterling, PIBOR (Paris interbank offered rate) and Euro-DM contracts have also grown rapidly since their introduction in 1982, 1988 and 1989 respectively.

Banks' use of interest rate futures

Banks are amongst the most active users of financial futures linked to short-term interest rates and have been estimated to hold nearly 45% of long positions and just over 40% of short positions in the Euro-dollar contract traded in Chicago. Since open interest positions in this Euro-dollar contract totalled $610 billion at the end of 1989, open positions held by banks amounted to nearly 20% of the international dollar claims of BIS reporting banks. Futures linked to short-term interest rates tend to be a more flexible instrument for managing banks' interest rate risks than cash market alternatives, such as interbank deposits, because they separate general interest rate risks from the banks' own credit and funding risks. Another advantage of interest rate futures is that they carry a zero weighting in the international capital adequacy guidelines because the clearing houses, which are interposed between the two counterparties, demand the marking-to-market of the contracts and impose margin requirements to allow for changes in net obligations.

Reasons for the prevalence of the Euro-dollar contract

The principal reason for the success of the Euro-dollar contract is its close linkage with the pricing of a wide range of other financial instruments, both in the cash markets (bank CDs, Euro-notes, etc.) and in other derivative markets (swaps, forward rate agreements, etc.). By contrast, trading in Treasury bill futures appears to have declined partly because the relationship between interest rates on short-term Treasury bills and other financial instruments has become more volatile in recent years. A further advantage of the Euro-dollar contract traded in Chicago and Singapore is that it can be settled in cash, thereby avoiding the problems which may be

Derivative instruments traded on organised exchanges worldwide

	Annual turnover of contracts				Open interest positions at end-1989
	1986	1987	1988	1989	
	in millions				in billions of US dollars
Futures on short-term interest rate instruments	16.4	29.4	33.7	70.2	1,002.5
of which: Three-month Euro-dollar[1]	*12.4*	*23.7*	*25.2*	*46.8*	*671.9*
Futures on long-term interest rate instruments	74.6	116.3	122.6	130.6	196.5
of which: US Treasury bond[2]	*54.1*	*68.4*	*72.4*	*71.3*	*31.5*
Ten-year Japanese government bond[3]	*9.4*	*18.4*	*18.8*	*19.1*	*129.1*
Currency futures	19.7	20.8	22.1	27.5	15.7
Interest rate options and options on interest rate futures	22.2	29.3	31.3	41.5	388.3
Currency options and options on currency futures	13.0	18.2	18.2	20.7	44.3

[1] Traded on the Chicago Mercantile Exchange – International Monetary Market (CME-IMM), Singapore Mercantile Exchange (SIMEX), London International Financial Futures Exchange (LIFFE), Tokyo International Financial Futures Exchange (TIFFE) and Sydney Futures Exchange (SFE). [2] Traded on the Chicago Board of Trade (CBOT) and LIFFE. [3] Traded on the Tokyo Stock Exchange (TSE) and LIFFE.

Sources: Futures Industry Association; various futures and options exchanges; BIS calculations.

encountered when the availability of the underlying securities to be delivered is limited. The linking of trading and clearing arrangements for the Euro-dollar contract between Chicago and Singapore has also contributed to the growth of turnover.

Expanding share of non-US markets in bond futures

The share of US markets in the trading of contracts linked to longer-term interest rates has declined very significantly in recent years. In terms of notional principal, turnover in the ten-year Japanese Government Bond Contract (JGB) traded on the Tokyo Stock Exchange, which was introduced only in 1985, has since 1987 been about twice that in the US Treasury Bond Contract listed on the Chicago Board of Trade. Another notable development has been the pronounced volume of business reached in the German Government Bond Contract (Bund) traded in London since 1988; indeed, this is the only longer-term interest rate contract traded offshore which has attracted a significant amount of business.

Apart from portfolio management, speculation and arbitrage, the principal use made of interest rate futures on longer-term securities is for the hedging of underwriting and dealing risks by securities companies and banks. In the United States the ratio between the daily volume of trading by securities dealers in the government bond futures contract and their cash market trading in government bonds with a maturity of over ten years may be estimated at over 50% in 1989. In Japan trading in bond futures by securities companies and other financial institutions was equivalent to well over 200% of their total transactions in longer-term government bonds.

Success and failure of individual contracts

Although the markets for interest rate futures have generally thrived in recent years, only a few contracts have been successful in terms of a consistently high level of turnover and many contracts, following considerable initial success, have been withdrawn from the markets. There are several reasons why the number of widely used interest rate and other financial futures contracts is limited. Firstly, trading in some contracts has declined because of a lack of demand for hedging and speculative purposes. For instance, turnover in the gilt-edged contracts (LIFFE) has shrunk in line with the Bank of England's buy-back programme for long-dated gilts. Other futures contracts have not measured up to initial expectations because they duplicated most of the functions of existing financial instruments. The depth of the forward market for foreign exchange has limited the expansion of foreign currency futures. Secondly, futures have proved very sensitive to the specification of contracts, particularly the delivery options available on the underlying instruments. The cash settlement of Euro-dollar and stock index futures is one factor accounting for the success of these contracts. The failure of the futures contract on US Government National Mortgage Association (GNMA) mortgage-backed securities – the first financial future and at one time a widely traded contract – can be attributed to a large discrepancy between the prices of securities which could be delivered and those which the GNMA contract was effectively meant to hedge. Thirdly, it may be less costly to use an actively traded financial instrument and to manage a "basis risk" (the risk that the spread between the futures price and the price of the instrument being hedged will change) than to hedge completely with a contract where such risks are theoretically lower but trading volume is not significant. For such reasons business tends to be concentrated on the most actively traded contracts. Finally, accounting rules, regulations and tax considerations may limit the uses of contracts. For example, if accounting rules require daily marking to market and do not permit the deferral of losses on futures positions until the realisation of gains on the position which is being hedged, asset/liability management with futures will be handicapped.

Impact of new technological developments

Traditionally, financial futures have been traded on the floors of exchanges by open outcry. Technological developments in recent years are rapidly changing this feature of the market and many of the newer financial futures exchanges have opened as automatic screen-based systems. This process is likely to continue and to alter the character of the market by, for example, allowing trade to be separated from a specific location and permitting a 24-hour market in specific contracts. This threat to open outcry systems is likely to be accentuated by the rapid growth of over-the-counter instruments.

Characteristics of the swap market

Interest and currency swaps. The most successful over-the-counter derivative products are interest rate and currency swaps, which made their first appearance in the early 1980s. Being tailor-made, swaps can vary markedly from case to case but all swaps entail the exchange of a stream of payments between two counterparties according to a pre-determined rule. For instance, a "plain vanilla" interest rate swap consists of the exchange of a stream of payments linked to LIBOR against another at a fixed rate. By end-1988, the outstanding notional principal amount of interest and currency swaps had risen to over $1,000 and 300 billion respectively; a further $390 and 80 billion of new swaps were arranged during the first half of 1989. At end-1988 the US dollar market accounted for over 70% of the notional principal value of interest rate swaps, with the yen, Deutsche Mark and sterling sectors together accounting for a further 20%. Over time the original maturity of new interest rate swaps has tended to decrease, with the share of the under-one-year maturity bracket growing from just under 13% to over 25% of all new interest rate swaps between the first half of 1987 and the first half of 1989. In the case of currency swaps, at end-1988 85% of activity involved the US dollar on one side of the transaction, with the yen and the Swiss franc being the next most commonly used currencies.

Factors behind the increasing use of swaps

There are three major reasons for the success of interest rate and currency swaps. Firstly, like futures and forward transactions, swaps allow counterparties to obtain a pattern of interest rate and foreign exchange exposures with fewer credit risks than those involved in cash market instruments. This has been recognised by the capital adequacy guidelines agreed by the Basle Committee on Banking Supervision, which attach a lower credit equivalent value to swaps than to cash market transactions. The separation of interest rate and exchange rate exposures from credit risks has indirectly encouraged the securitisation of lending and explains in part the prominence of swap-driven business in the international bond

Main features of the interest rate swap market at end-1988						
	Currency					
	US dollar	Japanese yen	Deutsche Mark	Pound sterling	Other	Total
	in billions of US dollars					
Notional principal value[1] of interest rate swaps	728.2	78.5	56.5	52.3	94.7	1,010.2
of which by counterparty:						
End-user	*484.3*	*35.5*	*39.3*	*34.7*	*75.1*	*668.9*
Interbank (ISDA member)[2]	*243.9*	*43.0*	*17.2*	*17.6*	*19.6*	*341.3*

[1] Hypothetical underlying amount on which swap payments are based. [2] Adjusted for double-counting of positions reported by ISDA members.

Source: International Swap Dealers Association (ISDA), Inc.

markets. Secondly, the swap market has proved more flexible than cash markets in achieving the desired structure of interest rate and currency risks of investors and borrowers. In the bond market, for example, borrowers wishing to alter the currency composition of their liabilities have often undertaken swaps instead of engaging in costly bond retirements and new issues. Finally, the swap market has thrived on arbitrage opportunities arising from the segmentation and imperfections of markets as well as the limitations on investors' and borrowers' portfolio choices. For example, in Switzerland in 1989 and early 1990, changes in longer-term interest rates were seen sooner in the swap market than in the domestic bond markets. Investors seeking long-term placements in Swiss francs preferred to acquire securities in other currencies and undertake a long-term currency swap into Swiss francs instead of investing directly in Swiss-franc-denominated securities.

Dichotomous character of the swap market

These various uses of swaps explain the dichotomous character of the market. On the one hand, the market is wholesale and, typically, the swap rates are quoted on screens by dealers and brokers. Often the rates in these markets will be closely related to those of similar products. In the United States, for example, the fixed interest rate payable in a "plain vanilla" swap at the shorter end of the maturity spectrum tends to follow closely that which could be achieved through a series, or "strip", of futures contracts. It can be estimated that roughly one-third and one-quarter of all interest rate and currency swaps respectively involve these fairly standardised trades between market-makers. On the other hand, the remainder of business with end-users is far less transparent, if not to some extent shrouded in mystery, owing to the complex nature of much tailor-made and arbitrage-based swap business.

Growing importance of instruments with option-like features

Interest rate and currency options and other derivative markets. Whilst swaps and interest rate futures have recorded the most striking expansion in terms of volume, the ever greater complexity and sophistication of financial markets in recent years is best exemplified by the increasing importance of products carrying option-like features. Initially, most trading of options took place on organised exchanges but in recent years a very pronounced shift has taken place, with a growing number of financial institutions trading over-the-counter contracts with their customers. In the case of foreign exchange options, out of a total daily volume of $22 billion in April 1989 roughly 80% was carried out over the counter. The growth of over-the-counter interest rate options, which include, inter alia, "caps" and "floors" on interest rates, has been even more striking, with an estimated $110 billion being arranged in the first half of 1989. During this same period nearly $30 billion of options to enter into swaps were arranged over the counter, and for the year as a whole 41.5 million contracts in the form of interest rate options, or options on interest rate futures, were traded worldwide on organised exchanges. As mentioned in Chapter IV, the recent success of such interest rate options is partly linked to the growth of highly leveraged transactions relating to

Composition of currency swaps at end-1988

Currencies	Total notional amount[1, 2]	Of which:		Of which:	
		against US dollar[2]	against other currencies[2]	end-user	fixed/floating[2]
	in billions of US dollars				
Japanese yen	131.0	103.5	27.5	93.9	74.9
Swiss franc	74.0	39.5	34.5	43.2	23.6
Deutsche Mark	34.0	25.1	8.9	28.0	17.5
Australian dollar	32.6	29.0	3.6	24.3	20.0
Canadian dollar	29.3	23.7	5.6	24.2	17.9
Ecu	24.5	17.2	7.3	20.8	15.6
Sub-total	325.4	238.0	87.4	234.4	169.5
Other	38.7	31.5	7.2	33.2	21.7
Minus double-counting of non-dollar swaps	−47.3	–	−47.3	−33.1	−8.2
Total	316.8	269.5	47.3	234.5	183.0

[1] Hypothetical underlying amount on which swap payments are based. [2] Adjusted for double-counting of positions reported by ISDA members.
Source: International Swap Dealers Association (ISDA), Inc.

the financial restructuring of companies, with "caps" being widely used to prevent the floating interest rate paid by borrowers from rising above a specified level.

Impact of derivative instruments on the structure of financial intermediation

Implications of derivative instruments. The development and expansion of the markets for derivative instruments have had several very important effects on the character and composition of financial intermediation, the behaviour of financial intermediaries and the pricing of the underlying financial instruments. There can be little doubt that individually most derivative instruments carry on balance a lower credit risk than economically equivalent cash transactions. And, to a considerable extent, this off-balance-sheet activity has been used as a substitute for more traditional borrowing and lending business and has facilitated hedging and risk management.

There are, however, several aspects of the growth of these off-balance-sheet transactions which may give cause for concern. The first relates to the novelty and complexity of most of the instruments. The uncertain legal standing and potential fiscal implications of many transactions may give rise to undesired risk exposures. In the swap market, for example, banks suffered sizable losses following a High Court ruling in the United Kingdom that the swap deals of some local authorities undertaken in excess of their underlying borrowing were "ultra vires". The financial institutions which had entered into these swaps had clearly not properly assessed the risks arising from the special legal status of the local authorities. Secondly, while much has been done in recent years to improve the quality of banks' risk management in respect of off-balance-sheet business, significant differences remain between institutions, and losses resulting from new financial instruments have not been uncommon. Finally, the growth of derivative instruments has had a more indirect and subtle impact on potential risks arising in the financial markets. By reducing transaction costs, financial engineering has allowed operations to be undertaken which otherwise would have been judged too risky. For example, the possibility of avoiding part of the burden of a rise in interest rates by way of a "cap" may have encouraged borrowers to increase their leverage ratios, thereby indirectly raising the level of systemic risk.

Potential risks associated with the growing use of derivative products

The macro-economic implications of the widespread use of derivative products and new methods of asset/liability management are difficult to assess in isolation because deregulation has often accompanied or stimulated their development. However, the growth of derivative products and of arbitrage activity employing these instruments has accelerated the elimination of institutional or regulatory barriers segmenting markets, especially in the case of swaps. By reducing transaction costs, derivative products have also increased the responsiveness of asset prices to changes in expectations. For instance, in 1989 and early 1990 the rise in German longer-term interest rates was transmitted from the Bund futures traded on LIFFE to the domestic cash markets.

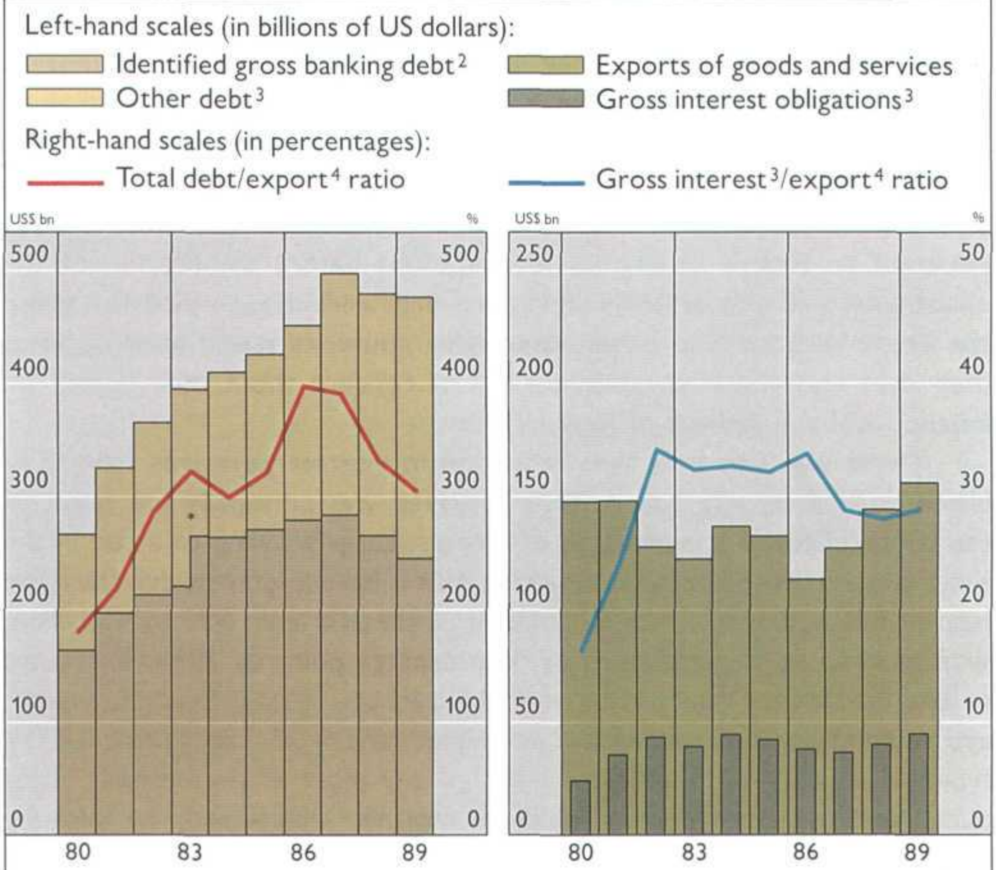
Macro-economic implications of derivative instruments

The international debt situation

Notwithstanding some signs of renewed resolve to pursue stringent programmes of structural adjustment, 1989 was on balance a disappointing year for the economies of countries facing external debt problems. In the fourteen heavily indebted middle-income countries there was an exceptionally wide divergence of growth performance but, at about 1%, their average economic growth remained well below the rate of population increase. Even though, thanks to a rigorous and successful programme of stabilisation, Mexico was able to slash its inflation rate from 115% to 20%, the average rate of price increase in the fourteen countries rose to more than 360% per annum from the previous peak of 220% recorded in 1988. Central government budget deficits crept up to the highest levels seen since the outbreak of the debt crisis and absorbed more of the scarce financial savings of the private sector. The ratio of investment to GDP, which had recovered slightly in the preceding four years, dropped back below 20%.

Disappointing performance of many heavily indebted countries ...

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.

Although world trade continued to expand at a rapid pace, the growth of these countries' exports slowed down to 4.9% in volume terms and, despite some improvement in the terms of trade, their aggregate current-account deficit rose by nearly $2 billion, to $13 billion.

... and in Sub-Saharan Africa

The Sub-Saharan African countries did not fare much better. Although they escaped the pronounced acceleration of inflation and the clear deterioration in central government finances, GNP growth continued to fall short of population growth, producing another year of falling per capita incomes. There was some modest improvement in these countries' aggregate current-account balance but, at 24%, the ratio of the deficit to exports of goods and services was about three times that of the heavily indebted middle-income countries.

Some decline in indebtedness of middle-income countries ...

Despite these developments, there was some further progress in dealing with the stock of outstanding debt. For the second year in succession, the heavily indebted middle-income countries as a whole succeeded in obtaining a modest reduction in their indebtedness, especially to commercial banks. Total debt declined slightly to $477 billion and debt to commercial banks fell by $21 billion to $245 billion. Together with the export growth recorded in 1989, this brought the ratio of total external debt to exports down to 305%, well below the peak of nearly 400% in 1986, but still higher than at the outbreak of the debt crisis.

... as a result of debt conversions

The decline in debt to commercial banks was mainly due to a variety of debt conversions and other operations which lowered countries' external debt without entailing conventional repayment. Nevertheless, such transactions were less numerous than in 1988. The resultant decline in the face value of total debt may be estimated to have slowed down from $22 billion in 1988 to $14 billion. Both creditor banks and debtors were reluctant to engage in large-scale operations before clarification of the exact nature of the officially supported debt reductions called for under the Brady Initiative. Moreover, developing countries scaled back some of their debt conversion programmes out of concern about their impact on inflation and the growth of internal debt.

Unprecedented build-up of interest arrears

There was also a further reduction in interest payments from $37 billion in 1988 to $32 billion. This, however, was principally the result of the unprecedented accumulation of arrears. Largely owing to a rise in the short-term rates to which floating rate debt is linked, interest due from the heavily indebted middle-income countries increased from $40 to 45 billion, with its ratio to exports rising by 1 percentage point to 29%. There are several reasons for the build-up of interest arrears. Firstly, until a few years ago rescheduling agreements and concerted lending packages provided the troubled debtors with sufficient funds to pay most of the interest falling due. With the strengthening of banks' balance sheets and the growing divergence in their business strategies, it has become increasingly difficult to achieve agreement on new rescheduling arrangements. Last year only five such agreements were reached, compared with ten in 1988 and nineteen in 1987. Secondly, arrears have ceased to bear as serious a stigma as in the past. Recently the multilateral institutions have begun to conclude arrangements with, and disburse money to, a small number of countries which are in arrears to commercial banks but implementing comprehensive adjustment programmes. The elimination of interest arrears on commercial bank debt, previously a sine qua non for even initiating negotiations, has also ceased to be an obstacle to the conclusion of agreements between banks and debtor countries.

Limited concessional debt relief for Sub-Saharan African countries

Unlike the heavily indebted middle-income countries, the debt-distressed countries of Sub-Saharan Africa experienced a $5 billion increase in their total indebtedness to $114 billion last year. Relief on debt to bilateral official creditors under the terms agreed at the Toronto Summit produced a reduction of only $50 million, or just 2%, in debt servicing. However, the amount of Sub-Saharan debt covered by the increasingly concessional Paris Club reschedulings for debt to official creditors jumped from $1 billion in 1988 to over $11 billion in 1989. Both the IMF and the World Bank have programmes in place to provide the debt-distressed countries in Sub-Saharan Africa with external resources for adjustment and growth. Debt relief is one element of these programmes. In September 1989 a World Bank facility was established to finance debt buy-backs by some of these countries. Although only $0.1 billion has been committed for this purpose, the very large discounts prevailing in the market mean that the debt relief generated will be many times greater.

Official endorsement of debt relief marks a new phase in the debt strategy

The endorsement in 1989 of the Brady Initiative calling for official support for debt and debt service reduction marked the beginning of a new phase in the debt strategy. In the first phase, lasting until 1985, the overriding concern had been the prevention of large-scale and irreparable damage to the international financial system. Commercial banks' exposures to troubled debtor countries exceeded their capital by substantial amounts, and it was in the interest of all parties to ensure that a critical shortage of liquidity did not lead to outright default. In the second phase emphasis was placed on the longer-term resolution of debt problems through growth and structural reform, with all the parties involved – debtors, commercial banks, governments of the leading industrial countries and the multilateral institutions – contributing through appropriate policies and the provision of finance. Although fundamentally sound, this approach entailed a further growth of external debt without achieving a commensurate increase in debtor countries' export capacities. In the third phase, it has been recognised that officially supported debt and debt service reduction could help to relieve the onerous burdens crippling certain heavily indebted developing countries and help them back onto the road to sustainable and balanced economic growth.

The Mexican agreement:

The principles guiding the provision of funds by the multilateral institutions for debt and debt service reduction were laid down in the spring of 1989. The IMF and the World Bank will provide financial support on a case-by-case basis for debt relief arrangements negotiated between the creditor banks and countries implementing medium-term adjustment programmes.

Specific agreements with the creditor banks had to be worked out before the exact shape of the new approach could be discerned. The Mexican deal, which was concluded in March 1990 and covered a three and a half year period, was notable because it was the first to be negotiated and covered $48.5 billion in medium and long-term debt of a major country making vigorous efforts to implement far-reaching structural reforms. The proposal agreed upon by the Mexican authorities and the commercial bank advisory committee gave creditor banks a choice of three options: exchanging their claims for collateralised bonds at a discount of 35%; exchanging their claims on a one-for-one basis for collateralised bonds paying a fixed 6¼%; and providing new money equivalent to 25% of their existing claims. A total of $7 billion in official funds, with $1.2 billion coming from Mexico's own exchange reserves, was set aside to provide collateral for, and guarantee the payment of part of the interest on, the bonds to be used in the first two options. The collateralised bonds were to be transferable, non-reschedulable and not subject to new money calls. Other features of the agreement included an undertaking by Mexico to institute a debt/equity conversion programme amounting to $1 billion per year for three and a half years, provisions for limited debt buy-backs and a

the three options

recapture clause which would compensate creditors for their concessions should the oil price exceed a certain benchmark level starting in 1996.

creditors' choices

Mexico's creditors showed a marked preference for exchanging their existing claims for collateralised bonds enjoying some effective seniority, while, in the absence of any official credit enhancement relating either to existing claims or to the new loans, they were reluctant to provide fresh money. Weighted by the amount of their claims, about 47% of the country's creditors opted for par exchange bonds and 41% for the discount bonds, even though these new bonds, in the absence of full interest payment guarantees, were sure to be traded at a discount in secondary markets. Only 12% of the banks chose to provide new money, which means that Mexico will only receive $1.5 billion in new loans over the term of the agreement. Assuming that short-term interest rates do not change, the arrangement will reduce Mexico's interest obligations by over $1 billion per year after the payment of interest on funds borrowed to provide collateral and interest guarantees.

extent of relief

The implementation of the agreement will lead to a greater reduction in Mexico's debt than was originally envisaged. To be sure, debt to official creditors will grow over the period covered by the arrangement by $5.8 billion and the new money commitments by commercial banks will raise Mexico's debt by a further $1.5 billion, but the banks' strong preference for discount operations will lower outstanding debt by $7 billion and the debt/equity swaps and debt buy-backs will reduce it still further. An additional notional reduction of around $7.5 billion may be attributed to the fact that the discounted present value of the par bonds bearing below-market rates of interest is lower than the face value of the claims they replaced. Moreover, last year conversions, amortisation and other debt elimination operations carried out outside the framework of the agreement reduced Mexico's public sector debt by $4 billion.

The agreement with Mexico was reached only after long and arduous negotiations in which the US authorities played a key role. As a result of this package, a large proportion of Mexican debt is no longer subject to future rescheduling and the number of banks that remain committed to Mexico is now quite small, since most of them have exchanged their medium and long-term Mexican exposures for claims not subject to new money calls. It may, therefore, be more difficult in the future for Mexico to raise significant amounts of balance-of-payments finance should the need arise unexpectedly.

Debt relief agreements with other countries

Agreements involving official support for debt and debt service reduction have been, or are being, worked out with some other countries, but not with the two other largest debtors, namely Brazil and Argentina. In keeping with the case-by-case approach, each agreement has features specifically designed to deal with the particular situation of the country in question. An arrangement with Costa Rica provided no new money but produced generous relief on the $1.8 billion in debt covered by the scheme. Weighted by their exposure, about 65% of the banks elected to sell their claims back to the country at a discount of 84%. A striking feature of the deal concluded with the Philippines was the speed with which it was reached. Banks and the authorities were able to agree in only six and a half working days on a programme providing for outright buy-backs of $1.3 billion, equal to nearly a fifth of eligible bank debt, at a discount of 50%. It also ensured some effective seniority for about $0.7 billion in new money claims. The agreement made allowance for further buy-backs at a later stage but generated less cash-flow relief than originally envisaged because a significant proportion of the creditor banks chose not to participate. The very existence of a preliminary agreement with Venezuela covering $20 billion of eligible debt is in itself noteworthy. Commercial banks have entertained doubts about the need for a concessionary package because of the conviction that appropriate macro-economic policies would have enabled the country to service its debt in an orderly fashion. A preliminary agreement involving officially supported debt relief has also been worked out between Morocco and its creditor banks.

Scope of debt relief

The total face value of the external debt covered by the first four agreements negotiated under the Brady Initiative amounts to $72 billion. About $8 billion of the total of $30–35 billion of the official funds originally earmarked for supporting such transactions has now been committed. The various transactions will lower debt to commercial banks by roughly $14 billion, while the reduction in the interest burden is equivalent to an estimated further $11 billion decline in debt. Altogether, about $25 billion, equal to about a third of the nominal value of the original debt, is being eliminated, but against this must be set the $8 billion increase in indebtedness to official creditors.

Strengths and ...

Apart from the impact on resource flows, debt reduction provides some additional benefits. By adding legitimacy to unpopular initiatives to enhance economic efficiency and debt servicing capacity, it may improve the chances for successful structural adjustment. In Mexico the agreement had a favourable impact on investors' attitudes and on the general economic climate. Domestic interest rates fell as inflationary expectations subsided, reducing the public sector's domestic interest bill. The improved prospects for the economy led to a return of some flight capital, attracted direct investment and boosted equity prices. While interest rates have subsequently been raised to prevent the economy from overheating, Mexico has been able to maintain its basic policy stance for the better part of a year.

... weaknesses of the new strategy

Useful as the Brady Initiative is, it only goes part of the way towards solving the problems of the heavily indebted countries. The prospects for fresh inflows of funds appear bleaker than they have done for some time for a variety of reasons. Firstly, initial impressions of the amount of debt relief that could be achieved through this new plan were excessive given the amount of official support available. This created exaggerated expectations on the part of debtor countries and generally soured the negotiating environment. Secondly, as a result of official policy choices, banks were compelled to negotiate with some countries that they considered neither in need nor deserving of debt reduction. A third problem has been the use of secondary market prices as a reference point for debt discounts, which creates an incentive for debtors to depress prices to gain deeper discounts. Finally, it is difficult to reconcile debt reduction with new credit flows. Banks confronting losses on their existing loans are unlikely to be eager to extend new credits unless the concessions on existing debt are sufficient to restore debtor countries' creditworthiness.

Implications for new bank lending

In fact it appears that governments in the main creditor countries have unwittingly encouraged banks to opt for debt and debt service reductions rather than for the provision of fresh money. In the context of the Brady Initiative, calls were made for a review of fiscal, accounting and regulatory impediments to debt and debt service reduction. Because countries were reluctant to alter regulatory and accounting rules designed to safeguard the soundness of the financial system, the changes that were introduced were primarily of a fiscal nature. However, very few of them have made new lending more attractive.

Need for increased official support

The unfavourable near-term economic prospects for many of the principal debtors make it even more essential than in the past to support them in their efforts to implement appropriate macro-economic and structural adjustment policies. Since under present conditions debt service reduction, direct investment and the repatriation of flight capital are in most cases unlikely to be sufficient to satisfy debtors' foreign exchange requirements for such policies, further new lending will be needed. Unless the new initiative succeeds in restoring countries' debt servicing capacity, the banks will be reluctant to provide significant amounts of new money without official credit enhancement, and it is not even clear whether, except for self-liquidating trade finance, the extension of further loans at market terms would be in the interests of the problem debtor countries themselves. It could therefore be argued that officially sponsored relief packages should provide for greater symmetry than in the past between the treatment of debt reduction and new lending and that there will be a greater need for the commitment of public funds.

VI. Monetary developments and policy

Highlights

Monetary policy in the industrial countries last year was largely geared to resisting a build-up of inflation, given that the pace of economic activity generally proved stronger than forecast. Divergences in cyclical situations and exchange rate movements had, however, some bearing on the interest rate policies followed in individual countries.

Short-term interest rates were lowered gradually in the United States as from the spring of 1989, in order to contain the weakening of economic activity. This contrasted with progressive rises in money market rates designed to forestall a build-up of pressures on productive resources in Japan and Germany.

Interest rates were also increased in France and in most other countries belonging to the EMS exchange rate mechanism (ERM) to the extent that this was considered necessary to maintain stability within the system. The rate rises, in most cases, were also required to help moderate domestic demand pressures. In the United Kingdom, Sweden and Canada demand pressures were slow to ease in response to earlier monetary restraint and interest rates had to be raised further in late 1989 or early 1990 in the context of downward pressures on the exchange rate.

Although interest rate developments helped to keep the growth of key monetary aggregates on track in 1989, strong monetary expansion had been recorded in most of the major countries in previous years. Some key aggregates had clearly become less reliable as short-term policy guides but, in addition, countries had given priority to countering the risk of recession following the 1987 stock market crash or the appreciation of their currencies against the US dollar. Now that inflation has risen or has remained high, the question is whether monetary restraint can be applied long or forcefully enough to restore a high degree of price stability. To attempt to do so may appear costly, but the cost of allowing inflation to rise further or to become entrenched at present levels will ultimately be greater.

International financial integration has continued to narrow the scope for monetary policy autonomy in individual countries. This is particularly true in Europe, where the aim of further liberalising controls on cross-border capital movements is combined with monetary policies directed towards the objective of exchange rate stabilisation in many countries. Monetary authorities have increasingly sought to rely chiefly on indirect instruments for influencing bank reserves and short-term interest rates. However, a reinstatement or reinforcement of exchange controls and credit ceilings has been necessary to permit effective monetary control in some countries, such as Spain, which face strong demand pressures and high inflation rates.

There is now more widespread agreement that monetary policy should aim primarily at achieving price stability and that this objective is most likely to be attained when the central bank is relatively independent of the Treasury and other public institutions. This has become particularly evident in discussions about the preconditions for further progress towards economic and monetary union in the European Community, beyond the first stage which is to begin in July this year. There is a broad consensus that a European system of central banks, as envisaged in the "Report on Economic and Monetary Union in the European Community" (report of the "Delors Committee") should have a high degree of independence from other national and Community bodies and a clear mandate to pursue price stability.

Central bank independence has also been recognised as a necessary condition for effective macro-economic policy in the former centrally planned economies of eastern Europe. The proposed currency union between the German Democratic Republic and the Federal Republic of Germany is a special case, in that it involves the regional extension of the use of a stable western currency. However, it draws attention to a more general requirement that suitable monetary arrangements must be supported by appropriate budgetary policies and wage developments if satisfactory overall results are to be achieved.

The conduct of monetary policy during the past year

While price pressures became a matter of general concern last year, monetary policies in individual countries reflected differences in expected and actual economic performance. In many of the larger economies policy was specifically forward-looking, attempting to anticipate developments, particularly in inflation. However, the strength of aggregate demand was widely underestimated and growth forecasts were progressively revised upwards. In a number of cases judgements about the size and speed of the responses of output, external payments balances and inflation rates to monetary restraint proved over-optimistic.

Contrasting interest rate policies in the largest economies

The brief easing of monetary policy in the United States in late 1987 was followed by a progressive tightening, with short-term interest rates reaching a peak in March 1989. Thereafter, in a context of growing concern about the extent to which the economic expansion, by then in its seventh year, was weakening, the Federal Reserve took a series of steps which brought the Federal funds rate down by about 1½ percentage points by the end of the year. The discount rate remained unchanged after February 1989. Bond yields receded broadly in line with money market rates until November, suggesting a moderation of inflation expectations. Federal Reserve policy seemed to be aimed at bringing about a gradual decline in the underlying inflation rate by keeping economic growth below potential for a time, whilst seeking to avoid recession. In the early months of 1990,

Progressive lowering of short-term interest rates in the United States ...

when the pace of economic activity strengthened, the Federal funds rate was held steady.

... contrasting with gradual tightening of monetary policy in Japan ...

In Japan, by contrast, call-money rates, which had previously edged up only slightly, moved onto a steeper upward course in the spring of 1989. Under new operating procedures introduced in November 1988 the Bank of Japan permitted market forces to initiate a progressive rise in money market rates until December, underpinning it with rises in the official discount rate in three stages in May, October and December. Short-term market rates rose only moderately in the early months of 1990 until the discount rate was raised to 5¼% in March.

... and anticipatory moves towards restraint in Germany

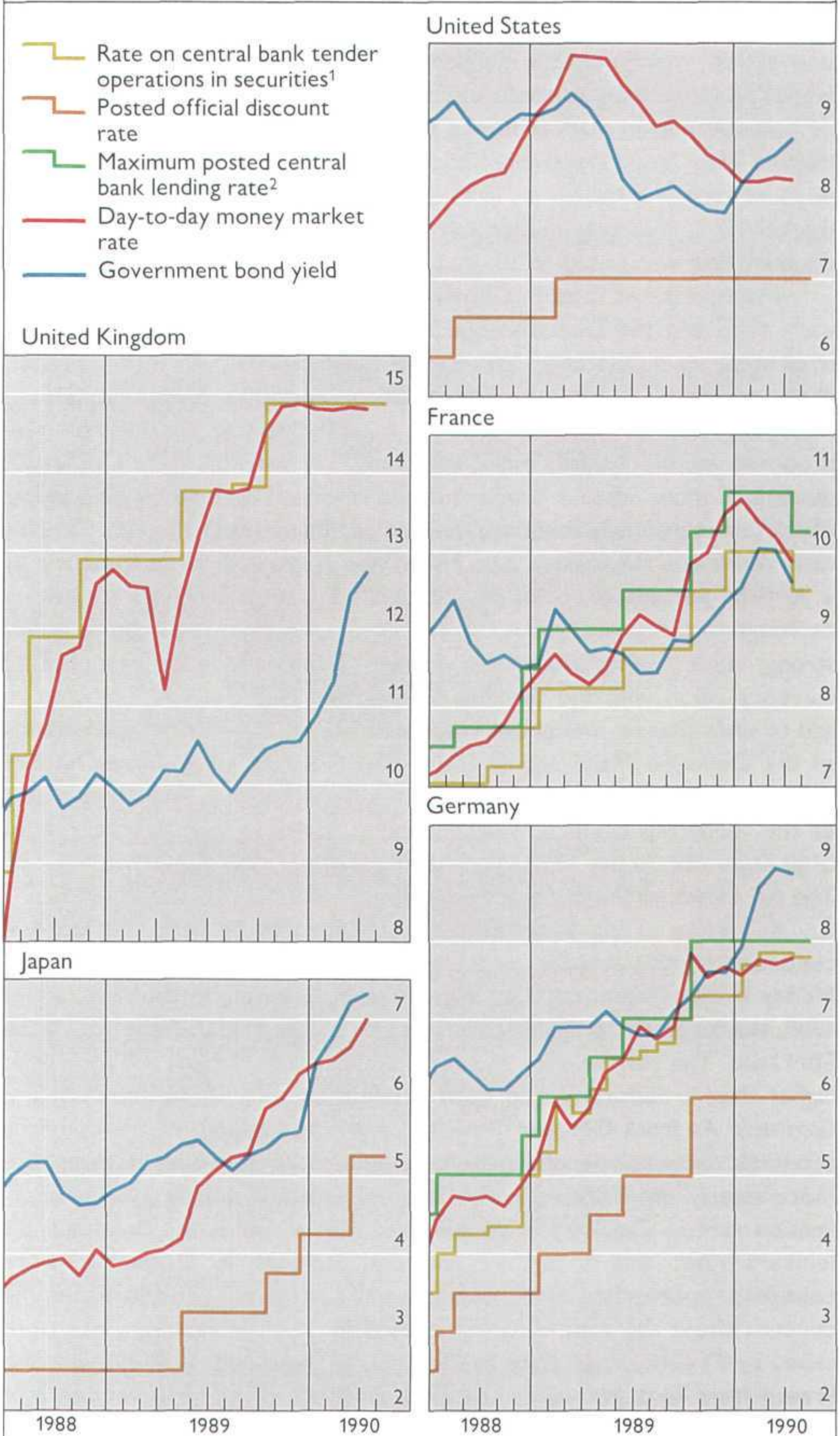
Money market rates in Germany had been on an upward trend since early 1988 and the Deutsche Bundesbank brought about further rises in small steps up to October last year. In supplying reserves through repurchase operations it made extensive use of American tender procedures (accepting bids for volumes above a cut-off point at the interest rate proposed by the bidder) but conducted fixed interest rate ("volume") tenders at times when a firmer interest rate lead seemed to be needed. Market rates generally remained close to the Bundesbank's lombard lending rate, which was raised from 6 to 7% in two stages in April and June and by a further percentage point in October. In the absence of significant exchange rate changes against other EMS currencies, exports had remained strong, while immigration from eastern Europe and the prospect of currency union with the German Democratic Republic was expected to add to pressures on productive resources. However, with the appreciation of the Deutsche Mark against many other currencies as from October helping to moderate the rise in consumer prices and with the achievement of the monetary objective contributing to policy credibility, the risk of large wage rises in the 1990 round of negotiations was somewhat reduced. The full effect of the increases agreed upon will only be felt in 1991.

Tightening on domestic and external grounds in France

In France strong domestic demand tended to be reflected more in continuing current-account weakness than in pressures on domestic prices. Money market rates rose less than those in Germany in the first half of 1989, thanks partly to the relative strength of the French franc within the ERM band. The year-on-year rise in consumer prices, though still somewhat higher than in Germany, had been accelerating at a slower rate than in Germany. As from October, however, with the strength of the domestic economic expansion becoming more evident, short-term interest rates rose more steeply. An increase in the Bank of France's money market intervention rate in October, in conjunction with a rise in the Bundesbank's lombard rate, and a further unilateral increase in December were considered appropriate on domestic as well as external grounds. Reflecting concern about the rate of credit expansion, reserve requirements were raised by ½ percentage point in October. In the spring of 1990, with the French franc stronger within the ERM band, the official intervention rate was lowered.

In the United Kingdom the interest rate applied to Bank of England purchases of very short-term bank bills, which had been raised from under

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.

UK economy slow to respond to earlier tightening

7½ to almost 13% between May and November 1988, reached nearly 13¾% by May 1989, with day-to-day market rates rising correspondingly. For much of last year monetary policy awaited the effect of this tightening. Although the rise in residential property prices gradually decelerated, the broad money stock and credit to the private sector continued to expand very rapidly. Signs of a response to the tightening in the external current account and in wage settlements were slow to emerge. In fact, it became evident that the economy had been much stronger than previously thought. The authorities resisted upward pressures on short-term interest rates until October, when they permitted a further 1 percentage point rise. Official rates subsequently remained unchanged, although a substantial depreciation of sterling took place.

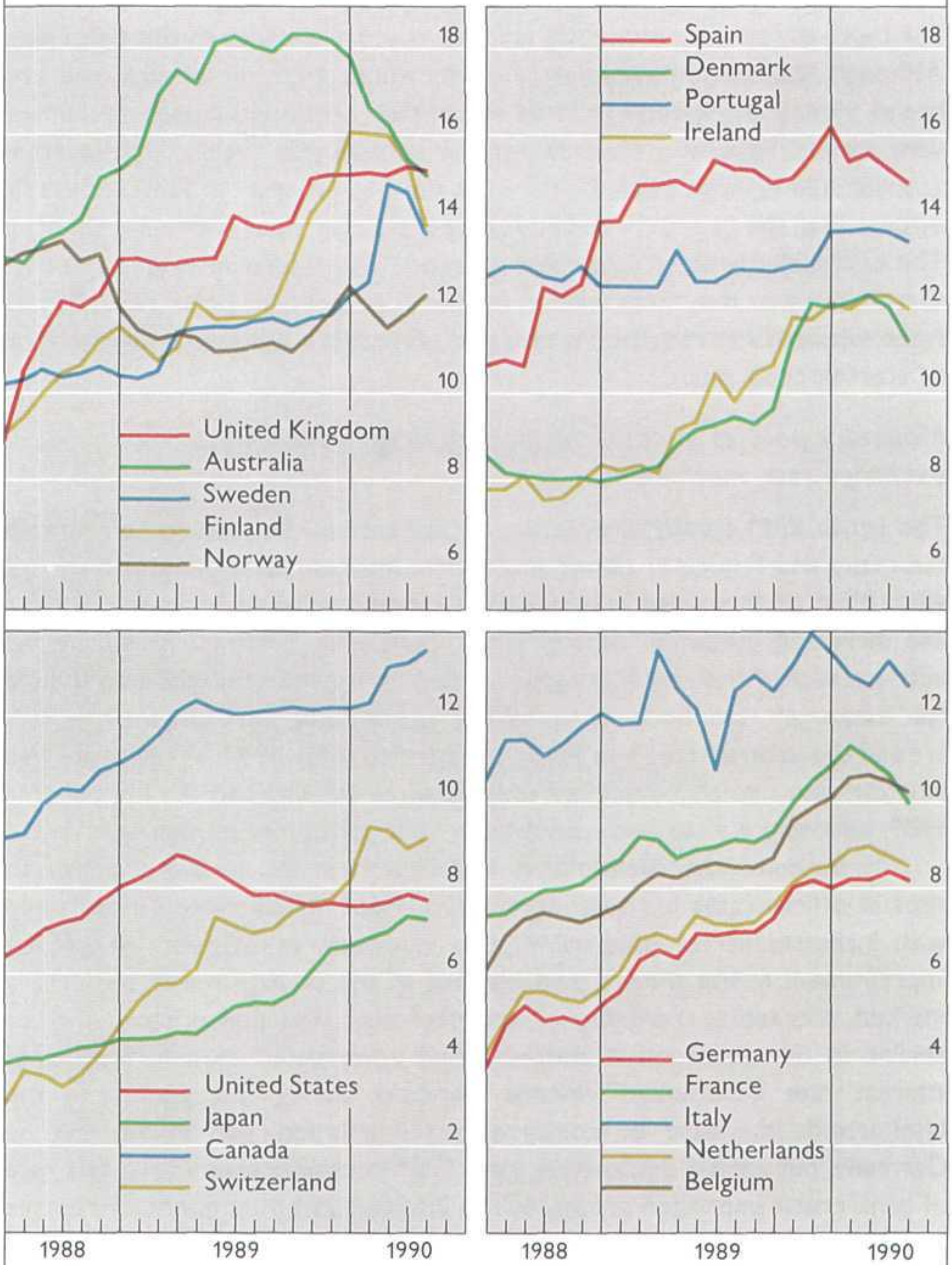
Monetary policies in countries participating in the EMS exchange rate mechanism

The other ERM countries adhering to the narrow fluctuation band joined Germany and France in raising short-term interest rates progressively last year. Most of them also experienced a strengthening of economic activity and increased utilisation of productive resources. Demand pressures and inflation were relatively high in Italy, where the wide band hitherto utilised for exchange rate fluctuations against other ERM currencies (+/– 6% around the central rate) was finally abolished in early 1990. A relatively high inflation rate was also experienced in Spain, which entered the ERM in June 1989, adopting a wide (+/– 6%) fluctuation band for the peseta.

Short-term interest rates also raised in other ERM countries

In Belgium, the Netherlands and Denmark the timing and size of rises in official rates between April and October 1989 were co-ordinated with increases in the lombard rate in Germany. In Belgium, where the improvement in the growth performance of the economy was particularly marked, increasing credibility of the exchange rate policy and a further decline in the government budget deficit contributed to a narrowing of interest rate differentials vis-à-vis Germany during this period. In the Netherlands the rate of consumer price inflation was lower than in Germany, but capital outflows in early 1989 in conjunction with a fast rate of bank credit expansion prompted the introduction of a monetary reserve arrangement (see page 176). Subsequently, large banking inflows developed and arrangements for the banks to hold deposits at the Netherlands Bank were used to help limit the money market impact of official purchases of foreign exchange. As in Belgium, official rates had to be raised further in late 1989 and domestic money market rates rose more than in Germany. Economic activity in Denmark remained very weak and money market interest rates were raised by less than rates in Germany in early 1989. The krone dropped to its lower limit in the ERM band and intervention was at times necessary. Short-term interest rates were raised unilaterally in October but were lowered somewhat in early 1990. Economic growth was very satisfactory in Ireland last year, but, partly as a result of outflows of funds attracted by interest rate differentials in favour of sterling, official foreign exchange reserves fell by IR£ 755 million in 1989. The Central Bank's

Interest rates on three-month interbank instruments*



* For Sweden, the United States and Canada, Treasury instruments.

short-term lending rate was raised from 8 to 12% in four stages between April and December.

Monetary policy dilemmas in Italy ...

The official discount rate in Italy was increased from 12½ to 13½% in March 1989. Although a compulsory reserve requirement on banks' net foreign currency positions was reinstated and the lira was permitted to rise within its ERM band, inflows of funds continued. The main aim of monetary policy during the year was to limit the impact of these inflows and of Treasury financing on bank reserves. With a huge volume of short-term Treasury debt to be refinanced each month and net sales of securities to the public at times affected by volatile market sentiment, overnight interest rates fluctuated over a wide range. When increases in official and market rates in other ERM countries in the autumn were not followed in Italy, the lira moved towards the bottom of its wide ERM band. The narrow ERM band was adopted in January 1990, with the new central rate set close to the market rate then prevailing. However, the lira immediately rose to the top of the band and intervention purchases of foreign exchange became necessary. In May the official discount rate was lowered to 12½%.

... and Spain

Against a background of a large current-account deficit and accelerating inflation, the official overnight lending rate in Spain was raised in stages from 10.5% in August 1988 to 13.8% by March 1989. Following a sharp appreciation of the peseta, a compulsory deposit requirement in respect of borrowing abroad by both banks and non-banks was imposed in January 1989. Accession to the ERM was partly motivated by the desire to increase the credibility of anti-inflationary policy. Yet in the short run ERM membership limited the scope for further rises in interest rates, although exchange controls on inflows of funds were kept in place. In these circumstances, the authorities relied mainly on an increase in reserve requirements and a request to banks to restrain the growth of lending to the private sector, which brought about some slowdown in monetary and credit expansion. The official overnight lending rate was raised to 14.5% in July and was kept at this level when interest rates abroad were increased, with the peseta moving down in its ERM band. Late in the year the deposit requirement on the increase in banks' foreign exchange positions was removed, but the credit guidelines were tightened for 1990.

Monetary policies in other industrial countries

Sharp rise in short-term interest rates in Switzerland

Austria continued to use monetary policy to stabilise the exchange rate of the schilling in terms of the Deutsche Mark. Good growth performance and a moderate inflation rate were achieved last year. In Switzerland, where the monetary-base-oriented policy had been more expansionary than intended in late 1987 and 1988, demand pressures in the economy intensified last year and consumer price inflation accelerated markedly. Short-term interest rates, which had fallen to very low levels in 1988, were raised sharply to stand above those in Germany in order to counter the depreciation of the Swiss franc.

Influence of changing exchange rate pressures in Sweden and Canada

In Sweden and Canada excess demand brought about balance-of-payments deficits and accelerating inflation, but relatively high nominal interest rates for a time continued to place upward pressure on the currency. The increase in short-term interest rates in Sweden, which took the rate on six-month Treasury discount notes from 10½ to 13% in 1989, attracted capital inflows in amounts exceeding the current-account deficit, particularly after the removal of most exchange controls on capital movements in July. The krona moved up within the published band around the trade-weighted exchange rate objective until October, when the markets began to reassess the underlying situation of the economy. Following the resignation of the Government in early 1990 the krona again came under downward pressure and in February the six-month Treasury note rate rose to 15%. With overall inflationary pressures in Canada remaining stronger than in the United States last year, the Bank of Canada kept short-term interest rates high while comparable rates in the United States fell. When a slight easing in early 1990 led to a marked weakening of the Canadian dollar, short-term interest rates were increased sharply. Even taking into account the estimated impact of the weaker exchange rate on aggregate demand, monetary conditions were judged to have become tighter. Market reassessments of the continuing large external deficit and high rate of inflation contributed to a steep fall in the Australian dollar in early 1989. Interest rates on overnight and call funds in Australia rose to around 18% by the end of the year. In early 1990, with the external deficit and the inflation rate still high but signs of weakness in the economy beginning to emerge, very short-term interest rates were permitted to move down to a 15–15½% range.

Monetary and exchange rate policies in Portugal and Greece

In Portugal monetary policy responded to accelerating inflation with a tightening and stricter application of the credit ceilings in March 1989. In addition, interest rate policy was used more actively than previously, administered rates in the interbank market being raised in several stages in the course of the year. Exchange rate policy was non-accommodating, in that the rate of depreciation of the escudo permitted under the crawling-peg arrangements less than fully offset the inflation differential vis-à-vis Portugal's trading partners. The interest rate adjustments made last year in Greece were not sufficient to reduce the growth of bank credit to the private sector or to make government debt attractive enough in relation to deposits. Credit ceilings and measures to restrain bank liquidity were introduced in late 1989 and early 1990. In the absence of an announced exchange rate objective, a continuing depreciation of the effective rate almost offset the trade-weighted inflation differential.

Intermediate objectives and indicators of monetary policy

Monetary policy becomes more eclectic in many countries

In countries that formerly relied heavily upon targets for the monetary aggregates monetary policy has become much more eclectic, while in countries where exchange rates serve as the principal intermediate objective the target has tended to become increasingly rigid. As the effectiveness of exchange rate standards in controlling inflation depends on the degree of price stability achieved elsewhere, the success of eclectic policies affects all countries. Judgemental policies have been guided by a range of indicators of present and future developments in economic activity and inflation rates – demand pressures in the economy, rates of monetary and credit expansion and conditions in the foreign exchange market being among the most important. In addition, changes in long-term interest rates, commodity prices and asset values have been taken into account in some countries.

Targets for monetary aggregates

Reduced role of monetary aggregates

The reduced role of targets for monetary aggregates in the conduct of monetary policy in the industrial countries reflects not only difficulties in interpreting monetary developments but also the need to promote economic adjustment following external disturbances. Annual norms for monetary expansion continue to be published in many countries – including some where monetary policy is oriented primarily towards exchange rate objectives – essentially because it is felt that stating the policy intention in this way can still help to moderate inflation expectations by underlining the authorities' long-run commitment to price stability.

Monetary aggregate norms met last year in the major countries

Under the influence of the tightening of monetary policy as from the spring of 1988 and the resulting rise in interest rates, the growth of the targeted monetary aggregates was contained within the published ranges in most of the larger economies in 1989, though in some cases monetary expansion showed signs of a renewed acceleration towards the end of the year. In the United States the rise in market rates in early 1989 helped to bring the growth of M_2 below the lower limit of its target range but it subsequently rebounded as market interest rates declined. Mainly reflecting

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]	
		1988[3]	1989[3]	1990[3]	1988	1989	1989QI	1990QI
		in percentages						
United States	M_2	4–8	3–7	3–7	5.2	4.5	4.1	5.6
	M_3	4–8	3½–7½	2½–6½	6.3	3.2	5.5	3.0
	TDND	7–11	6½–10½	5–9	9.1	8.0	9.2	7.5
Japan	M_2 + CDs	10–11	9–10	11–12	10.6	10.0	10.2	11.6
Germany	M_3	3–6	ca. 5	4–6	6.8	4.8	6.8	4.3
France	M_2	4–6	4–6	3½–5½	3.9	4.4	3.7	2.7
United Kingdom	M0	1–5	1–5	1–5	6.1[6]	6.3[6]	6.7	5.9
Italy	M_2	6–9	6–9	6–9	8.5	10.8	9.5	10.2
	CPS	6–10	7–10	12	15.6	18.1	17.6	n.a.
Netherlands	DM_2	–	–	5	–	n.a.	18.0	n.a.
Spain	ALP	8–11	6½–9½	6½–9½	12.1	11.3	12.5	9.3
Switzerland	CBM	3	2	2	−3.9	−1.9	−8.8	−3.4
Portugal	L–	10–13	7½–10½	ca. 12	14.8	8.8	15.3	n.a.
Greece	M_3	14–16	18–20	19–21	22.6	23.7	23.1	n.a.

[1] TDND = total domestic debt of non-financial sectors; M0 = wide monetary base; CPS = credit to the non-state sector; DM_2 = contribution of the banking system to M_2 creation (banks' short-term domestic lending to the private sector and long-term domestic lending minus the increase in their long-term domestic liabilities); ALP = liquid assets in the hands of the public – including asset transfer certificates; CBM = central bank money stock; 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 1990, 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. For the Netherlands, period running from the first quarter of 1989 to the second quarter of 1990 (the target is expressed as a four-quarter rate of increase). For Switzerland, average of annualised monthly changes from the fourth quarter of the preceding year (except 1988, annual average). [4] Calculated on the same basis as the objective. [5] Based on quarterly averages. [6] Twelve months to March 1989 and 1990.

Sources: National data.

the impact of the credit quality problems of thrift institutions on the demand for their deposit liabilities and the restructuring of their balance sheets, M_3 growth remained close to the lower limit of its target range. The four-quarter growth rate of M_2 + CDs in Japan decelerated gradually, in line with the Bank of Japan's projections, until the fourth quarter, when it began to pick up. In Germany, where monetary expansion had substantially exceeded the targets in each of the three previous years, the growth of M_3 remained closely in line with the single-figure target last year. The rise in M_2 in France was also within the published target range, while in Italy, where the December figures were distorted as a result of a labour dispute in the banking sector, M_2 generally expanded at rates close to the upper limit of the target range. The growth of the narrow monetary aggregate, M0, in the United Kingdom slowed down less than might have been expected in the light of developments in retail sales and subsequently moved above the upper limit of the target range. An unexpected further decline in the banks' demand for reserve balances held for payment purposes contributed to the decline in the central bank money stock in Switzerland last year, but the undershooting of the target was also partly attributable to the rise in interest rates associated with the tightening of monetary policy. Published objectives for the monetary aggregates were met in Portugal but overshot in Greece. The target was also exceeded in Spain, despite a marked slowdown in the growth of liquid assets in the hands of the public after mid-year.

Predictable response of broad aggregates to rising interest rates

In most countries targets for monetary expansion are now expressed in terms of broad aggregates which include savings instruments as well as transactions balances. In the short run the growth of these aggregates is strongly influenced by the extent to which banks adjust deposit interest rates promptly in response to changes in market interest rates. The well-documented delay in the adjustment of interest rates on bank and thrift institution deposits in the United States explains the sensitivity with which M_2 responded to changes in market interest rates last year. In Germany the usual limited response of interest rates on savings deposits to rises in market rates encouraged a marked shift towards time deposits within M_3, while rises in long-term interest rates stimulated the growth of long-term bank liabilities, which contributed markedly to the slowdown in the growth of M_3. M_2 in France consists entirely of non-interest-bearing transactions balances and deposits that are remunerated at regulated rates; its growth also moderated when market interest rates rose last year. While in most countries short-run control over developments in the monetary aggregates relies on such interest-induced portfolio shifts, excessive short-run interest rate sensitivity of the demand for money can complicate the use of monetary aggregates as intermediate targets.

The moderate growth of targeted monetary assets last year may understate the build-up of liquid assets by the personal and business sectors in some cases. The Bundesbank's extended M_3 aggregate grew at a rate of around 8%, reflecting a strong build-up of non-bank residents' deposits in the Euro-market, which are not included in the standard M_3 concept.

However, the Bundesbank considers that these deposits may not all be destined for financing spending on domestic goods and services. Relatively fast growth in the broad monetary and liquidity aggregates in France partly reflected a huge increase in residents' foreign currency deposits with domestic banks, which remained exempt from reserve requirements following the liberalisation of exchange controls. In the United Kingdom M_4 continued to rise at a very rapid pace.

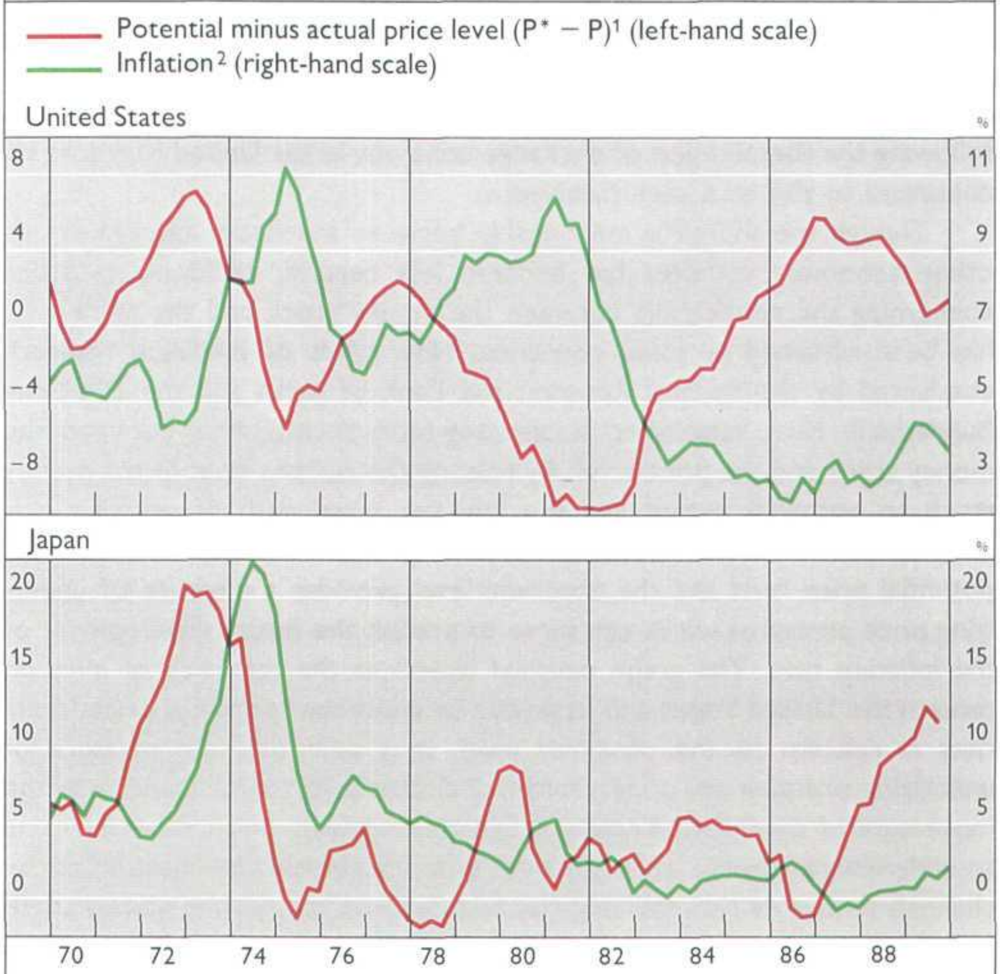
New evidence of a stable long-run relationship between the money stock and the price level

Though the short-run relationship between monetary aggregates and other economic variables has become less certain, additional evidence concerning the relationship between the money stock and the price level has been obtained in some countries. New kinds of empirical research conducted by the Federal Reserve, the Bank of Japan and the Deutsche Bundesbank have established stable long-term relationships between the money stock and the price level. By relating the current level of the money stock to potential output and the long-run trend path of velocity, it is possible to derive the "potential level of prices". The gap between this potential price level and the observed level provides a measure of underlying price pressures which can serve to predict the future development of the inflation rate. The graph overleaf illustrates the tendency of inflation rates in the United States and Japan to rise when the "potential price level" rises in relation to the observed level. It is true that the measure of underlying pressure on prices merely indicates long-run tendencies in the movement of the inflation rate and that the lags with which inflation reacts to underlying pressures may vary over time. Moreover, the question of the channels through which the long-run relationship between the money stock and prices may ultimately be established is not addressed. However, whatever its limitations, this kind of evidence draws attention to the possibility that the slowdown in monetary growth observed in the major countries in 1989 might not be sufficient to keep inflation from accelerating further because of the liquidity overhang created by the rapid monetary expansion in earlier years.

Monetary aggregate norms again published for 1990

The targets or norms for monetary aggregates for 1990 express the intent of the authorities to keep monetary policy tight enough to exert downward pressure on inflation. An unchanged target range of 3–7% for M_2 in the United States was expected to be consistent with somewhat slower growth in nominal GNP than in 1989, while a lowering of the range for the growth in M_3 to 2½–6½% reflected the expectation of a continued decline in the assets and funding needs of thrift institutions. In view of the relatively liquid position of the corporate sector and the pace of economic activity, the Bank of Japan considers the growth rate of M_2 + CDs projected for the second quarter of 1990 to be too high. To allow for the possibility that monetary conditions in Germany in 1990 could be influenced by developments in the foreign exchange market to which monetary policy might have to respond, the Bundesbank expressed its objective for the growth in M_3 in terms of a target range with a mid-point corresponding to the 1989 objective. Slightly lower or unchanged target ranges for the monetary aggregates in France, Italy and Spain underlined

Potential price pressure and inflation



[1] The potential price level (P*) is calculated from the equation of exchange as the price level consistent with the current level of the money stock (M), the assumed long-run value of velocity (V*) and the estimated current value of potential output (Q*); i.e. $P^* = M\,V^*/Q^*$. Based on M_2 for the United States and M_2 + CDs for Japan. Details are given in Federal Reserve Board and Bank of Japan publications. [2] Changes in the GNP deflator over four quarters, in percentages.

the authorities' desire to reduce inflation and to achieve greater monetary convergence with other countries participating in the ERM. The target for the central bank money stock in Switzerland was again set at 2%. As this is considerably less than the projected growth rate of nominal GNP, interest rates can be expected to remain high even if the Swiss franc should strengthen in the exchange market. In Canada, where there is evidence that the growth rates of over 10% in M_2 recorded in recent years were inconsistent with a path leading to price stability, the Bank of Canada's aim is to bring the pace of monetary expansion more closely into line with the feasible rate of expansion of the economy.

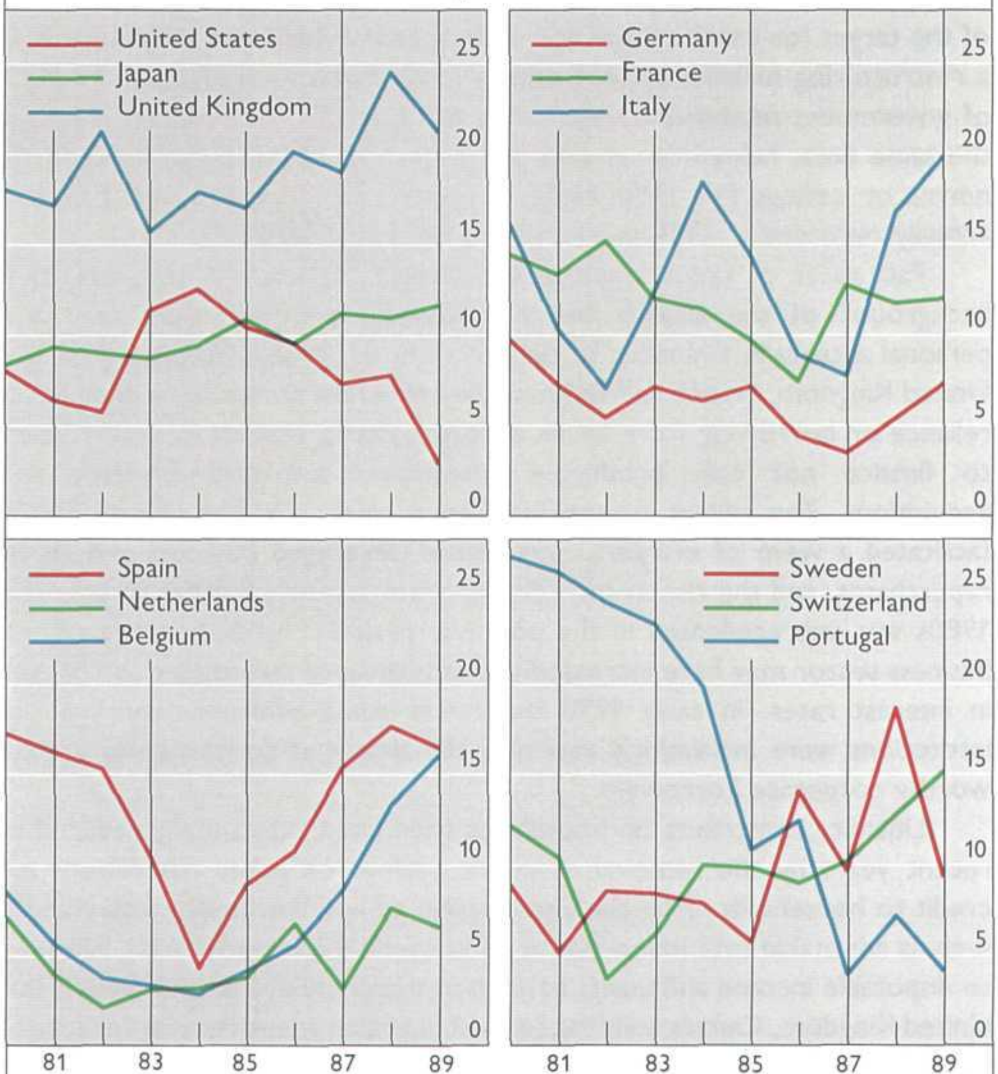
Norms for credit expansion

Norms or monitoring ranges for credit aggregates are published in a number of countries, in some cases in conjunction with targets for monetary aggregates. Though the statistical relationships involved may not be very stable, developments in credit typically mirror current developments in domestic demand. In a context of managed exchange rates they may indicate domestically generated pressures which give rise to current-account deficits or capital outflows in the non-monetary sector and are therefore not reflected in the growth of the money stock. In a few cases, quantitative credit controls are still an important monetary control instrument (see page 176).

Rapid expansion of bank lending to the private sector

The underlying strength of aggregate demand and the limited response of economic activity to the tightening of monetary policy last year was clearly reflected in bank lending. Credit from banks and savings institutions to the private sector continued to expand rapidly in the United Kingdom, Italy, Spain, Sweden and, to a lesser extent, in Japan, Germany and France. In some cases the rise was close to or exceeded that recorded in earlier cyclical peaks, when the rate of inflation was typically much higher. In general, credit to enterprises expanded very strongly last year; in the United Kingdom, France and Sweden lending to households, which had

Growth in bank credit to the private sector*



* Including credit from savings institutions and the central bank; percentage changes based on year-end data.

previously risen very rapidly following an easing of credit restrictions, slowed down somewhat. The contraction of thrift institution balance sheets in the United States had little impact on the overall supply of mortgage credit, mainly because the thrift institutions were able to sell mortgages on a large scale in the secondary market. In most countries the growth of bank credit to public authorities was very small last year. A striking interaction of a slowdown in domestic bank credit expansion and a balance-of-payments surplus on non-bank account could be seen in the Netherlands, where a monetary reserve arrangement (see page 176) was applied to banks' net money-creating activities (banks' short-term domestic lending to the private sector and long-term domestic lending minus the increase in their long-term domestic liabilities). Nonetheless, the growth of M_2 accelerated sharply.

Broad credit aggregates monitored in the United States, France and Italy

Shifts in the channels of intermediation had only a limited effect on the development of the broad credit aggregates monitored in the United States and France. These aggregates, which include domestic securities market financing and, in the case of France, funds raised abroad by non-financial sectors, expanded broadly in line with domestic demand. The overshooting of the target for credit to the non-state sector in Italy was associated with a restructuring of bank balance sheets which involved continuing net sales of government securities by the banks to the public – a process which, at the same time, helped to restrain the growth of M_2. The published credit norms or ceilings for 1990 imply a slower rate of expansion than was actually recorded in 1989 in all the countries concerned.

Concerns about heavy indebtedness of the corporate ...

Fast rates of credit expansion last year have to be seen against a background of the already heavy indebtedness of the corporate and personal sectors in a number of countries. In the United States, Japan, the United Kingdom, France and Belgium the corporate sector has increased its reliance on borrowing from banks or in the capital market in recent years to finance not only productive investment but also mergers and acquisitions. The advent of the junk bond market in the United States facilitated a wave of mergers, acquisitions, leveraged buy-outs and stock repurchases, and the rise in the US corporate sector's indebtedness in the 1980s was unprecedented in the post-war period. Higher leverage of the business sector may have increased the sensitivity of investment to changes in interest rates. In early 1990 there was some evidence that financial institutions were increasingly rationing the supply of credit to less credit-worthy corporate borrowers.

... and household sectors

Liquidity constraints on households have been substantially reduced in recent years by the removal of credit ceilings or other restrictions on credit to households or by the introduction of new borrowing instruments such as adjustable rate loans. Ratios of household interest-bearing liabilities to disposable income and assets have risen sharply in the United States, the United Kingdom, Canada and France, in some cases to unprecedented levels. Rising indebtedness has been reflected in declining saving ratios in some countries and may have helped to increase the role of interest rates in the monetary policy transmission mechanism, while that of availability constraints has declined. In the United Kingdom the household sector is now highly geared and a net payer of short-term interest. This may have helped to moderate the growth of personal sector mortgage borrowing when interest rates rose last year. In some cases increased risks associated with rising household sector indebtedness seem to have induced financial institutions to take the initiative in raising lending rates or in rationing new credit. Even so, a reinforcement of supervisory suasion in this area has also been considered advisable in several countries.

Exchange rates as objectives and indicators

Different types of exchange rate policy

Exchange rates have continued to play a large role in the conduct of monetary policy in many countries. The way exchange rates enter into the policy-making process and the role they play in the transmission mechanism differ, however, from country to country. In some countries exchange rate flexibility is thought to protect domestic economic activity from various kinds of real economic disturbances. In others explicit exchange rate commitments are used to enhance the credibility of monetary policy, given suitably stable partner currencies.

Even in the largest economies external influences have increased in importance in recent years and monetary policies have had to take into account the adjustment costs entailed in earlier large swings in real exchange rates. In 1989, however, the monetary authorities in the three largest economies were mainly concerned with the demand and cost effects of exchange rate changes on domestic inflation.

Difficulties associated with floating exchange rates

The authorities in some other countries remain firmly committed to leaving market forces a large role in determining the exchange rates of their currencies. One consideration in the United Kingdom, Canada and Australia has been that in a context of declines in the prices of oil or commodity exports which imply a major deterioration in the terms of trade, real exchange rate depreciation may facilitate economic adjustment. Experience since the mid-1980s suggests, however, that in the absence of a nominal exchange rate guide inflation may build up and become entrenched. Moreover, where large movements in real exchange rates are subsequently reversed the adjustment processes set in motion may not be appropriate in the longer run. In Switzerland, an independently floating currency has traditionally been thought beneficial to the country's position as a financial centre but last year increased attention was given to supporting the Swiss franc in relation to the Deutsche Mark, as it was recognised that the depreciation of the Swiss franc was contributing to accelerating inflation.

At times over the past two years the appreciation of their currencies has been considered in the United Kingdom, Canada and Australia to have made a useful contribution to strengthening the effect of high interest rates on overall demand. However, the relationship between changes in exchange rates and interest rates in individual countries has typically varied over time in unpredictable ways and has often changed abruptly. To the extent that capital inflows attracted by relatively high nominal interest rates were relied upon to finance large current-account deficits, the external adjustment process was not facilitated and countries remained vulnerable to an abrupt change in market sentiment.

Last year Sweden, Norway and Finland continued to apply stabilisation norms for their currencies expressed in nominal effective exchange rate terms. As currencies of countries with relatively high inflation rates were included in the currency baskets used, this has in practice implied a less strict inflation standard than the Deutsche Mark link used by Austria and by adherents to the exchange rate mechanism of the EMS. The aim of a nominal exchange rate objective is to control inflation without letting the competitiveness of the foreign trading sector deteriorate. Indeed, experience shows that the success of a "hard-currency" policy depends on establishing a pattern of wage responses which takes competitiveness into account. This aim is expressed in a law passed in 1988 in Belgium which authorises the Government to suspend the otherwise automatic indexation of wages if doing so becomes necessary to prevent the competitive position of enterprises deteriorating.

Success of hard-currency policies dependent on appropriate wage responses

The performance of more eclectic policies since 1987

Efforts to take longer-run objectives into account

Monetary policy in most of the major countries has become highly judgemental in recent years. To the extent that monetary authorities no longer felt able to rely on the monetary aggregates to signal future developments in output and prices, there was a clear risk that longer-term goals would not be taken adequately into account. However, central banks remained aware that the influence of monetary developments is felt with long and variable lags and attempted to allow for this by using a range of forward-looking indicators and by frequent adjustment of policy settings.

Experience has shown that interest rates, credit aggregates and floating exchange rates respond not only to changes in monetary policy but also to developments in the economy and may therefore fail to give reliable indications of a build-up of inflation. Similar difficulties arise when attempts are made to distil information from movements in the prices of real and financial assets and commodity prices. Asset prices have recently come to be viewed in some countries as potentially useful indicators of market expectations. However, they respond to a wide range of market-specific factors and at times seem to be more volatile than their fundamental determinants. Moreover, the relationship between movements in financial asset and commodity prices and economic developments which are of more relevance to the conduct of monetary policy is not well understood. Even when changes in asset prices appear to be giving clear advance warning about likely future developments, monetary authorities may have difficulty in justifying policy corrections before output or consumer prices respond.

Difficulties in interpreting individual forward-looking indicators

In retrospect, the interest rate policies followed since late 1987 may have been too easy. The speed and impact on the economy of the international current-account adjustment process and the delayed terms-of-trade effect on economic activity of the decline in oil prices were generally underestimated. In Germany monetary policy was tightened in early 1988 in advance of an acceleration in inflation but a number of other countries may

Despite the tightening of monetary policy, inflation has risen not have tightened policy soon enough. Policy was subsequently tightened further but too late to prevent inflation rates from rising. By the spring of 1990 demand pressures seemed likely to increase further in Japan and some continental European countries. Rates of consumer price increase accelerated but remained moderate in comparison with many other countries; it was still too early to be sure to what extent wage costs could be kept in check. In the United States and other countries where the economy had begun to respond to monetary restraint the authorities were confronted with calls to ease policy even though inflation continued or accelerated. In some countries there was a risk that fragility in some areas of the financial market could complicate the choice.

Monetary policy instruments and international financial integration

Impact of deregulation and international financial integration on instruments

Deregulation and international financial integration have made a deep imprint on the instruments and procedures used in the conduct of monetary policy. In the United States Federal Reserve operating procedures have remained largely unchanged since 1982, but the deregulation of deposit interest rates continues to give rise to major uncertainty about the effect of monetary policy on the aggregates, on interest rates and on the economy. Progress towards more market-oriented monetary policy operating procedures continued throughout the 1980s in Japan along with deregulation of the financial system, which is transforming the monetary policy transmission mechanism. By last year the pace of change was greatest in Europe. France, Italy and Belgium liberalised exchange controls as part of the programme for creating a unified financial area by 1993 and Sweden and Austria followed suit. European countries also continued to adopt more market-oriented monetary instruments to cope with the increasing international integration of their financial markets. However, Spain, Portugal and Greece found a tightening of direct controls necessary to achieve monetary restraint.

Instruments of money market management

The operation of monetary policy in all the Group of Ten countries now depends essentially on influencing the supply of and demand for bank reserves rather than on direct credit and interest rate controls. In many cases new, flexible instruments for influencing short-term interest rates have helped to preserve the effectiveness of monetary policy as that of administrative instruments, such as credit ceilings and exchange controls, was eroded by financial innovation.

Operating procedures which influence the demand for bank reserves ...

The demand for reserve deposits at the central bank depends mainly on reserve requirements or specific regulations governing interbank payment arrangements. In Switzerland the ability of banks to economise further on the holding of payments balances at the central bank has obliged the National Bank to make extensive use of interest rates as an operating guide, as has been done for some time in most other Group of Ten countries. In Italy high reserve ratios are still required to permit control of the central bank money stock in a context of large-scale central bank lending to the government but the arrangements are undergoing a review necessitated by the removal of exchange controls. A reduction in the reserve ratio in Spain from 17 to 5% in February 1990 brought it more into line with that in most other ERM countries, though the reserves freed in respect of existing deposits have to be invested in low-interest-bearing CDs issued by the Bank of Spain. Time-averaging provisions for banks' required reserve holdings continue to perform a useful function in helping to moderate short-term fluctuations in money market interest rates in most Group of Ten countries. For this purpose the reserve ratios need not be very high. In the Netherlands averaging provisions in the conditions governing the use made of central bank credit perform the interest rate smoothing function. However, provisions requiring banks to hold deposits at the Netherlands Bank in amounts fixed for two-week periods have been used since 1988 to help neutralise the money market impact of large-scale exchange market intervention.

... and the supply of bank reserves

The operation of monetary policy in most countries now depends mainly on indirect instruments which involve market operations by the central bank. This requires strict limits on balance-sheet operations which are outside the central bank's control – in particular, direct or indirect lending to the government, including purchases of government securities to support the market. In this respect the removal in Italy early last year of the floor price in auctions for six and twelve-month Treasury bills helped to limit purchases by the Bank of Italy. However, a direct credit line from the Bank of Italy to the Treasury which automatically increases each year in line with the budgeted rise in government expenditure continues to impede control of bank reserves. In Belgium the ceiling on the National Bank's line of credit to the Securities Market Stabilisation Fund, which indirectly serves to finance the government, was lowered substantially in two stages last year.

The degree of discretion the central bank enjoys with respect to foreign exchange market operations varies from country to country. Official purchases of foreign exchange were unusually large in relation to the central bank money stock last year in Italy, Sweden, Belgium, the Netherlands and even the United States, while relatively large sales took place in some other countries. The available operating instruments were adequate for offsetting the short-run direct effect on bank reserves in all of the Group of Ten countries except, at times, Italy.

Administrative control instruments

Reliance on credit controls in Spain, the Netherlands ...

In some countries credit controls are regarded as a supplementary instrument which can be used when short-term interest rate policy is pre-empted by exchange market objectives. Thus the credit guideline introduced last year in Spain was partly designed to encourage an increase in bank lending charges. A monetary reserve which came into force in the Netherlands in July 1989 is regarded as a market-oriented instrument. Individual banks were required to pay penalties if the expansion of their money-creating operations exceeded a growth norm of 5% (expressed at an annual rate). To limit the money market impact banks were required to pay the Netherlands Bank only the interest which would have been forgone had non-interest-bearing deposits been constituted. Banks were allowed to transfer unused margins among themselves and to offset any overdrawn margins against unused ones recorded in earlier or later periods. The arrangements were originally intended to last until June 1990 but, following a sharp slowdown in credit expansion, they were suspended in March.

... Greece ...

Notwithstanding a substantial liberalisation of interest rate controls and allocation rules in recent years, the credit system in Greece remains subject to regulations which divert credit to the public sector. Under the ceiling arrangement introduced in November 1989 banks were required to place the equivalent of 25% of their lending to the private sector in excess of a specified limit in non-interest-bearing accounts with the Bank of Greece for six months. In Portugal medium and long-term credit extended by banks to the public sector was brought within the existing credit ceiling in July and existing exchange controls were applied restrictively to limit loans to residents from abroad. Credit ceilings have been the main instrument of monetary policy for many years but recently announced plans for an extension of the coverage of reserve requirements by institution and instrument will pave the way for a system relying more on the control of bank reserves and interest rates.

... and Portugal

Exchange controls liberalised in many European countries

The EC countries had committed themselves at the Hanover summit in June 1988 to full liberalisation of intra-EC capital movements by 1990, or by the end of 1992 in the case of Greece, Ireland, Portugal and Spain (with a possible extension to the end of 1995 for Greece and Portugal). Exchange controls were relaxed in Ireland in 1989 and removed completely in France and Italy this year. Also in advance of the date of the commitment, the two-tier foreign exchange market in Belgium and Luxembourg was abolished in March 1990. In Spain and Portugal advantage has been taken of favourable exchange market conditions to liberalise some types of capital outflow in recent years. Exchange control restrictions were also virtually abolished in Austria and Sweden last year. Controls had not always proved effective in preventing large-scale cross-border flows. However, only in Sweden and Ireland were last year's liberalisation measures followed by large changes in capital movements.

Final objectives and the institutional framework

Price stability

Broad consensus that monetary policy should aim at price stability

While the difficulties monetary authorities face in interpreting developments have increased, a much broader consensus about final objectives has developed, with growing recognition by central banks that the most satisfactory overall economic performance can be attained if monetary policy aims primarily at the achievement of price stability. Even in countries where inflation expectations are firmly entrenched, it is now more widely accepted that the long-term benefits of bringing down inflation exceed the transitional costs.

The monetary authority's primary responsibility for price stability rests on the notion that sustained inflation cannot take place without monetary accommodation, notwithstanding the fact that many factors influence the prices of individual goods and services. Admittedly, price stability is not a precise statistical concept, but some central banks view it as a situation in which expected changes in the general price level are not a significant influence on economic decision-making. Though it may be difficult to achieve price stability without support from other economic policies and appropriate wage behaviour, the central bank has a special duty to ensure the stability of the basic monetary unit of account.

Risk of an acceleration of inflation and the costs of reducing it

By the early 1980s most monetary authorities were convinced that the observed short-run relationship between output and inflation did not provide an exploitable medium-term policy trade-off. In the longer run, there appeared to be no trade-off between inflation and unemployment. As inflation rose, expectations adjusted and became embedded in wage and price contracts. However, the 1982 recession in the United States confirmed that the adjustment of entrenched inflation expectations is subject to long lags. In some countries efforts to mobilise public support for reducing inflation further were relaxed once the inflation rate no longer seemed particularly high. With price pressures again increasing in 1988 and 1989, monetary authorities recognised that simply to maintain the existing rate of inflation affords little protection against an acceleration of inflation. The conclusion can be drawn that price stability is the only credible goal that the monetary authority can proclaim and defend. It is notable that this view has recently begun to be taken more seriously in the political arena in North America.

Central bank independence

The recognition that monetary policy can best contribute to a satisfactory economic performance by the resolute pursuit of the long-run goal of price stability has raised the question of how the central bank can be protected from pressures to pursue short-run aims which may prove inconsistent with the basic objective. The argument that a high degree of independence of the central bank from the Treasury and other public institutions is desirable has been reflected in discussions about the establishment of a suitable framework for macro-economic policy in the former centrally planned economies of eastern Europe. Increased independence for national central banks has also been seen as paving the way for an independent system of central banks in the European Community.

Influences on the independence of the central bank

The degree of independence of the central bank reflects institutional and informal arrangements which differ from country to country and which are difficult to compare and evaluate. These include the length of the terms of office and the security of tenure of key officials, the manner in which they are appointed, their experience and the relationship with the government. Another important distinction turns on whether instrument settings may be independently determined by the central bank or require the approval of the government. It is widely agreed that by these criteria the

Federal Reserve System and the Bundesbank are models of relatively independent central banks. The former is accountable to Congress but not to the Administration, and the Bundesbank Law gives the latter a clear mandate to pursue the objective of price stability.

Advantages of independence

One of the main arguments for central bank independence is that an institution which is relatively independent of political considerations, with a mandate to achieve price stability, is likely to be better able to establish the credibility needed to conduct monetary policy effectively. If, in the absence of such independence, an incentive to adopt short-term or partisan policies imparts over time an inflationary bias to economic policy all parties may be worse off. It has often been pointed out that, in practice, inflation performance seems to have been better in countries with relatively independent central banks, though such institutional arrangements may themselves reflect strong public sensitivity to inflation.

Constraints on independence

The central bank's policy independence may be limited by exchange rate commitments, though in some countries these form the basis of monetary policies geared to price stability. Also important are the conditions which apply to the granting of direct credit to the Treasury and to central bank operations in government securities. Unsatisfactory arrangements in these areas may seriously complicate the conduct of monetary policy. Central bank independence may not, in itself, be sufficient to ensure monetary stability if fiscal policy leads to excessive monetary financing of the government outside the central bank – borrowing from domestic banks or in foreign currencies for conversion into domestic currency. Even when the government's borrowing requirement is financed in the domestic capital market, the conduct of monetary policy may be made more difficult by upward pressure on interest rates or by large domestic or external imbalances. While satisfactory budgetary policies and wage developments are needed to achieve price stability, more weight is likely to be given to that objective if a relatively independent central bank has a mandate to pursue it.

Economic and monetary union in the European Community

Increased financial integration in the European Community

Significant progress has already been made in the implementation of the Single European Act, under which the member states in 1987 agreed to establish by 1993 a common market within the Community in which goods, labour, services and capital could move without impediment. As a result of past and prospective legislative measures to strengthen competition in financial markets and to liberalise capital movements, market forces can be expected to increase pressures on individual countries to adjust domestic and external imbalances and inflation rates. There has been some concern regarding the difficulties involved in reconciling the conduct of autonomous monetary and economic policies with the freedom of capital movements in a quasi-fixed exchange rate regime.

Decisions taken by the European Council in June and December 1989 provided for the implementation of the first stage of economic and monetary union, as envisaged in the report of the "Delors Committee", and for the calling of an inter-governmental conference to prepare amendments to the Treaty of Rome to permit the institutional changes needed for progress beyond that stage. In the first stage, to start on 1st July 1990, the intention is to co-ordinate macro-economic and monetary policies more closely. With respect to monetary policy the mandate of the Committee of Governors of the EC central banks has been extended. In future, it is to be consulted on decisions such as those relating to the setting of annual money supply and credit targets. It is also charged with promoting the co-ordination of monetary policies with the aim of achieving price stability as a necessary condition for the proper functioning of the EMS and with evaluating the overall orientation of monetary and exchange rate policy and the measures taken in these fields by individual member states. The Committee will henceforth prepare an annual report and its Chairman may be invited to appear before the European Parliament and its competent committee. At the same time it is hoped that multilateral surveillance of other economic policies, expected to take place at regular intervals, will contribute to fostering price stability, sound public finances and balances of payments and open, competitive markets in the member states. Within this new framework it will become clearer whether there is a genuine willingness to improve the co-ordination of economic, monetary and especially fiscal policies.

Institutional changes provide an opportunity for closer policy co-ordination

Public discussion of the further stages of economic and monetary union has raised a number of questions which require clarification in the political arena, including how far and how fast countries are prepared to proceed. With respect to the effectiveness of monetary policy, one important question is whether there would be sufficient political support for making price stability the mandate of a future European system of central banks. Another is whether a new central bank institution could be made sufficiently independent of political interference to carry out its tasks, which may logically have to include exchange rate and intervention policy. The question of how the design and implementation of monetary policy should be adapted during the transition was left largely open in the "Delors Committee" report. The few general proposals made so far, such as schemes for linking national money supplies to a European central bank money stock, have received little support. A related question is how – in the absence of a common currency or a composite monetary target – a kind of monetary anchor can be provided in place of the Deutsche Mark. Finally, effective monetary policy could be thwarted by destabilising budgetary developments in individual countries, but there seems to be great reluctance to complement monetary union by surrendering some sovereignty in this area.

Issues raised by further steps towards economic and monetary union

German currency union

General issues raised by the development of market economies in eastern Europe are discussed in Chapter II. The key monetary questions are how prices and wages will respond to liberalisation, how quickly new banking structures can be developed and how soon a framework for macro-economic policy can be put in place. Much will depend on how quickly cross-border transactions are liberalised and on the exchange rate policies followed. Developments in the German Democratic Republic are likely to differ from those in the other countries in some respects and to have significant near-term economic effects in the Federal Republic of Germany and in other EMS countries. Expectations in this regard have left their mark, particularly in the bond market.

Agreement reached on the extension of the Deutsche Mark to the German Democratic Republic

Political agreement has been reached on a currency union to be achieved by the extension of the Deutsche Mark to the GDR on 2nd July 1990. It will give a stimulus to the modernisation of the GDR economy, though complex monetary and economic questions are involved. One important issue has been the conversion rate to be applied to financial assets and liabilities, wages and pensions in the GDR. Agreement has been reached on a rate of generally M 2 : DM 1 for existing claims and liabilities, which is designed to protect the viability of GDR enterprises. However, a 1 : 1 rate will be applied to GDR residents' holdings of currency and savings deposits in amounts up to specified thresholds and to wages at existing levels (without compensation for price changes following the removal of subsidies). The implied immediate addition of about 10% to the broad money stock in the Federal Republic would not exceed the prospective enlargement of the gross national product in the unified currency area. Although the conversion could give a boost to the demand for goods produced in the Federal Republic, the Bundesbank considers that the agreed arrangements should not give rise to unmanageable monetary problems, assuming that GDR residents take advantage of the extended range of opportunities which will become available to them for holding financial assets.

Advantages of currency union and preconditions for satisfactory results

Currency union must be accompanied by the establishment in the German Democratic Republic of the necessary legal framework for a market economy and for the participation of western industrial and financial enterprises, skills and capital in the transformation of the economy. As reflected in its huge external current-account surplus, savings in the Federal Republic should be adequate to make a substantial contribution to the financing of the necessary investment, but the impact on the public authority budgets of the public investment and social security expenditures needed to maintain or raise standards in the GDR could prove a major challenge. Advantage will have to be taken of all possible scope for government expenditure savings in other areas. In the longer term, the course of economic developments and the rate of unemployment in the GDR will depend crucially on whether the level of wages, given the relatively low level of productivity, remains conducive to investment.

VII. The international monetary system

Highlights

In the international monetary field the outstanding features of 1989 and the first few months of 1990 were recurrent episodes of dollar strength, especially vis-à-vis the Japanese yen, significant movements in the exchange rate relationships between currencies other than the US dollar and, at times, very active presence of the central banks in the exchange markets.

Confirming a trend already seen in 1988, the dollar was repeatedly subject to pronounced upward pressure in the period under review, despite narrowing interest rate differentials, a still large, though declining, US current-account deficit and persistent central bank intervention aimed at curbing its appreciation. Indeed, concerted intervention was repeatedly undertaken on a very large scale and with some novel features, notably a much more prominent role of the US authorities than in earlier years. But with the markets increasingly unsure about the authorities' exchange rate commitment, the dollar appreciated markedly against the Japanese yen.

In the last few months of 1989 the dollar's overall strength was temporarily punctured by the buoyancy of the Deutsche Mark, which benefited from the accelerating developments in eastern Europe. This resulted not only in the Deutsche Mark more than recouping its earlier losses against the dollar, but also in a very strong appreciation of the Deutsche Mark and other currencies in the EMS exchange rate mechanism vis-à-vis the yen and sterling.

Despite the temporary, but very pronounced, strength of the Deutsche Mark and the ongoing removal of exchange controls, the situation within the European Monetary System remained mostly calm. This was not least the result of the continued convergence of economic performance between France and Germany, two of the key countries within the system. Moreover, the economic importance of the system was enhanced when, in mid-1989, the Spanish peseta was brought into the exchange rate mechanism with a wide band of fluctuation and, in early 1990, the Italian authorities abandoned the lira's wider margins and adopted the narrow band.

Gold continued to lose some of its attraction as a safe haven last year. Against the background of a strong dollar, higher long-term interest rates and expanding supplies, not even the volatility of some of the world's major stock markets and growing inflationary pressures could prevent a further decline in bullion prices, with quotations dropping at some points to their lowest level since mid-1986.

International reserve developments last year were shaped by countervailing influences. On the one hand, large US official purchases of Deutsche Mark and yen, as well as exchange market intervention in an EMS context, led to very strong growth in non-dollar exchange reserves. On the other hand, massive official dollar sales by a number of industrial countries, barely offset by dollar reserve accumulation in some smaller developed and developing countries, together with a further decrease in reserve positions in the IMF, prevented an expansion in other reserve assets. The net outcome of these developments was an increase in the current dollar value of official non-gold reserves of 6% – somewhat less than the rate of growth of international trade in 1989 – and a further move, partly incidental, towards a multi-currency reserve system. In particular, the share of the Deutsche Mark in official exchange reserves increased markedly, from 16.5 to about 20%.

Apart from surveying recent international monetary developments, this chapter contains a special section summarising the results of a comprehensive survey of exchange market activity conducted by the monetary authorities of twenty-one countries which account for the bulk of global exchange market turnover.

Exchange markets

Developments in the US dollar market

Repeated bouts of dollar strength ...

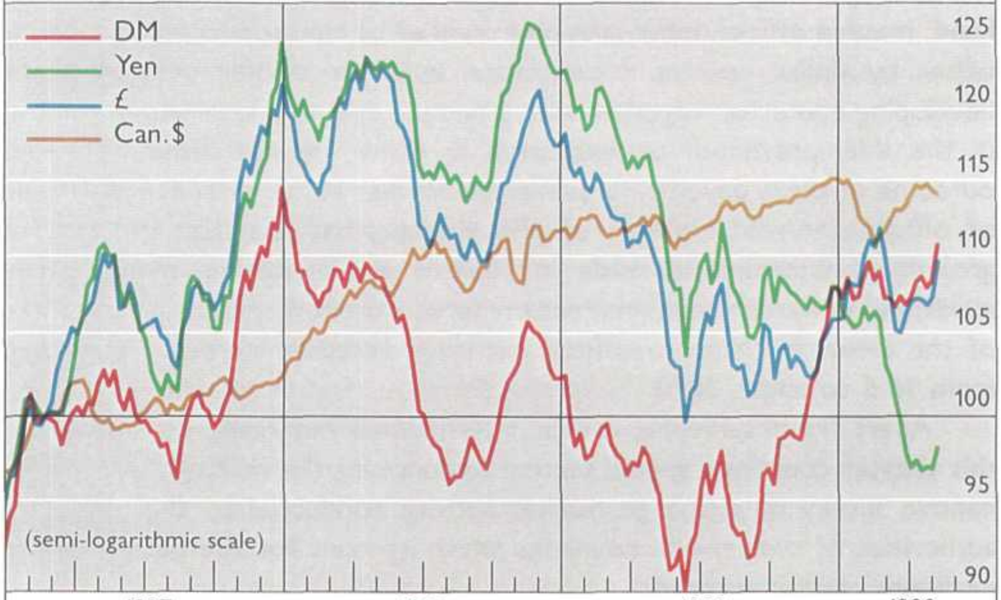
The period under review was characterised by repeated bouts of dollar strength, countered by vigorous official exchange market intervention and occasional monetary policy adjustments. With the US trade balance showing further improvement and the longer-term outlook for the dollar no longer clouded by fears of a sharp acceleration in inflation, the US financial markets began to regain their appeal for foreign investors. As a result, net capital inflows to the United States repeatedly exceeded the US current-account deficit, thereby exerting upward pressure on the dollar's exchange rate.

... give rise to increasing official concern and ...

The pronounced firming of the dollar in the course of the spring of 1989 was already described in last year's Annual Report. Encouraged by its relative stability in 1988, the markets felt increasingly reassured about the longer-term prospects for the currency. As a result, the high level of US interest rates began to exert a progressively more dominant influence on the pattern of international capital flows. A statement by the Group of Seven countries in early April stressing their strong opposition to a further dollar rise, and official dollar sales by the Bank of Japan – the first since the fourth quarter of 1985 – together with a round of interest rate increases in Germany and a number of other European countries brought only temporary relief. Towards the end of April the upward pressures on the dollar resumed with renewed vigour. Despite a substantial narrowing of interest rate differentials, the dollar broke through the DM 2.00 and Yen 140 levels on 22nd May. The unwinding of hedging positions against the dollar, the psychological impact of the publication of a set of favourable US

Bilateral exchange rates of selected currencies against the US dollar

Weekly averages, third week of February 1987 = 100



trade figures and strong investor interest in long-term dollar securities as a result of expectations of declining US long-term interest rates appear to have been important influences behind this renewed upsurge in the demand for dollars.

... heavy exchange market intervention

Concerned about the consequences of excessive dollar appreciation for the adjustment process, the authorities felt obliged to act. The US authorities in particular responded with what was, for them, unprecedentedly heavy intervention. Between 12th and 31st May they sold a total of \$5.8 billion, \$2 billion of which was committed in only two days. The Japanese authorities also stepped up their support for the yen. Moreover, at the end of the month the Bank of Japan raised the official discount rate from 2.5 to 3.25%, the first increase in nine years.

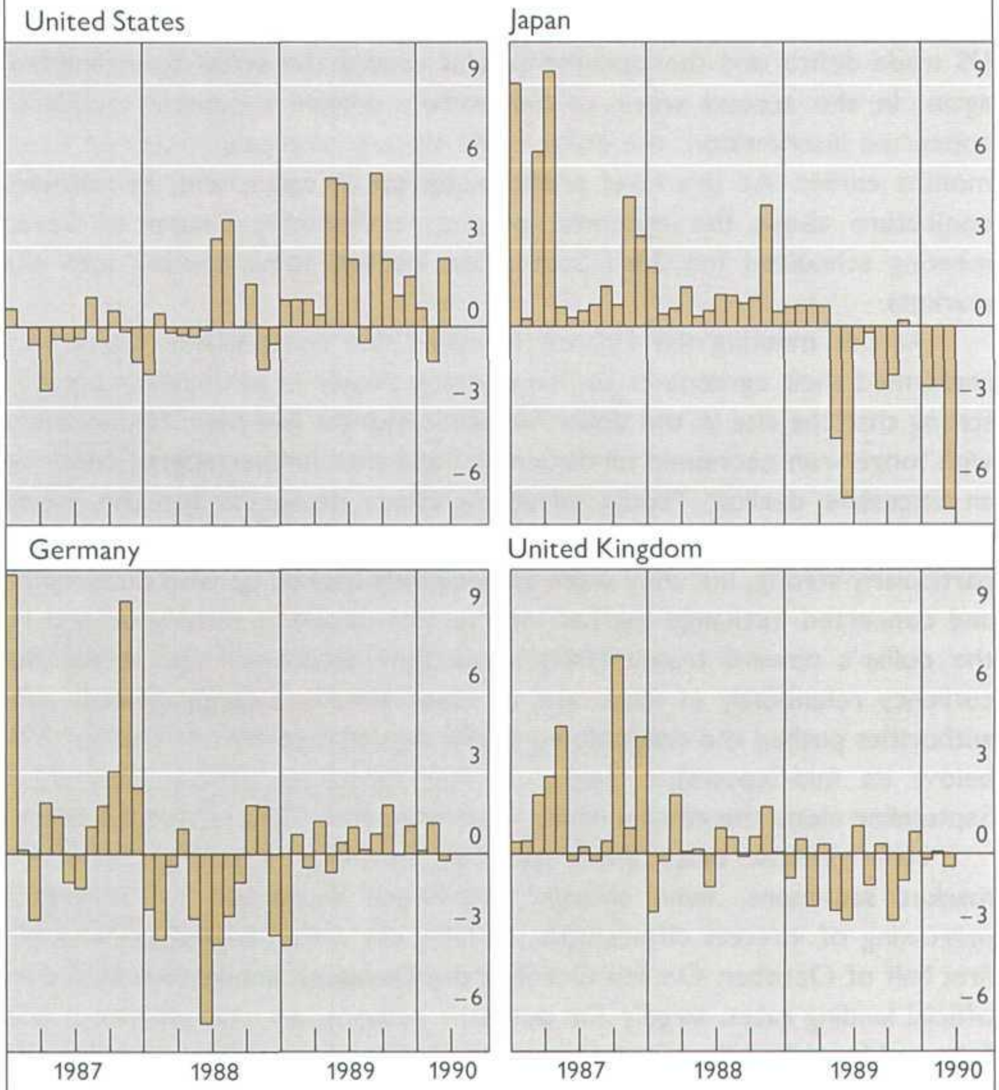
Nevertheless, the dollar rises sharply against the yen

Towards the end of May and in the first few days of June concerted intervention against the dollar, now with the participation of the Deutsche Bundesbank, resulted in some easing of market pressures. However, this success was only short-lived. On 5th June market sentiment once more shifted abruptly in favour of the dollar as political events in China were thought likely to spur outflows of capital from East Asian countries in search of a safe haven. Political uncertainties in Japan itself added to the upward impetus of the dollar, which soared from about Yen 141 to over Yen 151 within the space of ten days. By mid-June the dollar had risen to levels 29% and 24% above the record lows of early January 1988 against the Deutsche Mark and the yen respectively, while on a trade-weighted basis its appreciation amounted to nearly 15%.

At this point, however, market participants began to perceive risks of a downward dollar correction and profit-taking triggered a retreat of the

Movements in foreign exchange reserves in selected countries*

In billions of US dollars



* The movements reflect not only outright exchange market intervention but also interest receipts and other forms of foreign exchange income and expenditure.

A temporary pause in the upward pressures on the dollar ...

currency. Persistent, heavy and co-ordinated sales of dollars even after its mid-month turn-round, and the prominent role of the Federal Reserve in these operations, helped to restore the markets' belief in official determination to prevent an upsurge of the dollar. Between 6th and 30th June the US authorities sold a further $5 billion, while Japanese official reserve holdings fell by $6.4 billion in the same month. The German authorities, by contrast, were relatively inactive during this period, with German official reserve assets actually showing a slight increase in June. Cyclical factors also helped to contain the underlying strength of the dollar. Increasing evidence of a weaker US economy, together with buoyant growth and clearer signs of inflationary pressures abroad, led to expectations of a further narrowing of interest rate differentials in favour of the dollar. Towards the end of June the Deutsche Bundesbank and several other European central banks raised official lending rates. In July any incipient signs of renewed dollar buoyancy were successfully countered by relatively modest US official dollar sales.

During August and early September evidence that the US economy was less weak than had been feared, and a further contraction in both the US trade deficit and the Japanese surplus caused the dollar to strengthen again. In the second week of September, despite repeated rounds of concerted intervention, the dollar came close to the peaks attained three months earlier. At this level profit-taking set in again, and, in addition, conjecture about the outcome of the forthcoming Group of Seven meeting scheduled for 23rd September instilled some caution into the markets.

... before renewed strength in late summer

At this meeting the Finance Ministers and central bank Governors reaffirmed their agreement to "co-operate closely in exchange markets", stating that the rise in the dollar in recent months had been "inconsistent with longer-run economic fundamentals" and that further appreciation, or an excessive decline, "could adversely affect prospects for the world economy". Compared with earlier statements, these formulations were not particularly strong, but they were subsequently backed up with determined and concerted exchange market intervention aimed at putting an end to the dollar's upward trend. Using some new techniques and selling the currency relentlessly in what was at times already a falling market, the authorities pushed the dollar down in the days that followed to about 6% below its mid-September peaks. In the three-day period 25th–27th September alone the central banks were estimated to have sold $4 billion.

Group of Seven meeting followed by aggressive intervention

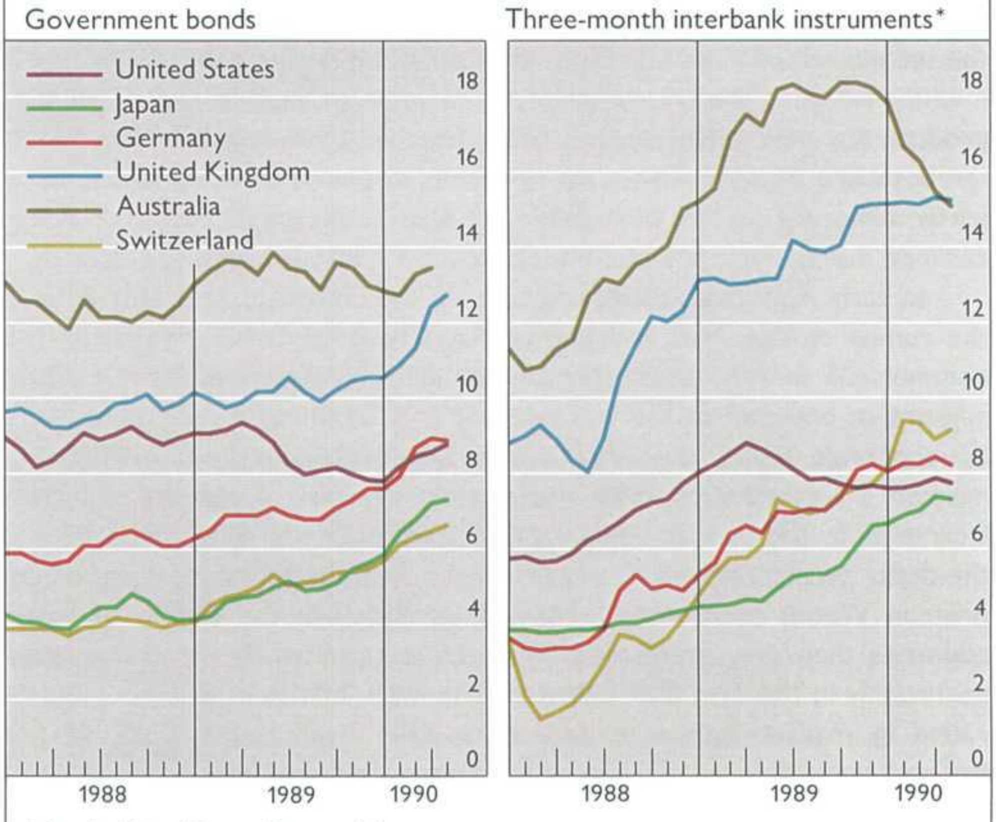
Nevertheless, these dollar sales did not have a lasting impact on market sentiment, even though they were supported by a further narrowing of interest differentials. In fact, the dollar firmed again in the first half of October. On 5th October the Deutsche Bundesbank raised its official lending rates, largely for domestic reasons, an example which was followed by eight other European central banks. A week later the Bank of Japan increased its official discount rate by ½ percentage point. At the same time, certain indicators suggested some moderation of the pace of US economic activity, thus nurturing hopes of an easing of US domestic monetary policy. Despite these developments, market sentiment did not turn round until after the sharp decline in US equity prices on 13th October. A few days later the publication of poor US trade figures for August served to reduce the dollar's attractiveness further.

Upward trend of the dollar not checked until mid-October

However, this weakness was largely vis-à-vis the Deutsche Mark and some other continental European currencies. Under the influence of the accelerating developments in eastern Europe and the continued upward movement in German interest rates, which resulted for the first time since the early 1970s in positive interest rate differentials vis-à-vis the United States, the Deutsche Mark began to rise steeply against the dollar. Between the second week of October and late December the dollar eased by about 12% against the Deutsche Mark, while its trade-weighted exchange rate declined by 5%. Although the dollar subsequently showed renewed signs of strength, the Deutsche Mark held its newly regained ground throughout

Pronounced strength of the Deutsche Mark

Nominal interest rates in selected countries



* For the United States, Treasury bills.

the early months of 1990, especially as in the first week of January another incipient rise in the dollar had been met by prompt and strategically well-timed intervention by the Bundesbank and several other central banks.

The dollar remains strong vis-à-vis the yen ...

Against the yen, however, the dollar remained firm throughout the autumn of 1989 and the early part of 1990. Despite some upward movement in Japanese interest rates, interest differentials continued to be strongly in favour of the United States, while domestic political uncertainties also acted as a drag on the yen. Although it continued to receive some occasional support from the Japanese and US authorities, the yen continued to weaken during the closing months of 1989. Notwithstanding a further rise in the Japanese discount rate in late December and a decline in US prime rates in the first few days of the new year, the downward pressure on the yen strengthened in January, and official support purchases were stepped up markedly.

... against the background of Japanese political and economic uncertainties

During February the strength of the dollar became more broadly based again, as concern about the economic consequences for the Federal Republic of Germany of monetary union with the German Democratic Republic exerted some weakening influence on the Deutsche Mark. Evidence of a further narrowing of both the US trade deficit and the Japanese surplus, as well as uncertainty about the possibility of another Japanese discount rate rise following the February parliamentary elections, also tended to buoy the dollar. Undeterred by massive concerted intervention, it firmed markedly in the last few days of February and, against the background of an increasingly weak and volatile Japanese stock market, continued to appreciate against the yen throughout March. The upward adjustment of the Japanese discount rate, when it eventually occurred in the second half of March, brought little relief. Following a speedily arranged meeting between the US and Japanese Ministers of Finance, which failed to produce any new initiatives, the dollar touched a new peak of Yen 160 at the beginning of April. The scale of official intervention in these months is partly reflected in the movement of Japan's exchange reserves, which declined during February and March by \$2.3 and 6.8 billion respectively.

In early April the upward pressure on the dollar subsided somewhat in the run-up to the Paris meeting of the Group of Seven. However, the communiqué merely noted the "undesirable consequences for the global adjustment process" of the yen's decline and "reaffirmed the commitment to economic policy co-ordination, including co-operation in exchange markets". Nevertheless, with the support of some co-ordinated official intervention, the yen subsequently stabilised at its prevailing low level and the dollar markets remained unusually calm until the spring meetings of the Bretton Woods institutions in early May. Although the Group of Seven countries then only reaffirmed their earlier statements, the dollar eased appreciably in the days that followed. The main influences behind this turnround in market sentiment appear to have been strong German and Japanese trade data, a recovery of the Tokyo stock market and evidence of a weaker US economy giving rise to expectations of lower dollar interest rates.

Calm dollar markets in April but weakening of the dollar in early May

Unlike all the other major currencies, the Canadian dollar remained firm against the US dollar virtually throughout 1989. After drifting higher between June and December, it ended the year 3% above its level of twelve months earlier, bringing its cumulative appreciation against the US dollar since late 1986 to 20%. The Canadian economy continued to experience high demand levels in 1989 and early 1990, but confidence in the anti-inflationary stance of monetary policy was evidently widely felt. This confidence was also fed by high and rising interest differentials. However, a certain fragility in the situation became apparent early in the new year when – following a fall in US prime rates – a relatively small decline in official Canadian interest rates was sufficient to trigger a sudden setback which temporarily wiped out all of the Canadian currency's 1989 gains vis-à-vis the US dollar. Official exchange market intervention and a renewed rise in Canadian interest rates eventually succeeded in reversing the currency's weakness.

Only temporary interruption of continued buoyancy of the Canadian dollar

Developments in cross rates

A year ago the Annual Report highlighted the remarkable 22% appreciation of the *Japanese yen* against the Deutsche Mark in the period between the signing of the Louvre Accord and mid-February 1989. In the intervening period that rise has been more than fully reversed, and in mid-May the yen stood approximately 25% below its early 1989 peak vis-à-vis the German currency.

The yen more than reverses its earlier rise against the Deutsche Mark

Bilateral exchange rates of selected currencies against the Deutsche Mark

Weekly averages, third week of February 1987 = 100

Reasons for Deutsche Mark strength ...

There were three main influences which help to explain this development. Firstly, German short-term interest rates, which had already moved above Japanese rates in 1988, continued to go up in early 1989 and the differential in Germany's favour remained unusually high throughout the period under review. Secondly, world political developments – the events in China and the opening-up of eastern Europe – were perceived by the markets as bearish factors for the yen but as positive for the Deutsche Mark. Thirdly, within the context of the EMS exchange rate mechanism, the German currency's exchange rate against the dollar received indirect support from official intra-marginal purchases of Deutsche Mark by other ERM member countries.

... and yen weakness

The decline of the yen in relation to the Deutsche Mark occurred essentially in three stages. One was in late May and the first half of June, when, despite a rise in the Japanese discount rate and heavy intervention by the Bank of Japan and the Federal Reserve, the yen weakened markedly against the dollar. The second was in the last three months of the year, when the Deutsche Mark, buoyed by the prospect of German reunification, appreciated sharply against the dollar. Then, in the early months of 1990, while the Deutsche Mark was relatively stable against the dollar the yen continued to lose ground. In addition to unfavourable interest rate differentials and the specific attractions of the Deutsche Mark, the yen had for some time been affected by political uncertainties at home and by the perception that the prices of some domestic assets had become too high relative to those elsewhere. Although the Japanese authorities continued to intervene heavily in the exchange market, they hesitated to raise official interest rates, apparently for fear of provoking an over-reaction in such asset prices. And when the discount rate was eventually increased – this time by a full percentage point – on 20th March, the reaction of the exchange markets failed to support the yen.

Sterling comes under pressure ...

During the early months of 1989 the *pound sterling* continued to benefit from the high level of UK interest rates. This situation did not persist, however. Developments in other currencies during this period demonstrated some of the risks involved in investment in the high-interest, high-inflation currencies. Rising inflationary pressures in the United Kingdom and a sharply deteriorating external current account gradually began to influence investors' attitudes. The pound came under downward pressure in May, and the UK authorities reacted by inducing a rise in bank base rates from 13 to 14% and by intervening in the exchange markets. The situation was somewhat novel, however, in that the budget was in very large surplus. In the light of this the then Chancellor of the Exchequer felt able to view the balance-of-payments deficit as a purely private sector affair, which would correct itself automatically in due course. He was in any case insistent that allowing the exchange rate to fall was no cure.

... despite higher interest rates

His successor apparently took a slightly different view. Although in early October the UK authorities followed the Deutsche Bundesbank's lead and raised interest rates once more by a full percentage point, sterling was allowed to weaken quite markedly during the fourth quarter, falling by more than 11% against the Deutsche Mark between late September and the end of December. There was continued concern about the UK inflation outlook, the large external deficit and the obvious divisions within the Government with respect to some basic policy issues. The authorities intervened from time to time in support of sterling as the currency reached record lows against the Deutsche Mark. Early in 1990 the pressures eased as the new Chancellor emphasised the authorities' continuing commitment to fighting inflation and there was some temporary improvement in the overseas trade figures. In March, however, when local authorities began fixing the levels of the new community charge (poll tax), political uncertainty engendered by fierce public opposition to this novel tax triggered a new bout of sterling weakness which temporarily took the pound to new historic lows not much above DM 2.70, before it more or less stabilised in the course of April.

After a burst of strength, the *Australian dollar* fell sharply in February of last year following the publication of disappointing current-account data. Even so, as the interest differential vis-à-vis the US dollar continued to widen, investors were again tempted into taking the exchange risk for the sake of yield. However, in order to avoid a further deterioration in the country's international competitive position and current-account balance, the authorities were reluctant to see the currency resume its rise. In the

The authorities succeed in curbing the strength of the Australian dollar

wake of a sharp upward movement of the Australian dollar in August, the Reserve Bank was seen to be intervening against the currency in September. Thereafter the authorities' reluctance to countenance renewed strength in the Australian dollar was largely satisfied by the growing firmness of the Deutsche Mark. Against the latter currency the Australian dollar fell by nearly 20% between mid-September 1989 and mid-May this year.

Unusual weakness of the Swiss franc ...

The *Swiss franc* experienced a sudden and unexpected period of weakness during the spring of 1989. This was, however, largely reversed in late May, following the Swiss National Bank's switch to a daily floating rate setting of its lombard rate. This had the effect of raising Swiss franc interest rates quite sharply, and during the summer the currency held at about 86–87 centimes against the Deutsche Mark, still somewhat lower than at the start of the year.

... and policy responses

The Swiss franc then experienced a second, and against the Deutsche Mark more pronounced, period of weakness beginning in October, which by the first week of January 1990 took it to a low point 8% below its level of a year earlier, its lowest quotation since May 1981. The Swiss National Bank had already responded in December by raising its flexible lombard rate to 2 percentage points above call-money rates. Swiss franc interest rates firmed markedly and at the short end moved well above those on both US dollar and Deutsche Mark instruments – a constellation without historical precedent. As a result, the Swiss franc subsequently began to recoup its earlier losses, and in mid-May, it was back to its early 1989 level in terms of the Deutsche Mark. With inflation well above German levels, and in the light of developments in the rest of Europe, eastern and western, the Swiss franc appears to have temporarily lost some of its special status. Although the tightening of monetary policy has succeeded in reversing its earlier decline against the Deutsche Mark, this has been at the cost of interest rates exceptionally high by Swiss standards.

Longer-term exchange rate perspectives

Return towards the early 1987 nominal exchange rate pattern ...

Since late 1988 movements in the *nominal* exchange rates of at least some of the major currencies have brought them back into closer alignment with the pattern prevailing at the time of the Louvre Accord in February 1987. This is particularly true of the yen, which in late 1988 stood about 25% above its Louvre Accord level against the dollar and which by mid-May of this year had fallen back to that level. Over the same period sterling's exchange rate against the dollar moved from nearly 20% to 10% above its February 1987 level. After having fallen to about 10% below its Louvre level against the dollar in mid-1989, the Deutsche Mark returned to that level in November, and in mid-May of this year was quoted nearly 12% above it.

Leaving aside for the moment the question of the continuing appropriateness of the pattern of nominal exchange rates prevailing at the time of the Louvre Accord, it should be noted at once that the picture is not quite the same when expressed in terms of *real effective rates*, as can be seen from the graph opposite. It is true that the Deutsche Mark's real effective rate has been remarkably stable, while its recent modest appreciation above its Louvre level would seem appropriate given Germany's continued large external surplus and the events in eastern Europe. Similarly, after strengthening in early 1989, the dollar's return to slightly lower levels in real terms after the middle of last year seems to have been a move in the right direction given the persistence of the US current-account deficit. On the other hand, sterling's decline since early 1989 has been quite modest in real terms, while the yen has moved from a real rate of nearly 10% above its Louvre level in early 1988 to almost 20% below it in April of this year.

... but in real terms undershooting of the yen

In the light of this summary picture of exchange rate developments, what can be said of the past three years' experience of trying to foster a greater degree of exchange rate stability? To begin with, as a glance at the graphs on pages 184 and 189 shows, the present proximity of nominal exchange rates to their Louvre levels has nonetheless been the net outcome of fairly large and frequent fluctuations in between. Furthermore, the fluctuations which have occurred understate the strength of exchange market pressures experienced during this period, given that the latter were in many instances countered by heavy official exchange market intervention. Nevertheless, the amplitude of exchange rate swings since early 1987 has clearly been less than in the earlier period of floating, while the recent performance of the world economy suggests that exchange rate fluctuations have not in the event been a vital hindrance to strong economic growth. That said, it cannot of course be ruled out that an increasingly unstable exchange rate structure could at some point become harmful, as theory suggests.

Limited success of the Louvre Accord in reducing exchange rate fluctuations

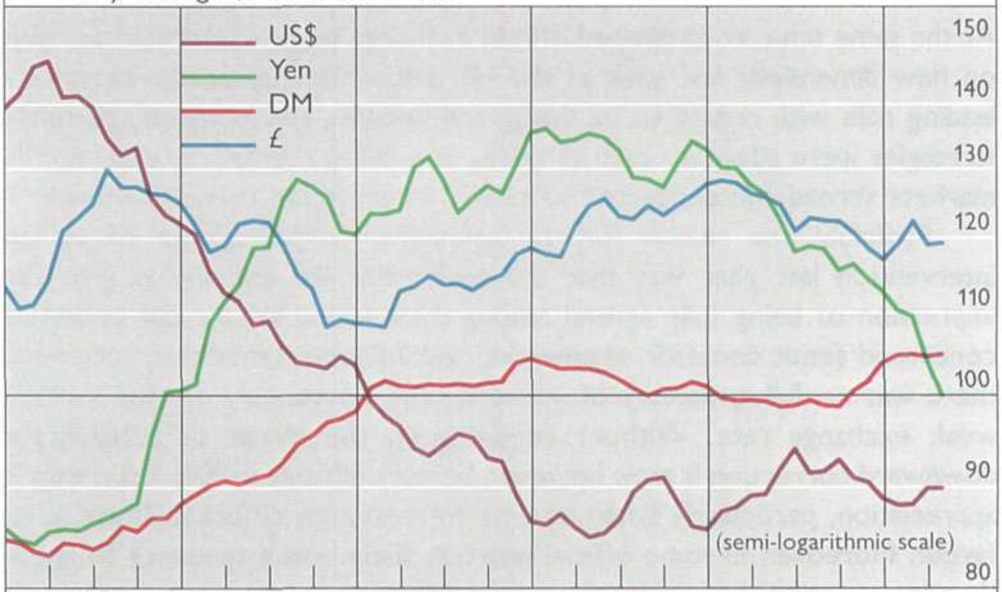
One salient feature of exchange rate movements since February 1987 has been that at times some countries with relatively high inflation and deteriorating current accounts nevertheless had strong currencies. In the – even temporary – absence of major exchange rate fears the high nominal interest rate levels in these countries sometimes exerted a strong attraction for foreign capital. The resulting inflows provoked substantial exchange rate appreciation which tended both to mask the severity of domestic inflation problems and to encourage more accommodating domestic monetary policy stances, while simultaneously contributing to a further deterioration in underlying current-account positions. Such developments, where the upward movement of the current exchange rate, through its macro-economic consequences, tends at the same time to push down the longer-term equilibrium level of the exchange rate, can lead to the build-up of major exchange rate distortions and longer-term balance-of-payments disequilibria, with conceivable potential for future instability and policy disruption.

Destabilising effects of nominal exchange rate stabilisation on the pattern of international capital flows

There is also the question of whether, given the macro-economic and political developments which have occurred in the meantime, an exchange rate structure which resembles that prevailing at the time of the Louvre Accord is still appropriate. For example, after allowance is made for

Real effective exchange rates of major currencies*

Monthly averages, March 1979 = 100



* Adjusted on the basis of movements in relative unit labour costs.

Increasing danger of real exchange rate misalignments

inflation differentials in terms of unit labour costs, the real exchange rate of the Deutsche Mark, both in effective terms and bilaterally against the US dollar, is now not much higher than at the time of the Louvre Accord. At the same time Germany's current-account surplus has widened despite booming domestic demand conditions. This raises the issue of whether a further real appreciation of the Deutsche Mark might not be desirable. A similar point applies to the Japanese yen, which in real terms has depreciated substantially in comparison with its Louvre Accord level. Although the Japanese current-account surplus has also declined markedly since 1987, there is the risk that, if recent exchange rate levels were to persist, it might start to widen again.

Official exchange market intervention, its theoretical role and ...

Finally, there is the question of the role and usefulness of official exchange market intervention during the past three years. Of course, official readiness to intervene in the exchange markets in order to impart more stability to rates was an essential part of the Louvre Accord itself. However, the idea was that, backed up with appropriate policy adjustments, this declared readiness of the authorities to intervene should by itself exert a stabilising influence on the exchange markets, thereby reducing the need for actual intervention. Instead, the authorities' resolve to defend the prevailing exchange rate structure has been repeatedly and severely tested by the markets during the past three years. An unprecedented volume of official intervention and the persistence of major exchange rate fluctuations – albeit of a somewhat reduced amplitude – indicates that success in stabilising the markets has been only partial.

Moreover, although it is quite likely that without strong official exchange market support the decline of the yen in the past fifteen months or so would have been even more pronounced, there were signs that the impact of intervention was beginning to wear off and that – on most occasions – more and more of it was required to achieve the same result. At the same time, co-ordinated official exchange market intervention took on new dimensions last year as the US authorities repeatedly assumed a leading role with regard to its timing and volume, and as more aggressive strategies were adopted, such as selling in a falling market, intervention in markets abroad and concerted successive intervention round the clock.

... its practical limitations

Probably one reason for the somewhat limited impact of official intervention last year was that the authorities did not always give the impression of being fully agreed among themselves. With most countries concerned about domestic overheating and inflation rather than recession, there was no full symmetry of interests, and no country wanted a really weak exchange rate. Without conjuring up the threat of a significant downward correction it may, however, be very difficult to halt a currency's appreciation, particularly when nominal interest rate differentials are in its favour. Moreover, in some official quarters there was a tendency to argue that intervention had little chance of success as long as interest rate differentials remained very large. This theory is correct, however, only when intervention cannot influence exchange rate expectations, which is, of course, its main purpose. Finally, the markets not only perceived at times less than full harmony of views across national borders, but also saw widely publicised differences of opinion among authorities within individual countries as to the kinds of exchange rate and interest rate strategies to be adopted.

Some signs of disaccord

On the other hand, macro-economic developments went broadly in the right direction last year and policy co-ordination can take some of the credit for that. While the US economy slowed down markedly, the German and Japanese economies were running at full steam and the negative interest rate differentials vis-à-vis the United States narrowed or disappeared altogether. It may therefore be doubted whether the failure of official exchange market intervention to exert a more profound influence on exchange market sentiment last year can be explained solely in terms of lack of credibility and less than full community of purpose. Instead, after almost three and a half years of experience with the Louvre Accord it may be time to take a fresh look at official exchange rate strategies and international policy co-ordination, and to consider ways in which their coherence and effectiveness might be improved.

Need for a new look at exchange rate strategies?

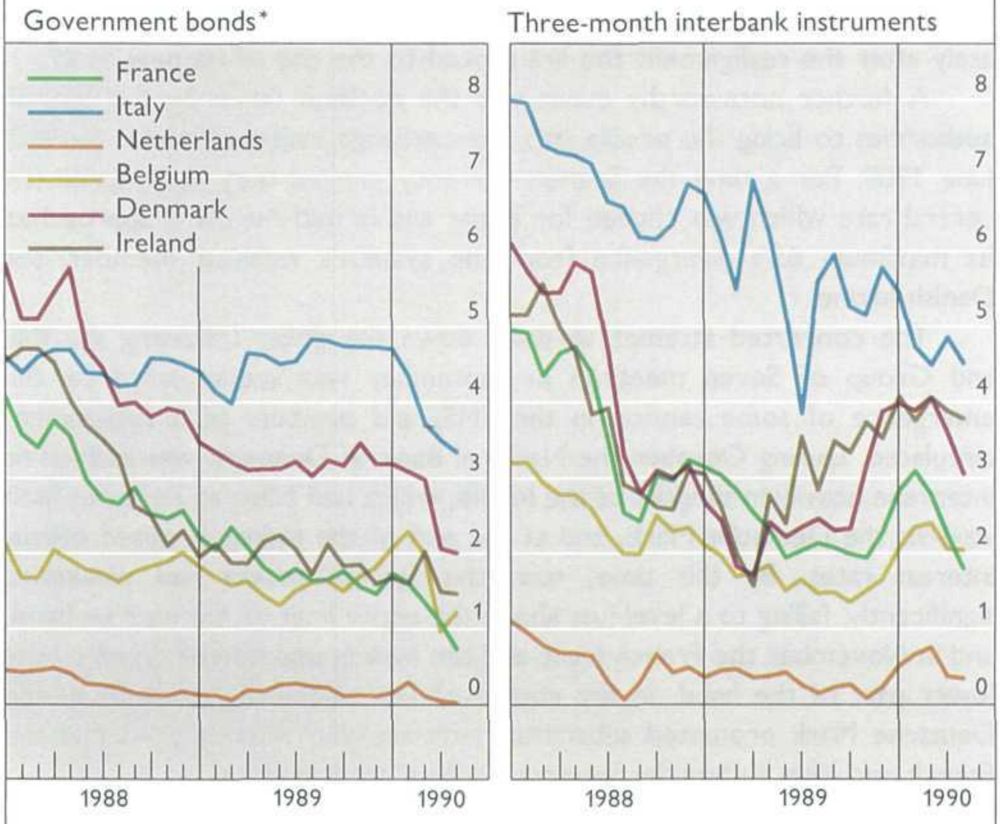
Developments within the EMS

The relative calm in the European exchange rate mechanism (ERM) noted in last year's Annual Report continued throughout much of the period under review despite the ongoing liberalisation of exchange controls in France, Italy and Ireland, the abolition of the dual exchange rate system in Belgium-Luxembourg, the still large German current-account surplus and the buoyancy of the Deutsche Mark in the last few months of 1989. Two important ingredients in this outcome seem to have been the earlier

Relative stability in the ERM ...

Nominal interest rate differentials in ERM countries

Vis-à-vis German interest rates, in percentage points



* For Denmark, all quoted bonds.

strength of the dollar and the firm commitment of the French authorities to avoiding any change in the bilateral Deutsche Mark/French franc central rate, which has helped to bring down French inflation rates to German levels. The confidence bonus of this further progress in economic convergence last year was that the differential between French long-term interest rates and those in Germany continued to narrow and that in the spring of 1990 France was able to lower official lending rates, despite the upward trend of interest rates in Germany.

... as a result of continued economic convergence

Another feature of the earlier part of the period under review was the further gradual appreciation of the Italian lira, until at the end of July 1989 it broke through the upper limit of the narrow band. Persistent intervention against the lira by the Bank of Italy seemed to give a first hint of the authorities' intention to abandon the wider band of fluctuation allowed to the lira, an intention which became fact on 5th January of this year. This timing meant, however, that a downward adjustment of the lira within the wider band could be effected before the new arrangements came into force. In particular, the Italian authorities very pointedly avoided following many other European countries when they raised their official interest rates on 5th October 1989. As a result, between mid-September and the end of the year the lira moved from around 1.5% above the centre of the band to nearly 3% below it. Thus when the realignment

The Italian lira brought into the narrower band came it was a smooth process. The lira's new central rate – which implied a devaluation of 3.7% against all other ERM bilateral central rates – was fixed close to the current market rate, with the lower limit of the new narrow band being identical to that of the previous wider band. Immediately after the realignment the lira moved to the top of its new band.

The peseta joins the ERM

A further noteworthy event was the decision taken by the Spanish authorities to bring the peseta into the exchange rate mechanism on 19th June 1989. For a time the Spanish currency proved very firm, given the central rate which was chosen for entry, and in mid-August it approached its maximum 6% divergence from the system's weakest member, the Danish krone.

Temporary tensions as a result of the pronounced strength of the Deutsche Mark ...

The concerted attempt to drive down the dollar following the IMF and Group of Seven meetings in September was accompanied by the emergence of some tension in the EMS, and rumours of a realignment circulated. During October the National Bank of Denmark was obliged to intervene heavily in support of the krone, which had fallen to its lower limit vis-à-vis the Deutsche Mark, and at the end of the month it raised official interest rates. By this time, too, the Spanish peseta had weakened significantly, falling to a level just above the upper limit of the narrow band, and in November the French franc and the Irish pound moved down to the lower part of the band. In the course of December the strength of the Deutsche Mark prompted substantial intra-marginal interventions and the French and Irish authorities increased official lending rates.

... but recovery of the lira ...

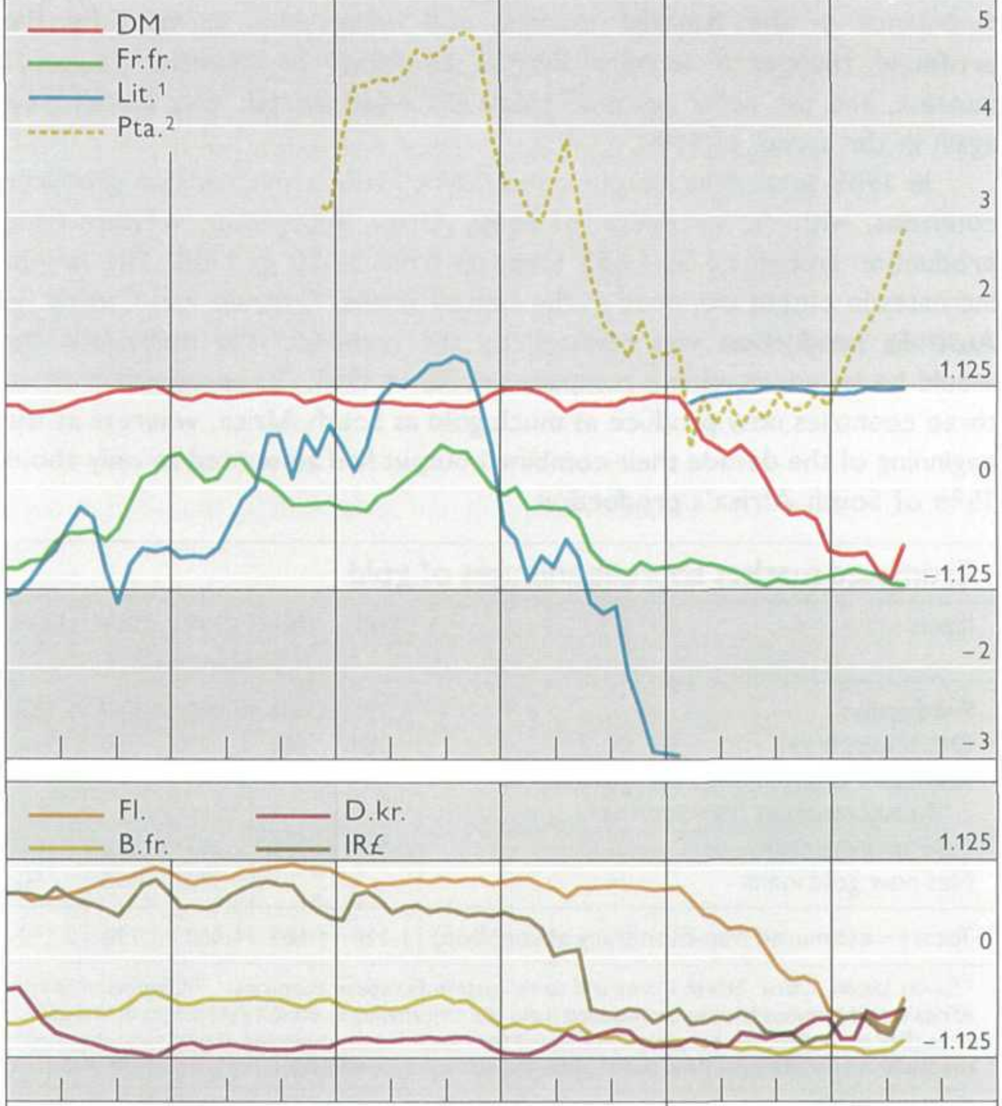
In early 1990, as the realignment of the lira served to defuse expectations of a more general adjustment of central rates, nominal interest rate levels again became a dominant influence on capital flows and the upward pressures on the Deutsche Mark subsided and were even reversed. Although capital inflows contributed to some narrowing of Italian interest differentials, the lira remained by far the strongest currency within the narrow band, obliging the authorities to intervene repeatedly in large volume. This post-realignment firmness of the lira provided a favourable background against which the Italian authorities felt able in mid-May to abolish all remaining exchange controls two months earlier than previously planned. Unperturbed by this move the lira remained at the top of the ERM band. Following the removal of exchange controls on capital inflows, the Spanish peseta, the currency with the highest interest levels in the ERM band, appreciated sharply in the course of April and May.

... and the French franc in early 1990

Similarly, the early abolition of all remaining French exchange controls at the beginning of 1990 was viewed as a positive sign by the market. The downward pressures on the French franc quickly abated and the authorities were able to repurchase reserves as the currency strengthened against the Deutsche Mark, which by then was itself moving away from the top of the ERM band. In March and April, with the French inflation differential vis-à-vis Germany disappearing, the French authorities were able to announce lower official lending rates without any repercussions on the French franc/Deutsche Mark exchange rate. Indeed, despite the narrowing of interest differentials and repeated and extensive intervention purchases by some

Positions of member currencies in the ERM band

Weekly averages of deviations from central rates, in percentages



[1] The lira's central rate was adjusted downwards by 3.7% on 8th January 1990, and its permitted margin of fluctuation was reduced from +/−6 to +/−2.25%. [2] The peseta entered the ERM on 19th June 1989 with a permitted margin of fluctuation of +/−6%.

other ERM countries, the Deutsche Mark moved down within the ERM band throughout the first four months of 1990, and in early May it temporarily joined the French and Belgian francs near the lower limit.

Gold production and the gold market

Sharp increase in the supply of gold to the markets

In 1989 gold supplies soared by over 25% to 2,190 tons, the highest level recorded since the early 1960s. The most important factor behind this large increase was the sharp turn-round in official transactions, but there was also a further expansion of western mine output and increased sales by the Soviet Union, China and some eastern European countries. Although the demand for gold for jewellery and other industrial uses remained buoyant, it was not sufficient in the face of such ample supplies to keep the price from falling during the first nine months of the year, particularly as the strength of the dollar tended to restrain investment demand for gold during that period. In the autumn the slight easing of the dollar, bouts of turbulence in the financial markets and uncertainty spawned by the profound changes in eastern Europe combined to reawaken investor interest, and the dollar price of gold rebounded sharply, only to fall back again in the spring of 1990.

Strongly rising mine output outside South Africa

In 1989 total mine output continued to rise in most major producer countries, with the exception of South Africa. Altogether, western mine production amounted to 1,655 tons, up from 1,550 in 1988. The largest increases in output occurred in the United States, Australia and Canada. In Australia production was boosted by the prospect that corporate tax would be levied on mining company profits in 1991. Taken together, these three countries now produce as much gold as South Africa, whereas at the beginning of the decade their combined output had amounted to only about 15% of South Africa's production.

Estimated market sources and uses of gold

Items	1985	1986	1987	1988	1989
	in metric tons				
Production	1,235	1,295	1,385	1,550	1,655
Other suppliers[1]	250	400	300	260	300
Estimated changes in official gold stocks through market transactions[2] (− = increase)	−165	−10	95	−240	185
Net new gold loans			70	150	50
Total (= estimated non-monetary absorption)	1,320	1,685	1,850	1,720	2,190

[1] Soviet Union, China, North Korea and some eastern European countries. [2] Changes in South Africa's gold reserves have been excluded from the movements in 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.

The dramatic events in eastern Europe last year affected both the demand for and the supply of gold. Partly because of concern about the real value of rouble-denominated claims, internal demand for gold surged in the Soviet Union. The amounts available for private domestic purchases, mainly in the form of jewellery, were, however, not sufficient to satisfy effective demand, which remained strong despite a sharp rise in the administratively set price. Soviet sales of gold in western markets increased because of the pressing need for foreign exchange and because call options written by Soviet exporters were reported to have been exercised when market prices rose temporarily towards the end of the year. Some gold also came onto the market from China and the smaller countries of eastern Europe. Altogether, the supply from these various sources in 1989 may be estimated to have amounted to roughly 300 tons.

Large gold sales by the Soviet Union

In sharp contrast to 1988, when official purchasers acquired considerable amounts of gold, 1989 saw official holders reduce their stocks by about 185 tons. The bulk was drawn from countries' international reserves, Substantial gold sales by official holders

and there was only a modest decline in the gold holdings of the international institutions. Moreover, the disposal of official gold was not confined to the industrial countries, which had on balance tended to reduce their gold holdings in earlier years, but also occurred in the developing countries, which in the aggregate had added to their official gold stocks throughout most of the 1980s. The largest decline in 1989 was recorded by Belgium, which reduced its official gold holdings by 107 tons following a decision early in the year to alter the composition of its international reserves. Mexico drew down its official gold stocks by over one-half, or by more than 47 tons. Canada, in keeping with its long-standing policy of gradually reducing its holdings of monetary gold, sold 32 tons. Austria transferred 15 tons from its reserves to the national mint. Colombia cut its reserve holdings by 15 tons, and the Philippines reported a decline of 12 tons. The only noteworthy net increase in official gold stocks was the 52 ton addition to Spain's holdings, which followed upon a decision to bring the share of gold in the country's official reserves closer to the European Community average.

Declining importance of gold loans

Gold loans, which had boosted market supplies substantially in 1988, declined in importance in 1989. Because of large repayments of earlier loans, the net amount of gold coming onto the spot market from this source may be estimated to have dropped to under 50 tons, compared with 150 tons the previous year.

Continued buoyancy of industrial demand

In 1989 manufacturing demand for gold remained buoyant. Continued growth in incomes and the weakness of the price of gold through the summer underpinned the already strong demand for jewellery, particularly in the Far East and Europe. In Japan the replacement of a 15% luxury tax by a 3% levy in April stimulated purchases of jewellery and similar gold products. On the other hand, the global use of gold for the minting of coins amounted to only about 100 tons, well below the peak of over 300 tons reached in 1986.

Temporary broadening of investment demand

Investment demand for gold appears to have been somewhat more broadly based in 1989 than in the previous year, when such purchases were heavily concentrated in the Far East. After a phase of manifest indifference, European and North American investors began to show some renewed, albeit transitory, interest in gold towards the end of the year. Taiwan's declared non-monetary imports amounted to 160 tons, compared with over 170 tons in 1988. Imports into Japan, at 287 tons, were also somewhat lower than one year previously despite a decision by the authorities that Japanese non-life insurance companies could invest up to 3% of their total assets in gold. On the other hand, Japanese purchases of gold-related financial instruments flourished. Stimulated by less stringent margin requirements, changes in market practices and the decline of the yen, daily trading of kilo gold futures on the Tokyo Commodities Exchange jumped from about 3,000 contracts in September 1989 to over 100,000 in early 1990, although it then fell back to under 20,000 in early April.

Gold price developments

In the face of buoyant equity and other asset prices, the strength of the US dollar and the increasing conviction that inflation could be kept

World gold production								
Countries	1953	1970	1980	1985	1986	1987	1988	1989
	in metric tons							
South Africa	371	1,000	675	672	640	607	621	608
Share of world gold production	*49.1*	*78.6*	*70.2*	*54.4*	*49.4*	*43.9*	*40.0*	*36.8*
United States	61	54	31	80	118	155	201	259
Australia	33	20	17	59	75	111	157	197
Canada	126	75	52	90	106	117	135	158
Brazil	4	9	35	72	67	84	100	97
Philippines	15	19	22	37	39	40	39	37
Papua New Guinea	0	1	14	31	36	34	37	34
Colombia	14	7	17	26	27	33	33	31
Chile	4	2	9	21	22	21	25	26
Zimbabwe	16	15	11	15	15	15	15	16
Venezuela	1	1	1	12	15	16	20	15
Japan	7	8	7	9	14	14	14	11
Other countries	103	62	71	112	122	136	154	164
World total[1]	755	1,273	962	1,236	1,296	1,383	1,551	1,653
Memorandum items:	annual averages, in US dollars per ounce							
Market price of gold								
in current US dollars	*35.00*	*35.94*	*612.76*	*317.30*	*367.59*	*446.63*	*437.09*	*381.54*
in constant US dollars[2]	*35.00*	*24.78*	*199.03*	*78.96*	*89.77*	*105.21*	*98.93*	*82.38*

[1] Excluding the Soviet Union, other eastern European countries, China and North Korea. [2] Deflated by the US consumer price index (1953 = 100).

Source: Gold Fields Mineral Services Ltd. (London).

under control, the dollar price of gold continued to slide for the first nine months of 1989. After having dropped from a five-year peak of $503 per fine ounce in mid-December 1987 to about $410 at the end of 1988, it slipped by a further 13% to a low of $356 in mid-September 1989. The rally that started at that point was quite pronounced and carried the price to nearly $418 by late November, the highest level for the year. The turnround can be attributed to a confluence of factors. Amongst the most important were the shocks which buffeted the financial markets from October onwards, the uncertainty generated by the radical changes in eastern Europe and the weakness of the dollar vis-à-vis the continental European currencies. Coupled with robust manufacturing demand and reduced suppliers' stocks, these factors spurred investor interest and by the end of the year lifted the price of gold almost back to its early 1989 level. Quotations were fairly volatile over the next few months but remained largely within the $400–420 range. In late March 1990, however, the price sank precipitously, dipping below $370 by the end of the month in the wake of large Middle Eastern sales, renewed dollar strength and higher interest rates, and subsequently moved within a range of $367–380 through mid-May.

Temporary strength of quotations in autumn 1989

Since the middle of the 1970s the dollar price of gold has fluctuated widely, peaking at $850 in 1980 and subsequently falling back to trade in the

Gold and commodity prices and the DM/US$ exchange rate

Monthly averages, December 1977 = 100

[1] London market "fixing" price. [2] All commodities, excluding energy.

$300–500 range. Although it has tended to move roughly in sympathy with average non-energy commodity prices, the amplitude of its fluctuations has been much greater. It is noteworthy that, in some contrast to the usual cyclical pattern, the decline in the gold price since late 1987 has occurred against a background of continuing robustness of commodity prices. Part of the explanation may be that, as from 1983, there has been a fairly close inverse relationship between the dollar price of gold and the strength of the US currency vis-à-vis major European currencies. Some non-dollar-based investors appear to treat gold as an alternative to dollar-denominated financial assets, increasing their gold purchases when the dollar weakens. Conversely, the gradual recovery of the dollar since 1988 seems to have discouraged investor demand.

Increasing influence of the dollar on the gold price

International liquidity

Further global reserve growth in 1989

In 1989 the current dollar value of countries' official international reserves other than gold rose by 6%, or $44 billion, to a total of $768 billion. Although stronger than in 1988, this expansion was only a fraction of the exceptionally large increase of 41% recorded in 1987, when official holders had financed the bulk of the US current-account deficit. Because the dollar appreciated on average in 1989, reserve growth was somewhat higher when valuation effects resulting from exchange rate changes are excluded. In SDR terms the expansion of non-gold international reserves amounted to almost 9% in 1989, compared with 7% in 1988 and 21% in 1987. As in

Global non-gold reserves and foreign trade growth						
Years	Total non-gold reserves[1]	Foreign ex-change[1, 2]	Of which: held in US dollars[3]	Annual growth rate of global non-gold reserves		Growth of foreign trade in SDRs
				in current US dollars	in SDRs	
	in billions of US dollars			in percentages		
1967	35.2	29.4	..			
1973	140.7	122.7	76.2	26.0[4]	22.1[4]	14.4[4]
1980	406.8	309.8	68.0	16.4[5]	15.5[5]	18.3[5]
1981	381.8	288.1	70.6	−6.1	2.8	9.2
1982	360.4	270.8	70.0	−5.6	−0.4	−0.1
1983	376.5	276.1	71.2	4.5	10.1	0.7
1984	395.0	300.8	69.9	4.9	12.1	10.8
1985	440.7	336.5	65.3	11.6	−0.5	2.0
1986	507.3	391.6	68.3	15.1	3.4	−4.9
1987	713.8	565.0	65.1	40.7	21.3	6.8
1988	723.8	595.6	63.2	1.4	6.9	10.3
1989	767.6	645.2	59.1	6.1	8.6	12.7

[1] Excluding eastern European countries. [2] Excluding official ecus. [3] Excluding dollars swapped against ecus. [4] Average growth rate for the period 1967–73. [5] Average growth rate for the period 1973–80.

1988, official reserve growth did not keep pace with the rate of expansion of international trade, but this only partly reversed the appreciable increase in the reserves-to-trade ratio that had occurred in 1986–87. Moreover, as discussed in last year's Annual Report, the ongoing globalisation of financial markets and the external financing opportunities associated with it have tended to reduce the general significance of the relationship between the growth of reserves and international trade.

The current dollar value of official gold holdings declined last year by 3%, or $11 billion, to $375 billion. This reduction can be attributed to a 2% decline in the market price of gold between end-1988 and end-1989, coupled with some official net sales.

Continued increase in the share of foreign exchange assets

As in previous years, the expansion of non-gold reserves in 1989 was heavily concentrated in foreign exchange holdings. Indeed, at almost $50 billion, the accrual of foreign exchange assets, excluding official ecus, exceeded the rise in total non-gold reserves. Measured at constant exchange rates, the expansion was still greater ($53 billion, or 9%). The further strong increase in this component of international liquidity brought the share of foreign exchange holdings in total non-gold reserves to 84% in 1989, up from 77% three years earlier.

Unprecedentedly large US official foreign exchange purchases ...

The main influence shaping the pattern and geographical distribution of exchange reserve growth was the constellation of exchange market pressures and the intervention policies of the major industrial countries. The novel feature last year, however, was the very strong presence of the US monetary authorities in the exchange markets. In its efforts to moderate the rise of the dollar, the United States bought large amounts of Deutsche Mark and Japanese yen. This was the main reason for the $27.2

billion increase in US exchange reserves, which boosted US official holdings by over 150% and accounted for well over half of global reserve growth last year. As a result, US official exchange reserves, at $44.6 billion, are now the largest after those of Japan, Taiwan and Germany.

Were the greater symmetry between the United States and other countries to become a permanent feature of the exchange markets, this would have important implications for the international monetary system. For one thing, it would loosen the quasi-automatic link between US balance-of-payments deficits or dollar weakness and global reserve growth. Global reserves may expand, or fail to contract, even when, as in 1989, the dollar is strong and the US official settlements balance is in surplus. In fact, the growth of US official exchange reserves last year more than offset the reserve losses of countries such as Japan and the United Kingdom whose currencies were under persistent downward pressure and which therefore drew down their dollar reserves. Moreover, since the United States necessarily holds its exchange reserves in non-dollar form, the growing presence of the United States in the exchange markets automatically entails an enhanced role for other currencies and countries as reserve media and reserve currency centres.

... limiting the official dollar reserve losses of other countries

A second reason for the fairly strong expansion of official exchange reserves last year was the intervention undertaken by countries participating in the EMS exchange rate mechanism. For example, faced with massive capital inflows, the Italian authorities added substantially to their foreign exchange reserves during the first nine months of 1989. The fact that such exchange market intervention in an ERM context largely takes the form of purchases of currencies other than the dollar, i.e. predominantly other member currencies such as the Deutsche Mark, means that, instead of leading simply to a redistribution of dollar reserves between member countries, it adds to total reserve growth. In a case such as that cited above, Italy's reserve holdings of Deutsche Mark will increase, while Germany's own dollar reserve holdings will not decline or might even expand. As a matter of fact, despite some official dollar sales in support of the Deutsche Mark, Germany's official exchange reserves (excluding official ecus) grew by $5.1 billion last year, largely as a result of interest accruals on reserve assets.

EMS interventions contribute to strong growth in non-dollar reserves

A third important influence on global exchange reserve growth last year was reserve accumulation by a number of developing countries and some smaller developed countries outside the Group of Ten and the ERM, such as Portugal, Turkey and Yugoslavia.

Official non-gold reserves other than foreign exchange assets declined by nearly $6 billion last year, although about $2.3 billion of this decrease was due to exchange rate effects. Moreover, the modest $0.9 billion contraction in official reserves held in the form of ecus was more than accounted for by the fall in the price of gold: the stock of official ecus is maintained by rolling over swaps of dollars and gold at market-related prices, and in 1989 the reference price used by the European Monetary Co-operation Fund (EMCF) for swaps involving gold fell by about 7.5%. In

Decline in other reserve assets as a result of ...

... reduced ecu swaps ...

Changes in global reserves							
Areas and periods	Gold		Foreign ex-change	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							
1987	−1.4	69.8	93.0	0.3	3.2	21.8	118.3
1988	−1.9	−56.9	19.5	−3.0	0.3	−15.3	1.5
1989	−4.4	− 8.5	25.8	−0.9	−0.5	− 1.1	23.3
Amounts outstanding[2]	728.9	292.3	296.1	22.2	20.7	53.5	392.5
Other developed countries[3]							
1987	−1.9	7.1	28.5	0.5	0.5	5.0	34.5
1988	−4.2	− 7.9	12.8	0.3	−0.1	2.7	15.7
1989	0.5	− 0.5	8.5	0.3	0.1	0.2	9.1
Amounts outstanding[2]	78.4	31.5	107.3	3.6	2.5	8.6	122.0
Developing countries							
1987	0.3	11.8	51.9	0.6	1.2	–	53.7
1988	6.6	− 6.7	−1.7	−3.8	−1.7	–	−7.2
1989	−2.0	− 2.0	15.3	−4.0	0.1	–	11.4
Amounts outstanding[2]	127.3	51.0	241.8	7.7	3.6	–	253.1
of which: Major debtor countries[4]							
1987	*−1.5*	*2.6*	*4.1*	–	*0.9*	–	*5.0*
1988	*1.1*	*− 2.1*	*−6.2*	*−0.7*	*−1.1*	–	*−8.0*
1989	*−1.9*	*− 1.1*	*2.2*	–	*−0.1*	–	*2.1*
Amounts outstanding[2]	*31.7*	*12.7*	*29.8*	*0.1*	*0.6*	–	*30.5*
Middle Eastern oil exporters[5]							
1987	*−0.2*	*2.2*	*4.0*	*0.5*	*0.4*	–	*4.9*
1988	*0.1*	*− 1.7*	*−3.8*	*−2.9*	*−0.3*	–	*−7.0*
1989	–	*− 0.2*	*1.8*	*−4.1*	*0.2*	–	*−2.1*
Amounts outstanding[2]	*22.8*	*9.2*	*36.9*	*5.6*	*1.6*	–	*44.1*
Total[3]							
1987	−3.0	88.7	173.4	1.4	4.9	26.8	206.5
1988	0.5	−71.5	30.6	−6.5	−1.5	−12.6	10.0
1989	−5.9	−11.0	49.6	−4.6	−0.3	− 0.9	43.8
Amounts outstanding[2]	934.6	374.8	645.2	33.5	26.8	62.1	767.6

[1] Gold reserves valued at market prices. [2] At end-1989. [3] Excluding eastern European countries. [4] Baker countries excluding Yugoslavia. [5] Iran, Iraq, Kuwait, Libya, Oman, Qatar, Saudi Arabia and the United Arab Emirates.

addition, the aggregate official gold holdings of the countries concerned declined slightly, despite the accession of the Luxembourg Monetary Institute to the EMCF. These influences were partially offset by ecu creation as a result of the increase in the dollar holdings of member countries.

After falling by 15% in 1988, overall reserve positions in the

... and smaller reserve positions in the Fund

International Monetary Fund declined last year by a further 12%, or by $4.6 billion, with Saudi Arabia alone recording a contraction of $4 billion. This can be attributed principally to the fact that for the fourth year in succession repayments of Fund credit (SDR 5.9 billion) continued to exceed new drawings (SDR 3.5 billion), which led to reduced use by the IMF of members' currencies and thus to a fall in these countries' reserve positions in the Fund. However, last year saw a considerable increase in new Fund credit arrangements, in part because of a decision in May to support debt and debt service reductions. Commitments to provide financing to members more than doubled during the course of 1989 to $18.1 billion, with undrawn amounts nearly trebling to $13.3 billion. Drawings under Extended Facility Arrangements intended to assist countries facing medium-term balance-of-payments problems jumped from $0.3 billion to $1.5 billion, while loans outstanding to low-income countries under the Structural Adjustment and Enhanced Structural Adjustment Facilities rose by $1.3 billion to $2.4 billion.

Decreasing role of SDRs

Expressed in SDR terms there was only a notional increase in the volume of SDRs in 1989, with the $0.3 billion fall in the US dollar value of the total stock being entirely due to the appreciation of the US currency. At the end of the year SDRs accounted for only about 3.5% of total non-gold reserves, down from 4.7% three years earlier. The progressive decline in the share of the SDR in global liquidity has occurred because the growth of reserves in other forms has been deemed adequate and no agreement could be reached on new allocations. Over the years there has been some change in the way SDRs are used. No designated transactions have been undertaken, and all transfers that have recently occurred have been voluntary.

In May 1990 the IMF's Interim Committee agreed that Fund quotas should be raised by 50% to SDR 135 billion (approximately $180 billion). This quota increase will be accompanied by an adjustment of the voting rights of some of the major industrial countries to reflect changes in their relative economic importance. Japan and Germany will share second place after the United States, while the United Kingdom and France will rank equally in fourth place. Agreement was also reached on ways to strengthen the strategy for dealing with the problem of arrears on Fund credit. Firstly, the quota increase was made conditional on the IMF's Articles of Agreement being amended to allow the suspension of the voting and related rights of member countries which are manifestly unwilling to co-operate with the Fund in reducing their arrears. Secondly, a new approach was endorsed to assist the eleven developing countries which are now in arrears to eliminate their $4.2 billion in overdue obligations.

Further growth in Group of Ten countries' overall reserve holdings as ...

Turning to the geographical distribution of last year's global reserve growth, the official non-gold reserves of the Group of Ten countries increased by $23.2 billion, or 6%. As in 1988, this aggregate growth was the net outcome of substantial accruals by some countries offset by extensive use of reserves by others. By far the largest expansion occurred in the United States, where official reserves rose by 73% to nearly

Changes in individual countries' official non-gold reserves*				
Countries	Changes			Amounts outstanding at end-1989
	1987	1988	1989	
	in billions of US dollars			
Developed countries	152.8	17.2	32.4	514.5
United States	−2.7	2.0	26.8	63.6
Other Group of Ten countries	121.0	− 0.5	− 3.5	328.9
Japan	38.8	15.7	−12.8	84.0
Germany	26.9	−20.3	2.4	60.7
Italy	10.2	4.5	12.2	46.7
United Kingdom	23.3	2.4	− 9.3	34.8
Switzerland	5.7	− 3.3	1.0	25.2
France	1.6	− 7.6	− 0.8	24.6
Netherlands	4.8	0.0	0.5	16.5
Canada	4.0	8.1	0.7	16.0
Belgium	4.1	− 0.3	1.5	10.8
Sweden	1.6	0.3	1.1	9.6
Other developed countries	34.5	15.7	9.1	122.0
Spain	15.9	6.4	4.4	41.5
Portugal	1.9	1.8	4.9	10.0
Denmark	5.1	0.7	− 4.4	6.4
Turkey	0.4	0.6	2.4	4.8
Yugoslavia	−0.8	1.6	1.8	4.1
Developing countries	53.7	− 7.2	11.4	253.1
Newly industrialising economies	33.0	7.7	5.5	108.7
Taiwan	30.4	− 2.9	− 0.7	73.2
Singapore	2.3	1.8	3.3	20.3
South Korea	0.3	8.8	2.9	15.2
Middle Eastern oil exporters	4.9	− 7.0	− 2.1	44.1
Saudi Arabia	4.4	− 2.1	− 3.8	16.7
Kuwait	−1.4	− 2.2	1.2	3.1
Other developing countries	15.8	− 7.9	8.0	100.3
China	4.9	2.2	− 0.6	18.0
Thailand	1.2	2.1	3.4	9.5
Mexico	6.8	− 7.2	1.1	6.3
Indonesia	1.5	− 0.5	0.4	5.5
Israel	1.2	− 1.9	1.3	5.3
Venezuela	−0.5	− 2.9	1.0	4.1
India	0.1	− 1.6	− 1.0	3.9
Total	206.5	10.0	43.8	767.6

* Including official ecu positions, but excluding eastern European countries.

$64 billion, the highest level ever recorded by this country. Italy experienced strong reserve growth ($12 billion) for the fourth year in succession. Germany, after drawing heavily on its international reserves in 1988 and the first half of 1989, when the Deutsche Mark had frequently been under downward pressure, added $5 billion to its official non-gold holdings in the second half of the year, when the Deutsche Mark was firm not only against

... strong reserve gains in the United States and Italy ...

the yen but also against the dollar. Smaller reserve accruals were recorded by Belgium, Sweden, Switzerland, Canada and the Netherlands.

... are only partly offset by Japanese and UK reserve losses

The largest absolute decline in reserve holdings among the Group of Ten countries occurred in Japan, where persistent intervention in favour of the yen was the primary reason for the $13 billion, or 13%, reduction in official non-gold reserves. The United Kingdom, which also intervened heavily in support of its currency, experienced the largest relative decline (21% or $9 billion) in its reserves.

Substantial reserve accruals in other developed countries ...

In the aggregate, the other developed countries added $9.1 billion to their non-gold reserves. The largest increases were recorded by Portugal ($4.9 billion, or 96%), Spain ($4.4 billion, or 12%), Turkey ($2.4 billion, or 100%) and Yugoslavia ($1.8 billion, or 78%). By contrast, Denmark, whose currency came under heavy pressure at times in the ERM, saw its official holdings decline by over 40% to $6.4 billion.

... and in the developing world

One noteworthy feature of the global pattern of reserve accruals last year was the resumption of the growth of the official assets of the developing countries. After dropping by $7.2 billion in 1988, the non-gold reserves of these countries expanded by $11.4 billion, or nearly 5%. The largest accumulations were recorded by Thailand ($3.4 billion), Singapore ($3.3 billion) and South Korea ($2.9 billion). Even though a number of countries built up arrears on their external debt at an unprecedented pace, the reserves of fourteen major debtor countries addressed by the Baker Initiative grew by only $2.1 billion. Mexico alone, which sold a considerable amount of gold last year, registered a $1.1 billion increase in its non-gold reserve assets.

Among Middle Eastern oil-exporting countries, Saudi Arabia recorded a further $3.8 billion contraction in its reserve assets. Elsewhere, India's reserves, which had already fallen sharply in 1988, declined by a further $1 billion to only $3.9 billion, or 60% of their level two years earlier. China, which had added significantly to its reserves in the two preceding years, reduced its holdings by $0.6 billion.

Strong growth in non-dollar exchange reserves, notably in Deutsche Mark ...

One of the outstanding features relating to the deployment of reserve accruals last year was the further marked expansion of official holdings of currencies other than the dollar. In fact, whereas dollar assets increased by only a little over 1% last year, other foreign exchange holdings expanded by 20%. Deutsche Mark reserves grew by about $30 billion to $128 billion, and official holdings of private ecus soared by nearly 60% to over $20 billion. As already explained, the increasing share of non-dollar holdings was in large measure a consequence of the intervention undertaken to stem the rise of the US currency, which entailed purchases of non-dollar assets by the United States and sales of dollars by other Group of Ten countries. However, it also reflected exchange market intervention in the context of the ERM and a more general trend towards reserve diversification.

Over the past fifteen years the share of reserves invested in secondary reserve currencies, particularly the Deutsche Mark, has expanded steadily. The data available suggest that in 1975 only about 9% of world exchange reserves were held in the German currency but that by the end of 1989 the share had increased to 20%. Over roughly the same period, between the end of 1973 and the end of 1989, the share of the dollar contracted from about 76% to under 60%, 4 percentage points of this decrease occurring during 1989.

... leading to a further decline in the share of the dollar

In the first three months of 1990 the non-gold reserves of the Group of Ten countries fell by $6 billion, or by $2.5 billion in constant dollar terms. This was because fairly large declines in Japan, Switzerland, Canada and the United Kingdom were not fully offset by the more modest reserve gains in other countries. Japan, in particular, which intervened heavily in the exchange markets in support of the yen, drew down its non-gold reserves by $10.4 billion. On the other hand, after the adjustment of its central rate in January, the lira displayed considerable strength, and Italy added $4.6 billion to its international reserves as it sought to keep its currency from moving outside the newly adopted narrower fluctuation band. Although the dollar remained quite buoyant, particularly vis-à-vis the yen, US intervention was much more modest than in the first half of 1989 and the United States added only $1.7 billion to its international reserves.

The 1989 foreign exchange market survey

Coverage of the survey

In 1989 twenty-one central banks and monetary authorities conducted detailed surveys of foreign exchange turnover in their countries in order to obtain a comprehensive picture of the scope and nature of exchange market activity. Banks and other major dealers were asked to provide information on the nominal value of all spot, forward and derivative product deals concluded during April, which was deemed to be a representative month. Because each transaction was to be counted once and only once, no account was taken of any netting or other settlement arrangements that might be in force, but efforts were made to eliminate the double-counting which arises when both counterparties to a deal report the same transaction. Notwithstanding certain differences in coverage and methodology and some omissions such as the absence of turnover data for Germany, the survey was the most comprehensive ever carried out and provides a basis for estimating total global foreign exchange market activity in a month relatively free of the types of shock liable to distort the volume and pattern of trading.

Huge volume of daily turnover ...

One of the most striking features emerging from this survey is the sheer size of the foreign exchange market. After eliminating all double-counting and making approximate allowance for gaps in the reporting of turnover, global exchange trading may be estimated to have amounted to roughly $650 billion per day, which was nearly forty times the average daily value of world exports of goods and services at the time of the survey. This suggests that, even allowing for the fact that an individual commercial transaction may give rise to a whole series of exchange market operations, foreign trade alone can account for only a fraction of global exchange market activity. The bulk must be driven by international capital flows and

... largely explained by financial transactions

Foreign exchange market activity in April 1989

Countries and items	Net turnover[1]	Of which:[2] Business with customers	Net domestic interbank operations	Cross-border interbank operations	Net spot turnover[1]	Identified US dollar transactions as a share of gross turnover
	average daily turnover in billions of US dollars					in percentages
United Kingdom	187[3]	26	54[3]	107[3]	(119)	89.6
United States	129[3]	10	45[3]	71[3]	81	96.0
Japan	115	34	31	47	46	95.2
Switzerland[4] [85%]	57	9.0	11	36	30	75.0
Singapore	55	(6.0)	8.0	(41)	(31)	95.2
Hong Kong	49	5.4	11	33	(30)	93.2
Australia	30	6.0	7.0	15.0	18	97.3
France[4] [95%]	26[3]	5.0	6.0[3]	15[3]	(15)	71.9
Canada	15	4.0	2.7	7.8	6.1	94.4
Netherlands	13[3]	1.5	3.1[3]	8.5[3]	7.2	68.8
Denmark[4] [90%]	13	1.3	1.8	10	(6.4)	80.0
Sweden	13	1.6	1.4	8.7	9.5	100.0
Belgium[4] [90%]	10	1.3	1.6	7.6	5.2	81.7
Italy[4] [75%]	10	1.4	0.8	8.0	7.6	53.6
Other countries[5]	22	1.6	4.4	15	16	80.7
Total	744	114	189	431	428	89.9
Adjustment for cross-border double-counting	−204				−123	
Total reported net turnover	540				305	
Estimated gaps in reporting	100				55	
Estimated global turnover	640				360	

Note: Figures in parentheses are rough estimates. Totals may not tally owing to rounding.

[1] The figures for individual countries indicate turnover net of double-counting arising from local interbank business. The totals at the foot of the table are estimates of turnover net of double-counting arising from both local and cross-border interbank business. [2] The items do not always sum to total net turnover because the classification is not exhaustive. [3] Based on estimates of domestic and cross-border interbank business arranged through brokers. [4] No adjustment for less than full coverage; estimated market coverage is given in square brackets. [5] Bahrain, Finland, Greece, Ireland, Norway, Portugal and Spain.

Source: Survey of Foreign Exchange Market Activity, BIS, February 1990.

the constant hedging, arbitrage and position-taking associated with modern risk management strategies.

High geographical concentration of business

Another salient feature of the market is the fairly heavy concentration of trading in a few countries. The United Kingdom, the United States and Japan, the leading centres in the European, American and Asian time zones, together accounted for nearly 60% of total reported global trading. The inclusion of the three next most important centres (Switzerland, Singapore and Hong Kong) brings the figure up to 80%.

The survey demonstrates that spot transactions still dominate exchange market trading. Even when such deals are defined in a narrow sense to include only outright spot transactions concluded during the month in question and to exclude the spot leg of swaps and maturing forward contracts, net spot market activity amounted to 56% of estimated total global dealing. The share ranged between 40 and 64% in the major centres but was appreciably higher in the smaller markets, where exchange controls and tax treatment sometimes inhibit or discourage forward, futures and options transactions.

Predominance of interbank operations

Although it has become increasingly difficult to distinguish between "interbank" and "customer" business in the foreign exchange market, it can safely be said that interbank dealing dominates the market. Over three-quarters of net reported transactions, excluding double-counting, took place between banks and other dealers located either at home or abroad. In the aggregate, business with banks abroad is more extensive than local interbank transactions. However, the latter type of activity is particularly important in the three major foreign exchange markets, presumably because a large number of foreign banks find it convenient to carry out much of their foreign exchange trading and risk management operations through affiliates located in the principal centres.

Prominence of the US dollar

The US dollar is the dominant currency in the foreign exchange market. It was on one side of roughly 90% of all deals concluded. The yen and the Deutsche Mark are the next most important currencies, each being involved in slightly over one-quarter of all deals, either against the dollar or against third currencies. Local currencies, such as the dollar in the United States and the yen in Japan, are employed in slightly over one-half of global transactions. The importance of the local currency varies greatly, being used in over 95% of all transactions in the United States but only in about 10% in Bahrain, Singapore and Hong Kong. Only a negligible proportion of transactions involved neither the local currency nor any of the three most actively traded currencies.

Rapid growth of turnover

The growth of total foreign exchange trading between March 1986, the date of the last survey, and April 1989 appears to have been dramatic. Total net turnover in the four countries (Canada, Japan, the United Kingdom and the United States) which collected data in both 1986 and 1989 expanded by about 116%, which was more than double the increase in the foreign trade of these countries and one and a half times the expansion of the international on-balance-sheet business of banks in their markets. The growth of foreign exchange market activity was strongest in countries experiencing the greatest increase in international banking business, suggesting again that many foreign exchange transactions are financially driven. Notwithstanding a diversification in the range of currencies traded and the emergence and growth of markets for futures and options, which now account for almost 3% of reported gross turnover, the pattern of foreign exchange market trading seems to have become somewhat more homogeneous across the main market centres over the past three years. This is reflected in such features as a narrower dispersion of the shares of interbank trading.

Growth of foreign exchange market transactions, foreign trade and international banking activity

Countries	Exchange market turnover: percentage changes between March 1986 and April 1989			Exports and imports of goods and services: percentage changes between first quarter 1986 and first quarter 1989	International claims of BIS reporting banks: percentage changes between end-March 1986 and end-March 1989
	Net turnover	Transactions with customers	Spot transactions		
United Kingdom	108	221	81	62	40
United States	120	134	134	39	39
Japan	140	111	142	82	203
Canada	58	38	53	44	−4
Total	116	136	104	54	76

Implications for the effectiveness of official exchange market intervention

Although the volume of trading in the global foreign exchange market is extremely large, with transactions on a single day nearly equivalent to the total stock of official foreign exchange reserves, this does not allow conclusions to be drawn about the effectiveness of official exchange market intervention. Firstly, exchange rates are determined by the net demand for individual currencies and not by the very large gross volume of frequently offsetting sales and purchases. Moreover, even fairly small transactions by central banks may, when strategically timed and astutely carried out, have a marked impact on expectations and market sentiment. This is all the more likely when intervention is concerted and gives an unambiguous signal to the markets. To be sure, exchange market intervention on its own is bound to be of only limited significance over a longer period and for this reason is best seen as one of a variety of instruments to be used within a broad economic policy strategy aimed at ensuring fundamental and lasting stability in macro-economic conditions.

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 the role of international banks in a rapidly changing financial environment.

The Basle Committee on Banking Supervision, formerly the Committee on Banking Regulations and Supervisory Practices, continued its work of encouraging co-operation in the prudential supervision of international banks. Much of its time was devoted to monitoring the implementation of the agreement on international convergence of capital measurement and capital standards reached by the Group of Ten central bank Governors in July 1988. The Committee also made progress in developing a supervisory framework for measuring foreign exchange risk, position risk in securities trading and interest rate risk. In September 1989 the Committee held a second meeting in Basle with representatives of securities industry regulators in the Group of Ten countries. It also continued to maintain close contact with groups of bank supervisors from other countries. In April 1990 the Committee issued a Supplement to the supervisors' Concordat of 1983 on "Principles for the Supervision of Banks' Foreign Establishments", designed to facilitate increased practical co-operation between supervisors of international banks throughout the world.

The Group of Experts on Payment Systems continued to provide the forum within which representatives of the central banks of the Group of Ten countries regularly meet to exchange information on developments in payment media and systems in their respective countries. Under the aegis of the BIS the Group published in December 1989 the first of a new regular series of Statistics on Payment Systems. Reflecting the increased attention paid by the Group to the policy issues relating to clearing and settlement systems, the Group also published in May 1990 a study on large-value funds transfer systems in the Group of Ten countries.

Following the February 1989 "Report on Netting Schemes" prepared by the Group of Experts on Payment Systems, the central bank Governors of the Group of Ten countries set up in the spring of last year a high-level ad hoc Committee on Interbank Netting Schemes to consider the broad policy issues raised by these schemes which were identified in the Group of Experts' report. The issues which the Committee is considering, with the aid of reports from a number of working parties, include the implications of netting schemes for interbank markets, for monetary policy and supervisory practices and for various central bank operations, as well as the legal basis and implications of such schemes. The Committee is scheduled to complete its work this summer and a report will be published later in the year.

The Group of Computer Experts continued to give priority to security issues, in particular the phenomenon of "computer viruses". The Group also paid attention to events that could disrupt the operation of electronic funds transfer systems and discussed measures designed to prevent such events from occurring or to limit their effects. A further important part of the Group's work was devoted to the need to adapt the central banks' data-processing services to developments in the technological environment and to the changing relationships with users.

The Group of Experts on Monetary and Economic Data Bank Questions focused its attention on the BIS Data Bank and its services to central banks in the Group of Ten countries. Upgraded telecommunication links were tested successfully for reporting and accessing data, in particular with a view to making further advances in the exchange of data on a daily basis. Steps were taken by the central banks and the BIS to expand the number of data series, most notably with respect to data on international bonds, notes and credits. There was a continuing interest in broadening the coverage of macro-economic series on countries outside the Group of Ten. Ways of achieving this were considered, including steps that might follow from bilateral arrangements for automated data exchange between the BIS and central banks outside the Group of Ten.

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.

The 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 European Monetary System, monetary policy co-ordination and the preparations for stage one of economic and monetary union in the Community, which is to commence on 1st July 1990. With a view to this event the Council Decision of 8th May 1964 on co-operation between the Central Banks of the Member States of the European Economic Community, which established the Committee of Governors, has been amended by a Council Decision adopted on 12th March 1990. At the same time the Committee has strengthened its existing structure and working procedures with a view to intensifying co-operation between Community central banks and the co-ordination of monetary policies.

The Board of Governors of the EMCF received applications from the Austrian National Bank and the Bank of Norway requesting 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 July and November 1989 respectively. The designation of these two central banks brings the number of Other Holders of official ecus to five, the BIS, the Swiss National Bank and the Central Bank of Malta having obtained this status earlier.

2. Functions as Agent and Trustee

During the past financial year the Bank continued to perform various Agency functions in connection with international financial settlements.

(a) Agent for the European Monetary Co-operation Fund (EMCF)

The Bank continued to perform the functions of Agent for the EMCF which it has been executing since 1st June 1973.* These functions, on the one hand, are connected with the operation of the EMS and, on the other, relate to the execution of financial operations in connection with Community borrowing and lending for the purpose of balance-of-payments support for EC member countries.

During the period from 1st April 1989 to 31st March 1990 very short-term financing operations through the intermediary of the EMCF in connection with interventions carried out by EMS central banks in other EMS member countries' currencies amounted to approximately ecu 1.5 billion.

* For a description of the structure and functions of the Fund, see the fifty-fourth Annual Report, pages 162–164.

The volume of ecus issued by the EMCF through quarterly swap operations with each of the EC central banks that are signatories to the Agreement of 13th March 1979 and with the Luxembourg Monetary Institute fell from ecu 52.7 billion at 1st April 1989 to ecu 49.4 billion at 31st March 1990. This contraction of ecu 3.3 billion over the year was due primarily to the fall in the price of gold expressed in ecus and the decline in the exchange rate of the US dollar vis-à-vis the ecu, but also to the decrease in some EC central banks' US dollar contributions.

Transfers of ecus between the "Ecu reserves" accounts of the EC central banks and of Other Holders of ecus totalled approximately ecu 3.2 billion during the period under review. For the most part they related to repurchases of ecus by a central bank with a view to settling its net debtor position in ecus, viz. approximately ecu 2.6 billion. The remainder represented transactions in connection with operations between EC central banks and Other Holders of ecus and 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.

The following table shows, as at 31st March 1990, the total of outstanding Community borrowing and lending operations.

Outstanding Community loans as at 31st March 1990

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]

As from May 1987, the system was opened to further EBA member

[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.

banks which, following their formal application, were granted the status of clearing bank by the Association. Nineteen banks joined the system in 1987, seven in 1988 and twelve in 1989, bringing the number of participating banks to forty-five as at 31st March 1990, compared with seven at the outset in 1986.

3. Financial assistance to central banks

Besides its normal banking operations, the BIS took part in three publicly announced bridging loans during the year under review:

(a) Within the context of the Brady Initiative, short-term credit support of up to US$ 2,000 million was offered to the Banco de Mexico in August 1989 in order to prefinance disbursements under an IMF Extended Fund Facility and three World Bank policy-based loans. Alongside a bilateral arrangement of US$ 1,000 million granted by the US monetary authorities, multilateral arrangements of US$ 1,000 million were set up to which the BIS (backed by ten member central banks) contributed US$ 700 million; the balance was provided by the US authorities (US$ 250 million) and the Bank of Spain (US$ 50 million).

In the event, the Banco de Mexico only drew down some US$ 672.6 million under the multilateral arrangements on 25th September 1989, of which some US$ 470.8 million was provided by the BIS. This was reduced in successive stages until the final repayment was made on 15th February 1990 on expiry of the facility.

(b) In December 1989 arrangements for a credit facility of US$ 500 million were concluded in favour of the National Bank of Poland: the BIS, with the backing of twelve member central banks, committed a maximum of US$ 300 million, the balance of US$ 200 million being provided by the US monetary authorities. This bridging finance, which was linked to expected disbursements under an IMF Standby Arrangement and various World Bank loans, was to be drawn in several tranches up to the beginning of May 1990.

The first tranche of US$ 215 million was drawn on 28th December 1989 and repaid in advance on 9th February 1990. The BIS share amounted to US$ 129 million. The facility was terminated in early May 1990 without any further drawings being made.

(c) In March 1990 the BIS participated in a US$ 400 million bridging facility in favour of the Banco Central de Venezuela intended to prefinance disbursements expected before the end of April under an IMF Extended Fund Facility and World Bank structural adjustment/trade policy loans. The BIS granted US$ 296 million (with the backing of six member central banks) to be drawn in three tranches pari passu with a parallel US$ 104 million arrangement established by the US monetary authorities.

A single drawing of US$96 million was made under the facility on 30th March 1990, the BIS share amounting to US$71 million. This had been fully repaid when the facility expired on 30th April 1990.

4. Operations of the Banking Department

The Balance Sheet of the Bank and the Profit and Loss Account at 31st March 1990, certified by the auditors, are reproduced at the end of this Report; they are expressed in gold francs.*

On 31st March 1990, the end of the financial year 1989–90, the balance-sheet total stood at GF 41,291,112,116
whereas on 31st March 1989 it had amounted to GF 42,233,811,401
There was thus a decrease of GF 942,699,285
or 2.2%. Had it not been for the effect of exchange rate changes, which resulted in an appreciation, in gold franc terms, of most currencies other than the US dollar, the decline in the Bank's balance-sheet total would have been considerably more pronounced. It should be mentioned that this decline occurred after a succession of increases recorded since the end of the financial year 1981–82.

The contraction in the balance-sheet total during the financial year under review was the result of a decrease in resources in gold and in currencies received both from central banks and from other depositors.

BIS: Development of the balance-sheet total over the past five financial years

Financial years ended 31st March	Balance-sheet total	Movement over the year	
	in millions of gold francs		in percentages
1986	26,558	+ 3,706	+ 16
1987	29,944	+ 3,386	+ 13
1988	38,151	+ 8,207	+ 27
1989	42,234	+ 4,083	+ 11
1990	41,291	− 943	− 2

The following are not included in the Balance Sheet:
– bills and other securities held in custody for the account of central banks and other depositors;
– accounting entries arising from the Bank's functions as Agent for the European Monetary Co-operation Fund as described in Section 2 above;
– gold held under earmark for the account of various depositors; this item rose appreciably, amounting to 1,413 million gold francs on 31st March 1990, compared with 1,238 million gold francs at the end of the preceding financial year.

* 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			
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
1990	1,476	38,673	1,142	41,291

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 the financial year 1989–90 GF 622,416,157

This compares with 600.8 million gold francs on 31st March 1989; the difference of 21.6 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 the financial year 1989–90 GF 39,530,055

This represents an increase of 4 million gold francs compared with 31st March 1989, when this Fund had been raised to 35.5 million gold francs. The proposed increase, by transfer from the net profit, is in accordance with the provisions of Article 51(4) of the Statutes.

(4) Free Reserve Fund
after allocation of the net profit
for the financial year 1989–90 GF 488,466,872

This Fund had been raised to 442.1 million gold francs on 31st March 1989; it has been recommended that an amount of 46.4 million gold francs be transferred to this Fund, also from the net profit.

The total of the Bank's reserves thus shows an increase of 72 million gold francs after allocation of the net profit for the financial year 1989–90, to stand at GF 1,180,483,397 compared with 1,108.5 million at the end of the preceding financial year.

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
	1989	1990	
	in millions of gold francs		
Deposits of central banks	38,385	37,374	−1,011
Deposits of other depositors	1,490	1,299	− 191
Total	39,875	38,673	−1,202

"Deposits of central banks" decreased by 2.6% and "Deposits of other depositors" by 12.8%. The percentages would have been greater had it not been for the effect of exchange rate fluctuations on both items.

The contraction in "Deposits of other depositors" was mainly due to a reduction in deposits received from various international organisations.

Over the financial year as a whole, there was a substantial decline in deposits in US dollars; on the other hand, resources in most other currencies increased, in some cases appreciably. Deposits in US dollars remained the largest item, however, followed by those in Deutsche Mark.

On 31st March 1990 the share of "Deposits of central banks" represented 96.6% of total borrowed resources, while that of "Deposits of other depositors" amounted to only 3.4%. At the end of the financial year 1988–89 the corresponding percentages had been 96.3% and 3.7%.

Sight deposits in gold and in currencies decreased. There was a slight increase in borrowed funds with a maturity not exceeding three months, while currency deposits with a maturity of over three months recorded a marked decline.

As a proportion of total borrowed funds, the share of deposits in gold and that of deposits in currencies remained relatively stable. Deposits in gold accounted for 11.6% and those in currencies 88.4%, compared with 11.7% and 88.3% respectively on 31st March 1989.

The movements appear more marked, however, if the composition of resources is examined in terms of maturity. Thus the share of sight deposits amounted to 17.9%, compared with 18.9%, and that of deposits with a maximum maturity of three months 80.1%, compared with 76.6%;

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
	1989	1990		1989	1990		1989	1990	
	in millions of gold francs								
Sight	4,654	4,454	−200	2,885	2,482	− 403	7,539	6,936	− 603
Not exceeding 3 months	21	14	− 7	30,523	30,938	+ 415	30,544	30,952	+ 408
Over 3 months	–	–	–	1,792	785	−1,007	1,792	785	−1,007
Total	4,675	4,468	−207	35,200	34,205	− 995	39,875	38,673	−1,202

deposits with a maturity of over three months accounted for only a very small proportion, viz. 2%, compared with 4.5% at the end of the preceding financial year.

(a) Deposits in gold GF 4,468,357,623

This item had amounted to 4,675 million gold francs on 31st March 1989; there was therefore a decline of 207 million, reflected for the most part in the total of sight deposits.

(b) Deposits in currencies GF 34,204,695,776

This compares with 35,200 million gold francs at the end of the previous financial year. The fall of 995 million, or 2.8%, reflects the movement in sight deposits and borrowed funds with a maturity of over three months. As already mentioned, the decrease in the total of these resources was mainly due to a decline in deposits in US dollars, which was only partly offset by the receipt of deposits in other currencies.

C. Other liabilities

(a) Staff pension scheme GF 129,504,330

This compares with 106 million gold francs on 31st March 1989. This item is denominated in Swiss francs and represents the Bank's liability in respect of staff pensions. The amount of Swiss francs held in this item was increased during the financial year; the gold franc equivalent also rose as a result of the appreciation of the Swiss franc in terms of gold francs.

(b) The item *"Miscellaneous"* stood at GF 980,037,341

against 823 million gold francs on 31st March 1989. The increase under this heading was partly accounted for by exchange rate movements affecting the component items denominated in currencies other than the US dollar.

(c) Dividend payable on 1st July 1990 GF 32,330,524

This amount corresponds to the dividend of 200 Swiss francs per share – compared with 175 Swiss francs in 1988 and 1989 – which it is proposed to set aside out of the net profit for the financial year 1989–90. In 1989 a sum of 25.9 million gold francs had been allocated for that purpose. The difference of 6.4 million gold francs reflects the increase in the dividend per share and the appreciation of the Swiss franc in gold franc terms.

The net surplus for the financial year 1989–90, before allocation, amounted to 104,330,524 gold francs, compared with 94,885,615 gold francs for the financial year 1988–89. Section 5 of this chapter gives details of the allocation it is proposed to make in accordance with the provisions of Article 51 of the Statutes.

Assets (employment of resources)

The following table gives a breakdown of the balance-sheet asset items according to their nature:

BIS: Development of investments and other assets, by nature

Nature	Financial years ended 31st March				Movement	
	1989		1990			
	in millions of gold francs					
Sight assets						
Gold	5,175		4,981		– 194	
Currencies	15	5,190	15	4,996	–	– 194
Treasury bills		2,057		905		– 1,152
Time deposits and advances						
Gold	210		206		– 4	
Currencies	29,824	30,034	28,203	28,409	–1,621	– 1,625
Government and other securities at term		4,938		6,887		+ 1,949
Miscellaneous		15		94		+ 79
Total						
Gold	5,385		5,187		– 198	
Currencies	36,849	42,234	36,104	41,291	– 745	– 943

(a) Gold GF 4,980,936,505

This item had stood at 5,175 million gold francs on 31st March 1989. The contraction mainly reflects a reduction in deposits in gold received from central banks.

(b) Cash on hand and on sight account with banks GF 15,096,809

The total of this item showed virtually no change from the preceding financial year.

(c) Treasury bills GF 905,177,602

This compares with 2,057 million gold francs on 31st March 1989. The appreciable decline in this item resulted from a reduction in most portfolios containing Treasury bills purchased on various markets.

(d) Time deposits and advances GF 28,408,902,082

This item, which had amounted to 30,034 million gold francs on 31st March 1989, decreased by 1,625 million.

The decline in these investments and the contraction in the portfolio of Treasury bills (see (c) above) reflected the reduction in resources but also a transfer of investments to placements in the form of purchases of government and other securities at term (see (e) below).

It should be mentioned that, in parallel with the movement in resources, investments in US dollars declined appreciably, while still constituting the largest item; they are followed by investments in Deutsche Mark and then, on a considerably smaller scale, investments in Japanese yen, pounds sterling, Swiss francs and ecus.

(e) Government and other securities at term GF 6,886,534,100

This portfolio recorded a marked expansion, having stood at 4,938 million gold francs on 31st March 1989. The rise in this item thus amounted to 1,949 million gold francs; it was mainly due to an increase in holdings of Treasury securities but also reflected purchases of private sector securities on various markets.

The following table gives a breakdown according to residual term to maturity of investments in time deposits and advances (in gold and currencies) and in government and other securities at term:

BIS: Time deposits and advances and government and other securities at term, by term to maturity

Term	Financial years ended 31st March		Movement
	1989	1990	
	in millions of gold francs		
Not exceeding 3 months	29,886	30,023	+ 137
Over 3 months	5,086	5,273	+ 187
Total	34,972	35,296	+ 324

The breakdown of investments by maturity remained relatively stable. Thus the share of investments with maturities not exceeding three months amounted to 85.1%, compared with 85.5%, while investments with maturities of over three months rose slightly to 14.9% from 14.5% on 31st March 1989.

(f) Miscellaneous GF 94,465,018

This compares with a figure of 15.1 million gold francs on 31st March 1989.

The movement in this item reflects, in particular, the effect of exchange rate fluctuations on forward operations concluded in currencies.

Forward gold operations

These operations, which are mentioned in Note 2 to the Balance Sheet, resulted in a negative balance of GF 56,823,607 compared with a negative balance of 48.3 million gold francs on 31st March 1989.

This movement was due to an increase in transactions involving the repayment of a weight of gold by the Bank at maturity.

5. Net profits and their distribution

The accounts for the sixtieth financial year ended 31st March 1990 show a net operating surplus of 126,845,080 gold francs, compared with 106,213,792 gold francs for the preceding financial year. The main reasons for the increase recorded in the year under review were the larger average volume of deposits available to the Bank for investment and the high levels of interest rates obtaining on various markets.

The net operating surplus is shown after deduction of 31,023,829 gold francs in respect of costs of administration, the moderate increase over the previous year's figure of 30,135,891 gold francs reflecting the fall 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 over 8%.

The Board of Directors has decided to transfer 9,014,556 gold francs to the Provision for Exceptional Costs of Administration, 5,000,000 gold francs to the newly created Provision for Building Purposes (which has been set up to meet expenditure associated with the acquisition by the Bank of an extension to its premises), and to supplement – by means of a further transfer of 8,500,000 gold francs – the Provision for Modernisation of Premises and Renewal of Equipment, the main purpose of which is to meet the cost of the continuing series of projects involving investment expenditure. As a result of these transfers, the net profit amounts to 104,330,524 gold francs, against 94,885,615 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 104,330,524 gold francs be applied by the General Meeting in the following manner:

(i) an amount of 32,330,524 gold francs in payment of a dividend of 200 Swiss francs per share;

(ii) an amount of 21,600,000 gold francs to be transferred to the General Reserve Fund;

(iii) an amount of 4,000,000 gold francs to be transferred to the Special Dividend Reserve Fund; and

(iv) an amount of 46,400,000 gold francs, representing the remainder of the available net profit, to be transferred to the Free Reserve Fund. This Fund can be used by the Board of Directors for any purpose that is in conformity with the Statutes.

If the above proposals are accepted, the dividend will be paid on lst July 1990 to the shareholders whose names are contained in the Bank's share register on 20th June 1990.

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 1990 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.

6. Changes in the Board of Directors and in the Management

The Bank suffered a grievous loss last year with the death of Prof. Paolo Baffi on 4th August. Prof. Baffi, who had been associated with the Bank's work in various capacities since the 1950s, was an Alternate member of the Board for more than fourteen years. He became an ex officio Director in 1975, when he was appointed Governor of the Bank of Italy; after retiring from that post four years later he continued to serve as a member of the Board, from November 1988 as its Vice-Chairman.

M. Bernard Clappier was elected Vice-Chairman of the Board to succeed Prof. Baffi as from 12th September 1989.

Baron de Strycker relinquished his directorship at the end of June 1989. The following month Baron Godeaux ceased to be a member of the Board when he retired as Governor of the National Bank of Belgium, and his successor in that post, M. Alfons Verplaetse, became an ex officio Director. Dr. Lamberto Dini and Baron Godeaux were appointed members of the Board as from 27th October and 1st November 1989 respectively. Mr. Bengt Dennis was re-elected to the Board in March 1990 and Lord Richardson of Duntisbourne re-appointed in April 1990.

Dr. Ciampi appointed Dr. Antonio Fazio as his Alternate in January 1990. M. Jacques Waitzenegger retired from the Bank of France at the end of January 1990 and was succeeded by M. Philippe Lagayette as Alternate to M. de Larosière. Herr Pöhl appointed Dr. Hans Tietmeyer as his Alternate in March 1990.

As regards the Management of the Bank, Mr. Yukio Iura was appointed Assistant Manager in September 1989.

Conclusion

Viewing developments since the spring of last year in a somewhat longer-term perspective, it would seem that, in the main, trends which had already been visible for some time have been confirmed or have even become accentuated. The only completely new and unexpected turn of events has been the political revolution in eastern Europe, the economic implications of which have been discussed in some detail in Chapters I and II and need no further elaboration here. One trend stands apart because its implications are mainly positive and it seems to have been largely the result of successful policies in the past. The trend in question is the growth performance of the industrial countries. It would appear that their potential for growth was in fact greater than was assumed in the early 1980s; what was then thought to be an intractable structural weakness of "mature" industrial economies can now be regarded as having been a temporary condition that should not have been extrapolated.

How well do we understand today the forces behind the stronger economic performance in the industrial countries? What, one might ask, did economic policy get right that it had previously got wrong? Framed in these terms the question is clearly too simplistic. Firstly, real growth is not determined by policy alone; unexplained changes in business sentiment may also play an important role. Secondly, the effects of many policies are not instantaneous. It seems in fact that to a large extent the second half of the 1980s saw a reaping of the benefits of resolute earlier policy efforts to bring inflation rates down and to rein in the government sector. These policies stimulated private investment, mainly because, when their first successes became evident, they led to a marked moderation of the increase in nominal and real wages. This, together with the fall in oil prices and the acceleration in growth, resulted in an improvement in profitability. Profit levels were restored in the second half of the 1980s in virtually all industrial countries.

Investment prospects may not be directly related to current profits (except in the important respect that they provide investible funds), but just as current inflation rates play a dominating role in forming inflation expectations so do current profits in forming profit expectations. High prospective rates of return on invested capital are the key factor in stimulating private investment – and private investment, of course, is the type of expenditure that does most to sustain economic growth. Not only does it lift the current growth rate, it also adds to productive capacity and/or increases productivity. At the same time, private investment is the most volatile component of final demand. One might almost say that while everybody must consume, nobody must invest, or at least investment can often be postponed without apparent damage for quite some time. Private investment thus depends much more on favourable circumstances than any other growth component, and it is quickly discouraged by a climate of uncertainty.

In this respect also there were gradual improvements in the course of the 1980s on a number of counts. In the first place, there were no *un*favourable external shocks. The general political climate improved with the relaxation of East-West tensions. Exchange rate uncertainties were reduced following the Plaza Agreement in 1985. Lower inflation rates, apart from their effect on wage moderation, also favoured productive investment by keeping investible funds from being diverted into unproductive inflation hedges. Fiscal policy was adjusted in many countries in order to curb both public sector deficits and the share of government expenditure in GDP. Reduced fiscal uncertainty as a result of medium-term strategies and lower taxes not only has a direct bearing on investment prospects but also benefits the general economic climate. Another important influence on investment behaviour is, of course, the demand for the products to be produced with the additional productive capacity. New technology and imaginative marketing have created ample scope for new products with promising markets. Last but not least, the prospect of a single market in the European Community by the beginning of 1993 has undoubtedly been an important spur to business investment in Europe.

Against these positive achievements one has to set a rather long list of largely unfavourable trends which confront policy-makers with challenges, at both the national and the international level. To some extent they are no doubt a consequence of the long economic upswing. Also, structural rigidities, insufficient levels of private savings and high public sector deficits undoubtedly go a long way towards explaining a number of them. We shall, however, confine ourselves here to summarising the trends we observe and considering immediate policy options without trying to establish links, except in one case where the two trends in question cannot be separated. Special emphasis will be placed on those problems which lie directly or indirectly within the sphere of responsibility of central banks. The mainly unfavourable trends which have continued or have even been reinforced are the following:

– higher rates of real growth have reduced *unemployment* levels significantly but have not eliminated the chronic labour market problems which exist in some countries;

– *inflationary pressures* have not been eradicated in any of the industrial countries; with continued economic growth they have resurfaced where they seemed to have disappeared, and have become stronger where they had persisted despite the windfall stability gains from, in particular, the fall in oil prices;

– although the *current-account imbalances* of the United States and Japan have continued to narrow, indeed by more than seemed likely a year ago, the outlook for further progress is not bright and European imbalances have widened appreciably. Yet concern about the sustainability of the US imbalance seems to have lessened;

– *exchange rates* have not only remained volatile but have continued to move for prolonged periods in directions detrimental to the correction of the imbalances – in spite of the regularly reaffirmed commitment of the major countries to co-ordinating their policies with a view to fostering adjustment and greater exchange market stability;

– worries about the *fragility of financial markets* in general are growing, partly in connection with developments in these markets themselves and partly owing to developments in real estate markets. Rising debt ratios and more restrictive monetary policies are further causes for concern in this context;

– with regard to the high *commercial bank debt of middle-income developing countries,* containment is all that has been achieved ever since the crisis broke in 1982;

– the *poorest developing countries* are falling further behind.

As regards *unemployment,* positive labour market developments have certainly outweighed negative ones recently, but in a large number of industrial countries unemployment, although reduced, is still high by any standard – at a time when capacity utilisation in manufacturing is close to record levels. It is evident that overall demand developments cannot bring much further relief if overheating is to be avoided. In some cases a certain easing of unemployment problems can be expected from a declining domestic labour force. Furthermore, one favourable effect of the real wage moderation, noticeable earlier in the United States and recently also in continental Europe, has been that a given rate of output growth is now accompanied by more employment growth than before. A key condition for a further reduction in unemployment is, therefore, that real wage moderation continues, which, in turn, will depend on inflation being kept under control. A considerable amount also remains to be done in the area of structural reform, from increasing labour mobility, between both locations and jobs, to providing the right incentives and refraining from giving wrong ones. Greater decentralisation in wage negotiations, permitting greater differentiation in wages, might also contribute to bringing structural unemployment down in some countries, although cross-country analysis does not provide unambiguous evidence to that effect.

To turn to the next trend on the list, there is unfortunately evidence that the fight against *inflation* is by no means over. This raises questions about the conduct of monetary policy over the last few years. Too much monetary easing for too long after the October 1987 stock market crash, or too much concern for foreign exchange market developments, could be explanations. But policy mistakes are always possible and what may seem crystal-clear with hindsight may not have been obvious at the time the policy decisions were taken. It is more fruitful to look at the fundamental questions involved in the old issue of trade-offs between different economic goals. The pessimistic view that only if unemployment remains above a certain level can inflation be prevented from edging up still finds wide support. However, this level differs from country to country and also varies over time, suggesting that we are not confronted with an iron law of inflation determination and that it is the task of economic policy to create the conditions which would permit the attainment of both high levels of employment and low inflation rates.

Monetary policy is obviously at the forefront in the fight to contain inflation, but it cannot achieve this alone, and still less a good combination of the two objectives. Institutional factors in the labour market, which have already been referred to, play a significant role. Fiscal policy has consequences for money growth, interest rates and inflation in most countries most of the time and must be geared to monetary policy objectives if their achievement is not to be jeopardised. Even when all these qualifications have been made, however, the question still remains as to the effectiveness of monetary policy itself, which depends on the indicators which guide it, the instruments it employs and the ingredients that are crucial for establishing credibility.

In some of these areas negative influences have been at work, in others one can see distinct improvements. Financial innovation and the globalisation of financial markets have made it more difficult for central banks to be sure which *indicators* they should select as their guide. However, monetary aggregates will no doubt remain the principal ones because, in spite of all the difficulties encountered in "reading" them, the alternatives are more ambiguous still. An exception, obviously, is a strategy aimed at linking the national currency via the exchange rate to a low-inflation currency, but that is not an option available to all and does not alter the main conclusion. Money is, after all, what central banking and monetary policy are all about, and nobody doubts that in the medium and long term price stability is incompatible with strong monetary growth.

On the question of *instruments*, national differences have been reduced; a broad consensus has emerged that the marginal interest rate at which the central bank provides reserves to the banking system constitutes the cutting edge of monetary policy. Many central banks also agree that averaging procedures, by stabilising the demand for reserves, can facilitate control over money market rates. Recourse to credit ceilings and other administrative tools has become the exception. The effectiveness of monetary policy has clearly been enhanced in this area.

There is also much to support the view that in most countries central banks have by and large gained in *credibility*. The second half of the 1980s demonstrated not only that ever-higher inflation rates can be avoided, but that inflation can be contained even at times of fairly strong economic growth. To some extent central banks today are more convincing to the outside world because they are themselves more convinced that price stability should be the main, or indeed the only, goal of monetary policy.

How can one reconcile this relatively optimistic assessment of the effectiveness of monetary policy with the earlier observation that inflation rates have been creeping up steadily again after the, partly windfall, lows of

1986? What is preventing the authorities from stopping this trend? Are they ambivalent, convinced of the benefits of price stability in principle, but adopting quite different priorities when they face the day-to-day contest between conflicting demands? One reason for such ambiguities may be that price stability has never been defined in very precise terms. Partly because of problems of statistical measurement, it has been common to accept inflation rates of 1% or even 2% as lying within a range indistinguishable from price stability. From there it is only a short step to viewing rates around 3% as implying a high degree of price stability. In the present situation in particular, given the fact that the "underlying" rates have not changed all that much and windfall gains have been followed by windfall losses, it could even be argued that there has been no great change on the inflation front.

Running counter to these tendencies towards complacency, initiatives recently launched – in the US Congress, and also in Canada – take the term "price stability" literally and suggest that monetary policy should aim for zero inflation in the medium term. The earlier belief that low inflation rates have more advantages than drawbacks by comparison with absolute price stability because they facilitate structural change has been seriously challenged. Once inflation rates are embedded in expectations they cease to have real effects of this kind and only the frictions and injustices which accompany even relatively low inflation rates remain. There is little doubt in the mind of many today that, once they have achieved it, the industrial economies could operate with price stability at levels of output and employment no lower or even higher than the present ones, which should make price stability a worthwhile target.

How to attain it, and over what time span, is, however, the crucial question, particularly for countries where the inflation rate at present is relatively high. Shock treatment involves too many risks to find much support. Gradualism carries the risk of losing direction along the way. The transition cannot be painless, and the option of "costs now – benefits later" never has strong political appeal. Independent central banks are praised for taking a longer-term view but even they do not operate in a political vacuum. A better understanding of the issues involved among the general public and the trade unions in particular will have to emerge if progress towards permanently lower inflation rates is to be achieved. The first step in this direction, and the most pressing need, is to break the trend of rising inflation rates before it becomes entrenched.

Moving on to the next two items on our list, namely the *persistent and large current-account imbalances* and the *related exchange market developments,* it is worth noting that the cumulative current-account deficit of the United States since 1983 amounts to $770 billion. The Japanese and German surpluses over the same seven-year period total $415 billion and $220 billion respectively. Since the peak in 1987 the annual US deficit has declined by one-quarter and the Japanese surplus by one-third. The German surplus has risen further, but it no longer corresponds to any significant extent directly to the US deficit; its counterpart is rather to be found in Europe. If one could be sure that progress in the right direction would continue, there would not be any great cause for concern. But few observers expect further substantial reductions in these imbalances in the years immediately ahead; indeed, according to many forecasts all three imbalances could widen again in 1990.

They attract attention mainly because of their absolute size, even though smaller countries have larger imbalances relative to GNP. Earlier fears that imbalances of this order of magnitude, if not corrected quickly, would disrupt the world economy through their impact on exchange markets or on financial markets in general have abated. Notwithstanding the high volatility in exchange markets and periods of turmoil in equity markets, the imbalances have evidently persisted without causing large-scale disruption. Will this remain the case in the years to come even if the trend towards adjustment in the United States and Japan does not continue? It could well be, although hardly indefinitely. As more and more obstacles to the free flow of capital have been removed, market forces pressing for current-account adjustment have clearly weakened. Indeed, the currencies of countries with high current-account deficits have in many cases appreciated and those of surplus countries depreciated. However, enough uncertainty remains to have convinced policy-makers in the three countries concerned that they must maintain their efforts to reduce the imbalances, which has been their declared common objective ever since 1985.

These efforts have been based on three strategic approaches: firstly, the co-ordination of macro-economic policies to ensure that they are consistent with the desired current-account adjustment; secondly, exchange market intervention with a view to establishing a pattern of real exchange rates conducive to adjustment; and thirdly, the stabilisation of nominal exchange rates in order to give the economies time to respond to the real exchange rate changes that have taken place, to avoid exchange rate overshooting and to prevent new, lasting misalignments from developing in the opposite direction. Of these three strategic elements, the second was superseded by the third at the time of the Louvre Accord in February 1987, so that it may now seem to be of only historical interest. It has been argued, however, that it would be only logical to revert to this earlier strategy if the imbalances were not reduced to acceptable levels as a result of the exchange rate changes that occurred between 1985 and early 1987.

Whatever one may think of this proposition, it is obvious that the first strategic element, the co-ordination of macro-economic policies, ran into difficulties almost from the beginning. Fiscal policy proved to be too deeply embedded in the domestic political process everywhere to leave much scope for modifying it with a view to influencing the current account. Japan's stimulative fiscal policy in the spring of 1987 may have been the exception to this rule. Fiscal consolidation has been the policy line pursued most widely in industrial countries, and with good reason. Monetary policy is much more flexible, but in the adjustment context it cannot be treated as an independent factor since it is too closely linked to exchange market intervention. While intervention itself does not force a change in the course of monetary policy, there would be no point in frustrating the purpose of intervention through interest rate policies which have counteracting effects. Herein lies the possible conflict between "co-ordinated" exchange rate policies and domestic policy objectives. Faced with such a conflict, the German and, especially, the Japanese monetary authorities have over the last five years or so often opted for co-ordination. It is only natural that they should ask themselves what they have to show for it, since exchange markets have remained volatile and current-account imbalances large, while they have had to accept monetary expansion at rates which have allowed inflationary pressures to build up.

There is, in addition, another problem in stabilising nominal exchange rates, and one which arises not just between the major countries but in any circumstances where countries have different inflation rates. Under the influence of both markets and policies, high-inflation countries, which also tend to be the countries with large current-account deficits, typically have high nominal interest rates. Where there are credible commitments to keep nominal exchange rates stable – at least for a time – high nominal interest rates exert an irresistible attraction over capital flows, even to the point where fundamentally "weak" currencies appreciate to the detriment of current-account adjustment.

What this means in effect is that a policy aimed at stabilising nominal exchange rates in the face of significant differences in national inflation rates will ultimately be self-defeating. The best way to deal with this dilemma is, obviously, to ensure that inflation rates converge towards zero. The next-best way of giving some exchange rate guidance without creating a vicious circle is to have *moving* nominal exchange rate targets, i.e. formal or informal exchange rate targets that explicitly allow for the movement of nominal exchange rates from time to time in line with international inflation differentials. It is evident, however, that this would not resolve the more fundamental conflict between domestic and external objectives, which can only be settled through a continuous assessment by all parties concerned of the priorities that are to be set between them in any given situation. Floating exchange rates have been seen to require a certain degree of international policy co-ordination if exchange rate relationships are not to become grossly distorted. However, the costs of such co-ordination must be kept within bounds. Unbridled monetary expansion and higher inflation would certainly be too high a price to pay.

This brings us to the growing *worries about the fragility of financial markets* in general. These worries arise from two separate sources, one diffuse and the other more precise. The first is the unease about the implications of the rapid pace of change in financial markets over the last decade. It is feared that the wide range of new financial products and practices and the enormous expansion in international financial market activity, together with historically high levels of private sector, in particular personal sector, indebtedness in several countries, may hold risks which have not yet come to the surface. The legal basis of many of the new instruments and operations has not yet been tested in the courts. Products that are safe as long as only a few operators use them can create problems when they are used on a large scale and when market participants all try to get on the same end of the see-saw at once. Underestimation of the risks involved, for instance, appears to have played a major role in the popularity of some program trading strategies in equity and derivative markets, notably portfolio insurance. The favourable general economic conditions and monetary policy ease over a number of years have created a propitious environment in which many products have flourished, but there is no way of telling how they will fare in a harsher climate.

The second source of concern lies in actual developments and events in financial markets or in parts of the financial industry. Despite the sustained pace of the current economic expansion, some signs of stress have emerged or become increasingly apparent, with respect to both prices and financial institutions: the mini-crash of October 1989 and the subsequent major correction in the Japanese stock market in early 1990; the recent sharp rise in interest rates; the mounting costs of the US thrift industry crisis; indications, so far primarily in the United States but also in the United Kingdom and Japan, of actual and potential future losses for financial intermediaries, notably banks, arising out of their involvement in real estate markets; the collapse of the US junk bond market and the potential problems faced by intermediaries heavily involved in the financing of highly leveraged transactions. These signs of stress have occurred against the background of a still unresolved debt crisis, which we shall come to in due course.

Although these developments differ in terms of their underlying causes and importance, they contribute to the general unease. They can be taken as indications of the increasing vulnerability of the financial sector to a slowdown in economic activity and to possible further rises in interest rates. They occur, moreover, at a time when events in eastern Europe, including moves towards German monetary and economic union, raise the prospect of additional demands on world savings. Were the difficulties experienced in the financial sector to become more widespread or more acute, they could have potentially serious consequences for economic performance not only in industrial but also in developing countries.

The greater fragility of the financial sector poses a number of challenges to policy in both the macro-economic and the structural fields. With regard to macro-management, there is a risk that growing pressure might be exerted on central banks to compromise their long-term focus on inflation in the pursuit of greater short-term stability in the financial sector. As the experience of the 1970s and early 1980s indicates, a policy of this kind would only store up greater pain for the future. Indeed, at least in some countries relatively lax monetary policy must take some of the blame for the present difficulties.

With regard to structural policies, the challenge is to enhance the ability of the financial sector to withstand shocks, and to reduce the likelihood of their occurrence, without compromising the benefits associated with the liberalisation of markets and activities of recent years.

This is an area in which much has been accomplished – witness the strengthening of banks' capital base and the numerous initiatives aimed at adapting the framework of prudential regulation and supervision to the rapidly changing contours of the financial environment.

What else should the authorities do to reduce the risk of instability? They should certainly not give market participants a false sense of security. On the contrary, one aspect which may require further attention is how to avoid arrangements that contain incentives to take excessive risks. More generally, deregulated markets require market participants professional enough to be capable of independent assessment of the risks they accept. Were they to prove clearly unequal to that task, re-regulation or some other form of official guidance and extended supervision might become necessary. To strike the right balance in this respect is something that the authorities in many countries are trying very hard to do, not least by learning from one another.

The *debt problem of the middle-income developing countries* remains on the agenda for policy-makers. The likelihood that debtor countries and creditor banks will make significant progress together without a mediator who is prepared to be more than just a mediator seems, if anything, to have diminished. The fundamental elements of the situation have been described so often and have changed so little that one can be quite brief in this respect. There can be no progress without unremitting efforts on the part of the debtor countries themselves. A government without a strong mandate may reach the limits of its influence very quickly. In such a case there is very little that the outside world can usefully do. However, any government which is in a position to implement an economic programme and see it through should in principle no longer be in any doubt as to what it has to do.

Politically, however, it remains difficult to correct the exchange rate of an overvalued currency, charge realistic prices for public services and, simultaneously, bring hyperinflation under control, reduce an overblown public sector and keep unemployment at tolerable levels, create a sound tax base and promote a strong private sector. The same is true of stimulating domestic saving and developing domestic financial markets in order to raise the level of investment. To do all these things more or less together demands enormous efforts and a broad base of domestic political support.

The final goal of restoring creditworthiness vis-à-vis the outside world requires still more than that: the size and the terms of the external debt must be brought into line with what a country can service *without incurring new commercial debt*. To service existing debt by raising the level of indebtedness further creates a vicious circle and is what has led to the current difficulties; it cannot provide a way out of them. There are obviously two aspects to the problem of being able to service external debt. Firstly, there is the amount of debt servicing a country can generate without strangling its economy, which, *on condition* that it finds open markets for its exports, is essentially its own responsibility, notwithstanding the fact that world interest rate levels and global demand conditions are important outside influences. Secondly, there is its level of indebtedness, which is something over which the country has no control retroactively. Here the heavily indebted countries need the help of their creditors, which they are only likely to get if they can show that they are playing their full part in mobilising resources and pursuing sound policies. Once, with the help of adequate debt or debt service relief, creditworthiness has been restored and the economies have been revitalised, the level of debt which can be serviced without undue economic sacrifice will also grow. Only at that stage will it be safe for borrowing to be resumed at market terms.

On the side of the creditor banks, some form of debt or debt service relief is no longer something they flatly refuse to consider. After so many years and so much rescheduling they are under no illusion that they will ever recover principal and interest in full. They have been able to make sizable provisions at the expense of their earnings. If they were to obtain the balance in cash now in the secondary market they would be no worse off in terms of profit and loss account and actually better off in terms of balance-sheet ratios. The Brady Initiative of March 1989 tried to take advantage of this perception, with some success. However, in the Mexican case the banks were not offered cash at secondary market discounts as in the Philippine and Costa Rican packages. The credit enhancement offered produced either a discounted asset with thirty years to maturity or an equally long-term asset at par with a fixed interest rate below current market rates, plus collateral for the principal and for some interest instalments on a revolving basis. In other words, the banks were offered assets which, while safer than those they had held before, were obviously inferior to cash. It is not surprising that they were reluctant to accept discounts on the scale of those prevailing in the secondary market.

The packages which were negotiated, however, contained options not only for debt and debt service reduction but also for new lending. Expectations regarding the amounts of new money which would be forthcoming were generally disappointed. This, again, hardly seems surprising in view of the fact that the new money option contained no quid pro quo, i.e. no credit enhancement for the old or the new money, the argument being that it would be inconsistent to grant new loans *and* to demand credit enhancement at the same time. This argument makes little sense. It presupposes that the providers of new money – in contrast to the other creditors – would consider creditworthiness as being instantaneously restored with the implementation of the package. This would tie in with the argument made earlier that new money on commercial terms should wait until creditworthiness has been restored. Unfortunately, rebuilding creditworthiness requires more than the amount of debt and debt service reduction which has been achieved so far under the Brady Initiative. This has been the real flaw in its implementation and not the fact that too little new money was forthcoming from the banks.

Where do we go from here? The only factor to determine how much further progress along the lines of the Brady Initiative can be made should be the extent to which the debtor countries are able to play their part in the way described above. The commercial banks should be offered a fair set of options from which to choose. In other words, there should be flexibility in the supply of official funds for credit enhancement. These funds should preferably not come from the IMF and the World Bank alone. Japan has set a good example; it may be necessary for others to follow suit, to make sure that adequate support is available for all countries making genuine efforts to revitalise their economy and enhance their debt servicing capacity.

To come to the final item on our list: the *poorest countries* have been treated fairly generously recently by their mainly official creditors, but that has not brought any significant improvement in their underlying condition. More fundamental help for self-help is obviously required. Greater readiness to embark on more imaginative joint efforts towards coping with the worst cases of human misery is needed. Whatever "peace dividend" accrues, this is an area to which some of it could well flow. This issue is, however, too complex and too far removed from the competence of the BIS for any specific suggestions to be made here. But its urgency can be in no doubt.

The last topic to be addressed in the Conclusion to this Report is not drawn from the list of confirmed trends with which we began. It is a matter closer to home for the BIS, namely the steps to be taken towards establishing *economic and monetary union in the European Community.* An important part of the initiative rests with the Governors of the EC central banks, who meet regularly at the BIS and who are in the process of preparing for stage one, which is scheduled to commence on 1st July 1990.

The report of the "Delors Committee", which proposed the realisation of economic and monetary union in three stages, had been endorsed by the EC Heads of State and Government at their meeting in Madrid in June 1989. Apart from confirming the intention to make monetary union a reality, they fixed the starting date for stage one but left open how long it should last. At their subsequent meeting in Strasbourg in December 1989 they noted that the necessary majority existed for convening, before the end of 1990, a conference with the task of preparing an amendment to the Treaty of Rome. Such an amendment is a precondition for progressing to stages two and three as envisaged in the report. Stage one represents, as the report put it, "the initiation of the process of creating an economic and monetary union". At its centre is the strengthening of policy co-ordination, the removal of all obstacles to financial integration and the inclusion of all Community currencies in the EMS exchange rate mechanism. During stage one the Committee of central bank Governors "would normally be consulted in advance of national decisions on the course of monetary policy, such as the setting of annual domestic monetary and credit targets". However, the report also noted that under present national legislation it is not possible for many countries to participate in arrangements for the binding ex ante co-ordination of policies. Only once agreement has been reached on a new treaty can more substantial steps be taken.

In the meantime a certain amount of agreement has emerged on some points of substance; this is not fully shared, however, by the United Kingdom. The informal agreement covers the broad structure of a European system of central banks strongly committed to price stability and endowed with independence from political interference. In all of these matters it is, of course, easier to agree on principles than on precise legal terms.

When the negotiations get down to details it will also become clearer than it may be at present that, while institutions can be created according to the design of the parties to the negotiations, the economic facts of life are not at their command. The extent to which monetary policy can succeed irrespective of what other policies are being pursued is one example. The "Delors Committee" had taken a strong view on this question and had suggested for stage three binding Community rules and procedures in the macro-economic and budgetary field, providing, inter alia, for enforceable constraints on national budgets. In the subsequent discussions among academics, and, more importantly, politicians, it has been asked whether such sacrifices of national sovereignty are necessary. What must be recognised by all, however, is that this is an empirical question and not one of political expediency. Behind it lies the larger issue of whether economic and monetary union will quickly have to develop into political union or whether it will be possible to succeed with the first while stopping short of the second. This question may not have to be answered if present moves by France and Germany to press ahead with political union within the Community find wide support. In any event, by the time the Treaty has been negotiated, it may well be possible to call on German experience of monetary union, which is also scheduled to precede, but is soon to be followed by, political union.

There can be little doubt that central banks in particular and monetary policy in general will be called upon to make their contribution to solving the problems outlined in this Conclusion. That is how it should be. Central banks have a major responsibility for safeguarding the integrity of the financial and payments systems. At the same time monetary policy has proved to be the most flexible and probably the most powerful policy instrument at the authorities' disposal for fighting inflation and controlling exchange rate developments. But precisely because of its efficiency, policy-makers will be tempted to overburden monetary policy with the task of trying to achieve too many objectives simultaneously. This temptation will naturally be strengthened by governments' growing unwillingness, or impaired ability, to employ fiscal policy as a tool of macro-economic management.

In such an environment it is of paramount importance that the pursuit of domestic price stability should unequivocally stand as the first priority of monetary policy. This is fully justified on the generally valid grounds that the persistence of inflation expectations is in the long run the worst enemy of both exchange rate stability and the smooth functioning of the financial system. The long-term benefits of pursuing domestic price stability far outweigh whatever unwelcome consequences the fight against inflation could have in the short run, in some instances, for exchange rate developments or for financial markets. Moreover, this order of priority also has an added practical relevance in the current circumstances: the upward drift of inflation rates, which could put the achievements of years of anti-inflationary monetary policy endeavours at risk, needs to be halted and reversed, and the sooner the better.

Basle, 22nd May 1990

ALEXANDRE LAMFALUSSY
General Manager

Balance Sheet and Profit and Loss Account

at 31st March 1990

Balance Sheet at 31st March 1990

(in gold francs - see Note 1)

Assets

Gold		4 980 936 505
Cash on hand and on sight account with banks		15 096 809
Treasury bills		905 177 602
Time deposits and advances		
Gold		
Not exceeding 3 months	66 130 305	
Over 3 months	140 075 059	
Currencies		
Not exceeding 3 months	24 964 948 617	
Over 3 months	3 237 748 101	
		28 408 902 082
Government and other securities at term		
Not exceeding 3 months	4 991 267 678	
Over 3 months	1 895 266 422	
		6 886 534 100
Miscellaneous		94 465 017
Land, buildings and equipment		1
		41 291 112 116

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 1990, gold payable against currencies on forward contracts amounted to 56 823 607 gold francs.

		Before	After
		allocation of the year's Net Profit	
Liabilities			
Capital			
Authorised: 600 000 shares, each of 2 500 gold francs	1 500 000 000		
Issued: 473 125 shares	1 182 812 500		
of which 25% paid up		295 703 125	*295 703 125*
Reserves			
Legal Reserve Fund	30 070 313		*30 070 313*
General Reserve Fund	600 816 157		*622 416 157*
Special Dividend Reserve Fund	35 530 055		*39 530 055*
Free Reserve Fund	442 066 872		*488 466 872*
		1 108 483 397	*1 180 483 397*
Deposits (gold)			
Central banks			
Sight	4 454 151 322		
Not exceeding 3 months	14 205 902		
Other depositors			
Sight	399		
		4 468 357 623	*4 468 357 623*
Deposits (currencies)			
Central banks			
Sight	2 449 268 313		
Not exceeding 3 months	29 674 857 258		
Over 3 months	782 024 911		
Other depositors			
Sight	32 699 131		
Not exceeding 3 months	1 263 270 813		
Over 3 months	2 575 350		
		34 204 695 776	*34 204 695 776*
Staff Pension Scheme		129 504 330	*129 504 330*
Miscellaneous		980 037 341	*980 037 341*
Profit and Loss Account		104 330 524	—
Dividend payable on 1st July 1990		—	*32 330 524*
		41 291 112 116	*41 291 112 116*

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 1990 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, 30th April 1990 — *PRICE WATERHOUSE & CO.*

Profit and Loss Account

for the financial year ended 31st March 1990
(in gold francs)

Net interest and other operating income		157 868 909
Less: Costs of administration		
Board of Directors	222 625	
Management and Staff	21 406 759	
Office and other expenses	9 394 445	31 023 829
Net operating surplus		126 845 080
Less: Amounts transferred to		
Provision for Exceptional Costs of Administration	9 014 556	
Provision for Building Purposes	5 000 000	
Provision for Modernisation of Premises and Renewal of Equipment	8 500 000	22 514 556
Net Profit for the financial year ended 31st March 1990		104 330 524

The Board of Directors recommends to the Annual General Meeting that the Net Profit should be allocated in accordance with Article 51 of the Statutes as follows:

Dividend: 200 Swiss francs per share on 473 125 shares	32 330 524
	72 000 000
Transfer to General Reserve Fund	21 600 000
	50 400 000
Transfer to Special Dividend Reserve Fund	4 000 000
	46 400 000
Transfer to Free Reserve Fund	46 400 000
	—

Movements in the Bank's reserves

during the financial year ended 31st March 1990
(in gold francs)

I. Development of the Reserve Funds resulting from allocations for the financial year 1989–90

	Legal Reserve Fund	General Reserve Fund	Special Dividend Reserve Fund	Free Reserve Fund
Balances at 1st April 1989, after allocation of Net Profit for the financial year 1988–89	30 070 313	600 816 157	35 530 055	442 066 872
Add: Allocations for the financial year 1989–90	—	21 600 000	4 000 000	46 400 000
Balances at 31st March 1990 as per Balance Sheet	30 070 313	622 416 157	39 530 055	488 466 872

II. Paid-up Capital and Reserve Funds at 31st March 1990 (after allocation) were represented by:

	Paid-up Capital	Reserves	Total
Net assets in			
Gold	295 703 125	366 257 514	661 960 639
Currencies	—	814 225 883	814 225 883
	295 703 125	1 180 483 397	1 476 186 522

Board of Directors

Dr. W.F. Duisenberg, Amsterdam
Chairman of the Board of Directors,
President of the Bank

Bernard Clappier, Paris
Vice-Chairman

Dr. Carlo Azeglio Ciampi, Rome
Bengt Dennis, Stockholm
Dr. Lamberto Dini, Rome
Prof. Dr. Leonhard Gleske, Frankfurt a/M.
Baron 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
Alfons Verplaetse, Brussels

Alternates

A. D. Crockett, London, or
L. D. D. Price, London
Dr. Antonio Fazio, Rome, or
Dr. Carlo Santini, Rome
Philippe Lagayette, Paris, or
Francis Cappanera, Paris
Jean-Jacques Rey, Brussels
Dr. Hans Tietmeyer, Frankfurt a/M., or
Dr. Wolfgang Rieke, Frankfurt a/M.

Management

Alexandre Lamfalussy	General Manager
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, Chief Accountant
Jean-Marc Andreoli	Assistant Manager, General Secretariat
Yukio Iura	Assistant Manager, Banking Department