BANK FOR INTERNATIONAL SETTLEMENTS

63rd ANNUAL REPORT

1st APRIL 1992–31st MARCH 1993 BASLE, 14th JUNE 1993

Bank for International Settlements

63rd Annual Report

1st April 1992–31st March 1993   Basle, 14th June 1993

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63rd Annual Report

submitted to the Annual General Meeting
of the Bank for International Settlements
held in Basle on 14th June 1993

Ladies and Gentlemen,

I have the honour to submit herewith the sixty-third Annual Report of the Bank for International Settlements for the financial year which began on 1st April 1992 and ended on 31st March 1993.

The net profit for the year amounted to 139,895,417 gold francs, after transfer of 3,295,256 gold francs to the Provision for Exceptional Costs of Administration and 19,237,046 gold francs to the Provision for Modernisation of Premises and Renewal of Equipment. This compares with a net profit for the preceding year of 119,460,160 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 38,895,417 gold francs in payment of a dividend of 240 Swiss francs per share.

The Board further recommends that 30,300,000 gold francs be transferred to the General Reserve Fund, 5,000,000 gold francs to the Special Dividend Reserve Fund and the remainder of 65,700,000 gold francs to the Free Reserve Fund.

If these proposals are approved, the Bank's dividend for the financial year 1992–93 will be payable to shareholders on 1st July 1993.

I. Exchange market turmoil and more widespread recession in Europe

Economic developments during the last twelve months do not lend themselves to easy generalisation, except in one respect: almost all the bright spots appear outside Europe. The most important of these is that a modest recovery began in the United States, where there was at the same time a significant improvement in the condition of the banking industry. Good news also came from a number of developing countries, to some extent from Latin America, but particularly from South-East Asia. The recent announcement of new large-scale stimulatory measures in Japan has raised hopes that the growth recession there will soon come to an end. On the other hand, while recovery appears to have started in the United Kingdom, the situation deteriorated sharply in continental Europe, with industrial production declining, GDP at best stagnating and unemployment and budget deficits rising. Banks and other financial institutions suffered serious losses in several countries and the European exchange markets experienced disorder on an unprecedented scale. The only unquestionably positive development on the European scene was the fairly broad-based consolidation of, and in some cases even improvement on, the gains made in the fight against inflation.

Chapter II describes the cyclical position of different groups of industrial countries and their fiscal policy stance. In many respects the economic downturn in the old industrial countries followed a – somewhat desynchronised – cyclical pattern but its duration has been unusually long and recovery in the Anglo-Saxon countries, which had already moved into recession in 1989 or 1990, has been slow. Counter-cyclical fiscal policies found little favour and in some countries with severe fiscal constraints even automatic stabilisers were allowed to operate only sparingly in view of the legacy of accumulated debt. The short-term benefits of automatic stabilisers, let alone stimulative government spending, had to be weighed against the long-run financing costs. Japan was the major exception to the general rule.

Monetary policy was eased sharply in response to economic weakness in countries where inflation had come down and where policy was not constrained by exchange rate commitments (see Chapter VI). Monetary relaxation does not so far seem to have rekindled inflation, but neither have its counter-cyclical effects been very strong. Among the various domestic transmission channels through which lower short-term interest rates are expected to stimulate economic activity, some alleviation of excessive debt burdens, in both the household and the corporate sectors, seems to have been the most important. In those countries in which short-term interest rates were brought down early and to very low levels, long-term rates were slow to follow, although they did decline eventually. In other countries where short-term rates remained high, or even moved up, long-term interest rates eased significantly, raising once again the familiar question of whether this should be seen more as an indication of high anti-inflation credibility or as a manifestation of globalised financial markets.

The absence of any real counter-cyclical activism was not a reflection of equanimity or of a confident expectation that downturn is bound to be followed by upswing. Rather, given the experience of the past, governments were cautious and reluctant to embark on a course that would exacerbate longer-term structural imbalance in the public sector. Unilateral action to stimulate the economy, they feared, might in any case not achieve much. And there has, until recently, been little enthusiasm for coordinated action, either at the European Community level or within the Group of Seven. One area in urgent need of further attention is of course trade policy. Here the potential for conflict is enormous, as the almost daily news of fresh disputes confirms. The recent drift towards bilateralism and regionalism in trade, and the further delay in concluding the Uruguay Round of GATT negotiations, are worrying developments, which are taken up in Chapter IV.

In Europe, Germany remained very much at the centre of the policy debate, not least because of its pivotal role in the European exchange rate mechanism. Here (as in most of Europe) the "normal" cyclical downturn after the long upswing which had begun in 1983 had been delayed by the strong boost given to demand by unification as from mid-1990. The country's economic problems, however, are clearly more than cyclical. This is evident from the large transfers from the west which keep domestic demand in the east at twice the latter's – sharply reduced – level of production. Private investment in the western part of the country has, in addition, weakened considerably, partly as a result of the many incentives designed to attract investment to the east. Real western German GDP has declined since mid-1991, except in the first quarter of 1992, when it rebounded strongly. In spite of this marked cooling-off, the inflation rate – partly because of changes in indirect taxation, but predominantly as a consequence of cost push pressures from steep wage increases – is now among the highest in the Group of Seven countries. In view of the large fiscal deficit – reflecting the huge transfer payments to the eastern part of the country, as well as the recent cyclical downturn – monetary policy was kept quite tight well into 1992 and has been relaxed only cautiously, but steadily, since September, when the European currency turmoil erupted and the extent of the economic weakness became increasingly apparent.

While German policy was criticised both at home and abroad, the domestic situation was such that most observers saw little room for manoeuvre in the conduct of monetary policy until the summer, given the inflation rate and the worsening fiscal position. At the same time, it clearly created problems for the countries linked to Germany through the ERM,

World output growth[1]							
Country groups and regions	1984–86 GDP	1982–87 average	1988	1989	1990	1991	1992
	as % of total	percentage changes in real GDP					
Seven major countries	61.2	3.4	4.5	3.3	2.3	0.8	1.5
Other industrial countries[2]	12.7	2.8	3.6	3.8	3.0	0.8	1.0
Developing countries	19.7	3.7	4.1	3.6	3.7	3.5	4.6
Major oil producers[3]	6.7	0.3	0.7	3.8	5.2	3.5	5.2
Others	13.0	5.5	5.8	3.5	2.9	3.5	4.3
Africa and Middle East	2.2	2.9	4.5	1.4	1.8	1.5	0.9
Asia	6.9	7.6	9.4	5.4	5.7	5.1	7.0
of which: NIEs[4]	1.7	9.4	9.6	6.3	6.8	7.1	5.3
Latin America	3.9	3.3	0.2	1.4	−1.3	1.7	1.6
Eastern Europe	6.4	2.7	3.3	1.6	−4.8	−11.7	−15.9
World	100.0	3.3	4.3	3.3	2.2	0.5	1.1
Memorandum item:							
World, excl. eastern Europe		*3.4*	*4.3*	*3.4*	*2.7*	*1.4*	*2.2*

[1] Average growth rates are calculated for the seven major and other industrial countries using 1990 GDP weights and exchange rates, and for eastern Europe using 1990–91 GDP and exchange rates, including eastern Germany up to 1991. Other averages are based on 1984–86 GDP weights and exchange rates and comprise all countries with 1985 GDP of at least US$0.1 billion. [2] Including the countries listed in the table on page 15, Iceland, Luxembourg and Malta. [3] OPEC members, Ecuador, Mexico and Trinidad and Tobago. [4] The newly industrialised economies: Hong Kong, Singapore, South Korea and Taipei China.

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

particularly those in which growth prospects were deteriorating. Despite, in some cases, lower inflation rates and weaker domestic demand, these countries have had to match German short-term interest rates even at times of calm on the foreign exchange markets. Their different domestic conditions did not translate into an interest rate advantage for expected currency appreciation because of the Deutsche Mark's unquestioned role as the nominal anchor of the system.

This already rather complicated situation became caught up with the fate of the Maastricht Treaty agreed in December 1991. Ratification of the Treaty had been scheduled to be completed before the end of 1992. In Denmark and Ireland this required a referendum. While the outcome of a referendum can never be predicted with certainty, for the other countries ratification was generally considered to be a foregone conclusion, given the broad consensus among politicians of different persuasions. Consequently, the prospect of the two referendums did not alter the prevailing view that ratification of the Treaty was virtually assured.

Linked to this in many minds was a firm expectation that the move towards European monetary union, after more than five years of virtual exchange rate stability, would not be disturbed by any deliberate realignments within the ERM. It became the conventional wisdom that realignments could be put off, if the authorities so wished, by making minor adjustments to short-term interest rates which, given the high degree of capital mobility, could be relied upon to trigger sufficiently large capital flows to relieve exchange market tensions.

When the Danish people rejected the Treaty by a narrow margin on 2nd June 1992 all these assumptions were called into question. The inevitable implication was that ratification would not be completed in 1992, raising the possibility that the whole time schedule might be upset, even if the Treaty were eventually approved. In the meantime, realignments could no longer be ruled out. What followed completely overturned the new wisdom regarding the possibility of maintaining exchange rate stability by short-term interest rate adjustments. The worst speculative attacks ever witnessed on the exchange markets, in terms of the amounts and the number of currencies involved, tested to the limit the authorities' ability to implement and maintain interest rate adjustments. Significant differences in the sensitivity of national economies to short-term interest rate increases came to light, which seemed to reflect deep-rooted structural differences in financial markets that are not easy to evaluate from a policy and an efficiency perspective (see Chapter VI).

These technical factors, which came on top of the long and deep recession in the United Kingdom, no doubt played an important role in the decision of the UK authorities to suspend participation in the ERM in September last year, which was justified on the grounds that it would allow monetary policy to be adapted to the requirements of the domestic economy. Speculative attacks on other currencies also mounted. After an initial devaluation (which had preceded the UK decision), Italy also decided "to abstain temporarily from intervention in the foreign exchange markets", while Spain devalued. In November 1992 and May 1993, Spain was forced to devalue twice more – on each occasion, now, necessitating devaluations of the Portuguese escudo as well. In the meantime, the Irish pound had also been devalued at the end of January 1993. On the other hand, despite heavy pressures on the French franc and Danish krone, the exchange rate relationships between these two currencies, the Benelux currencies and the Deutsche Mark were preserved. Chapter VIII and parts of Chapter VI of this Report give a fuller account of these events and the issues involved. Two of these issues merit attention here. The first concerns the operation of the ERM. The gradual transformation of this mechanism from a regime of fixed but adjustable exchange rates into a system of frozen parities bears much of the responsibility for the severity and the spread of the crisis. It stood in the way of the preventive parity adjustments that would have been warranted by the gradual emergence of fundamental exchange rate misalignments and other major imbalances. The adjustments ultimately had to be made in conditions of crisis, precipitately, triggering speculative attacks even in cases where the fundamentals were sound. Secondly, the size and speed of capital movements, which are the consequence of financial market deregulation, innovation and globalisation, raise questions not only for the ERM but also for the international monetary order in a broader sense. The spectacular increase in capital mobility has revived the debate on the merits and demerits of different exchange rate regimes.

The shock waves emanating from last September's ERM crisis did not greatly exacerbate the problems which had been accumulating in the financial industry in a growing number of countries. There may have been several reasons for this. Losses from exchange rate changes have been largely concentrated in the official sector. Private financial institutions may have been able to use gains from foreign exchange dealing to cover losses in other lines of business. In addition, the use of hedging techniques may have provided effective protection for some market participants. Finally, the turbulence did not markedly affect the major currencies in other parts of the world: the crisis was, geographically, a limited one. In the United States serious difficulties in the financial sector have gradually been overcome, albeit at a high cost. In most other countries in a similar plight an improvement is not yet in view. Chapter VII deals with these problems in some detail. The most interesting aspects are the linkages with other developments in the economies concerned, in particular the asset price cycle.

Brighter spots are to be found in some developing countries, particularly in the Far East. China deserves special mention here as an impressive illustration of the dynamic forces that can be unleashed by even controlled liberalisation and opening to the outside world. The smaller dynamic Asian economies continue to benefit greatly from international trade. It is worth noting that in 1992 growth in the developing countries far outstripped that in the developed world for the third year in succession (see the table on page 5). Latin America has made further strides on the road to recovery, although there are exceptions and it is by no means clear that all the lessons of the past are being heeded in all cases (see Chapter III).

The situation also improved last year in those eastern European countries furthest advanced in the transition process. Trade with the West has provided the main stimulus. The issues confronting policy-makers in the economies in transition are reviewed in Chapter III, which takes a close look at the restructuring of the financial sector that seems to be vital for growth prospects in the medium term. However, owing to serious deficiencies and a lack of consistency in the economic policies being pursued at present the outlook for many countries in the region remains bleak. The moulding of a new political order at a time when the necessary economic restructuring causes severe hardship over a prolonged period is the central task facing these countries, especially the new states of the former Soviet Union.

These are but a few of the themes covered in this year's Report. A full chapter (Chapter V) is, as usual, devoted to international banking and capital market developments. The order of chapters has been modified slightly, with Chapter VIII being devoted to recent exchange market developments and their analysis.

II. Developments in the industrial countries

Highlights

The two main features of developments last year were the unusually slow recovery in those countries which had moved into recession first and the progressive weakening of activity in Europe and Japan. One reason for the slow recovery appears to have been extensive balance-sheet restructuring following the asset price cycle and the large build-up of household and company debt in the 1980s. In such conditions, substantial reductions in interest rates had only limited effects on output, although lowering household income gearing and improving company cash flows.

In Europe, by contrast, high inflation and a monetary policy in Germany that started to ease only in the autumn contributed to high short-term real interest rates in countries using the Deutsche Mark as an anchor for anti-inflation monetary policies. Combined with fiscal constraints and falling external demand, this led to a growing inconsistency between internal and external policies, which was a factor in the autumn exchange market turbulence. In the Nordic countries the consequences of asset price cycles and high levels of indebtedness were exacerbated by various structural problems and a severe crisis in the financial sector.

A particular source of policy concern was the renewed rise in unemployment, observed in virtually all countries. This reflected a rise in both cyclical and structural unemployment and took place in conditions of unusually low and falling inflation.

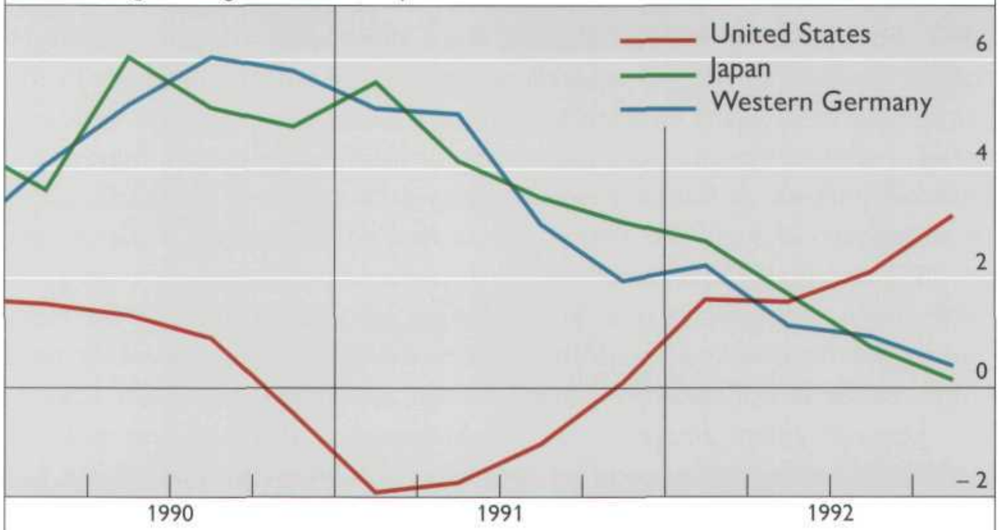
Higher outlays on unemployment benefits and measures to stimulate employment together with a cyclical fall in tax revenues led to increasing general government borrowing requirements in all but a few countries. Consequently, last year was marked by a general departure from medium-term consolidation aims; in countries with high public debt/GDP ratios the need to prevent an unsustainable deterioration in the public sector financial balance has become more urgent. Moreover, even some countries with low public debt but sharply rising borrowing requirements last year could, in the absence of measures to consolidate their budgets, soon face a situation in which servicing the public debt generates a further rise in the debt/GDP ratio. A major exception to the general picture of fiscal constraints is Japan, which in the course of the last nine months has adopted or proposed expansionary measures amounting to about 5% of GDP.

Main features of recent cyclical developments

Growth in the industrial countries last year remained at a low level, although slightly higher than it had been in 1991. Early in the year, the

Real GDP in the three major industrial countries

Percentage changes over four quarters



Source: National data.

Present cycle characterised by low growth and major differences between ...

divergence in growth rates between the three major countries, which had characterised much of 1991, narrowed as growth declined in Japan and Germany. However, in the course of the year the recovery gained strength in North America while activity weakened further, and by more than expected, in Japan and Germany (see the graph above). Hence the business cycle continued to be characterised by a high degree of desynchronisation.

Notwithstanding the incipient recovery in North America, another feature of the current cycle has been the unusually protracted downturn and slow recovery in those countries which had been the first to enter recession. Compared with previous cycles in the 1970s and 1980s, the latest cycle appears to have been both shallower and longer. This development, together with the progressive weakening of activity in continental Europe, has been one of the major problems confronting policy-makers during the past year.

... the Anglo-Saxon countries ...

Taking these issues as well as the current cyclical phase in individual countries into account, four groups of countries may be distinguished. In a first group, comprising the United States and most other Anglo-Saxon countries, the recession started relatively early and has been characterised by balance-sheet restructuring as a consequence of the previous asset price cycle and the related rise in company and household indebtedness. This has lengthened the recession and slowed the recovery and has also meant that substantially lower interest rates, notably in the United States, have had only a limited impact on aggregate demand. Balance-sheet restructuring has also been a dominant feature in a second group of countries, including Finland, Norway and Sweden. Because of severe structural problems the recession in Finland and Sweden has been much deeper than in most other industrial countries and prospects for a near-term recovery are poor. In all three countries, as well as in some of those in the first group, there have been signs of "debt deflation", as asset prices declined and households and

... Nordic countries ...

companies cut back spending in order to repay higher real debts. The majority of the continental European countries can be combined in a third group characterised by a progressive weakening of activity in the course of 1992. Forecasts for 1993, following large downward revisions, point to further declines or at best a levelling-out. The dominant influences in this group have been falling external demand and policy constraints, as reflected in high real interest rates and growing inconsistencies between internal and external policies. A fourth group comprises countries in the early stages of recession, though the underlying causes differ widely. In Japan, the predominant feature has been the adverse consequences of an asset price cycle more pronounced than in the Anglo-Saxon countries. In Germany unresolved distributional problems together with restrictive policies have led to a situation of stubbornly high inflation and rapidly weakening activity.

... continental Europe ...

... and Japan and Germany

Unemployment started to rise in Europe last year and continued to increase in recovering economies long after the business cycle trough had passed. This has swelled the already large pool of unemployed, depressed consumer confidence and added to the risk of protectionist trade measures. Moreover, the resulting fiscal imbalances prompted several countries to take measures offsetting the effects of automatic stabilisers and ruled out expansionary policies in all but a few countries.

Rising unemployment, reflecting ...

High and rising unemployment represents a worsening social and economic problem in its own right. Especially in continental Europe, where 40–50% of the unemployed have been without work for twelve months or more, unemployment constitutes a structural problem which cannot easily be resolved through faster output growth. Its root causes have not been clearly identified but would seem to include high minimum wages and social taxes which raise labour costs, inflexible wage structures and real wages, restrictive work regulations and low labour mobility. Whatever the precise causes, effective solutions become more difficult as time passes and the long-term unemployed progressively lose contact with the labour market. Part of the recent rise in unemployment in both North America and Europe may be of a transitory nature. It is related to changing output and foreign trade patterns, following the removal of trade barriers and the replacement of labour through automation. The extent of restructuring and automation is a novel feature which has in part been induced by the unusually low rates of inflation characterising the present cycle. It has also been accompanied by a marked, and possibly more than temporary, increase in productivity growth.

... structural factors and the effects of automation

Developments in output and demand in industrial countries

Hesitant recovery in the countries which entered recession early

Following a "false start" in 1991, when an apparent recovery faltered in the second half of the year, a more robust upturn became discernible in the *United States* in the second half of last year (see the table on page 12). It was led by consumption and residential investment, due in part to pent-up demand, especially for consumer durables. It also reflects progress in the

Beginning of recovery in the United States ...

balance-sheet restructuring process, as the ratio of debt service to disposable income for homeowners has fallen sharply in response to lower interest rates and debt repayments. In the enterprise sector there were also signs that the negative demand effects of restructuring were diminishing. Inventories started to rise again and the growth of investment in equipment, notably computers, which has supported activity throughout the recession, accelerated further. On the other hand, investment in non-residential construction continued to weaken owing to high vacancy rates and falling prices. Real government spending declined as a result of cutbacks in defence expenditure as well as fragile financial positions at all levels of government. Moreover, net real exports, which had been a source of strength since 1987, slackened, reflecting a slowdown in exports and a marked pick-up in imports.

... with unemployment remaining high

Despite the more positive outlook, the recovery remains fragile and growth declined sharply in the first quarter of this year, due to more hesitant household spending and the largest fall in defence outlays for more than twenty years. Measured from the trough in early 1991, the recovery is one of the weakest in the post-war period and this is particularly noticeable in private non-farm employment, which by the end of last year was still some 2% below the level in mid-1990. The continued fall in employment is due in part to the slow pace of recovery but is also the result of cost-cutting measures leading to higher productivity growth. Consequently, unemployment has remained high or continued to grow.

Falling real wages and widening income differentials

Another development delaying the recovery has been the continued decline in real wages. In the short run this can be viewed as a flexible response to weak labour market conditions. Seen in a longer perspective it reflects a trend which is rather unique to the United States. Real hourly wages have been falling since the early 1970s and throughout the 1980s this decline was accompanied by a progressive widening of wage differentials, as the position of wage earners in the upper income range improved. Less skilled workers at the lower end of the range experienced a steady deterioration in their relative income position. The proportion of income earners in the middle range, which had previously been dominated by unskilled workers in manufacturing, fell in step with automation and the declining importance of the manufacturing sector. Throughout the 1980s this "polarisation process", which has also been observed in the United Kingdom, served to create far more jobs than, for instance, in continental Europe, where minimum wages and other rigidities kept real wages in most sectors above market-clearing levels. However, job creation in the United States came in conjunction with low or negative real wage growth and, until recently, weak productivity performance.

Export-led recovery in Canada ...

The downturn started earlier in *Canada* than in the United States and the recovery which got under way last year appears less robust. It is mainly export-led, while domestic demand growth has remained sluggish. Profits have fallen sharply, notably in manufacturing, where output declined by 15% and employment by over 20% during the recession. Nonetheless, business equipment investment has been relatively strong, reflecting

Developments in real GDP and demand components: major industrial countries

Countries and periods	GDP	Total domestic demand	Demand components: Personal con-sump-tion	Public spend-ing[1]	Private fixed invest-ment[1]	Stock changes[2]	Net exports[2]	*Memo: Private non-resi-dential fixed invest-ment[1,3]*
	percentage changes							
United States								
1982–89	3.7	3.9	3.7	3.2	4.4	0.2	−0.3	*3.2*
1990	0.8	0.4	1.2	2.8	−2.8	−0.5	0.5	*−0.4*
1991	−1.2	−1.8	−0.6	1.2	−8.5	−0.3	0.6	*−7.1*
1992	2.1	2.5	2.3	−0.3	5.5	0.3	−0.4	*3.0*
1992 Q IV[4]	3.1	3.7	3.4	0.4	9.5	0.0	−0.6	*7.9*
Japan								
1982–89	4.2	4.5	3.8	1.3	8.4	0.1	−0.2	*9.6*
1990	4.9	5.1	4.0	3.3	10.0	−0.3	−0.3	*11.5*
1991	4.1	2.7	2.2	2.8	2.8	0.3	1.4	*5.8*
1992	1.3	0.6	1.8	6.6	−4.2	−0.2	0.7	*−3.9*
1992 Q IV[4]	0.2	−0.5	0.3	6.9	−5.7	−0.2	0.6	*−6.8*
Germany[5]								
1982–89	2.4	2.5	2.3	1.2	3.3	0.2	0.0	*4.6*
1990	5.1	4.9	5.4	2.3	9.6	−0.6	0.3	*10.3*
1991	3.7	3.1	3.6	0.6	7.0	−0.5	0.7	*8.2*
1992	1.5	1.6	1.0	2.5	1.3	0.2	0.0	*−0.9*
1992 Q IV[4]	0.4	1.8	1.8	2.0	−0.8	0.4	−1.3	*−6.5*
France								
1982–89	2.5	2.6	2.5	2.3	3.0	0.1	−0.2	*3.9*
1990	2.5	2.8	2.9	2.1	3.0	0.1	−0.4	*4.0*
1991	0.7	0.5	1.4	2.6	−2.3	−0.4	0.2	*−2.4*
1992	1.3	0.5	1.7	2.9	−3.3	−0.5	0.8	*−5.4*
1992 Q IV[4]	0.7	0.4	1.8	2.6	−3.6	−0.5	0.3	*−5.4*

For footnotes and sources see the table opposite.

attempts by enterprises to remain competitive in conditions of freer trade as well as tax changes which have lowered capital costs. On the other hand, activity in the commercial property sector has declined further for reasons similar to those in the United States.

As a result of the slow pace of recovery and restructuring in the enterprise sector, employment has fallen and by the end of last year the rate of unemployment, at 11½%, was 4 percentage points higher than before the recession. In response to the depressed labour market conditions and a stronger productivity performance unit labour cost growth has decelerated sharply. This has helped to offset the initial pass-through effects of a weakening exchange rate and to hold consumer price inflation in the lower part of the target range set by the authorities. Unlike in the recession of the early 1980s, the current account has remained in deficit, reflecting the strength of equipment investment and associated imports but

... with high unemployment and low inflation

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

Countries and periods	GDP	Total domestic demand	Demand components					Memo: *Private non-residential fixed investment*[1,3]
			Personal consumption	Public spending[1]	Private fixed investment[1]	Stock changes[2]	Net exports[2]	
	percentage changes							
Italy								
1982–89	2.8	3.0	3.0	2.7	3.1	0.0	−0.3	*5.4*
1990	2.1	2.5	2.5	1.2	3.8	0.0	−0.5	*4.1*
1991	1.3	1.9	2.3	1.5	0.6	0.1	−0.7	*−0.1*
1992	0.9	1.0	1.8	1.1	− 1.4	0.0	−0.1	*−1.1*
1992 Q IV[4]	−0.3	−1.6	0.9	1.0	− 5.2	−1.3	1.4	*−7.0*
United Kingdom								
1982–89	3.6	4.5	4.7	1.0	8.9	0.2	−1.2	*9.9*
1990	0.6	−0.5	0.7	3.7	− 4.9	−0.9	1.0	*−2.8*
1991	−2.1	−3.1	−2.1	1.7	−10.4	−0.6	1.1	*−9.2*
1992	−0.6	0.5	0.2	1.1	− 2.8	0.5	−1.1	*−2.9*
1992 Q IV[4]	−0.2	0.4	1.3	0.7	− 2.0	−0.4	−0.6	*−2.0*
Canada								
1982–89	4.1	4.8	4.2	2.5	6.6	0.5	−0.8	*5.5*
1990	−0.5	−1.0	0.9	3.4	− 5.2	−1.3	0.6	*−3.3*
1991	−1.7	−0.9	−1.7	2.0	− 4.7	0.6	−0.6	*−1.4*
1992	0.9	0.3	1.0	1.9	− 1.3	−0.5	0.7	*−4.9*
1992 Q IV[4]	1.3	−0.7	1.2	1.9	− 4.0	−1.2	2.0	*−7.4*
Group of Seven[6]								
1982–89	3.5	3.8	3.5	2.4	5.7	0.2	−0.3	*6.1*
1990	2.3	2.1	2.3	2.7	3.3	−0.4	0.2	*5.0*
1991	0.8	0.1	0.6	1.6	− 1.9	−0.2	0.6	*−0.3*
1992	1.5	1.4	1.8	1.4	− 0.2	0.0	0.0	*−1.3*
1992 Q IV[4]	1.4	1.5	2.1	1.7	0.1	−0.2	−0.1	*−1.8*

[1] For Germany (1992 Q IV) and Italy (all years), private fixed investment includes public investment. [2] Percentage point contribution to GDP growth. [3] For Germany (1992 Q IV) and Italy (all years), machinery and equipment only. [4] Change over four quarters. [5] Western Germany only. [6] Weighted average, based on GDP and demand components at 1990 prices and exchange rates.

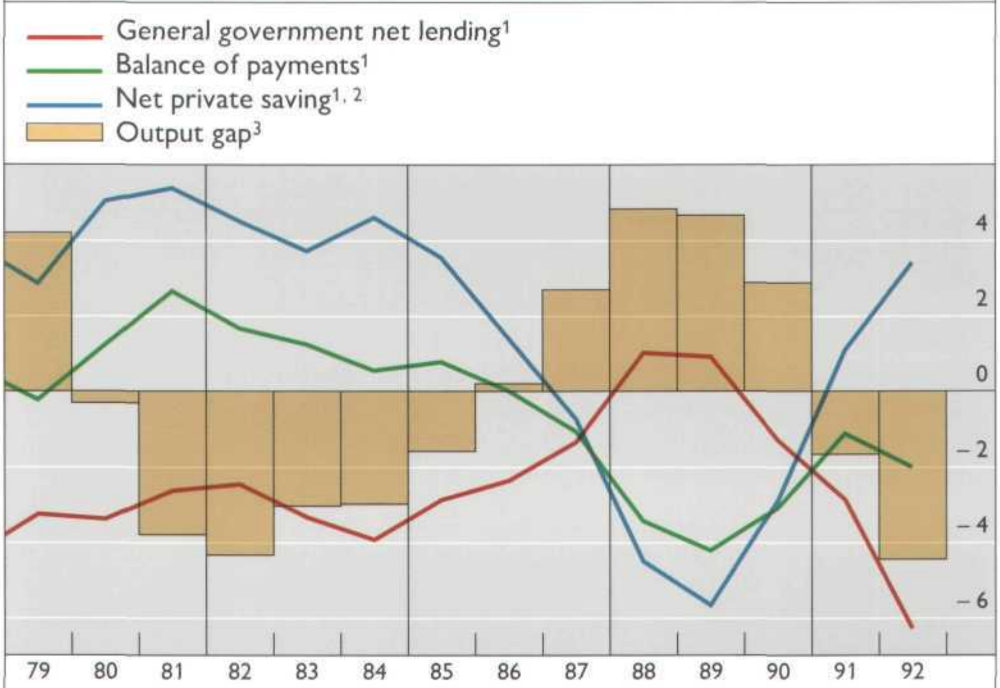
Sources: OECD and national data.

also a substantial public sector borrowing requirement, of which a large part is structural.

Protracted downturn in the United Kingdom ...

The downturn in the *United Kingdom* started at about the same time as that in Canada and has been one of the longest in the post-war period. It continued throughout most of 1992, but early this year there were signs of incipient recovery and a strengthening of business confidence. Household spending has been a major source of weakness, owing to a combination of high debt and falling house prices which has pushed more than 1½ million households (mostly young, first-time homeowners) into a situation in which their mortgage debt exceeds the market value of their property ("negative equity"). As a result, a key feature of the UK recession

United Kingdom: Developments in government net lending, the balance of payments and net private saving



[1] As a percentage of nominal GDP. [2] Financial balance of the private non-financial sector. [3] Deviation of actual from trend GDP (2¼% according to official estimates), in percentages.
Source: National data.

has been an unusually sharp rise in household saving (see the graph on page 18) and a corresponding fall in consumption.

... with falling net exports

Last year output was also affected by the fall in net real exports as import demand increased sharply during the first half of 1992 and export growth was slow throughout the year. This can to some extent be explained by poor competitiveness and sluggish export market growth. However, imports of manufactured goods were particularly strong, suggesting that the low level of manufacturing investment has led to a structural weakness as the capacity of UK manufacturing enterprises may not be sufficiently large to support the domestic market even in conditions of low demand.

Widening external deficit ...

This structural weakness can also be seen in the graph above. In contrast to the recession in the early 1980s the current account has been in deficit throughout the recent downturn and last year the imbalance actually widened to almost twice the 1991 level. Since the record current account deficit in 1989, the corresponding sectoral imbalances have also changed markedly. In 1989, as a consequence of the asset price cycle, both the household and company sectors recorded large financial deficits while the government balance was in surplus. The rise in household saving during the recession combined with cutbacks in fixed investment and destocking in the company sector has left the aggregate private sector with a net financial surplus. Consequently, the balance-of-payments deficit is entirely accounted for by the deterioration in public sector finances. Even though

... and government borrowing requirement

changes in financial balances are difficult to predict and the balance of payments contains a large "balancing item", this development may pose a dilemma for UK policy-makers. Growth above the present rate would be required to reduce the budget deficit but could increase the current account deficit. On the other hand, growth compatible with a stable current account deficit might lead to an unsustainable rise in the public sector imbalance.

Beginning of recovery in Australia ...

In *Australia* a recovery slowly gained momentum in the course of 1992 (see the table below). Household spending provided a major stimulus and residential investment revived in response to lower mortgage rates. However, owing to narrow profit margins, balance-sheet restructuring and other cost-cutting measures business fixed investment has fallen steeply, with spending on equipment at the lowest level ever recorded. Reflecting the poor state of the corporate sector, the rate of unemployment rose to a post-war high. Net real export growth was negative last year and, due to the weakness in world commodity prices, the terms of trade deteriorated.

A significant moderation of inflation has allowed the Reserve Bank to reduce short-term interest rates, while long-term rates declined more slowly, with the steepening yield curve partly reflecting a rise in the general government borrowing requirement. About half of the deterioration since

Changes in real GDP and gross fixed investment in other industrial countries

Countries	1990 GDP in billions of US dollars	Real GDP[1]				Real gross fixed investment			
		1982–89	1990	1991	1992[2]	1982–89	1990	1991	1992[2]
		percentage changes							
Australia	294	3.8	1.2	−1.1	2.0	4.2	− 7.5	−10.4	− 2.8
Austria	157	2.4	4.6	3.0	1.5	3.5	5.8	4.8	1.1
Belgium	192	2.3	3.3	1.9	0.8	5.3	7.7	0.3	0.7
Denmark	129	2.4	2.0	1.2	1.1	4.4	− 0.5	− 4.2	−10.4
Finland	137	3.7	0.3	−6.4	−3.5	4.9	− 4.9	−19.8	−14.4
Greece	66	2.1	−0.1	1.8	1.5	0.6	5.7	− 2.0	2.0
Ireland	43	3.3	8.3	2.5	2.4	−1.5	10.8	− 6.5	− 0.8
Israel	51	3.4	5.4	5.9	6.4	0.1	19.6	41.8	11.8
Netherlands	279	2.5	3.9	2.2	1.5	5.3	3.6	0.1	1.9
New Zealand	44	1.5	0.5	−1.5	3.0	3.2	1.9	−16.2	2.0
Norway	106	3.1	1.8	1.6	3.3	2.6	−26.8	1.7	3.5
Portugal	60	2.8	4.2	2.1	1.1	2.0	5.9	2.5	5.0
Spain	491	3.5	3.6	2.4	1.0	6.5	6.9	1.6	− 3.0
Sweden	228	2.5	1.4	−1.8	−1.7	5.8	0.7	− 9.0	−11.0
Switzerland	225	2.6	2.3	−0.1	−0.6	5.9	2.6	− 2.5	− 6.7
Turkey	108	5.1	9.2	0.3	5.5	4.8	14.0	− 0.4	1.3
Average[3]	–	3.0	3.0	0.8	1.0	4.8	2.3	− 2.4	− 2.6

[1] For Turkey, real GNP. [2] Preliminary. [3] Weighted average, based on 1990 GDP and exchange rates.

Sources: OECD and national data.

1990 may be structural, including state government support for ailing banks and financial enterprises.

... but deepening recession in Switzerland ...

The slowdown in *Switzerland* deepened further last year. Weakness can be observed mainly in the domestic sectors. Only public consumption provided a positive contribution to activity and domestic demand declined by 4%. Although Swiss enterprises have not increased their debt to the same extent as enterprises in the countries discussed above and balance-sheet problems are largely confined to the real estate sector and several regional banks, the length of the recession has induced a widespread restructuring process, including substantial reductions in investment and employment. Unlike in earlier recessions, job cuts have not affected only low-level jobs and foreign workers, and early this year the rate of unemployment rose to over 4%. Higher spending on unemployment benefits combined with stagnating revenue have caused a steep rise in the central government deficit, prompting the Government to cut spending and raise taxes. Throughout the downturn net export growth has been positive, though to some extent at the expense of profit margins. Towards the end of last year, however, export growth fell in response to weaker demand in major European markets.

... leading to record unemployment

Deepening recession in conditions of severe structural problems

Severe recession in Nordic countries ...

In three Nordic countries (Finland, Norway and Sweden) the downturn has not only lasted longer but has also been much more severe than in most other countries. In 1992 all three recorded historically low rates of inflation. However, because of deep-rooted structural problems they do not seem to have benefited from any credibility gains and last autumn were all forced to abandon currency pegs to the ECU (see Chapter VIII). Other common problems include the consequences of adjusting to overheating in the late 1980s, aggravated by volatile asset prices and steep increases in household and company debt. A severe crisis in the financial sector is also a characteristic feature of the three economies (see Chapter VII) and structural problems have not only deepened the recession but have also been a cause of financial fragility and of financial market turbulence. In Finland the structural problems are mainly related to the loss of export markets in eastern Europe, in Sweden to an overgrown public sector and in Norway to a lack of competitiveness in the "mainland sectors" (i.e. excluding oil and shipping).

... accompanied by financial and structural problems

Finland has suffered by far the deepest recession. Since the cyclical peak in early 1990 GDP has fallen by about 10%, and unemployment has increased from 3½ to over 15% in little over three years (see the graph on page 21). Exports have recovered and last year net exports contributed 2½% to output growth, helped by a real effective depreciation of more than 30% and low rates of capacity utilisation. However, all domestic demand components declined steeply as both households and enterprises increased saving to reduce debt accumulated during the previous asset price cycle. Real government spending was cut to limit the rise in the borrowing requirement. Despite the currency depreciation price inflation eased, since

Steep output decline in Finland ...

... reflecting a weak domestic economy

nominal wages have shown little growth for two years and enterprises have absorbed higher import costs in lower profit margins to prevent even larger declines in domestic sales. However, the squeeze on profits combined with the fall in domestic demand caused severe financial strains in many enterprises, adding to the already large stock of non-performing loans held by banks. Furthermore, the currency depreciation has increased the burden of servicing the foreign debt, which by the end of 1992 had grown to almost 50% of GDP. Consequently, the floating of the currency has in practice provided the monetary authorities with little additional room for manoeuvre.

Large public sector in Sweden with growing financial needs

The output decline in *Sweden* has been mild compared with developments in Finland, but the structural problems may be almost as severe, especially in the public sector. Although attempts to cut public sector growth had met with some success, at the end of the 1980s the share of government spending in GDP, at 60%, was still the highest among OECD countries. Moreover, a tax reform entailing a major shift from direct to indirect taxation in 1990–91 caused a large increase in the general government borrowing requirement as households cut back consumption. Last year's massive rise in the central government deficit, according to the Government's estimates from 7 to 14% of GDP and due in part to lagged tax payments to local authorities, led to considerable financial market uncertainty, contributing to exchange market turbulence and high real interest rates. In its revised budget for 1993/94 the Government has proposed a medium-term reduction in spending amounting to some 5% of GDP, notably in social transfers.

Sharp reversal of household saving

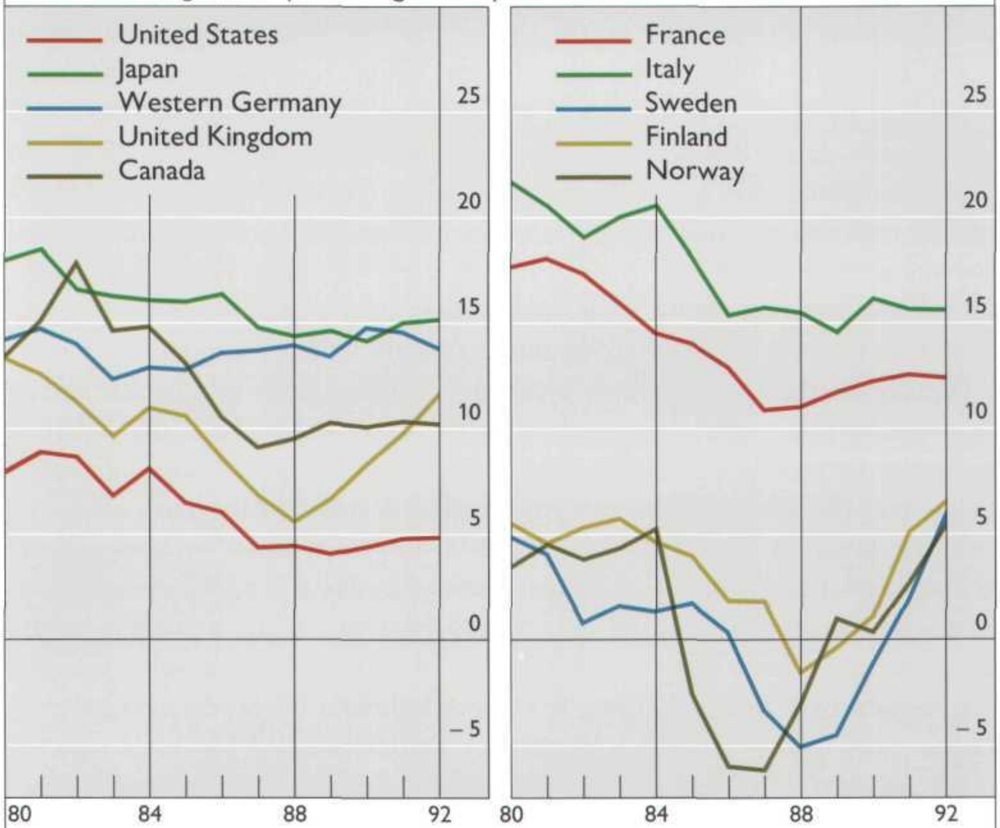
In the 1980s a key feature in Sweden, as well as in the other Nordic countries, had been a steep fall in household saving, with negative rates recorded in all three countries (see the graph overleaf). The decline, starting in the mid-1980s, coincided with financial market deregulation and the beginning of the asset price cycle, as households borrowed heavily to invest in real property. Last year, however, household saving rose sharply, reflecting attempts to reduce debt but probably also as a precautionary reaction to increasingly uncertain labour market conditions following the rise in unemployment to the historically high rate of nearly 6%. Debt reduction and a restructuring of balance sheets were also evident in the company sector, causing a marked contraction in fixed investment. Overall, domestic demand fell by 2%, notwithstanding strong residential investment early in the year owing to various measures to stimulate employment. Net exports provided a positive contribution to output growth but the current account imbalance rose further, as the increase in private sector net saving was not large enough to offset the deterioration in public sector finances.

Signs of recovery in Norway ...

The downturn in *Norway* had already started in 1986 and there are signs of a weak recovery this year. At the same time, the crisis in the financial sector has been as serious as in Finland and Sweden and activity in the mainland sectors has been very weak. The principal causes of high unemployment and of the accumulation of non-performing loans held by banks are also to be found in these sectors. The deterioration of the

Personal saving in selected countries*

Annual averages, as a percentage of disposable income



* For France, Italy and the United Kingdom, gross saving; for other countries, net saving. Figures for 1992 are partly estimated.

Sources: OECD Economic Outlook and national data.

budget balance since the mid-1980s reflects a steep increase in public consumption and other fiscal measures aimed at stimulating mainland activities and offsetting contractions in manufacturing and private services. The overall deficit of 2¾% of GDP in 1992 masks a deeper structural weakness, as the "non-oil deficit" (excluding net revenues from the oil sector) exceeded 8%. Last year saw some progress in removing the structural weaknesses. Unit labour cost growth fell (see the table on page 28) and the household saving ratio rose to over 5%, compared with less than 0.5% only two years earlier. The company sector also improved its balance-sheet position, though mainly by cutting fixed investment and shedding labour. A further improvement in competitiveness can be expected this year owing to lower payroll taxes and the depreciation of the krone.

... and some progress in remedying structural problems

Weakening output growth under the influence of falling external demand and internal policy constraints

Curbing inflation and improving foreign trade performance by maintaining a fixed exchange rate has for several years been a cornerstone of macroeconomic policies in *France*. Last year GDP growth, at 1¼%, was higher than in 1991 and also among the highest in Europe. Net exports accounted

Higher growth in France ...

for more than half of the overall rise, as French enterprises, helped by earlier cost-reducing measures, managed to gain market shares even in conditions of falling export demand. However, export growth weakened considerably following the ERM realignments and was negative in the last quarter. Domestic demand growth declined in the course of 1992, principally as a result of a progressive fall in business fixed investment. For most of the year real short-term interest rates in the tradable sectors, where prices were largely stable, were in the 8–10% range. Moreover, with poor demand prospects and falling capacity utilisation rates firms had little incentive to invest, even though cost-cutting and low nominal wage growth helped to maintain profit shares.

... with rising unemployment

Attempts by enterprises to remain competitive in an environment of uncertain growth prospects were a principal reason for the rise in unemployment to 10½% by the end of last year. To prevent a further rise the Government introduced various, mostly temporary, employment measures, including retraining schemes, public works programmes and tax reductions for firms hiring long-term unemployed and young workers. These measures, together with a cyclically induced decline in tax revenue, contributed to a rise in the general government deficit to the highest level since 1982.

Fiscal constraints in Belgium and the Netherlands

Other European countries adhering to a fixed exchange rate as a centrepiece of their macroeconomic policies recorded even less favourable developments last year: slower growth owing to weaker exports, notably to Germany, and falling and eventually negative growth in business fixed investment. There were, however, differences depending on the strength of the previous upturn, the deterioration in competitiveness following currency realignments and the scope for policy manoeuvre. In both *Belgium* and the *Netherlands* fiscal consolidation was the overriding constraint and there was little room for offsetting the negative demand trend. In Belgium, residential construction showed a sharp rise as a result of more intensive competition among mortgage institutions and lower interest rates. However, for the third year in succession, unit labour cost growth exceeded that of major trading partners, which gives the Government the right to adopt special measures to reduce labour costs. The Netherlands faced the problem of preventing a temporary rise in consumer price inflation – principally due to higher rents, administered prices and indirect taxes – from being reflected in wages, and a tripartite agreement was reached early this year freezing wages for two months.

Different trends in Austria and Denmark

Growth in *Austria* remained high during the first half of 1992, as lower exports to western countries were offset by brisk trade with eastern Europe, private consumption and construction. The second half of the year saw a sharp weakening as the construction boom came to an end and several industries lost market shares to imports from eastern Europe. In *Denmark* the general government deficit remained below 3% of GDP, inflation fell further and the current account surplus rose to over 3% of GDP. However, competitiveness deteriorated during the autumn, as the European countries with depreciating currencies account for about 40% of Danish foreign trade. GDP growth remained stable at a low rate and unemployment rose to over 11% by year-end.

Weakening output trend in Italy ...

Italy has entered a phase of marked slowdown which accelerated during the second half of last year. Both household consumption and business investment, following stagnation in the early part of the year, declined after the summer when confidence was badly shaken by the currency crisis. Employment growth also weakened considerably in the course of the year as workers released from large firms were no longer absorbed by smaller firms and labour demand in the services sector decelerated (see the table on page 26). Net exports, which had fallen during the first half of 1992, expanded significantly in the last quarter as a consequence of the large devaluation of the lira, but this only partly compensated for the decline in domestic demand. For the year as a whole GDP growth fell to around 1%, with the principal contribution coming from private consumption. The unfavourable output trend, common to most EC countries, was aggravated in the case of Italy by unresolved financial problems inherited from the past, notably the urgent need to achieve a sustainable fiscal position and to correct the excessive rise in labour costs and prices.

... and financial problems

The abolition in July of automatic wage indexation based on past price increases has significantly reduced the growth of nominal wages and unit labour costs. Lower cost pressures combined with uncertainties about the future development of income and employment and the acceptance of reduced profit margins in a context of falling domestic demand contributed to a deceleration in inflation to 4.2% early this year. This is only marginally above the EC average, but still 2½ points higher than in the three EC countries with the lowest rates of price increase.

Lower inflation but ...

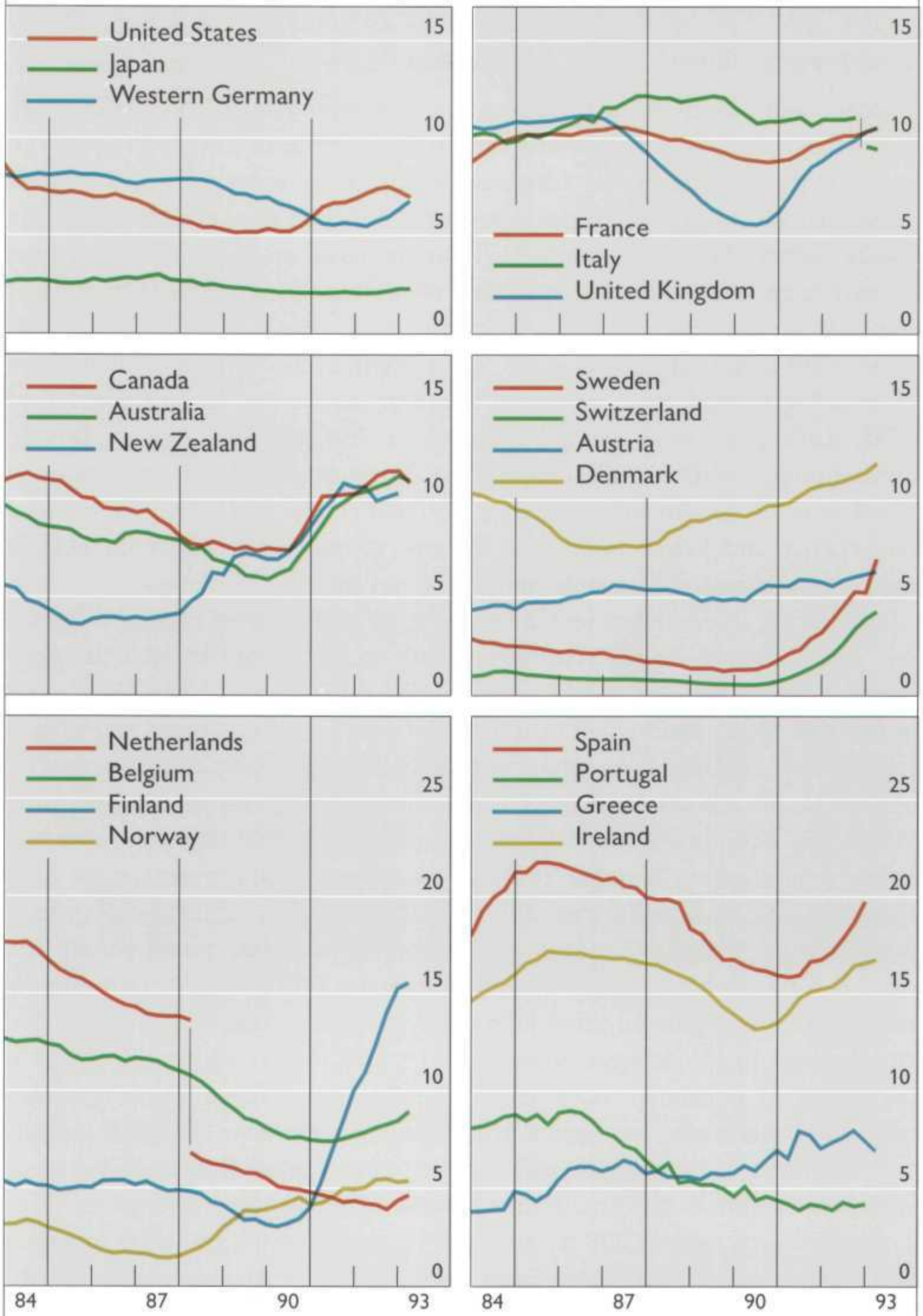
On the fiscal front progress was less evident. Despite a mid-year emergency budget entailing net savings of 2% of GDP, the 1992 borrowing requirement amounted to over 10% of GDP. The budget adopted for 1993 raises taxes on the self-employed and also assumes higher revenue from taxes on real estate and corporate assets and a first round of privatisation of state enterprises. In addition, it includes major cuts in pension allowances, transfers to local authorities, health services and public employment expenditure. However, lower revenues than initially foreseen, slippages in some expenditure cuts and new measures aimed at strengthening labour demand through fiscal incentives and public works caused the deficit for the first three months of this year to exceed the level compatible with the 10% annual target.

... little progress in reducing government deficit

The three EC countries which devalued their currencies within the ERM recorded rather different macroeconomic developments last year. *Ireland* was able to keep GDP growth relatively stable, helped by a strong export performance and a marked rise in consumer spending, whereas fixed investment declined, perhaps in response to high real interest rates. *Portugal*, on the other hand, saw GDP growth slow to only 1% even though investment demand was relatively buoyant and unemployment fell slightly. By contrast, fixed investment weakened significantly in *Spain*, owing

Stable growth in Ireland ...

Unemployment rates*



* In percentages. National data and definitions; for Italy and the Netherlands, break in series; for Switzerland, labour force based on 1980 census.

... and lower growth in Portugal and Spain

to a marked deterioration in enterprises' financial position and falling real property prices, and net exports declined for most of the year. A mid-year budget correction, including higher VAT rates and income tax withholding rates, contained the rise in the general government borrowing requirement but reinforced the negative employment trend, bringing unemployment to 20% by year-end. To prevent a further increase, early this year the

Government introduced various employment-stimulating measures within an otherwise austere budget.

Countries in the early stages of recession

Demand and output growth weakened progressively in Japan and Germany in the course of 1992 and by the end of the year both countries appeared to be in the early stages of recession. In *Japan* the sources of the current downturn can be traced to the asset price boom in the second half of the 1980s, which led to a surge in business fixed investment, residential construction and household spending on consumer durables. Once asset prices started to fall, the excesses of the boom became apparent and the downward phase of several stock adjustment cycles is now evident. The downswing started with residential construction in the second quarter of 1991. Last year new car purchases also fell and the rise in private consumption was the smallest since 1981. These developments took place in conditions of weakening consumer confidence due, in part, to political uncertainty and lower household income growth resulting from cuts in overtime and bonus payments and falling net interest earnings.

Onset of recession in Japan ...

Business fixed investment declined at an accelerating rate throughout last year. Low capital costs combined with a tight labour market had triggered a cumulative rise in labour-saving and capacity-expanding investment in the mid-1980s and by 1991 the ratio of non-residential fixed investment to GDP had reached 28%. Many enterprises had probably planned capacity expansion on the assumption of a continued strong rise in total demand. When the economy started to slow down and higher interest rates and falling equity prices brought the period of low capital costs to an end, the expected returns became difficult to realise. Consequently, operating profits in the company sector have fallen for the last three years. The decline is not only the result of excess capacity but also reflects mounting depreciation charges and some inflexibility in labour costs in a system traditionally based on lifetime employment. In addition, owing to the slump in purchases of consumer durables, enterprises have faced growing inventories and destocking has been a major cause of the fall in industrial output.

... with falling investment

Against this background the only sources of growth in Japan last year were consumption of non-durables, public spending and net exports. Net export growth raised GDP by almost 1%, partly owing to falling imports, and large terms-of-trade gains eased cost pressures in the enterprise sector. Public investment accounted for about half of domestic demand growth and public consumption also increased. The measures proposed in August last year – equivalent to about 2¼% of GDP and primarily aimed at stimulating the equity and real estate markets and increasing public works – as well as the 1993 budget and new measures proposed in April should provide a further strong expansion in public investment this year.

Growing net exports and public investment

Germany has not experienced an asset price cycle or the consequences of balance-sheet restructuring in an indebted private sector. Instead, the current downturn has its roots in distributional problems, in part related to unification. These were evident in discussions between

Distributional problems in Germany ...

federal, state and local governments on sharing the costs of unification and in negotiations between employers and trade unions regarding the distribution of income in western Germany and the speed of realigning wages in eastern Germany with those in the west. Typically, failure to resolve distributional problems results in higher inflation and eventually, when this is countered by an unaccommodating monetary policy, lower real income growth and higher unemployment.

... with a sharp downturn during 1992 ...

Led by business fixed investment, GDP in western Germany was still growing at a rate of over 2% in the first quarter of 1992. However, by mid-year signs of weakness had become evident and during the second half the economy declined at an unusually rapid pace, with real GDP contracting at a 2% annual rate. By the fourth quarter equipment investment was down by more than 6% and industrial output by over 5% compared with the previous year. In contrast, public and private consumption continued to grow, the latter particularly in the second half, prompted by the ending of the solidarity tax and the imminent rise in the VAT from 1st January this year. Residential construction also expanded at a brisk pace throughout 1992 under the combined influence of more favourable tax allowances and housing shortages caused by immigration. The sharp swing in business fixed investment should be seen against the background of a declining profit share, low capacity utilisation rates and sagging business confidence and probably also as a response to the policy of promoting investment in eastern Germany through tax credits and subsidies.

... but little easing of inflationary pressures

Despite growing slack and falling import prices, there was no appreciable decline in inflationary pressures last year. Higher rents and price pressures in the services sector largely offset more favourable developments in the price of tradables. Nominal wage increases remained high and productivity growth weakened in step with the advancing recession. However, early this year a 3% wage agreement for public sector employees was reached without a repeat of last year's work disruptions. Setting the pattern for negotiations in other sectors, this should bring about a marked easing of wage cost pressures.

Solidarity pact aimed at solving distributional issues

The extent to which a recently concluded "solidarity pact" will influence wages and inflation is more uncertain. Initially the Government had hoped to reconcile employers and employees as well as the different levels of government within a broad agreement to solve the distributional issues. However, the pact agreed so far comprises only the government sector. It essentially calls for higher transfers to eastern Germany in 1995, with part of the increased cost burden for the state governments in western Germany to be met by a larger share of VAT revenue, while the Federal Government will raise revenue through a 7½% surcharge on income tax and increases in wealth taxes. The pact also makes more credits available to eastern Germany with immediate effect, whereas earlier plans for cutting social expenditure to meet the cost of transfers were dropped.

Turnaround in eastern Germany ...

While output growth progressively declined in western Germany, there were signs of recovery in eastern Germany, though from an extremely low level. Led by fixed investment (see the table overleaf), real

Developments in eastern Germany: selected indicators	1991*	1992
Real household consumption, % change	– 1.9	5.4
As a percentage of domestic demand	52.0	50.3
Saving rate, %	6.4	13.0
Real fixed investment, % change	14.2	24.0
As a percentage of domestic demand	23.1	26.3
Real domestic demand, % change	10.6	9.0
As a percentage of GDP	192.5	196.5
Output, % change		
GDP	–16.5	6.8
Manufacturing	–34.3	– 1.2
Consumer prices, % change	13.3	11.1
Nominal wages per employee, % change	32.5	40.5
As a percentage of wages in western Germany	47.5	63.2
Productivity, % change	– 2.6	21.0
As a percentage of productivity in western Germany	29.0	34.8
Employment, % change	–14.4	–11.7
Short-time workers, % change	6.7	–77.1
As a percentage of employment	22.5	5.8
Rate of unemployment, %	10.4	14.8

* Changes calculated compared with the second half of 1990.

... but continued dependence on large transfers

GDP rose by almost 7% despite a 50% drought-related fall in the contribution of agricultural output. However, the conditions for a self-sustaining recovery are still far from being met. Last year domestic demand rose to almost twice the level of GDP, which was made possible by the transfers and subsidies from western Germany to meet the difference between wages and productivity in eastern Germany. Since unification many loss-making enterprises, notably in industry, have been closed and employment in eastern Germany has fallen by over 25%, pushing up expenditure on unemployment benefits and public works schemes. Moreover, even though output per worker rose to 35% of the level in western Germany last year, it remained well below the corresponding wage ratio of 63%. Consequently, a large part of the remaining enterprises rely on subsidies from the west to finance current production costs.

To prevent a further decline in profitability, employers in the metal industry recently cancelled a previous agreement on a 26% wage increase, offering only 9% instead. The outcome of this conflict is still open, but a settlement in one state together with revised agreements in other sectors may signal a slower convergence of wages and some easing of the need for subsidies.

Labour market developments in the present cycle

Unemployment near earlier peak

The average unemployment rate in the OECD area rose to 8% last year, almost 2 percentage points above the level of 1990. Even though the rise was much smaller than in the recession of the early 1980s and employment grew vigorously during the 1983–89 expansion, unemployment last year was as high as in 1982 and only slightly below the peak in 1983. This is indicative of a rise in structural and frictional unemployment, the latter due in part to the restructuring in Europe in preparation for the single market and in North America as a result of automation and recent free trade agreements.

Sluggish growth in services sectors ...

In past recessions industrial employment has typically been most adversely affected, whereas employment in the services sectors acted as a buffer. During the recent downturn, however, services sector employment decelerated in most countries and in some cases actually declined (see the table overleaf). Moreover, unlike in earlier recessions when slower services employment growth was confined to the cyclically sensitive trade and transport sectors, this time cutbacks have also affected the administrative staff of industrial enterprises and the financial services sector. This has been observed in several countries and can be attributed to automation and excess capacity in the financial industry.

... and rising unemployment among white-collar workers

Against the background of a longer-term rise in service-related jobs these recent developments have also affected the occupational and regional composition of unemployment. White-collar unemployment has been much higher than in earlier recessions. In the United States white-collar workers accounted for more than half of the overall rise in unemployment, and in Canada for only slightly less. The setbacks in the financial sector have also affected the regional distribution of unemployment. Typically, regional differences in unemployment tend to widen in a recession. In 1989–92, however, there was a considerable compression (especially in the United Kingdom and Australia) as the regions most affected by the difficulties in the financial sector were also those with the lowest unemployment rates before the recession.

Slow growth of small enterprises

A second feature last year was the relatively slow growth of small to medium-sized enterprises, which in earlier recoveries had provided most new jobs. This development was most pronounced in the United States, where such enterprises employ two-thirds of the workforce and accounted for 80% of the new jobs created in the 1980s. It was also observed in Canada, Japan, the United Kingdom and Sweden and may be related to the stricter terms and standards for bank credits. In contrast to larger enterprises with access to market financing, small to medium-sized enterprises rely almost exclusively on bank credits and are, therefore, especially vulnerable to more restrictive lending criteria.

Changing lay-off and hiring policies ...

Thirdly, many firms appear to have changed their lay-off and hiring policies. In several countries there are clear indications that firms adjusted employment more quickly to weaker output growth, but were slow to hire new workers during the recovery. As a result, almost half of the decline in unit labour cost growth in those countries which have experienced the deepest recessions can be explained by a remarkable strengthening of productivity growth (see the table on page 28). Sudden increases in productivity growth have also been observed in the past and the recorded fall in unit labour cost growth is in part a once-for-all effect of "downsizing" of the workforce and a shift from full to part-time

Employment by sector in selected countries						
Countries	Sectors	1980–85	1985–90	1990	1991	1992[1]
		annual percentage changes				
United States	Total	1.5	2.0	0.5	−0.9	0.5
	Industry	−0.2	0.6	−1.2	−4.3	−2.0
	Services	2.4	2.6	1.2	0.3	1.7
	Financial[2]	*2.9*	*2.5*	*0.5*	*−0.8*	*−0.1*
Japan	Total	1.0	1.5	2.1	1.9	1.1
	Industry	0.7	1.0	1.6	3.0	1.5
	Services	1.7	2.3	3.0	2.2	1.3
	Financial[2]	*2.5*	*3.3*	*2.0*	*1.1*	*0.8*
Germany[3]	Total	−0.3	1.4	2.8	1.9	0.5
	Industry	−1.6	0.9	2.8	0.4	−0.8
	Services	1.0	2.3	3.2	3.3	1.7
France	Total	−0.4	0.7	1.1	0.0	−0.3
	Industry	−2.8	−0.6	0.1	−1.5	−2.5
	Services	1.3	1.7	1.8	1.1	1.0
	Financial[2]	*1.3*	*3.9*	*0.9*	*0.0*	*−0.3*
Italy	Total	0.2	0.8	1.8	0.9	−0.6
	Industry	−2.2	0.1	2.8	−0.3	−1.0
	Services	3.2	1.8	2.3	2.1	0.4
United Kingdom	Total	−0.6	1.8	0.4	−3.3	−2.8
	Industry	−3.8	−0.1	−1.9	−7.0	−6.1
	Services	1.4	2.8	1.4	−1.7	−1.5
	Financial	*2.3*	*3.6*	*−5.3*	*−1.8*	*−3.3*
Canada	Total	0.9	2.3	0.7	−1.8	−0.9
	Industry	−1.4	1.6	−3.4	−7.3	−3.2
	Services	2.0	2.8	2.3	−0.3	0.2
	Financial	*0.9[4]*	*3.3*	*2.4*	*0.5*	*−2.2*

For footnotes and sources see the table opposite.

... accompanied by stronger productivity ...

workers to reduce social security, health insurance and pension fund contributions. However, the rise in productivity growth could be of a more than temporary nature, since it started shortly after or even before the output trough and labour hoarding has been low. Moreover, it has not been confined to industry but was observed in the services sectors as well, reflecting the influence of greater international competition and automation. Finally, in an environment of low inflation firms have a strong incentive to lower costs and increase labour productivity.

... and lower employment

Since the rise in productivity growth has been most pronounced in those countries which have suffered the most severe recessions it is too early to say how long it will continue. However, even if mainly cyclical, the increase in permanent job losses relative to temporary lay-offs will affect the near-term prospects for employment. Because it is more difficult to replace jobs that have been eliminated than to take back workers temporarily laid off, the rate of output expansion required to generate the same employment growth as in the past will, for a while, be higher.

Employment by sector in selected countries (continued)						
Countries	Sectors	1980–85	1985–90	1990	1991	1992[1]
		annual percentage changes				
Australia	Total	1.2	3.3	1.6	− 1.8	− 0.5
	Industry	−1.0	1.5	−2.6	− 6.7	− 1.6
	Services	2.4	4.0	3.2	0.1	0.1
	Financial[2]	*5.3*	*6.2*	*3.3*	*− 2.0*	*0.8*
Finland	Total	0.9	0.1	−0.1	− 5.2	− 7.1
	Industry	−0.8	−0.4	−0.3	−10.5	−11.6
	Services	2.7	1.7	0.7	− 2.6	− 5.2
	Financial[2]	*5.2*	*4.8*	*1.3*	*− 1.3*	*− 3.7*
Norway	Total	1.1	0.2	−1.1	− 1.0	− 0.2
	Industry	−0.6	−2.0	−3.2	− 5.3	− 0.9
	Services	2.3	1.2	−0.1	1.4	0.5
	Financial	*6.4*[5]	*3.2*	*−2.6*	*2.0*	*0.0*
Spain	Total	−1.6	3.4	2.6	0.2	− 2.0
	Industry	−4.1	4.5	4.2	− 0.9	− 3.9
	Services	0.5	5.4	4.0	3.0	0.1
	Financial[2]	*2.3*	*8.8*	*5.0*	*7.6*	*− 0.8*
Sweden	Total	0.3	1.0	0.9	− 1.7	− 4.1
	Industry	−1.3	0.5	−0.1	− 4.7	− 9.7
	Services	1.2	1.5	1.8	− 0.3	− 1.9
	Financial	*2.9*	*3.5*	*6.5*	*− 0.6*	*− 7.7*
Switzerland	Total	1.1	1.2	1.3	− 0.1	− 2.0
	Industry	−0.2	0.9	0.9	− 1.7	− 3.9
	Services	2.3	1.6	1.6	0.8	− 1.0
	Financial	−	*1.7*	*2.5*	*0.5*	*− 2.5*

[1] Preliminary. [2] Finance, insurance, real estate and business services. [3] Western Germany only. [4] 1983–85. [5] 1981–85.

Sources: OECD Labour Force Statistics and national data.

Furthermore, frictional unemployment may remain high since filling new jobs often entails worker relocation and retraining.

Labour markets in Japan and Germany

In a global context near-term unemployment will also depend upon developments in the two countries – Japan and Germany – that are in the early stages of recession. The Japanese labour market has so far been remarkably resilient in the face of weaker demand growth, with the unemployment rate remaining virtually stable and the ratio of job offers to job seekers still well above the trough of the mid-1980s. In Germany, however, both unemployment and the number of workers on short time have risen significantly.

Further moderation of inflation

Historically low inflation ...

Consumer price inflation in the industrial countries fell to only 3¼% by the end of last year, almost 1 point below the rate recorded in 1991 (see the table on page 29) and the lowest rate since the early 1960s. Unlike the deceleration between 1990 and 1991, in which the effect of one-time changes in oil prices was dominant, the outcome last year was largely the

Changes in the growth of unit labour costs, wages and productivity and in the rate of unemployment[1]					
Countries	Unit labour costs (ULC)	Wages	Produc- tivity	Rate of unemploy- ment	*Memo item: average growth of ULC 1989–91*
	in percentage points				
Finland	−12.7	−8.8	3.9	7.5	*7.1*
Sweden	− 6.5	−3.9	2.6	2.7	*9.0*
Australia	− 5.5	−4.0	1.5	2.6	*6.2*
United Kingdom	− 5.0	−2.3	2.7	3.0	*9.0*
United States	− 4.0	−1.5	2.5	1.3	*4.1*
Canada	− 3.6	−1.0	2.6	2.0	*5.4*
Switzerland	− 3.5	−2.8	0.7	2.0	*5.2*
Italy	− 2.0	−2.0	0.0	0.0	*7.1*
France	− 1.5	−0.5	1.0	1.0	*2.9*
Norway	− 1.2	−1.6	−0.4	0.6	*3.0*
Spain	− 0.7	1.0	1.7	2.1	*5.5*
Belgium	− 0.5	−1.6	−1.1	1.3	*3.4*
Japan	− 0.5	−3.0	−2.5	0.1	*1.8*
Denmark	1.0	−1.0	−2.0	1.0	*1.0*
Netherlands	1.0	0.8	−0.2	−0.4	*1.1*
Germany[2]	1.5	0.1	−1.4	0.0	*2.2*
Austria	2.0	0.2	−1.8	0.2	*2.3*

[1] Changes calculated as differences between 1990–91 average *growth rates* in the business sector (for unemployment, *levels* in the total economy) and preliminary figures for 1992. [2] Western Germany only.

Sources: OECD Economic Outlook and BIS estimates.

result of domestic price and wage developments. Unit labour cost growth declined in many countries and price increases were particularly low in the tradable sectors. By contrast, prices in the non-tradable sectors adjusted more sluggishly and the differential between service price increases and general inflation widened (see the table on page 30).

A major exception to the more moderate price trends was Germany. Partly reflecting the influence of German wage developments, inflation rose in Austria and declined only marginally in Belgium. In the Netherlands, which had recorded the lowest average rate of inflation during 1985–90, the influence of special factors (see page 19) progressively diminished. In the two countries (Canada and New Zealand) with explicit inflation targets, the outcome for 1992 was below or at the lower end of the target range. Another notable feature was that most countries with depreciating currencies succeeded in reducing inflation. Weak domestic demand and worsening labour market conditions had a dampening influence, but it also appears that the terms-of-trade declines associated with currency depreciation were "absorbed" in slower real wage growth and narrower profit margins. This was evident in Italy, Canada, Australia and Finland, while in Spain an inflexible labour market continues to keep nominal wage growth relatively high.

... with variations between countries

Disinflation, high real interest rates and the emergence of policy dilemmas in Europe

Owing to continuing inflationary pressures in Germany there was little scope for an early monetary easing by the central bank. Because of the currency links within the ERM this led to increasing tension between the external exchange rate constraint and the ability of macroeconomic policies to address the greater than expected weakness in aggregate demand.

Worldwide trends in interest rates affect the interest rate level in most industrialised countries with open capital markets. However, in a system of floating exchange rates divergent cyclical developments and policies can still result in significant short-run deviations from these global trends. Such asynchronous developments have played an important role in the current downturn. As can be seen from the graph on page 31, German yields have followed the worldwide downward trend in long-term interest rates. At the end of 1992 real long-term interest rates in Germany had

Falling long-term interest rates...

Consumer price inflation

Countries	1982–89	1990	1991	1992 March	1992 June	1992 Sept.	1992 Dec.	1993 March
	annual percentage changes, based on end-of-period figures[1]							
United States	3.7	6.1	3.1	3.2	3.1	3.0	2.9	3.1
Japan	1.4	3.8	2.7	2.0	2.3	2.0	1.2	1.2
Germany[2]	1.6	2.8	4.2	4.8	4.3	3.6	3.7	4.2
France	4.6	3.4	3.1	3.2	3.0	2.6	2.0	2.2[3]
Italy	7.3	6.4	6.0	5.4	5.4	5.1	4.6	4.2
United Kingdom	5.3	9.3	4.5	4.0	3.9	3.6	2.6	1.9
Canada	4.3	5.0	3.8	1.6	1.1	1.3	2.1	1.9
Australia	7.4	6.9	1.5	1.7	1.2	0.7	0.3	1.2
Austria	2.7	3.5	3.1	4.1	4.0	3.9	4.2	3.9
Belgium	3.4	3.5	2.8	2.7	2.6	2.3	2.4	2.9
Denmark	4.7	1.9	2.3	2.6	2.3	2.0	1.5	1.1
Finland	5.5	4.9	3.9	2.8	2.7	2.6	2.1	2.7[3]
Greece	17.7	22.9	18.0	18.3	15.1	15.3	14.4	16.4
Ireland	5.0	2.7	3.6	3.7	3.6	2.8	2.3	1.9
Israel	89.6	17.6	18.0	17.3	12.2	8.0	9.4	10.8
Netherlands	1.3	2.6	4.9	4.2	4.0	3.4	2.6	2.3
New Zealand	9.6	4.9	1.0	0.8	1.0	1.0	1.3	1.0
Norway	6.4	4.4	2.9	2.5	2.5	2.0	2.2	2.5
Portugal	16.1	13.7	9.2	8.5	9.5	9.1	8.4	7.3
Spain	7.8	6.5	5.5	6.9	6.2	5.8	5.4	4.0
Sweden	6.3	10.9	8.1	2.6	2.1	2.5	1.9	4.9
Switzerland	2.4	5.3	5.2	4.9	4.2	3.5	3.4	3.6
Turkey	50.8	60.4	71.1	78.7	65.8	67.7	66.0	58.0
Average[4]	4.5	5.8	4.1	4.0	3.7	3.5	3.2	3.2

[1] Quarterly figures for Australia, Ireland and New Zealand. [2] Western Germany only. [3] New index. [4] Weighted average, based on 1990 exchange rates and consumption weights.

Differential between changes in service prices and general price inflation in selected countries[1]

Countries	1990	1991	1992
	in percentage points		
United States	0.1	0.9	0.9
Japan	0.0	−0.6	1.1
Germany[2]	0.1	0.2	1.6
France	0.7	1.0	2.0
Italy	1.2	1.1	1.6
United Kingdom[3]	0.2	3.5	2.6
Canada	0.9	0.7	0.8
Belgium	−0.3	1.2	1.8
Switzerland	0.8	2.1	2.5
Spain	1.9	2.8	2.9

[1] Percentage changes in the services component of the consumer price index less changes in the overall index. [2] Western Germany only. [3] Excluding mortgage interest payments.

declined by about 3 percentage points from the peak of the current cycle, with about half of this decline reflecting a decrease in the nominal long-term rate. This is considerably more than the 1 point fall in the US real long-term interest rate over the same period.

A more diverse picture emerges when looking at short-term interest rates. While real short-term rates in both Japan and the United States have fallen to 2% or less – primarily as a result of early and rapid cuts in nominal rates – they remained between 5 and 6% in Germany during most of 1992. Only since September of last year has the upward trend in nominal short-term interest rates been reversed.

... with converging nominal rates

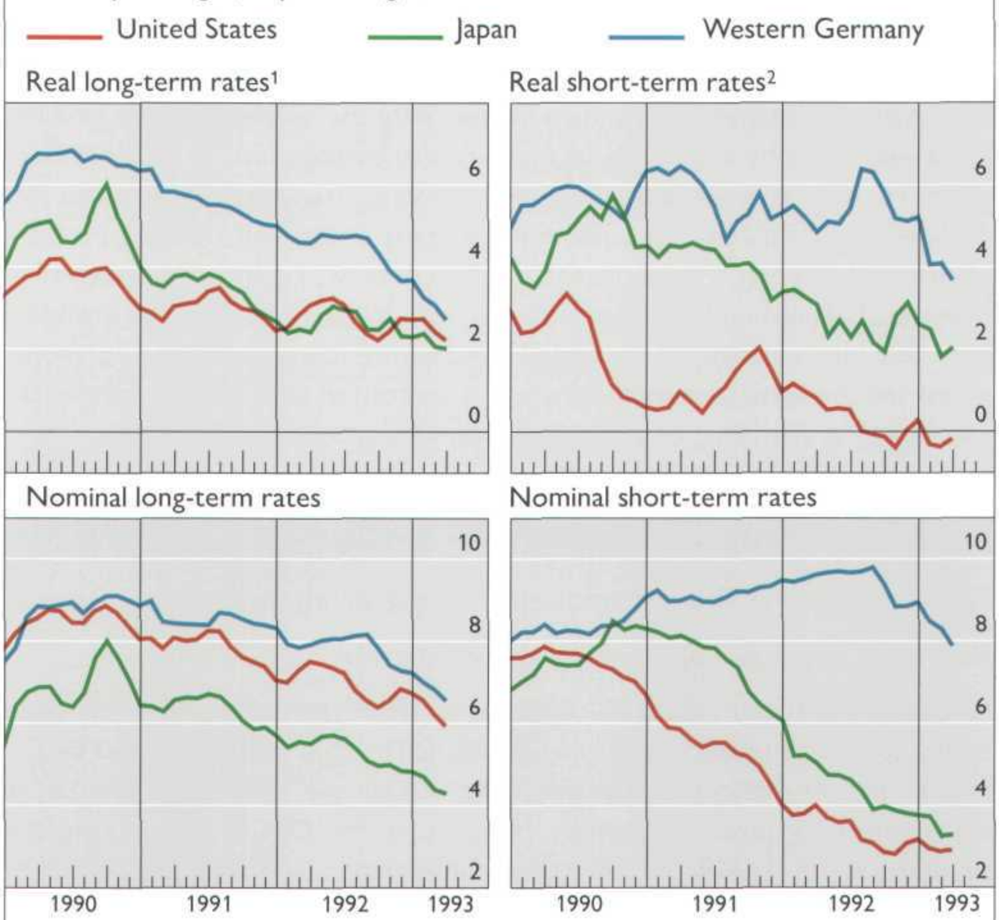
The high short-term interest rates in Germany have strongly influenced financial market conditions in those European countries whose currencies are linked to the Deutsche Mark, either within the ERM or through a unilateral peg to the ECU. After impressive reductions in nominal interest rate differentials vis-à-vis Germany in the early 1990s, the convergence of both short and long-term nominal interest rates had slowed in most European countries by the beginning of 1992. Between May 1990 and May 1992, before the Danish referendum and the outbreak of the currency crisis, nominal short-term interest rate differentials vis-à-vis Germany narrowed by 2 points on average, with the most marked reductions in countries such as the United Kingdom, Spain, Sweden and Norway, which had substantially higher interest rates than Germany in 1990.

Diverging real rates ...

During the same period many of Germany's partners in the ERM and the Nordic countries experienced an improvement in their inflation performance. Over the last three years France, Denmark and Belgium have all had a better average inflation performance than Germany. Even in Sweden and the United Kingdom inflation dropped below the German rate last year. As this relative disinflation more than offset the reduction in nominal interest rate differentials in most countries, short and long-term real interest rates increased relative to German rates. With a growing cyclical

Interest rate developments in the three major industrial countries

Monthly averages, in percentages



¹ Ten-year government bond yields less annualised changes in consumer prices over the previous three years. ² Representative three-month money market rates less annual changes in consumer prices.

Source: National data.

divergence within Europe, it became increasingly clear that the high level of interest rates was in conflict with domestic economic conditions.

... reflecting specific factors ...

The cyclical divergence within Europe is in part a result of country-specific developments, which have contributed to a much more rapid than expected reduction in inflation and made the monetary policy stance associated with the fixed exchange rate arrangement more restrictive. Structural imbalances and financial restructuring problems in Finland, Norway and Sweden had a major influence on cyclical developments and in the United Kingdom balance-sheet problems were also a crucial factor. The rapid disinflation and falling asset prices in these countries are reminiscent of a "debt deflation" cycle, where high real debt burdens force households and firms to cut real spending, leading to a further weakening of economic activity and disinflation. Another asymmetric development in Europe resulted from the demand impulse following German unification. While this is estimated to have raised growth rates in EC member countries by about ½ percentage point on average in both 1991 and 1992, it is also clear that the impact differed across countries depending on the degree of

... and the effects of German unification

integration with the German economy. In those countries most closely integrated with Germany the positive demand shock was greater than the adverse effect of higher interest rates. By contrast, countries with weaker trade links were equally exposed to the higher interest rates and received only a moderate boost to exports.

Increasing divergence after the Danish referendum

After the Danish referendum in June 1992 the convergence of nominal rates was abruptly reversed. In most countries that had to raise interest rates to defend their currency commitment, the rate of inflation has declined by a further ½–1 percentage point since June, leading to even higher real interest rate differentials. By contrast, of the three countries (Austria, Belgium and the Netherlands) with virtually no interest premium only the Netherlands has recorded significantly lower inflation. For some countries the level of real interest rates associated with the exchange rate objective, in the face of increasing domestic economic problems, was a factor in deciding on the devaluation or the abandonment of the fixed exchange rate commitment.

Fiscal policy and the accumulation of government debt

Budgetary developments during the recent cycle

In the 1980s most industrial countries changed the orientation of fiscal policy towards medium-term consolidation. The shift was prompted by the rise in budget deficits and public debt during the 1970s and led to an improvement in average primary balances in the OECD area during the second half of the 1980s. A further consequence was that the stance of fiscal policy was increasingly evaluated in terms of the deviation of budget deficits from the medium-term consolidation path.

Policy constraints during the recent cycle ...

In the recent period of sluggish output growth fiscal policy provided a smaller stimulus than in earlier recoveries. In many countries the fiscal authorities were constrained by the need to reduce high debt levels in the medium term. In addition, in countries with an exchange rate target it was felt that deviations from the medium-term strategy would have cast doubt on the commitment to the fixed exchange rate and to a monetary policy aimed at containing inflation. At the same time, in countries where enterprises and households were in the process of restructuring their balance sheets, the use of traditional fiscal measures was constrained by the need to prevent an increase in interest rates and interest burdens.

... but still a considerable deterioration ...

Nonetheless, as the table opposite shows, over the last three years most countries have seen a considerable deterioration in their fiscal balances. The cyclical downturn has reversed the earlier improvement in primary balances through the impact of automatic stabilisers on both revenue and expenditure. In a number of countries this cyclical deterioration has been reinforced by the effects of high interest rates and low growth on the interest burden of existing government debt and in a few by discretionary measures. In some cases this has aggravated the problem of the sustainability of current fiscal policies, that is, the ability to maintain revenue and expenditure paths without increasing debt levels in relation to

Developments in fiscal balances and general government debt									
Countries	1989			1992				Interest burden effect[1]	Stabilisation gap[2]
	Gross debt	Fiscal balance		Gross debt	Fiscal balance		Net debt		
		Net lending	Primary balance		Net lending	Primary balance			
	as a percentage of GDP								
Belgium	130.5	− 6.4	3.1	135.8	− 7.0	2.9	124.5	6.9	4.0
Italy	97.9	− 9.9	−1.5	107.3	−10.1	0.4	105.7	5.6	5.2
Ireland	108.0	− 1.1	5.2	96.8	− 2.8	3.5	96.5	1.1	−2.4
Greece	76.3	−17.7	−9.5	92.3	−10.6	1.0	89.5	4.8	3.8
Canada	69.5	− 3.0	1.8	83.0	− 6.4	−1.0	54.7	2.5	3.5
Netherlands	77.8	− 5.5	−0.5	79.2	− 3.9	1.3	62.0	3.7	2.4
Japan	70.6	2.5	3.4	66.2	1.8	2.0	4.2	0.1	−1.9
United States	54.0	− 1.5	0.5	63.2	− 4.7	−2.5	38.0	0.0	2.5
Denmark	58.5	− 0.5	3.3	62.4	− 2.5	1.2	29.5	2.9	1.7
Sweden	48.4	5.6	6.0	54.8	− 9.1	−8.6	5.0	3.2	11.8
Austria	56.9	− 2.8	0.3	55.7	− 2.1	1.1	55.5	1.7	0.6
France	47.5	− 1.1	1.1	51.3	− 3.7	−1.0	29.7	2.1	3.1
Spain	47.0	− 2.8	0.3	51.7	− 4.7	−0.8	36.0	1.7	2.5
Germany[3]	43.2	0.1	2.3	44.2	− 3.1	−0.4	24.5	2.0	2.4
Norway	42.7	1.6	−0.9	43.4	− 2.8	−4.2	−17.0	−0.1	4.1
United Kingdom	36.8	0.9	3.3	40.5	− 6.4	−4.6	35.5	0.9	5.5
Australia	27.0	1.5	3.3	29.3	− 4.5	−2.9	15.5	0.6	3.5
Finland	16.4	2.9	3.3	31.4	− 8.9	−7.8	13.0	2.7	10.5

[1] Calculated as the 1992 net debt ratio times $(i-g)/(1+g)$, where i = the projected average interest rate on net debt for 1993 and g = the projected nominal GDP growth rate for 1993. [2] The interest burden effect minus the primary balance/GDP ratio. A positive figure shows the strengthening of the primary balance needed to keep the net debt ratio stable. [3] Prior to 1991, western Germany only.

Sources: OECD Economic Outlook and BIS estimates.

... raising questions about sustainability

GDP. The one-period stabilisation gap calculated in the table above shows how large next year's adjustment in the primary balance needs to be in order to stabilise the net debt/GDP ratio at its 1992 level. It is made up of two components: the primary deficit/GDP ratio and the interest burden effect. The latter increases the debt ratio whenever the average interest rate on government debt exceeds nominal GDP growth. At current estimates of interest rates and nominal GDP growth for 1993 the one-period stabilisation gap can also be interpreted as the increase in the debt ratio which would take place in the absence of any change in the primary balance.

Rising debt ratios in most countries

The figures in the table suggest that on present assumptions the recent rise in debt/GDP ratios will continue in 1993. Given current primary balances only Ireland and Japan appear able to avoid an increase. Debt stabilisation in most other countries would require a substantial tightening of fiscal policy, in some cases beyond what is realistically possible. The relative importance of the two sources of debt accumulation differs significantly between low-debt and high-debt countries. Most of the former had substantial primary deficits in 1992. Mainly cyclical factors but also some stimulative budgetary measures caused their primary deficits to increase by an average of 4.5% over the last three years.

Among the seven major countries the largest deterioration in the primary balance was observed in the United Kingdom, owing to a relatively deep recession and a number of expansionary measures. A shift from a primary surplus to a deficit also occurred in the United States, Germany and France. A major influence on the relatively large increase in the US debt ratio was the measures taken to rescue the deposit insurance system and restructure the savings and loan industry. However, the deterioration was also caused by a rising structural deficit, notably in the case of the Federal Government. In Germany the budgetary costs of unification are understated by the moderate increase in general government debt because of commitments falling due after 1992 and other debt operations which are treated off-budget (notably the Unity Fund, the credit reduction fund and the Treuhandanstalt). France was in a relatively favourable position at the start of the recession but a series of employment-stimulating measures have led to a modest deterioration in the primary balance. Finally, Japan experienced only a small rise in the government deficit, partly because the downturn started later than in other countries.

Recent developments in major countries

Among the smaller countries in the low to medium-debt category, Austria was the only country to actually increase its primary surplus, mainly because the cyclical downturn started only last year, while Denmark and Spain saw their net borrowing requirement expand by around 2%. The largest deteriorations were recorded by the three Nordic countries and Australia. In all four cases the principal cause was severe recession.

Primary surplus in high-debt countries ...

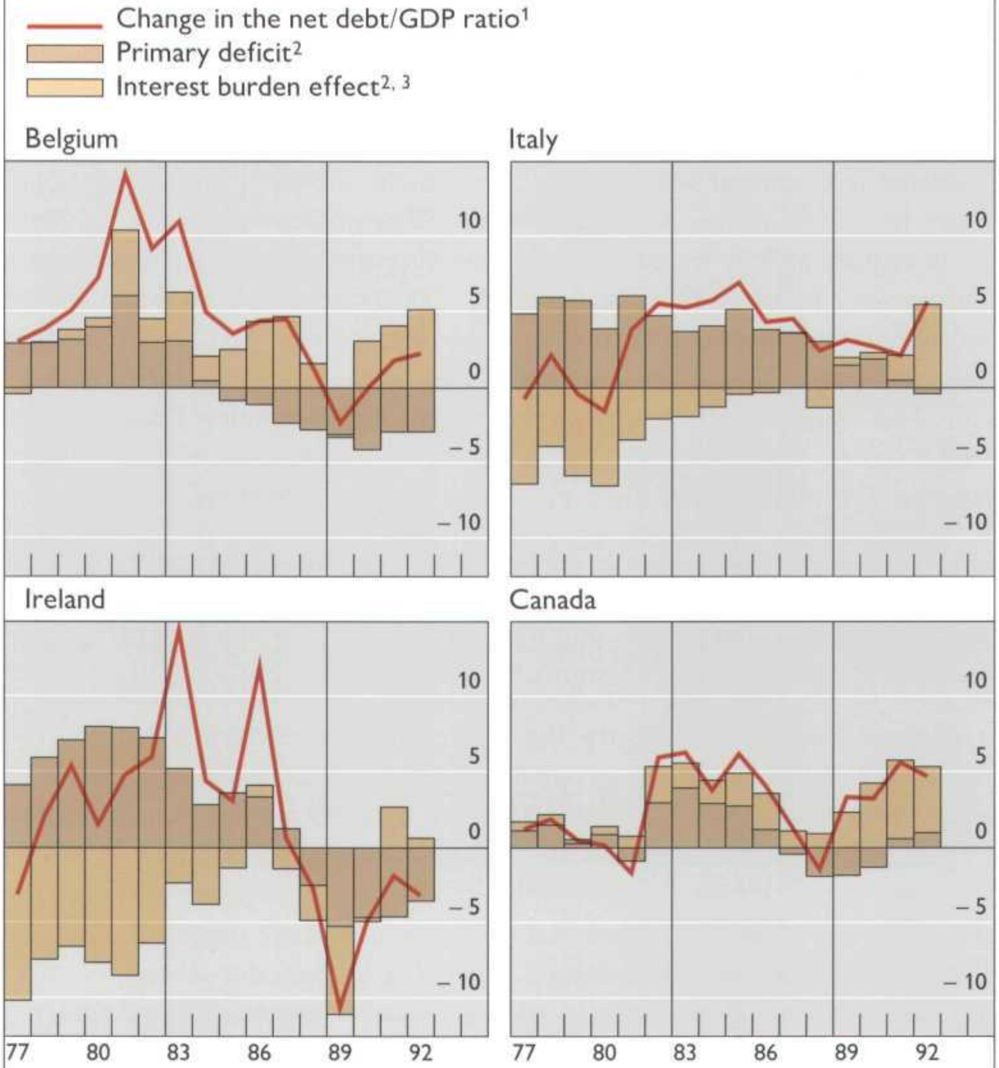
On the other hand, most high-debt countries have a primary surplus. Recognising that the cost of running primary deficits may be very high, even when they are the result of automatic stabilisers, countries in the high-debt category considered it necessary to neutralise the effects of fiscal stabilisers as much as possible in order to prevent a snowballing of future debt service payments. Since the autumn of last year the governments of virtually all the high-debt countries have taken additional fiscal measures to offset the effects of a worsening economic outlook on their borrowing requirements.

... but high interest burden

The recent deterioration in the public finances of the high-debt countries is primarily due to the interest burden effect. With a debt/GDP ratio in the region of 100%, any increase in the difference between average interest rates and nominal growth leads to an equivalent increase in the debt ratio. The danger of substantial interest burden effects can also be detected in some of the Nordic countries. Although their net debt ratios are still low, a comparison with the historical experience of some high-debt countries shows that a similar situation there resulted in a rapid accumulation of government debt in relation to GDP. Belgium, Italy and Ireland had started from government debt ratios of 50–60% in 1974 and ran substantial primary deficits during the remainder of the 1970s and the early 1980s, causing a gradual increase in the debt/GDP ratio even though nominal growth exceeded interest rates. Canada, on the other hand, had a very low net debt ratio until the early 1980s but then experienced a rapid accumulation of government debt due to high primary deficits and

Early rise in public debt ...

Changes in government debt by contributing factor



Note: The difference between the change in the net debt ratio and the sum of the primary deficit and the interest burden effect reflects debt valuation changes and accounting differences.

[1] In percentage points. [2] As a percentage of GDP. [3] For an explanation, see the table on page 33. A negative contribution indicates that nominal GDP growth exceeds the average interest rate on net debt.

Source: OECD Economic Outlook.

positive interest burden effects, in part a result of the deep recession in 1981–82.

... followed by policy reversals ...

As shown in the graph above, all four countries reversed their policy at different points and at different speeds during the 1980s. Belgium changed its fiscal stance relatively early, but still had the highest debt ratio in 1992, with the debt interest burden being one of the main reasons. As in Canada, the interest snowball started rolling very early in Belgium and has led to debt accumulation in virtually every year since the early 1980s. In Italy and Ireland the interest burden has increased the debt ratio only more recently, with differences in the time pattern of disinflation seeming to be an important factor. In Belgium disinflation started in the second half of the 1970s, when inflation fell from 12–13% to less than 4%. However, due to the sluggish adjustment of nominal interest rates to lower inflation, the differential with nominal growth rose substantially, adding as much as 4% to the debt ratio in 1981. In Italy, on the other hand, inflation remained in double digits until 1985 and the nominal interest/growth differential stayed below 2% during the second half of the 1980s. Further disinflation and low growth in the early 1990s resulted in an unprecedented differential between the nominal interest rate and growth, which in 1992 contributed more than 5% to the estimated debt ratio. The implications for future debt accumulation in Italy are particularly worrying and require improvements in the primary balance. The disinflation in Canada since the adoption of the inflation target has been accompanied by equally large and unprecedented contributions of the interest burden to government debt accumulation.

... and different speeds of disinflation

The comparatively better performance of Ireland since 1986 is due to two factors. Ireland opted for a radical improvement in the primary balance and managed to limit the interest rate burden by borrowing in foreign currency. This enabled the Government to reduce the funding cost as long as the fixed exchange rate could be maintained within the ERM.

Budget plans for 1993

Stimulatory measures in some countries ...

In view of the developments discussed above, very few countries are in a position to take stimulatory fiscal action in the current situation. The new US Administration has proposed short-term expansionary measures, amounting to less than 0.5% of GDP and subject to a high risk of rejection by Congress, coupled with tax and expenditure measures aimed at halving the federal deficit relative to GDP over the next five years. In Japan the measures introduced in August last year will have their main impact in the first half of this year. The budget for 1993/94 includes a further 10% increase in spending on public works, and a new stimulative package (the largest ever), totalling about 2¾% of GDP, was proposed by the Government in April. The package is heavily weighted towards public works and investment in social infrastructure but also includes measures to promote private residential and non-residential investment and the activities of small to medium-sized firms as well as steps to support employment, stabilise financial markets and reactivate the stock market. Various measures introduced by the UK Government in November last year, together with a less favourable outlook, raised the predicted borrowing requirement by 2% of GDP. The budget for this year is largely neutral, with higher taxes announced for 1994. Finally, the Australian Government introduced expansionary tax and spending measures earlier this year which may raise the federal deficit to around 4% of GDP.

... and a cyclical deterioration in others ...

In Germany, the initial 1993 budget envisaged a decline in the borrowing requirement. However, following revisions as a result of the worsening economic situation, the latest estimates point to a deficit almost 50% higher than that initially foreseen. The 1993 budget in France aimed at limiting the deficit to less than 2½% of nominal GDP. However, in response to an audit showing a likely shortfall of more than twice the initial projection, the new Government in May proposed wide-ranging expenditure

... but most are consolidating their budgets

and tax measures and a revised deficit target of 4½%. As mentioned earlier, the first three months of this year saw large budget overruns in Italy and measures to ensure compliance with EC commitments are now being prepared. Canada took restrictive measures in December last year to limit the rise in the deficit, but the cuts proposed in the 1993/94 budget are relatively moderate.

A number of the smaller continental European countries have adopted spending cuts or tax increases to meet medium-term targets. In some cases expenditure reductions have been coupled with employment measures or steps to alleviate the plight of the unemployed. In Finland and Sweden the additional room for manoeuvre provided by the floating of their currencies may be largely offset by rising government deficits. As a result, both countries are considering or have already adopted a range of consolidation measures to take effect in the course of this year.

III. Developments in other countries

Highlights

In eastern Europe, the countries furthest advanced in the reform process have been able to reap the first fruits of macroeconomic stabilisation and the transformation of their economies. In former Czechoslovakia, Hungary and Poland the output decline seems to have come to an end in the last quarter of 1992 and inflation has abated. In countries which have pursued less vigorous and consistent policies the results have been less favourable, suggesting that resolute stabilisation efforts are a necessary, though not sufficient, condition for creating a market economy. Inconsistent policies do not allow market participants to anticipate the direction in which reform will proceed. It seems that this is the lesson that Slovenia and the Baltic states have drawn from reform experience to date. By contrast, macroeconomic stability has proved elusive in Russia and the other former Soviet republics, partly owing to a lack of policy consensus and monetary arrangements which have fuelled inflation. In all countries major problems, notably rising budget deficits and the dependence of growth on export performance, remain unresolved and may undermine macroeconomic stability and growth prospects. More fundamentally, the issue of bank lending to loss-making state enterprises has not been tackled in a systematic way, although first steps have been taken.

The developing countries and the NIEs again grew much faster than the industrial countries last year, largely because of rapid growth in Asian countries, in particular China. The success of the reform programme in India was reflected in rising output growth and falling inflation, although a rebound in agricultural production also played a role. The reforms undertaken in Latin America in recent years were consolidated and inflation declined in most major countries except Brazil. Rapid growth of domestic demand combined with the policy of dampening inflationary pressures via the exchange rate pursued by some countries has, however, caused concern as current account deficits have widened substantially. The growth performance of Africa last year was poor, while the resumption of oil production in Kuwait explained the stronger output growth in the Middle East. As a result of diverging growth patterns over many years, world income distribution has become more unequal, in particular if China is excluded. The factors that have led to this widening gap are not well understood, but a tentative analysis suggests that economic policies have played a major role. The most important policies for growth appear to be investment in a skilled and well-educated labour force, the encouragement of saving and investment, the curbing of government budget deficits and inflation and measures to contain rapid population growth.

Developments in eastern Europe

Policy differences ...

Differences in economic policies and performance between eastern European countries became increasingly visible during 1992, in marked contrast to the previous year, when economic developments had been dominated by shocks common to most economies in the region. Outside the former Soviet Union, the collapse of the CMEA trading system and the terms-of-trade changes had contributed to a large decline in output, as had the need to achieve better macroeconomic balance. High annual inflation had reflected the absorption of monetary overhangs in some countries, the large deterioration in the terms of trade and the reduction of consumer subsidies. These factors were no longer at work during 1992, or were much less significant, so that performance indicators more closely reflected the different policy approaches and economic conditions; only the drought affected the whole region and may have reduced total output by between 1 and 3%. Therefore three groups of countries can usefully be distinguished. Countries that are at an advanced stage of transition and that have maintained tight monetary and adequate fiscal policies over the past few years have succeeded in bringing down inflation. They have also been able to limit the decline in output through rapid private sector growth, to reorient their exports to industrial countries' markets and to attract some foreign investment. A second group comprises countries which, in many cases, started reforms later and in more difficult initial conditions. There the fall in output has been larger (except in Slovenia) and macroeconomic stability has either proved elusive or has been achieved only very recently. A third group of countries has only lately embarked on reform. Lack of budgetary and monetary discipline and the collapse of trade in the former Soviet Union, excluding the Baltic states, resulted last year in very high inflation, large output declines and huge external imbalances.

... are reflected in economic performance

Countries at an advanced stage of transition

The output decline slows ...

In the countries furthest advanced in the transformation process (the Czech and Slovak Republics, Hungary and Poland) the decline in output may have come to an end in 1992 (see the table overleaf). Whether this already foreshadows sustained growth is, however, far from certain. So far, growth has remained largely dependent on exports, which may expand less rapidly in the future. Budget deficits increased in Hungary and Poland last year, and broad money rose in real terms in all the countries (see the table on page 53). Nevertheless, inflation declined substantially (see the table on page 43), as wage demands seem to have been brought under control (Poland) and the exchange rate was either held stable (Czechoslovakia) or its rate of depreciation reduced (Hungary). The private sector expanded strongly and raised its share of GDP to almost half in Poland, around one-third in Hungary and about one-fifth in Czechoslovakia.

... and inflation eases

The *Czech and Slovak Republics* maintained remarkable macroeconomic stability last year. Inflation was only 11%, and monthly inflation rates in the first quarter of 1993 remained low in both countries after the

Developments in real GDP[1]					
Countries	1988	1989	1990	1991	1992[2]
	percentage changes				
Albania	−1.4	9.8	−10.0	−27.7	− 8
Bulgaria	2.6	−0.3	− 9.1	−16.7	− 8
Croatia	−0.9	−1.9	− 9.3	−28.7	−25
Czechoslovakia	2.6	1.4	− 1.4	−14.7	− 7
Czech Republic	–	–	*− 0.4*	*−14.2*	*− 7*
Slovak Republic	–	–	*− 2.7*	*−15.8*	*− 6*
Hungary	3.2	−0.2	− 4.0	−11.9	− 5
Poland	4.1	0.2	−11.6	− 7.6	1
Romania	−0.5	−5.8	− 7.6	−13.7	−15
Slovenia	−1.9	−2.7	− 4.7	− 9.3	− 7
Yugoslavia	−1.3	−1.9	− 8.4	−12.2	−25
Average[3]	1.6	−1.0	− 7.6	−13.0	− 9
Former Soviet Union	4.4	2.5	− 2.2	− 9.0	−19
Russia	*4.5*	*1.9*	*− 2.0*	*− 9.0*	*−19*
Baltic states	*8.0*	*4.9*	*− 3.0*	*−11.2*	*−34*
Overall average[3]	3.5	1.3	− 3.9	−10.3	−16

[1] For Croatia, gross social product; for the Czech and Slovak Republics, GNP; for Yugoslavia, gross material product and, from 1990, Serbia and Montenegro only; for the former Soviet Union (including Russia and the Baltic states) prior to 1990, net material product (NMP). [2] Preliminary and partly estimated. [3] Weighted average, based on 1990–91 GDP/NMP and exchange rates.

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

Remarkable stability in Czechoslovakia ...

price jump in January due to the introduction of value added tax. To a large extent this stability must be ascribed to the fixed exchange rate policy, which contained inflationary pressures despite a relaxation of macroeconomic policies: money and credit grew in real terms, and rising real wages led to a recovery of consumption. A puzzling development was the decline in unemployment to 5.1% (see the table on page 45). It seems to have been due to a combination of vigorous private sector growth, a tightening of the rules governing eligibility for unemployment benefits and the postponement of lay-offs in state enterprises. The lowest unemployment rates are to be found in areas close to Germany, indicating that the employment of Czech labour by German firms is also playing a role, and the extremely rapid growth of bilateral trade with Germany points to increasing cross-border processing arrangements. Foreign direct investment doubled to about 3% of GDP.

... but separation ...

Since former Czechoslovakia split into two separate sovereign states on 1st January 1993, the Slovak Government, in contrast to its Czech counterpart, has favoured a more gradualist approach to reform: it has slowed down privatisation and reduced the role of vouchers, has continued to finance enterprises on a large scale and has pursued an active industrial policy. This can be explained in part by major differences between the two countries (see the table opposite). The Czech Republic has a higher per capita income, much lower unemployment and a smaller budget deficit, and has attracted the bulk of foreign investment so far. Last year it is estimated to have transferred 3½% of its GDP in fiscal subsidies to the Slovak Republic. In addition, its industry is more diversified and oriented towards western markets. By contrast, the Slovak economy is more dependent upon imports from and exports to former CMEA countries. After the separation, foreign exchange reserves declined initially in both countries, prompting the dissolution of the temporary currency union in February and the revaluation of the Czech koruna against the Slovak koruna for bilateral trade. Despite a customs union between the two countries, trade contracted sharply owing to the payment difficulties experienced by Slovak enterprises as a result of restrictions on their access to foreign exchange.

... leads to trade contraction

Hungary

Hungary has pursued economic reform for many years and had come to symbolise the gradualist approach to economic transformation. Last year the pace of reforms accelerated markedly. The Government started seriously hardening enterprises' budget constraints by tackling industrial and bank restructuring. Progress was also made in curbing inflation. To a large degree the slowdown in inflation to 23% was achieved by reducing the rate of depreciation of the forint to around 6%, implying a real appreciation of the currency. This was made possible by a current account surplus, reflecting continued export growth, and by foreign direct investment inflows of some 4% of GDP. A decline in exports in the first quarter of 1993, however, raised questions about the sustainability of the strategy and prompted a devaluation of the forint. Monetary policy was tight overall last year, with real interest rates on credits to enterprises at more than 10% and the growth of domestic lending below that of nominal income. Problems in keeping the budget deficit under control and the easing of monetary policy in the second half of the year could indicate that a further reduction in inflation may be difficult to achieve.

The Czech and Slovak Republics in 1992

Items	Czech Republic	Slovak Republic
Population (in millions)	10.3	5.3
Share of total GDP	70	30
Share of total primary energy resources (1991)	88	12
GDP per capita (at current exchange rate, in US dollars)	2,536	2,113
Infant mortality (per 1,000, 1991)	10.4	13.2
Sales to other republic (% of GDP)*	14	28
Exports to industrial countries (% of total exports)	68	56
Share of total foreign direct investment	90	10
Unemployment rate (%, at end-year)	2.6	10.4
Budget deficit (% of GDP)	1.3	4.9
Transfers to (−) or from (+) other republic (% of GDP)	−3.5	+8.3

* Estimate based on an enterprise survey for the first half of 1992.

Sources: Economist Intelligence Unit, national data and BIS estimates.

Poland was the only country to return to growth in 1992. This was mostly due to a dynamic private sector, which is now large enough to compensate for the shrinking output of state-owned industries. The authorities were also successful in their stabilisation efforts and inflation fell to 43%. Perhaps more important for the control of underlying inflationary pressures was the containment of nominal and real wages despite a flurry of strikes in the second half of the year (see the table opposite). The Government succeeded in holding the deficit target for 1993 to 5% of GDP in spite of strong parliamentary opposition to the reduction of real pension benefits and public sector wages. Spending increases since voted by Parliament have, however, raised doubts as to whether this target can be attained.

Poland

Countries in the early stages of transition

The situation in the second group of countries was characterised by continuing macroeconomic imbalances in some countries (Albania, Bulgaria and Romania) and recent success with stabilisation in others (the Baltic states and Slovenia). All recorded inflation rates of 90% or more.

Macroeconomic imbalances ...

Reform in *Bulgaria* has taken place under difficult external conditions and has been constrained by a very fragile political consensus. Nevertheless, spiralling inflation was avoided last year through a combination of an incomes policy which kept real wages below their December 1991 level, falling real domestic credit (excluding inter-enterprise arrears) and budgetary policies which held the cash deficit (excluding accrued but unpaid interest on external debt) to 5% of GDP. The stability of the floating exchange rate also helped, though at the expense of a sharp real appreciation. The legislative framework for a market economy was largely put in place, with the notable exception of a bankruptcy law. A privatisation law was passed and the process of consolidating the large number of small banks was started. In the second half of 1992, however, the fragile consensus on the Government's reform strategy began to erode. Government spending increased in the fourth quarter, and in December a new Government partly reversed the tight macroeconomic policies of its predecessor. It has since begun to exert expansionary pressure on the National Bank, plans a budget deficit of 8% of GDP for 1993 and intends to increase financial support to state enterprises, thereby further softening budget constraints.

... widen in Bulgaria ...

Romania has opted for "gradual reform at a fast pace". The main elements of the legal foundation for a market economy were put in place rapidly, but implementation has been slow and incomplete. In the area of macroeconomic management the gradual approach has meant that the Government has maintained partial control of the prices and allocation of essential goods and raw materials. The official exchange rate has generally been kept above market-clearing levels despite very low foreign exchange reserves but has nevertheless declined rapidly. The pass-through of exchange rate depreciation into prices was deliberately delayed throughout last year, resulting in poor performance of exports to industrial countries.

... and remain substantial in Romania

Consumer price (cp) and wage (w) inflation								
Countries		1988	1989	1990	1991	1992	1993 Q I[1]
		percentage changes					
Albania	cp	0.0	0.0	0.0	35.5	226	266[2]
Bulgaria	cp	1.3	5.5	23.9	474	92	83
	w	7.6	8.8	31.7	153	107	
Croatia	cp	200	1,200	610	123	669	
Czechoslovakia	cp	0.2	1.4	10.0	57.9	11	
	w	2.1	2.3	3.1	16.7	18	
Czech Republic	*cp*	*0.2*	*1.5*	*9.7*	*56.7*	*11*	*22*
	w	*1.9*	*2.3*	*3.0*	*16.7*	*18*	
Slovak Republic	*cp*	*0.2*	*1.3*	*10.4*	*61.2*	*10*	*19*
	w	*2.5*	*2.3*	*3.1*	*16.8*	*18*	
Hungary	cp	15.5	17.0	28.9	35.0	23	25
	w	11.1	17.4	24.3	27.9	26	
Poland	cp	60.2	251	586	70.3	43	40
	w	84.3	276	381	73.1	37	
Romania	cp	2.8	0.8	5.1	166	210	171
	w	2.6	3.9	10.6	121	170	
Russia	cp	0.0	2.4	5.6	92.7	1,353	800
	w	8.8	9.9	14.8	78.6	1,062	
Slovenia	cp	212	1,306	550	118	210	58
	w	166	1,541	379	82.5	199	
Yugoslavia[3]	cp	194	1,240	610	127	8,720	

Note: Wages cover all sectors in Russia, the public sector in Bulgaria and Slovenia (Slovenia: from 1992 including private firms), six major sectors in Poland and the industrial sector in all other countries.

[1] Changes over one year. [2] December 1992. [3] From 1990, Serbia and Montenegro only.

Sources: IMF, EBRD and national data.

The official budget deficit amounted to 1% of GDP, but when allowance is made for special accounting rules and off-budget funds, the actual deficit was much higher. After having been cleared at the end of 1991 through an injection of central bank credit and netting, inter-enterprise debt rose again, leading to an inflation rate of 210%.

Albania

Following a worsening of the economic crisis in the first half of 1992, in August *Albania* embarked on an IMF-supported stabilisation programme. Prices were liberalised, the exchange rate was floated and the huge budget deficit was reduced to 20% of GDP in the second half of the year. However, the situation continues to be very fragile and the country remains dependent on food aid.

Stabilisation in Slovenia ...

Slovenia and the Baltic states pursued tight monetary and fiscal policies which led to an easing of inflation rates in the second half of last year. The challenge facing these countries is to consolidate macroeconomic stability and find new markets for their exports.

Output declined by 7% in *Slovenia* under the influence of a continued contraction in trade with the other republics of former Yugoslavia. The legal and institutional basis for a market economy was introduced quickly. Privatisation of housing proceeded rapidly and a privatisation law for state enterprises was passed in November. This year Parliament has approved a law on bank recapitalisation and the first steps have been taken to swap non-performing loans held by the largest Slovenian bank for long-term government-guaranteed bonds. Macroeconomic policies have been tight, with the government balance in surplus and credit increasing by much less than inflation. As a result monthly inflation fell to below 3% in the second half of last year.

... as well as in Estonia and Latvia

The collapse of trade with the former Soviet Union, large terms-of-trade losses and severe shortages of fuel led to declines in output of about one-third in the *Baltic states* last year. All three countries introduced their own currencies and have made considerable efforts towards macro-economic stabilisation. *Estonia* introduced its new currency, the kroon, in June and pegged it to the Deutsche Mark through a currency board. This laid the basis for strict monetary discipline, while a tight fiscal policy led to a budget surplus of more than 1% of GDP. As a result of these policies, inflation slowed to monthly rates of less than 2% in the first quarter of 1993. *Latvia* introduced its own temporary rouble, later to be replaced by the lat, in July 1992 and reduced monetary expansion to well below the rate of inflation. Inflation eased to less than 5% a month by the first quarter of 1993. The sharp appreciation of the floating exchange rate reflects the tight macroeconomic policies, including positive real interest rates. Macroeconomic policies were less restrictive in *Lithuania*, where credit expanded rapidly and real interest rates remained highly negative.

Developments in the former Soviet Union

Economic breakdown ...

Political and economic disintegration were the dominant features of developments in the former Soviet Union (excluding the Baltic states) and in several republics of former Yugoslavia last year. Civil unrest and war were widespread. The economic breakdown was reflected in collapsing output and soaring inflation.

... results in collapse of output ...

In some of the former Soviet republics, civil unrest escalated into open civil war. Others, among them the Russian Federation, took the first steps towards a market-oriented economy. But in all these countries the legacy of the past remained the determining factor. Dislocations due to the breakdown of the planning apparatus were a major reason for the poor output performance, as was the collapse of trade (see Chapter IV).

... while poor monetary coordination ...

The legacy of the past was also one cause of the acceleration in inflation. With all central banks able to issue credit in a single currency, each had an incentive to expand credit rapidly in order to lay claim to resources within the currency area. Countries which pursued a stability-oriented policy risked losing real resources in return for increasingly depreciated paper claims. Thus Russia is reported to have accumulated claims on other republics up to July, when it finally introduced tight credit limits on their correspondent accounts with the Russian central bank. A cash shortage developed in the first quarter of 1992 because of price liberalisation and expansionary credit policies in other republics, combined with their inability to issue banknotes. This was reflected in a large dollar discount for cash

Unemployment rates

Countries	1989	1990	1991	1992	1993 Q I
	as a percentage of the labour force, at end of period				
Albania	1.9	2.1	5.1	12.5*	
Bulgaria	0.0	1.5	10.8	15.6	16.0
Czechoslovakia	0.0	1.0	6.6	5.1	
Czech Republic	*0.0*	*0.6*	*4.1*	*2.6*	*2.9*
Slovak Republic	*0.0*	*1.6*	*11.8*	*10.4*	*12.0*
Hungary	0.4	1.9	7.5	12.3	13.4
Poland	0.1	6.3	11.8	13.6	14.2
Romania	0.0	0.4	3.0	8.4	9.6
Russia	0.0	0.0	0.1	1.4	
Slovenia	2.9	4.7	10.1	13.4	13.5

Note: For most countries, data refer to officially registered unemployed only.
* Estimated.
Sources: EBRD and national data.

roubles (see the graph overleaf) and the development of republic-specific discounts for the Russian rouble, signifying the de facto breakdown of the rouble zone. To avoid the cash squeeze, Ukraine introduced its own coupons and left the rouble zone in November.

Russia freed most prices in January 1992 and kept macroeconomic policies relatively tight in the first half of the year. The general government budget deficit for this period is estimated at around 10% of GDP, while the cash deficit amounted to only 3% because the Government serviced little foreign debt and delayed the payment of wages and other bills. In the second quarter of the year the pressure on the Government to relax policies mounted. Enterprises had attempted to evade tight policies by running up arrears, which by June exceeded the level of domestic bank credit. Parliament also voted new social spending. Efforts towards financial stabilisation were finally abandoned in the third quarter as enterprise arrears were reduced through increased credit expansion and the cash deficit rose substantially. As a result, monthly inflation accelerated to around 30% by year-end and remained high thereafter. This was reflected in a further depreciation of the exchange rate.

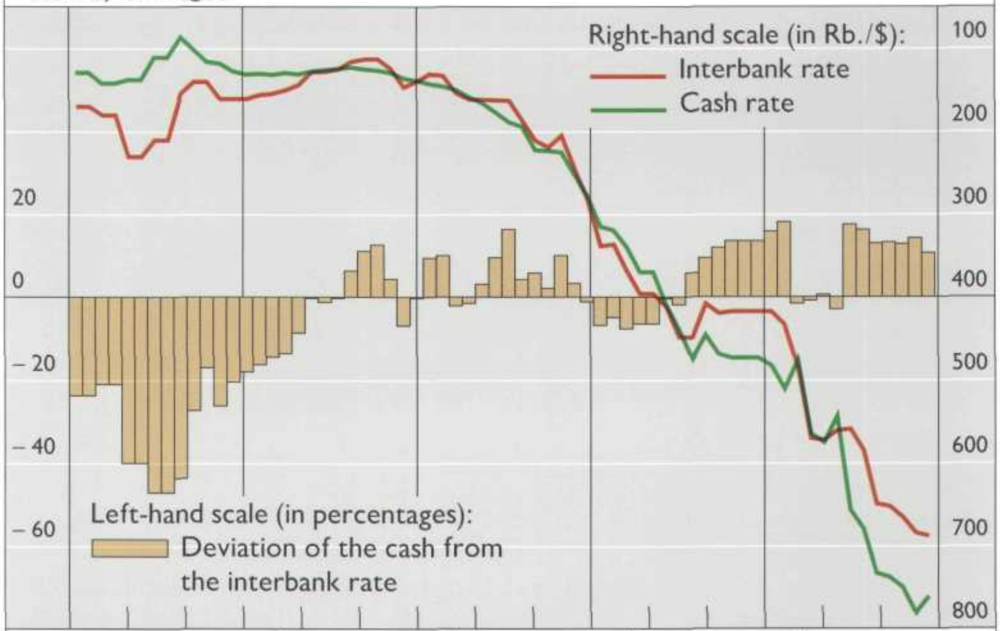
... and lax economic policies ...

... fuel inflation

In February this year, a new Government presented a programme to deal with the crisis by limiting the budget deficit to 5% of GDP and reducing monthly inflation to 5% by the end of the year. In order to meet the inflation target, monetary expansion in Russia will have to be brought under control and this will be possible only if the deficit target is met and if enterprises' budget constraints are hardened. A further condition for macroeconomic stabilisation is that other republics cease extending rouble credits so as to benefit from seigniorage at Russia's expense. This would mean that they would have either to switch completely to their own currencies or to accept the Russian central bank as the sole issuer of base money. Failure to make progress in these areas is likely to lead to hyper-inflation.

Bilateral exchange rate of the rouble against the US dollar

Weekly averages



Note: The interbank rate is the exchange rate quoted on the Moscow Interbank Currency Exchange; the cash rate is an average of black market rates in different cities of the former Soviet Union.

Source: Commersant.

While the macroeconomic situation has been bleak, some progress has been made. Small-scale privatisation is under way and the foundations for privatising large enterprises have been established.

The external debt situation

The external debt of the former Soviet Union, Poland and Bulgaria has continued to overshadow economic policy-making. While agreements have been reached with official creditors in the Paris Club, negotiations on debt and debt service reductions with commercial banks have made only limited progress and bargaining positions have remained far apart.

Including arrears, the external debt of the *former Soviet Union* is estimated at around $80 billion, more than half of which is owed to official creditors. The Paris Club rescheduled the official debt in April 1993, reducing service on this debt for 1993 by $15 billion to less than $2 billion. If commercial bank creditors grant Russia similar rescheduling terms, total debt service in 1993 would be approximately $3.5 billion. The Russian Government has indicated that it is able and willing to pay this amount.

Rescheduling of official debt ...

The distribution of federal debt among the successor states to *former Yugoslavia* is unsettled. Only *Slovenia* partly serviced its directly attributable debt last year and reached agreement with the Paris Club on its share of official debt.

Poland concluded a standby programme with the International Monetary Fund in March 1993. This was important because two-fifths of the

50% debt reduction agreed by the Paris Club in April 1991 is contingent on a satisfactory performance under an IMF programme up to the end of 1993. The three-year extended agreement with the IMF had been suspended in 1992 because budget targets had been overshot. An IMF programme is also the prerequisite for an eventual agreement with the London Club of creditor banks, to which Poland owes around $12 billion. The Paris Club agreement expects Poland to seek a debt reduction from its commercial bank creditors on terms comparable to those granted by official creditors, but the banks have been increasingly reluctant to agree to such a large debt reduction given the country's improved economic situation.

... but little agreement with banks

Bulgaria has hardly serviced its large external debt of around $13 billion, thereby saving about 8% of GDP in interest payments alone last year. It reached agreement with its official creditors in the Paris Club on a multi-year rescheduling with a six-year grace period. Some 85% of the country's total debt is owed to commercial banks. The Government resumed payment of one-quarter of the interest due on this debt in September, and agreed with banks in November on a general framework for debt reduction.

Problems common to all countries

Despite the increasing differentiation, four major difficulties continue to beset all eastern European countries and suggest that macroeconomic stability will remain fragile and output growth subdued.

Unresolved problems: growing budget deficits ...

Firstly, most budget positions deteriorated last year, confirming trends which had already become apparent earlier (see the table below) and were analysed in last year's Annual Report. For several reasons, reforms in formerly centrally planned economies are not revenue-neutral and tend to worsen the fiscal position in the short run: declining profits of state enterprises and tax arrears as a result of the severe liquidity squeeze; delays in the introduction of value added tax; and problems in shifting income taxes from the state to the private sector without lowering effective rates and losing revenue through tax evasion. On the expenditure side, the

General government budget balances

Countries	1988	1989	1990	1991	1992
	as a percentage of GDP				
Albania	−0.2	−5.5	− 3.7	−45.0	−17.1
Bulgaria	−5.6	−1.4	− 8.5	− 3.6	− 5.2
Including foreign debt interest arrears	*−5.6*	*−1.4*	*−12.7*	*−14.9*	*−13.0*
Czechoslovakia	−1.5	−2.4	0.1	− 2.0	− 1.6
Hungary	0.0	−2.1	0.9	− 4.6	− 7.2
Poland	0.0	−7.4	3.5	− 6.2	− 7.2
Romania	5.9	8.4	1.0	1.9	− 1.1
Slovenia	0.9	0.3	− 0.3	2.6	0.3

Sources: EBRD, Vienna Institute for Comparative Economic Studies, OECD, UN Economic Commission for Europe and national data.

growth of spending has proved difficult to control because of the need for social protection. In several countries, transfers to the unemployed and pensioners raised expenditure as a percentage of GDP.

... dependence on export growth ...

Secondly, output growth in eastern Europe has remained heavily dependent on exports to industrialised countries, which were the main demand component to make a substantial positive contribution to growth last year. Reasons for their good performance were the freeing of capacity in eastern European economies in the wake of the collapse in domestic demand and exports to former CMEA countries, low labour costs and improved, though still fairly limited, access to the market of the European Community (see Chapter IV). It is highly uncertain, however, whether rapid export growth can be maintained until a self-sustaining growth process gets under way. Indeed, developments in the first quarter of 1993 point to a substantial slowdown in the pace at which exports are growing.

... high real interest rates ...

Thirdly, in countries that have achieved some degree of macro-economic stability, monetary policy and financial intermediation have been hampered by the fact that consumer prices have risen much faster than producer prices. At the beginning of the transition process, this had been due to the elimination of consumer subsidies and the gradual raising of household energy prices towards world market levels, causing the consumer price index to overstate underlying inflation. Last year, the widening of the gap was primarily attributable to services. Because the rate of consumer price increase outstripped that of producer prices, maintaining moderately positive real interest on deposits entailed very high real rates for borrowing enterprises. This contributed to poor output performance and kept investment, which had declined substantially in 1991, depressed (see the table opposite).

... and enterprise restructuring

Finally, the liquidation of non-viable state enterprises has not yet begun in earnest. To some degree this reflects social and political concerns in a situation in which unemployment is already high and labour mobility is low and entire cities or regions may depend on one or two employers. It also reflects the lack of suitable policy instruments and institutions for weeding out loss-makers. Increasingly, governments are turning to the banking sector to play a larger role in this task. The need to restructure or liquidate state enterprises could severely limit the growth that can be achieved over the next few years.

Corporate control and hard budget constraints

The cumulative decline in output in eastern Europe over the last three years has been dramatic, ranging from one-fifth in Hungary and Poland to one-half in Albania, Bulgaria and Romania. While measurement is a major problem and official statistics overstate the decline because of the incomplete coverage of the fast-growing private sector, there can be little doubt that the living standards of a large section of the population have declined. To varying degrees this has undermined support for reform. The political sustainability of reform depends on the expectation that growth will resume in the not too distant future. This in turn will require a high rate of

Gross fixed investment					
Countries	1988	1989	1990	1991[1]	1992[2]
	as a percentage of GDP				
Bulgaria	26.1	25.2	20.4	11.3	13
Czechoslovakia	25.2	25.1	25.0	18.2	20
Hungary	21.0	19.9	17.8	17.8	18
Poland	22.5	16.4	19.1	19.6	19
Romania	28.0	29.6	20.0	13.1	13
Slovenia	20.1[2]	19.1[2]	18.0	18.9	17

[1] Partly estimated. [2] Estimated.

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

saving and its investment in profitable activities with growth potential. Saving has traditionally been high in eastern Europe and household saving has even risen in recent years. However, much of this saving has been channelled into loss-making enterprises.

Continued lending to loss-making enterprises was unavoidable ...

In the early stages of the transition this was unavoidable. Far-reaching, unprecedented and unanticipated changes in the economic environment – the loss of traditional export markets, the complete overhaul of the relative price structure, the sudden emergence of import competition and tight macroeconomic policies – made many companies unprofitable. In the immediate aftermath of these upheavals, continued bank lending to enterprises and the accumulation of inter-enterprise arrears served as safety valves to prevent the economy from coming to a complete standstill. This was acceptable for three reasons. Firstly, there was no basis for judging which companies might be able to survive in the medium term, given the uncertainty regarding export markets and relative prices. Secondly, poor reporting and accounting systems made it difficult to evaluate the financial position of enterprises. Thirdly, no policy instruments existed to deal with a situation of widespread insolvency and the requirements of enterprise restructuring. Bank and company lending to established customers was the only means available to buy time.

... but now undermines growth prospects

The continuation of this practice, however, undermines growth prospects. Yet the reduction or elimination of distress lending has proved difficult in eastern Europe because of political pressures relating to rising unemployment and the fact that banks and enterprises are locked into a mutual dependency through non-performing loans. Initially it was thought that the imposition of harder budget constraints would be facilitated by rapid privatisation, but problems in the implementation of privatisation programmes have led to a scaling-down of these expectations. Governments have come to accept that a substantial proportion of enterprises will remain in state hands for the foreseeable future. This has increased the need to harden the budget constraints on enterprises through improved corporate control. In this connection the reform of the banking system and the strengthening of banks' capital base have come to be seen as important policy instruments.

In several countries efforts have centred on making banks key enforcers of hard budget constraints by providing them with the means to exercise greater corporate control. The aim has been to break the inefficient link of mutual dependence between banks and enterprises and to eliminate the perverse incentives to lend by recapitalising banks, by improving banks' own corporate governance through supervisory boards, better internal control mechanisms and programmes for privatisation, and by strengthening their bargaining position vis-à-vis enterprises through improved bankruptcy laws and other legal provisions.

The role of banks in hardening budget constraints ...

An important question has concerned the method of bank recapitalisation. Two basic models have been considered. The first consists of removing bad loans from the banks' balance sheets and replacing them with government bonds. This has the advantage that the moral hazard for banks is reduced because they no longer have any incentive to lend to bad debtors. A problem with this approach, however, is the subsequent treatment of the bad loans, many of which may be recoverable, at least in part. If the loans are transferred to a government agency the debtors may have little incentive to repay since the agency itself would not in any case be a potential source of future funding. Such an agency may also lack the motivation to foreclose efficiently on enterprises. The alternative would be to give banks the capital needed to set provisions against or write off bad debts in the form of government securities, but to leave the loans on their books. This would encourage the banks to restructure the debt of enterprises which could become viable and to foreclose in cases where restructuring held out little prospect of success. The main argument advanced against this solution, in addition to the risk of moral hazard, has been that the banks do not have the necessary expertise to evaluate and restructure enterprises. It has also been argued that the restructuring of large state enterprises is politically too important to be entrusted to commercial banks. One possibility would be to assign the major problem cases to a government agency and leave the others to the banks. In practice, both solutions have been used. Hungary has transferred bad loans to a separate bank; in Poland, banks will have to manage their bad loans themselves, helped by substantial recapitalisation; and in former Czechoslovakia, a combination of these approaches has been adopted.

... and the need for recapitalisation

Hungary has taken the most far-reaching measures in bank reform, thereby clearly revealing the underlying weakness of the banking system and its implications for the economy. This does not mean that the problems are greater than elsewhere; rather, it is a sign that they have been brought into the open earlier and that solutions are urgently being sought. Reform in Hungary accelerated last year with the enactment of two laws. Firstly, a new bankruptcy law stipulates that enterprises with debts more than ninety days overdue must file for bankruptcy or risk being put into liquidation by creditors. This affected some 14,000 companies last year. Secondly, a new banking law requires banks to achieve a ratio of capital to risk-weighted

Bank reform in Hungary ...

Indicators of banking conditions in Hungary

Items	1991	1992
Non-performing loans[1]		
As a percentage of assets	3.9	9.3
As a percentage of loans	7.1	13.6
Budget revenues from banks (taxes and dividends)		
As a percentage of general government budget revenues	3.4	0.1
As a percentage of GDP	1.9	0.1
Spread between lending and borrowing rates (% points)[2]	4.4	11.2
Large banks	*6.1*	*12.9*
Small banks	*3.0*	*9.3*
Credit growth to enterprises, percentage change	18.7	1.9[3]

[1] Debts which have not been serviced for at least sixty days, claims on borrowers which recorded losses in the preceding two years or are undergoing restructuring or liquidation and claims otherwise classified by financial institutions as doubtful or bad. For 1992, September. [2] Loans and deposits at one year or less, at end-year. [3] Twelve months to November.

Source: National data.

assets of 8% by the end of 1994 at the latest, to fully classify their loan portfolios and to set provisions against their non-performing loans. The combination of the new bankruptcy and banking laws has highlighted some of the underlying fragility of the Hungarian economy. The share of doubtful and bad loans rose from 7.1% at the end of 1991 to 13.6% in September 1992 (see the table above).

The banks responded to the new economic environment by tightening lending criteria and internal loan approval procedures and by increasing the spread between lending and borrowing rates in order to generate funds for provisioning against substandard loans. The result was that bank lending to enterprises collapsed. In contrast to previous experience, reduced bank lending was not offset by a sharp rise in inter-enterprise arrears. This is perhaps the clearest sign of truly hardened budget constraints. Increased provisioning reduced budget revenues from profit taxes and dividends by 2% of GDP, which largely accounted for the widening of the budget deficit to 7% of GDP. The Government reacted by introducing a bank consolidation scheme with the aim of recapitalising banks by hiving off the worst loans to a special government-owned bank and swapping them for government bonds bearing market interest rates. It also helped establish a corporation to guarantee bank loans to small and medium-sized enterprises whose lack of adequate collateral had limited their access to bank credit. Amendments to the bankruptcy law are under consideration with a view to eliminating its bias towards liquidation.

... Poland ...

In *Poland,* Parliament has passed legislation to give banks a larger role in corporate restructuring by strengthening bankruptcy procedures. In addition, a framework has been established for debt/equity swaps and the trading of non-performing loans. Out-of-court restructuring arrangements for indebted firms have also been instituted. A major bank recapitalisation programme will be implemented in 1993, for which the Government, in addition to providing budgetary funds, has requested donors to endorse the reallocation of the $1 billion currency stabilisation fund which had been made available in 1989 but which has not yet been used. A strengthened capital base will allow banks to set provisions against their non-performing loans and to play an active role in corporate restructuring. Tighter control of the nine largest banks by their owner, the Ministry of Finance, and external audits have already led to more prudent lending behaviour. The creation of supervisory boards composed of external directors with non-renewable terms of office, together with steps to deal with the one-quarter of loans that are estimated to be non-performing, has also reduced pressure on the banks to lend.

... and the Czech and Slovak Republics

The *Czech and Slovak Republics* attempted to solve the problem of non-performing loans in 1991. Perpetual inventory loans at very low interest rates then accounted for more than 40% of the portfolios of the two major commercial banks. With capital ratios of under 2%, their solvency was threatened when interest rates rose. The Government took two measures. Firstly, it transferred around two-thirds of these loans, together with corresponding liabilities equivalent to 11% of GDP, to a special consolidation bank. Secondly, the banks were given additional government bonds to the value of 5% of GDP for recapitalisation. Enterprise restructuring, however, was postponed. Bankruptcies are expected to rise in the Czech Republic and this will test the ability of banks to play a constructive role in enterprise restructuring and control. Their ability to exercise better corporate control was strengthened by the earlier large-scale privatisation, in which state enterprises were sold against vouchers, distributed to the population for a nominal fee. Three-quarters of the shares of the 1,491 large and medium-sized enterprises privatised last year are concentrated in investment funds, most of which are owned by banks. This means that banks hold both debt and equity of companies and are therefore in a position to monitor them closely and to influence their business strategy.

Difficulties in banking system reform

Major difficulties remain:

Governments have made progress in improving financial intermediation and in paving the way for an expansion of credit to fast-growing small and medium-sized private enterprises. However, the public sector has itself absorbed more credit as budget deficits have risen (see the table opposite). When faced with a choice between risky private borrowers and risk-free government paper, banks have opted for the latter. This has retarded the development of banks' lending expertise and has reduced the volume of credit available to the private sector, where social returns may be particularly high in the transition to a market economy. The experience illustrates the importance of controlling budget deficits for the development of an efficient banking sector able to service the private sector and to revive investment.

the absorption of credit by budget deficits ...

Bank recapitalisation will add to budgetary strains. The creation of government debt to replace non-performing loans is purely an accounting

Developments in credit and monetary aggregates					
Countries and aggregates	1988	1989	1990	1991	1992
	percentage changes, at end-year				
Bulgaria					
Domestic credit: Total	10.7	4.2	25.6	148.0	50
To non-government sector	*6.1*	*8.0*	*10.7*	*112.5*	*31*
Broad money	10.3	10.5	14.8	124.8	50
Real broad money	*8.9*	*4.7*	*− 7.3*	*−60.6*	*−16*
Czechoslovakia					
Domestic credit: Total	7.3	7.6	9.7	18.0	16
To non-government sector	*3.1*	*− 1.9*	*1.4*	*20.3*	*18*
Broad money	11.5	3.5	0.1	27.3	20
Real broad money	*10.8*	*1.9*	*−15.2*	*−17.1*	*8*
Hungary					
Domestic credit: Total	5.4	16.8	11.8	7.1	11
To non-government sector	*5.8*	*17.2*	*20.1*	*0.1*	*5*[1]
Broad money	3.0	15.3	28.9	27.7	29
Real broad money	*−10.3*	*− 2.4*	*− 5.9*	*− 3.4*	*6*
Poland					
Domestic credit: Total	46.8	220.9	193.9	97.5	60
To non-government sector	*38.8*	*193.7*	*262.6*	*62.3*	*26*
Broad money	63.9	526.3	155.5	44.4	58
Real broad money	*− 3.4*	*−15.3*	*−26.9*	*−10.0*	*9*
Romania					
Domestic credit: Total	− 1.2	9.3	22.7	116.5	33
To non-government sector	*5.1*	*− 0.3*	*−15.6*[2]	*101.1*	*39*
Broad money	10.2	6.3	22.0	101.2	71
Real broad money	*7.2*	*5.5*	*−13.0*	*−37.7*	*−43*

Note: Credit to the non-government sector includes state enterprises, broad money is essentially equivalent to M_3 and real broad money is deflated by consumer prices.

[1] Estimated. [2] Not comparable with total domestic credit (break in series).

Sources: IMF and national data.

... the costs of recapitalisation ...

operation. The interest costs, however, could increase budget expenditure and deficits by perhaps 2% of GDP in the more advanced countries. The danger that the growth of public debt may become unsustainable has led governments to search for alternative sources of revenue to finance the recapitalisation programme. Hungary has earmarked part of future privatisation receipts for the purpose, and Poland has approached foreign donors for assistance in supplementing budgetary resources.

... the pace at which budget constraints can be tightened ...

Governments recognise the importance of hardening enterprises' budget constraints. The difficulty has been to determine the right pace. The danger in proceeding slowly is that incentives may not change because the private sector questions the government's resolve. A swift hardening of constraints, on the other hand, may not be credible because the rapid rise in unemployment would raise doubts regarding political sustainability. It would also be inefficient since enterprises need time to strengthen their capital stock and to retrain their employees.

The more advanced countries have tried to balance these considerations by taking measures to harden budget constraints but at the same time allowing banks to continue lending to insolvent companies for interest capitalisation and operating expenses. One challenge now is to release banks from this obligation. A second challenge is to improve the corporate governance of the banks themselves by reducing government control through at least partial privatisation. Only then will banks be able to exercise firm corporate control and lend more to profitable enterprises.

... and bank privatisation

Recent trends in the developing countries and the NIEs

Stronger growth, lower inflation but growing external imbalance

Output growth in the developing countries and the NIEs accelerated to almost 5% last year (see the table opposite) as stronger activity in Asia and the Middle East more than offset some weakening in Africa and Latin America. The average inflation rate increased to over 100%, but almost entirely owing to developments in Brazil. Most other countries in Latin America managed to lower inflation and both Asia and the Middle East improved their price performance. Current account imbalances (see the table on page 58) widened in most regions last year. In Latin America a surge in imports combined with a further deterioration in the terms of trade (see the table on page 59) produced a marked swing into deficit on trade account and, with interest payments largely unchanged, the current account deficit rose to $33 billion. Less pronounced but broadly similar trends were seen in Africa and Asia, whereas in the Middle East higher net real exports helped to stabilise the trade surplus. The principal reason for the fall in the current account deficit in the Middle East was the decline in transfers, which, owing to the Gulf conflict, had amounted to almost $25 billion in 1991. Overall, real exports rose by 8½% as intra-regional trade strengthened, especially in South-East Asia owing to the influence of China, but also in Latin America. However, reflecting the buoyancy of domestic demand relative to that in industrial countries, import growth was even stronger. Hence, the improvement in the net transfer balance was more or less offset by a mainly cyclical deterioration in the trade balance.

The NIEs

Marked slowdown in South Korea ...

Following several years of uninterrupted rapid expansion, output growth fell in the NIEs last year. The slowdown was especially marked in *South Korea*, where domestic demand weakened progressively during the year in response to a tightening of policies (including restrictions on construction permits and credit to the corporate sector) in order to curb a build-up of inflationary pressures. Real private fixed investment actually declined following an average increase of over 16% during 1985–91. Because of weaker domestic demand and broadly unchanged export growth, net real exports accounted for about one-third of overall GDP growth and for the improvement in the current account. Price inflation also moderated in response to lower excess demand pressure, whereas the rise in nominal wages remained relatively high until late in the year, notwithstanding the Government's policy of wage restraint. Nonetheless, the competitive

GDP growth and inflation in developing countries and the NIEs

Countries and country groups	Real GDP				Consumer prices			
	1984–89 average	1990	1991	1992	1984–89 average	1990	1991	1992
	percentage changes							
Africa	3.1	1.7	1.6	1.1	17.2	17.0	32.0	40.0
Nigeria	5.8	8.2	4.5	3.6	24.0	7.4	13.0	45.0
South Africa	1.5	−0.5	−0.4	−2.0	15.7	14.4	15.3	14.5
Sub-Saharan countries	2.8	0.9	0.5	0.4	20.5	26.0	65.0	73.0
Middle East	−0.5	5.5	2.1	6.0	11.6	7.5	13.0	12.5
Egypt[1]	6.9	2.6	2.3	0.7	18.8	16.8	19.8	13.6
Iran[2]	−4.1	11.7	8.1	6.5	20.2	7.6	17.1	25.0
Asia	7.1	5.8	5.2	6.9	8.3	7.5	8.5	7.5
China	9.2	4.8	7.7	12.8	12.8	2.1	3.0	6.5
India[1]	6.1	5.5	1.2	4.2	7.7	9.0	13.9	11.8
Indonesia	5.3	7.1	6.6	5.9	6.8	7.5	9.2	7.5
Malaysia	4.5	9.8	8.7	8.0	1.3	2.6	4.3	4.7
Philippines	2.2	2.7	−0.7	0.0	9.5	14.1	18.7	9.0
Thailand	8.6	10.0	8.2	7.4	3.2	5.9	5.7	4.0
NIEs	8.6	6.8	7.1	5.3	3.3	7.0	7.6	6.0
Latin America	2.4	0.7	2.9	2.3	266.0	1,568	193.0	355.0
Argentina	−1.3	0.0	8.9	8.7	444.5	2,314	171.7	25.0
Brazil	4.5	−4.0	0.9	−0.9	391.5	3,118	428.0	982.0
Chile	6.2	2.1	6.0	10.4	20.5	26.0	21.8	15.5
Mexico	1.0	4.4	3.6	2.6	77.3	26.7	22.7	15.5
Peru	−0.5	−4.4	2.6	−2.7	371.5	7,482	409.5	73.5
Venezuela	2.0	6.9	10.4	7.3	30.5	40.8	34.2	31.5
All countries[3]	3.7	3.7	3.5	4.6	86.0	469.0	67.0	115.0

[1] Fiscal year. [2] Year beginning 21st March. [3] Weighted average, based on 1984–86 GDP and exchange rates.

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

position of South Korean manufacturers, which had deteriorated sharply during the late 1980s, improved moderately, owing to a lower nominal effective exchange rate. The new Government recently presented a plan aimed at stimulating the economy by abandoning the tight monetary policy and seeking to contain the risk of higher inflation by means of a partial price and wage freeze.

... and moderation in other NIEs, except Hong Kong

Real currency appreciation, mostly due to relatively high wage increases, together with sluggish growth in key export markets and private investment, was the main reason for the less buoyant trend in *Taipei China*, whereas domestic demand was stimulated by large investments in infrastructure. In *Singapore* activity remained subdued in the first half of 1992, but the second half saw a sharp turnaround owing to the worldwide boom in demand for personal computers. *Hong Kong*, in particular, has benefited from the booming conditions in China (see below) and the strong impetus from net exports raised aggregate output growth to 5%, the highest rate in four years. Following seven years of surpluses, Hong Kong's budget for this year envisages a deficit, mainly as a result of increased infrastructure investment.

Other developing countries

Low growth and higher inflation in Africa

Average output growth in *Africa* fell to only 1% last year. A severe drought affected agriculture in large parts of the region and civil unrest in several countries had a further adverse effect. The terms of trade worsened by over 5% and some countries in the early stages of implementing structural reform programmes recorded lower output growth. In *Nigeria,* accounting for 20% of overall output, real GDP grew by 3½%. However, surging inflation – reflecting a 50% devaluation of the currency, a widening gap between the official and the "parallel" market exchange rate and a doubling of credit expansion – together with a rise in the budget deficit and growing interest arrears on a foreign debt now exceeding 100% of GDP suggests that fundamental problems have not been solved. By contrast, *Tunisia,* which appears to have benefited from an austere reform programme, achieved real growth of 8½%. *South Africa,* also accounting for 20% of the region's GDP, has seen output decline for three consecutive years. When presenting the budget for 1993/94 the Government also proposed a comprehensive austerity and reform programme. To promote investment and growth and reduce poverty the plan calls for a sharp reduction in government spending and a shift from company to indirect taxation within the framework of a balanced budget. Exchange controls are also to be removed and annual real wage growth limited to less than 1%, while, during a transitional phase, employment is to be stimulated by various labour market measures.

Reform plan in South Africa

Recovery in the Middle East ...

Growth in the *Middle East* accelerated sharply but about half the rise was attributable to the resumption of oil production in *Kuwait* and the stabilisation of output in *Iraq,* both countries having recorded steep declines in 1990–91. Growth slowed in *Iran* as the reform process stalled and imports surged. *Egypt* recorded a growth rate of less than 1% but made progress in reducing inflation. Despite delays in lowering the fiscal deficit and reforming the economy, the conditions attached to the IMF standby agreement were met, triggering a reduction in official debt.

... and dynamic developments in Asia

Output growth also rose in *Asia,* reflecting the dynamism of intra-regional trade and buoyant domestic demand. There were, however, marked variations across the region. Growth declined from a high level in countries, such as Indonesia, Malaysia and Thailand, in which restrictive policies were implemented to counter rising inflationary pressures. At the same time, activity strengthened substantially in India and, in particular, in China, and these two countries alone accounted for more than the overall acceleration.

Marked upturn in India owing to reform policies

India, which in 1991 had experienced a decline in per capita income owing to a tightening of policy as part of a coordinated move to avert a liquidity crisis, recorded a marked recovery last year. This was due, in part, to more favourable weather but was mainly the result of recent economic reforms and success in reducing inflation. Additional reform measures, including the abolition of the dual exchange rate system and a substantial cut in import duties – notably on capital goods and raw materials – combined with increased government investment should provide a further boost to domestic demand this year and improve the competitive position of exporters. One disturbing development has been the recent rise in the current account deficit as imports have grown rapidly in response to liberalisation while exports were adversely affected by the collapse of domestic demand in the former Soviet Union. With 70% of the labour force employed in agriculture, the success of reform policies and public support for them could also be threatened by adverse weather conditions.

Vigorous growth in China with large sectoral and regional variations ...

In *China* real GDP rose by almost 13% in 1992 (more than twice the rate planned), spurred by vigorous investment and export growth. The aggregate output figures, however, mask large differences between and within sectors and regions. Agricultural output growth was sluggish, as farm incomes were squeezed between output prices and the rising cost of raw materials. Within industry, two-thirds of the state enterprises recorded losses, which continue to jeopardise the success of reform policies. State enterprises are not subject to a hard budget constraint and last year received direct subsidies amounting to 2% of GDP as well as bank credits to finance their losses. In addition to raising credit growth the losses narrow the central bank's scope for using interest rates as a policy instrument, because higher rates would further increase the state enterprises' need for bank credits and subsidies. There were also large regional differences, with a risk of severe overheating in the coastal regions while the interior regions continued to develop slowly. On the external side, import growth exceeded export growth, but the current account remained in surplus. Capital inflows increased and for the first time direct investment was the largest component.

... and growing inflationary pressures

Inflation accelerated last year but part of the rise reflected the deregulation of prices for more than 600 products. A sharp increase in household saving – according to some estimates to over 25% of GDP – had a moderating influence and half of the 30% growth of M_2 was accounted for by time and savings deposits. Nonetheless, in the course of 1992 there was growing evidence of a strong build-up of inflationary pressures. The currency weakened sharply (see Chapter IV) and the government deficit widened to almost 4% of GDP. Moreover, prices in major cities rose by twice the national average, indicating a slow supply response and the existence of partly segmented markets. Early this year, following a further strengthening of output growth, inflation accelerated to 8½% and measures to dampen the investment boom were introduced.

Notwithstanding the growing risk of overheating, China's performance since the adoption of reforms compares rather favourably with developments in eastern Europe and, especially, with those in neighbouring *Mongolia*, another former socialist country. Despite foreign aid totalling $130 per capita, the economy has shrunk by almost 20% over the last two years while prices have increased by almost 500%.

Current account balances of developing countries and the NIEs									
Country groups	Current account balance			of which					
				Trade balance			Net interest payments		
	1990	1991	1992	1990	1991	1992	1990	1991	1992
	in billions of US dollars								
Developing countries	−18.8	−80.3	−75.5	59.7	17.9	−12.5	89.2	84.3	79.6
Africa	− 2.4	− 3.9	− 7.8	9.1	8.2	2.4	14.4	14.3	14.2
Asia	− 6.5	− 6.6	−21.2	−8.1	−10.4	−18.4	21.6	22.6	22.3
NIEs	14.4	9.3	7.8	7.5	3.0	1.9	4.3	4.0	4.2
Middle East	− 3.1	−51.4	−13.1	32.2	10.3	10.0	14.4	11.8	11.4
Latin America	− 6.8	−18.4	−33.4	26.6	9.9	− 6.5	38.8	35.6	31.7

Sources: IMF World Economic Outlook and national data.

Stabilisation in Latin America ...

In *Latin America* there were clear signs of a further consolidation of recent stabilisation and structural reform policies, even though output growth declined. Mexico and Venezuela experienced lower growth, but the principal reasons for the weaker performance in the region were contractions in Brazil, Cuba and Peru, poor harvests owing to adverse weather conditions and relatively slow export growth. In addition, imports rose sharply and the terms of trade deteriorated, bringing the cumulative decline since 1984 to over 20%.

... with a marked fall in inflation ...

The most obvious achievement of the stabilisation policies was the marked fall in the rate of inflation, except in Brazil. By the end of last year half the countries in the region were recording price increases of 15% or less. Although it was the outcome of different policy measures, progress was especially notable in three countries – Argentina, Peru and Nicaragua – which only a few years earlier had suffered from hyperinflation. Fiscal consolidation and tight monetary policies contributed significantly to the more favourable price trends. In several countries with appreciating currencies, severe constraints on price developments in the tradable sectors also had a dampening effect. On the other hand, as in industrial countries, inflation remained relatively high in the non-tradable sectors and the resulting shift in relative prices contributed to the deterioration in the external balance.

... but a widening external imbalance

The continued widening of current account deficits in Latin America gives cause for concern. Under the influence of a renewed surge in imports and the aforementioned terms-of-trade deterioration, the trade balance swung from a surplus to a deficit and the current account deficit reached its highest level since 1982. Capital inflows allowed most countries to add to their foreign exchange reserves and finance imports. There was a further rise in direct investment inflows, reflecting greater confidence among foreign investors in the policies pursued. However, a large proportion of the total inflow was of a short-term nature, attracted by high real interest rates and booming equity markets.

Brazil a major exception

The deviation of *Brazil* from the more favourable trends in the rest of Latin America became even more pronounced last year as the rate of inflation accelerated in conditions of deepening recession. Following some recovery in the first half of 1992 due in part to the release of financial assets frozen under an earlier stabilisation programme, output declined in the second half against the background of growing political uncertainty. Currency depreciation and a worsening fiscal imbalance contributed to a monthly rate of inflation of 20–25%, while monetary policy was kept restrictive, leading to high real interest rates and large capital inflows. Unlike most other countries in the region, Brazil saw an improvement in its external balance, reflecting weak domestic demand and a stronger competitive position vis-à-vis its Latin American trading partners as relatively high wage growth was more than offset by currency depreciation.

Further consolidation in Argentina

The stabilisation policies adopted by *Argentina* in 1990 were consolidated further last year, bringing the inflation rate down to 18% by the end of 1992, the lowest rate for more than twenty years. Despite some weakening in the second half, real GDP grew by 8¾%. Fixed investment rose by some 35% and consumption was buoyant even though real wages stagnated. As a result of the policy of relying on a fixed exchange rate against the US dollar as the principal instrument for reducing inflation, exports declined last year, while the level of imports almost doubled, leading to a significant deterioration in the trade balance. In contrast to earlier years, when external imbalances were chiefly due to fiscal deficits, last year's imbalance was the counterpart of a financial deficit in the private sector, as the government budget was in surplus.

Indicators of foreign trade of developing countries and the NIEs

Country groups	Periods	Export volumes	Import volumes	Terms of trade
		percentage changes, annual averages		
Developing countries	1985–90	8.5	6.3	– 2.4
	1991	7.6	9.1	– 3.7
	1992	8.5	10.5	– 1.6
Africa	1985–90	3.7	0.3	– 4.8
	1991	1.7	–3.0	– 5.5
	1992	1.4	3.3	– 5.5
Asia	1985–90	11.6	11.5	0.7
	1991	11.3	11.2	– 0.3
	1992	11.1	11.9	– 0.4
NIEs	1985–90	11.6	16.5	3.2
	1991	11.8	14.4	0.4
	1992	10.7	12.1	– 0.4
Middle East	1985–90	7.3	–1.3	– 7.0
	1991	3.0	3.6	–11.6
	1992	6.9	3.6	– 3.9
Latin America	1985–90	4.3	4.7	– 2.8
	1991	4.2	16.5	– 4.0
	1992	4.3	17.9	– 0.6

Sources: IMF World Economic Outlook and national data.

Mexico and Chile, among the first countries in the region to adopt stabilisation and adjustment policies, both reduced inflation to around 15% last year, but otherwise recorded very different developments. Spurred by house-hold consumption and private fixed investment, final domestic demand in *Mexico* rose by 7%. However, because of destocking, weak export demand and a further deterioration in competitiveness, output growth declined to about 2½%. The current account deficit reached over 7% of GDP, at which level exports would have to grow almost twice as fast as imports just to prevent it from widening further. Since the first wage-price accord was concluded in 1987 the real effective exchange rate has appreciated by some 50% and in order to improve the competitive position of enterprises the central bank last year increased the daily adjustments of the peso against the US dollar. *Chile*, by contrast, experienced a rise in real growth to over 10%, thereby raising the cumulative increase in per capita income since the 1982 recession to over 45%. Over the same period the rate of unemployment has fallen from 20 to only 5%. Capital inflows more than financed the current account deficit and, as a further sign of international investors' confidence, the country was the first in Latin America to receive an investment-grade rating of its debt.

Large external deficit in Mexico ...

... and buoyant developments in Chile

Chile was also one of the first Latin American countries to adopt measures to alleviate the plight of the lowest income groups. Despite the recent progress, almost one-third of the population is still living in poverty and last year social expenditure broadly defined was increased to two-thirds of total government outlays. Elsewhere in Latin America the situation of the poor is even bleaker, with about half of households earning incomes below the poverty level and almost one-quarter living in conditions characterised as "extreme poverty". Income inequalities are also pronounced in other parts of the developing world, though in several Asian countries vigorous growth has been accompanied by a more equal sharing of the gains. Consequently, in addition to a strengthening of the external balance, the consolidation of recent progress in Latin America may hinge on the adoption of policies aimed at reducing income inequalities and raising the living standards of the poor.

The problem of poverty

World income distribution and economic growth in the medium term

The large regional differences in growth last year continued a trend observed throughout the 1980s: high growth in Asia contrasting with low growth and declining per capita incomes in Africa and Latin America. Since income developments in Africa and Latin America have also been significantly weaker than in the industrial countries and most of the countries with extremely low per capita income levels are concentrated in Africa, this trend raises two questions: firstly, to what extent has the distribution of world income become more unequal and, secondly, how can the marked differences in growth between countries be explained?

Developments in the distribution of world income

Trends in the distribution of world income ...

The distribution of world income is presented in the table below. As column (a) shows, the 20% of the world population with the lowest per capita incomes received only 5% of world income in 1960 and its share has steadily fallen. Following a moderate rise during the 1960s, the income share of the 20% with the highest per capita incomes (exclusively industrial countries) has also declined over time, but was still nearly 63% in 1990. The only population group to show a gain is the third quintile (40–60%), which over the last two decades almost doubled its share.

... and the role of China

This gain is entirely due to the exceptional performance of China, which accounts for almost 20% of the world population and occupies the whole of the third quintile. China's per capita income growth has averaged almost 7% per year since the start of economic reforms in 1977–78, compared with only 1½% previously. If China is excluded (column (b) of the table) there is a clear increase in inequality, with the richest countries gaining relative to all other groups, especially the poorest 20%.

Regional income trends

The rise in inequality is also apparent in the income developments by region shown in the table overleaf. The comparative position of Africa, which includes most of the countries in the first quintile of the previous table, steadily worsened, while that of Latin America, after remaining broadly stable until 1980, deteriorated sharply during the subsequent decade. Asia, by contrast, recorded a clear gain, notably in the 1980s, when income growth declined much less than in other regions. In addition to the exceptional development in China, the improvement in Asia was influenced by the four NIEs, which by 1990 had reached a per capita income level only 17% below that of industrial countries.

Distribution of world income by population groups

Population groups	Percentage of world income received by population quintile including (column a) and excluding (column b) China										Change 1960–90 in percentage points	
	1960		1969		1979		1987		1990			
	a	b	a	b	a	b	a	b	a	b	a	b
1st quintile	5.0	3.9	4.2	3.3	3.3	2.6	3.4	2.9	3.4	2.9	−1.6	−1.0
2nd quintile	6.2	4.9	5.2	4.0	5.9	3.7	6.1	3.6	6.0	3.7	−0.2	−1.2
3rd quintile	7.3	9.6	6.0	8.8	7.0	9.3	10.6	8.8	11.5	8.4	4.2	−1.2
4th quintile	17.9	23.3	18.5	24.8	18.9	25.8	17.1	22.0	16.3	20.4	−1.6	−2.9
5th quintile	63.7	58.3	66.1	59.1	64.9	58.6	62.7	62.7	62.8	64.6	−0.9	6.3
Memo items:	ratios											
Richest 20% to poorest 20%	*12.7*	*14.9*	*15.7*	*17.9*	*19.7*	*22.5*	*18.4*	*21.6*	*18.5*	*22.3*	*5.8*	*7.4*
Richest 20% to poorest 80%	*1.8*	*1.4*	*1.9*	*1.4*	*1.8*	*1.4*	*1.7*	*1.7*	*1.7*	*1.8*	*−0.1*	*0.4*

Note: Calculations are based on country averages and do not take account of income differences within countries.

Sources: Summers, R. and Heston, A. (1991): "The Penn World Table (Mark 5): an expanded set of international comparisons, 1950–88", *Quarterly Journal of Economics*, pp. 327–348, IMF International Financial Statistics, World Bank World Tables and BIS estimates.

Distribution of income by region				
Countries	1960	1970	1980	1990
	Per capita income relative to the industrial country average			
Latin America	0.41	0.38	0.40	0.29
Africa	0.17	0.14	0.14	0.11
Asia	0.25	0.26	0.31	0.35
China	0.14	0.12	0.13	0.20
NIEs	0.31	0.40	0.59	0.83
All developing countries	0.25	0.24	0.24	0.20
Memorandum item:	Average per capita income growth during decade ending			
Latin America	–	*3.0*	*3.1*	*−0.8*
Africa	–	*2.2*	*2.0*	*−0.3*
Asia	–	*3.5*	*3.4*	*2.7*
China	–	*2.2*	*3.5*	*6.9*
NIEs	–	*6.3*	*6.7*	*5.6*
All developing countries	–	*2.9*	*2.4*	*−0.1*

Note: Unweighted annual averages by country, based on the same data sources as the previous table, except that Middle Eastern oil producers are excluded.

Growth determinants: a tentative analysis

The developments shown in the tables above cast doubt on the widely held assumption that poor countries will generally gain relative to more advanced countries through the spillover of technology and capital inflows. In fact, the graph opposite would rather suggest that other conditions have to be met if countries are to benefit from technological spillover. Those which do not possess the infrastructure or the labour skills needed to attract foreign investment and to absorb modern technologies remain locked in poverty.

Fundamental determinants of growth

The graph is based on contributions to per capita income growth, using a broad analytical framework, including generally recognised growth determinants such as the ratio of investment to GDP, the rate of population growth, school enrolments and the level of 1960 per capita income relative to that of the United States (see the note to the graph for details). The last variable is also used as a measure of convergence and has been included in most growth studies on the assumption that countries starting with low income levels should achieve higher growth rates than countries with high initial incomes. These fundamental growth determinants were supplemented with more policy-related factors, including the rate of inflation, the share of government expenditure in GDP and various measures of openness.

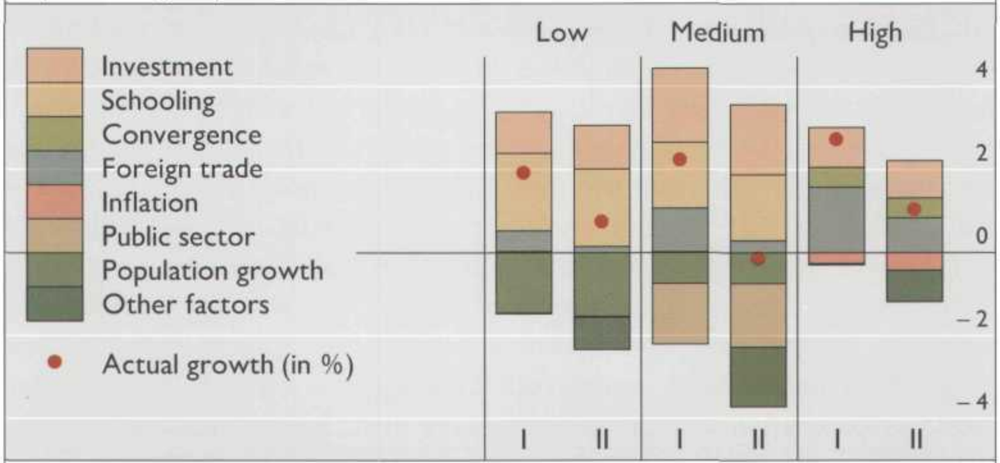
Growth determinants in broad income groups ...

As the upper panel of the graph shows, convergence has largely been confined to the high-income group, composed almost exclusively of industrial countries. In the group of medium-income countries, which comprises a large part of the Latin American region, there appears to have been only modest convergence, whereas schooling and the ratio of investment to GDP have provided positive contributions. At the same time, developments

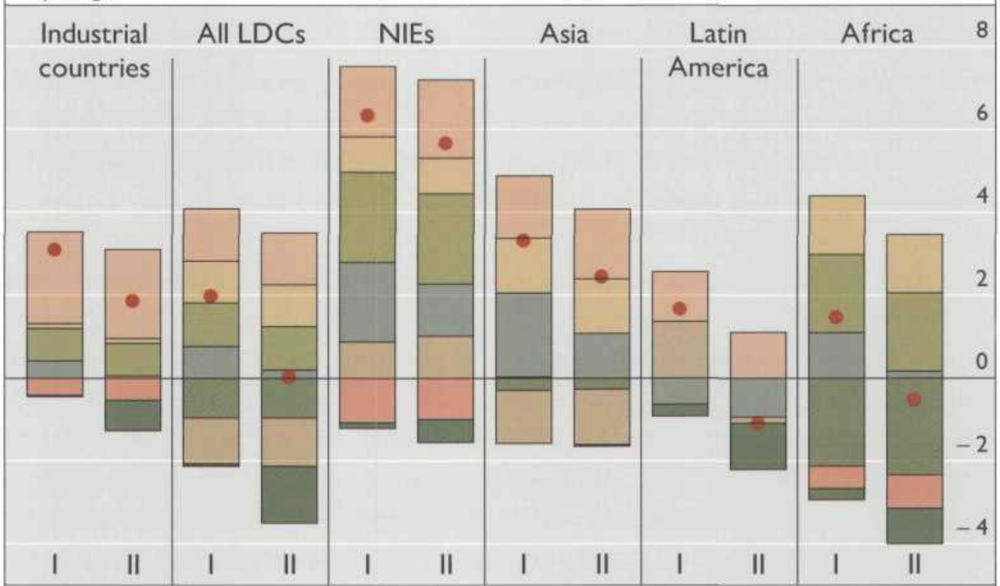
Changes in per capita income by contributing factor

In percentage points for the periods 1960–90 (I) and 1980–90 (II) respectively

By income group



By region



Note: The contributions were obtained by regressing per capita GDP growth on the share of investment in GDP, the rate of population growth, the proportion of the population enrolled in either primary or secondary schools, the ratio of 1960 per capita income to that of the United States (convergence), export growth (or the share of foreign trade in GDP), the average rate of inflation and the ratio of government expenditure to GDP (or real government expenditure growth) and calculated from average changes in the growth determinants. The estimates were based on purchasing power parity data for per capita income in 113 countries (of which 88 are classified as developing and 25 as industrial countries) over the period 1960–90. Recent studies of a similar nature have identified altogether 50 different factors with a significant influence on growth. Consequently, even though the calculations were confined to areas where a broad consensus exists, the results are inevitably somewhat arbitrary.

Sources: See the table on page 61.

in this group have been adversely affected by population growth. A high ratio of government expenditure to GDP appears to have been accompanied by some misallocation of resources. In the low-income group, which is dominated by Africa, convergence seems to have been absent, whereas schooling has stimulated growth. However, the principal cause of the relatively poor performance of this group was the high rate of population increase, which may have reduced per capita income growth by as much as 1½% per year.

An alternative explanation of growth in the medium and low-income countries may be that convergence *did* take place but was masked by developments specific to countries in a given region. This possibility is further examined in the lower panel of the graph using the same broad framework. For all developing countries combined the average growth for the period 1960–90 was more than 1 percentage point below that of the industrial countries, but the reason for the shortfall was not failure to converge as this factor contributed more than 1 point to average growth. Schooling and foreign trade played a greater role than in the industrial countries, whereas the contribution of capital formation was only half as large. Most importantly, a high rate of population increase reduced per capita income growth by a full percentage point by substantially lowering the ratio of the population of working age to the total population and by stretching scarce resources.

... and groups of countries

Another reason for the lower growth in the less developed countries was the marked slump in the 1980s, when per capita income stagnated. Slower export growth was one important cause, but for the less developed countries considered as a group the downturn is otherwise difficult to explain, because the steepness of the decline differed considerably between regions.

Reasons for high growth in Asia

The *Asian* countries managed to maintain a relatively high growth rate during the 1980s and the principal reasons for their better overall performance appear to have been a high investment ratio, strong export growth and high school enrolments. Like other Asian countries, the *NIEs* experienced lower export growth, but were able to partly offset this by expanding investment and containing inflation. They also succeeded in obtaining a positive growth contribution from government spending by avoiding high fiscal deficits and the associated misallocation of resources. However, the principal factor explaining the better performance of the NIEs was the absence of any adverse population growth effects and their ability to take advantage of advanced technologies, as indicated by the contribution of over 2 percentage points from the convergence factor.

Fluctuations and destabilising policies in Latin America

Developments in *Latin America* have been marked by large fluctuations. In the 1960s and 1970s Latin American countries were able to achieve an average growth rate of over 3%, mainly by boosting domestic demand through expansionary fiscal policies. The resulting rise in imports and in external imbalances was financed by capital imports, which made it possible to overcome the adverse effect of high inflation. However, the price of policies oriented towards the very short term was paid in the 1980s when, because of the debt crisis and consolidation measures taken to reduce fiscal deficits, the contribution of the government sector became negative and per capita income declined by 1%. As a further sign of the short-term and inward-looking orientation of policies, foreign trade had a negative influence, in particular in the 1980s.

The adverse influence of population growth in Africa

The main reasons for the low growth in *Africa* were the absence of any investment effects and a rapidly growing population. These two features are probably not independent of each other. When per capita income is low, the saving rate is also low and not sufficient to finance stronger investment growth. At the same time, when the population is growing at nearly 3% per annum and the proportion of the population of working age is declining, the capacity for raising per capita income to a level that will generate higher saving is minimal. The overall performance was also influenced by the slump in the 1980s, when average growth became negative owing to a marked fall in export growth and higher inflation. On the other hand, there was some convergence, albeit at a slow pace, and school enrolment also provided a positive contribution. However, the aggregate impact of these two factors was overshadowed by the adverse influences mentioned above.

Preconditions for growth ...

To sum up, it would appear that the most important preconditions for economic growth and for reducing existing inequalities between industrial and developing countries are high saving and investment, strong export growth and a well-educated labour force. Rapid population increases create the risk of a vicious circle of poverty, where income growth is too low to raise per capita income above the threshold which would generate the saving and investment rates required for higher and more sustainable growth. Above all, growth depends on policies. The literacy rate of the population is very much a question of the resources allocated to education. Also, the ability to absorb advanced technologies and attract foreign investment depends on a range of policy-related institutional and structural conditions. Similarly, saving and investment can be affected by policies, through interest rates and, in particular, government saving. Macroeconomic policies also play a key role, although their precise influence is difficult to measure. Expansionary monetary and fiscal policies can achieve short-run gains, but at the risk of widening fiscal and external deficits and rising inflation, with subsequent adverse effects on growth. Instead, investment and export-promoting policies with a medium-term orientation offer better prospects for stimulating growth and reducing income inequalities both within and between countries.

... and the fundamental influence of policies

IV. International trade and payments

Highlights

Events last year underlined how dependent national economies have become on external developments, financial as well as real. A significantly higher proportion of world output is now traded than even a decade ago. Capital flows have risen faster still and the value of international portfolio movements now exceeds the value of aggregate trade transactions in most of the larger industrial countries.

The abrupt end of a long period of nominal exchange rate stability in Europe provided a dramatic illustration of this shift. The medium-term accumulation of significant changes in intra-European real exchange rates had already begun to affect current account balances when a prolonged weakening in German import demand as from 1991 added further pressure. Things came to a head in autumn 1992 when doubts about the sustainability of prevailing exchange and interest rate configurations led to huge capital flows that forced five countries to abandon fixed exchange rate arrangements. As three other countries also devalued, European exchange rates changed more radically than for many years.

The stagnation of import demand in continental Europe virtually coincided with a period of even greater weakness in Japan. Despite a sharp rise in imports in the major Anglo-Saxon countries – itself coming on the back of only halting growth – industrial country trade as a whole has therefore remained rather sluggish. Weak demand growth, higher unemployment and excess capacity in many sectors have contributed to an atmosphere of intensifying competition. Moreover, the renewed rise in the external imbalances of Japan and the United States last year as well as the large European deficit have aggravated protectionist sentiment. Such macroeconomic conditions have hardly been auspicious for multilateral negotiations on further trade liberalisation. Trade conflicts have become more acute and the much-delayed Uruguay Round had, by April 1993, failed to reach any conclusion.

At the same time, several areas of the world have seen that policies of increased integration with the global economy have yielded many benefits. This has been nowhere clearer than in Asia, where export growth has held up well in the face of recession in Japan and stagnation elsewhere: intra-regional trade and investment have grown markedly. An important aspect of this is that the continued rapid economic integration of China with other areas in South-East Asia was again associated with greatly increased Chinese trade with the industrial world.

In eastern Europe it was the continued buoyancy of exports that provided the main stimulus to growth last year. Some of the Baltic states, which had begun the same internationalisation process only last year, took dramatic and successful measures to ensure the stability of their new currencies as a first step in reorienting their economies from heavy dependence on the former Soviet Union. In addition, a number of countries in eastern Europe attracted increased foreign investment, notably direct investment. As in 1991, Latin America also received sizable capital inflows as earlier economic reforms in many countries have apparently done much to win foreign and domestic confidence and as high interest rates attracted short-term inflows. But export performance has been less favourable, held back in some cases by overvalued exchange rates, and the region's current account deficit was larger last year than at any time since 1982.

In bleak contrast with successful adjustment elsewhere, the states of the former Soviet Union failed to address the central issues of international economic policy. The rouble's lack of a stable international value and large deviations of domestic from international prices created incentives to conceal export earnings, and significant capital flight occurred. Little was done to provide an economic basis for commerce between the former Soviet republics – trade policy, exchange arrangements and payment systems were all shrouded in confusion, with actual trade and payments being left to various ad hoc arrangements. In early 1993, however, the official restatement of the intention to implement economic reforms was supported by offers of significant external financial assistance.

World trade

Developments

Trade growth weak in industrial countries ...

World trade grew slowly again last year while developing country trade continued to expand much more rapidly than that of the industrial world. Although North America emerged only slowly from recession, the volume of US and Canadian imports grew strongly. But a marked weakening of activity in Japan and continental Europe limited overall import growth in industrial countries to about 4% last year (up from 2½% in 1991); exports rose by only 3% in volume terms.

... but strong in the developing world

The Asian NIEs recorded a rise in import volumes of over 12%; their exports increased by 11%. Their importance in world trade was thus further enhanced: they now export as much as Japan, even though the value of their output (measured at purchasing power parities) is less than one-third as large. Elsewhere in the developing world, imports rose by almost 10%, and exports by 7½%, with Asian economies (in particular China, Thailand and Malaysia) increasing their share of international markets. In most Latin American countries, with the notable exception of Brazil, strong domestic demand and real exchange rate appreciation led to a large rise in import volumes. Since exports grew much more slowly, the region's current account deficit widened sharply. The Mexican deficit exceeded $20 billion; at the other end of the spectrum, the Brazilian surplus was over $5 billion. Eastern European trade with industrial countries continued to expand in 1992; the trade of the former Soviet Union shrank further.

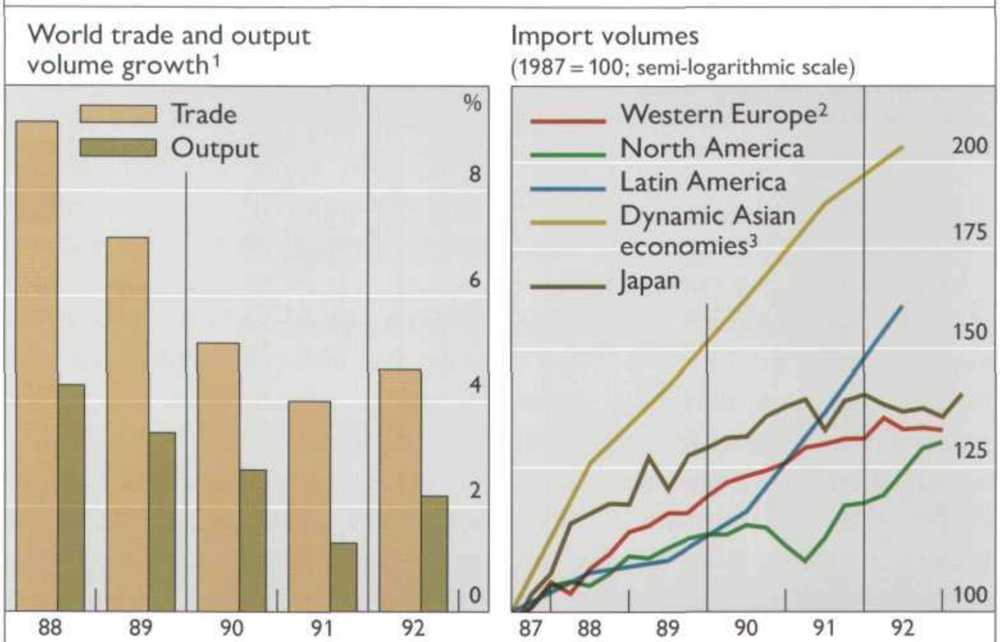
Trade prices

With world economic activity relatively subdued last year, manufactured goods prices rose by only 4% in dollar terms. Following three years of decline, non-oil commodity prices stabilised at low levels. Agricultural commodity prices recovered slightly from earlier declines, but those of tropical beverages dropped for the sixth consecutive year. Excess capacity in heavy industry continued to depress metal and mineral prices. Overall, real non-oil commodity prices (deflated by manufactured goods export prices) have fallen by 22% since 1989. World oil output increased marginally last year as a sharp decline in Russian production was offset by an expansion of Middle Eastern output, particularly that of Kuwait; weak demand kept the average oil price virtually constant, despite a temporary rally at mid-year. The industrial countries' terms of trade therefore improved by almost 2% last year; developing countries suffered terms-of-trade losses for the second year in succession.

Services

The last fifteen years have seen a rapid expansion of invisibles transactions. According to GATT calculations, commercial services – mainly travel, transport, communications and professional and technical services – have grown much faster than merchandise trade since 1980. Last year, the dollar value of commercial services increased by 8%, as against 5½% for merchandise trade; such services now account for almost 21% of total exports, some 4 percentage points more than in 1980.

Indicators of world trade



[1] Excluding eastern Europe and the former Soviet Union. Output growth as measured by percentage changes in real GDP. [2] Belgium, France, western Germany, Italy, the Netherlands, Spain, Sweden, Switzerland and the United Kingdom. [3] Hong Kong, Malaysia, Singapore, South Korea, Taipei China and Thailand.

Sources: IMF and national data.

Trade policies

1992 was not a good year for the multilateral trading system. The unusually large number of regional agreements negotiated or implemented last year inevitably contained some discriminatory elements. More seriously, perhaps, ad hoc bilateral arrangements governing trade seem to have assumed greater importance. At the same time, conclusion of the long-drawn-out Uruguay Round has proved difficult and trade conflicts among the major industrial countries have increased.

Regional arrangements ...

The broad framework of the single market programme of the European Community was implemented at the beginning of 1993, significantly increasing competition within the area. In many fields, however, several EC directives needed to give the programme its full scope remain to be agreed; even where such directives are in place, a number of countries have not yet put them into effect by passing the necessary enabling legislation. The draft North American Free Trade Agreement (NAFTA) between Canada, Mexico and the United States was concluded in August; if ratified in its present form, it promises to give much stimulus to intra-regional trade. Finally, a number of smaller regional trade agreements were reached: many more such arrangements were notified to the GATT in 1992 than in 1991. Part of the impetus for such arrangements came from a desire for autonomous liberalisation in developing countries that had previously had very protectionist regimes.

... risk discrimination ...

However, all regional trade arrangements almost inevitably run the risk of discriminating against more efficient producers in the wider world, and some features of recent agreements suggest the need for vigilance. The retention of Article 115 of the Treaty of Rome in the Maastricht agreement left open for individual EC member countries the possibility of taking, with the consent of the Commission, ad hoc protective measures against imports from third countries. This raises the danger that what is a single market for EC members may not always be so for countries outside. Although the NAFTA was carefully drafted to be consistent with GATT obligations, it generally sets the rules of origin governing preferential treatment more tightly than had been the practice before. Also, the required local content for cars is to rise from 50% to 62.5%, thus encouraging car manufacturers outside North America to produce more within the area and to export less from their, possibly lower-cost, home base.

... as do bilateral agreements

The increasing importance of bilateral, rather than multilateral, negotiations was again evident last year; moreover, such negotiations were on occasion associated with threats of sanctions. An apparent bilateral understanding that US producers of semiconductors would have 20% of the Japanese semiconductor market by the end of 1992 was fulfilled, thanks only to a determined spurt in the final quarter. A similar agreement was reached to increase Japanese imports of US-made car parts by the mid-1990s. The EC/Japanese agreement to continue to apply "transitional" limits on Japanese car exports to Europe until the end of the decade effectively maintained barriers which differ greatly within the Community. In early

1993, a dispute between the United States and the European Community about public procurement rules culminated in a threat of US sanctions. Perhaps the most wide-ranging dispute arose from a worldwide glut of steel that increased the clamour for protection almost everywhere. Europe, the United States, Canada, Japan, Taipei China and Mexico have all imposed restrictions on steel (or steel-related) imports during the last twelve months or so, while at the same time finding their own steel exports blocked by other countries' restrictions.

Uruguay Round delayed

The Uruguay Round of multilateral trade negotiations has dragged on for more than two years beyond the date originally set for completion. Nevertheless, sufficient progress towards tentative agreement had been made to enable a Draft Final Act to be tabled at the end of 1991. This Act foreshadowed the most extensive re-ordering of the multilateral trading system since GATT's inception, comprising some twenty-eight agreements on fifteen areas.

Agricultural trade disputes

In the negotiations that followed, however, pressure from vested interests precluded any final accord. Agricultural policy differences among the industrial countries proved particularly intractable. Although many issues involving other countries remained unresolved (for example, Japan's quantitative restrictions on agricultural imports), disagreement between the European Community and the United States on subsidised agricultural exports and domestic support prices provided a highly visible test case. This dispute came to a head over EC exports of oilseeds, one of the few agricultural products already included in GATT and one on which the United States had obtained two GATT panel rulings against EC practices. In early November 1992, the United States responded to a breakdown of bilateral talks by seeking GATT authority to impose prohibitive tariffs on $1 billion worth of EC goods. This threat was averted only after renewed negotiations had produced a draft US/EC agreement on oilseeds, which France, however, did not accept. At any event, continued multilateral negotiations on the full range of topics had not produced a definitive GATT agreement by early May 1993.

Benefits of multilateralism

Failure to bring the Uruguay Round to an effective conclusion would cast a large shadow over the future of multilateralism. It is difficult to overstate the practical importance of the GATT system, which gives multilateralism its specific content. Commitments made by governments in GATT help to create a stable trading environment, strengthen competition and encourage investment. Moreover, trade disputes can be defused. Exporters' need for improved market access creates pressure for lower barriers to imports which benefit consumers. Because concessions granted to one country normally have to be extended to all GATT contracting parties (under the key most-favoured-nation article of the Agreement), the interests of smaller countries are far better protected than in a bilateral framework. This is why so many countries have joined in recent years or are now actively seeking membership. It would be regrettable if the emergence of truly global GATT arrangements were to be tarnished by increased recourse to bilateralism among the industrial countries.

Current account developments in industrial countries

Underlying forces

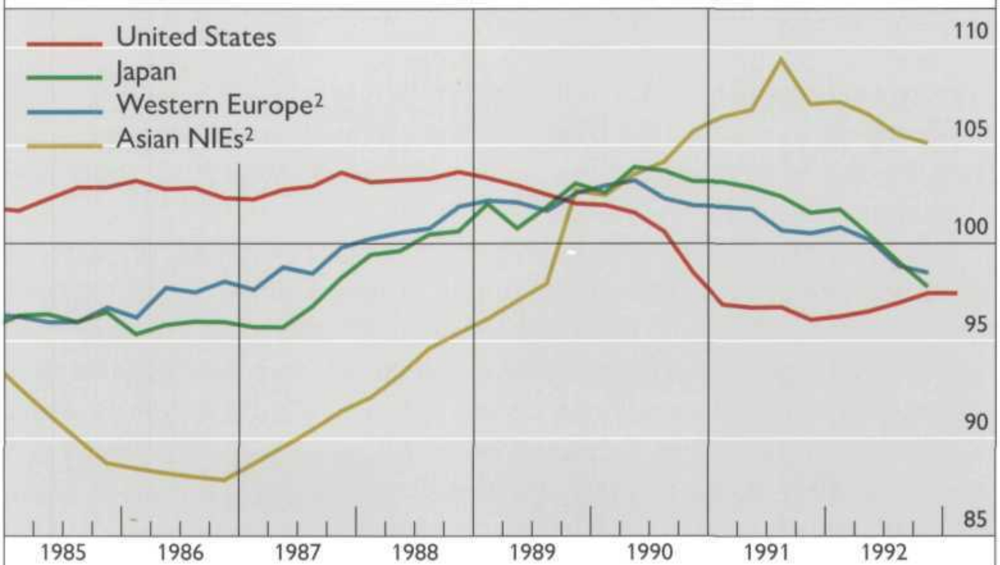
Competitiveness strong in the United States ...

For the first time in five years, the US current account deficit widened last year as a three-year period of slow growth in domestic demand came to an end and as the downturn in the rest of the industrial world deepened. Even so, the deficit, at around 1% of GNP, remained proportionately much smaller than it had been in the late 1980s – thanks in large part to the maintenance of a strong competitive position in recent years. On the basis of the three measures of real effective exchange rates shown in the graph overleaf, it is clear that the sharp improvement in US competitiveness brought about by the nominal depreciation of the dollar in 1985–87 has been sustained. US wage inflation remained relatively low, and the nominal effective rate of the dollar, though fluctuating, showed no trend to further depreciation after 1987. In short, a nominal change brought about a durable real shift without igniting inflation.

... but not in Europe ...

The pronounced weakening of domestic demand last year in Japan contributed to a rise in its surplus to over $117 billion, a record in dollar terms and over 3% of GNP. The western European deficit rose to almost $70 billion, even though domestic demand in continental Europe weakened progressively during the year. The persistence of a large European deficit reflects the effects of German unification and, more generally, the marked deterioration in Europe's global competitiveness. Some indication of the magnitude of this loss is given in the graph overleaf which shows various measures of real effective exchange rates for Europe as a whole, that is, excluding intra-European trade. With the exception of a brief dip in the first half of 1991 – when the dollar rose temporarily – Europe's effective

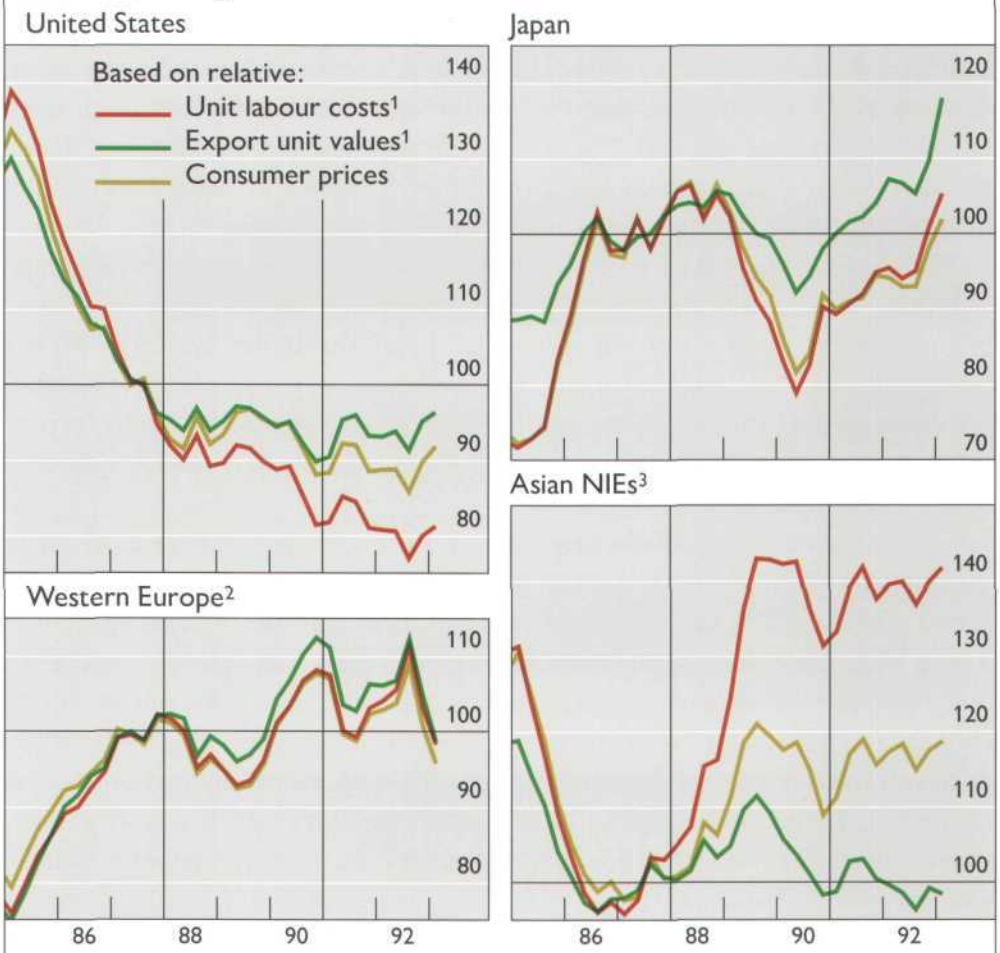
Domestic demand growth relative to trend[1]



[1] Deviation of total domestic demand from the 1980–92 trend (United States, 2.7%; Japan, 4.5%; western Europe (Belgium, France, western Germany, Italy, the Netherlands, Spain, Sweden, Switzerland and the United Kingdom), 2.8%; Asian NIEs (Hong Kong, Singapore, South Korea and Taipei China), 10.2%). [2] Weighted average based on 1990 GDP weights and exchange rates.

Real effective exchange rates

Quarterly averages, 1987 = 100



Note: Indices for western Europe and the Asian NIEs exclude intra-area trade.
[1] In manufacturing. [2] Belgium, France, western Germany, Italy, the Netherlands, Spain, Sweden, Switzerland and the United Kingdom. [3] Hong Kong, Singapore, South Korea and Taipei China.

exchange rate tended to rise in the early 1990s. In mid-1992, on the eve of the European exchange rate crisis, the real effective exchange rates calculated on the various price bases were between 15 and 20% above the levels prevailing in the late 1980s.

... where labour costs are high

Studies of *absolute* levels of competitiveness – based on detailed assessments of productivity, valuing output at international prices – suggest that European unit labour costs are appreciably higher than US levels, and may well be higher than Japanese levels. Although such studies yield only very approximate measures, one central calculation suggests that average unit labour costs in manufacturing were, by mid-1992, 70% above US levels, and 40% above Japanese levels. Among the major European countries, unit labour costs were particularly high in Germany.

This loss of competitiveness came after a decade of already poor European performance in world markets. At the beginning of the 1980s European producers had about 33% of the large US market for imports of finished manufactured goods; by 1992, this share was down to 24% and western Europe had been overtaken by both Japan and the group of dynamic Asian economies (see the graph below). This latter group of countries has also made deep inroads into the Japanese and European markets.

Asian NIEs

The rise of the Asian economies in the world economy owes much to the combination of low labour costs and rapid productivity growth. Because these advantages were not at first reflected in nominal exchange rates, large current account surpluses emerged: the Asian NIEs' surplus amounted to more than 9% of GDP in 1987. Sharp nominal exchange rate appreciation from 1987 to 1989 eroded much of this competitive advantage. Nevertheless, the fact that the huge rise in relative unit labour costs that took place during this period was not reflected in export prices (see the graph on page 72) suggests that earlier profit margins were very comfortable. Given the very strong expansion in real domestic demand in the late 1980s, the NIEs' current account surplus declined appreciably.

Recent changes

Changes in exchange rates since summer 1992 have significantly improved the competitive position of almost all European countries vis-à-vis the world outside Europe as well as causing large shifts within Europe. Among the major areas, Japan saw the sharpest appreciation in its real effective exchange rate; the US change was relatively modest; and the competitive position of the Asian NIEs remained virtually unchanged.

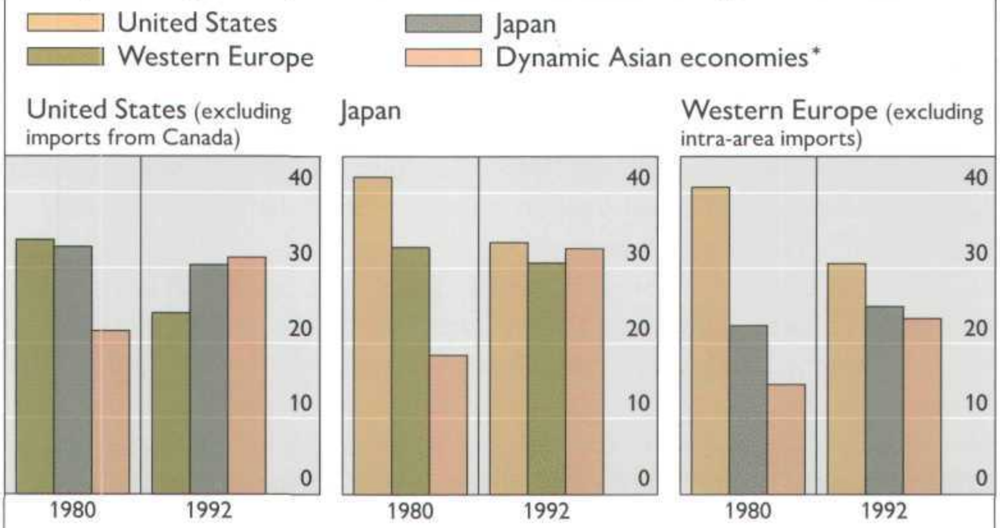
United States

US deficit widens ...

Excluding Gulf war-related transfers, the US current account deficit, which had narrowed from $163 billion in 1987 to about $46 billion in 1991, widened to almost $63 billion last year. The trade deficit increased to $96 billion as the volume of imports rose sharply after two years of virtual

Export market shares in three major markets

As a percentage of imports of total finished manufactured goods in each market



* China, Hong Kong, Indonesia, Malaysia, Singapore, South Korea, Taipei China and Thailand.
Source: BIS calculations based on OECD trade data (1992 estimated).

The US current account

Items	1988	1989	1990	1991	1992 Year	1992 Q IV[1]
	in billions of US dollars					
Current account	−126.7	−101.1	− 90.4	− 3.7	−62.4	− 88.1
Trade balance	−127.0	−115.7	−108.9	−73.4	−96.3	−103.9
Net investment income	12.5	14.4	19.3	16.4	10.0	3.4
Other services	12.7	25.8	32.1	45.3	55.1	51.8
Transfers	− 24.9	− 25.6	− 32.9	8.0	−31.4	− 39.3
Memorandum items:						
Oil imports	*39.6*	*50.9*	*62.3*	*51.2*	*51.4*	*55.0*
Non-oil trade balance[2]	*− 76.4*	*− 55.3*	*− 39.7*	*−22.3*	*−46.1*	*− 48.9*
	percentage changes					
Export volumes	*19.3*	*11.8*	*7.2*	*6.5*	*6.4*	*6.6*[3]
Import volumes	*4.0*	*4.4*	*2.2*	*0.7*	*11.0*	*11.0*[3]
Terms of trade	*1.3*	*− 1.1*	*− 2.1*	*0.6*	*− 0.6*	*− 1.2*[3]

[1] At a seasonally adjusted annual rate. [2] At constant 1987 trade unit values. [3] Change over fourth quarter 1991.

stagnation. Exports held up quite well last year, with strong growth in exports to the developing world (notably Latin America) making up for weak demand in the industrial world.

... as imports surge

Much of the deterioration in the real trade balance was accounted for by trade in computer equipment. After large increases in the two preceding years, computer equipment import volumes jumped by 45% last year, twice the rate of growth of computer exports. Import volumes of capital goods other than computers increased strongly, rising, in the year to the fourth quarter, by about 13%, well above the expansion of US investment in non-computer equipment; consumer goods imports rose closely in line with private consumption. Although export growth was less buoyant than in earlier years, it continued to exceed foreign market growth as US exporters maintained their healthy competitive position.

Surplus on services rises ...

Nearly half of the deterioration in the US merchandise trade balance was offset by a further expansion in the surplus on non-factor services, which reached $55 billion last year. At constant prices, however, the surplus on services changed little as exports, which had grown steeply in recent years, reached a plateau.

... while that on investment income falls

Net investment income on both direct and portfolio investments continued to decline last year. Overall, net investment income dropped to just $10 billion, barely one-third of net earnings in the early 1980s. This decline reflected the sharp reversal in the US net external position from one of net creditor to the tune of just under $400 billion at the end of 1980 to a net liability position of almost equal magnitude at the end of 1991. The fact that US net investment income nevertheless remained positive throughout this period was largely due to the wide discrepancy between the rather high returns earned on US direct investment abroad

The Japanese current account						
Items	1988	1989	1990	1991	1992	
					Year	Q IV[1]
	in billions of US dollars					
Current account	79.6	57.2	35.8	72.9	117.6	125.7[2]
Trade balance	95.0	76.9	63.5	103.0	132.3	136.1[2]
Net investment income	21.0	23.4	23.2	26.7	36.2	37.1
Other services	−32.3	−39.0	−45.5	−44.4	−46.3	−41.9
Transfers	− 4.1	− 4.2	− 5.5	−12.5	− 4.7	− 5.5[2]
Memorandum items:						
Oil imports	*25.8*	*29.8*	*41.3*	*37.8*	*36.4*	*40.2*
Non-oil trade balance[3]	*48.3*	*37.7*	*47.8*	*47.3*	*53.6*	*67.1*
	percentage changes					
Export volumes	*4.4*	*4.2*	*5.7*	*2.5*	*0.7*	*− 2.0*[4]
Import volumes	*16.7*	*7.9*	*6.0*	*2.8*	*− 0.7*	*− 3.4*[4]
Terms of trade	*3.0*	*− 4.2*	*− 5.9*	*8.5*	*8.2*	*6.6*[4]

[1] At an annual rate. [2] Seasonally adjusted. [3] At constant 1985 trade unit values. [4] Change over fourth quarter 1991.

and the poor earnings of foreigners on direct investment in the United States. Indeed, returns (based on market value) on foreign direct investment in the United States averaged just under 1% in the 1988–92 period, compared with 4½% in the mid-1980s and much lower than the returns of US-controlled enterprises abroad (7½% compared with 10% earlier).

Japan

Record Japanese surplus ...

Two-thirds of the $45 billion widening in Japan's current account surplus last year was due to an increase in the trade surplus. With the yen appreciating against the dollar, the terms of trade improved as export unit values changed little in yen terms but import unit values dropped by almost 7%. Moreover, the progressive slowdown of the Japanese economy produced a fall in import volumes that reached almost 3½% in the year to the final quarter. Imports of machinery and equipment in dollar terms, which had nearly tripled over the preceding five years, reached a peak last year whereas those of iron and steel products contracted by nearly one-third. This decline affected all foreign suppliers except China, which expanded its exports to Japan by nearly one-fifth.

... as export structure changes ...

Export volume growth also slowed appreciably, although some categories of exports, notably office machinery and semiconductors, continued to expand rapidly. Even though the number of cars exported fell, their dollar value increased strongly as a shift towards more expensive models continued – partly to conform to quantitative restrictions on direct exports. All this indicates that the structure of exports is changing, with greater emphasis being put on high value added goods and less on more standardised products. Exports of iron and steel products and of consumer electronics were sluggish. Much of this production has been relocated to Japanese subsidiaries overseas, particularly those elsewhere in Asia where labour costs are much lower. Moreover, in recent years Japanese enterprises have increasingly served the European and North American markets through their affiliates in these regions, and less through direct exports. By the early 1990s, Japanese affiliates' production had risen to 7% of total parent company output, compared with only 3% in 1985.

... and investment income rises

Developments in invisibles transactions last year were dominated by an increase of almost $10 billion in net portfolio investment income. Over the previous six years net investment income had nearly quadrupled as Japan's net external asset position grew from $130 billion at the end of 1985 to almost $400 billion at the end of 1991. Last year, receipts of interest and dividends remained stable, but payments dropped by nearly $8 billion owing to lower interest rates and a sharp reduction in the cross-border liabilities of Japanese banks in recent years.

Western Europe

Creeping divergence in real exchange rates in Europe abruptly reversed

1992 saw a major break in European trade and competitiveness trends as stagnation set in and the long period of nominal exchange rate stability stretching back to January 1987 came to an end. Since domestic price and cost trends had tended to converge only slowly during the late 1980s, marked shifts in the real exchange rates of European currencies had occurred. The configuration that had emerged was transformed by large movements in nominal exchange rates from the autumn of 1992. There are of course many ways of measuring real exchange rates depending on the price index used, and in what follows several indicators are given to avoid undue reliance on any one indicator. The choice of the base year is also arbitrary, so that the indices discussed below should be interpreted as measures of changes, and not of levels.

The changes in competitiveness measured from a price and cost perspective are shown in the graph opposite. One important general observation is that the recent effective depreciations of the currencies that are now floating have been very large while the effective appreciations of those that have maintained their DM parities have been small. This reflects the general European depreciation against the dollar and the yen in recent months and the large weight of Germany in trade-weighted measures of effective exchange rates.

Germany the anchor

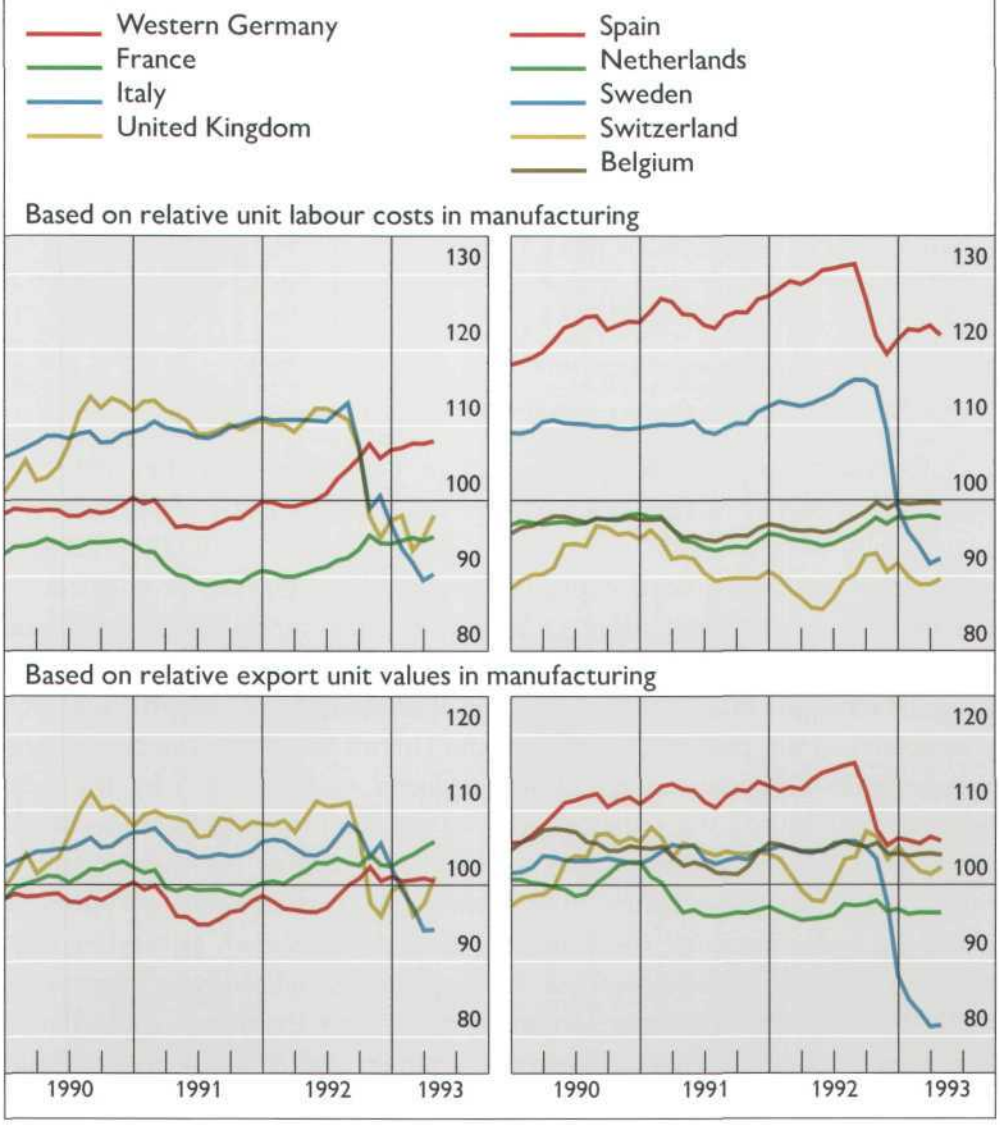
Germany was at the centre of developments in recent years both because of the anchor role played by the Deutsche Mark in European exchange rate arrangements and because of the major effects of unification on import demand which had initially masked the full consequences of declining competitiveness in a number of European countries. In the event, Germany's current account swung from sizable surplus to significant deficit, and its inflation rate rose above the industrial country average.

Low-inflation countries become more competitive ...

Among the other larger European countries two broad groups can be distinguished on the basis of trends over the past five years. In a first group (Belgium, France and the Netherlands) comparatively low inflation and the

Real effective exchange rates in selected European countries

Monthly averages, 1987 = 100



close link to the Deutsche Mark preserved – or even improved – their price position relative to other major European countries. Switzerland achieved much the same by a small nominal depreciation vis-à-vis the Deutsche Mark which offset its higher inflation over the period as a whole. The French current account had returned to rough balance by the early 1990s; the other three countries have had large and persistent surpluses for several years: over 2% of GDP for Belgium, about 3½% for the Netherlands and 4½% for Switzerland (averages over the last four years). A second group (Italy, Spain, Sweden and the United Kingdom) experienced higher than average inflation which had brought about a significant real appreciation of their currencies by mid-1992. All four countries had substantial current account deficits. Spain had proportionately the largest deficit (over 3% of GDP over the last four years), followed by the United Kingdom (2½% of GDP), Sweden (just under 2% of GDP) and Italy (under 1½% of GDP).

... than high-inflation countries ...

Consumer prices in selected European countries in a common currency											
Periods	Surplus countries[1]					Western Germany	Deficit countries[1]				
	Belgium	France	Nether-lands	Switzer-land	*Average*		Italy	Spain	Sweden	United Kingdom[2]	*Average*
	in Deutsche Mark, 1987 = 100										
1990	108.4	109.1	104.3	107.0	*107.2*	106.9	115.4	130.1	119.8	114.7	*120.0*
1991	112.4	111.5	108.4	112.5	*111.2*	110.6	121.9	138.8	131.6	125.7	*129.5*
1992	115.1	114.6	112.4	112.5	*113.6*	115.0	121.9	140.6	131.8	123.8	*129.5*
1992 Q I–III	114.8	114.4	111.9	111.9	*113.3*	114.6	125.5	143.9	134.7	128.0	*133.0*
1992 Q IV	116.1	115.0	113.9	114.0	*114.8*	116.4	110.9	130.8	123.3	111.0	*119.0*
1993 Q I	117.2	116.1	113.6	112.5	*114.9*	118.4	104.3	132.8	111.2	109.9	*114.6*

[1] According to the current account position in 1992. [2] Excluding housing.

Consumer price indices measured in Deutsche Mark provide one simple indication of relative price movements within Europe and are shown in the table. Between 1987 and the first three quarters of 1992 (i.e. largely before the turbulence on European exchange markets) consumer prices in the deficit countries had risen, in Deutsche Mark terms, by between 25 and 45%, while in surplus countries the increase was between 10 and 15%. Large exchange rate changes from September 1992 wiped out this discrepancy in the case of Sweden and the United Kingdom. The cumulative rise in Italian DM-adjusted prices was reduced to only 4.3% by the first quarter of 1993 as a sharp depreciation of the lira more than compensated for relatively high inflation during the earlier period of nominal exchange rate stability: on this measure, Italian competitiveness therefore improved markedly against each of the other eight countries shown in the table. In the case of Spain, competitiveness also improved significantly in relation to 1991–92, but not in comparison with 1987. Over the whole period, the cumulative rise in German prices was greater than the rise in the four surplus countries (because of a pick-up in German inflation) and also greater than that in three of the four deficit countries (because of exchange rate changes).

... until abrupt correction from mid-1992

Deteriorating competitiveness is beginning to affect *Germany's* external balance. Expressed in constant prices, the trade surplus shrank further last year. Although exporters no longer tended to divert sales to domestic markets, exports declined in the year to the fourth quarter of 1992. Sluggish foreign demand for investment goods depressed machinery exports, one of Germany's key export sectors. Car exports rebounded after the sharp decline seen in 1991 when manufacturers had diverted production to meet pent-up demand in the new German Länder, but there were signs of renewed weakness in early 1993. Export growth fell further behind that of export markets, widening a gap that had begun to emerge in the late 1980s. The volume of imports, which had risen strongly until early 1991, broadly stagnated thereafter and declined towards the end of 1992 as the downturn in activity deepened.

Impact of competitiveness in Germany

Competitiveness factors have also started to accentuate the deficit on

The German current account[1]

Items	1988	1989	1990	1991	1992	
					Year	Q IV[2]
	in billions of US dollars					
Current account	50.7	57.6	46.7	−19.8	−26.0	−33.0[3]
Trade balance	78.2	76.2	69.8	21.5	29.5	23.8[3]
Net investment income	5.2	11.8	17.2	18.3	10.8	14.1
Other services	−14.6	−12.4	−17.5	−23.3	−34.2	−38.3
Transfers	−18.1	−18.0	−22.8	−36.3	−32.0	−32.6
Memorandum items:						
Oil imports	*14.7*	*16.1*	*21.9*	*23.9*	*22.9*	*21.9*
Non-oil trade balance[4]	*57.3*	*55.9*	*41.9*	*6.7*	*5.2*	*− 4.3*[3]
	percentage changes					
Export volumes	*6.4*	*8.6*	*4.9*	*1.4*	*0.2*	*− 4.5*[3,5]
Import volumes	*6.0*	*7.7*	*13.9*	*13.9*	*0.7*	*0.6*[3,5]
Terms of trade	*− 0.1*	*− 2.7*	*1.5*	*− 2.3*	*2.4*	*2.8*[5]

[1] From July 1990, including the external transactions of eastern Germany. [2] At an annual rate. [3] Seasonally adjusted. [4] At constant 1980 trade unit values. [5] Change over fourth quarter 1991.

services. The real appreciation of the Deutsche Mark has contributed to increased spending on foreign travel, which rose by 14% in DM terms last year; with receipts stagnating, the travel deficit was up by $6 billion. A similar deterioration affected other components of the services account. Moreover, investment income earnings fell last year as a widening German short-term interest rate differential vis-à-vis the United States tended to boost payments more than receipts.

French turnround ...

Elsewhere in Europe, too, the link between competitiveness and trade and current account developments was evident last year. Except in the case of the Netherlands, the current account balances of the low-inflation countries strengthened further. Most significant of these developments was the turnround in *France's* current account from deficit to surplus. The improvement of nearly $10 billion was almost entirely due to a strong trade performance, with export volumes growing by about 6% as French exporters increased market shares. Import volume growth decelerated to just 1%, thus arresting a steady rise in import penetration which had persisted for almost a decade.

... contrasts with deterioration in the United Kingdom ...

In stark contrast, most of the European countries that had lost competitiveness over the five years or so before the currency crisis faced widening current account deficits last year. In many instances, trade deficits have grown and several years of current account deficits have increased net investment income outflows. The renewed deterioration of the *United Kingdom's* trade deficit of nearly $6 billion reflected poor competitiveness and reduced manufacturing capacity. Despite the still very hesitant recovery of domestic demand, imports rose steeply in the first half of the year before stabilising: the year-on-year growth amounted to more than 6% in volume terms, with manufactured imports rising by 8½%. Manufactured

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		
	1990	1991	1992	1990	1991	1992	1990	1991	1992
	in billions of US dollars								
Industrial countries	−103.7	−20.9	−47.9	−48.5	−1.9	23.5	−5.8	−9.8	−21.0
United States	−90.4	−3.7	−62.4	−108.9	−73.4	−96.3	19.3	16.4	10.1
Japan	35.8	72.9	117.6	63.7	103.0	131.9	23.2	26.7	36.2
Western Europe	−13.0	−57.2	−69.6	−19.5	−48.3	−28.7	−9.2	−16.7	−31.8
France	−9.8	−6.3	2.9	−13.0	−9.0	1.7	−2.9	−5.1	−7.9
Germany	46.7	−19.8	−26.0	69.8	21.5	29.5	17.2	18.3	10.8
Italy	−14.4	−21.4	−25.4	0.6	−0.9	2.4	−13.4	−16.1	−20.2
United Kingdom	−29.4	−11.6	−21.5	−33.0	−18.3	−24.1	4.0	0.7	5.7
BLEU[1]	4.6	4.5	6.3	0.6	−0.1	0.9	0.7	1.4	1.5
Netherlands	10.2	7.7	6.7	10.3	10.7	10.8	0.8	0.9	0.5
Sweden	−6.9	−3.3	−5.1	2.5	5.1	6.0	−4.6	−4.8	−6.5
Switzerland	8.6	10.4	15.6	−6.8	−5.6	−0.6	14.8	15.0	15.2
Austria	1.2	0.1	−0.3	−7.9	−9.7	−9.7	−1.0	−1.5	−1.3
Denmark	1.4	2.2	4.6	4.9	4.7	7.1	−5.6	−5.6	−5.8
Finland	−7.0	−6.7	−5.1	−0.6	1.1	2.7	−3.7	−4.6	−5.3
Greece	−3.6	−1.5	−1.9	−12.3	−12.3	−13.7	−1.6	−1.7	−2.0
Iceland	−0.1	−0.3	−0.2	0.1	−0.1	0.0	−0.2	−0.3	−0.2
Ireland	0.0	1.4	2.8	3.0	3.2	5.7	−5.2	−4.7	−5.4
Norway	4.0	5.0	2.9	8.3	8.3	7.6	−2.7	−2.7	−3.6
Portugal	−0.2	−0.7	−0.2	−6.8	−7.8	−9.5	−0.2	0.1	0.6
Spain	−15.7	−17.0	−24.8	−29.5	−31.8	−37.3	−3.7	−4.2	−6.2
Turkey	−2.6	0.3	−0.9	−9.6	−7.3	−8.2	−1.8	−1.9	−1.7
Other industrial countries	−36.0	−33.0	−33.4	16.2	16.9	16.5	−39.1	−36.3	−35.4
Australia	−15.0	−10.1	−10.4	0.4	3.5	1.5	−14.0	−13.3	−11.2
Canada	−22.0	−25.5	−23.7	8.5	5.0	7.8	−20.8	−19.5	−20.6
New Zealand	−1.3	0.0	−0.8	1.0	2.0	1.9	−1.7	−1.5	−2.0
South Africa	2.3	2.7	1.5	6.3	6.3	5.3	−2.7	−2.0	−1.6
Asian NIEs	14.4	9.3	7.8	7.5	3.0	1.6	4.2[2]	4.8[2]	4.6[2]
Hong Kong	3.6[3]	2.7[3]	1.6[3]	−0.3	−1.7	−3.9	n.a.	n.a.	n.a.
Singapore	2.2	3.3	2.9	−5.1	−4.1	−4.9	1.3	1.4	1.6
South Korea	−2.2	−8.7	−4.6	−2.0	−7.0	−2.2	−1.0	−1.0	−1.2
Taipei China	10.8	12.0	7.9	14.9	15.8	12.6	3.9	4.4	4.1

[1] Belgium-Luxembourg Economic Union. [2] Excluding Hong Kong. [3] Balance of trade in goods and non-factor services.
Sources: IMF, national data and BIS estimates.

exports, on the other hand, expanded by only 2½%, below the average rate of industrial countries, even though some traditional UK export markets grew strongly last year and the capacity of foreign-owned manufacturing enterprises expanded. *Sweden,* too, continued to lose export market share last year; because of very depressed import demand, the trade surplus increased somewhat but not by enough to offset the rapidly growing deficit on net investment income.

... Sweden ...

... and Italy

Significant losses in competitiveness up to the middle of the year did not prevent *Italy* from recording a trade surplus of nearly \$2½ billion last year. However, real exchange rate appreciation stimulated imports (with the volume of imports rising much faster than domestic demand) and caused a further loss of export market share, albeit smaller than in preceding years. Competitiveness factors, moreover, further compressed the surplus on travel services. In addition, there was an increase in net investment income payments abroad on net external liabilities which now amount to more than 10% of GDP. The current account deficit widened to \$25 billion.

Smaller European countries

Trade developments in the smaller European countries have, in a number of cases, reflected rather specific influences. Of the countries shown in the graph below, *Finland* has faced a current account deficit of around 5% of GDP in recent years; the collapse of exports to the former Soviet Union was a major factor behind this. The real exchange rate fell sharply following devaluation in November 1991 and floating in September 1992. By contrast, the real exchange rates of *Denmark*, *Ireland* and *Norway* have remained relatively stable in recent years; all three countries registered significant surpluses last year. Despite a marked real appreciation of the escudo, the current account deficit of *Portugal* remained small, as a strong pick-up in EC transfers offset a further deterioration in the trade balance.

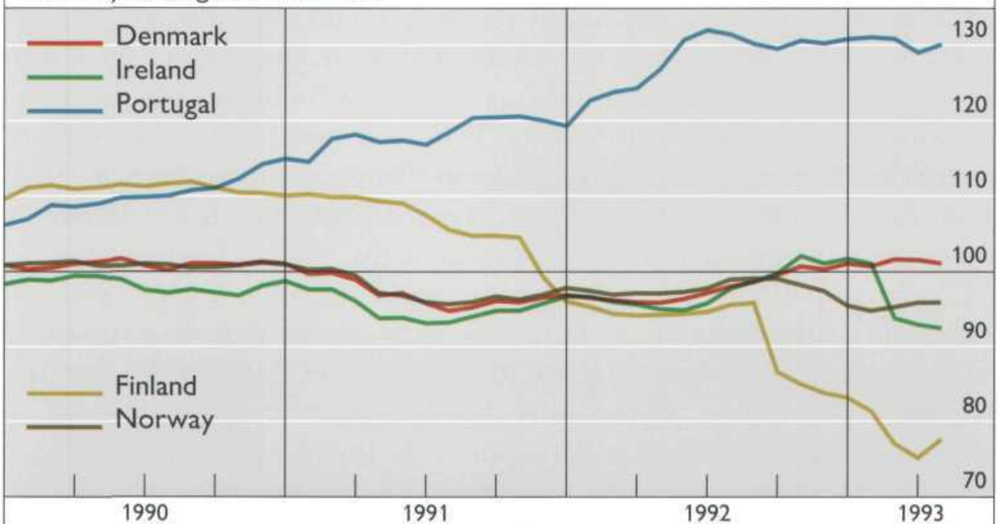
Other industrial countries

Trade expands strongly

Despite an only hesitant recovery of demand and output in *Australia*, *Canada* and *New Zealand* last year, import demand rebounded strongly, with volume increases ranging from 7 to 10%. In contrast to most other industrial countries, these countries' export markets for manufactured

Real effective exchange rates in other European countries*

Monthly averages, 1987 = 100



* Based on relative consumer prices.

goods were buoyant last year. Moreover, competitiveness gains achieved since 1989 further supported export performance in Australia and New Zealand. The volume growth of manufactured exports in these two countries, as well as in Canada where competitiveness gains are much more recent and have followed a prolonged period of deterioration, was close to 10% last year; agricultural and commodity exports grew more slowly. Despite trade surpluses in both Canada and Australia, their current accounts remained in deep deficit as the servicing of large external debts required heavy investment income payments abroad.

Former centrally planned economies

Eastern Europe

Trade booms in reforming countries ...

Decisive measures liberalising trade and prices, an opening to foreign investment and the adoption of more realistic exchange rates have been among the key ingredients of reform policies in eastern Europe. The countries which are at an advanced stage in transition and made this policy choice a few years ago have been rewarded by a marked dynamism of exports to the industrial world which grew strongly again last year: in the three years to 1992, the dollar value of their exports to the West rose by about 85%, implying a significant increase in market share (see the table). However, exports from the area showed distinct signs of weakness in the early months of 1993. As noted in Chapter III, the sweeping reorientation of trade has been crucial in limiting the recent decline in output. Nevertheless, imports from the West also grew sharply last year, and the region's trade deficit vis-à-vis industrial countries widened significantly, with the deterioration deepening as the year progressed.

... with exports helped by ...

Some of the factors accounting for the buoyancy of exports were common to all countries more advanced in the transition process. First, depressed domestic demand and the loss of traditional markets in the former CMEA countries forced domestic producers to find outlets in the West. Secondly, Hungary, Poland and the Czech and Slovak Republics have all benefited from improved access to western European markets through a number of trade agreements, notably the Association Agreement with the European Community and an agreement with the EFTA countries. However, there were signs during 1992 and early 1993 that eastern European countries were beginning to run into protectionist barriers: their main exports – agricultural products, iron and steel, textiles and clothing – are among the products most protected in the West. The imposition of EC restrictions on steel imports from former Czechoslovakia was one indication of the limits of the European trade agreements. Also, the rules of origin governing goods exported to the European Community under the preferential treatment accorded by the Agreement may limit the attractiveness of eastern Europe as an export base for foreign enterprises.

... improved market access

Differing competitiveness trends in ...

Divergent developments in competitiveness explain much of the differences in export performance. In the absence of reliable data on unit labour costs, the graph on page 84 shows measures of competitiveness

Eastern European trade with the industrial world									
	Exports			Imports			Trade balance		
	1990	1991	1992[1]	1990	1991	1992[1]	1990	1991	1992[1]
	in billions of US dollars								
Former Soviet Union	27.0	28.7	26.7	23.6	27.3	24.6	3.5	1.5	2.2
Former Yugoslavia	11.5	10.9	8.8	13.8	10.5	8.6	−2.2	0.3	0.3
Other eastern Europe	22.2	25.7	30.3	22.0	29.5	36.9	0.2	−3.8	−6.6
Bulgaria	1.0	1.2	1.5	1.6	1.7	1.9	−0.6	−0.5	−0.4
Czechoslovakia	4.7	6.3	8.8	4.9	6.3	10.6	−0.2	0.1	−1.8
Hungary	5.5	6.4	7.0	5.4	6.6	7.8	0.1	−0.2	−0.8
Poland	8.5	9.5	10.7	7.7	12.6	13.5	0.8	−3.1	−2.8
Romania	2.6	2.3	2.3	2.4	2.3	3.1	0.2	0.0	−0.8
Memorandum item:	1989 = 100								
Industrial countries[2]				*121.0*	*137.0*	*145.6*			

Notes: Based on OECD countries' trade data. Import data on a c.i.f. basis adjusted to f.o.b. by subtraction of a 4% f.o.b./c.i.f. margin. The trade of eastern Germany is excluded for 1990. Bilateral trade between the former Soviet Union and Finland is excluded.

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

Source: Estimates from OECD trade statistics.

based both on producer prices for industrial goods and on consumer prices. As discussed in more detail in Chapter III, consumer price indices may tend to overstate "true" inflation at a time of price decontrol. Whichever indicator is taken it is clear that *former Czechoslovakia,* thanks to tight macroeconomic policies, has been the most successful in containing inflation, and thus in maintaining its competitive position. Holding its nominal exchange rate constant since January 1991, it has also been the most successful in increasing exports to the West, which grew by 40% in dollar terms last year. However, a boom in imports, reflecting rising household consumption and advanced purchases ahead of changes in import duties, led to a marked deterioration in the trade balance.

... former Czechoslovakia ...

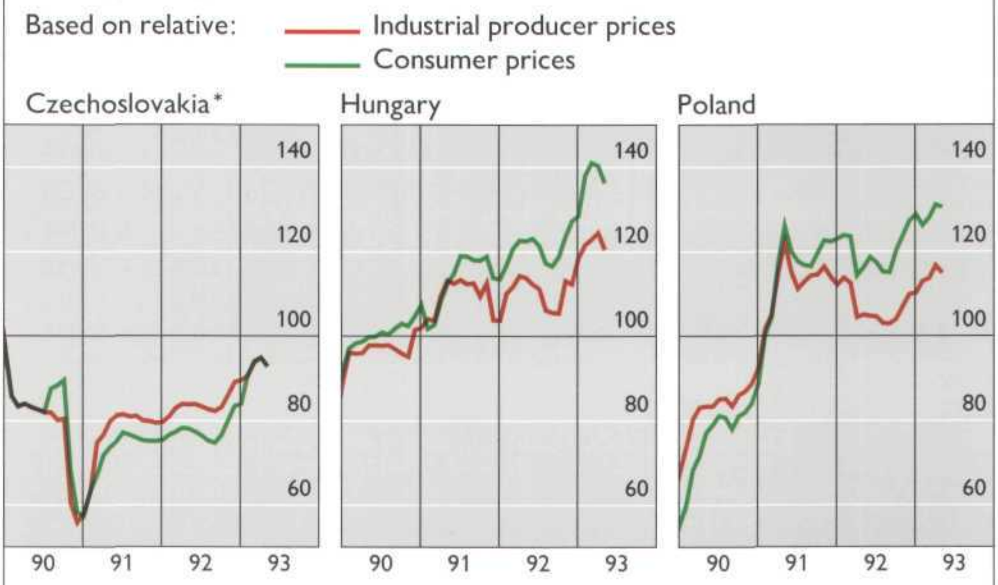
... Poland ...

Neither Poland nor Hungary has been as successful in maintaining competitiveness. According to the consumer price measure, continued (although declining) inflation in *Poland* has more than offset both the steady downward crawl in the exchange rate and the February 1992 devaluation. On this basis, Polish price competitiveness has deteriorated greatly from the levels seen in 1989 (i.e. before a massive devaluation of the zloty led to a marked temporary undervaluation of the currency). While the deterioration appears much less marked on the basis of producer prices, a significant erosion of competitiveness has occurred; last year, export growth was modest for the second year running. The loss of competitiveness in *Hungary* has continued as the authorities had followed a policy of small and episodic depreciations which did not fully compensate for the country's inflation differential. The resultant real appreciation appears to have slowed export growth in 1992, with more marked weakness emerging in early

... and Hungary

Real effective exchange rates in selected eastern European countries

Monthly averages, 1989 = 100



* From January 1993, Czech Republic.

1993. However, two small devaluations in February and March 1993 heralded a new policy of more frequent nominal adjustments to prevent further real appreciation.

Contrast between Romania and Bulgaria

Developments in the countries at an earlier stage in transition have been more mixed. *Romania's* exports to the West, which had fallen sharply at the beginning of the 1990s as the earlier policy of forced exports was abandoned, remained flat. Despite large nominal depreciations, the official exchange rate remained overvalued, and export controls were maintained to underpin domestic price controls. By contrast, *Bulgaria's* exports grew rapidly, and the floating exchange rate actually came under upward pressure, which was moderated by central bank purchases of foreign currency, before declining in late 1992 and early 1993; with inflation high, the country suffered a significant loss of competitiveness during the year.

New currencies

The separation of the Czech and Slovak Republics in January 1993 led to the introduction of new currencies. Although formal parity was maintained immediately after separation, the Slovak koruna used in bilateral trade was shortly afterwards devalued vis-à-vis the Czech koruna. Of the new states in former Yugoslavia, *Slovenia,* a relatively high-income republic not directly entangled in the conflict, had introduced its own currency, the tolar, in October 1991 and allowed it to float. Foreign exchange reserves were boosted by the sale of state-owned housing for hard currency (there were large private holdings of Deutsche Mark); with monetary policy held extremely tight, a sizable current account surplus developed as imports were compressed and firms could find markets only abroad. The reserves thus grew rapidly. Despite a sharp real appreciation during much of 1992, the country's hard-currency current account surplus rose to about 6% of GDP.

The former Soviet Union

Trade developments

Despite considerable economic disruption the dollar value of exports from the former Soviet Union to the industrial world held up relatively well last year. The volume of oil exports to the industrial countries appears to have risen slightly; the brunt of the 13% decline in oil production therefore fell on internal consumption in Russia and on oil shipments to other former Soviet republics. There was, however, a marked decline in the volume of imports from industrial countries. Overall, an aggregation of trading partner data suggests that the trade surplus of the former Soviet Union with the industrial countries may have risen slightly in 1992.

Rouble stabilisation fails

Even so, the authorities' attempts to stabilise the external value of the rouble came to nothing. During the first half of 1992, the currency's much-depreciated value in the local auction market was supported by intervention and by some attempts at macroeconomic stabilisation. Indeed, the rouble appreciated during this period (see the graph on page 46). By mid-year the Russian Government had unified the various exchange rates and announced its intention to stabilise the external value of the currency. At the same time, the Group of Ten stood ready to contribute to a $6 billion rouble stabilisation fund. In the event, however, the authorities did not carry out their announced programme of macroeconomic stabilisation. The budget deficit widened alarmingly and the central bank increased credits on a massive scale. Inflation accelerated, and the rouble fell steeply from about Rb. 135 to the dollar in late June 1992 to Rb. 415 by the end of December and to Rb. 886 by mid-May this year.

Capital flight

The collapse of the rouble naturally made exporters very reluctant to surrender the required 50% of their hard currency to the authorities. The incentives to understate – and even conceal – export earnings were strong, and a major capital flight into hard currencies (held in Russian bank accounts or deposited abroad) occurred. According to BIS banking statistics, deposits from the former Soviet Union held with reporting banks rose by $5.8 billion in 1992; almost all of this build-up took place in the second half of the year when the rouble was plummeting. Faced with an acute shortage of official foreign exchange reserves, Russia was unable to meet its debt service obligations; as outlined in Chapter III, a major debt relief and rescheduling programme was agreed in early 1993.

Political disintegration ...

Few of the new states have yet managed to come to grips with the economic consequences of the political disintegration of the Soviet Union. The scale of the transformation needed was truly daunting as decades of rigid central planning had left a pattern of mutual exchange and payments that was a far cry from anything that passes for international trade in the rest of the world. The planners' obsession with economies of scale had fostered extreme specialisation, producing a heavy reliance on inter-republican trade, with often as much as one-half of domestic output being exported to fellow republics. Mutual exchange took the shape of complicated barter arrangements; relative prices bore no relation to the world market; and payment arrangements remained little more than the bookkeeping counterpart of the plan.

This legacy created four challenges for international economic policy. First, trade relations had to be put on a commercial basis, and in particular prices had to be brought into line with world prices if local economic agents were to be given an appropriate "signal" about the opportunities available on world markets. Secondly, mechanisms had to be devised to enable the exchange of goods to be governed by comparative advantage, and not by the state. Thirdly, the nature of the exchange rate regimes that would govern trade between the republics had to be decided. Finally, arrangements had to be made for trade payments until such time as their currencies were convertible. Little progress was made during 1992 in meeting any of these challenges.

... requires economic policy reforms

The most glaring price distortion was the undervaluation of energy, which was not eliminated by very large increases in real energy prices during the year. The impact of several steep increases in the rouble price of energy was to a great extent undone by the sharp fall in the rouble: by the final quarter of the year, Russia was supplying oil to the other states at about one-third of world prices, although there was great variability across countries and considerable volatility over time. Even though the non-Russian republics were thus shielded from the full terms-of-trade deterioration inherent in a move to world prices, they nevertheless ran very large deficits with Russia.

Need to adopt world prices for energy ...

As for the second challenge, a significant amount of trade effectively continued to take the form of state trading, with transactions often being little more than a scaled-down version of exchange patterns laid down under planning. Despite the abolition of the multiple exchange rate system, centralised imports of key commodities are still heavily subsidised.

... remove subsidies to imports ...

Except in the Baltic states, the third challenge, that of the exchange rate regime, was evaded as most of the new states continued to use roubles. By and large they failed to resist the temptation of inflating domestic rouble issuance to "buy" goods from other republics, an inherent problem in the multiple and uncoordinated issuance of a single currency. In the second half of 1992, however, certain restrictions on correspondent bank transfers among the republics created de facto different currencies among the various domestic rouble deposits.

... put in place a realistic exchange rate regime ...

Finally, much discussion and numerous proposals failed to put anything systematic in place to organise payments for mutual trade. Rather, ad hoc arrangements were settled upon mainly to allow the non-Russian republics to run large imbalances so that Russian enterprises could be paid for their exports – thus perpetuating earlier trade patterns. However, an agreement was reached in early 1993 to establish a rouble-based clearing mechanism for inter-republican payments, a so-called Interstate Bank. The outline of the proposed structure of this new institution suggests rather limited credit facilities and allows for the possibility of flexible exchange rates.

... and an effective payments system

Only in the Baltic states has the introduction of new currencies been

New currencies successfully introduced in Estonia ...

backed up by macroeconomic measures aimed at preserving the value of the new money. In June 1992 *Estonia* introduced the kroon, with a currency board holding foreign currency assets to guarantee the fixed link with the Deutsche Mark. Such a system can – if supported by the right policies – quickly establish public confidence in the local currency even in difficult circumstances; moreover, by investing in interest-bearing foreign assets, the board can capture at least some of the seignorage profits of currency issuance. The return of pre-war Estonian gold and some other assets provided the initial backing for this arrangement: further increases in the domestic money supply can be made only as the foreign assets of the currency board rise – whether through a current account surplus or through capital inflows. A very tight stance of monetary policy kept interest rates on kroon deposits very high and led to hard-currency inflows.

... and Latvia

As a transitional measure (with inflation still running high), *Latvia* made the Latvian rouble the sole legal tender in July 1992. Although the Latvian approach differed from that of Estonia in that the exchange rate was allowed to float, similarly rigorous fiscal and monetary policies were maintained. Once the earlier rapid inflationary momentum had been broken, and it had become clear that the currency's value on the foreign exchanges had been stabilised, the authorities began the process of replacing the Latvian rouble with a new permanent currency, the lat. After initial use of rouble-denominated coupons, *Lithuania* intends to introduce a new currency by mid-1993.

The success of stabilisation policies in both Estonia and Latvia despite the different exchange rate regimes adopted suggests that fiscal and monetary policies are of prime importance in avoiding hyperinflation; the particular choice between fixed and floating exchange rates is secondary. Even with such success, these economies still face a formidable task of external adjustment as they seek to wean themselves from heavy economic dependence on Russia and digest a huge rise in real energy prices.

The Asian NIEs and China

Asian NIEs' trade expands ...

The Asian NIEs' trade expansion hardly slowed last year, with export and import volumes growing by over 10%, but developments in the four economies diverged significantly. While domestic demand was subdued in South Korea and decelerated in Singapore, it gained momentum in Taipei China and Hong Kong, giving rise to appreciable differences in the strength of import demand.

... with significant differences

Relatively weak domestic demand, real exchange rate appreciation and sluggish demand in some key markets led to a marked drop in the real growth of *Singapore's* imports and exports last year. The country's important services sector, most notably travel and transport, produced a further large surplus, partly offsetting the widening deficit on merchandise trade. An even more pronounced weakening of domestic demand in *South Korea* brought import growth down from over 17% in 1991 to less than 2% last year. But improved competitiveness appears to have stimulated exports, which rose by 10% in volume terms, at about the same rate as a year earlier but much more strongly than at the turn of the decade, when exporters had had to cope with three years of rapid real appreciation. South Korea's current account deficit thus narrowed appreciably.

Further integration between ...

As the economies of China, Hong Kong and Taipei China continued to become more integrated, the importance of this group in world trade increased further, with combined exports to the industrial world last year amounting to about $137 billion. Hong Kong's direct investment and its position as an open trading area have greatly contributed to China's economic transformation. More recently, a relaxation of political inhibitions has permitted growing links between China and Taipei China.

... Taipei China ...

Exports from *Taipei China* to China (through Hong Kong) rose to over $6.3 billion last year; with imports from China flat, Taipei China recorded a bilateral surplus of over $5 billion. Exports to Japan and the European Community, however, fell as demand in these markets weakened considerably, while exports to the United States expanded. At the same time, real domestic demand grew by over 9%, a little faster than in 1991; and the volume of imports rose by 17%. The current account surplus amounted to $8 billion, the smallest for eight years.

... Hong Kong ...

Trade with China also provided much of the dynamism for *Hong Kong's* exports last year. Heavy Hong Kong investment in recent years has greatly increased manufacturing capacity in China, and supported a rapid expansion of Sino-Hong Kong trade: re-exports from China have doubled since 1989, while domestic exports have hardly changed (see the table).

... and China

According to industrial country import statistics, *China's* exports rose to $63 billion in 1992, almost double the level registered only three years earlier. This continued surge of exports and a much stronger than expected investment boom – itself export-related – contributed to GDP growth of about 13%. Although imports rose sharply, China's surplus vis-à-vis the industrial world widened to $30 billion. According to official Chinese statistics, however, the global trade surplus halved to $5 billion.

Trade barriers remain ...

As discussed in more detail in last year's Annual Report, China's integration with the world economy has proceeded gradually for more than a decade, and some vestiges of the earlier centrally planned system remain. Two aspects are important for international economic relations. First, international trade remains restricted by a plethora of rules and regulations. The country does not have a unified trade regime; imports face high tariffs as well as certain quantitative controls; and special benefits for exporters have artificially promoted exports. Nonetheless, significant steps to reduce barriers to imports have been taken recently as China prepared for the resumption of talks on GATT membership; these measures appear to have contributed to the surge in imports seen in 1992.

... currency non-convertible ...

A second aspect is the continued non-convertibility of the local currency. In managing the economy's opening to the outside world, the authorities have relied on a dual exchange rate structure, maintaining an official exchange rate but at the same time increasing the share of foreign exchange transactions permitted through the more market-responsive

China's foreign trade						
	1980	1985	1989	1990	1991	1992[1]
	in billions of US dollars					
Current account	0.7	−11.4	−4.3	12.0	13.3	6.4
Trade balance	−0.1	−13.1	−5.6	9.2	9.6	5.2
Memorandum items:						
Trade with industrial countries[2]						
Balance	*−5.2*	*−11.4*	*9.8*	*18.8*	*24.8*	*30.0*
Exports	*8.1*	*13.2*	*34.1*	*40.0*	*50.9*	*63.1*
Imports	*13.3*	*24.6*	*24.3*	*21.1*	*26.1*	*33.1*
Exports of Hong Kong						
Domestic exports	*13.7*	*16.7*	*28.7*	*29.0*	*29.7*	*30.2*
Re-exports from China	*1.7*	*4.4*	*24.1*	*30.9*	*40.6*	*52.2*
Other re-exports	*4.4*	*9.1*	*20.3*	*22.3*	*28.2*	*37.1*

[1] Partly estimated. [2] Based on OECD countries' trade data. Import data on a c.i.f. basis adjusted to f.o.b. by subtraction of an 8% f.o.b./c.i.f. margin.
Sources: OECD trade statistics and national data.

Foreign Exchange Adjustment Centres. By the early 1990s about one-half of foreign exchange transactions were indeed passing through these centres. Moreover, substantial devaluations of the official rate (in December 1989 and November 1990) and considerable progress towards macroeconomic stability (with much lower inflation and the elimination of the current account deficit) had by late 1991 reduced the gap between the official rate and the market-related swap rates to less than 10%.

... and large real depreciation

However, this convergence – which had raised expectations that the authorities would shortly seek to unify exchange rates – was abruptly reversed in early 1992. The main causes appear to have been an acceleration in inflation and a sharp rise in imports as well as worries that the trade liberalisation needed to secure GATT membership would be accompanied by a large devaluation of the official rate. The gap between the two rates widened for most of 1992 and in the early months of this year: by March 1993, swap rates had fallen 40% below the official rate and black market rates were lower still. With the official rate itself managed so that it declines broadly in line with China's inflation differential vis-à-vis trading partners, this amounted to a large real depreciation that has exacerbated recent inflationary pressures.

Major capital movements

Direct investment

Less Japanese direct investment

Total foreign direct investment from industrial countries fell again last year, mainly as a result of a sharp cutback in Japanese investment (see the table overleaf). The flood of Japanese investment in recent years – cumulative direct investment amounted to more than $175 billion in the 1987–91 boom period – has apparently yielded a very poor return. Japanese balance-of-payments statistics put total direct investment earnings for 1992 at $7.7 billion; one important depressive influence was the further losses recorded on investment in the United States (of around $2 billion according to US balance-of-payments statistics). The United States recovered its position as the major investor, accounting for about one-quarter of total industrial country outflows in 1992. US investment in Latin America rose to over $11 billion, compared with $8½ billion of investment in the European Community.

By contrast, foreign investment in the United States, running at over $50 billion annually in the second half of the 1980s, turned negative last year as some earlier investments were liquidated. Despite recession, foreign direct investment held up relatively well elsewhere in the industrial world, with the European Community countries again taking a greater share. Intra-European mergers and the increased presence of non-EC companies were important influences. Once again the United Kingdom received the lion's share of investment ($19 billion), followed by France ($16 billion); relatively little investment flowed to Germany and Italy ($3–4 billion each last year). Investment in Spain and Portugal fell back from the relatively high levels of recent years.

Continued strong investment in Europe ...

Global pattern of direct investment

	1976–80	1981–85	1986–90	1990	1991	1992*
	in billions of US dollars, annual averages					
Total outflows	39.8	43.6	165.9	226.0	182.2	158.5
Industrial countries	39.2	42.1	157.4	213.0	171.1	147.1
of which:						
United States	*16.9*	*8.4*	*24.6*	*32.7*	*27.1*	*35.3*
Japan	*2.3*	*5.1*	*32.1*	*48.0*	*30.7*	*17.2*
European Community	*16.9*	*20.8*	*74.4*	*99.4*	*90.9*	*82.5*
Developing countries	0.6	1.5	8.5	13.0	11.1	11.4
of which:						
Asia	*0.1*	*1.1*	*7.5*	*11.4*	*9.5*	*10.4*
Latin America	*0.2*	*0.2*	*0.6*	*1.0*	*0.8*	*1.0*
Total inflows	31.8	52.5	145.6	186.0	143.3	133.6
Industrial countries	25.2	34.9	122.6	156.2	101.8	83.9
of which:						
United States	*9.0*	*19.1*	*52.5*	*45.1*	*11.5*	*−3.9*
Japan	*0.1*	*0.3*	*0.3*	*1.8*	*1.4*	*2.7*
European Community	*13.5*	*12.8*	*54.5*	*86.0*	*68.6*	*70.3*
Developing countries	6.6	17.6	23.0	29.8	41.5	49.7
of which:						
Asia	*2.1*	*4.9*	*13.3*	*18.6*	*24.0*	*28.0*
Eastern Europe	*0.0*	*0.0*	*0.1*	*0.3*	*2.4*	*3.3*
Latin America	*4.1*	*5.0*	*6.3*	*7.3*	*12.0*	*13.0*

* Partly estimated.

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

Portfolio capital movements in industrial countries						
	1976–80	1981–85	1986–90	1990	1991	1992*
	in billions of US dollars, annual averages					
Total outflows	15.0	60.6	185.0	152.8	274.0	238.0
of which:						
United States	*5.3*	*6.5*	*13.6*	*28.8*	*45.0*	*48.6*
Japan	*3.4*	*25.0*	*85.9*	*39.7*	*74.3*	*34.4*
United Kingdom	*2.3*	*13.6*	*26.1*	*29.2*	*51.6*	*47.3*
Other European Community	*3.8*	*10.4*	*44.4*	*47.2*	*69.2*	*92.3*
Total inflows	31.9	77.8	184.6	154.9	374.6	308.5
of which:						
United States	*5.2*	*29.4*	*44.7*	*– 0.9*	*51.2*	*65.0*
Japan	*5.1*	*12.6*	*26.9*	*34.7*	*115.3*	*8.2*
United Kingdom	*2.3*	*3.5*	*22.1*	*9.4*	*28.7*	*29.6*
Other European Community	*9.7*	*18.5*	*57.3*	*85.0*	*123.6*	*168.9*
Memorandum item:						
Equity inflows	*5.0*	*12.4*	*24.4*	*–18.0*	*79.0*	*20.0*
of which:						
United States	*1.8*	*3.4*	*4.9*	*–14.5*	*9.2*	*–11.2*
Japan	*1.0*	*2.1*	*–11.6*	*–13.3*	*46.8*	*8.7*
United Kingdom	*0.5*	*1.4*	*10.1*	*2.6*	*5.4*	*9.4*
Other European Community	*1.1*	*2.4*	*13.2*	*7.0*	*10.9*	*8.1*

* Partly estimated.

Sources: IMF Balance of Payments Statistics and national data.

... Asia ...

Foreign direct investment flows within Asia shifted from South-East Asia, where interest waned somewhat after years of large-scale investment, to China, where investment rose to almost $7 billion from $4.4 billion in 1991, with entities from Hong Kong and Taipei China investing heavily. Investment in Latin America also rose markedly, and there was a significant increase of investment in eastern Europe.

... and Latin America

Portfolio capital

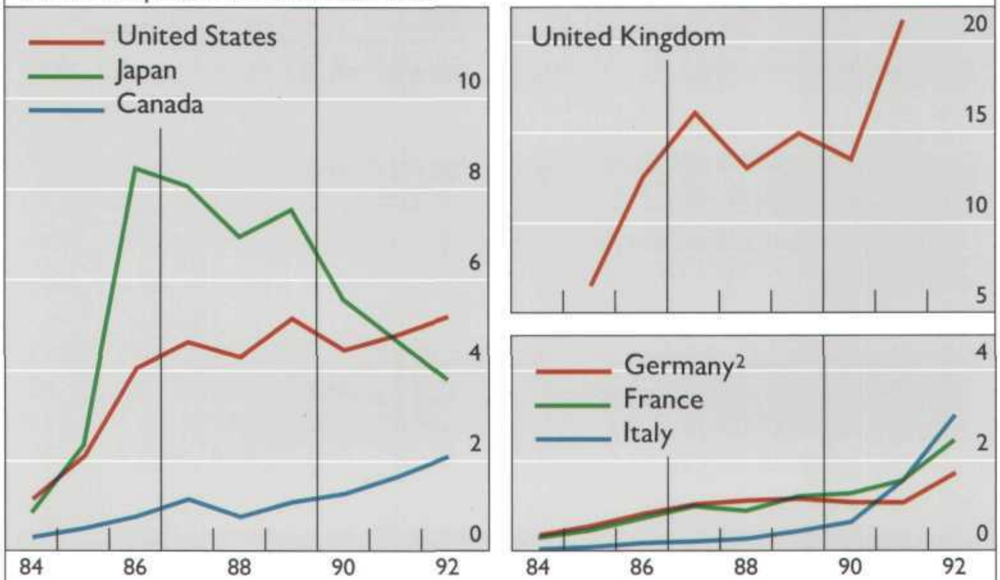
Greater portfolio investment in Europe

Flows of portfolio capital fell last year but remained high, with aggregate outflows of $238 billion (see the table above). Investment by Japan and the United Kingdom – the biggest players in 1991 – declined last year; US investment increased a little; and continental European investment rose sharply, with German investment setting a new record of $43 billion. Indeed, the steep rise in portfolio capital flows to and from continental Europe has been one of the key features of the 1990s, reflecting not only the elimination of exchange control restrictions on capital flows but also the relaxation of limits on institutional investors' investment in foreign securities.

Inflows into continental Europe rose and accounted for well over half of inflows into the industrial world; transactions in bonds dominated, as net investment in foreign equities dropped sharply. There were much-increased inflows into Germany and France, while inflows into Italy, Spain and Sweden

International portfolio transactions[1]

As a multiple of trade transactions



[1] Gross securities transactions between residents and non-residents divided by the sum of exports and imports of goods and non-factor services. [2] Prior to July 1990, western Germany only.

Sources: IMF Balance of Payments Statistics and national data.

fell back. Inflows into Japan all but evaporated as low long-term interest rates on bonds led to net sales of Japanese bonds by non-residents and as uncertainty about the Tokyo stock market limited net purchases of equities. Non-residents were net sellers of US equities as the slowness of recovery weakened confidence; for much of the year, the decline in long-term dollar rates relative to DM and DM-linked rates and expectations of dollar weakness reduced foreign interest in US bonds. However, a marked improvement in sentiment towards the dollar in the fourth quarter led to heavy inflows into US securities. Although balance-of-payments data on flows into the developing world are incomplete, there is evidence that investment in developing countries, notably in South-East Asia and Latin America, continued to be strong.

Portfolio flows greater than trade transactions

One consequence of the increased cross-border investment in securities and of the often high turnover in securities transactions is that portfolio-related transactions now exceed trade-related transactions – and sometimes by a large multiple. For the United States, Japan and the United Kingdom this change took place in the mid-1980s, while in continental Europe the shift has been more recent (see the graph). This greatly increased volume of portfolio capital movements in Europe has inevitably made the foreign exchange markets much more sensitive to swings in sentiment.

Capital accounts of major countries

Unprecedented pressure on European currencies dominated the capital account of Germany last year. The detailed chronology of events as they unfolded during the year is given in Chapter VIII. Briefly, three broad periods can be distinguished: first a period of relative calm on European markets, followed by a period of increased tension which reached a climax in September, bringing down two major ERM currencies; thereafter, nervousness persisted, but did not reach the earlier feverish pitch.

Heavy inflows into Germany during the currency crisis ...

During the first half of the year the German current account deficit, as well as modest net outflows on direct and portfolio investment, were financed through German commercial banks as the widening gap between DM and dollar short-term interest rates encouraged a shift into DM assets. European markets were relatively calm and capital inflows over this six-month period exceeded the current account deficit by only DM 10 billion (see the table). In early summer, however, as the dollar weakened further and a number of European currencies began to come under pressure vis-à-vis the Deutsche Mark, the pace of capital inflows into Germany increased. Foreign purchases of German bonds rose steadily while German purchases of foreign securities declined and, by July, the earlier net outflow had been reversed. Pressure intensified from late August as financial markets came to regard a number of ERM parities as unsustainable, and private capital flooded into Germany. During the month of September (when these flows peaked), non-residents bought DM 33 billion of German securities (mainly bonds) and increased deposits with German banks by DM 28 billion. Net inflows, including a large errors and omissions item that is likely to have mostly reflected unrecorded capital movements, exceeded DM 86 billion

German capital flows

Periods	Current account	Capital account					*Changes in net external position of*	
		Total (including errors and omissions)	of which					
			Net direct investment	Foreign investment in German securities	German investment in foreign securities	Commercial banks' short-term transactions	*Bundesbank**	*Commercial banks*
		in billions of Deutsche Mark						
1992								
January–June	−19.4	29.7	− 8.0	10.5	−33.9	57.0	*10.3*	*−58.6*
July	− 7.8	9.4	− 1.7	12.7	− 5.4	− 8.5	*1.5*	*8.1*
August	− 1.4	4.8	− 1.2	10.5	− 2.4	3.0	*3.3*	*− 7.7*
September	− 3.6	86.1	− 3.1	33.5	2.9	33.1	*82.5*	*−40.2*
October	− 2.5	−35.5	− 0.1	21.3	−10.6	−24.9	*−38.0*	*15.3*
November	− 0.7	− 0.4	− 1.9	8.3	− 9.0	− 2.2	*− 1.1*	*− 3.7*
December	− 4.8	15.0	− 6.0	30.1	− 9.7	6.7	*10.2*	*−21.3*
1993								
January	− 5.3	− 6.1	− 1.6	31.7	−11.3	11.8	*−11.3*	*−15.1*
February	n.a.	n.a.	0.1	24.1	−12.4	− 6.3	*−12.1*	*− 1.7*
July 1992– Jan. 1993	*−26.2*	*73.3*	*−15.6*	*148.2*	*−45.5*	*19.0*	*47.1*	*−64.5*

* The change in the net external position of the Bundesbank equals the sum of the current and capital accounts.
Source: Deutsche Bundesbank.

and, with a small current account deficit, the net external asset position of the Bundesbank rose by DM 82.5 billion.

... only partly reversed subsequently

Once the lira and sterling were floated and the French franc had weathered a first period of very heavy pressure, some reflow out of DM assets took place. In October, non-residents' deposits with German banks declined and DM lending to non-residents rose, implying a net outflow through commercial banks of DM 25 billion, thus reversing about three-quarters of the September inflows. But continued uncertainty about the other European currencies and expectations of a decline in long-term rates on DM paper led to continued heavy foreign purchases of German securities. However, a significant proportion of these "foreign" purchases were made by foreign investment funds which in turn offer DM-denominated investments to German residents: the net inflow on securities account fell to about DM 11 billion. Overall, net non-official outflows came to over DM 35 billion in October, allowing a little less than one-half of the Bundesbank's accumulation of external assets in September to be reversed.

After only moderate flows in November, there were further significant inflows in December, with strong net foreign demand for German securities continuing into January. By the beginning of 1993, then, only part of the heavy inflows into Germany had been reversed. Over the seven months from July 1992 to January 1993 net private inflows amounted to over DM 73 billion, almost three times the size of the current account deficit and thus associated with a DM 47 billion rise in the central bank's net external position.

US deficit financed by increased official holdings of dollars ...

The widening of the US current account deficit last year coincided with the heaviest net direct investment abroad for many years. A $42 billion increase in foreign official assets in the United States was the main financing element in the first half of the year (see the table), with non-OPEC developing countries' assets rising by $22 billion, following the $32 billion increase recorded in 1991. In the third quarter, however, foreign official assets in the United States fell by over $7 billion as European central banks intervened heavily in the foreign exchange markets, although much of this decline was reversed in the fourth quarter. In the second half of the year, there were large inflows through banks as non-residents continued to repay US bank credits and foreign-owned banks borrowed from abroad (see Chapter V). As the dollar came under strong upward pressure in the final quarter, there were heavy foreign purchases of US securities.

... and bank inflows

Japan

The increased Japanese surplus on current account was, in the first half of 1992, financed by a further large contraction in Japanese banks' external liabilities as they continued to scale back their international business. By the second half of the year, however, this retrenchment – the main financing item also in 1991 – appears to have largely run its course. In the second six months, the net outflow through the securities account increased, mainly as a result of much heavier Japanese purchases of foreign bonds, together with sizable foreign sales of Japanese bonds as their yield fell relative to that on DM and dollar paper.

The capital accounts of the United States and Japan							
Items	1988	1989	1990	1991	1992	1992	
						H I	H II
	in billions of US dollars						
United States							
Capital account	90.3	118.1	60.5	−18.9	20.7	−17.1	37.9
of which: Direct investment	*41.8*	*38.9*	*12.4*	*−15.6*	*− 39.3*	*−21.4*	*−17.8*
Securities[1]	*38.7*	*46.3*	*−29.7*	*6.1*	*16.3*	*7.4*	*8.9*
Banks, other than above	*13.9*	*12.1*	*23.8*	*−18.4*	*47.0*	*21.8*	*25.3*
Statistical discrepancy	*− 0.1*	*2.4*	*47.4*	*− 1.1*	*− 13.1*	*−36.3*	*23.2*
Net official monetary movements[2]	36.3	−17.0	29.9	22.6	41.7	41.8	− 0.1
Japan							
Capital account	−64.2	−81.9	−56.6	−90.0	−118.9	−63.0	−55.9
of which: Direct investment	*−34.7*	*−45.2*	*−46.3*	*−29.4*	*− 14.5*	*− 5.7*	*− 8.8*
Securities	*−66.7*	*−28.0*	*− 5.0*	*41.0*	*− 26.2*	*− 0.8*	*−25.4*
Banks, other than above	*44.5*	*8.6*	*−13.6*	*−93.5*	*− 73.0*	*−65.5*	*− 7.5*
Statistical discrepancy	*2.8*	*−22.0*	*−20.9*	*− 7.8*	*− 10.5*	*6.9*	*−17.4*
Net official monetary movements[2]	−15.5	24.7	20.9	17.1	1.4	6.7	− 5.3

[1] Including US Treasury securities. [2] Changes in gold and foreign exchange reserves less changes in liabilities to foreign monetary authorities. Valuation adjustments are excluded. A minus sign indicates an increase in official assets.

International non-gold reserves

Modest growth of total reserves

Countries' global reserves rose by $21.8 billion last year, an increase of only 2.3%; at constant exchange rates, the change amounted to 6.5% as the US dollar appreciated against all currencies except the yen. On the other hand, valued at market prices, official holdings of gold declined by $22 billion (see Chapter V).

Intervention affects reserve movements in Europe

Massive foreign exchange market intervention in Europe was the single most important factor shaping the development of individual countries' reserves last year. *Germany's* official assets rose by 44% to $91 billion at the end of the year, making it the world's largest holder of official assets. Indeed, the reserves had jumped to $119 billion by September 1992 as a result of the extension of support for European countries whose currencies came under pressure; as most of these credits were repaid, official holdings fell back. *Italy* experienced a substantial decline in gross official reserves last year, with its holdings plummeting by $20 billion to their lowest level since 1986. The decrease was concentrated in the first eight months of the year. After the suspension of the lira's participation in the ERM in mid-September official holdings rose for three months, but dropped again in December as the currency came under renewed pressure. *Spain's* reserves fell by over $20 billion, or by more than those of any other country. Considerable official borrowing limited the decline in the gross reserves of the *United Kingdom* and contributed to an increase in *Swedish* reserves.

In the case of the *United States*, the $6 billion reduction in foreign exchange reserves can be attributed to a series of off-market operations

Official non-gold reserves

Countries and areas	Changes 1989	1990	1991	1992	Amounts outstanding at end-1992
	in billions of US dollars				
Industrial countries	30.6	87.3	−15.7	−26.0	556.1
of which:					
Germany	*2.4*	*6.8*	*− 4.4*	*27.9*	*90.9*
Japan	*−12.8*	*− 5.5*	*− 6.4*	*− 0.4*	*71.6*
United States	*26.8*	*8.7*	*− 5.6*	*− 6.4*	*60.3*
Spain	*4.4*	*9.7*	*14.7*	*−20.4*	*45.5*
United Kingdom	*− 9.3*	*1.1*	*6.0*	*− 5.3*	*36.6*
Italy	*12.1*	*15.9*	*−14.0*	*−19.9*	*28.8*
France	*− 0.7*	*12.1*	*− 5.4*	*− 4.3*	*27.0*
Eastern European countries[1]	2.4	− 8.2	− 4.8	2.1	15.2
of which:					
Hungary	*− 0.2*	*− 0.2*	*2.9*	*0.9*	*4.9*
Poland	*0.3*	*2.2*	*− 0.9*	*0.5*	*4.1*
Czechoslovakia	*0.6*	*− 1.1*	*2.1*	*− 0.2*	*1.1*
Asian NIEs[2]	5.4	6.2	15.2	9.1	139.3
of which:					
Taipei China	*− 0.7*	*− 0.8*	*10.0*	*− 0.1*	*82.3*
Singapore	*3.3*	*7.4*	*6.4*	*5.8*	*39.9*
South Korea	*2.8*	*− 0.4*	*− 1.2*	*3.4*	*17.1*
Other developing countries	7.3	34.9	54.6	36.6	271.9
of which:					
China	*− 0.6*	*11.6*	*14.1*	*2.7*	*46.4*
Brazil	*0.6*	*− 0.1*	*0.6*	*14.5*	*22.5*
Thailand	*3.4*	*3.8*	*4.2*	*2.8*	*20.4*
Malaysia	*1.3*	*2.0*	*1.1*	*8.6*	*19.4*
Mexico	*1.1*	*3.5*	*7.9*	*1.2*	*19.0*
Egypt	*0.3*	*1.2*	*2.6*	*5.5*	*10.8*
Saudi Arabia	*− 3.8*	*− 5.1*	*0.0*	*− 5.7*	*5.9*
India	*− 1.0*	*− 2.3*	*2.1*	*2.1*	*5.8*
Total	45.7	120.2	49.3	21.8	982.5
Memorandum item:					
Reserves by instrument					
Foreign exchange	*51.4*	*117.3*	*41.2*	*22.0*	*849.1*
IMF reserve positions	*− 4.6*	*0.3*	*3.2*	*9.6*	*46.6*
SDRs	*− 0.2*	*2.0*	*0.4*	*−11.7*	*17.7*
Official ECUs	*− 0.9*	*0.6*	*4.5*	*1.9*	*69.1*

[1] Albania, Bulgaria, Czechoslovakia, Hungary, Poland, Romania, the former Soviet Union and former Yugoslavia. Data for Albania and Bulgaria relate to deposits with BIS reporting banks. [2] Excluding Hong Kong.

with the Bundesbank similar to those undertaken in 1991 to bring the two countries' holdings of each other's currencies down to levels commensurate with current needs.

Developing countries

There was a further substantial expansion in developing countries' official non-gold reserves, with particularly marked increases in the middle-income countries of Latin America and Asia. Brazil, which added $14.5 billion to its holdings, recorded the largest increase of any developing country. In Asia the largest additions occurred in Malaysia, Singapore and South Korea. Egypt more than doubled its reserves to $10.8 billion. On the other hand, Saudi Arabia registered a decline in its reserves of $5.7 billion. Moreover, the poorest developing countries continued to suffer from a severe shortage of international liquidity.

Ninth quota increase affects SDR holdings and IMF reserve positions

Significant changes in IMF-related components of reserves took place last year. The $11.7 billion decline in countries' *SDR holdings* reflected reserve asset payments to the IMF in the final quarter of 1992 to meet increased subscriptions in the context of the ninth general review of quotas. Industrial countries, in particular, tended to use SDRs to meet this expenditure because they are likely to see their SDR-denominated claims rise as countries in need of IMF resources draw on usable currencies. The quota increase was the principal factor behind the $9.6 billion expansion in *IMF reserve positions.* Despite the extension of unprecedented amounts of ECU-denominated credit to ERM countries whose currencies were under pressure, the total amount of reserves held in *official ECUs* grew by only $1.9 billion, as over two-thirds of the credits granted in the autumn to ERM countries had been repaid by the end of the year.

V. International financial markets

Highlights

Against the background of a poor economic and financial environment, 1992 was an eventful year in the international financial markets. Strong, but opposing, forces led to sharp contrasts and fluctuations between sectors and periods. In particular, the currency upheaval was the dominant factor behind the sudden interruption in the contraction of bank credit in the third quarter. It also stimulated securities trading in perceived safe-haven currencies, at the expense of high-yield sectors. The general easing of long-term interest rates boosted financing and refinancing in longer-term instruments, albeit to the detriment of short-term paper. Greater volatility in exchange rates and short-term interest rates also encouraged the use of derivative instruments for managing the additional risks. Another expansionary influence was the increased public sector borrowing to meet deepening fiscal deficits and, in certain instances, to replenish depleted foreign exchange reserves. At the same time, the growing institutionalisation of portfolio management, in a context of deregulation, favoured cross-border investment. The buoyancy of the Asian economies and renewed Latin American access to spontaneous financing were other contributory factors.

There were, on the other hand, substantial impediments to the growth of the markets. Firstly, the general economic weakness and, partly related to it, the downgrading of credit ratings acted as a constraint on both demand and supply in all sectors. Secondly, heavy government borrowing combined with greater investor selectivity exacerbated the crowding-out of non-prime borrowers, with credit differentiation also affecting certain public sector entities. Thirdly, subdued stock markets limited recourse to equity-related financing, at a time when redemptions were growing rapidly. Finally, competition from domestic commercial paper markets tended to divert borrowing away from the Euro-market, although, in view of the differences in regulatory settings, or in the deregulatory process itself, shifts in favour of certain Euro-currency sectors were also apparent.

Even more than in 1991, the general environment constrained banks' international business in the first half of the year. Banking crises in several countries, together with large loss provisions, poor stock market performance and the implementation of the new capital adequacy guidelines, accentuated the retrenchment. However, these factors were subsequently, if temporarily, eclipsed by the exchange market turmoil, as banks in Europe

Estimated net financing in international markets

Components of net international financing	Changes[1]						Stocks at end-1992
	1987	1988	1989	1990	1991	1992	
	in billions of US dollars						
Total cross-border claims of reporting banks[2]	601.8	436.1	684.9	608.3	− 54.7	180.5	6,197.6
Local claims in foreign currency	163.0	74.8	122.2	105.9	− 48.7	−24.7	1,154.0
minus: Interbank redepositing	*444.8*	*250.9*	*397.1*	*249.2*	*−183.4*	*−39.2*	*3,691.6*
A = Net international bank credit[3]	320.0	260.0	410.0	465.0	80.0	195.0	3,660.0
B = Net Euro-note placements	23.4	19.5	6.9	30.9	32.5	37.5	176.9
Total completed international bond issues	180.5	221.6	264.7	239.8	319.7	340.0	
minus: Redemptions and repurchases	*72.6*	*82.5*	*89.4*	*107.9*	*149.3*	*222.5*	
C = Net international bond financing	107.9	139.1	175.3	131.9	170.4	117.5	1,687.2
D = A + B + C = Total international financing	451.3	418.6	592.2	627.8	282.9	350.0	5,524.1
minus: Double-counting[4]	*51.3*	*68.6*	*77.2*	*77.8*	*37.9*	*70.0*	*584.1*
E = Total net international financing	400.0	350.0	515.0	550.0	245.0	280.0	4,940.0

Note: The inclusion for the first time at end-September 1990 of the positions of banks located in the five eastern German Länder added about $20 billion to the recorded expansion in the cross-border claims of reporting banks. At the same time, positions vis-à-vis the former German Democratic Republic have been reallocated to Germany.

[1] Banking flows and, from 1990, Euro-note placements at constant end-of-quarter exchange rates, bond financing at exchange rates prevailing 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] Excluding, on an estimated basis, redepositing between reporting banks. [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.

played a major intermediary role in supplying or absorbing individual currencies.

In the securities markets, there were also major differences between individual sectors and periods. Whereas the large volume of unused facilities for prime names limited further growth in short-term paper, the broadening range of techniques and instruments available favoured Euro-medium-term note (EMTN) programmes. In the international bond market, increased public sector borrowing in the traditional fixed rate sector on the one hand and repayments of equity-related paper on the other resulted in a 7.5% rate of growth in the total outstanding. Despite the easing of long-term interest rates, which encouraged locking-in at prevailing rates, the market suffered from the ready availability of other sources of funds, in particular through EMTN facilities. The shift away from certain sectors at the time of the currency turmoil was dramatic in the case of the ECU. The sudden switch in sentiment about the European Monetary System and doubts about prospects for ratification of the Maastricht Treaty hit the ECU sector hard in June, with difficulties deepening after the summer.

The European currency crisis was also responsible for the explosion in the volume of derivatives trading on organised markets recorded at the height of the turbulence between August and October. With unprecedented volatility in short-term interest rates, and liquidity problems in a number of underlying cash markets, users sought protection in the hedging opportunities offered by derivative instruments. The principal swap and swap-related over-the-counter markets also continued to expand at a rapid pace, but difficulties were experienced in options on European cross rates and in interest rate related options products.

The international banking market

Upsurge in activity during the currency upheaval ...

The marginal 2 percentage point revival in the annual growth of the total international banking aggregates last year was solely due to the exceptional upsurge in the third quarter, when European exchange market tensions reached a climax. While the flows tended to subside thereafter, they were large enough to cause major shifts in the aggregates, in terms of currencies, reporting centres and nationality of reporting institutions. Allowing for this special set of influences, the underlying forces which had caused the 1991 decline remained the same. In particular, Japanese banks continued to streamline their international operations, accounting for more than the whole of the contraction in interbank business. In addition, Nordic banks withdrew from the market, owing to funding difficulties and repayments of foreign currency loans by their customers. By contrast, other European banks benefited from the large flows of capital associated with the currency turbulence.

The expansion in bank credit net of interbank redepositing, at 6%, was similarly inflated by inflows and outflows of funds at the time of the exchange market turmoil. In addition to the net take-up or supply of

Main features of international banking activity

Uses and sources of international bank credit	Changes, excluding exchange rate effects				Stocks at end-1992
	1989	1990	1991	1992	
	in billions of US dollars				
A = Claims on outside-area countries	− 1.7	−11.9	8.1	63.7	813.2
of which: On non-banks	*−11.7*	*− 9.6*	*− 0.7*	*17.7*	*412.8*
B = Claims on entities within the reporting area	793.8	680.8	−103.9	88.2	6,421.7
(1) Claims on non-banks	*229.7*	*284.4*	*100.8*	*89.8*	*1,878.6*
(2) Banks' own use for domestic lending	*167.0*	*147.2*	*− 21.3*	*37.6*	*851.5*
(3) Interbank redepositing	*397.1*	*249.2*	*−183.4*	*−39.2*	*3,691.6*
C = Unallocated	15.0	45.4	− 7.6	3.8	116.8
D = A + B + C = Total gross international bank assets	807.1	714.2	−103.4	155.8	7,351.6
E = D − B *(3)* = Estimated net international bank credit	410.0	465.0	80.0	195.0	3,660.0
A = Liabilities to outside-area countries	57.6	92.2	− 12.4	11.8	717.4
of which: To non-banks	*29.7*	*37.7*	*− 12.1*	*− 9.5*	*307.1*
B = Liabilities to entities within the reporting area	720.4	626.2	−201.6	84.8	6,048.7
*(1) Liabilities to non-banks**	*158.1*	*175.7*	*16.4*	*93.0*	*1,241.2*
(2) Banks' own supply of domestic funds	*148.6*	*165.1*	*20.2*	*64.5*	*1,282.3*
(3) Interbank redepositing	*413.7*	*285.4*	*−238.2*	*−72.7*	*3,525.2*
C = Unallocated	45.7	32.0	55.8	25.7	419.0
D = A + B + C = Total gross international bank liabilities	823.7	750.4	−158.2	122.3	7,185.2

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

domestic funds and currency switching operations by the reporting banks themselves during the crisis, the main support to final credit within the reporting area came from record Euro-Deutsche Mark business with the German non-bank sector and strong credit demand from the United States. At the same time, the growth of bank lending to countries outside the reporting area was the highest in ten years, with heavy borrowing demand from developing countries met selectively and on tight terms. All in all, aside from the major intermediary role played during the currency crisis, reporting banks' international business remained constrained by a combination of slow economic growth, the accompanying weak credit demand, a heightened perception of risk and, in some specific instances, the new capital adequacy requirements.

... in an otherwise subdued market

Reporting banks and the currency crisis

Large currency flows in Europe, out of currencies under pressure ...

As the table on page 102 only partly reveals, the turbulence on the European exchange markets in the second half of the year entailed substantial net currency flows between national banking systems and the corresponding sectors of the Euro-market. On the one hand, large volumes of domestic currency funds were exported by banks in the countries of currencies under pressure. Most outstanding in this respect were the net exports of domestic currency by banks located in France ($24 billion) and the United Kingdom ($11 billion) during the third quarter, when speculation against their respective currencies was at its highest. The funds were taken up in part by other reporting banks (Euro-banks) and sold on the exchange markets. This is illustrated by the changes in these banks' net foreign currency positions, in particular the $21 billion shift in their position in French francs to net liabilities and the $5 billion increase in their net liabilities in pounds sterling. However, two points should be made here: firstly, changes in Euro-banks' net positions resulting from currency conversions may have been only marginally, if at all, the result of banks' own position-taking on the exchange markets, and were presumably in the main the counterpart of forward transactions, notably customers' forward sales of these currencies; secondly, since data are reported to the BIS only on an end-of-quarter basis, recorded changes do not necessarily reflect the full extent of position-taking in connection with the currency crisis.

... and into perceived safe-haven currencies

On the other hand, the movement into perceived safe-haven currencies was seen in particular in net capital imports by banks located in Germany, the Benelux countries, Switzerland and, to a lesser extent, the United States, as well as net purchases by banks located outside the country of issue. Large inflows were recorded by banks in the Benelux countries, reflecting additional upward pressures on the Dutch guilder and Belgian franc in the closing months of the year. In the case of the Deutsche Mark, the net liability position of banks located outside Germany remained unchanged on balance in the second half of the year. However, this was the net result of a $32 billion contraction in the third quarter which was fully reversed and accompanied by an outflow of capital from the German banking system in the subsequent three months, when speculation against

Development of banks' net currency positions*

Currencies	External positions in domestic currency					External and local positions in foreign currency				
	Years		1992		Stocks at end-1992	Years		1992		Stocks at end-1992
	1991	1992	Q III	Q IV		1991	1992	Q III	Q IV	
	in billions of US dollars									
US dollar	5.4	−52.8	−25.6	−11.6	−119.5	−34.4	52.3	22.1	4.3	63.0
Belgian franc	5.5	− 3.9	− 2.9	− 1.3	− 6.8	− 6.0	1.1	− 1.1	2.5	− 6.2
Deutsche Mark	−11.4	−41.4	−20.7	9.7	60.9	0.8	− 2.3	32.2	−31.9	−61.4
Dutch guilder	2.3	−11.2	− 4.9	− 8.6	− 0.1	− 4.8	− 3.1	0.8	0.6	− 8.4
French franc	−12.3	37.8	24.0	10.6	− 6.1	2.2	−34.4	−20.6	− 5.4	−22.3
Italian lira	4.4	2.3	0.3	− 3.1	− 11.7	4.8	− 2.8	− 5.7	3.9	16.0
Japanese yen	82.1	45.4	− 3.0	7.8	245.8	− 8.7	−17.0	9.5	− 3.5	2.8
Pound sterling	5.9	14.5	11.0	− 0.7	− 47.9	− 6.7	− 0.4	− 4.7	1.9	−13.3
Spanish peseta	− 0.6	10.8	3.5	3.3	− 1.0	..	..	..	..	..
Swedish krona	0.4	− 1.0	2.3	− 0.9	− 2.4	..	..	..	..	..
Swiss franc	− 6.5	− 7.2	− 2.6	− 1.9	25.4	7.9	10.0	4.6	5.2	− 4.5
ECU						4.6	4.6	14.6	5.7	4.3

Note: − = decrease in assets, increase in liabilities; for stocks, net liabilities.
* Banks in industrial reporting countries only; changes at constant end-of-quarter exchange rates.

other major European currencies subsided. The final quarter also saw large-scale exports of funds by the German non-bank sector ahead of the introduction of a domestic withholding tax and repayments of DM-denominated debt by Nordic companies, which accentuated the effect of the unwinding of earlier positions taken in favour of the Deutsche Mark.

The particular pattern of the ECU market

There were two main departures from this general pattern of the second half of the year. In the absence of a domestic counterpart, banks met major withdrawals of ECU deposits by both non-bank and official holders by reconstituting ECUs from the component currencies. Indeed, whereas buoyant demand for ECU-denominated assets had caused reporting banks' net position to move from $1 billion of assets at the end of 1991 to $16 billion of liabilities at end-June, the movement was more than fully reversed thereafter (see also page 122). The other main exception to the exchange market related movements of funds concerned the yen sector. Undisturbed by the currency turmoil in Europe, yen business continued to be dominated by Japanese banks' retreat from the international market. As the fall in liabilities exceeded that in assets, the net external yen creditor position of banks located in Japan widened, while the Euro-yen market shifted from net taker to net supplier of that currency.

Developments in individual market centres

Impact of the currency flows on transactions between centres

In view of the developments just described, the contrast between the upsurge in cross-border banking transactions in Europe and the reduction in outstanding positions of banks in other BIS reporting countries is hardly surprising. However, nearly two-thirds of the total 9% expansion recorded in Europe was accounted for by banks in the United Kingdom and France. Exports of domestic currency funds and Euro-market transactions

Developments in individual reporting market centres

Positions of banks in		Changes, excluding exchange rate effects						Stocks at end-1992		
		1991			1992			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	−10.0	−41.9	14.9	24.0	64.4	10.0	86.2	933.5	266.2
	L	−15.9	−27.5	5.4	9.5	56.7	10.8	134.1	983.7	228.4
France	A	5.5	−20.0	− 9.9	50.1	25.4	9.9	114.1	349.9	75.6
	L	17.8	0.9	− 6.7	12.3	10.6	9.4	120.2	375.5	62.8
Switzerland	A	− 8.2	1.7	− 0.2	− 8.5	14.5	− 0.2	88.0	291.6	18.9
	L	− 1.8	1.9	− 2.8	− 1.3	5.1	1.9	62.6	241.4	61.2
Luxembourg	A	0.7	17.7	0.7	1.7	38.4	13.1	6.8	325.4	59.4
	L	0.1	11.5	5.3	0.9	22.5	23.5	5.7	280.2	85.2
Germany	A	− 6.4	16.6	1.3	−16.0	22.1	2.8	205.4	163.2	11.5
	L	5.0	7.3	− 0.6	25.3	25.0	1.5	144.5	126.3	11.3
Belgium	A	3.2	− 1.6	1.7	− 1.7	10.6	− 2.7	14.4	182.4	51.3
	L	− 1.7	− 4.4	2.0	3.0	5.9	− 1.2	22.3	182.6	45.0
Italy	A	3.3	1.2	13.8	2.7	1.5	30.1	11.0	93.8	129.5
	L	− 1.2	26.2	1.7	0.3	30.5	27.1	22.7	221.0	43.6
Netherlands	A	6.4	0.9	6.8	− 7.7	10.1	1.9	29.6	141.0	32.7
	L	4.1	− 0.9	− 0.5	3.5	11.2	0.7	29.7	124.4	31.2
Spain	A	1.7	6.6	4.0	10.6	14.8	11.1	15.1	53.4	36.5
	L	2.3	7.5	1.9	− 0.1	14.9	2.8	16.1	67.4	16.9
Sweden	A	0.4	− 0.9	− 3.8	1.5	− 1.7	−28.2	3.0	29.1	38.9
	L	− 0.1	− 7.5	− 0.7	2.5	−29.0	6.4	5.4	57.3	17.2
Other European countries	A	2.6	2.2	1.1	− 2.0	9.9	− 4.2	22.3	111.3	58.4
	L	2.2	− 8.8	8.2	− 1.4	−15.4	10.4	15.4	144.4	45.4
Total European countries	A	− 0.8	−17.5	30.4	54.7	210.0	43.6	595.9	2,674.6	778.9
	L	10.8	6.2	13.2	54.5	138.0	93.3	578.7	2,804.2	648.2
Japan	A	20.8	−56.7	−77.6	−28.5	−29.4	−69.0	440.8	438.4	346.2
	L	−61.4	−66.6	−40.8	−73.9	−54.9	−64.6	195.0	513.6	305.9
United States	A	1.6	5.2	..	−18.4	− 6.3	..	495.5	62.7	..
	L	− 3.8	5.0	..	34.4	3.8	..	615.0	73.0	..
Asian market centres	A	0.9[1]	− 6.2[2]	..	2.9[1]	18.8[2]	..	10.7[1]	844.9[2]	..
	L	3.6[1]	−23.8[2]	..	− 0.1[1]	11.6[2]	..	16.2[1]	762.2[2]	..
Other centres[3]	A	− 0.7[4]	− 1.2	− 1.4[4]	0.0[4]	−23.3	0.6[4]	3.5[4]	630.7	28.9[4]
	L	− 1.6[4]	1.2	− 0.3[4]	− 1.1[4]	−19.7	1.2[4]	6.6[4]	654.2	12.4[4]
Total	A	21.8	−76.4	−48.7	10.7	169.8	−24.7	1,546.3	4,651.3	1,154.0
	L	−52.4	−78.0	−27.8	13.6	78.8	29.9	1,411.5	4,807.2	966.5

Note: A = assets; L = liabilities.

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

associated with developments in the other country's currency were the determining factors. Strong growth in external claims was also recorded by banks in Luxembourg, the largest Euro-DM centre on the Continent, and by banks in Spain, in the latter case owing to massive exports of funds in the second half of the year. By contrast, large-scale domestic currency inflows into Germany and the Netherlands meant much greater increases in resident banks' external liabilities than in assets.

Turning to the market outside Europe, the most severe contraction was recorded by banks located in Japan, whose combined international claims fell by $127 billion, following a $114 billion decline in 1991. While closely connected with the domestic situation in Japan, the downturn was accentuated by the streamlining of positions between Japanese banks' head offices and their foreign subsidiaries, which accounted for nearly half of the total reduction. As in 1991, the decline in liabilities was much more pronounced and, as a result, the net external creditor position of the Japanese banking system widened by $71 billion, the major counterpart to the country's $118 billion current account surplus. Net funding of Japanese banks' foreign affiliates and partial repayments of yen previously imported through neighbouring offshore centres to circumvent domestic restrictions were the main components of the net outflow.

Large net capital flows through banks in Japan ...

The retrenchment by Japanese banks dampened expansion in other Asian market centres, where they play a major role, despite the booming business of these centres with the Middle East and South-East Asia. Similarly, Japanese banks' US affiliates accounted for 70% of the $25 billion decline recorded in the external assets of banks located in the United States and for a substantial part of the $63 billion net capital inflows through the US banking system. There was, by contrast, a small net export from the United States by US-owned banks; however, this conceals a further reduction in inter-office gross assets and liabilities, which was indirectly responsible for the stagnation in business recorded by the Caribbean reporting centres.

... and in the United States

The nationality structure of international banking activity

As the statistics classified by nationality of reporting banks do not provide a currency breakdown, exchange rate adjusted movements can only be estimated. Only broad conclusions can therefore be drawn from the accompanying table. In the case of Japanese banks, for instance, exchange rate changes may have accounted for about one-third of the $256 billion current dollar contraction in the international assets of their domestic and foreign offices last year, leaving an estimated 10% cutback in yen terms, similar to that in 1991. Their share in total claims outstanding slipped further to less than 28%, from a peak of 38% in 1988. More than 30% of the current dollar decline in Japanese banks' international assets took place on the foreign currency market within Japan, reflecting in the main repayments of funds by banks' domestic customers. A further 45% represented the scaling-back of inter-office accounts, which had in the past been closely linked to the circumvention of domestic regulations. However, the contraction in assets was considerably smaller than that in external liabilities; considering the traditional interbank borrowing role of Japanese banks, their large-scale repayment of funds had an even stronger impact on other reporting banks' international activity.

Further retrenchment by Japanese banks ...

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

Nationality		Change in current dollars in 1991				Change in current dollars in 1992				Total stocks at end-1992
		Total	of which vis-à-vis			Total	of which vis-à-vis			
			Related offices	Non-related banks	Non-banks		Related offices	Non-related banks	Non-banks	
		in billions of US dollars								
Japanese banks	A	−190.0	−61.0	− 98.4	−30.6	−256.4	−114.3	− 97.8	−44.3	1,677.7
	L	−232.3	−53.2	−159.2	−19.9	−310.8	−143.4	−121.7	−45.7	1,512.7
German banks	A	29.6	14.6	− 7.7	22.7	43.9	18.8	− 1.0	26.1	683.1
	L	28.8	14.4	− 1.3	15.7	83.9	25.1	8.9	49.9	571.6
French banks	A	− 10.5	10.6	− 3.2	−17.9	91.2	10.4	61.8	19.0	657.0
	L	5.6	− 2.6	− 3.1	11.3	62.4	23.9	18.6	19.9	693.0
US banks	A	− 2.3	−22.1	− 3.3	23.1	7.5	− 19.8	10.0	17.3	656.3
	L	1.5	−40.1	16.2	25.4	− 2.9	− 7.8	1.1	3.8	678.7
Italian banks	A	21.7	7.1	− 1.5	16.1	10.4	12.0	− 2.8	1.2	407.4
	L	27.0	10.3	12.0	4.7	26.5	7.8	24.8	− 6.1	451.8
Swiss banks	A	14.2	5.3	2.1	6.8	− 3.1	6.7	− 9.1	− 0.7	396.7
	L	− 4.8	10.1	− 5.7	− 9.2	1.4	− 1.6	− 2.3	5.3	391.4
UK banks	A	− 12.4	− 1.9	− 17.1	6.6	16.2	− 2.6	12.2	6.6	293.9
	L	− 9.6	− 2.6	− 4.2	− 2.8	10.9	− 2.0	12.7	0.2	340.3
Dutch banks	A	15.8	0.1	12.6	3.1	5.2	4.8	− 3.0	3.4	204.4
	L	8.9	0.8	7.8	0.3	13.5	8.4	4.1	1.0	191.1
Nordic banks[2]	A	− 3.2	5.4	− 8.9	0.3	− 50.2	0.2	− 7.6	−42.8	223.5
	L	− 10.0	8.2	− 20.7	2.5	− 53.6	− 1.8	− 45.1	− 6.7	221.4
Other	A	32.4	− 3.8	15.8	20.4	60.5	24.1	24.4	12.0	840.0
	L	39.0	14.5	22.9	1.6	37.1	19.1	25.7	− 7.7	885.4
Total	A	−104.7	−45.7	−109.6	50.6	− 74.8	− 59.7	− 12.9	− 2.2	6,040.0
	L	−145.9	−40.2	−135.3	29.6	−131.6	− 72.3	− 73.2	13.9	5,937.4

Note: A = assets; L = liabilities.

[1] Cross-border positions in all currencies plus the foreign currency positions vis-à-vis residents of banks in the following countries: Austria, Belgium, Luxembourg, Canada, Denmark, Finland, France, Germany, Ireland, Italy, Japan, the Netherlands, Norway (from 1992 only), 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. Positions are classified according to the nationality of ownership of banks. Non-bank positions include official monetary institutions and, on the liabilities side, banks' issues of CDs and other securities. [2] Danish, Finnish, Norwegian (from 1992 only) and Swedish banks.

... and Nordic banks ...

Nordic banks also retreated from the international market, by an estimated 13% in exchange rate adjusted terms. Repayments of outstanding foreign currency loans by domestic non-bank customers were reflected in a cutback in these banks' own borrowing from the international interbank market. At the same time, official support programmes helped to limit the reduction in their international books, with their share in total reported assets contracting by 0.8 percentage point to 3.7% at the end of the year.

... but pick-up in the activity of other European banking groups ...

On average, the growth in the international assets of other European banking groups, excluding exchange rate effects, can be estimated at around 13%. French banks recorded the largest increase, one-quarter of which was in the books of foreign affiliates (mainly in London and

Luxembourg), and shifted from a net borrower to a net lender position in the international interbank market. Strong offshore expansion and net interbank funding also characterised Spanish banks' activity, whereas the growth experienced by UK, Italian and Belgian banks was associated with some redirection of business back to the home base. In the case of German and Swiss banks, expansion was generally confined to London or Luxembourg; the business conducted by foreign affiliates of German banks primarily took the form of direct intermediation with the non-bank sector, particularly with customers in Germany.

... as well as North American banks

Following retrenchment in 1991, the international positions of US and Canadian banks rose slightly last year. While interbank Euro-market borrowing for onlending to non-bank entities was the prime cause of the revival in Canadian banks' business, the marginal gain posted by US banks conceals a 12% upswing after estimated exchange rate effects and inter-office balances are excluded.

Direct business with the non-bank sector

Sizable changes in cross-border deposits ...

... especially of German residents ...

Direct international credit and deposit-taking business with the non-bank sector inside the reporting area was subject to contrasting movements in 1992, in part reflecting the currency crisis. This crisis was more strongly felt on the deposits side, where short-term Euro-currency rates adjust quickly to variations in demand and supply conditions. Indeed, in virtually all Group of Ten countries, changes in offshore deposits were quite substantial. In particular, the build-up of foreign balances by the German non-bank sector was equivalent to nearly 40% of the expansion of German M_3. Heavy foreign demand for DM funds and avoidance by German residents of the withholding tax on interest income were the two major contributing factors. Large Euro-deposits of Deutsche Mark or of their national currencies were also made by non-bank residents of the Benelux countries. Moreover, close to 45% of the offshore deposits made by the French non-bank sector were in the Euro-French franc market, where interest rates fluctuated more sharply than on the domestic market. By contrast, non-bank entities located in the United States continued to repatriate funds from the Euro-dollar market, as Euro-dollar accounts became less attractive with the overall downward trend of dollar interest rates.

... and recovery in bank credit, owing to special factors

At the same time, new cross-border credits to non-bank entities recovered somewhat, despite the persistence of weak demand. There were three principal reasons. Firstly, reporting banks were themselves important purchasers of securities. Thus, the bulk of the additional cross-border exposure vis-à-vis the German and French non-bank sectors, and the whole of the increase in the case of Italy, were due to the purchase of securities. Secondly, a substantial part of the new funds went to governments or other public sector entities. In Sweden, there were massive repayments of foreign currency loans by non-bank residents, partly offset by large syndicated credits to the Government (see below). Thirdly, the downward trend of long-term interest rates induced many borrowers

BIS reporting banks' business with non-bank entities in the Group of Ten countries									
Country of residence of non-bank customers	Changes, excluding exchange rate effects						Stocks at end-1992		
	Cross-border positions		Local positions in foreign currency		*Memo item: Domestic bank credit[1] and money[2]*		Cross-border positions	Local positions in foreign currency	*Memo item: Domestic bank credit[1] and money[2]*
	1991	1992	1991	1992	*1991*	*1992*			
	in billions of US dollars								
Assets									
Japan	44.1	11.4	−19.8	−38.4	*133.7*	*147.0*	261.8	165.8	*5,169.2*
United States	5.6	28.1	..	..	*−4.9*	*99.6*	304.2	..	*4,435.7*
Germany	9.5	34.3	1.7	1.8	*174.9*	*191.5*	119.9	7.7	*2,164.9*
France	2.2	6.6	− 0.1	3.7	*60.9*	*64.7*	36.0	24.5	*1,588.3*
United Kingdom	5.6	1.8	16.2	− 1.7	*61.7*	*41.2*	59.9	112.3	*970.1*
Italy	8.0	9.8	9.1	10.1	*83.1*	*43.3*	83.9	93.3	*701.2*
Netherlands	4.7	− 1.7	7.0	1.6	*14.9*	*14.3*	55.9	25.0	*339.3*
Switzerland	− 1.3	1.9	0.2	0.4	*17.5*	*7.4*	24.6	14.1	*329.9*
Belgium[3]	0.9	0.1	− 1.2	1.3	*9.2*	*19.5*	29.1	33.9	*319.6*
Canada	3.4	3.7	− 1.9	1.2	*30.8*	*23.4*	40.0	26.6	*307.2*
Sweden	1.5	15.0	− 1.1	−24.1	*11.5*	*−5.0*	33.8	38.2	*106.2*
Liabilities									
Japan	− 5.7	− 0.7	..	..	*90.9*	*−4.4*	16.7	..	*4,135.5*
United States	−12.1	−11.4	..	..	*60.0*	*13.7*	253.8	..	*4,111.6*
Germany	11.7	30.8	− 0.4	0.2	*64.3*	*78.0*	159.0	7.1	*1,064.9*
France	− 0.1	6.9	− 0.9	0.7	*23.3*	*51.4*	46.0	11.5	*986.8*
United Kingdom	3.9	− 2.2	5.5	13.8	*51.3*	*33.4*	59.5	85.1	*787.8*
Italy	3.2	5.4	1.0	3.9	*67.9*	*26.6*	38.4	9.0	*626.7*
Netherlands	4.7	7.0	0.0	0.7	*11.9*	*15.0*	57.5	23.6	*239.8*
Switzerland	1.3	1.5	− 0.6	1.3	*8.0*	*7.7*	57.2	52.7	*271.3*
Belgium[3]	0.0	4.4	3.9	13.3	*9.1*	*11.4*	36.2	53.6	*182.7*
Canada	− 3.6	− 2.0	− 0.5	1.6	*14.8*	*21.9*	12.0	10.1	*296.7*
Sweden	0.6	− 0.9	− 0.1	2.6	*4.6*	*0.5*	3.1	7.0	*96.8*

[1] Excluding lending in foreign currency. [2] For Japan, M_2+CDs; for the United Kingdom, M_4; for the United States, M_3-overnight and term Euro-dollars; for Italy, "extended" M_2; for other countries, M_3. [3] Including Luxembourg.

to lock in at prevailing rates. The most active in this respect were US non-bank entities, which raised 28% of their total bank credit in the Euro-market.

Business with countries outside the reporting area

At 8%, the growth of bank credit to countries outside the reporting area was the highest in ten years. While new lending to the non-OPEC developing world was a major driving force, special factors caused sizable changes in positions vis-à-vis other groups. Thus, new flows to developed countries outside the reporting area stemmed from large syndicated loans to Australia and Turkey and short-term capital inflows into Portugal. Most of the new credits to Australia represented refinancing operations, with a mere \$1.1 billion increase in claims and a \$1 billion reduction in liabilities. By contrast, the \$1.9 billion rise in banks' outstanding claims on Turkey was

Selective lending to developed countries ...

dwarfed by a $3.1 billion upsurge in the country's deposit holdings. Assets and liabilities vis-à-vis Portugal, whose entry into the ERM earlier in the year had triggered capital inflows, increased on balance by $1.2 billion and $1.9 billion respectively, with part of the inflows having been reversed in the wake of the currency crisis.

... and increased exposure vis-à-vis the former Soviet Union ...

The small expansion in reporting banks' claims on eastern Europe was more than accounted for by the former Soviet Union ($5.8 billion). Officially guaranteed credits and interest arrears were responsible for much of the rise, as successive debt deferrals were granted by creditor banks pending a definitive rescheduling agreement. Total deposits identified as received from the successor states rose by the same amount, the largest increase ever recorded, presumably reflecting capital flight. Among the three countries most advanced in the transformation process in eastern Europe, current account surpluses and reliance on other financing sources allowed repayments by Hungary ($1.6 billion) and Czechoslovakia ($0.3 billion), with the latter's net banking debt cut to $1.1 billion on the eve of the dissolution of the federation. Stalled debt negotiations and further accumulations of interest arrears froze new credits to Poland, so that the country reduced its net banking debt by one-third, to $5.6 billion at the end of the year, following a $2.7 billion accumulation of deposits.

... and a limited number of OPEC countries

As regards OPEC countries, nearly half of the total credit flows were accounted for by the Middle East residual item, which includes the unallocated positions of banks in the United States vis-à-vis the whole region (in particular Bahrain). More than the whole of the identified increase in claims on that area was due to Kuwait ($5.2 billion), Iran ($3.1 billion) and Saudi Arabia ($1.3 billion). Large-scale investment in infrastructure and interest arrears on Iran's commercial debt were the main factors; however, most of Saudi Arabia's financing was met through a drastic cut in the country's deposits (by $17.3 billion), whereas Kuwait added $2 billion to its balances with reporting banks. Outside the Middle East, the only major OPEC borrower was Indonesia ($6.2 billion), which recorded a similar increase in its deposits; tight domestic conditions made it cheaper for companies to borrow in the international credit market and convert the proceeds.

Buoyant lending to Asia

The buoyancy of business with the non-OPEC developing world was heavily concentrated on the largest economies in Asia and Latin America, while lending to Africa and the Middle East remained subdued. New credits to non-OPEC Asian countries continued at a brisk pace, albeit with diverging trends. On the one hand, lending to China ($6.3 billion), India ($3.2 billion) and Malaysia ($1.9 billion) gathered momentum, reflecting in the main sustained domestic demand. On an assets-minus-liabilities basis, banking flows translated into even larger capital imports in India ($6 billion, or more than its current account deficit), but net outflows from Malaysia ($2.2 billion), whose efforts to stem the appreciation of its currency led to a substantial accumulation of reserves in the third quarter. On the other hand, new credits to Thailand ($4.8 billion), South Korea ($4 billion) and Taipei China ($0.6 billion) slowed down from 1991. On an assets-minus-

BIS reporting banks' business with countries outside the reporting area								
Positions of banks vis-à-vis	Changes, excluding exchange rate effects							Stocks at end-1992
	1986	1987	1988	1989	1990	1991	1992	
	in billions of US dollars							
Borrowing from reporting banks								
Non-reporting developed countries	7.2	4.8	2.1	2.9	6.0	0.4	7.4	153.4
Eastern Europe	3.7	2.3	8.3	9.3	− 9.9	− 1.5	3.8	95.0
of which: Former Soviet Union	*3.6*	*0.3*	*5.5*	*7.5*	*− 6.2*	*1.3*	*5.8*	*58.9*
OPEC	0.5	2.2	5.4	5.7	− 2.3	− 4.6	22.3	154.7
of which: Middle East	*− 0.9*	*2.2*	*4.5*	*7.6*	*− 0.7*	*− 6.7*	*17.9*	*71.3*
Non-OPEC developing countries	3.1	2.2	−2.4	−19.6	− 5.7	13.8	30.3	410.1
*of which: Latin America**	*1.5*	*−3.7*	*−5.0*	*−16.7*	*−23.0*	*− 0.3*	*12.1*	*200.1*
Asia	*2.6*	*7.7*	*3.9*	*0.3*	*18.0*	*17.8*	*19.2*	*176.5*
Africa	*− 0.2*	*−0.6*	*−0.6*	*− 1.8*	*0.0*	*− 1.6*	*0.8*	*22.7*
Middle East	*− 0.8*	*−1.1*	*−0.7*	*− 1.4*	*− 0.7*	*− 2.0*	*− 1.8*	*10.7*
Total borrowing	14.4	11.6	13.5	− 1.7	−11.9	8.1	63.7	813.2
Deposits with reporting banks								
Non-reporting developed countries	7.4	6.1	13.4	17.3	7.8	− 3.5	11.4	111.9
Eastern Europe	0.2	−0.7	4.1	0.2	− 5.9	1.3	9.7	30.7
of which: Former Soviet Union	*0.8*	*−1.9*	*1.8*	*− 0.7*	*− 6.6*	*0.3*	*5.8*	*14.2*
OPEC	−22.1	19.2	11.6	14.4	25.4	−13.9	− 9.2	218.7
of which: Middle East	*−13.5*	*17.5*	*12.0*	*9.5*	*18.0*	*−17.6*	*−10.7*	*165.3*
Non-OPEC developing countries	12.9	24.2	12.4	25.7	64.9	3.7	0.0	356.1
*of which: Latin America**	*0.7*	*6.7*	*3.4*	*4.6*	*19.0*	*− 2.9*	*0.3*	*114.9*
Asia	*13.1*	*14.0*	*7.7*	*16.5*	*34.6*	*2.1*	*− 7.6*	*163.8*
Africa	*0.0*	*1.6*	*1.5*	*1.7*	*3.7*	*− 0.7*	*3.2*	*27.6*
Middle East	*− 0.9*	*1.9*	*−0.2*	*2.9*	*7.6*	*5.2*	*4.0*	*49.8*
Total deposits	− 1.6	48.7	41.5	57.6	92.2	−12.4	11.8	717.4

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

liabilities basis, banking flows were virtually nil in the case of South Korea, owing in part to new official deposits, but resulted in a $12.1 billion drop in the net creditor position of Taipei China, whose authorities withdrew funds from the market. The Philippines was the only major borrower in the group to record a reduction ($1.3 billion) in its gross banking debt, as a result of debt buybacks under the recent debt rescheduling agreement.

Improved credit relations with Latin America ...

Aggregate lending to non-OPEC Latin American countries was positive for the first time in six years, at $12.1 billion – a level not seen for a decade. There were increases in claims on Brazil ($3.3 billion), Argentina ($2.6 billion), Chile ($2.2 billion), Mexico ($1.1 billion), Colombia and Uruguay ($0.6 billion each). Despite delays in the signing of a preliminary debt rescheduling agreement between Brazil and its creditor banks reached in July last year, the movement in claims vis-à-vis that country still understates the actual volume of new lending, as a result of repayments of more than $6 billion of interest arrears during the year; on the banks' liabilities side, an almost threefold rise in the country's official reserves was more than responsible for the $2.7 billion increase in its deposits. Elsewhere, extensive economic and financial reforms have led to improved relations with creditor banks, with Argentina having successfully completed a debt and debt service reduction programme in December. There has at the same time been a return of flight capital, as evidenced by the reduction in many of these countries' identified non-bank deposits with reporting banks.

... but greater reliance on other sources of funding

New banking flows to Latin America in 1992 mainly reflected short-term trade financing, banks' new contributions under rescheduling agreements and a small amount ($5 billion) of new syndicated facilities, which included $3.2 billion for Mexican entities and several re-financing operations. On the other hand, debt conversions, outright loan sales, write-offs and other debt reduction schemes continued to compress the region's banking debt; by far the largest debt reduction operations were carried out by Mexico, whose Government announced that it had bought back more than $7 billion of banking debt on the secondary market. Thus, bank credits were not the region's main external source of funding, which was met primarily through participations, equity purchases and international securities issues (for a total of some $30 billion). While foreign purchases of securities were encouraged by extremely high real interest rate levels, equity flows benefited from the accelerating pace of privatisation and deregulation.

Reasons for the shift away from bank credit ...

Important demand and supply factors dampened long-term bank lending to Latin America last year. In the first place, banks' continuing restrictive stance, as reflected in tight lending conditions, discouraged potential borrowers from tapping the market, all the more so as interest rate developments made refinancing in fixed rate bond issues more attractive than predominantly floating rate syndicated credits. In addition, reflows of flight capital also meant, for the investors concerned, substituting purchases of securities issued by home-country companies for assets held with banks abroad. Finally, since creditor banks needed to comply with the new capital standards, and as sovereign borrowing demand was strong, some crowding-out cannot be ruled out.

At the same time, banks made considerable progress in consolidating their exposure vis-à-vis Latin America, mainly through loan sales and write-offs. This exposure now represents only a small fraction of their international assets. Better market sentiment was reflected in an increase in the average price of the region's banking debt, the trading of which was an important source of income for certain banks. Improved creditworthiness in turn made it possible for countries to reduce reliance on bank credits and finance growing current account deficits through other spontaneous capital flows. This broadening of the investment base, however, poses new challenges for the recipients. To the extent that it reflects repatriated flight capital, it cannot be viewed as a durable pattern of development finance. Moreover, portfolio investment can prove highly volatile, as illustrated by the sharp movements recorded in local stock markets. Finally, international securities markets demand a high degree of creditworthiness, with little, if any, non-investment-grade paper attracting interest.

... and the question of its sustainability

The syndicated credit market

Persistence of banks' cautious and selective attitude ...

As in 1991, cyclical weakness, a small volume of merger and acquisition related facilities and access to more readily available funding sources affected borrowing demand in the syndicated market. Credit concerns, revised lending strategies and pressures on capital led banks to persist in their cautious and selective attitude. Indeed, demand and supply conditions tilted further towards a tightening of lending terms: the average spread on new loans increased, and average maturities remained below six years; completion periods proved protracted, with documentation, guarantees and covenants being more thoroughly scrutinised by the banks; and an increasing number of deals made provision for adjustments in bank margins.

... but record refinancing operations

The upsurge in announced facilities, from $137 billion in 1991 to $222 billion in 1992, was therefore due to a number of special factors. Most important was the unprecedented volume of refinancing operations, which accounted for the greater part of the $91 billion arranged for US names. A second factor was the completion of several large facilities for sovereign and supranational borrowers, including in particular two syndicated deals for Sweden (ECU 8 billion) and the United Kingdom (ECU 5 billion) in the third quarter as part of wider funding programmes. A third factor was the heavy reliance of Asian countries on the market. The largest borrowers within this group were Thailand ($8.8 billion) and China ($7.5 billion). On the other hand, a number of countries scaled down their recourse to syndicated loans. These included Saudi Arabia and Kuwait, which had taken up record jumbo credits in 1991, Australia, where recession reduced new financing operations, and Italy, whose creditworthiness suffered as a result of the liquidation of a state holding company in July.

The securities market

The short and medium-term note market

Shift from ECP to EMTN financing

In the short and medium-term Euro-note market, the most significant feature was the contrasting performance of short-term commercial paper and medium-term notes. In the Euro-commercial paper (ECP) sector, the volume of new programmes slowed down to $19 billion, with, for the first time, stagnation in new placements; in addition, the expansion of other underwritten and non-underwritten short-term Euro-notes showed signs of tapering off, despite sizable issues of certificates of deposit by financial institutions. By contrast, both announced new programmes and placements of Euro-medium-term notes (EMTNs) surged to unprecedented levels. At year-end, EMTNs accounted for 35% of the total volume of Euro-note paper outstanding, compared with 27% at the end of the preceding year.

The Euro-commercial paper market. Several factors constrained ECP activity in 1992. Firstly, large borrowing facilities were already in place in this market, limiting the scope for further growth, particularly as poor economic conditions reduced demand for working capital and exacerbated short-term credit concerns. Secondly, lower dollar interest rates induced

Domestic and international markets for commercial paper and medium-term notes								
Items	Market opening	1986	1987	1988	1989	1990	1991	1992
		amounts outstanding at end-year, in billions of US dollars[1]						
Commercial paper markets								
United States	pre-1960	326.1	373.6	451.8	521.9	557.8	528.1	545.1
Japan	end-1987		13.8	73.8	91.1	117.3	99.0	98.1
France	end-1985	3.7	7.6	10.4	22.3	31.0	30.8	31.6
Spain[2]	1982	6.3	4.3	6.3	8.3	26.1	28.4	29.3
Canada	pre-1960	11.9	14.9	21.0	25.0	26.6	27.4	24.5
Sweden	1983	3.7	7.8	9.5	15.9	23.1	24.0	16.6
Australia[3]	mid-1970s	4.1	7.5	7.9	11.1	10.9	12.3	13.8
Germany	early 1991						5.4	10.2
United Kingdom	1986	0.8	3.8	5.7	5.7	7.4	6.9	5.8
Finland	mid-1986	0.4	2.5	4.9	6.9	8.3	5.9	3.8
Netherlands	1986	0.1	0.9	1.0	0.8	2.0	2.6	2.6
Norway	end-1984	1.0	3.1	2.7	2.7	3.5	3.5	2.2
Belgium	1990					0.0[4]	0.2[4]	1.3[4]
Total domestic		358.1	439.8	595.0	711.7	814.0	774.5	784.9
Euro-commercial paper	mid-1980s	13.9	33.3	53.2	58.5	70.3	79.6	78.7
Other short-term Euro-notes	early 1980s	15.1	16.9	13.5	11.1	19.1	26.8	37.0
Total		387.1	490.0	661.7	781.3	903.4	880.9	900.6
Medium-term note markets								
United States	early 1970s	35.0[4]	50.0[4]	65.0[4]	76.0	100.0	142.3	175.7
United Kingdom	mid-1990					0.7	1.9	4.9
Euro-medium-term notes	mid-1980s	0.4	2.6	5.6	9.6	21.9	38.5	61.1

[1] Converted at current exchange rates. [2] Up to 1991, non-financial institutions only. [3] Up to 1991, mid-year data. [4] Estimate.

Sources: Euroclear and national authorities.

Reduced demand for ECP financing

borrowers to lock in at the longer end of the maturity spectrum, while the turmoil on the foreign exchange markets caused liquidity to dry up in several sectors, in particular the ECU and Italian lira sectors. Thirdly, ECP issues continued to face growing competition from domestic commercial paper markets, especially the more mature US market, which expanded by $17 billion. However, activity increased in several European markets which had recently been opened or deregulated. The tightening of swap conditions meant that borrowers could obtain funding more cheaply domestically than by issuing dollar-denominated ECP and converting the proceeds. While the French commercial paper market remained the largest in Europe, the German market nearly doubled to $10 billion. The new liberalisation measures introduced by the Bundesbank in August permitting issues by foreign non-banks boosted activity in DM-denominated paper, both inside and outside Germany. Indeed, the Deutsche Mark sector was, with that of the dollar, the only major ECP sector to expand last year. By contrast, the yen market, which remained almost exclusively domestically driven, stagnated.

The Euro-medium-term note market. The broadening of techniques and options available to issuers further enhanced the EMTN market's

Widening range of EMTN instruments ...

competitive edge over both commercial paper and bonds. Thus, several programmes included bond issues, while others allowed for the possibility of issuing short-term paper. There was, moreover, an increasing number of multi-currency facilities with the option to raise funds in Deutsche Mark, as permitted under the newly liberalised German regulations. The introduction of the underwriting technique, which had hitherto been limited to short-term programmes and bonds, also contributed to market growth. While very similar to bonds, EMTNs can be issued under the same documentation incorporated into the initial programme, that is, without additional cost, and with a wide range of fund-raising alternatives better adapted to the needs of borrowers and investors.

... with limited domestic competition

In contrast to the ECP market, domestic competition with EMTNs was in the main confined to the US market, which expanded by $33 billion, against $11 billion for Euro-dollar issues. In other countries, a fully-fledged domestic medium-term note market is generally lacking. Since its opening, the French franc MTN market has remained constrained by strict regulations, and less than $1 billion of corporate issues were outstanding at the end of 1992. Elsewhere in Europe, the only notable development was recorded in the recently liberalised Deutsche Mark sector, both within Germany and in the Euro-market, which in the latter case grew by $2.1 billion. However, growth was more pronounced in the Euro-yen market ($3.6 billion) and in the Euro-sterling market ($2.8 billion), which are dominated by domestic borrowers, whereas, following strong expansion prior to the currency crisis, the markets for ECU and lira-denominated paper subsequently contracted.

The international bond market

Bond refinancing and the globalisation of government borrowing ...

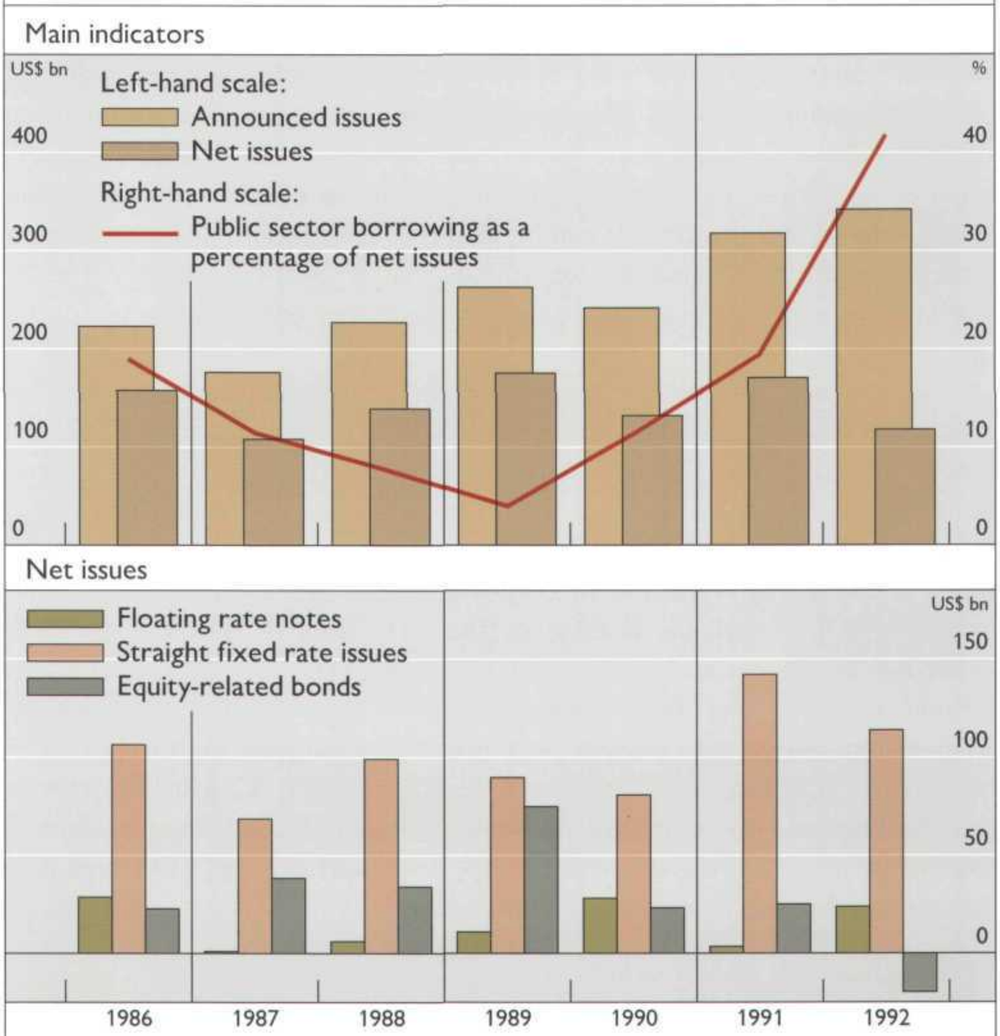
Refinancing requirements and the globalisation of public debt management were the main driving forces in the international bond market in 1992. Gross announcements of new issues reached an all-time record of $342 billion, but net growth amounted to only $118 billion (7%). Public sector entities and international institutions together accounted for 60% of the net flow figure. The turbulence on the exchange markets led to significant currency reallocations, while poor stock market performance resulted in a marked shift away from equity-related instruments.

At the same time, secondary market trading surged to unprecedented levels, with turnover reported by Cedel and Euroclear on average almost 70% higher than in 1991. Notwithstanding the liquidity problems encountered in some sectors at the height of the crisis, the currency turmoil was associated with major portfolio adjustments, accompanied by sharp swings in spreads. Pricing conditions in national and Euro-markets tended to converge, and an increasing number of domestic issues were traded internationally. The growing number of large benchmark issues by sovereign and supranational borrowers added to depth and liquidity.

... boost straight fixed rate issues ...

Straight fixed rate bonds. Gross issuing activity in this sector, at $275 billion, was unprecedented, but the amount of net new issues, at $114 billion, was smaller than in 1991, owing to record repayments.

The international bond market



Sources: Bank of England, ISMA and BIS.

Several strong opposing factors were at work. On the positive side, the market benefited from public sector preference for fixed rate debt, the disaffection with equity-related techniques and the decline in long-term interest rates. On the negative side, the traditional fixed rate sector suffered from competition from other forms of borrowing, downgradings of credit standing, reduced swap opportunities and the currency upheavals.

... in selected market segments ...

The exchange market turmoil resulted in an abrupt shift in investor preference from high-yielding currencies to perceived safe-haven instruments. There was in particular a sharp turnround in the ECU and Italian lira sectors, from rapid growth in the first six months to actual net repayments. By contrast, activity in the dollar and Deutsche Mark segments became increasingly buoyant, boosted in the latter case by the German liberalisation measures in August. Moreover, issuing activity in a few Euro-currency segments continued to be driven by issuers from the home countries. For example, the greater flexibility and lower cost of the Euro-French franc sector diverted French borrowers away from their own national market, while the Euro-Canadian dollar market remained a prime source of financing for Canadian public corporations. Despite pressures on these currencies at times, foreign investors were attracted by the prevailing conditions, which were considered to more than compensate for the exchange rate risks. Finally, the widening range of refinancing instruments available to Japanese borrowers depressed activity in the Euro-yen and foreign Swiss franc sectors, which, together with the dollar, had been the main beneficiaries of the original financing of this group of borrowers.

Floating rate notes. The revival of FRN business was particularly pronounced after allowing for redemptions. Net new placements amounted to $24 billion, compared with $3.5 billion in 1991. Dollar issues accounted for 62% of the total. The surge in activity can be explained primarily by three sets of factors. Firstly, banks and other financial institutions, including bank holding companies, faced pressing capital needs; together, such institutions accounted for more than half of net new issues, a large proportion being in the form of subordinated notes, which are eligible as tier 2 capital under the Basle accord. Secondly, there was a large volume of "collared" Euro-dollar notes, which guarantee minimum and maximum yields; investors were attracted by the guaranteed returns, at a time when market rates were perceived as unlikely to exceed the pre-set ceilings. Thirdly, the downward trend of swap margins made it generally

Type and currency structure of international bond issues

Sectors and currencies	Announced issues				Net issues				Stocks at end-1992
	1989	1990	1991	1992	1989	1990	1991	1992	
	in billions of US dollars								
Straight fixed rate issues	150.2	166.2	256.2	275.3	89.6	80.7	142.0	113.6	1,211.4
US dollar	54.6	52.2	75.0	90.7	26.1	15.9	27.9	40.7	390.7
Japanese yen	23.1	30.2	39.1	38.5	15.3	24.8	20.7	2.5	196.3
Deutsche Mark	9.4	7.3	12.2	29.2	6.0	1.3	4.8	17.1	124.2
Swiss franc	5.7	15.5	13.5	13.5	−3.9	3.4	3.4	− 4.2	105.8
ECU	11.7	15.1	30.2	18.6	7.5	9.6	24.3	7.6	91.5
Pound sterling	11.9	9.5	17.2	18.2	10.9	7.8	14.6	9.2	71.3
Canadian dollar	10.9	6.3	22.6	15.2	10.0	1.7	14.0	7.0	61.2
French franc	4.6	8.2	16.4	23.0	4.2	6.0	14.7	20.4	56.6
Other	18.2	21.9	30.1	28.4	13.4	10.1	17.5	13.4	113.8
Floating rate notes	27.4	42.5	19.0	42.8	10.9	28.0	3.5	23.7	221.6
US dollar	10.2	15.0	4.4	25.0	−0.5	7.5	−5.1	14.7	125.4
Pound sterling	9.3	10.8	7.6	5.4	7.4	6.9	4.6	3.0	41.6
Deutsche Mark	2.6	8.2	2.8	3.5	2.2	7.3	2.7	1.9	24.2
Japanese yen	1.0	2.2	1.4	3.9	0.0	2.0	0.0	2.1	9.8
Other	4.3	6.2	2.8	5.0	1.8	4.5	1.3	2.0	20.6
Equity-related issues	85.2	33.1	42.4	23.8	74.8	23.1	25.0	−19.8	254.2
US dollar	65.1	19.5	24.9	12.5	60.4	15.9	15.1	−20.4	164.4
Swiss franc	13.6	8.2	7.0	5.3	8.9	4.1	2.2	− 2.4	48.6
Other	6.5	5.4	10.6	6.1	5.5	3.1	7.6	3.0	41.2

Sources: Bank of England, ISMA and BIS.

cheaper for prime names to raise Euro-FRNs directly rather than to issue at fixed rates and swap the proceeds into floating rate payments.

Equity-related bonds and international equities. With limited issuance opportunities and increasing redemption obligations, the outstanding volume of convertibles and bonds with warrants contracted for the first time, by $20 billion. Japanese issuers accounted for more than the whole of the decline. The sharp and protracted fall of the Tokyo stock market deterred investors from exercising their conversion options and obliged borrowers to refinance maturing bonds through other channels. For the year as a whole, nearly $40 billion of equity-related bonds issued by Japanese entities in the late 1980s were redeemed, and a further $90 billion are due to mature in 1993.

... at the expense of equity-related bonds

Outright international equity issues were, at $24 billion, virtually unchanged from 1991. Activity was brisk until the summer but tended to decline under the influence of the turbulence on the foreign exchange markets and weak stock indices. The largest direct issuers were US and UK corporations, while entities from developing countries continued to rely primarily on the technique of American Depository Receipts (negotiable instruments issued by a bank in the United States against the custodians of a company's shares). Unfavourable stock market conditions also led governments to postpone privatisation programmes, and large private equity offerings were cancelled partly for the same reason.

Type and nationality of borrowers

One salient feature last year was again the key role played by the official sector on the borrowing side of the market. Together, central governments, regional and local authorities and other public sector entities accounted for a record 42% of total net new international bond issues, and international institutions for a further 20%. However, while large in absolute terms, international bond issues by public sector entities remain marginal in relation to their total debt outstanding. Therefore, even minor changes in government debt strategies can have profound repercussions on the market. Moreover, last year's figures were boosted by a few exceptional transactions, due to the need on the part of certain governments to reconstitute their foreign exchange reserves. The record volume of issues arranged for the United Kingdom ($6.6 billion), Sweden ($5.9 billion) and Finland ($3.7 billion) in the last quarter are cases in point. At the same time, the diversification of public sector borrowing in favour of the Euro-bond market accentuated the crowding-out of non-prime borrowers. The private sector was the main victim of this market tiering, but it also increasingly affected certain segments of the public sector.

Predominance of public sector entities ...

This globalisation of public debt management seems to be more than a passing phenomenon. In tapping the international markets, governments gain access to a deeper and more liquid pool of resources than is available domestically, and are able to make use of a wider range of instruments and techniques, as illustrated by the growing interest in the EMTN formula. Although the crowding-out effect on private borrowers should not

... and consequences for the market

Issuing activity in the domestic and international bond markets										
Currencies	Domestic markets[1,2]				International markets[2]				Amounts outstanding at end-1992	
	Total		of which: Public sector		Total		of which: Public sector[3]		Domestic	Inter-national
	1991	1992	1991	1992	1991	1992	1991	1992		
	in billions of US dollars									
US dollar	538.3	558.6	400.1	446.8	37.9	35.0	10.2	28.2	6,676.2	680.5
Japanese yen	141.5	141.6	61.6	79.2	20.6	4.8	3.5	4.7	2,888.6	207.5
Deutsche Mark	150.3	188.8	58.0	117.2	11.2	20.5	0.8	11.7	1,234.0	168.5
Italian lira	117.8	71.6	104.4	63.7	9.3	6.2	4.3	1.7	734.9	24.2
French franc	31.6	36.1	18.3	26.8	15.9	21.7	4.9	6.6	525.0	64.3
Canadian dollar	26.9	24.3	27.0	21.6	14.1	7.5	5.7	4.7	321.7	63.5
Pound sterling	13.1	44.0	14.4	42.3	20.6	11.2	4.7	4.8	254.0	121.3
Swiss franc	13.4	11.8	2.3	7.2	5.4	−6.4	1.7	0.6	109.5	155.5
Dutch guilder	13.4	14.8	15.2	15.7	0.9	4.7	−0.4	0.0	168.8	29.1
Spanish peseta	26.1	11.8	23.5	12.0	3.0	1.6	2.4	1.6	113.1	8.9
Other[4]	103.1	78.0	68.1	58.4	31.5	10.7	20.6	7.4	1,043.7	163.9
Total	1,175.6	1,181.4	792.9	890.8	170.4	117.5	58.4	72.0	14,069.6	1,687.2

[1] OECD countries only, excluding Iceland and Turkey. [2] Net issues adjusted for exchange rate changes. [3] Including international institutions. [4] Including the ECU.

Sources: Bank of England, ISMA, national authorities and BIS.

be underestimated, the increased presence of governments brings considerable benefits to the market by widening the range of benchmark reference paper and thus enhancing its liquidity. With the institutionalisation of investment and the growing importance of collateral and securities lending, liquidity is becoming a key consideration in global investment strategies.

Reduced borrowing by the private sector ...

Borrowing by the private sector in 1992 was adversely affected by the unfavourable economic conditions, which reduced demand and weakened creditworthiness, and by more readily available alternative funding opportunities. The most notable examples were US, Australian and Japanese industrial companies, which on balance made net repayments to the Eurobond market. In all three cases, borrowing tended to shift towards the EMTN and domestic markets. In particular, different perceptions of risk by dollar investors in Europe and the United States diverted activity towards the latter. Since April 1990, when private placements under the Security and Exchange Commission's Regulation 144A were liberalised, an increasing number of foreign names have availed themselves of the simplified US issuing rules to tap that vast market.

... except for LDC issuers

Private sector entities in the developing world were an exception to this general pattern, significantly strengthening their presence in the market. Borrowing by these entities was, however, subject to great selectivity on the part of investors, who often demanded substantial margins. Together, private borrowers from developing countries raised a total of $14 billion, compared with $12 billion in 1991. By far the largest borrower

Issuance by private sector entities in the domestic and international securities markets[1]

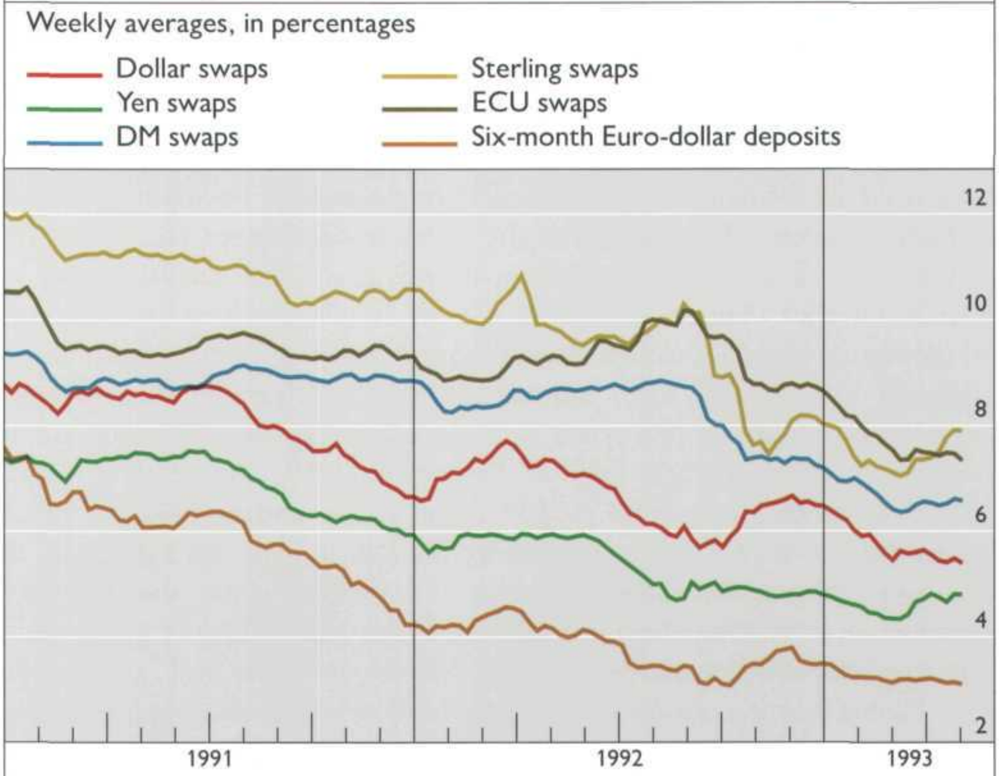
Countries and years	Domestic markets			International markets				*Memorandum items*	
	Total	of which		Total	of which			*Issues by financial insti-tutions*	*Inter-national securities*[3]
		Com-mercial paper	Bonds		Short-term Euro-notes[2]	Medium-term notes[2]	Bonds		
	net issues adjusted for exchange rate movements, in billions of US dollars								*in %*
United States									
1991	144.3	6.1[4]	138.2	4.5	3.7	2.6	− 1.8	*58.5*	*7.1*
1992	166.3	54.5[4]	111.8	−3.1	3.1	3.8	−10.0	*72.9*	*6.4*
Japan									
1991	53.0	−26.9	79.9	42.0	−0.1	−0.1	42.2	*48.1*[5]	*27.4*
1992	61.1	− 1.3	62.4	−0.1	0.3	−0.1	− 0.3	*39.4*[5]	*25.8*
Germany									
1991	97.7	5.4	92.3	10.7	1.1	0.2	9.4	*98.5*	*9.7*
1992	76.7	5.1	71.6	15.3	2.7	0.7	11.9	*83.4*	*10.4*
France									
1991	13.4	0.1	13.3	20.7	2.7	1.2	16.8	*27.5*	*25.9*
1992	11.9	2.6	9.3	18.2	0.0	0.8	17.4	*23.2*	*28.3*
United Kingdom									
1991	−0.9	0.4[6]	−1.3	30.2	4.2	2.9	23.1	*12.0*	*84.2*
1992	3.0	1.3[6]	1.7	17.6	0.3	3.9	13.4	*7.9*	*85.4*
Sweden									
1991	15.4	0.2	15.2	1.4	−1.6	0.6	2.4	*14.9*	*13.8*
1992	9.2	− 2.2	11.4	9.6	3.3	1.8	4.5	*13.9*	*19.9*
Italy									
1991	13.4	0.0	13.4	8.7	3.9	1.8	3.0	*19.9*	*23.7*
1992	7.9	0.0	7.9	0.8	−2.6	−0.1	3.5	*9.5*	*26.1*
Canada									
1991	0.6	0.7	−0.1	6.6	0.0	0.3	6.3	*−0.9*[5]	*52.6*
1992	2.3	− 0.5	2.8	−1.7	0.0	0.9	− 2.6	*−2.1*[5]	*52.2*
Australia									
1991	4.9	1.7	3.2	1.0	1.5	1.7	− 2.2	*4.2*[5]	*66.5*
1992	1.1	1.8	−0.7	−1.4	0.8	1.4	− 3.6	*−1.4*[5]	*65.8*
Other									
1991	30.2	1.6	28.6	19.9	1.7	5.4	12.8	*35.2*	*30.5*
1992	17.3	4.9	12.4	22.3	1.5	9.5	11.3	*23.5*	*33.2*
Total									
1991	372.0	−10.7	382.7[7]	145.7	17.1	16.6	112.0	*317.9*	*19.8*
1992	356.8	66.2	290.6[7]	77.5	9.4	22.6	45.5	*270.2*	*19.6*

[1] Excluding equities. [2] Net issues at current exchange rates. On a valuation-adjusted basis, total net issues of short-term Euro-notes in 1991 and 1992 amounted to $16.4 billion and $12 billion respectively. The corresponding figures for medium-term notes were $16 billion and $25.4 billion. [3] As a share of total securities outstanding in domestic and international markets at end-year. [4] Including corporate medium-term notes. [5] Excluding issues of commercial paper in domestic markets. [6] Including sterling medium-term notes issued by UK entities. [7] OECD countries only, excluding Iceland and Turkey.

Sources: Bank of England, ISMA, Euroclear, national authorities and BIS.

was Mexico, whose financial institutions had issued nearly $5 billion of privately placed certificates of deposit in 1991 and which in 1992 again issued $5 billion, split roughly equally between Euro-notes and bonds.

Selected long-term yields* and Euro-dollar deposit rates



* Yields in annual terms on five-year interest rate swaps.

Regulatory developments and the global bond concept

New steps taken in the deregulatory process ...

As mentioned above, various domestic regulatory developments affected the working of the international securities markets last year. With a few exceptions, the tendency has been towards a reduction of competitive inequalities. Thus, steps were taken last year by the Bundesbank to facilitate the issuing of DM-denominated bonds, notes and commercial paper. The new rules, which entered into force on 1st August, permitted listing on foreign stock exchanges, issuance under foreign law and clearance through international systems. The minimum two-year maturity for foreign non-bank issues was also abolished, opening the way to non-resident issues of DM commercial paper. Similarly, the Japanese Ministry of Finance eased the requirements to be met by Japanese entities issuing bonds overseas and by foreign borrowers tapping the domestic market.

... with varying implications for the Euro-market

Nonetheless, because of the large differences that still remain between national laws, tax regimes, trading regulations and practices and clearing and settlement arrangements, the impact of the deregulation of recent years has been far from uniform across currencies and countries. In the case of the dollar and, to a lesser extent, the yen, easier access to the domestic market has led to some repatriation of business at the expense of the Euro-market. By contrast, the German measures, which were explicitly designed to broaden the market for DM-denominated paper, boosted both domestic and Euro-paper issues. Similarly, the

Euro-french franc sector, which had expanded rapidly following the abolition of exchange controls in 1990, deepened further last year. At $22 billion, its growth exceeded that of its domestic French counterpart (excluding government issues), which remained more costly and less flexible.

The global bond concept: success ...

At the same time, recent regulatory developments have gone a long way towards evening out the competitive inequalities between Euro and domestic markets. The success of the global bond concept best illustrates this point. The technique consists in launching an issue simultaneously in North America, Europe and Asia. Global bonds combine the features of domestic bonds (through registration requirements) and Euro-bonds (through the fee structure) and can be held or cleared either through Euro-clearing systems (Euroclear and Cedel) or through domestic ones. Introduced by the World Bank in September 1989, the total of global bonds outstanding amounted to $37 billion at the end of 1992, of which nearly $15 billion was accounted for by the World Bank. All categories of borrowers were represented among the issuers, while the currency denomination, originally limited to the US dollar, included paper in Canadian and Australian dollars and yen.

... and limitations

Global bonds considerably enlarge borrowers' funding opportunities and reduce the costs. Subscribers to these bonds, mainly institutional investors, have been willing to accept a lower yield in return for a high degree of liquidity. The technique does, however, have its limitations. In order to qualify for US placement, issues have to fulfil the strict US registration requirements. Moreover, issuance is restricted to first-class names and, in the main, to large individual offerings. Finally, different perceptions among centres and different absorption capacities may restrict the links between markets. Indeed, several global issues were reported to have been subsequently absorbed almost entirely in one market, with differences in pricing conditions suggesting limited arbitrage.

The private ECU market

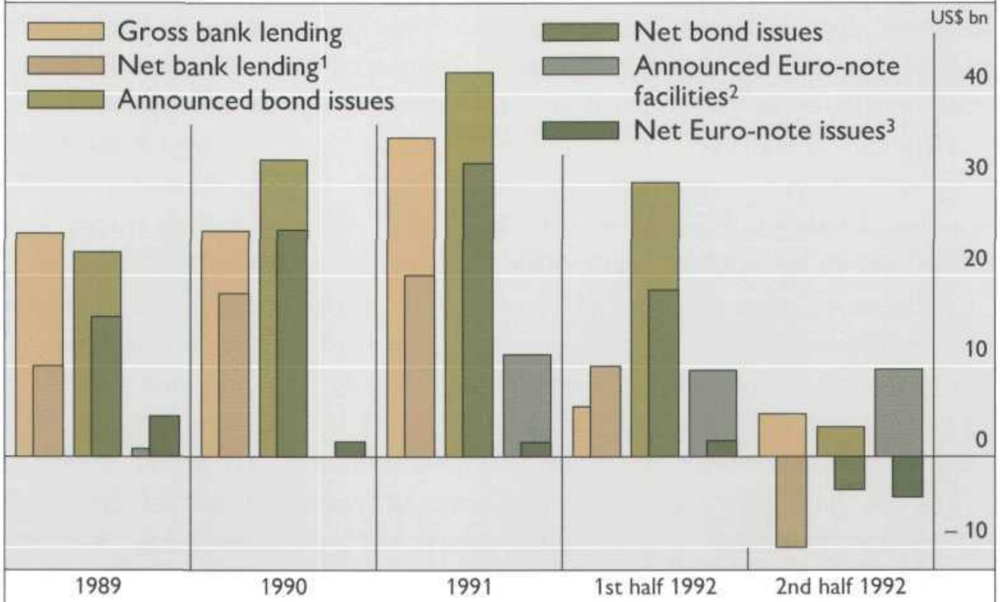
Abrupt turnround in ECU market activity ...

The abrupt reappraisal of the role of the ECU following the Danish rejection of the Maastricht Treaty on 2nd June 1992 had major effects on the private ECU market. The turnround appeared all the more dramatic because bullish sentiment after the Maastricht agreement in December 1991 had given a strong boost to ECU securities business. In the first six months of 1992 announced international bond issues denominated in ECUs amounted to a near-record $21 billion, while the expansion in the volume of paper outstanding, at close to $15 billion, was the largest in the Euro-bond market. On domestic markets, net new bond issues by the French and UK Governments totalled a record $5 billion. Indeed, with a total of $20 billion of sovereign and supranational benchmark bonds launched during that period, the depth and liquidity of the market increased considerably. In particular, two three-year UK Treasury notes and a thirty-year French Treasury bond were introduced for the first time. Secondary market trading in ECU securities through Cedel and Euroclear was 40%

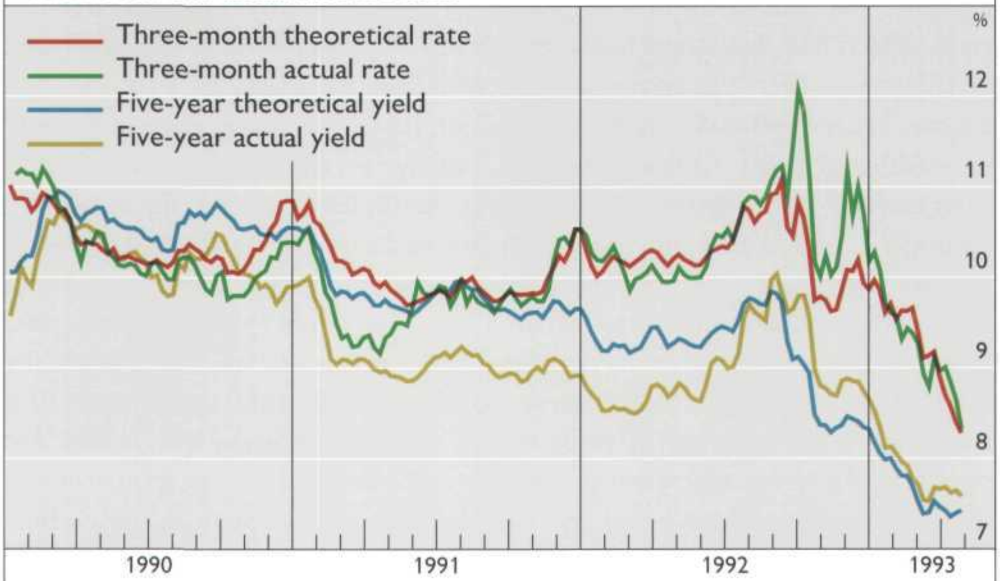
... from buoyant growth in the first half of the year ...

The private ECU market

Total financing



Theoretical and actual interest rates



[1] Estimates net of interbank redepositing. [2] Including multi-currency facilities denominated in ECUs. [3] Including Treasury bills.

Sources: Bank of England, ISMA, Euroclear, Paribas, national authorities and BIS.

above its 1991 average. Reflecting strong investor interest, yields were quoted at substantial discounts to their theoretical values.

Similarly, in the banking sector, large inflows of deposits from non-bank entities and official holders both within and outside the European Community led to an excess of supply over lending capacities. As a result, banks' combined ECU positions, which had been virtually in balance at the end of 1991, shifted to $16 billion of net liabilities at mid-1992. Downward pressure on deposit rates, pushing them below theoretical rates, encouraged some intermediaries to unbundle the basket into its constituent currencies.

New issues of ECU-denominated securities practically came to a standstill after 2nd June. In the secondary market the clearing mechanism of the International Securities Market Association (ISMA) collapsed and large-scale liquidation by institutional investors drove yields on benchmark issues from below to well above their theoretical levels. Government bill and bond programmes were suspended and transactions in less liquid paper virtually dried up. Trading in ECU futures on the MATIF was temporarily suspended, while holders of ECU deposits withdrew from the banking market.

... to a virtual standstill ...

However, the outcome of the first Danish referendum was only one factor influencing activity in the private ECU in the second half of 1992. At the beginning of the year, the market had already been showing increasing signs of strain. As the initial euphoria following the Maastricht agreement waned, concerns about its practical implementation started to develop. Unfulfilled expectations of European interest rate cuts and of exchange rate stability added to the uncertainty. Large government issuance programmes resulted at times in absorption difficulties, while intense competition and the growing number of market-makers squeezed profit margins. The discount on five-year ECU bonds vis-à-vis their theoretical yield, which had fluctuated between 50 and 75 basis points in the early part of the year, began to narrow in May, when the possibility of a referendum on the Treaty, officially announced on 5th June, was being aired in France.

... as increasing strains ...

Although heavy selling pressure rapidly developed after the Danish referendum, the market did not dry up. Indeed, transactions on the secondary market and the volume of contracts traded on the MATIF were at their highest in June. The spread between market and theoretical yields soon narrowed and fluctuated within a thin margin until the end of August. Thereafter, uncertainties surrounding the ratification of the Treaty by member states, in particular prior to the French referendum on 20th September, the build-up of pressure on several European currencies and the related interest rate divergence between individual European currencies were the main depressive factors. The crisis reached its peak in September, when the differential between five-year actual and theoretical ECU yields, which had become positive in August, widened to more than half a percentage point.

... lead to a general reassessment of the ECU

There was, nonetheless, some evidence of market resilience during the second half of the year. Despite the suspension of many issues, government support was not entirely lacking; in particular, the UK monthly ECU Treasury bill auctions and the Greek ECU-linked bond programmes were maintained, albeit generally at a slower pace than before. Moreover, secondary market activity and trading of short and long-term futures contracts remained on average above their 1991 level. In addition, banks' assets in ECUs continued to expand, despite large-scale liquidation of deposits by a wide range of investors, leading to a $16 billion fall in banks' ECU liabilities and obliging banks to reconstitute ECUs. As a result, banks' combined ECU positions shifted back from $16 billion of net liabilities at the

Evidence of market resilience ...

end of June to $4 billion of net assets at the end of the year. Interbank clearing operations, far from contracting, reached a record average daily turnover of ECU 56 billion in September and continued to exceed the 1991 average throughout the rest of the year. The clearing system also benefited from the commitment by several central banks to provide lending and borrowing facilities for participants. Bank liquidity was supported by the shift of investors away from long-term placement, as substantial amounts of ECU-denominated bonds were redeemed. There were also new ECU-denominated syndicated facilities granted to the United Kingdom and Sweden, to replenish foreign exchange reserves and finance the public sector deficit, although the funds were drawn in Deutsche Mark and other national currencies.

... materialises in early 1993

Confidence revived somewhat at the beginning of 1993, with a return of both borrowers and investors. In the first quarter announced new bond issues amounted to $4 billion, all for sovereign and supranational bodies. A large volume of redemptions available for reinvestment was a major supportive factor, as expansion in the ECU bond market net of redemptions amounted to only $1.2 billion.

The markets for derivative instruments

Exchange-traded financial futures and options

Record turnover of exchange-traded instruments ...

Turnover of financial futures and options contracts traded on organised exchanges increased by 35% in 1992, well above the expansion recorded in the previous year. Growth in European markets was especially sharp, but turnover on US, Latin American and many Asian exchanges also expanded strongly. However, activity shrank in Japan for the second year running.

... amidst money market and currency turbulence ...

The explosion in trading in Europe reflected first and foremost the hedging needs that arose in connection with the volatility of interest rates during the currency turbulence. However, the surge also reflected difficulties in effecting cash market hedging transactions, as well as the shrinking of liquidity in over-the-counter (OTC) interest rate and foreign exchange related derivatives markets. The growth in turnover was by far the strongest for short-term interest rate instruments. Turnover in short-term DM and French franc futures rose to well over twice their previous record levels, with trading during September alone accounting for about one-sixth of the total for the year. Activity in the main interest rate futures and related options on European long-term government bonds also expanded significantly in this period, as did turnover in the smaller Italian, Spanish and Nordic futures markets.

... with futures supporting liquidity in cash markets ...

The turbulence provided a further illustration of the role of interest rate futures in supporting liquidity in underlying cash markets, especially in unsettled times. In a number of countries whose currencies came under pressure, liquidity in cash instruments with no corresponding futures contract suffered more than in markets where contracts were available, causing pricing anomalies across the yield curve in government bond markets. In response, some exchanges, notably those in France, Italy and

Derivative financial instruments traded on organised exchanges worldwide						
Instruments	Annual turnover of contracts					Open positions at end-1992
	1988	1989	1990	1991	1992	
	in millions					in billions of US dollars
Interest rate futures	156.3	201.0	219.1	234.7	335.4	3,048.1
On short-term instruments	33.7	70.2	75.8	84.8	130.8	2,802.3
of which: Three-month Euro-dollar rates[1]	*25.2*	*46.8*	*39.4*	*41.7*	*66.9*	*1,389.6*
Three-month Euro-yen rates[2]	*0.0*	*4.7*	*15.2*	*16.2*	*17.4*	*431.8*
Three-month Euro-DM rates[3]	*0.0*	*1.6*	*3.1*	*4.8*	*12.2*	*229.2*
On long-term instruments	122.6	130.8	143.3	149.9	204.6	245.9
of which: US Treasury bonds[4]	*73.8*	*72.8*	*78.2*	*69.9*	*71.7*	*31.3*
French government bonds[5]	*12.4*	*15.0*	*16.0*	*21.1*	*31.1*	*21.0*
Japanese government bonds[6]	*18.8*	*19.1*	*16.4*	*12.9*	*12.1*	*105.9*
German government bonds[7]	*0.3*	*5.3*	*9.6*	*12.4*	*18.9*	*27.8*
Interest rate options and options on interest rate futures	30.5	39.5	52.0	50.8	64.8	1,385.4
Currency futures	22.1	27.5	29.1	29.2	30.7	24.5
Currency options and options on currency futures	18.2	20.7	18.8	21.5	23.0	80.0
Total	227.1	288.6	319.1	336.2	453.9	4,538.0
of which: In the United States	*165.3*	*198.1*	*205.7*	*199.7*	*238.7*	*2,538.2*
In Europe	*32.6*	*49.0*	*61.0*	*84.4*	*140.5*	*1,055.4*
In Japan	*18.8*	*23.7*	*33.6*	*30.0*	*28.7*	*537.6*

[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 TIFFE and SIMEX. [3] Traded on the Marché à Terme International de France (MATIF) and LIFFE. [4] Traded on the Chicago Board of Trade (CBOT), LIFFE, Mid-America Commodity Exchange (MIDAM), New York Futures Exchange (NYFE) and Tokyo Stock Exchange (TSE). [5] Traded on the MATIF. [6] Traded on the TSE, LIFFE and CBOT. [7] Traded on the LIFFE and Deutsche Terminbörse (DTB).

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

Spain, have introduced new futures contracts to fill gaps in the maturity spectrum.

... and alleviating liquidity problems in some OTC markets

Despite the intensity of pressures on exchange rates, turnover in currency-related futures and options traded on organised markets expanded by a modest 5% and 7% respectively. These markets have in the past been overshadowed by OTC forward foreign exchange and options markets. However, liquidity problems in the European cross rate segments of the latter markets in September and October diverted business to organised markets, causing turnover of exchange-traded options on the principal ERM currencies to expand to twice their normal levels in September. This upsurge in activity subsided as liquidity in the OTC markets improved towards the end of the year.

Over-the-counter markets

Although some segments suffered significant setbacks during and after the European currency turmoil, activity in the principal OTC markets continued to grow at a rapid pace.

Markets for selected derivative instruments traded over the counter[1]						
Instruments	New contracts arranged					Amounts outstanding at end-1991
	1988	1989	1990	1991	1992 H I	
	in billions of US dollars					
Interest rate swaps	568.1	833.5	1,264.3	1,621.8	1,318.3	3,065.1
Currency swaps[2]	124.2	178.1	212.8	328.4	156.1	807.2
Other swap-related derivatives[3]	..	335.5	292.3	382.7	293.6	577.2
Total[4]	..	1,347.1	1,769.4	2,332.9	1,768.0	4,449.5

[1] Underlying notional principal amounts on which contracts are struck. [2] Adjusted for reporting of both sides, including cross-currency interest swaps. [3] Caps, collars, floors and swaptions. [4] Excluding other over-the-counter instruments such as forward rate agreements, currency options, forward foreign exchange transactions and equity and commodity-related derivatives.

Source: ISDA.

Surge in interest rate swaps between financial entities ...

Interest rate and currency swaps. In the first half of 1992, the last period for which figures are available, a record $1,318 billion (notional principal amount) of new interest rate swaps was arranged, or only 20% less than in the whole of 1991. The surge reflected both the buoyancy of underlying debt markets and further growth in the use of swaps by financial institutions for risk management and funding purposes. On the end-user side of the market, transactions with European and US financial and non-financial corporations as well as public sector entities expanded markedly. Indeed, European financial entities accounted for nearly one-third of all new end-user swaps in the first half of 1992, up from 24% in 1991, whereas business with Asian financial counterparties fell off. New contracts in currencies other than the US dollar came close to matching new dollar-denominated swaps, pointing to the spreading use of interest rate swaps worldwide. Particularly strong growth was recorded in the Deutsche Mark, French franc and Italian lira sectors, but most other currencies shared in the upsurge.

... and in non-dollar currencies ...

... but reduced activity in currency swaps

Growth in the currency swap market, which had exceeded that in the interest rate swap market in 1991, tapered off in the first half of 1992. New swaps involving the yen fell off sharply, and declines were also

Main features of the interest rate swap market							
Components	US dollar	Japanese yen	Deutsche Mark	Pound sterling	Swiss franc	French franc	Other
	notional principal value in billions of US dollars						
Swaps outstanding at end-1991							
by counterparty: End-users	831.0	214.0	152.2	147.3	72.9	99.0	206.4
Interbank*	675.0	264.9	111.2	106.3	64.7	16.6	103.6
New swaps in the first half of 1992							
by counterparty: End-users	360.1	76.9	53.3	41.8	18.5	60.1	89.9
Interbank*	321.9	113.8	49.0	43.9	20.7	9.0	59.4

* Swaps between ISDA members adjusted for double-counting of positions.

Source: ISDA.

Composition of new currency swaps in the first half of 1992

Currencies	Total notional amount[1,2]	of which: Against US dollar[2]	of which: Against other currencies[2]	of which: End-user	of which: Fixed/ floating[2]
	in billions of US dollars				
Japanese yen	38.0	26.0	12.1	26.6	16.2
Swiss franc	26.3	8.8	17.5	21.5	7.0
Deutsche Mark	24.4	10.7	13.7	19.7	9.0
ECU	19.8	11.4	8.4	17.1	9.7
Canadian dollar	16.4	13.8	2.6	15.2	7.3
Pound sterling	15.5	8.2	7.3	13.5	5.2
Italian lira	15.3	8.5	6.8	11.8	8.7
Sub-total	155.7	87.4	68.3	125.4	63.0
Other	49.9	19.2	30.7	35.6	22.3
minus: Double-counting of non-dollar swaps	*−49.5*		*−49.5*	*−39.1*	*−16.1*
Total	156.1	106.6	49.5	121.9	69.2

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

Source: ISDA.

recorded in contracts involving the Swiss franc and the US dollar. A notable feature was the sharp contraction in the share of new swaps arranged between the principal swap intermediaries. On the end-user side, financial institutions also reduced their share, and growth was concentrated among European governments and US and Asian corporations.

Expansion in swap-related instruments

Other swap-related derivatives. Along with the growth of the interest rate swap market, the markets for swap-related instruments expanded vigorously. Reflecting the heavy volume of new capital market issues at the low level of US interest rates, a large amount of dollar-denominated interest rate caps was sold to floating rate issuers wishing to lock in low rates. Combinations of caps and floors also increased, associated in part with the growth of collared floating rate issues. Swaptions traded among interbank entities in European currencies also rose sharply, as views began to firm that interest rate changes were in store in Europe. However, swaptions trading slowed down in the second half of the year as the turbulence in money and foreign exchange markets made them increasingly difficult to hedge and price.

Other developments

Competition between organised exchanges intensifies ...

As far as organised markets are concerned, the year under review saw the continuation of two trends which have emerged in recent years. On the one hand, competition for market share between organised exchanges, and between exchanges and OTC markets, intensified further. In Europe, futures on Spanish government bonds were introduced almost simultaneously in Barcelona and in London. Likewise, contracts on medium-term German bonds started trading in both Frankfurt and London. On the other

... motivating new alliances to stem fragmentation of trading ...

hand, reflecting a growing recognition that a fragmentation of trading also undermines liquidity and drains business away to OTC instruments, new alliances between markets were announced. The Marché à Terme International de France (MATIF) and the Deutsche Terminbörse (DTB), the second and third-largest exchanges in Europe, agreed early this year to allow their members to trade certain of their respective contracts, and to consider further linking of their markets and trading arrangements. The Chicago Board of Trade (CBOT) and the London International Financial Futures Exchange (LIFFE) also contemplated listing some of each other's products. These alliances come on top of that formed last year between four smaller European exchanges and complement Globex, the 24-hour global screen-based automated trading system which gives dealers access to a range of contracts through one electronic medium. The incentives which such alliances represent for the adoption of common trading and clearing practices are likely to lead to greater convergence across exchanges and more integrated futures and options markets in the years ahead.

... and promising greater convergence in future ...

The migration of trading to OTC markets also spurred some exchanges, notably in the United States, to consider introducing contracts that have some of the flexibility of OTC instruments but at the same time offer the clearing-house benefits and price transparency advantages of exchange-traded contracts. Plans also re-emerged for clearing-house arrangements for OTC contracts. Such arrangements could reduce the counterparty credit risk inherent in OTC instruments; this risk has led to a high degree of concentration of such business on a small number of highly rated firms. They could also lessen the incentives for lower-rated firms to establish separately capitalised AAA-rated derivatives subsidiaries, as many have lately sought to do. Doubts have been raised as to whether the capital costs associated with such entities can be justified, and whether they would be immune from the contagion problems that beset conglomerate structures when one of their affiliates encounters problems. Bank regulators have also expressed reservations about the tying-up of parent capital and collateral in such units for the benefit of selected counterparties.

... perhaps even between features of OTC and organised markets

Some legal ambiguities are resolved ...

The year under review also saw the removal of certain legal uncertainties affecting some segments of the derivatives markets. The International Swap Dealers Association (ISDA) published its new Master Agreement, which clarified the rights and obligations of swap counterparties in the event of default. In the United States, a dispute as to whether a swap should be considered to be a futures contract, and thus be traded on organised exchanges and subject to regulatory oversight, emerged in connection with the congressional re-authorisation of the regulatory powers of the Commodity Futures Trading Commission (CFTC). While not in the end adopted, a ruling defining swaps as futures contracts would have called in question the legality and enforceability of swaps involving US counterparties. This could have created a situation akin to that following the UK ruling which declared swaps entered into by UK local authorities to be null and void, but would have affected a much larger section of the swap market.

Expressions of regulatory interest in the burgeoning OTC markets multiplied last year, following from, as well as spurring, a number of studies of the risks in this business. While none of these studies disputed the value of derivative instruments for risk hedging purposes, regulatory concerns centred on four areas: the adequacy of risk management practices at the level of individual firms; the presumption of liquidity and other assumptions which underlie the pricing and trading of derivative products; the deepening linkages that derivatives have encouraged across markets; and the lack of transparency in the derivatives markets themselves. The relevance of some of these concerns was underscored by the difficulties experienced in the markets for options and options-related foreign exchange and interest rate instruments at the time of the ERM turbulence. A large number of options on ERM cross rates were struck at or beyond the mechanism's intervention limits when currencies were still within the parity grid. As long as the central parities were considered viable, no hedging on the part of option writers was deemed necessary. However, as uncertainty mounted as to the credibility of central rates, these positions became exposed. This triggered a scramble to hedge, putting further pressure on the currencies under attack. Both the pricing and hedging of options became progressively more difficult as the greater volatility of underlying prices rendered pricing models invalid, and as liquidity tightened in the money markets of weakened currencies. This drove up implied volatility and spreads in the currency options market and brought trading to a halt for much of September. While central bank intervention enabled some option writers to cover their positions, the devaluations that ensued left others with substantial losses.

... but regulatory interest mounts ...

... with some concerns underscored by the ERM crisis

There are signs that the turbulence has led many market participants to re-examine their pricing models and risk management practices and to reassess their presence in markets that are often highly concentrated. The market segments worst affected by the turbulence have since seen less activity, and spreads, which increased sharply during the crisis, have remained wide.

Gold

Lacklustre price performance

Despite a pronounced strengthening of demand in Asia, the price of gold fell again last year. Purchases for industrial and related uses, most notably jewellery, exceeded western mine production by a wider margin than in 1991. Significant disposals of official holdings and various gold-related financial operations added to the supply, while net absorption by other countries, notably China, reduced amounts available in western markets.

Increased mine output ...

Western mine output expanded by 3.7%, having grown by 1.7% in 1991. The increase was broadly based, with greater output in the newer, lower-cost mining regions as well as in South Africa and the United States. The reversal of the downward trend in the world's largest producer country can be attributed to the depreciation of the rand vis-à-vis the US dollar and some modest improvements in productivity, both of which

Estimated market sources and uses of gold					
Items	1988	1989	1990	1991	1992
	in tonnes				
Western world production[1]	1,550	1,680	1,745	1,775	1,840
South Africa	*621*	*608*	*605*	*601*	*614*
United States	*201*	*266*	*294*	*294*	*322*
Australia	*157*	*204*	*243*	*236*	*240*
Canada	*135*	*160*	*167*	*177*	*157*
Brazil	*102*	*101*	*84*	*79*	*77*
Papua New Guinea	*37*	*34*	*34*	*61*	*71*
Chile	*27*	*29*	*33*	*33*	*40*
Indonesia	*12*	*11*	*13*	*18*	*40*
Others	*258*	*267*	*272*	*276*	*279*
Changes in official stocks[2]	−175	175	35	70	320
Net supply from financial operations[1,3]	330	140	240	40	150
Other suppliers[4]	260	300	350	250	−100
Total (= estimated non-monetary absorption)	1,965	2,295	2,370	2,135	2,210
Memorandum items:	annual averages, in US dollars per ounce				
Market price of gold					
in current US dollars	*437*	*381*	*384*	*362*	*344*
in constant US dollars[5]	*99*	*82*	*79*	*71*	*66*

[1] As published by the Gold Fields Mineral Services Ltd. (London). [2] As reported to the IMF; − = increase in official stocks. [3] Including gold loans, forward sales and option hedging. [4] Net amount supplied to western markets by the former Soviet Union, China and some minor producers. [5] Deflated by the US consumer price index (1953 = 100).

supported mining profitability. Net supply from gold-related operations added an estimated 150 tonnes to the market.

Information on gold transactions in Russia and China remains sketchy. Nevertheless, the available evidence suggests that the former Soviet Union continued to supply important quantities to western markets notwithstanding production difficulties and a reported increase in official holdings.

... offset by net absorption by China

However, it appears that China absorbed much more gold than was supplied to the market by the former Soviet Union. Although production in China continued to expand, strong economic growth, worsening inflationary pressures and a dearth of financial assets offering real positive returns underpinned demand in that country.

Substantial official sales

Net official gold holdings declined by 320 tonnes in 1992, the largest fall since 1979. Much of the decrease was the consequence of Belgium's sales of 202 tonnes in June. However, owing to the return of some gold previously swapped with the EMCF, the country's holdings did not fall by the full amount of its sales. The second-largest reduction was the 94 tonne drop in Canada's reserves, which amounted to only 309 tonnes at year-end, compared with 630 tonnes ten years earlier. Total official holdings continued to decline in the early months of 1993, mainly as a result of the settlement of forward sales in November of 400 tonnes by the Dutch central bank.

Reduced price volatility in 1992

In the aggregate, non-official demand for gold display greater strength in 1992, owing mainly to increased purchases in Asia. Apart from contributing to a minor and temporary rise in the gold price in July and again in September, the considerable turmoil in the foreign exchange market did little to enhance the appeal of gold. Even in the period of the most severe turbulence gold traded in quite a narrow range. Indeed, interday price volatility continued to decline in 1992, with the standard deviation of day-to-day percentage changes in quotations falling to only 0.49 from a low of 0.70 one year earlier.

Prices remained in a narrow trading range of $326–338 in the first quarter of 1993. Subsequently, however, highly publicised transactions by some prominent investors, strong underlying consumption demand and renewed investment interest suddenly pushed the price to a twenty eight-month high of nearly $382 in mid-May.

VI. Monetary policy: domestic and external aspects

Highlights

Against a background of spreading recession and currency turmoil in Europe, monetary policy was eased in many industrial countries last year, although the easing was undertaken at different times and under differing circumstances. Short-term interest rates were lowered further in the United States and Japan in efforts to support economic expansion and were brought down in Germany starting in September. In many European countries monetary policy was tightened as from mid-1992 to underpin exchange rate commitments and was subsequently eased back at varying speeds.

Monetary authorities in several European countries faced severe policy conflicts. On the one hand they desired to preserve a medium-term policy framework which had been designed to keep the exchange rate stable and to control inflation. On the other hand, their policy options were increasingly constrained by private sector debt burdens and the weakness of output and employment. In a number of countries devaluation or floating involved a change in intermediate objectives or a reduction in their role in the conduct of monetary policy. Efforts are now being made in individual countries to re-establish the credibility of monetary policy by basing it on revised exchange rate levels or on other anchors, including monetary aggregates and explicit inflation objectives. How effective the various new approaches will prove remains to be seen.

European monetary authorities responded to pressure on their currencies during the year with substantial exchange market intervention and, in varying degrees, increases in interest rates. Extensive exchange market intervention complicated monetary management in countries experiencing capital inflows as well as in those experiencing outflows. Developments last year clearly showed that the possibility of adhering to existing exchange rate commitments largely depends on the willingness and ability of the authorities to increase money market interest rates even when this conflicts with domestic considerations. Differing country experiences suggest that when policy dilemmas arose the viability of exchange rate commitments to some extent depended on the availability of policy instruments and on transmission mechanisms which affect the response of key domestic lending charges to changes in money market rates. Ultimately, however, the resolve of several authorities to accept sustained increases in interest rates when market sentiment shifted dramatically was weakened because the costs of coping with basic misalignments and divergences in cyclical conditions without exchange rate adjustment became too high.

Monetary policy objectives and indicators of stance

Monetary policies based on a broad range of indicators ...

Difficulties encountered in recent years in using monetary aggregates as intermediate policy guides have led in the United States, Japan, Australia and some other countries to policies based on a broad range of indicators. In a number of countries, the difficulties at first stemmed mainly from the direct impact of deregulation and financial innovation on the predictability of the demand for money and the response of monetary aggregates to interest rate policy. More recently, problems experienced by deposit institutions in the United States and asset price cycles in Japan and some European countries have impaired the reliability of the monetary aggregates as leading indicators of inflation and output. Unable to use monetary aggregates as a focus for the presentation of policy, several central banks have increasingly in recent years placed greater emphasis on the ultimate objective of price stability. In Canada and New Zealand the objective of lowering inflation over time was quantified in published targets. Quantified inflation objectives were also announced in the United Kingdom, Sweden and Finland after these countries suspended their exchange rate commitments last year.

Because price-setting behaviour in the goods and labour markets does not respond immediately to changes in monetary conditions, monetary policy may have a direct effect on output in the short run. The potential for such effects – the stance of policy – is often judged by developments in short-term interest rates. Depending on the size and openness of the economy, allowance has also to be made in assessing the potential impact of policy for the effect of movements in the exchange rate, which constitutes a major channel through which monetary policy influences aggregate demand. In the industrial countries with long-established floating exchange rate regimes – the United States, Canada, Switzerland and Australia – the stance of policy, as indicated by developments in short-term interest rates and the exchange rate, eased further last year. However, in several of these countries, the lagging response of other interest rates to declines in short-term money market rates continued to weaken the impact of monetary stimulus on economic activity.

... eased further last year

Exchange rate objectives and policy stance in European countries

In most European countries exchange rate commitments had for some years served to bring about inflation convergence. For many years interest rate policy in Germany has been geared to countering domestic inflationary pressures, with a monetary target continuing to play a considerable role in policy decisions. As a result short-term money market rates edged up until mid-September 1992. In other European countries exchange rate commitments have to a large extent determined the stance of monetary policy. In most of these countries monetary policy last year was significantly affected by the September exchange market crisis. When defending exchange rate commitments called for increases in money market interest rates, conflicts with short-term domestic policy objectives intensified. This was particularly the case in the United Kingdom, Sweden, Italy and Ireland. A gradual easing of monetary policy in Germany after mid-September permitted short-term interest rates to be lowered subsequently in a number of the countries which remained within the EMS exchange rate mechanism. In countries which floated their currencies last year the suspension of the exchange rate commitment was followed by a lowering of short-term interest rates to a varying extent, with most of the currencies undergoing substantial depreciation.

Monetary policy in countries with established floating exchange rate regimes

In the United States, Japan, Canada and Australia central banks have for some time been bringing about significant declines in short-term interest rates in response to weakness in the economy. In Canada and Australia there has been a striking fall in inflation. Between early 1992 and the spring of 1993 short-term interest rates were brought down further, on balance, in all of these countries and in Switzerland.

Easing of interest rate policy in the United States ...

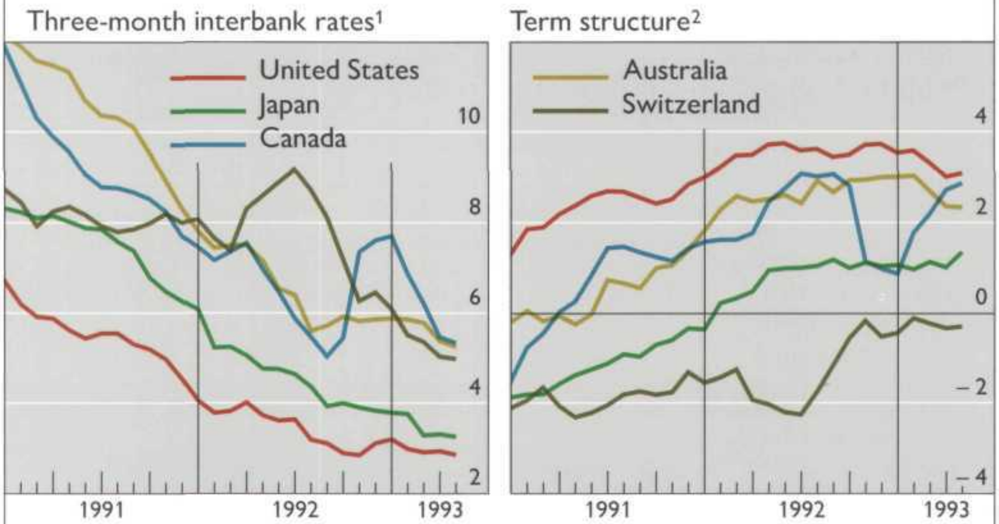
A further marked easing of interest rate policy in the United States in late 1991 brought the federal funds rate to around 4%, compared with nearly 10% at its April 1989 peak. Though aware of the lags in the operation of monetary policy, the Federal Reserve viewed a quickening in the pace of the economic recovery as consistent with further progress towards price stability, considering the prevailing degree of under-utilisation of resources and the financial constraints on the recovery. Responding to indications that the previous easing had not stimulated economic activity as much as expected, it lowered the federal funds rate, in three stages, to around 3% in September 1992. At 3% as from July, the official discount rate stood at the lowest level since 1963.

... Japan ...

The Bank of Japan also sought to facilitate an economic recovery and an improvement in private sector balance-sheet positions by encouraging

Short-term interest rates and differentials with bond yields

Monthly averages



[1] For the United States, Treasury bills; for Canada, prime corporate paper; for Australia, bank bills.
[2] Representative government bond yield less three-month rate.

declines in short-term market interest rates. It gradually lowered its discount rate from 6% in June 1991 to 2½% in February 1993. This level had been reached previously only in the 1987–89 period. The fiscal expansion measures announced by the Government between August 1992 and April 1993 could be seen as helping to reduce the burden placed on monetary policy to an extent which is precluded in most other countries by constraints on fiscal policy.

... Canada ...

In Canada short-term interest rates were brought down nearer to comparable US rates between March and August 1992, in response to deep recession and evidence that the published inflation targets were within reach. Short-term interest rates were sharply increased when the Canadian dollar came under severe downward pressure in September in connection with the constitutional referendum and in November under the influence of concerns about the budget deficit and the financial difficulties of some large Canadian firms. Money market rates were lowered in early 1993 when pressures on the exchange rate subsided. In Australia, a substantial lowering of short-term interest rates began in January 1990 and continued until July 1992, and the Australian dollar weakened considerably in effective terms. Overnight cash rates subsequently remained unchanged until March 1993, when they were lowered from 5¾ to 5½%.

... Australia ...

... and Switzerland

In Switzerland short-term interest rates had to be raised in early 1992 to counter a sharp weakening of the Swiss franc vis-à-vis the Deutsche Mark but were lowered substantially when the currency subsequently strengthened in the wake of the crisis in the ERM.

Developments in the monetary aggregates

The unusually weak recovery of economic activity in North America and the recession in Japan continued to raise questions about the influence of financial constraints and the effectiveness of monetary policy in stimulating output. While some observers argued that the fast growth of M_1 recorded last year in the United States might herald a resurgence of inflation, others suggested that the slow growth of bank credit and broad monetary

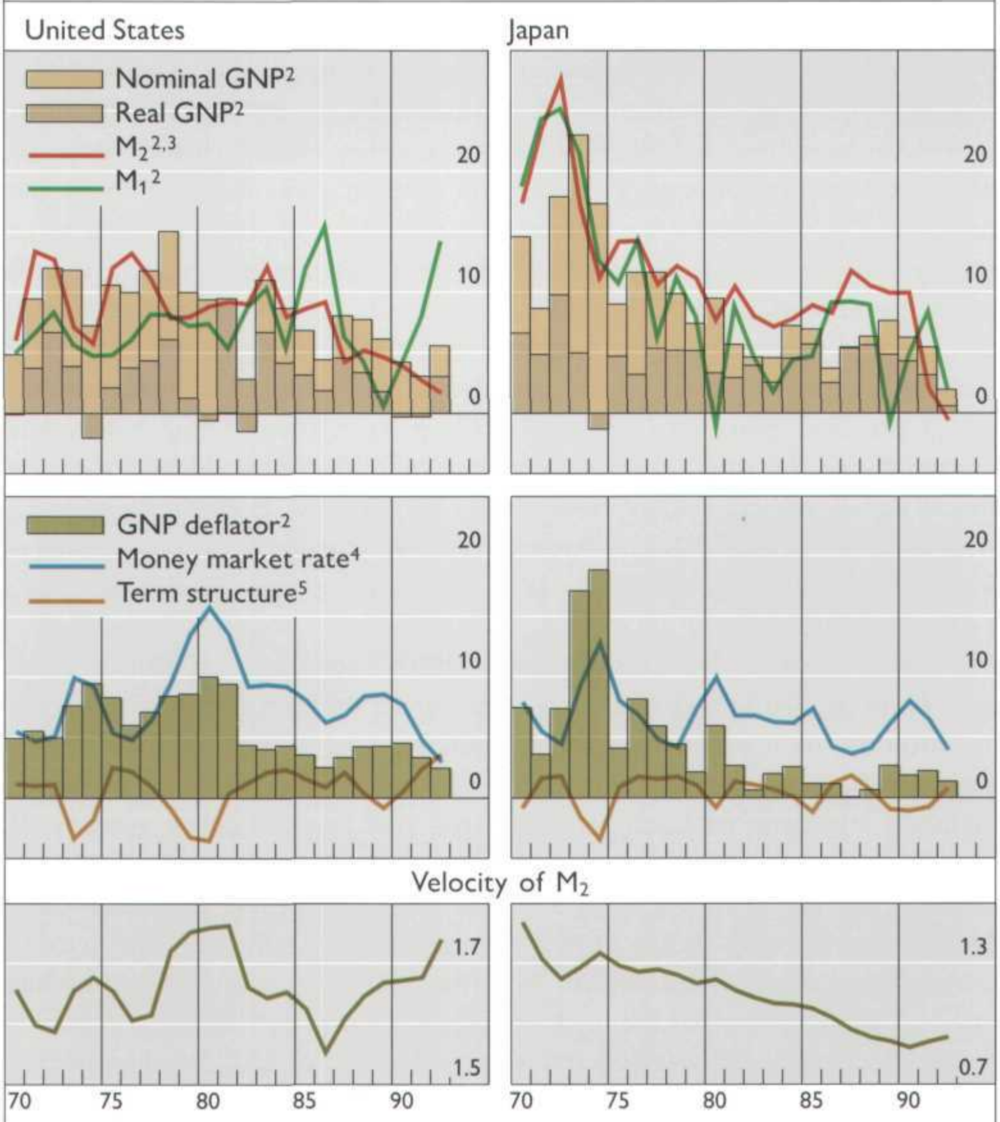
Published objectives of monetary policy

		United States			Japan	Switzer-land	Canada
		M_2	M_3	TDNS	M_2 + CDs	CBM	CP
		fourth quarter to fourth quarter changes, in percentages[1]					
1992	Objective[2]	2½–6½	1–5	4½–8½	ca. 0	−0.6	2–4
	Outcome	1.8	0.3	4.9	−0.5	−1.0	2.1
1993	Objective[2]	2–6	½–4½	4½–8½	< 1[3]	1.0	1½–3½

Note: TDNS = total domestic debt of non-financial sectors; CBM = central bank money stock; CP = consumer prices.

[1] For Canada for 1992, December to December, for 1993, twelve-month period ending in June 1994. [2] For TDNS in the United States, monitoring range only; for M_2 + CDs in Japan and CBM in Switzerland, projection only. The figure shown for Switzerland for 1993 is a medium-term norm only. [3] Second quarter to second quarter.

Source: National data.



[1] Based on fourth-quarter data. [2] Annual changes, in percentages. [3] For Japan, M_2 + CDs. [4] For the United States, federal funds; for Japan, overnight call money. [5] Ten-year government bond yield less money market rate.

aggregates in the United States and Japan indicated a need for stronger monetary stimulus. In fact central banks in these countries no longer rely on only one aggregate as the main policy guide.

Influences on the weak growth of M_2 in the United States ...

In the last two years weakness in the growth of M_2 in the United States and of M_2 + CDs in Japan has reflected developments in the supply of and demand for credit in a way which mirrored weakness in the economy. However, the demand relationships for these aggregates have changed fundamentally, as is illustrated by the unusual rise in income velocity when short-term interest rates fell last year. In the United States, where the contrast with previous experience was particularly striking, part of the explanation may be found in the unprecedentedly large gap between long and short-term interest rates. However, new aggregates constructed by adding the non-bank public's holdings of stock and bond investment fund shares, which increased strongly in 1991 and 1992, have not shown stable relationships with prices and output. Indeed, the unexpected rise in the velocity of M_2 accompanying the declines in interest rates largely reflected the speed with which banks lowered deposit rates in response to falling market rates, and a tendency for households to use funds that might otherwise have been held in M_2 balances to repay loans following steps by banks to widen the margin between the interest rates on their loans and deposits. The change in the velocity of the aggregate is thus to a large extent attributable to the response of deposit institutions to loan losses, which resulted in a decline in their share of total borrowing and lending in the financial markets. As the relationship between the growth of M_2 and nominal income seemed to be undergoing a significant transformation, policy was not geared to preventing M_2 growth from falling below the lower limit of the official target range last year. Moreover, judging that the special influences on velocity were likely to continue in the near term, if with diminished intensity, the Federal Reserve lowered the target ranges for the monetary aggregates for 1993, emphasising that this did not imply a change of policy.

... and of M_2 + CDs in Japan

The decline in M_2 + CDs in Japan in 1992, following very slow growth in 1991, in part reflected a reversal of an earlier interest rate induced accumulation by the corporate sector of time deposits financed by bank loans, and shifts between deposits with banks and the postal system. More fundamentally, the Bank of Japan attributes the rise in the income velocity of M_2 + CDs partly to reduced efforts by banks to expand their loans and deposits and partly to the effects of the asset price cycle on the demand for deposits for both transactions and wealth-holding purposes. The greater sensitivity of deregulated deposit interest rates to movements in market rates in recent years has made the aggregate more difficult to control.

Misleading signals given by the weak expansion of traditional monetary aggregates increased the difficulties confronting central banks in explaining why policy was not eased more in recession. However, the problems central banks face in defending policy are likely to become greater when a strengthening of economic activity calls for rises in interest rates if it is not possible to identify aggregates whose development supports the need for a tightening of policy.

Developments in credit markets

Financial constraints on economic recovery in the United States ...

In the United States signs that financial constraints on economic growth were easing emerged by the end of last year. Federal Reserve surveys indicated that bank lending standards were not being tightened further and were being relaxed in some cases. Spreads between interest rates charged on bank lending and the federal funds rate remained unusually wide. However, wide spreads had bolstered banks' profits and thus facilitated their fund-raising in equity and debt markets. During the last two years, when the growth of bank lending was weak, banks accumulated substantial portfolios of government securities. A similar build-up has occurred in some previous recessions. Banks now seem well placed to meet private demand for credit as it recovers. Last year the supply of business credit from life assurance and finance companies also continued to be restrained by the efforts of these intermediaries to restructure their balance sheets. However, the potential impact of difficulties experienced by car sales finance companies in raising funds on the availability and cost of consumer credit was counteracted by increased securitisation of consumer loans. The adjustment of the financial markets to the contraction in the activities of deposit institutions, particularly in the field of mortgage financing, continued to mitigate the effect on the overall availability of finance. Higher share and bond prices encouraged a large volume of issues by non-financial companies, which were partly used to repay bank debt. Debt/income ratios in the corporate and household sectors fell and, reflecting also the decrease in interest rates, debt servicing burdens declined substantially.

... Japan, Canada and Australia

Last year economic activity weakened in Japan and remained weak in Canada and Australia. In all three countries the cyclical adjustment process was characterised by asset price declines, following earlier large rises, and by weak demand for credit associated with balance-sheet restructuring in the corporate sector. In Japan, notwithstanding sharp falls in asset prices, household indebtedness remains low. Balance-sheet strains were experienced mainly by real estate related businesses and financial institutions. Except in the case of real estate loans, weak demand for credit seems to have been the main cause of the very slow growth of bank lending in 1992. However, the effect on bank balance sheets of declines in share prices and the problem of non-performing loans at small and medium-sized banks have raised questions about the ability of monetary ease to contribute strongly to a recovery of economic activity in the near term.

Growth in bank lending and securities portfolios[1]

Countries and years	Total	Securities		Loans			
		Government	Other	Total	Business	Real estate	Persons
	December to December at annual rates, in percentages						
United States							
1975 (recession)	4.4	35.2	3.4	−0.5	−3.7	3.3	2.4
1981 (recession)	5.5	5.1	4.0	5.9	9.1	8.2	1.8
1983–89	8.9	7.4	1.3	10.2	7.5	14.9	9.9
1991	3.8	23.7	0.6	−0.2	−4.1	3.4	−4.3
1992	3.7	17.9	−1.9	0.4	−3.2	2.5	−2.3
Japan							
1975 (recession)	14.1	155.6	14.7	12.1	n.a.	n.a.	n.a.
1982 (recession)[2]	8.0	3.6	4.4	9.0	9.3	13.5	5.0
1983–89	10.0	8.8	9.9	10.1	6.8	21.8	15.0
1991	4.2	−8.2	5.3	5.0	3.2	4.4	6.1
1992	2.8	9.5	1.6	2.4	1.8	1.8	1.7

[1] For the United States, commercial banks; for Japan, deposit money banks (the breakdown of loan categories relates to all banks). [2] Growth recession.

Source: National data.

Long-term interest rates and exchange rates

In lowering short-term interest rates central banks paid close attention to their relationship with current rates of inflation and long-term interest rates. The former relationship was viewed mainly as an indicator of the potential expansionary impact of policy on economic activity and asset prices. The latter could be seen as a guide to market expectations of the future course of inflation as influenced by monetary policy. It could be viewed both as a constraint on policy and as a constraint on the effectiveness of policy.

Constraints on policy and its effectiveness due to ...

In the United States real short-term rates did not become as negative as in previous recessions, while in Japan, Canada and Australia real short-term rates remained positive. In the United States bond yields fell significantly in early 1993 in response to the new Administration's budgetary consolidation programme but the margin by which they exceeded money market rates remained high, presumably reflecting continuing concerns about the budget as well as inflation. In view of the importance of long-term interest rates for the process of financial restructuring and other monetary policy transmission mechanisms, the limited response of bond yields to declines in short rates over the 1989–92 period, considered as a whole, reduced the effectiveness of monetary stimulus. An unusually large differential between long and short rates is evident in Australia and could also be observed in Canada before short-term rates rose in late 1992. That the differential remained smaller in Japan probably mainly reflects inflation expectations. It may be viewed as a measure of confidence in monetary policy and as helpful in enhancing the impact of monetary policy stimulus.

... responses of long-term interest rates ...

Currency depreciation placed a constraint on further relaxation of monetary policy at times last year in Canada, Australia and Switzerland. The experience of these countries suggests that there are limits to the extent to which the constraints on monetary policy in open economies can be eased by floating the currency. In the United States official exchange market intervention was occasionally employed to resist strong exchange market pressures, but while exchange rate movements were taken into consideration they do not appear to have been a major influence on interest rate decisions.

... and floating exchange rates

Monetary policy in countries with exchange rate commitments

Response of monetary policy in Germany to inflationary pressures

Last year monetary policy in Germany had to take account of a sharp slowdown in output but also a second round of large wage claims and protracted negotiations about ways of reducing public sector deficits. With the unification boom subsiding, strains on productive resources eased as from the spring of 1992 but inflationary pressures persisted and the money stock and credit aggregates continued to expand rapidly. Following a tightening of monetary policy around the turn of 1991–92 long-term interest rates fell but money market rates moved closer to the 9¾% lombard rate. The Bundesbank raised its discount rate to 8¾% in July. Taking into account the effect of the appreciation of the Deutsche Mark on domestic inflationary pressures, it then lowered its official rates by ¼–½ percentage point on 15th September during the ERM crisis. Market rates were guided down further, with the Bundesbank's rate for securities tenders under repurchase agreements reaching 7¾% in April 1993 following a lowering of the lombard rate to 8½%. Long-term interest rates fell further and stood at around 6½% in April 1993, compared with 8% in August 1992 and over 9% at their 1990 peak.

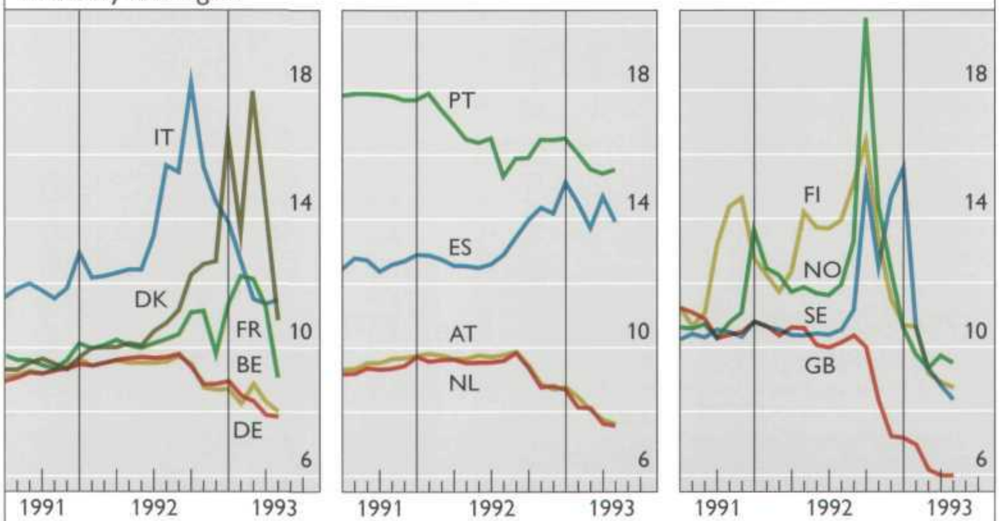
Short-term interest rates continued to decline in the spring of 1992 in the United Kingdom but remained close to German money market rates in France, Belgium, the Netherlands and Austria, and at higher levels in other European countries with exchange rate commitments. Short-term interest rate differentials vis-à-vis the Deutsche Mark exceeded inflation differentials in the case of the United Kingdom, Sweden, Finland and Norway, where inflation rates had fallen rapidly, and in that of France, Belgium and Denmark, where rates of consumer price increase remained lower than in Germany. A source of growing concern in a number of countries was the fact that exchange rate commitments left little scope for taking the weakness of economic activity into consideration in setting interest rate policy. Reflecting a further build-up of market confidence in the stability of existing exchange rate relationships, long-term interest rates in most European countries with exchange rate commitments declined in line with, or by more than, bond yields in Germany at the turn of 1991–92 but then edged up in the spring and summer.

Conflicts between objectives for output and exchange rates in other European countries

The conflict between objectives for output and exchange rates sharpened as from mid-year when exchange market pressures were resisted with increases in short-term interest rates. Money market rates

Three-month interbank interest rates in European countries*

Monthly averages



Note: AT = Austria; BE = Belgium; DK = Denmark; FI = Finland; FR = France; DE = Germany; IT = Italy; NL = Netherlands; NO = Norway; PT = Portugal; ES = Spain; SE = Sweden; GB = United Kingdom.

* For Portugal and Sweden, Treasury bills.

were raised in all ERM countries other than Germany, the Netherlands and Belgium, and in Nordic countries whose currencies were linked to the ECU. Short-term interest rates were brought down broadly in line with German rates as from mid-September in the Netherlands, Belgium and Austria and fell markedly in the spring of 1993 in France and Ireland. However, in April 1993, three-month rates remained about as high as in early September 1992 in Denmark. The same was true in Spain and Portugal, whose currencies' central rates had been adjusted downwards within the ERM. Short-term interest rates were lowered in varying degrees in Italy, the United Kingdom, Sweden, Norway and Finland after these countries suspended their exchange rate commitments and, except in the case of Norway, their currencies all depreciated substantially. In April 1993 three-month interest rates stood only slightly below their level of a year earlier in Italy but had fallen considerably over the year in the other four countries.

Short-term interest rates lowered in countries that suspended exchange rate commitments

Monetary and credit expansion in European countries last year reflected the widespread slowdown in economic activity but also bore the imprint of the exchange market crisis. In Germany the growth of short-term bank credit to the private sector slowed markedly as economic activity weakened. However, medium and long-term credit, which accounts for over three-quarters of the total and includes subsidised credit granted in eastern Germany, expanded by nearly 13%, compared with an annual average increase of less than 7% during the 1980s. The above-target growth of M_3 to some extent reflected the decline in long-term interest rates, which provided an incentive to place funds on short-term deposit. The slightly higher target range set for 1993 allows, in particular, for faster growth of productive potential in eastern Germany.

Developments in M_3 in Germany

During 1992 the stability of the demand for M_3 in Germany was widely questioned. Econometric estimates of the relationship between money, income, prices and interest rates always depend on the choice of variables, sample periods and econometric techniques, and are therefore

Published objectives of monetary policy

		Germany	France	Italy	Spain	United Kingdom			Sweden
		M_3	M_3	M_2	ALP	M0	M_4	RPIX	CP
		fourth quarter to fourth quarter changes, in percentages[1]							
1992	Objective[2]	3½–5½	4–6	5–7	8–11	0–4	4–8	1–4	–
	Outcome	9.4	5.9	5.9	5.1	4.9	3.6	3.7	1.9
1993	Objective[2]	4½–6½	4–6½	5–7	4½–7½	0–4	3–9	<2	1–3

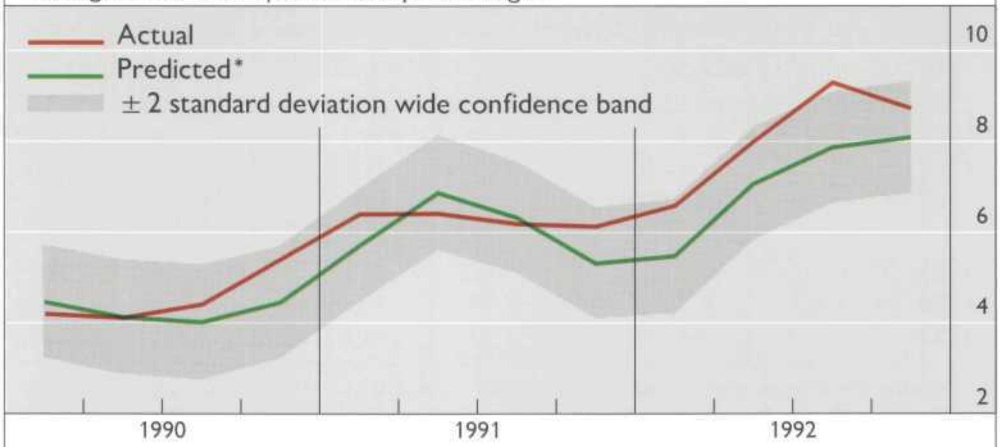
Note: ALP = liquid assets held by the public; RPIX = retail prices excluding mortgage interest payments; CP = consumer prices.

[1] For Spain, December to December; for M0 and M_4 in the United Kingdom, twelve-month periods ending in March of the following year. [2] For M0 and M_4 for 1993 in the United Kingdom, monitoring ranges only. The inflation objective shown for the United Kingdom for 1993 defines the long-run objective of price stability; that shown for Sweden is a long-run objective which applies as from 1995.

Source: National data.

Actual and predicted growth rates of M_3 in Germany

Changes over four quarters, in percentages



* Based on a money demand equation estimated from quarterly data for the period 1971–89 and computed using actual data for the independent and predetermined variables. Actual M_3 growth rates which fall outside the confidence band suggest instability of the money demand relationship.

open to debate. Even so, it was widely accepted in the past that in contrast to money demand relationships in many other countries, the demand for M_3 in Germany was stable. Recent investigations suggest that, perhaps surprisingly, this is still the case. As the graph above illustrates, actual and predicted M_3 growth rates based on one such estimate are strikingly similar, with the exception of the third quarter of 1992 when M_3 expanded strongly as a consequence of speculative capital inflows which were largely reversed subsequently. The high rate of growth of M_3 in the 1990–92 period thus appears to be well explained by the strength of output in western Germany following unification and by persistent inflationary pressures, rather than a structural shift in the demand for money relationship.

Developments in monetary and credit aggregates in other European countries

In France a slowdown in bank lending to the private sector last year, partly reflecting greater bank caution in lending to households, was to some extent offset by increased securities issues. Total indebtedness of domestic non-financial sectors expanded by 5½% in 1992, or at about the same rate as in 1991. The growth of M_3 accelerated and came close to the upper limit of the target range. In Italy, a rise in money market interest rates as from June, which was quickly transmitted to bank lending charges, contributed to the slowdown in bank lending. At the end of the year the growth of lira lending by financial institutions was within the monitoring limits which the Bank of Italy had introduced in October.

Rates of growth in bank lending to the private sector reflected deep recession and retrenchment in the banking sector in several Nordic countries but remained very high in Greece and Portugal. In some countries increases in interest rates at the time of the currency crisis undoubtedly contributed to a weakening of credit demand. However, in a number of countries there was a sharp rise in bank lending late in the year which seems to have served to finance capital outflows. In Sweden the Riksbank provided the banks with foreign currency funds borrowed abroad so as to

Growth in bank credit to the private sector[1]

December to December, in percentages

	Germany	France	Italy	Belgium	Nether-lands	Spain	United Kingdom
1982–84 trough[2]	5.5	6.1[3]	13.6	3.0	2.8	4.8	17.9
1988–90 peak[2]	9.5	12.1	18.4	16.4	12.1	18.9	24.9
1992	9.9	3.0	6.9	5.8	5.2	6.2	4.1
	Portugal	Ireland	Greece	Denmark	Sweden	Norway	Finland
1982–84 trough[2]	21.9	n.a.	17.3	11.0	7.8	13.3	16.1
1988–90 peak[2]	13.8	10.7	19.8	7.6	18.6	5.7	27.7
1992	18.3	6.0	17.1	−4.1	8.3	−0.1	−6.6

[1] Including credit from savings institutions and the central bank. [2] Lowest (trough) or highest (peak) December to December rate of increase during the period. [3] 1986 recession.

Source: National data.

counteract a cutback in foreign currency lending to domestic enterprises when banks encountered difficulties in refinancing such lending abroad.

The framework of monetary policy and credibility

Alternatives to exchange rates as anchors for monetary policy

The abandonment of exchange rate commitments in several countries and the subsequent easing of policy raised the question of what might serve as an alternative anchor for monetary policy. In Italy the objective for M_2 was assigned an enhanced role in the new monetary policy framework. In view of the prospective domestic price response to the depreciation of the lira the unchanged target is tight. However, achieving the monetary target will depend on continued wage restraint and progress in reducing the budget deficit.

Publication of inflation targets in the United Kingdom, Sweden and Finland

In the United Kingdom a monitoring range for M_4, based on an assumption of stable income velocity, was announced in September but in a context of very weak demand for credit M_4 growth soon fell below the lower limit of the range. In view of previous unsatisfactory UK experience with policies based on monetary aggregates, the Chancellor also announced the aim of achieving a rate of inflation in the long term of 2% or less. For the remainder of the present Parliament the objective is to keep underlying inflation, measured by the annual growth of retail prices excluding mortgage interest payments, within a range of 1–4%. It is intended that the inflation rate should be in the lower part of this range by the end of the period. After abandoning the krona's exchange rate link to the ECU, Sveriges Riksbank announced its intention of gearing monetary policy to the achievement of an explicit target of 1–3% for consumer price inflation, to be operational from 1995 onwards. The Bank of Finland stated that it would aim at keeping the inflation rate at 2% as from 1995.

The effectiveness of monetary policy depends critically on the credibility of the authorities' statements of their intentions. Credibility can be built up only by demonstrating a commitment to meeting pre-announced objectives over time. Published objectives can be helpful in establishing credibility provided that the monetary authorities have the means necessary to meet them and that meeting the objectives can help to convince the markets that policy is on course.

Targets for intermediate objectives may be useful if meeting them is consistent with achieving the ultimate objectives of policy. In Italy, as in Germany, France, Spain and some other European Community countries, the demand for broad money has been sufficiently stable to permit developments in monetary aggregates to be used as policy indicators. Monetary aggregates may be less useful in smaller open economies, particularly when the demand for money is distorted by a crisis in the banking system.

Although the use of exchange rates as intermediate objectives has proved useful in reducing inflation, adherence to unchanged commitments last year came to be viewed in some countries as conflicting with objectives for economic growth. While the exchange rate commitments contributed in several countries to agreement on fiscal and centralised wage adjustments, there were limits to what could be achieved quickly in this respect.

Credibility of new approaches may take time to establish

It is questionable whether inflation targets alone can easily fill the void left by the abandonment of the exchange rate as an intermediate objective. Given the lags with which monetary policy has an impact on inflation, the effectiveness of policy in meeting inflation objectives can be judged only after a long delay. Whether an inflation objective is met also depends on fiscal, wage and many other developments which monetary policy cannot directly influence. Moreover, the price indices for which targets are published may be affected by unexpected developments in supply or demand conditions in particular goods markets. The credibility of inflation targets may take time to establish in countries which have changed the framework of policy several times in recent years and adopted inflation targets only after a substantial depreciation of their currencies.

Constraints associated with floating exchange rates and long-term interest rates

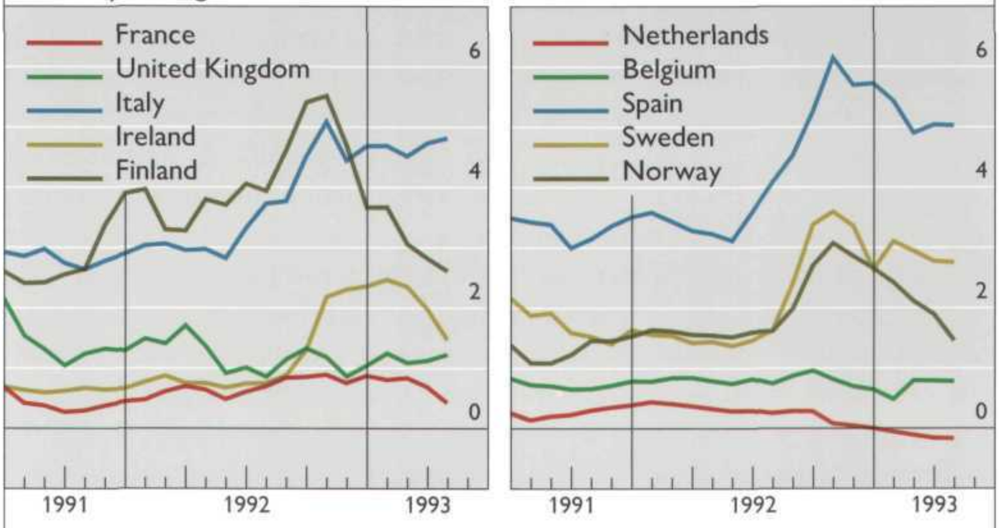
In open economies the influence of the exchange rate on aggregate demand and prices is an important element in the transmission mechanism. Although the current weakness of economic activity in European countries may delay the pass-through of currency depreciation to domestic prices, there is a serious risk that inflationary pressures will strengthen as economic activity revives.

Currency depreciation and inflation expectations

This risk appears to have been reflected in long-term interest rates which stood higher in early 1993 than in the spring of 1992 in Italy, Spain and Sweden – countries that devalued or suspended their exchange rate commitments. One way of gauging the effect of exchange rate policy is to compare bond yield differentials vis-à-vis Germany. These differentials responded to the risk of currency realignments in the summer and autumn of 1992. However, as can be seen in the graph on page 144, they stood higher, on balance, in the spring of this year than in the summer of 1992, even in the United Kingdom and Ireland where long yields had fallen in absolute terms. By contrast, in nearly all of the countries whose currencies

Long-term interest rate differentials vis-à-vis Germany*

Monthly averages



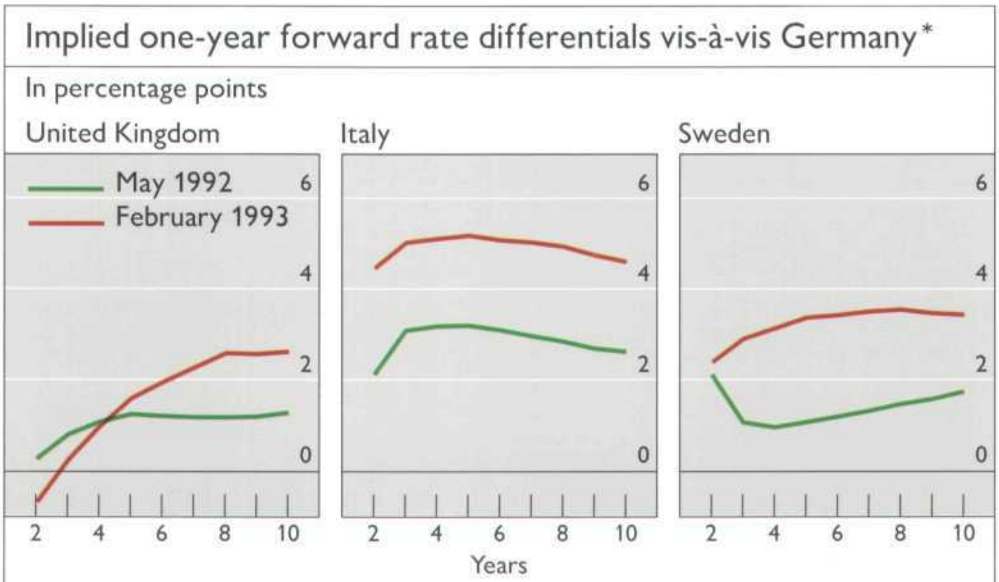
* Based on representative (mainly ten-year) government bond yields.

had remained within the ERM at unchanged central rates long-term interest rates fell on balance last year, with the differentials vis-à-vis Germany remaining low.

The change in inflation expectations is also reflected in expectations of future interest rates, as measured by forward interest rates embedded in the term structure of interest rates. In May 1992, before the Danish referendum on the Maastricht Treaty, the differential between forward interest rates in the United Kingdom and in Germany implied in their respective term structures could be interpreted as suggesting that one-year interest rates in the United Kingdom were expected to stand ¼–1¼% above German rates in the next few years. In February 1993, however, interest rates in the United Kingdom were apparently expected to remain below rates in Germany for about two years, but to exceed DM rates by as much as 2½% thereafter. To the extent that interest rate expectations in the longer run reflect mainly inflation expectations, the increase in the spread between forward interest rates between May 1992 and February 1993 suggests that financial markets anticipate a deterioration in future inflation (and exchange rate) performance in the United Kingdom compared with Germany.

Inflation expectations in Italy and Sweden seem also to have risen in the course of 1992–93. While forward interest rates in May 1992 suggested that the differential between interest rates in Italy and Germany was expected to remain at about 2–3% over a time horizon stretching from two to ten years, this wedge had increased to 4–5% by February 1993. Similarly, between May 1992 and February 1993 the margin by which Swedish forward interest rates exceeded German forward rates rose from 1–2% to 2½–3½%.

Monetary authorities are well aware of the risk of an acceleration of inflation in the longer term and have in some cases sought to limit currency



* Calculated from yield curves for government bonds in the months shown. For example, the one-year forward interest rate five years ahead is the yield on a one-year bond issued in five years that equalises the return between investing today in a six-year bond and investing today in a five-year bond and, upon maturity, investing in a one-year bond.

depreciation through exchange market intervention. Though the experience of the last year showed the difficulties involved in adhering to exchange rate commitments, the authorities in some of the countries may after a time accept some form of exchange rate commitment as a way of re-establishing a credible inflation anchor for monetary policy.

Policy responses to the exchange market crisis

Differing country responses to exchange market pressures

In the absence of exchange controls, countries faced with downward pressure on their currencies may respond with exchange market intervention financed from foreign exchange reserve assets or through borrowing, by raising interest rates or by changing or suspending an exchange rate objective. Last year European countries applied different combinations of these measures with varying speeds. For instance, whereas Sweden quickly made large interest rate adjustments, the United Kingdom was much more hesitant in this regard. Italy increased its interest rates progressively and was prepared to accept a realignment of its currency only in September; Denmark permitted money market interest rates to rise sharply in response to exchange market pressures but remained consistently opposed to a currency realignment. Reluctance to give up exchange rate commitments or to accept large increases in interest rates resulted in substantial intervention in many cases.

The problems of monetary management to which official exchange market intervention gives rise have both quantitative and qualitative dimensions pertaining to the use of signals in the conduct of policy and ultimately central bank credibility. The quantitative implications for monetary management of net official intervention can be gauged by setting it in the context of central bank balance sheets. Expressing net official foreign exchange transactions as a percentage of the central bank money stock

Changes in the central bank money stock and contribution of counterparts

Changes over the period as a percentage of the central bank money stock[1]

Countries	Central bank money stock[2]				Central bank net foreign assets[3]			
	1987	1987–91[4]	1992	1992 Q III	1987	1987–91[4]	1992	1992 Q III
Germany	12.5	9.0	14.5	3.0	23.1	−5.6	23.9	17.4
France	8.3	1.6	−13.8	0.2	−21.2	1.8	−19.2	−22.0
United Kingdom	4.3	4.8	2.6	2.1	77.7	−3.2	−37.1	−49.7
Italy	10.1	8.4	4.0	−0.6	4.9	4.9	−30.6	−21.6
Netherlands	11.9	2.7	−0.2	−1.8	16.9	3.1	22.9	2.1
Belgium	2.9	0.6	−0.4	−5.5	18.9	4.0	4.4	5.9
Sweden	2.9	4.7	−2.9	−5.4	16.1	38.4	−144.2	−141.9
	Central bank loans, market operations[5]				Other domestic influences[6]			
	1987	1987–91[4]	1992	1992 Q III	1987	1987–91[4]	1992	1992 Q III
Germany	−5.8	14.9	−6.3	−10.2	−4.8	−0.3	−3.1	−4.2
France	29.1	−2.8	23.7	23.7	0.4	2.6	−18.3	−1.5
United Kingdom	−48.9	−15.8	47.3	50.3	−24.5	23.8	−7.6	1.5
Italy	−3.4	3.7	23.8	4.7	8.6	−0.2	10.8	16.3
Netherlands	−9.6	−2.1	−0.9	−3.7	4.6	1.7	−22.2	−0.2
Belgium	−0.4	n.a.	−38.2	−18.3	−15.6	−3.4	33.4	6.9
Sweden	13.8	−21.1	−172.9	121.2	−27.0	−12.6	314.2	15.3

[1] Flows net of valuation changes. For Germany, France and the Netherlands, based mainly on monthly averages of daily or weekly data; for other countries, month-end data. [2] For Germany, at current reserve ratios but excluding the effects of changes in the ratios; for the United Kingdom, M0; for other countries, currency and bank reserves. [3] Excluding foreign exchange swaps used for the purpose of influencing bank liquidity. [4] At annual rates. [5] Lombard and (except for Germany) discount credit; purchases and sales of bills and securities outright and under repurchase agreements, special loans at market interest rates, foreign exchange swaps and government deposits transferred to the market. [6] Including movements in the government accounts and, in the case of Germany, the effect of changes in reserve requirements and rediscount quotas.

Sources: National data and BIS estimates.

Large scale of exchange market intervention last year

(basically currency and bank reserves) at the beginning of the period shows their huge potential (positive or negative) contribution to the growth of the central bank money stock in European countries in 1992, especially in the third quarter. The figures in the table include the effect of intervention financed by borrowing but do not fully capture the size of gross intervention flows over short periods. Even by this imperfect measure the scale of last year's intervention appears larger in most countries than at the previous peak level of official intervention in 1987, when it was substantial not only in the ERM context but also in the dollar market.

Implications of intervention for the management of bank reserves

Official exchange market intervention potentially alters domestic banks' reserve balances at the central bank. Monetary policy in the industrial countries is essentially implemented through the setting of very short-term interest rates. The arrangements which permit the central bank to influence short-term interest rates and to use monetary policy for attempting to meet exchange rate or other objectives oblige the central bank ultimately to adapt the supply of bank reserves closely to the demand as determined by lagged or semi-lagged reserve requirements or the banks' typically small demand for central bank clearing balances. Interest rates may be increased to reduce the need for intervention but, in general, if intervention occurs, the impact on bank reserves affects other central bank operations in an offsetting way so as to restore the desired level of reserves by the end of the day or, at the latest, within the current reserve holding period.

In general, the central bank implements interest rate policy by determining the marginal interest rate at which it supplies or withdraws bank reserves. This may be done explicitly, by announcing a rate in advance and raising it to counter outflows of funds as was done in Sweden in September last year. In systems where such a rate is not announced very short-term interest rates may be permitted to respond to changes in the pace at which bank reserves are supplied in the early part of the day or reserve period. At times last year very large increases in day-to-day rates were encouraged in this way in Denmark and Ireland. However, such rate movements essentially reflect uncertainty on the part of the banks about the terms on which their residual reserve needs will ultimately be met.

Monetary policy questions raised by intervention

The relevant questions about intervention therefore relate mainly to the adequacy of the instruments available for offsetting intervention and to the effectiveness of intervention with or without interest rate adjustments. However, broader questions may be asked about the effect of intervention on the money stock, particularly in countries with monetary aggregate objectives, and the role of official intervention in facilitating currency speculation.

The effects of intervention in countries experiencing inflows of funds

Last year extensive use was made of ad hoc inter-central-bank credits and of the very short-term financing facilities under which ERM central banks may automatically draw other EMS currencies for financing compulsory intervention undertaken when exchange rates reach the bilateral limits. The facilities may be used for intramarginal intervention, on which ERM countries had mainly relied until last year, only with the permission of the central bank of issue. Even in the absence of intervention by the home central bank, intervention by other central banks may influence bank reserves in the country whose currency is used. Such effects will only be indirect when the intervention is financed from exchange reserves not held with the bank of issue of the currency concerned. Some central banks which held large balances of Deutsche Mark in the market could draw on these when the domestic currency first came under pressure. However, when central banks financed intervention from balances held with, or through loans from, other central banks, bank reserves in both countries were directly affected.

Difficulties of money market management

Faced with huge additions to bank liquidity resulting from intervention some central banks found themselves short of domestic assets which could readily be used to contain the rise in bank reserves. They could increase their liabilities by imposing or raising reserve requirements, at the risk of stimulating inflows through non-bank channels, or by offering the banks interest-bearing investments as an alternative to non-interest-bearing central bank reserve balances. The issue of paper by the central bank on its own behalf, or on behalf of the government, is subject to legal limits in some countries, including Germany. The extent to which reserve-absorbing market operations, such as foreign exchange swaps, can be expanded in the short run may be limited by the availability of suitable marketable claims in the foreign exchange reserves. Experience in 1992–93 again showed that money market management is very difficult when large-scale reserve surpluses must be absorbed.

Last year the Bundesbank countered the potential impact of intervention on bank liquidity mainly by cutting back on its provision of bank reserves through the use of securities repurchase agreements. Its outstanding stock of securities fell from DM 147 billion to DM 97 billion in September. Reflected on the liabilities side of its balance sheet, bank reserves were also absorbed by foreign exchange repurchase transactions and under a facility which permits banks to invest reserve surpluses in three-day Treasury bills. In Belgium repayment of outstanding government foreign currency debt helped to reduce net acquisitions of foreign exchange by the central bank. The National Bank used market transactions, including foreign exchange swaps, on a large scale. In the Netherlands, an increase in cash reserve requirements was among the instruments used.

Other monetary effects of capital flows

Capital flows may have a direct impact on domestic money and credit which cannot normally be offset by the central bank in the short run. For instance, M_3 in Germany expanded by 2% in September 1992 mainly because part of the sizable inflow of foreign exchange came via accounts of non-bank residents who held the proceeds largely in the form of sight and short-term time deposits with domestic banks. Primarily reflecting the subsequent reflux of capital abroad the level of M_3 remained unchanged in seasonally adjusted terms between October and February 1993. In March 1993, the Bundesbank took advantage of an extension of its authorisation to issue short-term Treasury paper at its own discretion. It announced an offer to issue three to nine-month paper by a tender procedure open to banks and non-banks. The new procedure was intended to permit the Bundesbank to influence money balances held by non-banks and to increase the flexibility of its operations to regulate bank reserves. At the same time, reserve requirements for time and savings deposits were lowered substantially.

The effects of intervention in countries experiencing outflows of funds

In countries experiencing capital outflows operational constraints are usually set by the amount of owned or borrowed reserves the authorities are prepared to use. The effect of intervention sales of foreign currency on bank reserves can be delayed by borrowing foreign currency to replenish the reserves or by recourse to forward sales of foreign exchange. Last year part of the potential impact on bank reserves was offset in some countries through drawings by banks or the government on existing central bank credit facilities.

Instruments used to offset impact of intervention on bank reserves

However, in all cases the central bank took action to offset the potential decline in bank reserves caused by central bank sales of foreign exchange. For this purpose most central banks employed specific instruments, including foreign exchange swaps and outright or reversed purchases of domestic paper, on a large scale. In some cases the use of basic reserve-supplying instruments was adapted (e.g. the tender in France and Spain), new instruments were introduced (e.g. repurchase agreements for foreign currency assets in Italy) or existing financing facilities which normally serve to limit rises in market rates (e.g. the overnight lending facility in Ireland) were suspended so as to permit market interest rates to rise. It is not always easy to employ these instruments flexibly.

General aspects of intervention

Usefulness of intervention

In recent years official exchange market intervention has helped central banks to cope with upward pressures on the currencies of countries where relatively high nominal interest rates seemed appropriate on domestic grounds. In Belgium, the Netherlands and Austria commitments to narrower ranges of exchange rate fluctuation against the Deutsche Mark than the standard ERM band, combined with the practice of not permitting rates to fall far below German levels, implied that intervention would be relied upon to contain upward pressures on their currencies last year. This approach undoubtedly contributed to the credibility of policy in these countries. Experience of other EMS central banks suggests that using intervention to help keep a currency in the upper part of the band or to prevent it from reaching the limits of the band can also be helpful in underpinning the credibility of exchange rate commitments. Yet the events of last year confirmed that any hope that official exchange rate commitments, when seriously tested, could be defended by intervention alone was unfounded. When reserve losses reach an unsustainable scale, countries face the choice of whether to raise interest rates significantly and for relatively prolonged periods or to change their exchange rate policies.

Disadvantages of large scale intervention with limited interest rate adjustments

In intervening on a large scale to defend currencies while attempting to limit interest rate adjustments, central banks indirectly accommodated the efforts of market participants to hedge exposures in weak currencies and to take open positions against these currencies. Regulation and prudential practice discourage banks from taking large open positions in foreign currencies for their own account. By intervening central banks helped to place banks in a position to meet customer demand for long foreign currency positions in deposit, loan or off-balance-sheet operations. In replenishing bank reserves central banks helped to refinance increases in bank lending in domestic currency and facilitated sales of domestic currency securities by investors wishing to close positions in the currency or to take positions against it. This is not to dispute the effectiveness of intervention as such. Rather, it should caution against large-scale intervention with limited interest rate adjustments. Only by vigorously adjusting interest rates can central banks create a disincentive to private sector operations with potentially easy profits.

Interest rate adjustments and the credibility of exchange rate commitments

It has always been a presumption of EMS arrangements that responses to strong exchange rate tensions should include interest rate and exchange rate adjustments. Experiences of the Netherlands, Belgium and France in the late 1970s and early 1980s in defending exchange rate commitments illustrated the scale of the increase in short-term market rates which can be required under a fixed exchange rate system to counteract effectively expectations of a devaluation in the near future. The absence of such pressures in recent years seems to have led to an underestimation of the risk of their emerging. Yet the liberalisation of exchange controls and growing competition in domestic financial markets have greatly reduced the scope for confining interest rate increases to the offshore markets and for delaying the pass-through of increases to domestic borrowing charges.

Exchange market impact of interest rate increases

Market participants are well aware of the potential output costs of increasing interest rates enough to discourage the taking of positions against the domestic currency and that monetary authorities may lack the scope for raising interest rates sufficiently. Even if the monetary authorities increase interest rates sharply to demonstrate their determination to defend an exchange rate commitment, their action may be ineffective if their ability to keep rates high is not perceived as credible. Such credibility will obviously depend on the strength of the domestic economy and on the ability to achieve consensus on appropriate budgetary policies. Furthermore, if interest rates are raised only after extensive exchange market intervention the move may even be interpreted as a signal that the resolve of the authorities to defend the currency has reached its limits. In these circumstances the increase in interest rates may trigger further outflows, and, paradoxically, itself make the exchange rate commitment untenable.

A two-step increase in official rates from 10 to 15% announced in the United Kingdom during the September crisis, following heavy official exchange market intervention, apparently failed to convince the market that, in the prevailing domestic economic circumstances, a sustained rise in domestic retail interest rates would be feasible. The Riksbank increased its marginal lending rate substantially during the crisis in September, first to 75% then to as much as 500%. This, together with agreement on measures of fiscal restraint, stabilised the foreign exchange market and the marginal lending rate was gradually reduced to 12% by early November. However, the markets doubted that it would be possible to raise interest rates to similarly high levels if renewed outflows took place. Indeed, when the marginal lending rate was moved back up to 20% in November, in the absence of agreement on further budgetary measures, there was little effect in restraining capital outflows.

The use of central bank instruments to influence interest rate pass-through

The credibility of a policy of raising money market interest rates to defend the currency may be greater in countries where the central bank can limit or delay the impact on other interest rates by selectively influencing bank financing costs. For this purpose a combination of reserve-supplying instruments may be used. In many European countries central bank operating

Central bank operating procedures and lending charges of financial institutions

procedures have been designed to permit flexible influence over money market rates through fine-tuning instruments while more traditional procedures can be used to limit the response of rates in other markets to changes which may not prove lasting. In Germany, France, Belgium, the Netherlands and Spain the central bank's interest rate intentions are signalled largely through the interest rates at which bank reserves are supplied by periodic tender. These signals can be modulated by means of special procedures such as changes in the form of the tender and the size of allocations. In most of these countries official lending rates now bear only an indirect and limited relationship to money market rates but can still be used to give strong signals of the central bank's intentions. Official lending rates may also selectively influence the interest rates applied in certain types of bank lending, particularly lending to small enterprises and individuals whose access to other markets is limited.

Instruments used to limit pass-through in some countries

In France the interest rate on the Bank of France's five to ten-day standing repurchase facility, which banks can use at their own discretion, normally tends to limit upward movements in money market rates. In September the interest rate on this facility was raised, while in early 1993 the facility was replaced for a time by day-to-day operations conducted at interest rates which could be changed at the discretion of the Bank of France. Meanwhile, the Bank of France provided large amounts of bank reserves by tender at much lower interest rates. These procedures permitted increases in money market rates while moderating their impact on the cost of bank funding, and contributed to the banks' decision to limit rises in their base lending rates. In late September, Sveriges Riksbank supplied a small amount of credit to mortgage institutions at an interest rate of 20%, while counteracting the effect on bank reserves so as to ensure that short-term money market rates remained at the 50% set by the official marginal lending rate. Various adjustments to central bank reserve-supplying instruments were also used to help moderate the impact of rises in money market interest rates on key bank loan charges in Italy, Denmark and Ireland. In some cases the provisions governing access to central bank facilities or eligible collateral contributed to driving a temporary wedge between offshore or domestic money market rates and other rates on critical occasions.

The impact of selective central bank financing arrangements on the borrowing costs of domestic non-banks depends on the scope for segmenting funding markets. It is usually limited, even in the short run, but may help in coping with a brief crisis. Moreover, the extent to which banks respond to changes in very short-term official rates by adjusting their lending charges depends on country-specific conventions. In the United Kingdom, significant changes in the rates at which the Bank of England purchases bills with very short maturities are normally quickly reflected in bank base rates, which in turn determine the interest rates charged by banks on the bulk of the outstanding stock of lending as well as on new loans. This consideration was clearly a crucial influence on the reluctance of the authorities to accept sustained rises in money market rates.

In several countries last year the relationship between bank lending charges and money market rates was also influenced by changes in reserve requirements. In France in May 1992 the banks agreed to lower prime rates in relation to money market rates in conjunction with a reduction in reserve requirements. The lowering of reserve requirements in Italy in February 1993 should also eventually permit a substantial narrowing of the spread between bank lending charges and money market rates. In Spain a planned decrease in reserve requirements was brought forward to help cope with the September exchange market crisis.

Interest rate transmission mechanisms

Influence of monetary policy transmission mechanisms on interest rate pass-through

The response of lending rates charged by financial institutions to changes in short-term money market rates, and hence the credibility of exchange rate oriented interest rate policies, also depends on certain characteristics of the interest rate transmission mechanism. These include the response of long-term interest rates, the relative importance of short, medium and long-term financing and the use of fixed as opposed to adjustable rate lending. In the United Kingdom and Ireland changes in very short-term money market interest rates are quickly passed on in the adjustable charges applied to most house mortgage loans and to business loans. In the United Kingdom, a relatively high proportion of outstanding corporate bond issues bear adjustable interest rates. In some other European countries, variable rate bonds form a large part of the stock of government bonds outstanding. However, in many countries a substantial share of loans by financial institutions for financing housing and business fixed investment is at long term. The interest rates applied are fixed over the medium or long term in relation either to comparatively stable interest rates on tap issues of medium-term bank certificates or to capital market yields on negotiable instruments. This situation basically reflects the availability of medium and long-term sources of funding. In some countries this is partly a result of measures taken over the years to facilitate the supply of long-term financing through special channels, such as the long-term credit institutions in Italy. In others, it can be attributed to the encouragement given to private long-term financing by long experience of low rates of inflation and comparatively stable interest rates.

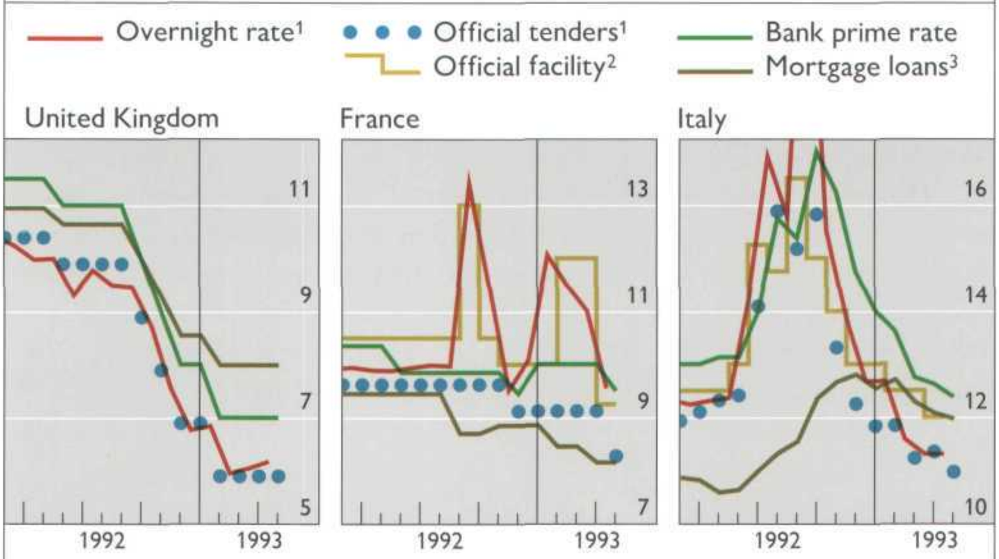
Impact of balance-sheet weakness

The impact of interest rate increases also depends crucially on the balance-sheet structures in the economy. In some countries the willingness of the authorities to accept sustained increases in interest rates last year was decisively influenced by the weakness of balance-sheet positions in the personal, corporate or banking sectors which rendered these sectors particularly vulnerable to large and sustained increases in short-term interest rates. In Italy an evident constraint was set by the size and short average maturity of the public debt, while in Ireland the large foreign currency component of the public debt was a concern.

Exchange controls

By last year exchange controls had been abolished in most European

Official, market and bank lending interest rates



Note: Overnight rates in Italy averaged 22.1% in September 1992.
[1] For the United Kingdom, call money and bill purchases respectively. [2] For France, five to ten-day repurchase facility; for Italy, secured advances. [3] For Italy, bonds issued by special mortgage credit institutions.

countries. As provided for in the EC single market programme, controls remained in place or were tightened to help deal with the exchange market crisis in Spain, Portugal and Ireland. However, in all three countries they were lifted by the beginning of 1993.

Use of exchange controls to help shield domestic interest rates

Exchange controls may limit the need to increase domestic interest rates, whilst permitting interest rates in offshore markets for the currency to rise sharply when speculative pressures emerge. If the controls are effective in preventing the funding of short non-resident forward positions in the domestic currency by the domestic banking system, the central bank may even encourage rises in offshore interest rates in order to discourage or penalise position-taking against the currency by non-residents. In cases where non-residents are seeking to cover existing holdings of domestic currency securities in the banking markets, exchange controls may be less effective in protecting domestic interest rates and may even discourage foreign investment in domestic securities in the longer run.

Central bank independence

Given the political sensitivity of interest rates, it is not surprising that the credibility of exchange rate commitments last year was influenced by the potential for policy changes as a result, for instance, of forthcoming elections. This has raised the question in some countries of whether the credibility of monetary policy might not be increased by ensuring that monetary policy decisions are made more clearly the responsibility of an independent central bank. It seems probable that long-standing or recently enhanced central bank independence helps to explain why the credibility of policy in Austria, the Netherlands and Belgium was not put to a severe test. Moves currently under way in other EMS countries, including France, Italy, Spain and Portugal, to give greater independence to the central bank should reduce the vulnerability of credibility to short-term political considerations. These changes, which aim at fulfilling provisions of the Maastricht Treaty at an early date, would give central banks responsibility for interest rate decisions.

However, even an independent central bank, acting alone, cannot achieve satisfactory overall policy results. The experience of countries such as Sweden and Italy in the exchange rate crisis last year seems to confirm that monetary policy may not be effective in defending an exchange rate if it is not supported by adequate fiscal restraint and appropriate wage developments.

VII. Asset prices and the management of financial distress

Highlights

There was a significant contrast between the behaviour of equity and property prices in the period under review. Residential and commercial real estate prices continued to weaken last year, although in some countries the trough appeared to be approaching. By the first quarter of 1993 equity prices were roughly at or above their level at the beginning of 1992 in most countries. In the United States this reflected signs that a recovery was under way; in Europe it appeared to be partly a response to adjustments in exchange rate parities and an actual or anticipated easing of monetary policies. In Japan the market slid steeply until the autumn, stabilised and then staged a strong recovery in early 1993.

Asset prices have played a prominent role in the present business cycle, both in terms of the amplitude of their fluctuations and because of their impact on financial institutions and economic activity. Such medium-term swings are of course not new; the last similar episode took place in the early 1970s. What has drawn attention to the recent asset price movements is not only their absolute size and geographical compass; it is also the fact that the prolonged upswing, in contrast to the previous one, occurred against a background of positive inflation-adjusted interest rates. An examination of the two episodes suggests that the distinguishing characteristic of the recent experience has been the ample availability of credit in the wake of market-driven and policy-determined structural changes in the financial industry.

The large swings in asset prices, in conjunction with a fairly generalised increase in private sector indebtedness during the past decade, have exacerbated the effects of weakening economic activity on banks' profitability and asset quality. To varying degrees, the combination of these factors left a mark on bank results last year too, partly offsetting the positive impact of a favourable configuration of interest rates in some countries and continued restructuring in the industry.

In a number of countries the deterioration in the profitability and asset quality of credit institutions in recent years has raised doubts about the soundness of certain parts of the industry or at least severely affected its operations, leading to government intervention aimed at securing an orderly resolution of the problems. Previous Annual Reports have discussed in some detail and from a broader perspective the causes of the restructuring in progress in the financial industry worldwide as well as its long-term implications for prudential regulation and supervision. The focus this year is on the management of financial distress as such, taking the example of five countries with recent experience in this regard, viz. the United States, Sweden, Norway, Finland and Japan.

Asset prices: recent developments

Equity prices

In the period under review stock price movements were generally dominated by the outlook for economic activity and by monetary and exchange rate policies. The combination of these factors varied considerably among countries.

After rising sharply at the end of 1991 in response to significant monetary easing by the Federal Reserve, US stock prices moved within a narrow range for most of 1992, as investors awaited conclusive signs of a strong pick-up in the economy (see the graph below). Prices began to firm in the last quarter of the year, as economic data and the changed political climate led the market to conclude that a robust recovery had begun. By the end of the first quarter stock prices had reached a record high.

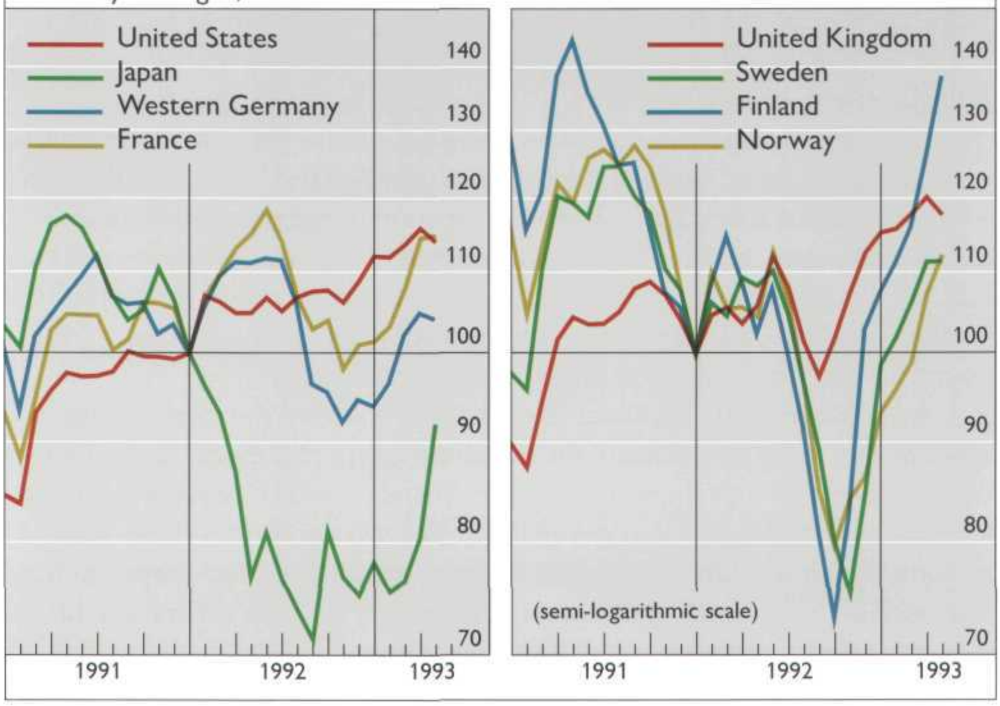
Equity prices rise in the United States ...

In most of Europe stock markets moved upwards in the first half of the year, particularly in the United Kingdom, following the general election result in April, and in France. However, the United Kingdom, Italy and some of the Nordic countries all experienced sharp falls in stock prices in the third quarter of 1992, in part because of growing concern about the consequences of defending a fixed exchange rate parity for interest rates and economic activity. These declines were reversed in the final quarter,

... fluctuate in Europe ...

Stock market prices

Monthly averages, December 1991 = 100



either partially (Sweden, Italy and Norway) or wholly (the United Kingdom and Finland), as currency depreciation and lower interest rates improved the prospects for economic activity and made equity investments relatively more attractive. By contrast, in Germany and France stock markets began to recover only towards the end of the year in response to signs of an easing of monetary policy by the Bundesbank.

... fall and then rise in Japan

Japanese stock prices fell steeply during the first four months of 1992 against the background of new revelations of financial malpractice, heavy selling of stocks by financial institutions prior to the end of the financial year in March and mounting evidence of a slowdown in growth. A package of fiscal and monetary stimulus announced in April failed to halt the slide, and the Nikkei index dropped below the 20,000 mark. After a brief respite, share prices resumed their fall in the middle of the year with the emergence of new signs of weakening. In July the index reached a six-year low. In response, the authorities announced a number of measures at the end of August designed to boost the economy and share prices. The programme included increases in public investment and housing loan facilities totalling ¥10.7 trillion (over 2% of GNP), tax incentives for equipment investment, the relaxation of restrictions on share purchases by individual investors and publicly managed funds and the freezing of stock offerings by public entities. Share prices reacted quickly, rising by almost 15% between August and September. However, they soon began to decline again, as investors appeared to be waiting for evidence that the economy had bottomed out. By early 1993 stock prices were over 20% below their level a year earlier. Since February, however, they have regained much of the ground lost, partly as a result of the announcement of further increases in public investment and tax concessions totalling ¥13.2 trillion, or close to 3% of GNP.

Real estate prices

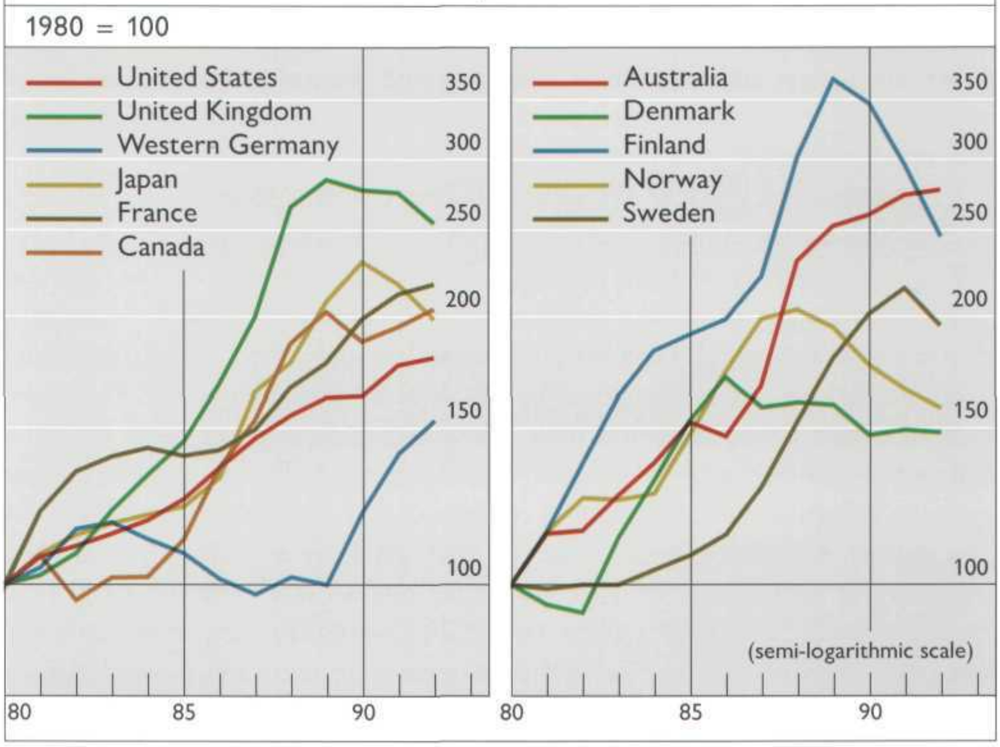
Generalised weakness in real estate prices

The downward correction of real estate prices in both the residential and commercial sectors in some countries continued last year. Indeed, property price falls seemed to become more widespread and in several instances intensified. Undoubtedly this reflected to some extent an inevitable adjustment following earlier excessive increases. It could also be attributed in part to the widening economic slowdown affecting a growing number of continental European countries and Japan and to the absence in others, such as the United Kingdom, of a robust recovery. In those countries where the downturn in prices had begun first, there were indications in the course of the year that the trough was being approached. However, the likelihood of a pronounced resurgence remained small in many cases, given a considerable supply overhang.

Residential real estate

Nationwide declines in property prices in the housing sector were particularly severe in Finland, where by the end of 1992 nominal house prices had fallen by 34% from their peak in 1989, and in Norway, where the cumulative decline from 1988 reached 23% last year (see the graph overleaf). In Denmark and the United Kingdom the overall reduction in

Nominal residential real estate prices



house prices was more modest, even though it had started earlier. While house prices began to fall nationally only in 1991 in Japan and during 1992 in Sweden, in both cases the decline exceeded that which had occurred in the United Kingdom since the beginning of the downturn in 1990. By contrast, in Germany prices continued to rise last year, albeit at a slower pace.

Regional variations have been particularly pronounced in some countries, including France, the United Kingdom and the United States. For example, in comparison with the rest of the country, a relatively marked cycle has taken place in Paris, where prices are now reported to have dropped back to levels last seen in 1987. In Germany last year prices stabilised in Frankfurt but increased further in Berlin, to virtually double their 1989 level.

Significant reductions in house prices have in some cases been accompanied by a substantial contraction in the volume of housing transactions. Most notably, in the United Kingdom the number of transactions has fallen by almost 50% from its peak in 1988, and currently stands at its lowest level since 1974. Similarly, in Denmark turnover in 1991 was around 35% lower than in the peak year of 1985 and not much higher than in 1974–75. As a proportion of the existing stock of dwellings the scale of the declines has been even greater. Efforts to improve turnover and stabilise prices by governments in both countries have followed similar lines: a general or partial suspension of stamp duty and measures to stem forced sales so as to prevent further downward pressure on prices. Recent estimates suggest that the volume of transactions has stabilised in Denmark and risen in the United Kingdom, which is perhaps an early sign of a return to a more stable price environment.

Commercial real estate

The pattern of commercial property price movements during the year broadly followed that in the residential sector. Prices continued to fall everywhere, and in fact tended to do so more rapidly, while vacancy rates rose further (see the table below). The sharpest decline in commercial property prices in 1992 was recorded in Sydney, where the cumulative fall since 1989 reached 60%. In London prices also dropped steeply, for the fourth consecutive year, but renewed interest from overseas investors provided grounds for optimism that the market might finally be approaching a turning-point. A similar optimism pervaded the United States. Although Japanese commercial property prices had fallen only modestly in comparison with other countries and vacancy rates in Tokyo remained low, the series of economic measures announced in August 1992 and April 1993 included specific provisions to support real estate prices, in particular the bringing forward of government land purchases, an increase in funds for the Housing Loan Corporation and tax relief on borrowing for the acquisition of residential property. In addition, in late 1992 banks established a body to handle doubtful loans secured against real estate.

In continental Europe last year further declines were recorded in Paris, Madrid and Milan among other cities. Prices also fell back in Frankfurt, following a decade of growth, and in Berlin. The French Government responded to weakness in the market by announcing plans in late December to relax the system requiring official authorisation for large

Nominal commercial property prices: major cities

Cities	Vacancy rates[1] December 1992	1980–85	1985–92	1987	1988	1989	1990	1991	1992
		annual percentage changes							
United States[2]									
North-East	22[3]	10	−4	5	2	1	− 7	−18	−13
Pacific	20[4]	4[5]	−3	2	4	2	− 2	−11	−14
Tokyo	1	7	11	61	3	5	4	− 7	−19
Berlin[6]	1	n.a.	25	0	5	35	151	38	− 7
Frankfurt	8	3	13	25	13	37	21	12	−24
Paris	7	17	6	10	7	23	17	−13	−18
Milan	10[7]	n.a.	11	4	27	26	52	− 8	−18
London	14	10	−3	40	18	− 3	−14	−28	−30
Toronto[2,8]	15	n.a.	2	10	13	10	− 3	− 9	−13
Sydney	21[9]	18	−2	38	30	6	−24	−20	−35
Copenhagen[10]	5[7]	11	4	5	0	5	1	− 9	− 6
Helsinki	11	30	2	37	27	32	−20	−17	−20
Oslo[10]	15[7]	20	−2	24	−10	−16	− 9	−17	− 8
Madrid	7	17	12	50	36	44	12	−26	−28
Stockholm	7[7]	30	2	35	20	13	3	−43	−13

[1] The vacancy rate is the total amount of available finished office space, expressed as a percentage of the total office stock. [2] Fourth quarter to fourth quarter. [3] Downtown Manhattan. [4] Los Angeles. [5] 1983–85. [6] Up to 1989, West Berlin only. [7] Based on the limited market information available. [8] Price index for offices in Ontario. [9] September. [10] Property prices are national averages.

Sources: Jones Lang Wootton and various private real estate associations.

office moves within Paris (designed to encourage relocation to the regions). In addition, there were several measures providing for a more favourable tax treatment of property transactions and leases.

Asset prices: a longer-term perspective

The aggregate asset price indices ...

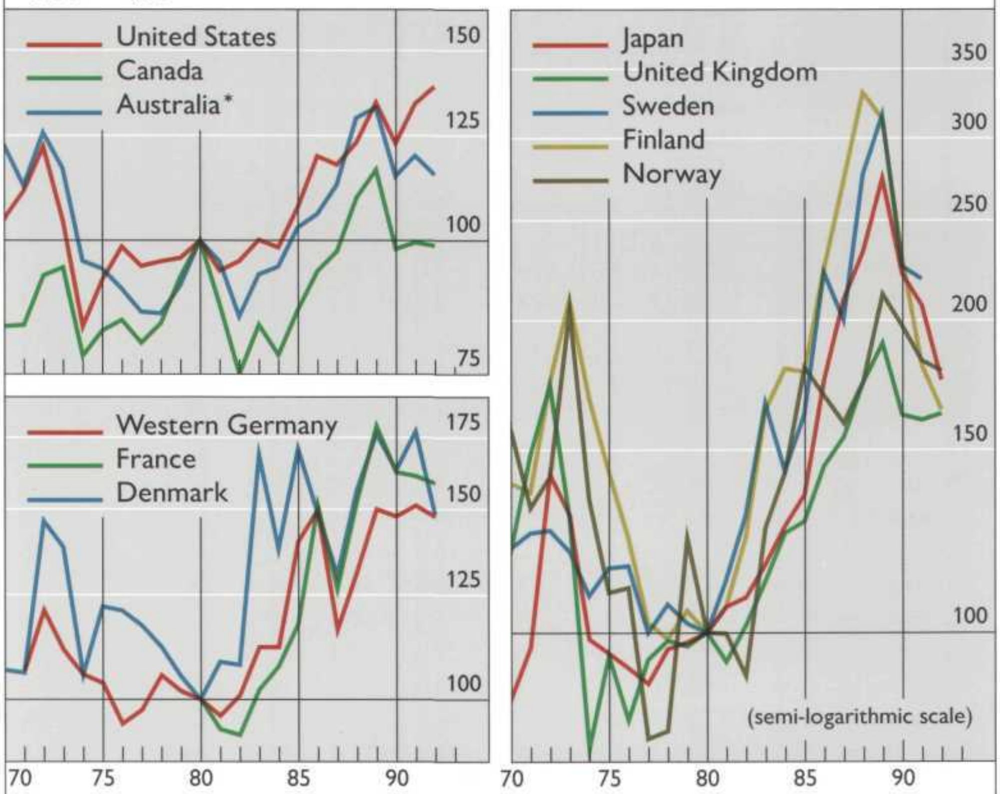
The graph below provides a longer-term perspective on the movements in real asset prices in several industrial countries over the past two decades. It plots for each country a summary measure of asset prices, or aggregate asset price index, constructed as a weighted average of national equity and residential and commercial real estate price indices. The weights represent estimates of the shares of these assets in total private sector wealth. The graph offers a number of insights into the behaviour of real asset prices, both across countries and over time.

... exhibit large swings in the 1980s

While a large number of countries experienced a cycle in real aggregate asset prices over the last ten years, the severity of asset price inflation and deflation varied widely. The sharpest movements occurred in some of the Nordic countries and in Japan. In Sweden and Finland, for example, asset prices increased by over 200% in real terms between 1980

Real aggregate asset prices

1980 = 100



Note: The real asset price index is a weighted average of equity and residential and commercial real estate price indices deflated by consumer prices. The weights are based on the composition of private sector wealth.

* Calculated by the Reserve Bank of Australia.

Sources: National data and BIS estimates.

The two upswings in real asset prices

Countries	Residential property			Commercial property			Equities		
	1970s upswing[1]	1980s upswing		1970s upswing[1]	1980s upswing		1970s upswing[1]	1980s upswing	
		First half[2]	Second half[3]		First half[2]	Second half[3]		First half[2]	Second half[3]
	cumulative percentage changes								
United States	10	2	13	n.a.	2	−15	22	44	46
Japan	57	23[4]	74	24	10	86	128	88[5]	166
Western Germany	39[6]	− 7	21	16[6]	1	98	6	139	13
France	n.a.	−14	27	n.a.	39	78	13	112	86
United Kingdom	64	16	60	n.a.	−1	33	41	78	41
Canada	40	3	52	n.a.	n.a.	1	18	31	15
Australia	15	2	22	62[7]	126[4]	65	29	67	25
Denmark	24	38	8	2	52	30	88	190[5]	14
Finland	17	35[5]	59	31[6]	235[8]	73	237[9]	105	146
Norway	35	10	15	n.a.	65[10]	37	65	246	31
Sweden	2	0	35	−30	6	52	18	182[5]	114

[1] From trough to peak, or, where no trough could be identified, from 1970 to peak. [2] From trough to 1985, or, where no trough could be identified, from 1981. [3] From 1985 to peak. [4] Trough in 1977. [5] Trough in 1979. [6] Series begins in 1971. [7] Trough in 1969. [8] Trough in 1978. [9] Trough in 1967. [10] Series begins in 1980.

Sources: National data and BIS estimates.

and 1989, only to have a substantial part of the rise reversed in the last three years. Norway also experienced large fluctuations, though not quite as pronounced. In the United Kingdom the upswing can be traced back to the mid-1970s: an increase of around 150% from trough to peak was only moderately affected by the recession in the early 1980s. Asset price swings in other countries, notably Australia, have also been steep relative to their own past experience and have had serious effects on the financial system and the economy.

Though useful as a synthetic measure of asset price behaviour, the aggregate index masks certain noteworthy movements in its individual components. In some countries distinct cycles in property prices are concealed by volatile movements in the equity index. The clearest case is Denmark, where real estate prices peaked in 1986. In addition, in some countries there have been sizable regional movements. In the United States, for example, major desynchronised swings have occurred successively in the Mid-West, the North-East and the South-West. Similarly, London and Paris have seen booms and busts which are diluted in the country-wide measures. Indeed, the only country in the sample that appears to have avoided a significant cycle in property or equity prices is Germany.

Comparison with the 1970s

In some respects asset price movements since the early 1980s resemble those in the early to mid-1970s. Large asset price fluctuations occurred during both periods, although their amplitude was generally greater in the 1980s (see the graph opposite). Moreover, major swings took place around business cycle peaks, in sharp contrast to the experience of the business cycle around the end of the 1970s.

The two downswings in real and nominal aggregate asset prices				
Countries	1970s[1]		1980s[1]	
	Real	Nominal	Real	Nominal
	cumulative percentage changes			
United States	−32	−17	− 8[2]	− 3[2]
Japan	−37	4	−36	−31
Western Germany	−22	− 2	− 2	1
France	n.a.	n.a.	−12	− 4
United Kingdom	−56	−41	−15[3]	− 7[3]
Canada	−17	− 7	−16	−12
Australia	−32	39	−14[2]	− 8[2]
Denmark	−28	− 9	−16	−10
Finland	−53	−16	−51	−42
Norway	−61	−56	−16	− 8
Sweden	−13	4	−31	−17

[1] The period is defined by the change in the real index from peak to trough or, when no trough was reached in the 1980s, to the most recent observation. [2] Trough in 1990. [3] Trough in 1991.
Sources: National data and BIS estimates.

Nevertheless, a number of differences are also apparent. First, in many countries asset price increases in the early 1970s generally occurred over a much shorter period – two to three years at most compared with over twice that in the 1980s. Secondly, movements in the early 1970s were dominated in most countries by increases in equity as opposed to real estate prices (see the table on the previous page). By contrast, although in the first half of the 1980s the rise in the asset price index was again mainly the result of stock price booms, in the second half the contribution of property prices was much greater, mainly reflecting the steep increase in the residential component. Australia and the United Kingdom are two notable exceptions to this pattern, in that property prices also played a major role in the 1970s. Thirdly, in a majority of countries the reversal of the upswing in real asset prices has involved larger declines in nominal terms than those in the 1970s (see the table above). This has been due in part to lower inflation, but has occurred despite the more prominent role played by property prices, historically much less likely to fall in nominal terms than equity prices. It goes some way towards explaining the more severe impact of asset prices on the balance sheets of both financial and non-financial economic agents in recent years.

Possible explanatory factors: real economic growth;

Differences between the two episodes can also be found in the mix of factors that may have underlain the asset price movements. Although in both periods asset price increases took place against a backdrop of robust economic growth, in almost all countries the sensitivity of the asset price index to real GDP growth was considerably higher in the 1980s (see the table opposite). The only countries where it was significantly lower were the United Kingdom and Denmark. Thus, while the more protracted upswing in economic activity of the 1980s may account for the longer duration of the rise in asset prices it cannot by itself completely explain its greater steepness.

inflation-adjusted interest rates;

Nor can the steeper rise be attributed to the level of inflation-adjusted interest rates (see the graph overleaf). In both episodes there is a clear negative relationship across countries between inflation-adjusted interest rates and asset price increases; however, rates were low or even negative in the early 1970s but positive and much higher in the 1980s.

taxation;

Explicit consideration of tax factors does not fundamentally alter this conclusion. Admittedly, the relevant opportunity cost of funds was lower in the 1980s once adjusted for tax provisions, a factor particularly significant in countries with relatively high inflation and for those agents able to deduct borrowing costs from their tax liability. For instance, once such an adjustment is made, the cost of funds for households' house purchases was negative for a good part of the 1980s in the Nordic countries, where full deductibility of mortgage interest payments combined with persistent inflation (see the graph on page 165). Moreover, a reduction in the effective tax relief may help to explain the timing of the recent downturn in residential property prices in several countries, notably some Nordic countries, and in commercial real estate prices in the United States. Nevertheless, favourable tax provisions also applied in the early 1970s, so that they cannot by themselves explain differences in the responsiveness to inflation-adjusted interest rates between the two episodes. As argued below, however, the impact of these provisions may have increased because of changes in the financial environment.

and credit availability

If the strength of economic growth, the level of inflation-adjusted interest rates and tax factors cannot satisfactorily account for the vigour of asset price inflation in the 1980s, then the main driving force has to be sought elsewhere. An obvious possibility is the behaviour of credit. In most countries in the sample there has been a relatively close relationship between the ratio of private sector credit to GDP and asset price movements, closer than in the early 1970s (see the graph on page 166).

There are a number of reasons why credit and asset prices may be correlated. On the demand side, borrowing is typically driven by

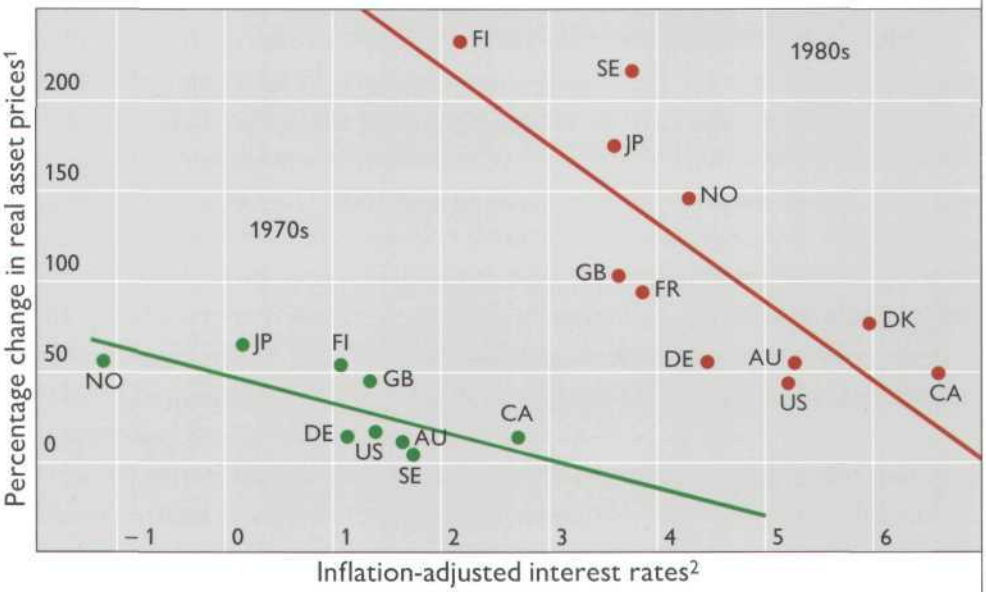
Sensitivity of real aggregate asset prices to economic growth in the two upswings*

Countries	1970s	1980s	Countries	1970s	1980s
United States	1.14	1.48	Australia	1.02	1.68
Japan	3.12	3.18	Denmark	3.19	2.31
Western Germany	1.36	1.82	Finland	2.43	6.35
France	n.a.	4.11	Norway	3.82	5.75
United Kingdom	4.05	3.39	Sweden	0.30	6.88
Canada	0.60	1.41			

* Trough-to-peak percentage increase in the real aggregate asset price index divided by trough-to-peak percentage increase in real GDP.

Sources: National data and BIS estimates.

Real aggregate asset prices and inflation-adjusted interest rates



Note: AU = Australia; CA = Canada; DK = Denmark; FI = Finland; FR = France; DE = western Germany; JP = Japan; NO = Norway; SE = Sweden; GB = United Kingdom; US = United States.

[1] Trough to peak. [2] Averages of quarterly ten-year government bond yields less an uncentred three-year moving average of inflation over the period defined by the movement in the real asset price index for each country.

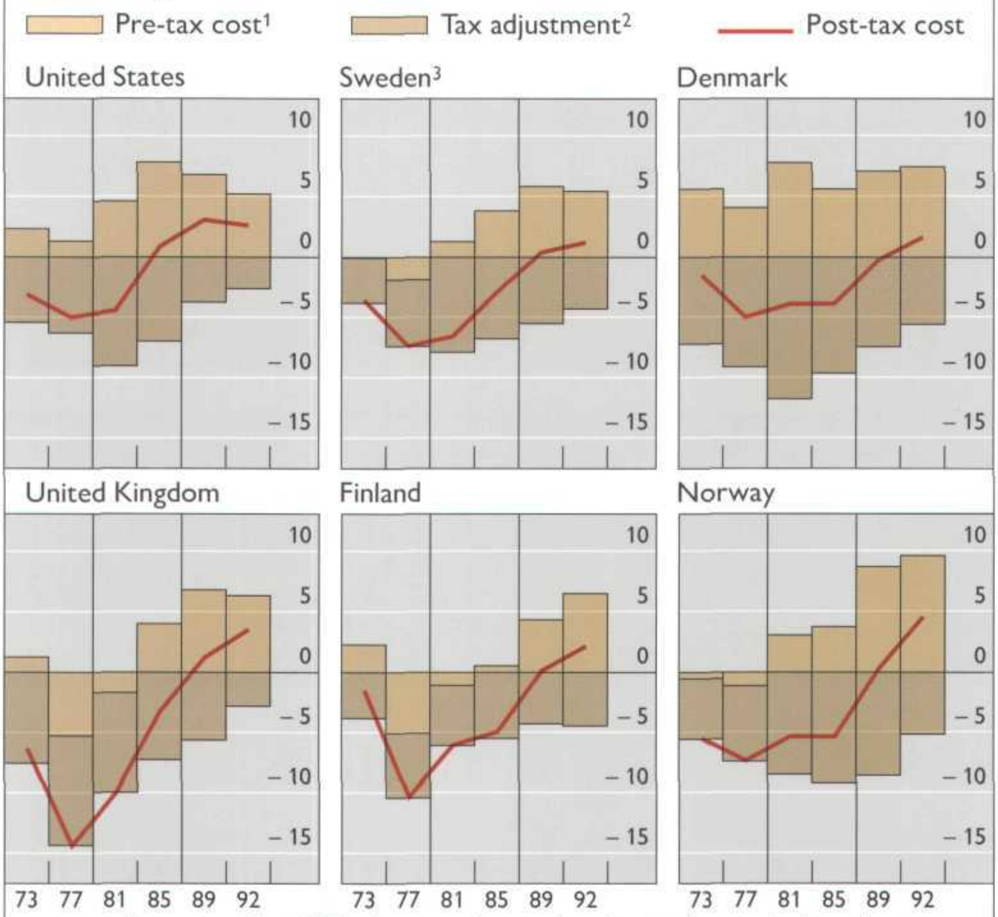
Sources: National data and BIS estimates.

expectations about the future income stream from investments, real and financial, which are reflected in the market price of assets. Borrowing decisions may also be of a more speculative nature, as when market participants seek to take advantage of anticipated capital gains. On the supply side, the financial intermediaries' willingness to lend increases when asset prices rise because of the borrowers' improved ability to provide collateral. In the later stages of asset price booms anticipated capital gains can become the dominant force and be disconnected from underlying fundamentals in the real economy. The downturn can then be triggered by a broad range of factors, including a slowdown in economic activity, less attractive tax provisions or a tightening of monetary policy. The stage can thus be set for a period of falling asset prices, adjustments in the balance sheets of both financial intermediaries and borrowers and declining or negative credit growth. For example, after borrowing heavily in the 1980s against the rising value of their dwellings (see the graph on page 167), many households in some countries saw the price of their property fall below their outstanding mortgage debt. It is estimated that in the United Kingdom at the end of 1992 as many as one and a half million homeowners, around 10% of the total, were so affected. Households in some Nordic countries and certain regions of the United States have faced similar problems.

Some elements of the above general scenario tend to accompany all medium-term swings in asset prices. What distinguishes the experience of the 1980s is their breadth and severity following the major expansion of

Inflation-adjusted cost of borrowing for house purchases

In percentages



Four-year (for 1992, three-year) periods ending in the year indicated

[1] Defined as the pre-tax mortgage rate less the rate of consumer price inflation. [2] Based on the top personal income tax rate. [3] New series since 1986.

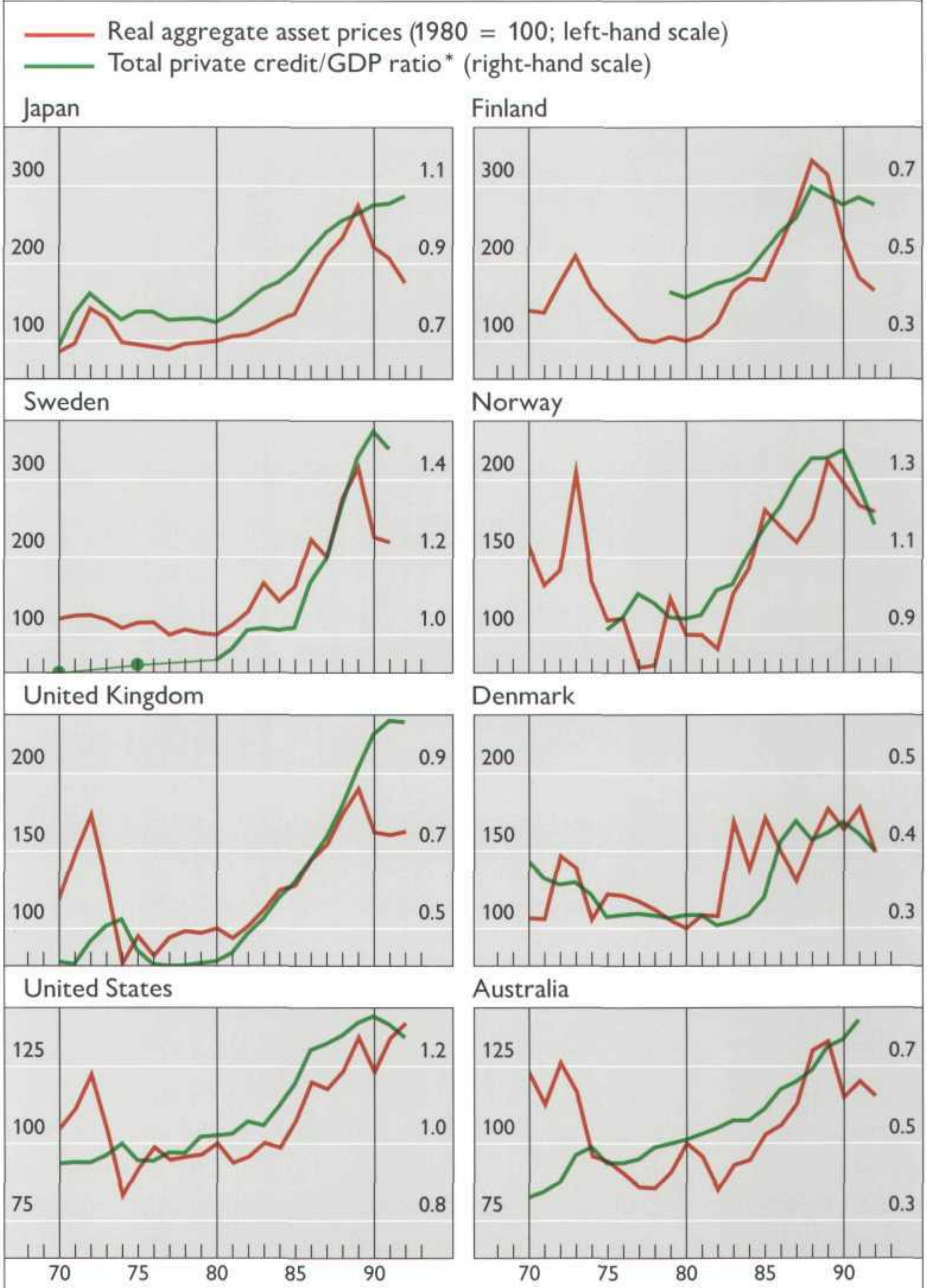
Sources: National data and BIS estimates.

credit during the decade. To a large extent this rapid growth reflected a relaxation of credit constraints in the financial industry in the wake of both market-driven and policy-determined structural changes. The end result of those changes was greatly to increase competitive pressures in the industry and to broaden the range of borrowing opportunities. In the process, they also heightened the impact of pre-existing tax provisions which encouraged indebtedness and which had been less effective during the period when credit rationing was prevalent.

The roles of deregulation and competition ...

The relative importance of government and market forces in affecting financial structures and behaviour is not always clearly identifiable, since deregulation has sometimes reflected the perception that existing controls were becoming ineffective. The mixture, however, has varied considerably across countries. For example, market forces were primarily responsible for the increase in competition between banks and securities firms in the United States which fuelled the debt-financed takeover wave during the 1980s, a factor contributing to the rise in stock prices. By contrast,

Real aggregate asset prices and credit



* For Denmark, bank credit only; for Sweden, data shown for 1970, 1975 and 1980 onwards.

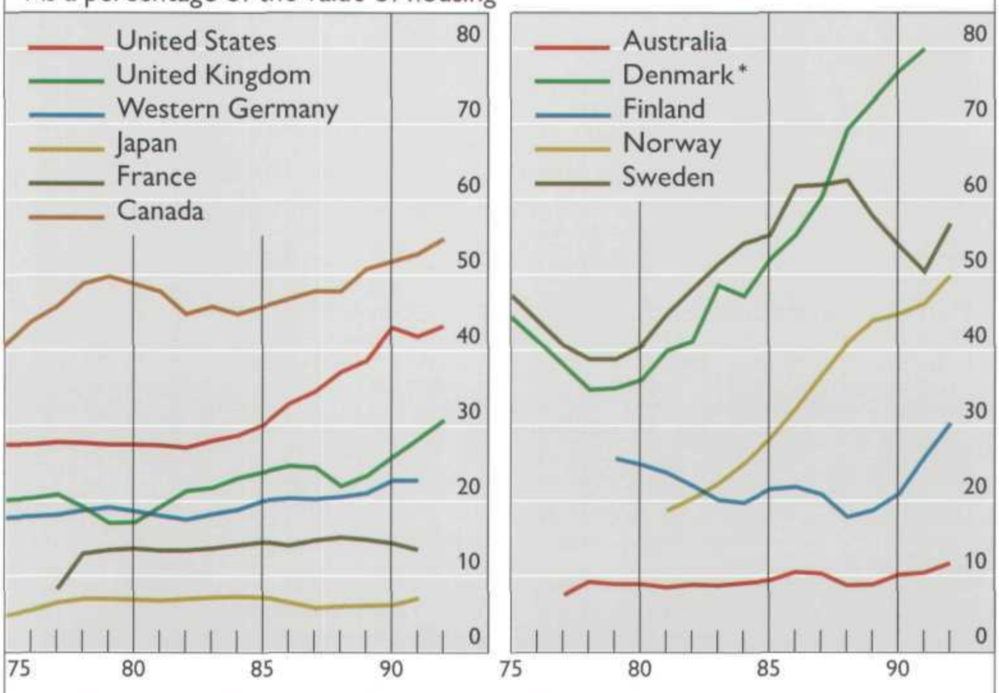
deregulation was especially broad in Sweden, Norway and Finland, which moved from a system where credit was rationed to one of open competition, all in the space of a few years in the mid-1980s. A similar process took place in Australia in the early 1980s. Deregulation was also extensive in the United Kingdom, where (direct and indirect) restrictions on credit were abolished and greater competition between banks and building societies was encouraged in the early to mid-1980s, thereby reinforcing an underlying market trend. Interestingly, in that country a deregulatory process (under the Competition and Credit Control Act of 1971) had also preceded the increases in asset prices of the early 1970s. In Japan deregulation has been more gradual, but as from the mid-1980s restrictions on corporations' access to international markets were relaxed and deposit rates partly freed, while less regulated non-bank credit institutions thrived. By contrast, in Germany, where the financial system underwent little structural change, there was no major cycle in asset prices.

... and of monetary policy

Alongside structural factors, easy monetary policy appears to have been partly responsible for the rapid growth of credit during the asset price upswing, particularly in some of the countries experiencing the largest price cycles. To different degrees, the policy stance in Sweden, Norway, Finland and Japan was arguably not consistent with restraint in borrowing. This was also true of the United Kingdom around the mid-1980s, just as it had been in the early 1970s. No doubt the rapidly changing contours of the financial system complicated the authorities' task. Where interest rates replaced quantitative rationing as the main mechanism governing the granting of credit, their level tended to provide a misleading indication of the tightness of credit conditions, especially in the presence of significant pent-up demand. Similarly, the surge in credit and broad monetary aggregates was sometimes discounted as an innocuous by-product of deregulation. In some cases, the relatively easy credit conditions were also connected with reluctance to let the exchange rate appreciate, the effects of which are

Mortgage debt

As a percentage of the value of housing



* Mortgage debt at market value, excluding intra-sectoral liabilities.

Sources: National data and BIS estimates.

especially significant in a context of liberalised capital flows. By contrast, the monetary discipline enjoyed by ERM members probably helped to temper speculative behaviour.

A fundamental question raised by the latest episode of medium-term swings in asset prices is whether such large movements are here to stay or whether the recent experience has been exceptional. To the extent that this episode reflected the costs of adjustment to a more competitive, deregulated financial environment, there are grounds for optimism. At the same time, in such an environment credit demands can be more easily accommodated, and so can speculative pressures. As is argued below, preventing such excesses, with the threat that they carry for financial stability, is a major policy challenge, and one that calls for consistent action at the macro and micro level.

The banking industry: recent performance

Widespread deterioration in bank results

Since the late 1980s there has been a widespread deterioration in the profitability, asset quality and credit standing of banks in most industrial countries. The unprecedented wave of downgradings which has swept through the industry is the most telling indicator of this trend.

This deterioration in part reflects the weakening of economic activity during the period. Its magnitude, however, has been exacerbated by the pronounced swings in asset prices, together with the fairly generalised surge in private sector indebtedness, which have characterised the present business cycle. Banks in those countries where asset price movements and the increase in credit have been relatively greater have been among the most severely affected. Real estate prices have played a particularly important role, not only because of the common use of property as collateral, but also because of the large and typically growing scale of lending for the acquisition and construction of property (see the table below).

The role of real estate ...

Preliminary data on the performance of the banking industry last year bear witness to the significant impact of real estate, especially commercial real estate, on profitability and asset quality (see the table opposite).

Banks' real estate lending in selected countries[1]

Countries	1982	1985	1990	1992	Countries	1982	1985	1990	1992
	as a percentage of loans to the private sector					as a percentage of loans to the private sector			
United States	29	31	41	43	Canada	30	33	46	51
Japan[2]	12	14	24	19	Norway	51[3]	48	50	46
Germany[4]	44	46	42	40	Portugal	23	28	34	33
France	28	29	31	30	Spain	19[3]	19	27	30
United Kingdom	16	19	31[5]	32	Switzerland	51	52	54	54[6]

[1] The data are not fully comparable across countries. [2] Lending to construction and real estate management firms. [3] 1983. [4] Prior to 1990, western Germany only. [5] Break in series resulting from the inclusion of a building society which was converted into a bank. [6] 1991.

Source: National data.

Profitability of major banks in 1991 and 1992[1]

Countries	Number of banks	Return on assets[2]		Loan loss provisions		Net interest margin		Operating costs	
		1991	1992	1991	1992	1991	1992	1991	1992
		as a percentage of total assets							
United States	15	0.60	1.12	1.13	0.97	3.19	3.45	3.93	3.89
Japan[3,4]	21	0.31	0.22	0.09	0.14	0.81	0.97	0.65	0.69
Germany[5]	3	0.63	0.67	n.a.	n.a.	2.15	2.11	2.30	2.30
France	6	0.39	0.29	0.67	0.73	2.13	2.20	2.15	2.07
United Kingdom	4	0.35	0.29	1.41	1.50	3.08	2.99	3.60	3.49
Canada[4]	6	1.26	0.60	0.54	1.11	3.24	3.12	2.80	2.80
Australia[4]	4	1.07	−0.25	1.27	1.88	3.66	3.43	3.61	3.71
Denmark[6]	2	0.01	−1.03	1.26	1.56	2.72	2.78	2.30	2.34
Finland	3	−0.49	−1.67	0.90	2.23	1.70	1.47	2.32	2.12
Netherlands	3	0.59	0.61	n.a.	n.a.	2.14	2.20	2.08	2.11
Norway	4	−3.77	−1.22	3.68	2.34	2.52	2.69	3.63	3.00
Spain	6	1.24	0.94	0.55	0.60	3.35	3.00	2.98[7]	2.88[7]
Sweden	6	−0.41	−1.99	1.82	3.20	2.37	2.28	1.85	2.05
Switzerland	3	0.74	0.73	0.48	0.57	1.45	1.40	2.07	2.18

[1] The data are not fully comparable across countries. [2] Pre-tax profit. [3] For 1992, half-year results at an annual rate. [4] Fiscal years. [5] Partial net operating profit, which excludes loan loss provisions, gains/losses on own trading and extraordinary items. [6] The portfolio of securities is marked to market. [7] Five banks.

Sources: For Sweden, national authorities; otherwise, IBCA Ltd.

The weakness of property prices and defaults on property loans were a key factor behind loan loss provisions in several countries, most notably in some of the Nordic and Anglo-Saxon countries, Japan and France. In the United States provisions closely followed the fortunes of the commercial real estate market: they fell somewhat from the very high levels of previous years as the market stabilised across much of the country, particularly in the North-East, but continued to rise in Southern California, where prices were expected to fall further. In Sweden as much as one-half of loan losses were reportedly associated with real estate.

... and equity prices

The behaviour of share prices was comparatively less important but played an appreciable role in at least two countries where banks have significant longer-term equity investments. In Finland the sharp decline in the stock market added to the banks' serious problems. In Japan, unlike in previous years, banks were unable to boost their results by realising latent gains on their shareholdings owing to a combination of continued market weakness and moral suasion on the part of the authorities, concerned that such sales could drive prices down further.

Positive factors

The unfolding of asset price deflation last year partially offset the impact of certain positive factors on bank performance. One of these was the decline in short-term interest rates and the steepening of the yield curve, which widened interest margins primarily among banks located in non-ERM countries. In addition, the currency turmoil in the ERM was a significant source of windfall income for several major institutions, particularly in the United States and the United Kingdom. A longer-term factor was banks' continued efforts to contain operating expenses, as part of the broader retrenchment in the industry following the rapid expansion of the previous decade and in response to structural competitive pressures. In some cases attempts to raise spreads on lending also played a role, most notably in the United States.

The combination of the various forces impinging on bank profitability resulted in a mixed picture last year. In Norway, Sweden and Finland banks continued to incur losses (albeit in Norway on a diminishing scale, indicating that the crisis was beginning to abate). In most other countries profit margins declined, steeply in France and Australia, where some large banks made substantial losses. Results were uneven in the United Kingdom: some major institutions saw their profits rise considerably from the depressed levels of the previous year but one recorded its first ever pre-tax loss. By contrast, in the United States the banking industry as a whole reported record earnings and credit rating upgrades outnumbered downgrades by a substantial margin, suggesting that the worst of the difficulties had been overcome.

A major bright spot: the United States

The management of financial distress

Some recent episodes of financial distress

From a longer-term perspective, in a number of countries the deterioration in the performance of credit institutions has been sufficiently severe for governments to be called upon to share the costs of the required restructuring. Financial distress in significant segments of the industry has occurred in the United States, Norway, Sweden and Finland. In Japan actual bankruptcies or rescues have so far been limited to non-bank financial institutions and some of the smaller banks; but the authorities have taken measures and encouraged private initiatives aimed at securing an orderly resolution of the asset quality problems afflicting credit institutions more generally. In all these countries policy-makers have had to find answers to pressing questions regarding the appropriate management of the difficulties, with implications for macroeconomic stability and the efficiency of their financial systems.

The problems: scale and implications

Indicators of distress:

institutions that fail or receive support;

An indication of the relative scale of financial distress is given by the size of the assets of the institutions which have failed or received assistance (see the tables on pages 171 and 172). The statistics indicate that the problems have been most acute in the Nordic countries, where the banks affected in any given year have accounted for at least one-quarter of total industry assets. In Finland several banks have been restructured and all banks have been allowed to benefit from a general infusion of capital by the Government in proportion to their risk-weighted assets. In Sweden at least three more institutions, not included in the table and accounting for about half of total industry assets, have applied for assistance in 1993. By comparison, the problems have been less significant in the United States. However, because of the lower degree of concentration, the number of institutions affected has been much larger.

Bank support operations in the United States								
Institutions	Recipients			Total support[1]			Government support[2]	
	number		assets as % of industry	as % of recipients' assets	as % of GDP	in billions of US dollars	as % of total support	as % of government deficit[3]
	absolute	as % of industry						
Banks								
1980–87 average	82	0.6	0.5	33.3	0.1	3.5	–	–
1988–91 average	181	1.4	1.1	39.5	0.3	13.4	–[4]	–[4]
1992	122	1.0	1.2	28.3	0.2	12.5	–[4]	–[4]
Peak (1991)[5]	127	1.0	1.7	31.2	0.4	19.8	–[4]	–[4]
Thrifts[6]								
1980–87 average	36	1.1	1.1	94.5	0.2	9.1	–	–
	321	*9.9*	*8.6*					
1988–91 average	197	7.8	6.1	96.6	1.3	67.9	100.0[7,8]	25.5[7]
	364[9]	*12.3*[9]	*8.1*[9]					
1992	69	3.6	4.1	76.5	0.5	27.0	100.0[8]	9.2
Peak (1990)[5]	315	12.5	8.4	88.6	1.5	83.5	100.0[8]	26.4
	520[10]	*16.5*[10]	*14.1*[10]					
Total								
1980–87 average	118	0.7	0.6	59.6	0.3	12.5	–	–
1988–91 average	378	2.4	2.3	70.3	1.5	81.3	54.6[11]	25.5[7]
1992	191	1.4	1.7	49.7	0.7	39.5	68.4[11]	9.2
Peak (1988)[5]	426	2.6	3.2	73.9	2.3	113.7	–	–

[1] Gross disbursements of deposit insurance funds and the Resolution Trust Corporation. [2] Excluding lending for working capital. [3] Scaling factor only. [4] In 1991 the Government authorised the Federal Deposit Insurance Corporation to borrow US$ 30 billion, but so far the agency has not used that authority. [5] Peak measured in terms of percentage of assets of all institutions supported. [6] Figures in italics refer to those institutions technically bankrupt according to Generally Accepted Accounting Principles (GAAP). [7] 1989–91; there was no funding in 1988. [8] Authorised on and off-budget funding totalling some US$130 billion in 1989–92; additional funding required is estimated to exceed US$ 30 billion. Less than 10% of the total is expected to be recovered from industry resources. [9] 1988 only. [10] 1987 peak. [11] Based on gross disbursements only, including lending for working capital.

Sources: National authorities and BIS estimates.

the amount of support;

A second measure of financial distress is the amount of support provided by private guarantee/insurance funds or governments, in the form of capital injections, loans, guarantees and payments to depositors and creditors (also shown in the tables). Although the size of the support obviously depends on the form of assistance, the picture that emerges is broadly similar to that just outlined. The amounts involved have been especially large in the Nordic countries, where they have imposed a heavy burden on deteriorating government finances. They have also added appreciably to the budget deficit in the United States. The United States is the only country for which estimates of the costs of the resolution of distress, as opposed to the amount of support, are available. The estimated cumulative cost since 1980 is equivalent to some 3% of 1992 GDP (see the graph on page 173).

and non-performing loans

A useful complementary indicator of distress is non-performing loans (see the table on page 174). This measure focuses on asset quality and gives some idea of problems that are latent in the institutions' portfolios.

Bank support operations in selected countries

Countries	Recipients			Total support[1]			Government support[2]	
	number		assets as % of industry	as % of recipients' assets	as % of GDP	in billions of local currency units	as % of total support	as % of government deficit[3]
	absolute	as % of industry						
Norway[4]								
1988	2	1.0	2.5	5.4	0.1	0.8	25.0	1.3[5]
1989	7	3.8	3.9	16.5	0.6	3.9	14.6	6.5[5]
1990	9	5.3	4.5	6.8	0.3	1.9	–	–
1991	17	10.5	59.4	4.1	2.0	14.0[6]	59.8[6]	298.9[6]
1992	11	7.4	69.8	2.8	1.7	12.0[6]	100.0	50.6[6]
Finland[7]								
1991 (individual)	28	6.3	15.7	3.7	0.9	4.6	84.5	13.2
1992 (individual)[8]	22	6.0	23.8	15.1	5.7	28.2	86.2	58.9
1992 (general)[9]	135	33.0	92.4	1.1	1.6	7.9	100.0	19.2
Sweden[10]								
1991	1	0.8	18.2	1.5	0.3	4.2	100.0	19.8
1992	3	2.7	26.9	7.1	2.0	29.3	100.0	26.0
1993[11]	1	0.9	4.4	50.7	2.4	34.0	100.0	24.1
Japan								
1991–92[12]	2	0.3	0.1	3.3	0.0	28.0	–	–

[1] Total support provided to institutions in distress by private guarantee/insurance funds or by governments. It includes guarantees but excludes the acquisition of bad assets. [2] Including the central bank. [3] Scaling factor only: the support granted represents in part the acquisition of assets whose eventual contribution to government revenues is difficult to quantify. [4] Around one-eighth of the support in the form of guarantees. [5] Surplus. [6] Excluding a concessionary loan programme for which all banks were eligible amounting to some N.kr. 15 billion. [7] No support in the form of guarantees. Authorised support up to end-1993 not utilised by end-1992 amounts to some F.mk. 25 billion, or around 5% of 1992 GDP. [8] A single joint stock company was formed through a merger of forty-one savings banks, some of which were in distress. [9] General capital injection. [10] Around one-third of the support in the form of guarantees. [11] Industry assets, total number of banks, GDP and government deficit in 1992. [12] Only mergers assisted by the bank deposit insurance fund.

Sources: National authorities and BIS estimates.

The main drawback, however, is that statistics on non-performing loans are not generally available and definitions vary widely across countries, reflecting different approaches to disclosure and accounting. Existing information suggests that the share of impaired loans is broadly similar in the Nordic countries, where in each case over 10% of the loan portfolio is non-performing and a further significant proportion has been restructured because of a deterioration in the borrowers' financial position. Such problem loans net of accumulated provisions exceed tier 1 capital. Figures for US commercial banks confirm that asset quality in this sector has never been as seriously affected as in the Nordic countries.

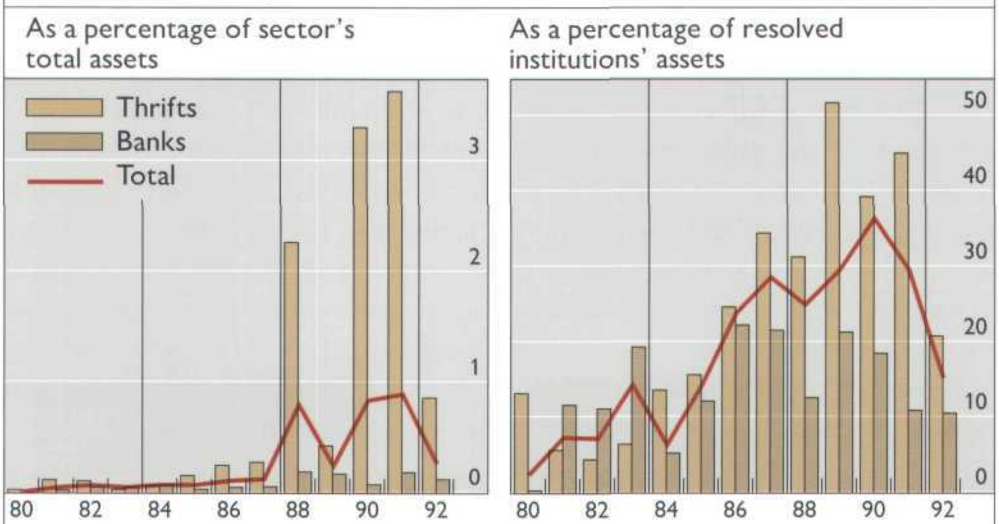
The limited statistics on non-performing loans make it particularly difficult to assess asset quality in the case of Japanese banks. Disclosed information covers only loans that are 180 days past due at twenty-one major banks. The exclusion of loans granted at concessionary rates, transferred to liquidating companies or on the books of troubled affiliates has encouraged suggestions that the actual scale of problem loans is likely to be larger, especially given the close ties of banks with non-bank financial institutions, either as owners or principal lenders. The total loans of these institutions amount to around one-quarter of those of the twenty-one major banks, with some 40% being collateralised by real estate. According to market estimates, about one-third of the loans of housing loan finance companies alone, for instance, are non-performing (¥ 5 trillion or over 40% of the officially identified bank problem loans); the debt of several of them is in the process of being restructured in informal arrangements. In addition, there is no disclosed information about asset quality at regional and "shinkin" banks, some of which were among the most active in speculative dealing in the property and share markets during the boom years and are relatively more exposed to the impact of the deregulation of deposit rates.

The implications of distress ...

... when market and supervisory discipline is limited ...

Latent or overt losses impairing credit intermediaries can have serious implications for the economy, although these are often difficult to assess. If market and supervisory discipline is limited, whether because the problems remain undisclosed, because markets are slow to react or because of bailout expectations, there is likely to be a tendency for resources to be misallocated. Intermediaries continue to obtain funds on terms that do not reflect their underlying condition, are under pressure to lend to distressed borrowers at the expense of sounder customers and have a greater incentive to take excessive risks in an effort to redress their financial position. As vividly illustrated by the experience of the savings and loan industry in the United States, these patterns of behaviour can set the stage for a delayed but more serious crisis. At the macro level, a large element of "wealth illusion" is involved, as holders of claims on the institutions overestimate the value of their assets. Budgetary statistics may be severely distorted, since under these conditions the government is often de facto accumulating hidden liabilities, especially burdensome when denominated in foreign currency and vis-à-vis non-residents.

Cost of resolving financial distress in the United States*



* Estimates of the net cost to the insurance funds and the Resolution Trust Corporation (RTC) of dealing with failed or failing institutions.

Sources: Federal Deposit Insurance Corporation, Office of Thrift Supervision and RTC.

Banks' non-performing loans in selected countries, 1992[1]						
Countries	Non-performing[2]		Restructured[3]		Net problem loans[4]	*Memo: Property owned[5]*
	as % of loans	as % of assets	as % of loans	as % of assets	as % of tier I capital	*as % of assets*
United States[6]	3.1	1.8	0.6	0.3	7.9	*0.7*
Peak (1991)	3.7	2.2	0.5	0.3	13.9	*0.8*
Norway[7]	11.5	9.3	n.a.	n.a.	99.5	*n.a.*
Finland	12.9	7.7	1.0	0.6	141.0[8]	*n.a.*
Sweden	13.4	8.3	3.9	2.4	145.4	*1.1*
Japan[9]	3.1	2.0	n.a.	n.a.	40.4	*n.a.*

[1] Non-consolidated accounts except for the United States and Finland. Unless otherwise specified, both loans and assets are measured gross of accumulated provisions. [2] United States: at least ninety days past due on an accrual basis plus loans on a non-accrual basis; Norway and Finland: over ninety days past due; Sweden: over sixty days past due plus other credits whose repayment is doubtful; Japan: over 180 days past due. [3] Loans whose terms have been renegotiated because of a deterioration in the financial position of the borrower. [4] Non-performing and, where available, restructured loans net of accumulated provisions. [5] Property taken over on loans foreclosed. [6] Commercial banks only. [7] Preliminary data. [8] Including non-performing guarantees. [9] Twenty-one large banks; end-September.

Sources: National authorities and BIS estimates.

...and when the crisis erupts

When the crisis erupts, it can have a major contractionary impact on the economy. The crisis is transmitted through several channels. As confidence in the intermediaries evaporates, the disorderly withdrawal of funds, the drying-up of credit lines and the unwillingness to transact with troubled institutions force them to cut their lending drastically and to dispose of assets at "distress" prices. The payment system may be seriously disrupted: as credit dries up, so does the banks' ability to provide settlement services. The typically high leverage of credit institutions, the close linkages between them and imperfect information about their underlying condition create a flammable mixture with the potential for amplifying the crisis and its associated costs, as localised distress can easily spread through the system.

Reasons for government intervention

Concern about systemic problems of this kind has historically been at the root of the authorities' involvement in the management of financial distress. The form that this involvement has taken has depended on several factors, including the severity of the problems, country-specific features of the legislative and regulatory environment and broader political and economic constraints. In all cases, however, three interrelated issues have had to be tackled: how to avoid a disorderly market reaction; how to achieve the required restructuring of the institutions' balance sheets and operations; and how to prevent a recurrence of the problems.

Avoiding a disorderly market reaction

The options open to the authorities to avoid a disorderly market reaction depend to a large extent on the timing of their action and the scale of the problem. Early identification of the latent distress and swift intervention are crucial. These in turn call for appropriate information systems and the necessary funding capacity.

The role of accounting standards ...

A key element of information systems is accounting standards. Unless banks are required or allowed to make provisions against doubtful loans on a timely basis, there is a risk that losses will be understated and remain undetected. This can obscure the build-up of distress. In Japan, where provisioning has largely been determined by restrictive rules limiting tax deductibility, banks were given somewhat greater flexibility to set provisions against their doubtful loans in 1992. In the Nordic countries provisioning and write-off rules have been tightened in recent years so as to offer a more realistic picture of an institution's financial strength. The tightening in Norway has been regarded by some as excessive and as having contributed to the depth of the crisis. However, since actual losses have typically tended to exceed previous estimates, the rules are more likely to have affected their timing than their scale.

... public disclosure ...

A closely related question concerns the extent to which information known to the authorities about banks' balance sheets is to be publicly disclosed. Countries have traditionally differed widely in this respect. In the United States, for instance, disclosure standards have been comparatively high, at least for publicly quoted banks; they have recently been improved significantly in the Nordic countries and Japan under pressure from the market. The differences observed reflect in part structural features of financial arrangements not specific to the operation of banks, such as the extent to which corporate control is exercised through capital markets. They also result from different perceptions as to the role to be assigned to market forces in disciplining banks: less disclosure inevitably shifts the burden towards prudential supervision and regulation. It is generally agreed, however, that while disclosure may be useful in preventing the build-up of distress, once latent distress is present simply revealing the underlying condition of the intermediaries risks precipitating a disorderly market reaction. Accompanying stabilising measures are necessary.

... and funding capacity

Swift intervention and the maintenance of confidence in the system call for appropriate funding capacity. One possible source of funding is industry-financed deposit insurance or guarantee schemes. These predated the emergence of distress in all five countries except Sweden. In their absence a greater role has to be played by the central bank and the government directly. The schemes, however, may not be sufficient to secure an orderly resolution of large-scale problems. In the United States, Norway and Finland existing arrangements had to be supplemented by government resources; in the United States limited funding capacity was one reason why the resolution of technically insolvent thrifts was delayed for so long. In Japan the reserves of the deposit insurance fund, at around ¥700 billion, are comparatively limited. In Sweden, Finland and, less formally, Norway the authorities felt obliged to state publicly that the timely fulfilment of all the banks' liabilities would be guaranteed, not least with a view to allaying concerns in the international financial community which might have threatened external funding.

There are several ways of dealing with institutions in distress: forbearance, liquidation, and balance-sheet restructuring as a means of maintaining the institutions in operation either as independent entities or merged with other companies. Examples of all these strategies can be found in the experience of the countries considered.

Three strategies:

Forbearance – defined broadly as a "buying time" approach, possibly combined with a relaxation of supervisory and regulatory standards – has sometimes been adopted when the difficulties have been viewed as temporary and/or manageable by the impaired institutions. One such example is the experience of the US savings and loan industry in the wake of the sharp rise in interest rates in the early 1980s which undermined its solvency: many institutions were allowed to continue operating despite being technically insolvent (see the table opposite). A similar example in some respects is the accommodating treatment of US money centre banks immediately after the eruption of the crisis in lending to developing countries, especially as regards provisioning levels. Some elements of forbearance can also be found in the Japanese authorities' handling of the current asset quality problems, as exemplified by the temporary relaxation of the accounting treatment of valuation losses. Although forbearance may work in certain circumstances, it is not without risk. Its success typically depends on external events largely beyond the control of the authorities and the intermediaries: in the cases just mentioned, a more favourable configuration of interest rates, an improvement in the debt repayment capacity of the borrowing countries and a propitious macroeconomic environment. In the meantime, any relaxation of supervisory discipline can weaken the constraints on imprudent behaviour.

forbearance;

Liquidation, or the piecemeal sale of the institutions' assets, is a comparatively infrequent procedure. This in part reflects the view that considerable value is lost when the assets of a bank are broken up, not least because of the disruption to established credit relationships. It is also due to concern about the knock-on effects on other parts of the banking and financial system more generally. Because the significance of these factors tends to grow with the size of the bank, it is typically the smaller institutions that are liquidated. This is clearly illustrated by the US experience, where the authorities responsible (the Federal Deposit Insurance Corporation (FDIC) for the banks and the Resolution Trust Corporation (RTC) for most thrift institutions) have been statutorily bound to choose the least costly solution, except possibly, in the case of the FDIC, when the intermediary was considered to be "essential to the community" (see the table opposite). In the Nordic countries and Japan liquidation procedures have been initiated almost exclusively in the case of non-bank financial companies.

liquidation;

The more common solution is to restructure the distressed institutions' balance sheets. This invariably involves a direct or indirect recapitalisation. One possibility, standard practice in the Nordic countries, is to

and balance-sheet ...

Forms of resolution of financial distress

	United States		Norway	Finland	Sweden	Japan
	Banks	Thrifts				
Liquidation						
Number	290	344	1	–	–	–
% of cases	19.3	29.9	3.6	–	–	–
% of assets	5.2	11.9	0.2	–	–	–
Closure and acquisition						
Number	1,137	807	3	–	–	–
% of cases	75.5	70.1	10.7	–	–	–
% of assets	73.8	88.1	31.6	–	–	–
Open-bank assistance[1]						
Number	78[2]	–	24 (16)	34 (16)[3]	3 (1)	2 (2)
% of cases	5.2	–	85.7 (57.1)	100.0 (47.1)	100.0 (33.3)	100.0 (100.0)
% of assets	21.1	–	68.1 (6.8)	100.0 (47.4)	100.0 (13.7)	100.0 (100.0)
Memorandum items:						
Government takeovers						
Number	*106*[4]	*698*[5]	*2*	*2*[3]	*2*[6]	–
% of cases	*7.0*	*60.6*	*7.1*	*5.9*	*66.7*	–
% of assets	*24.8*	*85.5*	*30.2*	*83.5*	*86.3*	–
of which:						
Negotiated acquisitions	–	–	–	*2*[3]	*2*[7]	–

[1] Assisted mergers in brackets. [2] Banks were often merged but no precise figures exist. [3] A single joint stock company was formed through a merger of forty-one savings banks, some of which were in distress. [4] FDIC bridge banks (temporary ownership); only eight transactions if subsidiaries are consolidated. [5] RTC conservatorships (temporary ownership). [6] One bank was already majority-owned by the Government. [7] The value of one of the banks' shares is subject to arbitration.

Sources: National data and BIS estimates.

inject capital into the troubled intermediaries themselves, either through an explicit infusion of funds or through guarantees. The guarantee may relate to the value of the assets, the fulfilment of repayment obligations or the residual acquisition of share capital issues. A second, complementary possibility is to assist in the merger of the institution with a better capitalised one, often after having taken over its bad assets. This is the most frequent procedure applied to US banks ("purchase and assumption"); a variant is also common in Japan, where the authorities encourage stronger institutions to take over weak ones. Mergers have also been numerous among savings banks in Norway and Finland. They may be more problematic when the degree of concentration in the industry is already high, as is the case among large banks in the Nordic countries. A third possibility is for creditors to accept a significant reduction in the contractual value of their claims, an element present in informal arrangements in Japan. The recent rescue of a large housing loan company, in which creditor banks restructured their loans on concessionary terms, illustrates this approach.

... and broader restructuring

The reshuffling of assets and liabilities, however, is only a means to a more efficient use of human and financial resources. The restructuring, therefore, is generally extended to broader aspects of the institutions' operations, such as the elimination of excess capacity. In the Nordic countries, for instance, the restructuring plans have typically involved the slimming-down of branch networks, the shedding of labour (see the table on page 27 in Chapter II), withdrawal from certain activities or markets and internal organisational changes.

Separate management of bad assets

Questions of recapitalisation and efficiency underlie the decision as to whether bad assets should be managed separately (see also Chapter III). Separate management in a so-called "bad bank" or liquidating company is usual in the United States, where these assets are administered by the FDIC and the RTC. In Sweden the assets of a number of banks have been transferred to a separate subsidiary of the distressed institution or to an independent company. A similar scheme, set up jointly by banks, has recently begun to operate in Japan. When the assets are removed from the banks' balance sheets at a concessionary price, there is an element of recapitalisation. This has been the rule in the United States when the distressed institutions are not liquidated. Otherwise, the main rationale for separate management rests on organisational efficiencies, which may help to extract greater value from the bad assets and reduce cross-subsidisation between healthy and distressed borrowers. The internal restructuring of Swedish banks is one such example. In addition, separation may reflect an attempt to alleviate pressures to dispose of collateral or to overcome specific regulations. This has been the case in Japan, for instance, where the scheme allows banks to claim tax relief on their doubtful loans.

Two pressing concerns:

avoiding distortions in competitive conditions;

One pressing concern which must be addressed in any approach to crisis management is how to minimise distortions in competitive conditions deriving from the authorities' involvement. These take at least two forms. The first, which has been the focus of debate in the United States, is the disparity in the treatment of distressed institutions between smaller ones, typically liquidated, and larger ones, more likely to be taken over and/or to receive assistance without being closed down. The more favourable treatment of creditors and, possibly, shareholders of larger intermediaries can be reflected in better funding terms. The second form, typical of the Nordic countries, where liquidations have been very rare, is the disparity between the weak institutions, which receive assistance, and the strong ones, which do not. This is perceived as particularly unfair, since in general the healthier companies are also better managed.

There is no simple solution to either problem. The concern voiced in the United States could be met by ensuring greater uniformity of treatment of distressed institutions, as in the Nordic countries. There would then be a risk, however, of relaxing market discipline excessively. The Nordic concern can be tackled in a number of ways. Eligibility for assistance can be broadened. Assistance can be provided on terms designed to minimise the cost to the government and to replicate market conditions. The behaviour of the institutions can be monitored with a view to identifying and correcting unfair competitive practices. All of these possibilities have indeed been employed, particularly in Sweden and Finland, where the need to minimise competitive distortions has explicitly been adopted as a guiding principle of intervention. In Norway concerns about unequal treatment were the motivation for special central bank loans at concessionary interest rates granted to all banks on the basis of their risk-weighted assets and amounting to some N.kr. 15 billion (or around 2% of GDP). Nevertheless, it is in the nature of government involvement in crisis management to interrupt the free operation of market forces. Distortions, therefore, are unavoidable.

and moral hazard

A second pressing concern is how to limit the risk that the authorities' management of distress may indirectly soften constraints on financial discipline ("moral hazard"). In the short run the problem is comparatively manageable: when assistance is provided, the authorities may either take over the distressed institutions and hence control the restructuring more directly, as in the case of large banks in Norway, or grant support conditional on specific rehabilitation measures, in principle the preferred solution in Sweden and Finland. In the longer run, however, to the extent that the management of distress insulates those with claims on the intermediaries from the losses incurred, market discipline may be relaxed. Moreover, experience suggests that public ownership may tend to exacerbate this risk.

The treatment of depositors and creditors ...

Protecting small depositors is everywhere a basic public policy objective. Larger depositors and other creditors are de facto insulated when the institutions are spared bankruptcy proceedings and are not liquidated; protection may, however, be less than complete in informal arrangements, as in Japan, or when the authorities retain some discretion as regards the treatment of creditors and depositors, as in the United States since 1989. Moreover, while it is generally agreed in principle that it would be desirable to hold owners and, where appropriate, managers financially responsible for the institutions' distress, various constraints and other considerations may complicate matters in practice.

... of owners ...

The owners may not be clearly identifiable as a separate category, as in the case of savings banks in the Nordic countries, which are "owned" by local communities or organised as mutual companies. The authorities may not have the legal power to enforce losses on shareholders. In Norway, for example, a special royal decree had to be passed in November 1991 in order to permit the write-down of share capital without the consent of shareholders. Neither in Sweden nor in Finland are such forced write-downs possible. Similarly, in neither country is there a legal basis for the authorities to take over a bank other than through bankruptcy proceedings or by mutual consent. Planned legislation in Sweden is designed to remedy these constraints. More generally, government reluctance to own institutions may place natural restrictions on the harshness of treatment. Similar problems have also existed in the United States, where the FDIC was not empowered to own voting stock in a bank until 1987. As a result, failure to find a suitable candidate to take over a distressed institution in a "purchase and assumption" transaction could leave the FDIC with little alternative but to provide assistance without closing the bank, to the benefit of existing shareholders. This partly explains the contrast between the handling of Continental Illinois, assisted and not closed, and that of the Bank of New

England, temporarily taken over by the FDIC under the new "bridge bank" authority, which allows the agency to own a bank for a period of up to five years.

... and of management

Certain cross-country differences are also apparent in the policy adopted towards managers. Available evidence suggests that replacing managers has been standard practice in the United States and Norway. It has been less frequent in Sweden, reflecting in part prior dismissals by shareholders, and appears to have received somewhat less priority in Finland. When distress is generalised, it may be felt that the fault does not primarily rest with the managers of the individual institutions. In addition, the comparatively limited pool of alternative managerial resources in small countries may be seen as a constraint.

The limitations of government involvement

Concerns about distortions of competitive conditions and moral hazard are a reminder that government involvement in the management of financial distress comes at a cost and is subject to its own limitations. Governments cannot be viewed as a kind of "deus ex machina", capable of erasing painlessly and at a stroke the serious consequences of financial disequilibria. For example, the assumption of losses by the government in effect redistributes their burden more widely; it does not eliminate it, as is reflected in swelling government borrowing requirements. And when the liabilities vis-à-vis non-residents are sizable, the constraints on external financing can quickly be tested.

Prevention

Lessons for prevention:

The emergency management of financial distress needs to be supplemented by longer-term measures aimed at preventing the recurrence of the problem. A key lesson to be drawn from the origins of the recent difficulties is that prevention calls for mutually reinforcing policies at the macro and micro levels with a view to ensuring financial discipline.

a long-term anti-inflation commitment;

At the macro level, historically the best safeguard against financial excesses has been a firm long-term anti-inflation commitment. The inflation of the 1970s set the stage for the sharp rise in the level and volatility of interest rates in the early 1980s, which triggered the crisis in the US thrift industry and in lending to heavily indebted developing countries. Relatively high inflation has also contributed to the present difficulties in the Nordic countries, not least by interacting with tax provisions to provide generous subsidies to borrowers. As discussed above, the comparatively easy monetary stance in the Nordic countries and in Japan arguably facilitated the surge in asset prices, a pattern also observed elsewhere, notably in the United Kingdom.

At the same time, a firm anti-inflation policy is clearly not sufficient. The difference in the responsiveness of asset prices and the general price level to credit conditions can pose a serious dilemma for the monetary authorities, who may have to weigh the risk of failing to restrain speculative behaviour, on the one hand, against that of an unwelcome contraction in the real economy, on the other. This dilemma arose most obviously in Japan, where evident signs of speculative excesses coexisted with low inflation.

and prudential supervision and regulation

At the micro level, the additional policy lever for achieving financial discipline is prudential supervision and regulation. As is most clearly illustrated by the experience of the Nordic countries and the US savings and loan industry, unless prudential safeguards are considerably strengthened in a liberalised, more competitive financial environment so as to complement market discipline, the emergence of distress is a major risk.

Steps in this direction have been taken in all the countries which have experienced problems. Some have been part of broader international efforts, most notably the strengthening of capital standards in line with the Basle capital accord. Others have been in response to more specific shortcomings of domestic arrangements. Improvements in disclosure are one example. Another is the measures taken in Japan to bring under an upgraded supervisory umbrella those non-bank financial companies where distress first emerged. In Finland the supervisory system is being overhauled. In the United States several policy initiatives since the savings and loan crisis have aimed at reinforcing the framework of prudential regulation and supervision. The most recent, the Federal Deposit Insurance Corporation Improvement Act of 1991, is especially broad-ranging. As part of its implementation, late 1992 saw the introduction of a system of measures, some mandatory and some discretionary, to be taken by federal bank regulators depending on the level of capitalisation of institutions at risk. The system is designed to ensure "prompt corrective action" with a view to reducing the probability of failure and the associated costs to the Bank Insurance Fund. The Act also tightened the conditions under which the FDIC may provide open-bank assistance. In addition, in January 1993 the FDIC for the first time charged risk-related deposit insurance premiums, based on levels of capitalisation and regulators' supervisory evaluations. The change was motivated by the belief that the previous system was overly generous and underpriced, thus blunting incentives to prudent behaviour.

Paradoxical consequences of deregulation

As discussed in last year's Annual Report, strengthening the framework of prudential regulation and supervision in response to the highly competitive and rapidly changing financial environment is a global policy challenge. Together with the pursuit of a stable and prudent macroeconomic policy it is also a precondition for securing and preserving the benefits, while avoiding the costs, of the process of deregulation that has gathered pace during the past decade. A key objective of this process has been to reverse the pervasive government involvement that characterised the financial systems of many industrial countries. The experience of those countries in which a financial crisis has erupted indicates that, unless buttressed by the appropriate macro and micro policies, deregulation may paradoxically lead to more, rather than less, government involvement.

VIII. Foreign exchange markets: developments and their possible causes

Highlights

This chapter first describes events in the foreign exchange markets during the period under review. In a second part it discusses the many complex, and often interrelated, factors which came together to cause the protracted exchange market crisis in Europe in 1992 and the first five months of 1993.

The dollar again described a complete cycle of appreciation and depreciation during the period under review, as confidence in the recovery of the US economy first waxed and then waned. In late 1992 confidence strengthened yet again and a second cycle appeared to have set in. After several bouts of weakness, the yen at last began to appreciate noticeably after September.

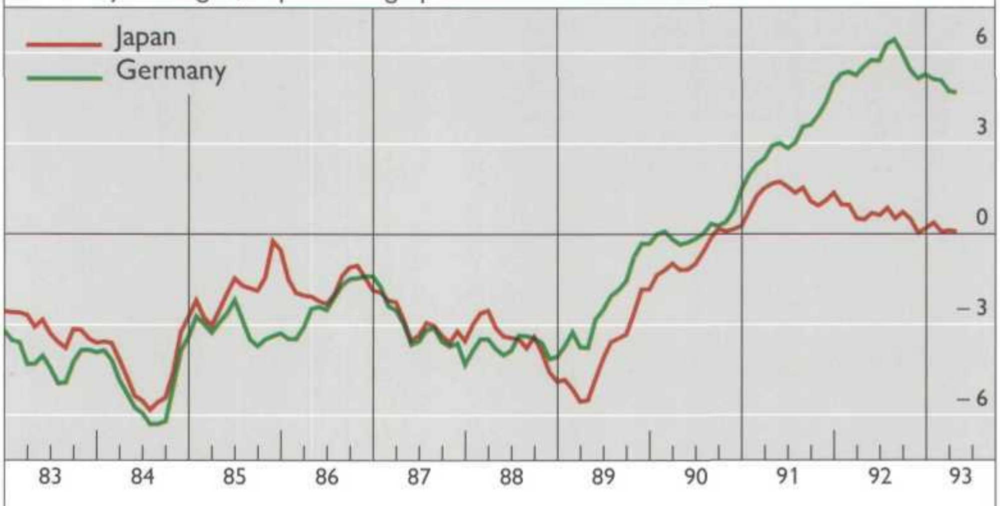
In Europe, a total of seven ERM and three pegged Nordic currencies experienced severe market pressures at times, and one other some temporary and limited strains. Of these, only three narrow band ERM currencies avoided either a devaluation or a switch to a floating rate regime. The three were the French franc, the Danish krone and the Belgian franc. A combination of sound fundamentals and clear commitments on the part of the authorities concerned was successful in eventually convincing the markets that attacks against these currencies were bound to fail – as they did.

The causes of the exchange market turmoil were many, and their separate influences – political as well as economic – can be neither neatly disentangled nor ranked in order of importance. Nevertheless, viewed in a global context, it is probably no exaggeration to say that the period under review witnessed the most significant events in the international monetary system since the breakdown of the Bretton Woods arrangements twenty years ago.

The events of 1992 and early 1993

The background to the European currency crisis ...

1992 opened with the dollar approaching the low point of its latest cycle, US official interest rates having being cut yet again as the economy's recovery continued to be weak and delayed. In Europe, the situation in Germany looked likely to require the maintenance of a tight monetary stance for some time. Indeed, the differential between US and German short-term interest rates continued to widen for much of the year, reaching an all-time high of more than 6½ percentage points in September (see the graph opposite). The European exchange rate mechanism was also experiencing some tension as the year began, the narrow band being



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

Monthly averages, in percentage points

* Three-month Euro-rates.

stretched to its limits during a short period, with the Belgian franc at the top and the Danish krone at the bottom (see the graph on page 187).

... includes an episode of severe pressure on the Finnish markka ...

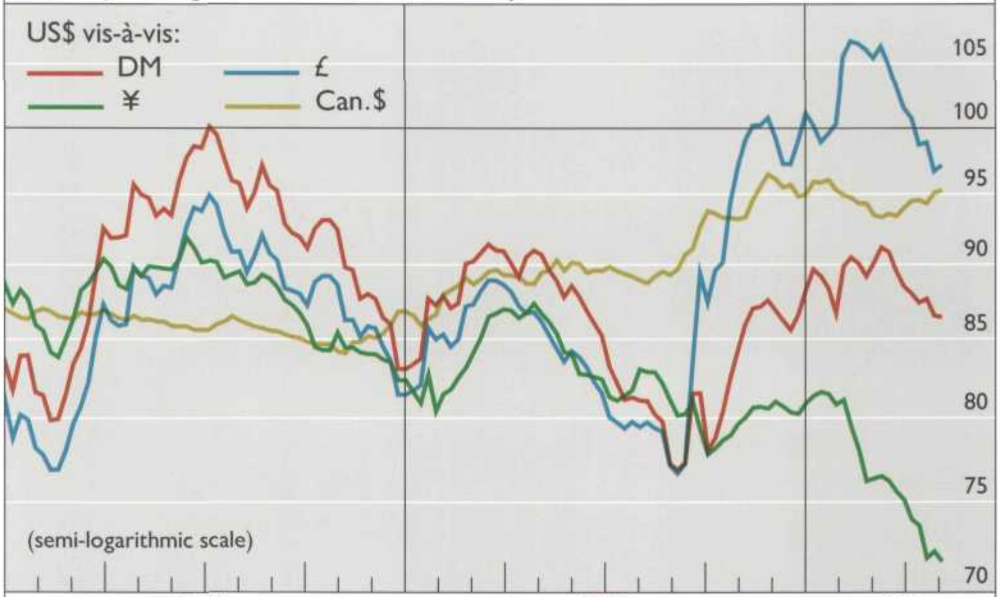
Tension in the ERM had, however, also been preceded in November 1991 by a major exchange market crisis in Finland. By 14th November 1991 Finland had experienced such massive capital outflows that its foreign exchange reserves (including forward positions) were virtually depleted. There was therefore little choice but to abandon the pegged link to the ECU (introduced only five months previously) and, after one day of floating, the markka was re-pegged with a devaluation of its ECU central rate of 12.3%. Pressure was then also felt on the Swedish krona, and the Riksbank moved forcefully on 5th December, raising its marginal lending rate by 6 percentage points to 17½%.

... and after only a temporary strengthening of the US dollar ...

The dollar reached a low point of DM 1.51 in early January 1992; and then suddenly, as on several previous occasions, it began to rise as some US indicators were published suggesting a stronger than expected economy. In addition, uncertainty generated by the dissolution of the former Soviet Union was having some adverse effect on sentiment about the Deutsche Mark, and the yen was also weak as the Japanese official discount rate had been reduced once more at the turn of the year. Indeed in February, following the release of further weak economic indicators in Japan, the US and Japanese authorities intervened jointly in support of the yen. In spite of this the Japanese currency fell a further 5½% against the dollar over the following four weeks. In mid-March the dollar's rise vis-à-vis the Deutsche Mark peaked at some 11% above its January lows, and, in early April, at 9.6% vis-à-vis the yen. Thereafter the US currency declined on average until early September, against the Deutsche Mark by over 17%. The reason, basically, was that, yet again, expectations of recovery proved to have been over-optimistic, while in Germany monetary policy was held tighter, and for longer, than had been expected.

Bilateral exchange rates of the US dollar against selected currencies

Weekly averages, third week of February 1987 = 100



The yen's weakness against the European currencies persisted on and off until the autumn as signs of a weakening Japanese economy and stock market intensified, and interest rates were lowered again – the official discount rate to 3¼% in late July. At the end of April the Group of Seven Finance Ministers and central bank Governors had already noted that "the decline of the yen ... was not contributing to the adjustment process". Further intervention failed to halt the yen's slide, however, in spite of a rising Japanese trade surplus.

... a weakening of both the yen and the dollar until ...

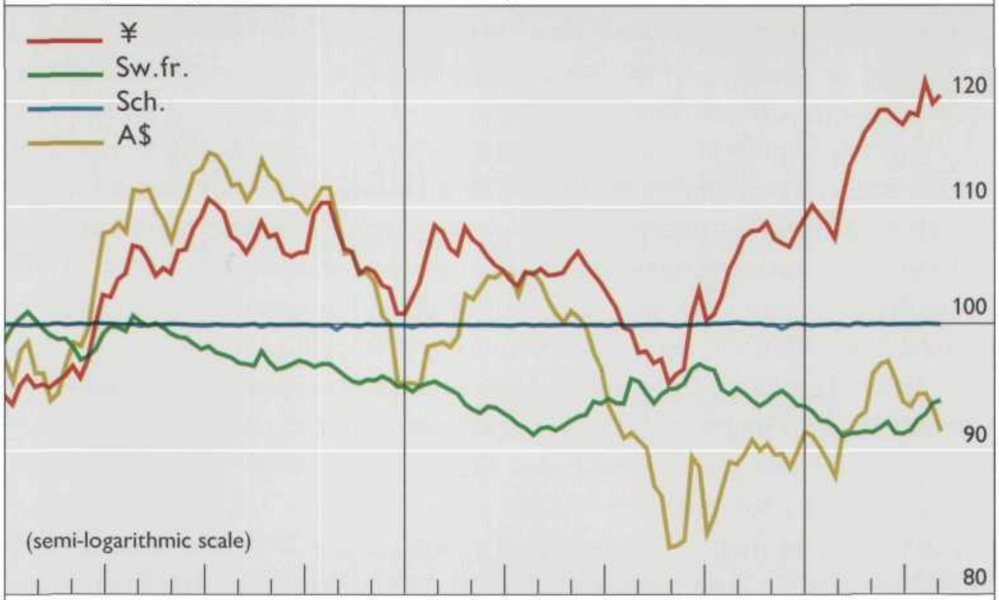
In the case of the dollar, the US discount rate was moved to its lowest level for thirty years in early July. At the same time relatively large and concerted intervention in its support began to be undertaken, and continued intermittently until late August. Even so, the dollar touched an all-time intraday low under DM 1.39 on 2nd September.

Following this, both the dollar and, especially, the yen strengthened, the latter at one point by as much as 29% against the Deutsche Mark, as the Japanese Government continued to implement packages of fiscal stimulus (see Chapter II) and the stock market also rose. In Germany meanwhile the economy weakened and monetary policy gradually began to be eased. In Japan the authorities soon started to fear too sharp a rise of the yen, and intervened against it in March and April 1993. In the meantime the official discount rate had in February already been lowered again, to 2½%. The dollar's rise, though less steep, was influenced by publication of the firmest indications so far showing an acceleration of US growth. From late March, however, sentiment about the dollar switched once more, as a weak rate of growth in the first quarter began to look likely – and was indeed later confirmed.

... the crisis begins in Europe, when both the dollar and, especially, the yen start to strengthen

Bilateral exchange rates of selected currencies against the Deutsche Mark

Weekly averages, third week of February 1987 = 100



It was against this background that the series of European exchange market crises erupted, spanning a period of eight months from mid-September 1992 to May 1993. Exchange market pressures first affected some of the so-called "high-yielding" currencies. On the other side, the Deutsche Mark was buoyed by the decreasing likelihood of an early easing of German monetary policy. In mid-July the Bundesbank actually raised its discount rate by an unexpectedly large jump from 8 to 8¾%, though the more internationally relevant lombard rate was left unchanged. In spite of the announcement of a tough fiscal package by the newly (but belatedly) formed Italian Government, official Italian interest rates had to be raised for the second time that month. The lira nevertheless fell to a new record low against the Deutsche Mark.

The European crisis erupts as the US/German interest rate differential peaks

Meanwhile, sterling had also been weakening in the ERM, and only partly because of its stronger than average link to the declining US dollar. Despite some official intervention, by 26th August the pound had fallen close to its ERM floor, and a firm statement by the Chancellor of the Exchequer was accompanied by overt buying of sterling for Deutsche Mark, the effects of which were, however, only short-lived. Several other EMS central banks were also reported to be intervening in support of their currencies, and official interest rates were raised in Sweden and Finland. On 28th August European Community Finance Ministers issued a strong statement in which they asserted that "a change in the present structure of central rates would not be the appropriate response to the current tensions in the EMS". Nevertheless, the following working day the tensions turned into outright turmoil and, despite obligatory intervention, the lira closed at its ERM floor.

In the ERM pressures intensify in late August ...

On 3rd September the United Kingdom announced that arrangements had been made to borrow the equivalent of ECU 10 billion for conversion into sterling. The funds were to be used as part of the financing of the growing public sector borrowing requirement. In the wake of this, sterling rose sharply for three to four days, but concerted intervention continued in support of the lira, which, despite another rise in Italian interest rates, again fell to its official floor.

On 5th September therefore, the ECOFIN Council (the Council of the European Communities (Economic and Financial Affairs)) met in Bath in a highly charged atmosphere. However, with domestic conditions in Germany still not considered sound enough, and with the President of the Bundesbank in any case not constitutionally empowered to commit the Central Bank Council, little concrete progress could be made.

... and spill over onto the Nordic currencies

Three days later, after the breakdown of a previously negotiated wage agreement, the Finnish markka was once more forced to float, and quickly fell by a further 14% against the ECU. The Swedish and Norwegian currencies also promptly came under pressure again. The Finnish currency has continued to float since then, and by early April 1993 had fallen a total of 31% below its June–November 1991 ECU parity. On 9th September 1992 the Swedish central bank raised its marginal lending rate to 75%. To strengthen the country's foreign exchange reserves it was simultaneously announced that the equivalent of ECU 16 billion would be borrowed in the international markets by the official sector. The Swedish National Debt Office was also publicly instructed to arrange further such borrowing in an amount of ECU 15 billion.

Devaluation of the lira and a cut in official German interest rates ...

Meanwhile, in the ERM matters were coming to a head, despite – or indeed as witnessed by – further wholly unprecedented volumes of official intervention. Following a breach of the lira's official limits, emergency discussions over the weekend of 12th and 13th September resulted in a 3½% devaluation of the lira's central rates together with an equivalent revaluation of those of all the other ERM member currencies. The following day the Bundesbank decided to cut its lombard rate by ¼% and the discount rate by ½%, and operations were conducted to ensure a fall of ½% in German money market rates.

... fail to calm the markets

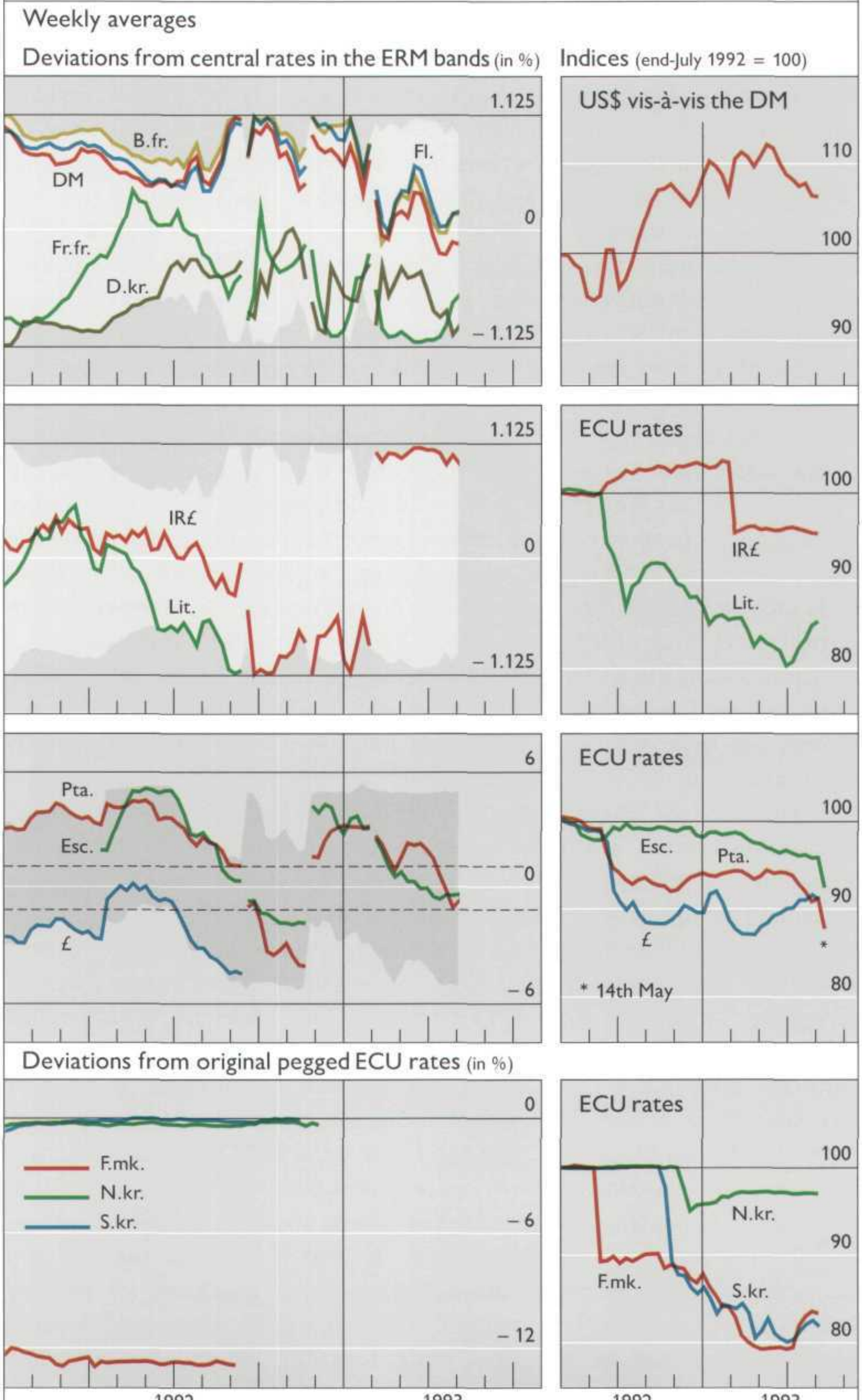
The foreign exchange markets, however, at once took the view that these actions had not been sufficient, and market pressures continued, in particular against the lira, the pound, the Swedish krona, the Spanish peseta and the Portuguese escudo. On 16th September sterling came under tremendous pressure, and despite "massive" concerted intervention plus the announcement of two interest rate increases during the same day, the pound too remained at its ERM floor. The Swedish central bank raised its marginal lending rate – to 500%. The Norwegian krone was also supported during this period by very large intervention.

The pound and the lira leave the ERM, and the peseta is devalued ...

Later that day the UK authorities decided to suspend, "in current circumstances", sterling's participation in the ERM. The Italian authorities likewise announced their decision to "abstain temporarily from intervention", thus also effectively removing the lira from the system for the

European currencies in fixed or pegged rate arrangements prevailing in mid-1992

Weekly averages



Notes: The shaded areas indicate the maximum actual spread of the narrow band of the ERM (lighter grey), and (darker grey) the maximum permitted spread of the wide band given the actual positions of the narrow band currencies. The Austrian schilling is not shown.

time being. (The Bank of Italy later announced that it had spent $24 billion in defence of the lira in September alone.) Finally, the peseta was formally devalued by 5%.

The focus of speculation then moved on, in particular to the French franc, in spite of what were agreed to be sound fundamentals underpinning that currency. Intervention was therefore again heavy but – perhaps significantly – all of it was intramarginal, as the franc remained above its ERM floor. A little later, the Swedish Government announced a tough package of fiscal measures, and thus the Swedish krona survived the first storm, and the marginal lending rate was reduced from 500 to 50%. During the turmoil, the effects also spilled over onto the Greek drachma. Intervention was heavy here too, and the Bank of Greece raised its official lending rate from 30 to 40%. Nevertheless the drachma fell further.

... leading to pressures on the French franc ...

For three days following the narrow French referendum result, selling pressure continued in full force on the French franc. But these three days also proved decisive, as both the French and German authorities made it crystal clear, by deeds as well as words, that they were adamant that the franc's parity was wholly the correct one. In particular, as was only later made public, a total of Fr.fr. 160 billion (about $32 billion) was spent on the currency's defence during the seven days up to 23rd September. The Bank of France also raised its five to ten-day repurchase rate by 2½ percentage points to 13% on 23rd September. Overnight market rates rose on a weighted average basis to over 24% at one point, but banks' base lending rates remained unchanged. The strategy was so successful that, in a matter of only five days, substantial reflows of funds into the French franc began to be observed.

... which are repulsed

The Bank of England later published an estimate of the volume of official intervention which had taken place over the four months to end-September: the figure was over $160 billion, most of which had been accounted for by sales of Deutsche Mark. For the period June–December the Bank of Italy estimated that total intervention in defence of exchange rates had been about $200 billion, of which half had taken place in September alone. The April 1993 Group of Ten report on "International Capital Movements and Foreign Exchange Markets" was roughly consonant with this, putting the figure for total European central bank net sales of Deutsche Mark at DM 284 billion during the same seven-month period. Of this, DM 188 billion had been used to defend ERM currencies.

Record levels of intervention ...

Nevertheless, exchange market pressures persisted into October and, particularly, November. Many currencies were involved, including sterling, as UK interest rates were lowered. In mid-November the Swedish Government failed to obtain the necessary all-party support for its new fiscal austerity package. The market's response was instantaneous – indeed, possible failure had already been hedged against for several days. The authorities decided to let the krona float. It was later announced that over six days the currency outflow had been the equivalent of $26 billion, or 11% of Sweden's GNP. The comparable intervention figure during the three weeks of the September crisis had been something over half this

... still leave some other currencies under pressure amount. At the same time, the Norwegian krone also had to be supported again by very large official intervention, amounting in two days alone to N.kr. 48 billion – 46% of Norway's non-gold reserves as at end-October.

Once more, the focus of speculation moved on, and now the peseta, the escudo, the Danish krone and the Irish pound came under intense pressure. The French Finance Ministry reported, however, that Fr.fr. 33 billion had flowed back into France's reserves during October.

The Canadian and Australian dollars experience intermittent pressures

In the meantime, the Canadian dollar had also come under further, if intermittent, pressure, first in May, and now again in September–November 1992. It was to do so once more in late April 1993. The markets reacted, successively, to the failure of a large property conglomerate; to the potential implications of a negative vote in the Canadian constitutional referendum; to the currency turmoil in Europe; to the general strengthening of the US dollar; and, finally, to the deteriorating financial positions of the federal and provincial governments (see the graph on page 184). The central bank responded at times with intervention, and, especially in late 1992, with sharp increases in interest rates, partly to contain the movement in the exchange rate and partly to offset the impact of depreciation on overall monetary conditions. In Australia too, in addition to occasional nervousness about European developments, political uncertainties and market concerns over the deteriorating outlook for federal and state government finances led to sharp downward pressures on the exchange rate in January, August and October–November 1992 (see the graph on page 185). On each occasion the central bank responded with official intervention and by permitting some widening of short-term interest differentials against US rates.

The peseta and the escudo are devalued ...

Returning to European developments, on 22nd November the peseta and the escudo (the second of which had been taken into the ERM in April 1992) were both devalued by 6% within the ERM. Pressure continued on the Danish krone, the Norwegian krone and the Irish pound, and soon encompassed the French franc again. The Irish central bank raised its overnight rate to as much as 100% towards the end of the month, and throughout December 1992 and January 1993 the French franc, the Danish krone and the Irish pound continued to come under intermittent heavy pressure, which was resisted by intervention as well as by interest rate increases. The Norwegian krone's parity, on the other hand, did not survive the old year, despite yet more intervention, and on 10th December it was floated. In contrast to most other such cases, however, it did not fall by more than 6%, and has even recovered somewhat since mid-December (see the graph on page 187).

... the Norwegian krone is floated ...

The next act involved the Irish pound. The effect of the loss of competitiveness, which was imposed in particular by sterling's decline, was compounded by that of having to keep domestic interest rates so high in a heavily underemployed economy. On 30th January 1993 the Irish currency was therefore devalued by 10%, and has since remained close to the top of the ERM's narrow band.

... and the Irish pound devalued

The Belgian franc experienced a bout of pressure in February 1993 and a certain weakness again in March, following political uncertainties aroused by discussion of constitutional reform and opposition to certain proposed budgetary measures. These pressures were, however, fairly easily and promptly countered by an increase in interest rates, combined with intervention, as well as by the fact that, a little later, a budgetary package was agreed.

Some temporary pressures on the Belgian franc are countered

The French franc also came under some further pressure, together with the peseta and the Danish krone, especially after the Irish devaluation at the end of January 1993. On 4th February, however, the Bundesbank cut its interest rates again, the lombard rate from 9½ to 9%, and the discount rate by ¼ percentage point to 8%. This provided some, but only temporary, easing of pressures, and the markka, the lira and the Swedish krona soon began to fall even further.

Official German interest rates begin to decline further ...

On 4th March, as the Bundesbank Council apparently decided not to cut official rates further for the time being, the French franc once more experienced some downward pressure. This was interrupted when the Bundesbank surprised the markets only the next day by announcing a cut in its fourteen-day repurchase rate from 8.49 to 8.25%. The effect of this on the Deutsche Mark was compounded by growing political uncertainties in Russia. Then, on 18th March the Bundesbank lowered its discount rate once more, to 7½%, but left the lombard rate unchanged.

In the run-up to the second round of elections for the National Assembly in France, the French franc came under very heavy selling pressure. But following the decisive result of the elections, and in view of the obviously firm commitment of both the French and German authorities to the franc's ERM parity, pressure on the currency eased, as the Bundesbank again began to reduce official and market interest rates as from 23rd April. Indeed, in April and early May the franc's incipient strength permitted the French authorities to continue to reconstitute French reserves while simultaneously lowering interest rates cautiously until, in terms of three-month Euro-rates, the differential between French and German rates virtually disappeared.

... and the French franc recovers, even as interest rates fall

The final act during the period under review came on 13th May 1993 when – after earlier concerted intervention and a rise in Spanish official interest rates – the peseta, for the third time, came under unsupportable pressure and the Spanish authorities requested another devaluation of their currency in the ERM. The figure agreed was a decline of 8% in the currency's bilateral central rates in the ERM. The Portuguese authorities devalued the escudo, for the second time, now by 6½%.

Pressures on the peseta force a third devaluation, and a second one for the escudo

Thus, out of a total of ten fixed or pegged European currencies which came under repeated and severe (downward) attack between November 1991 and mid-May 1993, only two (plus the Belgian franc) – all in the narrow ERM band – avoided either a devaluation of their central rates or floating. (The Deutsche Mark and the Dutch guilder, of course, experienced only upward pressures.) Another pegged European currency, the Austrian schilling, seemed to avoid the crisis altogether and remained remarkably stable against the Deutsche Mark throughout. On the other hand, the Swiss franc fluctuated against the Deutsche Mark quite markedly during the period under review. Swiss interest rates were raised in March 1992 and the National Bank intervened in the currency's support. For a time during the second and third quarters the Swiss franc benefited from the dollar's decline and from some return of its "safe-haven" status, given developments in Russia, and the turmoil in the exchange markets. Thereafter, however, as interest rates were reduced – in particular the discount rate, in four separate steps from 7 to 5% – the franc weakened somewhat again until early April (see the graph on page 185).

Anatomy of the European exchange market crisis

Why did the European exchange market crisis erupt so violently? Or, more precisely, why did the pressures build up for so long, so that, when the crisis came, it was almost necessarily violent?

A multiplicity of factors lay behind the crises in Europe ...

Before attempting to answer these questions it is perhaps worthwhile noting at once that many factors were involved. Moreover these factors, by coincidence, all came together at one particular time, making it virtually impossible to disentangle them or to rank them clearly in order of importance, or size of impact. Indeed, to attempt to do so rigorously would probably be futile, given that, in economics, history cannot, as it were, be re-run with different assumptions, in order to measure the separate impact of each of them. The European exchange market developments during the period under review were basically one unique, if protracted, event ("European" here covers both the ERM member countries and the three Nordic ones with formal exchange rate commitments).

... political ...

One (non-economic) background factor was the strength of the commitment, at the political level, to the Maastricht process. At the core of the European Community, a strong political commitment has always been the fundamental, powerful and beneficent binding force, and one which has to be interpreted in the light of the history of the first half of this century. But the concrete manifestation of this political will has tended to concentrate for most of the time not on political union, but rather on economic cooperation and institutions (and with undoubted economic benefits). This has been the case all the way from the European Coal and Steel Community, through the EMS and, finally, to the agreement on the Maastricht Treaty on European Union reached by the twelve Heads of State and Government in December 1991.

In addition, and partly to begin preparing for their own possible entry into the European Community at some time, two other Nordic countries, Sweden and Finland, had, during 1991, joined their Norwegian neighbour in adopting a policy of unilaterally pegging their exchange rates to the ECU (Norway had already done so in 1990). These policies also had the effect of providing a low-inflation anchor on which to focus monetary policy. Finally, in April 1992 the Portuguese escudo had joined the exchange rate mechanism, bringing to ten the number of participating currencies.

... as well as economic

All this perhaps distracted attention from the insidious but fundamental fact that progress towards convergence in the ERM countries had been proceeding only slowly and unevenly. In particular, the real effective exchange rates of some countries (as well as those of the Nordic countries) had been creeping up for some time (see the graph on page 77, Chapter IV). Even with the numerous statistical difficulties underlying the measurement of changes in real effective exchange rates, and even though the choice of the base period is open to debate, there is no doubt that a number of countries with fixed or pegged exchange rate commitments were experiencing a deterioration in their competitive positions – and this in a period of emerging recession. Admittedly, as a result of active anti-inflation policies, there was at the same time a remarkable convergence of inflation rates. This, however, had necessarily taken time and had not therefore prevented some divergence of real exchange rates. It is not clear whether the markets, and policy-makers, thought it possible that these misalignments might in time be corrected by further adjustments in domestic costs and prices rather than by a deliberate exchange rate realignment.

Slow convergence and gradual real exchange rate misalignment

Time, though, turned out not to be on the side of such a solution. The perception of the political will to press ahead with economic and monetary union was severely weakened by the result of the Danish referendum in June 1992, as well as by polls suggesting that even the French electorate might give a negative answer in their own referendum in September. With this altered perception, the political "bonus" factor, which had helped to suppress doubts about exchange rate misalignments, evaporated. It began to seem that EMU might well be delayed, and that there might have to be a realignment at some point before its implementation.

The shock of the first Danish referendum result

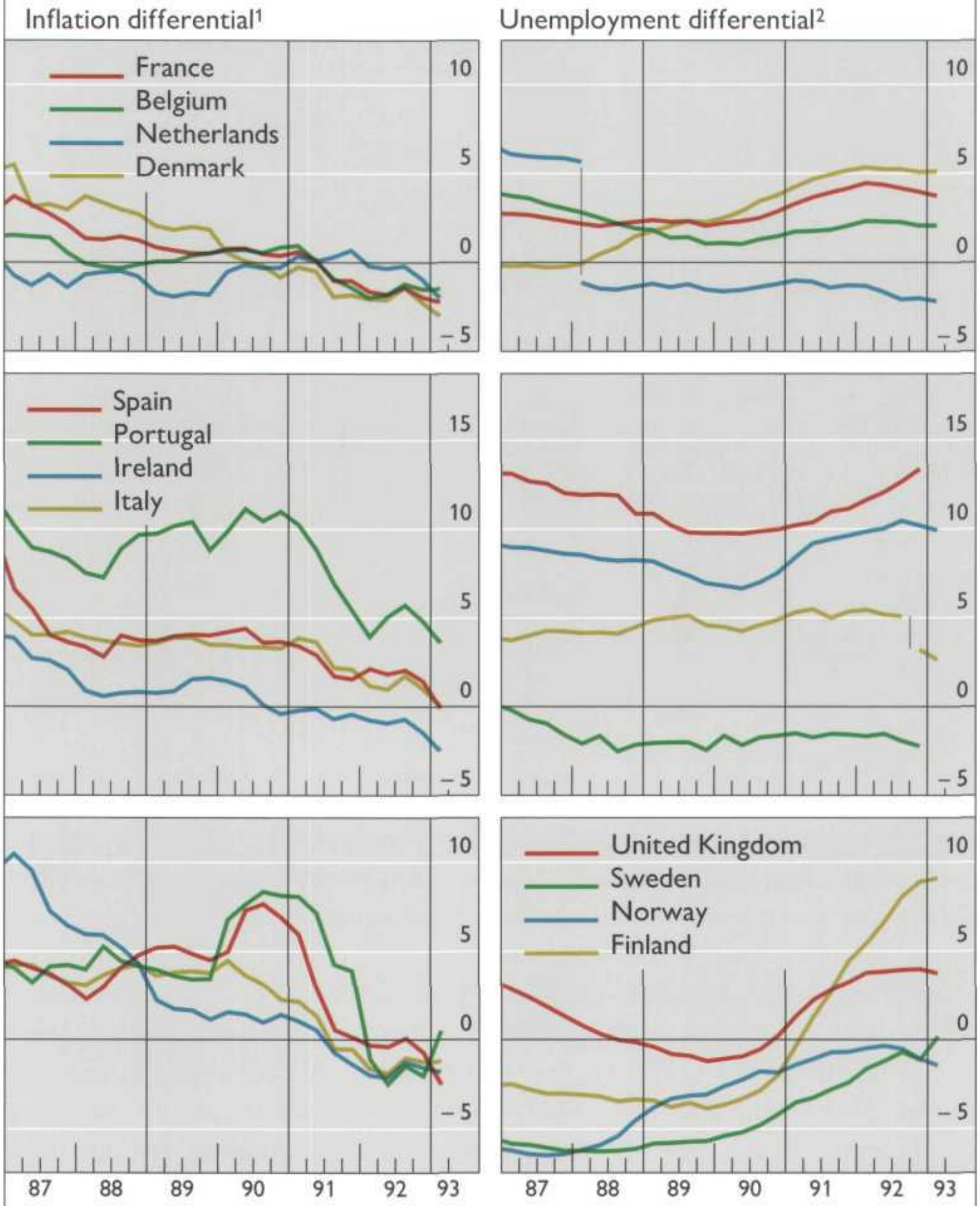
Another background factor was the German policy mix, that is, the German fiscal deficit and the high rates of interest – especially short-term rates – which accompanied it. There are indeed some fairly close parallels with the imbalanced US policy mix of the first half of the 1980s. The main difference, from the present perspective, is that, the dollar being a floating currency, its huge rise and resulting misalignment set up different kinds of pressures from those which were instead "bottled up" in the ERM and Nordic countries' pegged rate arrangements in 1992. Another difference was that inflation in Germany was already above the Bundesbank's desired maximum of 2%. In the earlier US episode, the rise in the dollar had of course worked in the direction of keeping inflationary pressures relatively low. Even so, as in the present German case, the US monetary authorities had felt it necessary to keep short-term interest rates relatively high. In Germany during the period under review the need to do so was perhaps even greater, given that the Bundesbank was confronted with both an excessive fiscal deficit and, for Germany, a rather high degree of wage cost pressure, both of which stemmed largely from the unique circumstances of the country's reunification (see Chapter II). But, in the longer run, investment in DM bonds also looked attractive because there was some confidence that Germany would in the end master its problems, and that long-term interest rates would then fall. The result of all this, for countries with fixed or pegged currency arrangements, was a need to hold their own

The policy mix in Germany ...

... required other European countries to keep interest rates high against a weak economic background

Inflation and unemployment rate differentials vis-à-vis western Germany

Quarterly averages, in percentage points



[1] Calculated from consumer price changes over four quarters. [2] For the Netherlands and Italy, break in series.

Source: National data and definitions.

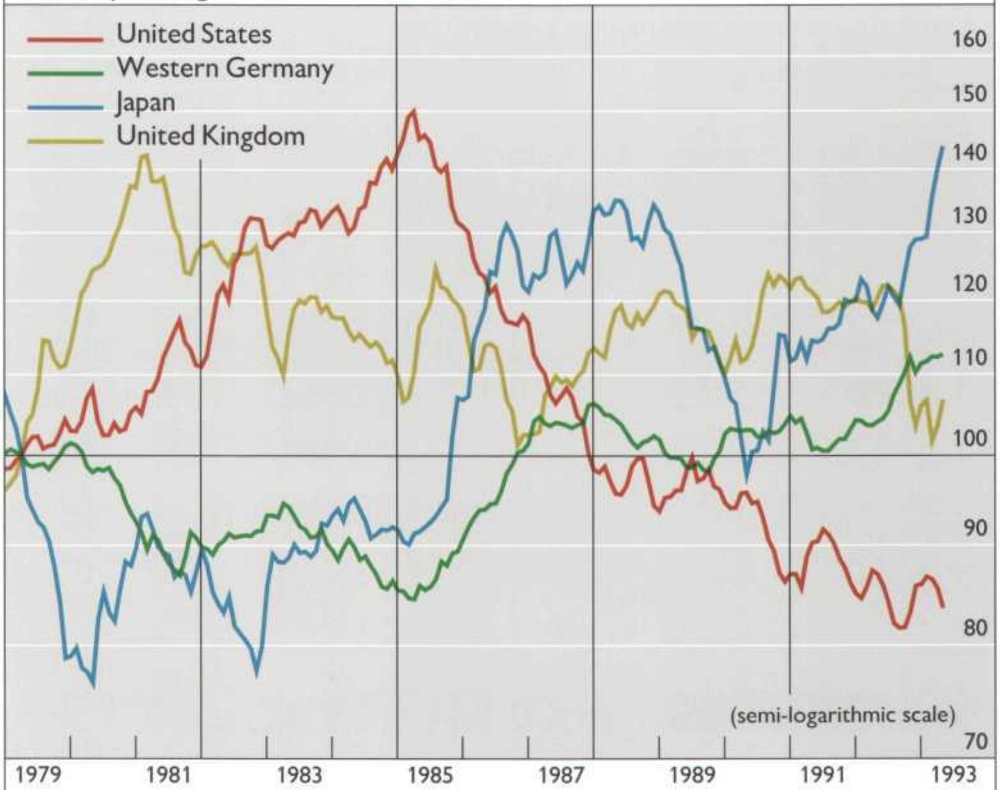
interest rates higher than might otherwise have been necessary. And, at times of exchange market tensions, they were even forced to raise them sharply regardless of the state of the fundamentals.

The role of the dollar

It is sometimes suggested that the weakness of the dollar during much of the spring and summer of last year was an important causal factor in the European crisis which followed. And it is certainly true that previous episodes of dollar weakness had been accompanied by strains in the ERM as

Real effective exchange rates in major countries*

Monthly averages, March 1979 = 100



* Based on relative unit labour costs.

capital flowed into the Deutsche Mark. In the present case it also seems likely that the unprecedented interest differential between the United States and Germany, with its attendant transatlantic exchange rate pressures, played at least a subsidiary role.

There had also been a decline in US interest rates over a prolonged period ...

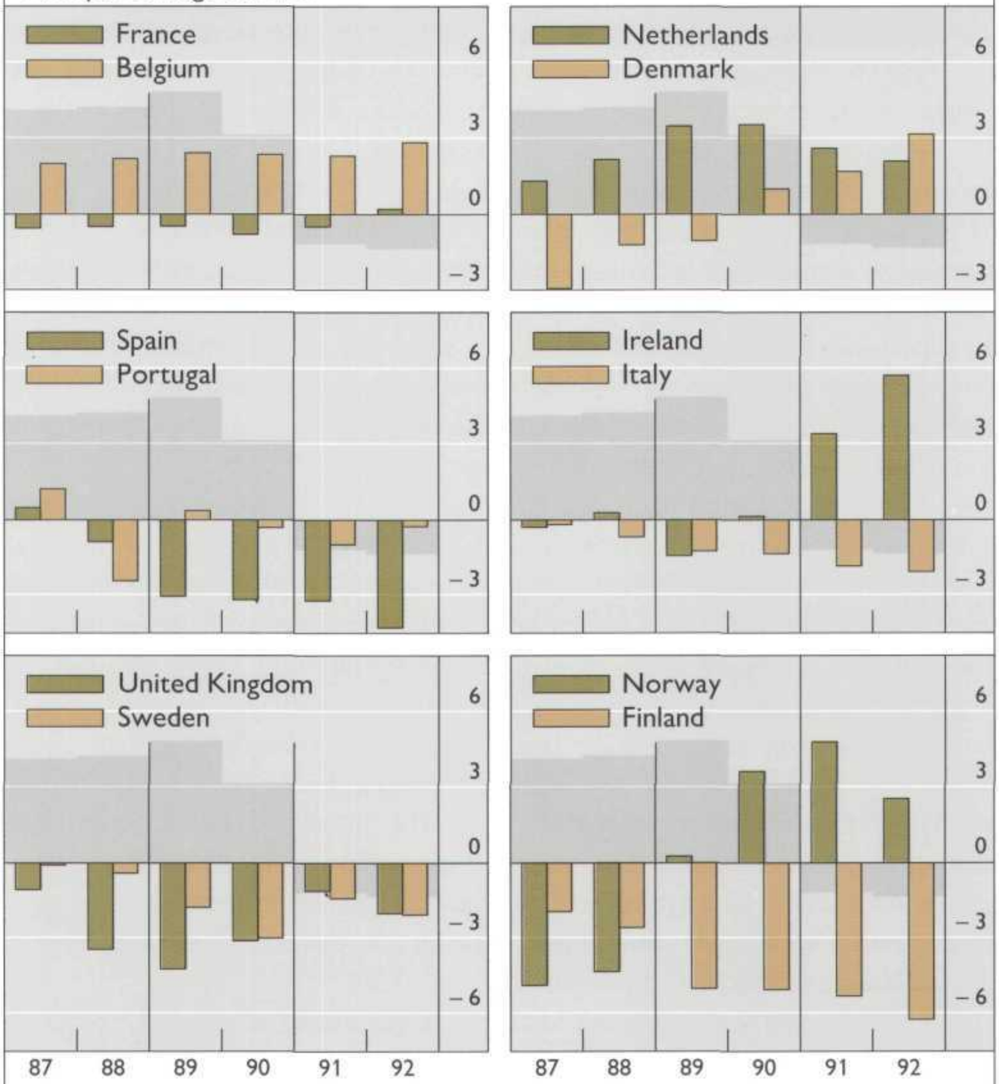
In addition, the prolonged easing of US monetary policy (before 1992), with its accompanying tendency to dollar weakness, had probably been one reason for capital to flow out of the dollar. Some of this outflow had no doubt gone into high-yielding European currencies and other assets denominated in the same currencies. In mid-1992, however, the situation suddenly reversed itself, and holders of high-yielding currencies were very quickly beginning to try to get out of them. Indeed, at the height of the crisis, some of the proceeds from sales of high-yielding European assets flowed back into the dollar, which rose during the September crisis, and, mainly sustained by improved economic prospects in the United States, continued to do so on average until March 1993 (see the graph on page 187). Holders of high-yielding currencies might have calculated that, given the continuing, albeit weakened, political will behind the Maastricht process, central bank intervention would be likely to be forthcoming in support of these currencies. Such behaviour helps to explain why the crisis was delayed, and why, when it did arrive, it was so violent and widespread.

... making high-yielding currencies even more attractive

One factor which, according to most economists, tends today to play a considerably smaller role in exchange rate determination and pressures

Current account balances

As a percentage of GDP



Note: The shaded areas represent the current account balance for Germany (prior to 1991, western Germany only).

Source: National data.

The smaller role of current account developments nowadays

than it once did is the current account of the balance of payments. It is the capital account which now dominates (see Chapter IV), and which can also, if capital flows result in exchange rate changes, actually help to drive the current account itself. Nevertheless, as the graph above shows, certain current account developments in Europe in recent years are consistent with many of the strong pressures which were felt in the exchange markets in 1992. The Finnish case of course stands out given the severe effect on that country's exports of the collapse of the former Soviet Union. But the UK, Spanish, Italian and Swedish deficits also stand out, especially when account is taken of the various degrees of recession in which their economies found themselves. At the same time, it is striking that all four currencies (excluding the Deutsche Mark, but including the

Dutch guilder) which have been held within their ERM bands are currencies of economies whose external current accounts are much stronger than virtually all the rest shown in the graph. This did not, however, prevent considerable pressure having to be countered intermittently in the cases of the French franc, the Danish krone and, to a much lesser extent, the Belgian franc, where political uncertainties were a factor at times.

The Irish case is perhaps an exception, where the fundamentals appeared to be sound, but where unemployment was also running at about 17% towards the end of last year. More influential probably was the competitiveness effect of the devaluation of sterling, given Ireland's trade relations with the United Kingdom. This was, however, just one example of a more general phenomenon which was observed as the crisis unfolded: as one currency after another fell, so did the competitive position of others worsen, thus increasing the risk that one or other of them would become the object of the next speculative attack.

The serial nature of the attacks

As to intervention itself, the question necessarily arises as to whether it was, in some sense, insufficient. Or was it simply ineffective in the new globalised financial world? Technology, innovation, free capital mobility and investors' desire for international portfolio diversification have by now all combined to increase vastly the potential for shifting large amounts of financial capital around the world, and across currencies, at great speed. For, even leaving aside outright speculation, and also the relatively new highly leveraged "hedge funds", far more investors now have an interest in exchange rate developments than formerly. In other words, even the managers of the increasingly diversified portfolios of traditionally conservative institutions such as pension and insurance funds, as well as retail investors, must necessarily now take account of perceived exchange rate prospects – and they no doubt do so.

The effectiveness of official intervention is questioned...

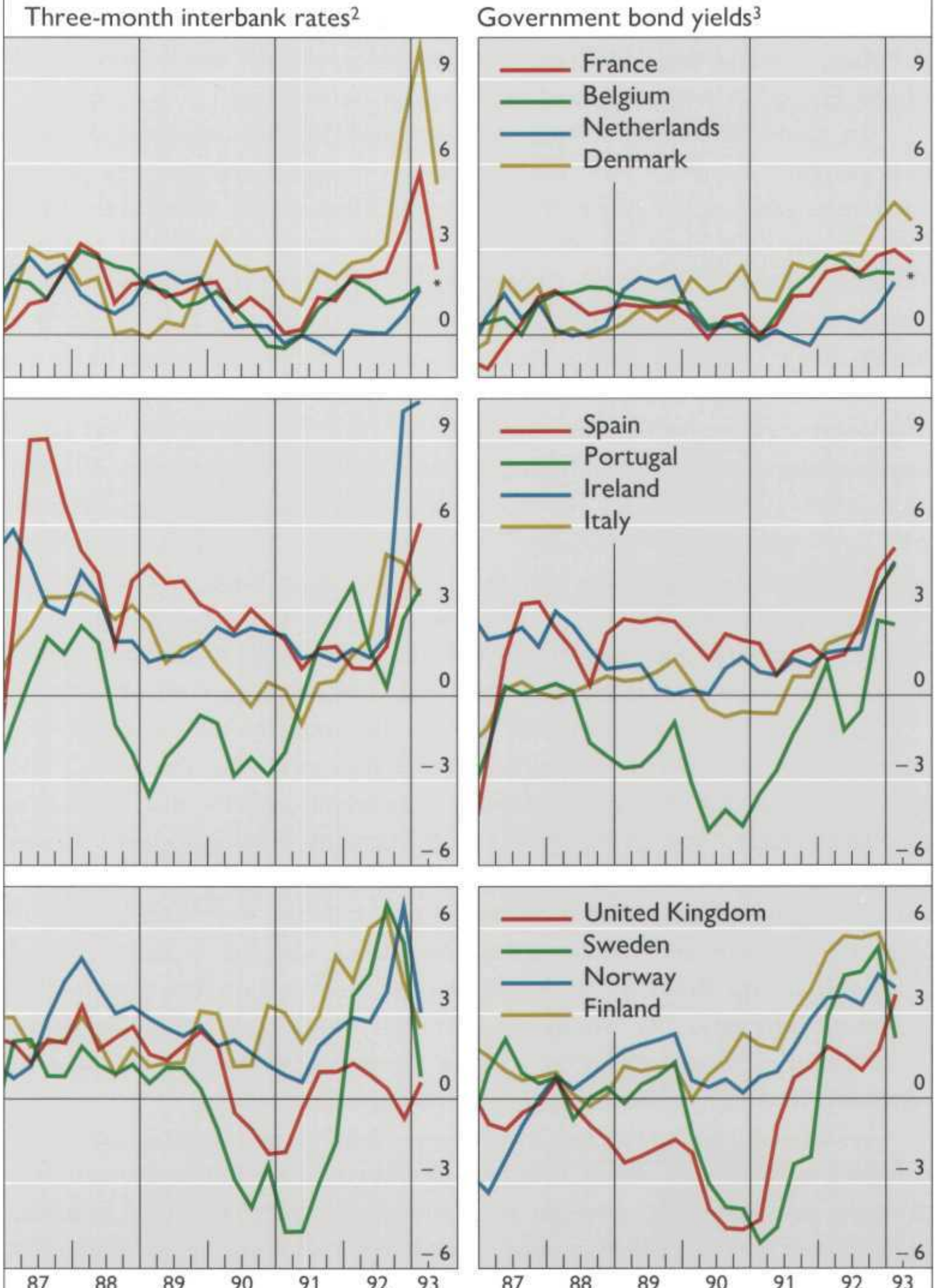
... as many more investors now take account of exchange rate expectations

In the foreign exchange markets, the latest survey of foreign exchange turnover, conducted by twenty-six central banks, revealed that (adjusted for most local and cross-border double-counting as well as for estimated gaps in reporting) global foreign exchange turnover in April 1992 came to some $880 billion per business day. This must be many times the volume of purely trade-related transactions, and it therefore suggests that much exchange market business is now finance-driven.

In retrospect too, the writing had also been on the wall during the first Finnish exchange rate crisis in November 1991. In that episode, the scale of the pressures which can now be brought to bear on even the currencies of relatively small countries was dramatically demonstrated. The Bank of Finland later revealed that in 1991 as a whole gross official sales of foreign currencies (including forward transactions) had amounted to the equivalent of 17% of the country's GDP, or nearly 80% of its (reduced) annual exports of goods and services. Moreover, much of the intervention had been concentrated in quite short periods of time; nevertheless, the markka was devalued. In the light of this, it may be more correct to say that the later and more general crisis in Europe was in fact first heralded by the demonstration effect of these unprecedented events in Finland.

Real interest rate differentials vis-à-vis western Germany[1]

Quarterly averages, in percentage points



* Based on the average interest rate for the first half of May 1993.

[1] Based on relative consumer price inflation. [2] For Portugal and Sweden, Treasury bills. [3] Representative (mainly ten-year) government bonds.

Even where the fundamentals are sound ...

Returning to the question of intervention per se, it is true virtually by definition that, in the new kind of circumstances just illustrated, it is very likely that, to be successful, even in the face of an attack on a currency whose fundamentals are sound, intervention now has to be greater than in the past – perhaps far greater. It may also be that, to be effective, more of it would have to be accompanied by larger and more persistent interest rate movements than has been the practice so far. But this would imply, ceteris paribus, significant changes in the stance of domestic monetary policies, which might not necessarily be appropriate. This matter has been discussed in some detail in Chapter VI. Its relevance for the understanding of the European exchange market crisis can be summed up as follows.

... intervention has to be accompanied by convincing changes in interest rates, otherwise it is unlikely to be successful

To underpin the efficiency of exchange market intervention, the interest rate weapon *was* used by those monetary authorities whose currencies came under downward pressure, although the speed and size of the interest rate increases varied considerably from country to country. That these policy actions failed to achieve their objective in most instances can be attributed to the fact that the markets did not believe in their sustainability. They had doubts about the ability of the authorities to go on with monetary tightening in situations of rising unemployment, already high real interest rates, high private and/or public sector indebtedness and other manifestations of financial fragility. These doubts turned into outright conviction in those cases where the fundamentals – competitiveness, inflation rates, wage settlements, current accounts and budget deficits – were perceived to preclude the possibility of maintaining exchange rate parities. Where all, or most, of these fundamentals looked right – in France, Denmark and Belgium – the determination of the authorities turned out to be sufficiently strong to overcome the markets' doubts.

The German fiscal and wage situations precluded any large decline in German interest rates

Germany's position mirrored that of the countries whose currencies came under downward pressure. The Bundesbank did intervene, and provide substantial borrowing facilities, especially within the ERM, and through other ad hoc arrangements to other central banks in need. It also started a gradual relaxation of its monetary policy in September 1992. But with Germany experiencing a relatively high inflation rate, facing difficult wage negotiations and running a high budget deficit, the markets did not believe that the Bundesbank would accept intervention on a scale that would lastingly upset its money supply target, nor that it would be willing to relax its monetary policy at a speed which would remove, or at least substantially weaken, the pressure on the other currencies.

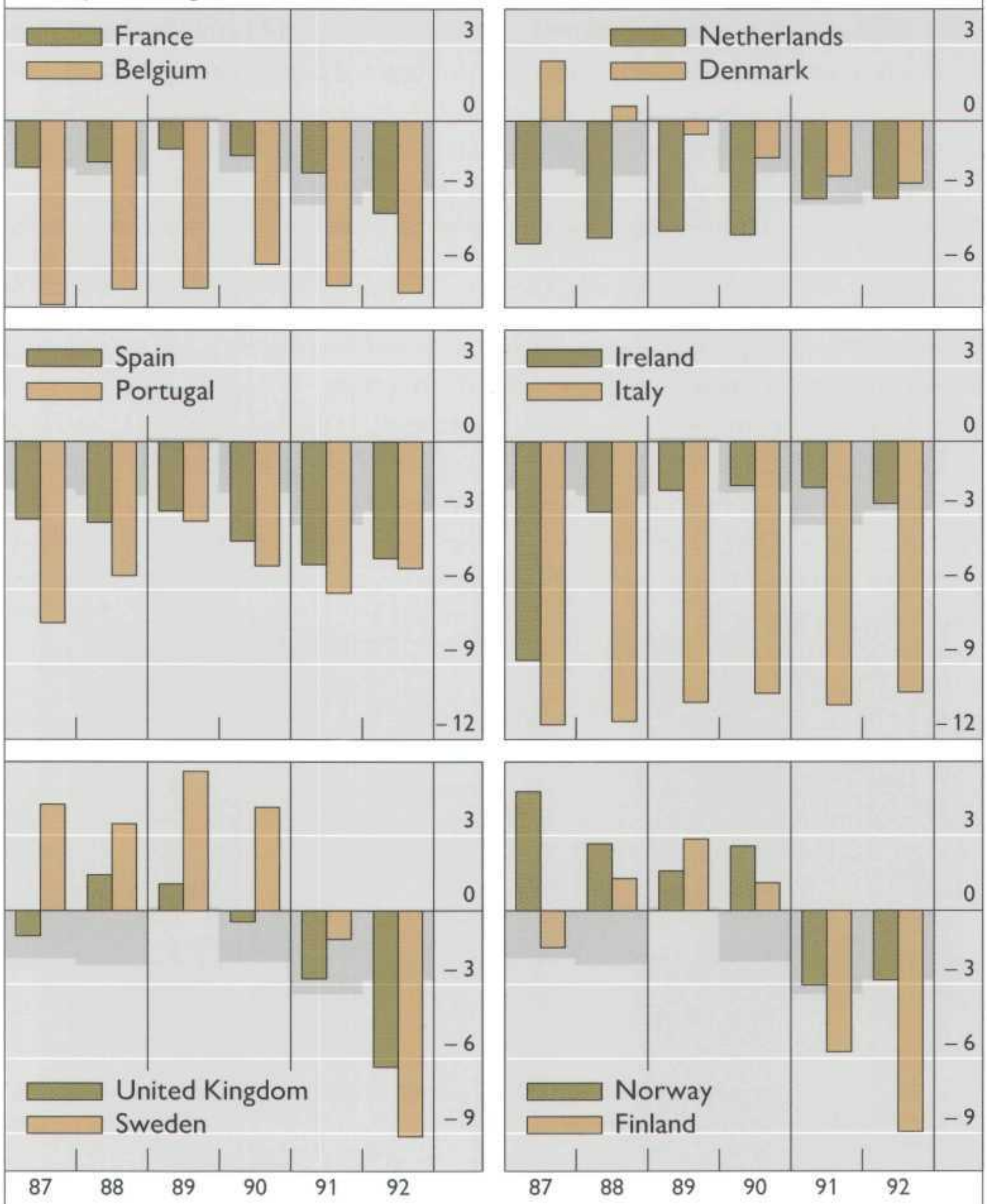
Realignment became the only option left ...

... but events moved too fast for policy-makers to conduct it in an orderly and comprehensive fashion

As a result, policy had become almost completely "boxed in": the only conceivable way out was a realignment. But it was also understandably difficult to discuss a general realignment in such a rapidly moving environment, and especially one in which currencies were being attacked in a serial fashion. The situation was made even more complex by the fact that currencies were being attacked for a multiplicity of reasons. The ERM had in any case become for politicians both the cornerstone of their drive towards greater European unity and prosperity, as well as, for many, an important focus for their anti-inflation monetary policies. But the result of all this was that, when the crisis broke, it proved impossible to address, at the beginning, the issue of a general realignment. The position of individual currencies therefore had to be dealt with one after the other, as they came under attack from market forces. This piecemeal approach to crisis management opened the way for official positions to be misunderstood or

General government financial balances

As a percentage of GDP



Note: The shaded areas represent the general government financial balance for Germany (prior to 1991, western Germany only).

Sources: OECD Economic Outlook and national data.

misrepresented. In such an atmosphere it was not difficult for the markets – rightly or wrongly – to perceive differences of opinion between various governments and institutions – a guessing exercise that probably added to the severity and rapid development of the crisis.

The European exchange market crisis in summary

To sum up, in the ERM especially, the 1992–93 European currency turmoil was fundamentally the result of the fact that, despite the impressive convergence of inflation performances, several countries' real exchange rates had become misaligned, and at a time when European economies were displaying signs of more or less severe weakness and/or financial fragility. The German policy mix also made the interest rate starting-point more difficult for countries needing to defend their currencies. At the same time it was basically unlikely – though not theoretically impossible – that appropriate domestic cost adjustment pressures might in time have resolved the misalignment of real exchange rates. In theory too, domestic adjustment pressures – in economies which had been pursuing policies to improve the flexibility of market mechanisms – might have solved the unemployment problem as well. Even if possible though, all this would have taken time. The exchange markets – stung by the sudden and unexpected appearance of weak popular support for the Maastricht Treaty – in effect decided not to grant the time for further adjustment. There were, in any case, examples of fiscal and wage policy failure, or the prospect of such failure, in a number of countries.

And so the markets pounced, in several separate episodes, and to remarkable effect: so much so that, despite its geographical confinement to Europe, it is probably no exaggeration to say that the period from late 1991 to early 1993 witnessed the most severe and widespread foreign exchange market crisis since the breakdown of the Bretton Woods system twenty years ago.

IX. Activities of the Bank

1. Cooperation between central banks and international organisations

During the past year the Bank played its traditional role in fostering international monetary cooperation.

The Bank participated as an observer at meetings of both the Interim Committee of the Board of Governors of the International Monetary Fund and the Finance Ministers and central bank Governors of the Group of Ten countries. It also contributed to the work of the Deputies of the Group of Ten Ministers and Governors on international capital movements and foreign exchange markets. 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 compiling and distributing data concerning the financing of the 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 organised periodic meetings of central bank officials on a wide variety of subjects. As in the past, it also provided the secretariats for various committees and groups of experts; moreover, in order to enhance coordination between them and to promote their activities, the Bank set up a Secretariat for Central Bank Cooperation.

The Euro-currency Standing Committee continued to monitor developments in international banking and capital markets and to consider issues relating to the functioning and stability of financial markets. In particular, the Committee discussed the impact on market participants and individual market segments of the turbulence in the foreign exchange and money markets in the autumn of 1992. It reviewed and assessed various implications of recent developments in international interbank relations, notably the growth of trading in derivative financial instruments among banks. In addition, the Committee set in train work aimed at improving the global monitoring of activity in derivatives markets, following recommendations made in the report on Recent Developments in International Interbank Relations prepared by a working group of officials from the central banks of the Group of Ten countries and published by the Bank in October 1992. The Bank also continued to compile, analyse and publish statistical data on developments in international banking and financial markets.

The Basle Committee on Banking Supervision continued its work on the coordination of international supervisory arrangements and in July 1992 issued a set of minimum standards governing the supervision of international banking groups and their cross-border establishments. These standards, which reinforce the Basle Concordat of May 1983, were endorsed in October 1992 by the representatives of more than one hundred supervisory authorities attending the seventh international conference of banking supervisors in France. A number of initiatives are being taken by the international supervisory community to put the standards into effect. Work also proceeded on a number of other important issues and in April 1993 the Committee released a package of consultative proposals dealing with netting, market risks and interest rate risk, the first two of which provide for an elaboration of the Basle capital accord of July 1988. In June 1993 Mr. E. Gerald Corrigan, Chairman of the Basle Committee since June 1991, will retire from the chairmanship on relinquishing the office of President of the Federal Reserve Bank of New York.

The Committee on Payment and Settlement Systems met twice in 1992 to review developments in domestic and cross-border payment, netting and settlement arrangements in the Group of Ten countries. Attention was paid to existing and evolving payment and settlement mechanisms which provide linkages between systems in different countries, such as cross-border and multi-currency netting schemes. The Committee also discussed reports drawn up by its working groups. The final report by one study group, entitled Delivery versus Payment in Securities Settlement Systems, was published by the Bank in September 1992. Work is being pursued on cross-border securities settlements and on measures that central banks might take to improve efficiency and reduce risks in the settlement of cross-border and multi-currency transactions. A new edition of the report on payment systems in the Group of Ten countries (the "Red Book") is also being prepared. Updated statistics on payment systems in these countries were published by the BIS in December 1992.

The Service for Eastern European Countries and International Organisations extended its work of coordinating the technical assistance and training provided by an increasing number of central banks to their counterparts in eastern European countries and the republics of the former Soviet Union. The Service also continued to organise meetings and seminars for representatives from most of these central banks. Cooperation with other international organisations, in particular the International Monetary Fund, was intensified, notably as regards the exchange of information and participation in technical assistance and training programmes. The BIS joined five other international organisations (the European Bank for Reconstruction and Development, the Commission of the European Communities, the International Bank for Reconstruction and Development, the International Monetary Fund and the Organisation for Economic Cooperation and Development) in establishing the Joint Vienna Institute (JVI), which commenced operations in September 1992. The purpose of the JVI is to provide training, chiefly for officials but also for some private sector managers from eastern Europe, the former Soviet Union and a number of Asian countries, in those areas which are essential for the functioning of a market economy. The Service organised specialised courses focusing on central banking in early 1993 with lecturers from the BIS and various central banks.

The Group of Computer Experts completed the final phase of its study on the networks and computer systems which provide the technical infrastructure for the main payment systems in the Group of Ten countries; this phase consisted of an analysis of the various factors which help to ensure both continuity of service and the integrity and confidentiality of data. The Group also discussed in depth the following topics: the individualisation of computing resources, the productivity of information systems and services and the development of internal information systems in the context of the increasing number of international exchanges. The Working Party on Security Issues undertook a survey of the external links which the central banks have established for the purpose of data exchanges outside the framework of payment systems and identified the potential risks incurred by each type of exchange. It now intends to define appropriate measures for managing and controlling these risks.

The Group of Experts on Monetary and Economic Data Bank Questions focused its attention on the Data Bank Services of the BIS which involve central banks in the Group of Ten countries. Improvements in the timeliness and quality control of statistics were reviewed and further initiatives were agreed. Information security issues continued to be explored, with special emphasis being given to telecommunication links with participating institutions. In addition, the BIS reported on progress towards broadening the coverage of statistics in the database, particularly through bilateral data exchange arrangements with the central banks of countries 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 subcommittees and working groups continued to hold most of their meetings at the BIS, where the Committee of Governors' permanent Secretariat is also located. The Committee of Governors is the principal forum for monetary cooperation in the Community and is currently undertaking preparatory work in the monetary field for the transition to the second and third stages of economic and monetary union in accordance with the Maastricht Treaty. A detailed account of the activities of the Committee of Governors can be found in the Committee's annual reports to the European Parliament, the Council of the European Communities and the European Council. The most recent annual report was published in April 1993 and essentially covered developments in 1992.*

* Copies of the annual reports of the Committee of Governors can be obtained by Community residents from their national central banks and by non-Community residents from the Secretariat of the Committee of Governors.

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.[1] 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.

The volume of ECUs issued by the EMCF through three-month swap operations with each of the EC central banks that are signatories to the Agreement of 13th March 1979 and with the Luxembourg Monetary Institute rose from approximately ECU 46.3 billion at 1st April 1992 to ECU 51 billion at 31st March 1993. This expansion of ECU 4.7 billion over the year was due primarily to an increase in the US dollar reserve contributions received from EC central banks and an appreciation of the US dollar vis-à-vis the ECU.

As regards the Community borrowing and lending operations referred to in Council Regulation (EEC) No. 1969/88 adjusting the Community loan mechanism designed to support the balance of payments of member states,[2] particulars of which were given in the fifty-sixth, fifty-seventh and sixty-first Annual Reports on pages 171, 183 and 205–206 respectively, during the period under review the Agent continued to receive from the borrower, namely Greece, and to distribute to the creditors vis-à-vis the Community the sums due in respect of interest, commission and expenses on loans outstanding.

The Agent also carried out the financial transactions relating to the repayment by Greece of the following loans at the final maturity dates:

– value 3rd December 1992, the Sw.fr. 227,000,000 loan 1986–92 at 4⅞% per annum, corresponding to the issue of notes in the same amount and at the same rate,
– value 30th December 1992, the DM 300,000,000 loan 1987–93 at 5⅜% per annum, corresponding to the issue of notes in the same amount and at the same rate,
– value 29th January 1993, the ECU 150,000,000 floating rate loan 1988–93 (the third tranche of the ECU 350,000,000 loan 1988–91/92/93 in three tranches), corresponding to the third tranche of the issue of notes at 7½% per annum in the same amount,
– value 2nd March 1993, the ¥25,000,000,000 loan 1987–93 at 4¾%

[1] For a description of the structure and functions of the Fund, see the fifty-fourth Annual Report, pages 162–164.
[2] 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.

per annum, corresponding to the issue of notes in the same amount and at the same rate, and
– value 4th March 1993, the US$ 250,000,000 loan 1987–93 at 7¼% per annum, corresponding to the issue of notes in the same amount and at the same rate.

In addition, by virtue of the Decision of the Council of the European Communities of 18th January 1993 and under the terms of the above-mentioned Regulation (EEC) No. 1969/88, the Community granted to the Italian Republic a loan in four tranches for a total amount of ECU 8 billion, or its equivalent in other currencies; the first tranche of ECU 2 billion was made available to Italy in March 1993 and involved the following two loans: a DM 2,900,000,000 loan 1993–2000 at 6½% per annum and an ECU 500,000,000 loan 1993–96 at 7⅞% per annum.

The financial transactions connected with these two operations were carried out value 10th and 11th March 1993 respectively.

The following table shows, as at 31st March 1993, the total of outstanding Community lending operations.

Outstanding Community loans as at 31st March 1993

Borrowing countries	Deutsche Mark	ECUs
	in millions	
Greece	536	940
Italy	2,900	500
Total	3,436	1,440

(b) Agent for the private ECU clearing and settlement system

Since October 1986 the Bank has performed the functions of Agent for the private ECU clearing and settlement system in accordance with the provisions of successive agreements concluded between the ECU Banking Association (EBA), Paris, and the BIS, the most recent of which was signed and entered into force on 27th December 1990.* Member banks of the EBA may be granted the status of clearing bank on the basis of criteria drawn up by that body. On 31st March 1993 there were forty-four clearing banks.

(c) Trustee for international government loans

As from 1953 and essentially until 1980 the Bank fulfilled the functions of Trustee for the conversion and funding bonds issued by the Government of the Federal Republic of Germany in respect of the Dawes and Young Loans in accordance with the London Agreement on German External Debts of 27th February 1953. As mentioned in the Bank's sixty-second Annual Report of June 1992, the Government of the Federal Republic of Germany

* For a description of the structure and operation of the clearing system, see the fifty-sixth Annual Report, page 172.

– as a consequence of German unification on 3rd October 1990 and in the light of the obligations assumed under the London Agreement regarding the settlement of arrears of interest for the period 1944 to 1952 – has floated thirteen new issues of funding bonds in respect of the Dawes and Young Loans (1990–2010), details of which are given in the table below. At the request of the German authorities the Bank has once again assumed certain trustee functions in respect of those issues.

Dawes Loan			Young Loan		
3% funding bonds 1990–2010			3% funding bonds 1990–2010		
Nominal value		Issue	Nominal value		Issue
US$	15,400,000	American	US$	16,300,000	American
		Belgian,	B.fr.	45,000,000	Belgian
		Dutch,	£	4,600,000	British
£	1,500,000	French	Fl.	14,000,000	Dutch
		and Swiss	Fr.fr.	86,000,000	French
		pound sterling	DM	8,500,000	German
£	2,400,000	British	S.kr.	24,000,000	Swedish
S.kr.	4,100,000	Swedish	Sw.fr.	16,500,000	Swiss
Sw.fr.	3,500,000	Swiss			
Interest:	3% per annum from 3rd October 1990, payable half-yearly in arrears on 3rd April and 3rd October.				
Maturity:	Twenty years, reaching final maturity on 3rd October 2010.				
Redemption:	Subject to a grace period of five years; as from 3rd October 1995 bonds will be purchased or drawn for redemption yearly, in the latter case for the first time on 3rd October 1996.				

The arrangements for servicing those new issues partly differ in their technical aspects from those previously applied. In particular, physical securities have been replaced for the most part by dematerialised bonds. However, in an exchange of correspondence the German authorities have assured the Bank that holders of dematerialised funding bonds deposited on collective securities accounts are not at any disadvantage in relation to holders of physical securities.

For the various issues of the Dawes and Young Loans the following Exchange Agents, which also act as Paying Agents in respect of physical securities, have been appointed:

Belgium:	Banque Bruxelles Lambert S.A., Brussels
France:	Crédit Lyonnais, Paris
Germany:	Deutsche Bundesbank, Frankfurt am Main
Netherlands:	ABN-AMRO Bank N.V., Amsterdam
Sweden:	Skandinaviska Enskilda Banken, Stockholm
Switzerland:	Schweizerische Kreditanstalt, Zurich
United Kingdom:	Bank of England, London
United States:	[The related negotiations have not yet been concluded.]

The German Federal Debt Administration (Bundesschuldenverwaltung) has informed the Bank that only ninety-three claimants had opted for the issue of physical securities by 31st March 1993. The Deutsche Bundesbank has also assumed the additional function of Paying Agent for all dematerialised bonds of all issues; it has notified the Bank that it has paid out approximately DM 12.8 million to bondholders in respect of the interest maturity dates from 3rd April 1991 to 3rd October 1992, inclusive.

The exchange guarantee clause contained in paragraph 2(e) of Section A of Annex I to the London Agreement of 1953 is applicable to the Young Loan funding bonds. Details of the calculation of the funding values made by the German authorities on this basis for exchange against the new Young Loan funding bonds, in particular the conversion factor and the redemption values for the interest maturity date of 3rd April 1991, can be found in the Conversion Offer (October 1991). In respect of the interest maturity dates of 3rd October 1991, 3rd April and 3rd October 1992 and 3rd April 1993, respectively, the newly calculated redemption values and conversion factors were published by the German Federal Debt Administration in the Federal Journal.

The Bank has repeated its earlier reservations concerning the application of the exchange guarantee clause for the Young Loan by the German Federal Debt Administration and has stressed that these reservations, in particular regarding the right to additional payments, also extend to the newly issued funding bonds 1990–2010. Details may be found in the Bank's fiftieth Annual Report of June 1980 (pages 168–169) and in its announcement published in various financial newspapers on 30th/31st May 1980.

3. Multilateral financial assistance to central banks

In addition to the bilateral credits which the BIS concluded with central banks, in the year under review it again granted a multilateral facility to the National Bank of Romania. This very short-term transaction was set up in the form of a bridging loan for a total of ECU 76 million, of which ECU 61.2 million was made available by the BIS and ECU 14.8 million by the KfW (Kreditanstalt für Wiederaufbau) of Germany; the BIS share was backed by ten EC central banks. The purpose of this operation was to prefinance a loan granted to the Republic of Romania by the European Community with a view to covering a balance-of-payments deficit.

4. Operations of the Banking Department

The Balance Sheet of the Bank and the Profit and Loss Account, expressed in gold francs,* have been certified by the auditors; they are reproduced at the end of this Report.

* 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.

On 31st March 1993, at the close of the financial year 1992–93, the balance-sheet total stood at GF 59,966,449,459

This compares with the figure of GF 47,961,052,059 reached on 31st March 1992.

The increase of GF 12,005,397,400 is the largest ever recorded by the Bank during a financial year.

The rise was accounted for by an increase in resources in currencies; it would have been even slightly greater had it not been for the effect of exchange rate movements. In gold franc terms, the Deutsche Mark and the yen appreciated by 1% and 14% respectively, but the pound sterling and the ECU depreciated by 14% and 4%.

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
1989	42,234	+ 4,083	+ 11
1990	41,291	− 943	− 2
1991	45,719	+ 4,428	+ 11
1992	47,961	+ 2,242	+ 5
1993	59,966	+ 12,005	+ 25

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.

The total of earmarked gold stood at 1,059 million gold francs on 31st March 1993, compared with 1,246 million on 31st March 1992.

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			
1989	1,404	39,875	955	42,234
1990	1,476	38,673	1,142	41,291
1991	1,557	42,856	1,306	45,719
1992	1,644	44,866	1,451	47,961
1993	1,745	56,515	1,706	59,966

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 reserve funds, commented on below, are shown in the table at the end of this Report, under Item I.

With the exception of the Legal Reserve Fund, which remains unchanged, it is proposed that the other reserve funds be increased as follows:

(1) Legal Reserve Fund	GF	30,070,313

The total of this Fund has remained unchanged since 1971, when it was raised to 10% of the then paid-up capital. This is 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 1992–93	GF	703,116,157

This Fund had been raised to 672.8 million gold francs on 31st March 1992. It is proposed that it be increased by 30.3 million, this sum to be transferred from the net profit for the financial year, in conformity with the provisions of Article 51 (3) of the Statutes.

(3) Special Dividend Reserve Fund after allocation of the net profit for the financial year 1992–93	GF	47,530,055

This compares with 42.5 million gold francs on 31st March 1992, representing an increase of 5 million, also by transfer from the net profit.

(4) Free Reserve Fund after allocation of the net profit for the financial year 1992–93	GF	668,766,872

It is proposed that this Fund be raised from 603.1 million gold francs to 668.8 million by allocation of 65.7 million from the net profit.

The total of the Bank's reserves will thus be increased to

GF 1,449,483,397

compared with 1,348.5 million on 31st March 1992, by transfer of a total of 101 million gold francs from the net profit for the financial year 1992–93. At the end of the preceding financial year the reserves had been raised by 87 million.

B. Borrowed funds

The following tables show the origin, nature and term of the Bank's borrowed resources.

BIS: Borrowed funds, by origin			
Origin	Financial years ended 31st March		Movement
	1992	1993	
	in millions of gold francs		
Deposits of central banks	43,204	54,686	+ 11,482
Deposits of other depositors	1,662	1,829	+ 167
Total	44,866	56,515	+ 11,649

The Bank's activity was marked by a very sharp expansion of 26% in resources received, whereas in the preceding financial year they had grown by only 4.7%.

The expansion in deposits, due mainly to an increase of 27% in the holdings of central banks, also reflected the receipt of deposits from other depositors (+ 10%).

On 31st March 1993 the share of "Deposits of central banks" in total borrowed funds stood at 96.8%, compared with 96.3% at the end of the preceding financial year. Funds placed by other depositors represented only 3.2% of the total, compared with 3.7% previously.

The increase in resources in currencies was due primarily to the receipt of new deposits in US dollars; over the financial year the total of deposits in that currency rose by 47%. It should also be noted that the share of resources in dollars as a proportion of total deposits in currencies now stands at 60%, compared with 53% at the beginning of the financial year; on the other hand, that in Deutsche Mark, the second-largest item, which had remained stable at 24% during the first eleven months of the financial year, declined to 21% in March 1993. Deposits in ECUs decreased sharply and account for only 5% of resources in currencies, compared with 12% previously.

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
	1992	1993		1992	1993		1992	1993	
	in millions of gold francs								
Sight	4,562	4,334	− 228	1,862	1,845	− 17	6,424	6,179	− 245
Not exceeding 3 months	9	30	+ 21	37,853	49,437	+ 11,584	37,862	49,467	+ 11,605
Over 3 months	–	3	+ 3	580	866	+ 286	580	869	+ 289
Total	4,571	4,367	− 204	40,295	52,148	+ 11,853	44,866	56,515	+ 11,649

Deposits in gold decreased by 4%, while those in currencies rose by 29%; the two items represented 7.7% and 92.3% of total borrowed funds respectively, compared with 10.2% and 89.8% on 31st March 1992.

In terms of the maturity of borrowed funds, there was a decline in sight deposits but an increase in deposits with a maximum maturity of three months and in those at over three months.

The expansion in deposits was mainly accounted for by those with maturities not exceeding three months (+31%), although the percentage increase in deposits at over three months was more pronounced (+50%).

As a proportion of total borrowed funds, sight deposits amounted to 10.9%, compared with 14.3% on 31st March 1992, deposits with a maximum maturity of three months 87.5%, compared with 84.4%, and deposits with longer maturities 1.6%, against 1.3%.

(a) Deposits in gold GF 4,367,255,684

This item had stood at 4,571 million gold francs on 31st March 1992. The reduction of 204 million reflected the decrease in sight deposits, partly offset by a rise in the total of time deposits.

(b) Deposits in currencies GF 52,147,751,915

This compares with 40,295 million gold francs on 31st March 1992. The increase of 11,853 million reflected, for the most part, a parallel movement in deposits with a maximum maturity of three months and, to a lesser extent, in those with longer maturities.

C. Other liabilities

The total of other liabilities amounted to GF 1,706,255,338 compared with 1,451 million gold francs on 31st March 1992.

(a) The item "Staff pension scheme" stood at GF 172,105,388

whereas it had amounted to 158 million gold francs at the end of the preceding financial year. This item represents the Bank's liability in respect of staff pensions; it is denominated in Swiss francs and is increased during the financial year.

(b) The item "Miscellaneous" rose to GF 1,495,254,533

against 1,260 million gold francs on 31st March 1992.

(c) Dividend payable on 1st July 1993 GF 38,895,417

The increase in the dividend from 200 to 240 Swiss francs per share accounts for the rise in this item. It is proposed that this sum be set aside out of the net profit for the financial year 1992–93; it compares with the amount of 32.5 million gold francs set aside out of the net profit for the previous financial year.

The Profit and Loss Account showed a net profit, before allocation, of 139,895,417 gold francs, which it is proposed to allocate in accordance with Article 51 of the Statutes. Details of this allocation appear in Section 5 below.

The net profit for the previous financial year had amounted to 119.5 million gold francs.

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	
	1992		1993			
	in millions of gold francs					
Sight assets						
Gold	4,808		4,727		− 81	
Currencies	12	4,820	8	4,735	− 4	− 85
Treasury bills		3,623		2,175		− 1,448
Time deposits and advances						
Gold	460		413		− 47	
Currencies	31,588	32,048	41,184	41,597	+ 9,596	+ 9,549
Government and other securities at term		7,458		11,428		+ 3,970
Miscellaneous		12		31		+ 19
Total						
Gold	5,268		5,140		− 128	
Currencies	42,693	47,961	54,826	59,966	+12,133	+12,005

In parallel with the development of resources, there was a decline in assets in gold and an appreciable rise in those in currencies.

(a) Sight assets in gold GF 4,726,895,651

This compares with 4,808 million gold francs on 31st March 1992. The decrease of 81 million in this item corresponds to the difference between withdrawals of gold by central banks and the repayment of time deposits placed on the market which reached maturity (see item (d)).

(b) Cash on hand and sight assets in currencies GF 7,557,219

This compares with 12 million gold francs at the end of the preceding financial year.

(c) Treasury bills GF 2,175,383,708

The value of this portfolio had stood at 3,623 million gold francs on 31st March 1992. In the course of the financial year its volume and composition varied appreciably. Purchases of Treasury bills were made on several markets.

(d) Time deposits and advances GF 41,596,864,761

This compares with 32,048 million gold francs on 31st March 1992. The rise of 9,549 million, or 30%, represents the difference between the decrease in deposits in gold and the increase in those in currencies.

– In gold GF 412,988,974

This compares with 460 million gold francs on 31st March 1992, a decline of 47 million over the financial year.

– In currencies GF 41,183,875,787

This compares with 31,588 million gold francs on 31st March 1992. The rise in resources in currencies was reflected primarily in an expansion in this item, which increased by 9,596 million.

(e) Government and other securities at term GF 11,428,278,309

At the end of the previous financial year this portfolio had stood at 7,458 million gold francs, giving an increase of 3,970 million. The portfolio is made up of securities purchased on various markets.

Reflecting the composition of resources received, assets are also denominated for the most part in US dollars, followed by Deutsche Mark; the share of other currencies is much smaller.

It should also be noted that the decrease of 128 million gold francs in the total of assets in gold compares with the decline of 204 million in the total of liabilities in gold. The difference of 76 million is reflected in a corresponding rise in forward gold operations, to which reference is made below.

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
	1992	1993	
	in millions of gold francs		
Not exceeding 3 months	32,083	43,649	+ 11,566
Over 3 months	7,423	9,376	+ 1,953
Total	39,506	53,025	+ 13,519

An examination of the maturities of all investments made shows an increase of 36.1% in investments with maturities not exceeding three months and of 26.3% in those at longer term.

The share of investments with a maximum maturity of three months was 82.3% and that at over three months 17.7% of the total of these two items, compared with 81.2% and 18.8% respectively on 31st March 1992.

(f) Miscellaneous GF 31,469,810

This compares with 12 million gold francs on 31st March 1992.

Forward gold operations

These operations, which are mentioned in Note 2 to the Balance Sheet, resulted in a negative balance of GF 110,573,384

At the end of the preceding financial year they had also shown a negative balance, of 34.3 million gold francs. They involve the repayment of a weight of gold by the Bank at maturity.

5. Net profits and their distribution

The accounts for the sixty-third financial year ended 31st March 1993 show a net operating surplus of 162,427,719 gold francs, compared with 134,110,445 gold francs for the preceding financial year. This year's result is shown after deduction of 49,255,621 gold francs in respect of costs of administration, the 7% increase over the previous year's figure of 46,056,417 gold francs reflecting the higher level, during much of the year, of the gold franc value of the Swiss franc; the increase in terms of Swiss francs, in which currency most of the Bank's expenditure is incurred, was actually less than 3%.

The Board of Directors has decided to transfer 3,295,256 gold francs to the Provision for Exceptional Costs of Administration and to supplement – by means of a further transfer of 19,237,046 gold francs – the Provision for Modernisation of Premises and Renewal of Equipment, the main purpose of which is to meet the cost of maintaining the Bank's premises and to finance the continuing series of technical projects involving investment expenditure. As a result of these transfers the net profit amounts to 139,895,417 gold francs, against 119,460,160 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 139,895,417 gold francs be applied by the General Meeting in the following manner:

(i) an amount of 38,895,417 gold francs in payment of a dividend of 240 Swiss francs per share;

(ii) an amount of 30,300,000 gold francs to be transferred to the General Reserve Fund;

(iii) an amount of 5,000,000 gold francs to be transferred to the Special Dividend Reserve Fund; and

(iv) an amount of 65,700,000 gold francs, representing the remainder of the available net profit, to be transferred to the Free Reserve Fund. This Fund can be used by the Board of Directors for any purpose that is in conformity with the Statutes.

If the above proposals are accepted, the dividend will be paid on 1st July 1993 to the shareholders whose names are contained in the Bank's share register on 20th June 1993.

The Balance Sheet, the Profit and Loss Account and a summary statement showing the movements in the Bank's reserves during the financial year will be found at the end of this Report. The Bank's accounts have been audited by Price Waterhouse, who have confirmed that the Balance Sheet and the Profit and Loss Account give, on the basis described in Note 1, a true and fair view of the state of the Bank's affairs at 31st March 1993 and of its profit for the year ended on that date. Price Waterhouse's report is appended at the foot of the Balance Sheet.

6. Shareholding central banks

As a consequence of the three Baltic states regaining their independence, the status of the central banks of Estonia, Latvia and Lithuania as member central banks of the BIS was reactivated in June 1992. At last year's Annual General Meeting of the Bank the Chairman of the Board of Directors was thus in a position to welcome representatives from those three shareholding central banks, who were attending the Annual Meeting for the first time in more than fifty years.

7. Changes in the Board of Directors and in the Management

Mr. B. Dennis was re-elected to the Board in March 1993 and Lord Richardson of Duntisbourne reappointed in April 1993. Dr. C. Ciampi ceased to be a member of the Board at the end of April 1993, when he relinquished the office of Governor of the Bank of Italy. His successor in that post, Dr. A. Fazio, became an ex officio Director as from 7th May 1993.

M. F. Cappanera retired from the Bank of France at the end of September 1992 and was succeeded by M. A. Robert as Alternate to M. de Larosière in the absence of M. Lagayette. M. P. Lagayette left the Bank of France in December 1992 and was replaced by M. H. Hannoun as Alternate to M. de Larosière. In April 1993 Mr. T. Clark succeeded Mr. M. Foot as Alternate to Mr. Leigh-Pemberton.

As regards the Management of the Bank, Dr. H.W. Mayer, Deputy Manager, retired at the end of June 1992. Dr. R. Filosa was appointed a Manager on 15th January 1993. Prof. Dr. M. Giovanoli, the Bank's Legal Adviser, was also appointed a Manager as from 1st April 1993. As from the same date Dr. J. Bisignano was promoted to the rank of Deputy Manager and Mr. J. Bispham and M. D. Lefort to that of Assistant Manager.

The Bank learned with deep regret of the death of Dr. G. Carli on 23rd April 1993. Dr. Carli had been Governor of the Bank of Italy and an ex officio member of the Board from August 1960 to August 1975.

Conclusion

The experiences of 1992 and early 1993 have raised some new questions and brought into sharper focus a number of longer-standing issues that seem likely to dominate the economic policy debate for years to come. There is, first, the question of what policy-makers in industrial countries can and should do when confronted with sluggish growth if it appears to be not just the result of a "normal" cyclical variation around an accepted potential growth path. This question is closely linked with the factual one of whether unemployment is likely to rise more or less independently of temporary swings in activity. If no other remedy can be offered for these twin concerns, there is an acute danger that protectionist forces will gain the upper hand – and only make matters worse.

A second important question is whether new efforts are needed to put the financial industry in many countries onto a sounder footing. Clearly, the health of the financial sector depends on, and at the same time affects, the performance of the real economy, a lesson which has been brought home forcefully by recent events.

A third question which acquired greater urgency in 1992 relates to the nature of the advice and assistance being given to the economies in transition in eastern Europe. It has become commonplace to admit that the difficulties have been vastly underestimated. But it is also clear that the countries most advanced in the transition process have achieved some notable successes. In fact, for some the worst may be over. Whether the new-found realism will soon produce results elsewhere remains to be seen.

A fourth question concerns exchange rate relationships, and specifically the problems faced by different exchange rate regimes in a world of virtually instantaneous portfolio adjustments. The potential for private capital flows to move the exchange markets has grown formidably in the past ten to fifteen years.

On the brighter side, questions arise mainly in relation to sustainability. Will the low inflation rates achieved in many countries be maintained? Will the structural improvements and high growth rates in a large number of developing countries prove durable?

As to the sluggish growth trend in the industrial countries and how to respond to it, there is no doubt that in some cases the present recession is the most severe experienced in the second half of this century. Finland has been particularly hard hit owing to the loss of export markets in the former Soviet Union and serious debt problems in the private sector.

Unemployment there now exceeds 15%, and is even higher in Spain and Ireland. Structural problems of various kinds have also deepened the downturn in Sweden and, to a lesser extent, in Australia and Norway. Debt problems and real asset price cycles have been identified as factors responsible for the long duration of the recession and the slow recovery in the United States, the United Kingdom and several other countries. Where the recession shows no signs of bottoming out yet, any judgement on exactly how severe it is in comparison with earlier ones has to be suspended.

To conclude from this, however, that what we are observing in one country after another is in fact more than a normal cyclical downturn and strongly suggests a permanent lowering of the trend growth of productive potential would not be fully consonant with the evidence that is available at present. After all, the current downturn has, in most cases, followed the "longest and strongest upswing in recent history", a phrase that has been used so often as to be still fresh in everybody's memory. There are other arguments which seem to speak against excessive pessimism. Wage moderation and the restoration of profit shares, which had contributed to the length of the upturn in the 1980s, also help to account for the surprising resilience of business investment in machinery and equipment during the recession. Household saving has recently strengthened significantly in a number of countries – in the short run, of course, exacerbating the fall in domestic demand, but at the same time helping to create a sounder financial basis for recovery. There are also signs that productivity growth may be increasing, not only in the manufacturing sector but also in services. Finally, even though budget deficits have been rising during the recession, the medium-term orientation of fiscal policies towards consolidation should have a favourable impact on private sector confidence and on long-term interest rates.

The rising trend of unemployment, notably in Europe, is a different matter. It started in the 1970s and 1980s and has been reinforced in many cases by growth in the labour force as a result of higher participation rates and, in some instances, substantial immigration. The prospects for reversing the long-term rise look bleak, even when output recovers and if inflation remains low. Attempts to soften the full rigours of competition in the European labour market may actually have made unemployment worse. Despite the impressive wage moderation of the 1980s, there are few signs that the underlying flexibility of the labour market has increased. A few examples from a long list of labour market rigidities may serve to illustrate the issues and the challenges facing policy-makers. Very often wages are set at levels that do not take sufficient account of productivity. Payroll taxes and other non-wage labour costs paid by employers to finance various social benefits have increased to around 50% or more of total labour costs in several European countries, and thus have impaired the international competitiveness of enterprises. High redundancy payments, combined with low mobility of the labour force, have given those in employment ("insiders") a disproportionate or virtually exclusive influence in the wage bargaining process. This may be seen in Spain, where real wages continued to grow last year as output stagnated and the rate of unemployment rose.

Even unorthodox measures seem to have offered little remedy for the rising trend of unemployment. Some countries have introduced early retirement schemes, or eased eligibility criteria for invalidity pensions, and have then recorded some decline in unemployment. Unfortunately, however, this has frequently been at the cost of a larger fiscal deficit and lower potential output. Several countries have adopted work-sharing schemes, including a shortening of the working week. However, the effect on unemployment has in most cases been relatively modest, owing to higher hourly wages or higher productivity. More flexible working hours have facilitated the employment of part-time workers in several countries, although much of the rise reflects a larger inflow of women into the labour force, or unemployed workers taking a part-time job while looking for a full-time one.

Overall, flexible wage-setting systems such as those in the United States, Japan and Austria seem to hold out the best prospects for containing unemployment, though these systems have very different institutional foundations. In the United States and Japan most wages are determined at the firm or the industry level and a high sensitivity of remuneration to market developments – including a flexible bonus or profit-sharing system in Japan – has enabled both countries to adjust to adverse shocks and changes in technology with smaller or only temporary increases in unemployment. In Austria wage negotiations are sectoral, but coordinated within a broad incomes policy framework in which income claims are subordinated to the overall target of maintaining a fixed nominal exchange rate. Systems like these cannot, however, easily be copied by other countries. Creating such conditions is obviously not simply a matter of applying specific labour market measures, but rather of introducing a general spirit of realism and cooperation and a greater readiness to make use of the opportunities that the markets have to offer.

Slow growth and rising unemployment inevitably raise the spectre of protectionism, especially when they are associated with an erosion of competitiveness. The industrial countries in western Europe are no longer facing competition from the United States and Japan alone. New competitors are emerging in particular in the Far East – and not just the so-called "newly industrialised economies" – but also in eastern Europe. One important aspect of competitiveness is of course the development of real exchange rates. Real currency appreciation in Europe and very large depreciation in the United States since 1985 have greatly affected competitiveness. Temporarily misaligned exchange rates no doubt nurture the feeling that such-and-such a country is "too" competitive and so tend to foster protectionist sentiment. As for the effectiveness of protectionism itself, the old myth that restricting imports can reduce unemployment carries little conviction. It is true that limits on imports can save jobs in import-competing industries in the short run, but at the cost of inducing job losses in other sectors. Restrictions inevitably raise costs and so put unprotected producers at a competitive disadvantage; the resulting higher prices reduce households' real spending power. Moreover, restrictions invite retaliation: a country caught in a vicious circle of retaliatory trade restrictions would only replace high-wage jobs in its most successful sectors with low-wage jobs elsewhere.

Some prominence has recently been given to arguments that economies of scale and externalities in high-technology industries may justify some government intervention in trade. This is akin to the infant industry argument, one of the oldest exceptions to the case for free trade. It rightly points to the need to be vigilant about trading partners' possible use of trade and other restrictions to secure long-term advantage. But to jump from this to the conclusion that trade in high-tech goods must be vigorously "managed" to prevent competitors from gaining long-term advantage is a leap of logic that ignores other telling considerations. Firstly, product development in the high-tech sector is so rapid that patterns of trade and production evolve too quickly to be covered by managed trade. Secondly, the weakening of the usual commercial disciplines on trade leaves consumers and producers at the mercy of domestic lobbies, and an important spur to greater efficiency is removed. Finally, but by no means least important, managed trade is inevitably "politicised" trade. One of the great virtues of the GATT arrangements has been that, because governments have been expected to eschew direct control of trade, and allow commercial considerations to predominate, international trade has indeed expanded enormously over the last forty years. It is to be hoped that the great common interest in maintaining and extending this system will eventually prevail, and that the remaining issues in dispute in the Uruguay Round will be quickly resolved.

Given these concerns on three fronts – growth, employment and free trade – what follows for the role of macroeconomic policy and for demand management in particular? Japan stands out as having used periods of buoyant growth to redress fiscal imbalance, so that it can now afford to give substantial stimulus to domestic demand. In most countries the absence of fiscal flexibility – in situations in which it might be needed – is, more than anything else, the result of past policy mistakes, compounded by the built-in "snowballing" effects of public debt. In these cases policy should, and indeed can only, be firmly directed towards the medium-term consolidation of fiscal balances. If credible, such efforts can contribute to a further decline in long-term interest rates or at least prevent an increase in the early stages of recovery. They can also restore public confidence. In the short run automatic stabilisers should in principle be allowed to function, but only where the recession is severe and the structural deficit and the stock of outstanding public debt are not excessively high. Some consideration could also be usefully given to restructuring expenditure or revenues with a view to expanding public investment in infrastructure and education and thus promoting future private investment activities.

Monetary policy can play a helpful, but limited, role in demand management. The case for a medium-term orientation remains wholly valid.

This does not preclude declines in interest rates in the face of weak demand when inflationary pressures subside. Exchange rate adjustments and some easing of wage cost pressures in Germany have now at last opened the way for Europe to participate in the process of monetary relaxation which began earlier in North America and Japan. Experience in countries where the process began first seems to suggest that it can go quite far without rekindling inflation. However, the challenge of keeping inflation under lasting control remains a formidable one. Moreover, differing financial structures and monetary transmission mechanisms mean that the scope for using monetary policy to stimulate demand, while keeping inflation at bay, varies from country to country. The experience of asset price bubbles during the 1980s and the tendency of some floating exchange rates to "overshoot" in response to declines in interest rates are warnings to be heeded.

This brings us to the question of whether new efforts should be made to put the financial industry on a sounder footing. It is of the utmost importance that the lessons learnt from the management of the deregulation process which gathered pace over the past decade are not quickly forgotten. Last year's Annual Report devoted a whole chapter to this question. The new element this year is the spreading of loan losses to a number of continental European banks, together with the aggravation of the banking crisis in several Nordic countries. The deepening banking crisis in Sweden and Finland has brought home the message that deregulation has to be supported by cautious and consistent micro and macro policies. This essentially means strengthened prudential regulation and supervision, and a firm long-term anti-inflation commitment, which in turn requires a high degree of fiscal discipline. The experience of these countries and, earlier, of Norway has highlighted the risk that, in the absence of appropriate safeguards, deregulation may paradoxically lead to more, and more costly, government involvement in the financial industry, rather than less. For, reluctant as they may be, governments are inevitably called upon to intervene once there is a danger of a financial crisis, which would threaten the real economy. Central banks may also come under pressure to lower their guard against inflation.

It may be tempting to think that government intervention can, with one wave of a magic wand, eliminate the costs of financial distress. True, disruptive runs on banks, by both wholesale and retail customers, can be countered. Rebuilding the capital base of damaged institutions can forestall serious constraints on lending. The incidence of losses can be spread widely, alleviating the pain for some segments of the population. Yet the costs remain real. Competitive conditions are inevitably distorted between the weak institutions that receive support and the strong ones that do not. The very provision of assistance, no matter how carefully it is administered, risks undermining incentives to prudent behaviour, possibly setting the stage for more problems in the future. Public finances can become, and in fact in some cases have become, overburdened. Especially in the presence of large external liabilities, financing constraints can quickly be tested.

The costs of resolving financial distress put a premium on prevention. Despite the major efforts made in recent years to preserve the integrity of the financial system, much still remains to be done in the field of prudential regulation and supervision to take account of the new market realities, both nationally and internationally. At the level of individual institutions, high on the list are some form of consolidated supervision of complex organisational structures, greater cooperation between different supervisory authorities and the refinement of capital standards beyond the coverage of credit risk. The April proposals of the Basle Committee on Banking Supervision extending the framework of capital standards to include market risk and the measurement of interest rate risk are a step in this direction. At the level of linkages between institutions and markets, it is important to ensure that derivatives markets and payment and settlement systems operate subject to adequate safeguards. And in designing all of these lines of defence the authorities will inevitably need to address the issue of the appropriate balance between market discipline and official involvement. Limiting "moral hazard" and improving information disclosure are key objectives in this context.

Turning to eastern Europe, resolute stabilisation efforts there have by now borne some first fruits, but the road ahead is still long. The creation of a market economy requires changes in the entire economic landscape, in political and economic – notably financial – institutions, and in people's habits. It is a process that cannot be accelerated beyond a certain point. Consistency in economic policies during this period is essential because it allows market participants to anticipate the direction in which reform will proceed. Such coherence is hard to achieve at a time of shrinking output and rising unemployment, but it can be supported by external help. In the case of Germany, this has partly taken the form of large public transfers. In eastern Europe, technical assistance and multilateral lending have been important in the initial stages of reform. Access to western markets has been no less vital. Not only has it given direction to enterprises' restructuring, but it has also helped to limit the decline in output. This has increased popular support for government policies based on fuller economic and political integration with the West. All the more regrettable, therefore, are the recent restrictions imposed by some industrial countries on imports from eastern Europe, in particular in view of the industrial countries' bilateral trade surplus of some $6 billion with that region (excluding the former Soviet Union). These restrictions are perceived in eastern Europe as a fundamental backtracking from the earlier commitment to support the transformation process.

Macroeconomic stabilisation is still lacking in most parts of the former Soviet Union. It will remain beyond reach as long as republics do not either switch completely to their own currencies or accept the Russian central bank as the sole issuing authority. Further prerequisites for effective monetary control are that budget deficits are brought down and that the expansion of credit to loss-making enterprises is restrained. Such policies will have a better chance of success if they are underpinned by a clear commitment by western industrial countries to offer substantial funds, conditional on determined adjustment programmes. The examples of Estonia and Latvia show that there is hope, and western commitment in support of stabilisation in Russia has indeed been forthcoming in greater measure in recent months. The question now is whether the Russian Government can forge and maintain a sufficiently strong consensus on a stabilisation programme, which is the precondition for lasting western support, no matter how much such support is seen to be in the West's own interest.

To move on to the fourth question raised at the beginning of this Conclusion, the future of exchange rate relationships, what lessons can be drawn from the turmoil in the European exchange markets?

The crisis erupted (as crises usually do) as a result of the coincidence of a number of adverse developments and circumstances. Two of these – the exchange rate misalignments and the high level of short-term German interest rates – have now been, or are in the process of being, corrected. At the same time, the exchange rate relationships between five currencies have passed a stiff test. It is therefore arguable that the crisis is now over. However, even if this relatively optimistic, but not unreasonable, view is confirmed in the months ahead, it would be unwise not to consider the implications of past events both for those European countries which wish to operate under explicit exchange rate commitments and for those with floating rates.

The exchange market crisis provided graphic evidence that the potential for private capital flows to influence exchange rates has increased dramatically over the last ten to fifteen years. The reasons for this are clear. The dismantling of capital controls and deregulation more broadly have created a new environment. The large-scale accumulation of financial claims and liabilities both domestically and internationally has provided a huge volume of funds which can be shifted with great speed from one currency to another. An additional factor has been the emergence of an activist asset and liability management culture, encouraged by the successive waves of financial innovation and accelerating advances in information systems and communications technology. Because exchange rate movements have a major impact on portfolio performance, those in charge of the management of financial assets are bound to take a view of possible or likely exchange rate changes, and when they do so, they can more often than not make that view self-fulfilling.

The authorities cannot therefore afford to ignore the crucial role of expectations. If they want to meet exchange rate targets, they will have to influence these expectations, or at least avoid giving rise to adverse ones. The difficulty in this lies in the fact that in the present transparent world the information possessed by market participants is only rarely inferior to that available to the authorities. Hence the importance of policy actions that are credible. Credibility, however, hinges not only on the intentions of policy-makers, nor even on the successful implementation of their policies, but also on the sustainability of the policies themselves.

In practice this means that the use of the most direct exchange market policy tool, intervention, needs to be underpinned by interest rate changes. Such changes serve the twofold purpose of raising the cost of speculation and signalling a shift in the stance of monetary policy. But this can only be effective if the financial markets believe that the interest rate changes are sustainable, and will be sustained, for a sufficient period of time. The markets will base this judgement not only on their perception of the authorities' determination to stick to their guns, but also on their assessment of the authorities' ability to do so – and it is at this point that the economic fundamentals, and the politics, of the countries concerned assume such crucial importance.

What are the specific implications of this for the operation of the ERM? Firstly, while the exchange rate commitments will have to play a role in constraining any inflation-prone behaviour of governments and market participants (this being one of the objectives of such commitments), they will be able to perform this role in the longer run only if financial markets are persuaded that the factors responsible for home-made inflation are well under control. If the markets are not so persuaded, they will force an exchange rate adjustment. To avoid this, the authorities will have to try to identify such situations and, if possible, agree on pre-emptive realignments. Secondly, they will have to weigh carefully the pros and cons of individual as opposed to general realignments. A general realignment might appear politically more acceptable. But if recent experience is any guide, the gradual accumulation of a multiplicity of tensions may entail a decision-making process which, under the pressure of speculation, could become unmanageable. Thirdly, however, if there are attacks on the currencies of countries where the fundamentals are sound and where the determination of the authorities is unequivocal, these attacks should be resisted. And they should be resisted by both intervention and interest rate changes, in ways, moreover, which demonstrate the multilateral nature of the commitment.

The combination of more frequent currency realignments for countries whose fundamentals are not sound with the preservation of exchange rate stability among the rest would not, of course, be easy to manage, either technically or when realignments require political decisions. One temptation might be to adjust exchange rates too readily. The constraining effects of exchange rate commitments on the behaviour of governments and/or market participants could then be weakened. In addition, overly large or frequent realignments might disturb exchange rate relationships even for countries with sound fundamentals. A possible solution to this would be to reinforce these countries' own exchange rate commitments, and speed up their move towards monetary union. Some might find such a prospect acceptable, others not. But the alternative is to continue with the present set of heterogeneous and potentially very unstable exchange rate arrangements, including the floating of two major currencies.

In any case, the spectacular increase in capital mobility may also pose serious problems for floating currencies. Market forces have led at times – albeit sometimes in combination with misguided policies – to huge medium-term swings in real effective exchange rates which clearly took them out of line with the requirements of domestic and external equilibrium – even without the benefit of hindsight. Such misalignments increase the uncertainty faced by business decision-makers and hence risk provoking the postponement or cancellation of investment decisions, as well as an international misallocation of productive resources and powerful protectionist pressures. There is a risk of the reappearance of such misalignments, which could become particularly damaging if they were to arise between the currencies of countries with close trade ties. Hence the interest in trying to contain them.

However, the new environment makes such a containment, no matter how desirable, more difficult to achieve. True, very short-term exchange market instability may be smoothed out to some extent by carefully timed intervention and the amplitude of medium-term real exchange rate swings may be dampened by sound, and internationally compatible, economic policies. But the probability of successful containment outside the constraining framework of an explicit exchange rate commitment should not be overestimated.

Because movements in real exchange rates have a major effect on the domestic economy, the countries with newly floating currencies will still have to take account of the exchange rate in setting monetary and other policies, even though they have for the moment no explicit exchange rate commitment. Up to now, favourable conditions have permitted substantial cuts in short-term interest rates: in recent months, the exchange rates of the European currencies now floating seem to have stabilised (or have even appreciated) after their initial fall and inflation pressures appear to be largely dormant. Nonetheless, these countries will need to remain on guard against the inflationary risks – and stand ready to increase interest rates – if a shift in foreign exchange market sentiment threatens too sharp a depreciation of their currencies. The hard-won gains in reducing inflation could easily be lost.

If the general vigilance against inflation is maintained, and is made clear to all economic agents, then there are good overall prospects for keeping inflation down. It should not be forgotten that the low rates of inflation observed throughout the current cyclical phase do not reflect once-for-all effects of price declines or other special factors as in 1986, but rather several years of determined anti-inflationary monetary policy. So far, there are few signs that inflation is reaccelerating in the countries recovering from recession. Indeed, the impressive productivity performance seen in some of these countries, which could itself be the result of pressures to reduce costs in a low-inflation environment, should help to hold down future growth in unit labour costs. Monetary policy remains of course the key to success on the inflation front, and, as pointed out above, a difficult task lies ahead.

As to the rewards of low inflation, the experience of the developing countries is encouraging. One of the factors contributing to the impressive growth performance of the NIEs and other Asian countries has been their low rate of inflation. Moreover, in most of Latin America a reorientation of policies towards stability has cut inflation, and output growth is higher than in the 1980s now that debt burdens have been reduced significantly. Compared with earlier developments in Latin America this recent experience illustrates that while it is possible to impart a temporary boost to output growth by allowing higher inflation and a build-up of external debt, sustainable long-run growth is only feasible in a stable low-inflation environment.

In addition to low inflation, high saving and investment combined with low budget deficits (or surpluses) and strong productivity growth have been the main features of the impressive growth performance of the NIEs and have enabled them to offset the influence of weaker import growth in the industrial countries. And yet, despite saving/GDP ratios of 35% or more the NIEs are themselves being challenged by other highly competitive countries in Asia. Hence, just as in the more developed countries, near-term growth may be lower than in the past because of weakening competitiveness. But this, clearly, is one of the most encouraging pieces of news to emerge in the period under review. The development process in formerly poor countries is embracing one country after the other, at present in the Far East, and also increasingly in Latin America. It is to be hoped that this process of learning from others will not come to a halt too soon.

Basle, 27th May 1993

ALEXANDRE LAMFALUSSY
General Manager

Balance Sheet and Profit and Loss Account

at 31st March 1993

Balance Sheet at 31st March 1993

(in gold francs - see Note 1)

Assets		
Gold		4 726 895 651
Cash on hand and on sight account with banks		7 557 219
Treasury bills		2 175 383 708
Time deposits and advances		
Gold		
Not exceeding 3 months	158 973 875	
Over 3 months	254 015 099	
Currencies		
Not exceeding 3 months	35 280 021 131	
Over 3 months	5 903 854 656	
		41 596 864 761
Government and other securities at term		
Not exceeding 3 months	8 210 111 292	
Over 3 months	3 218 167 017	
		11 428 278 309
Miscellaneous		31 469 810
Land, buildings and equipment		1
		59 966 449 459

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 1993, gold payable against currencies on forward contracts amounted to 110 573 384 gold francs.

Liabilities		Before allocation of the year's Net Profit	After allocation of the year's Net Profit
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	672 816 157		*703 116 157*
Special Dividend Reserve Fund	42 530 055		*47 530 055*
Free Reserve Fund	603 066 872		*668 766 872*
		1 348 483 397	*1 449 483 397*
Deposits (gold)			
Central banks			
Sight	4 334 083 270		
Not exceeding 3 months	29 967 132		
Over 3 months	3 204 883		
Other depositors			
Sight	399		
		4 367 255 684	*4 367 255 684*
Deposits (currencies)			
Central banks			
Sight	1 755 962 355		
Not exceeding 3 months	47 699 381 714		
Over 3 months	863 467 791		
Other depositors			
Sight	89 375 240		
Not exceeding 3 months	1 737 255 922		
Over 3 months	2 308 893		
		52 147 751 915	*52 147 751 915*
Staff Pension Scheme		172 105 388	*172 105 388*
Miscellaneous		1 495 254 533	*1 495 254 533*
Profit and Loss Account		139 895 417	—
Dividend payable on 1st July 1993		—	*38 895 417*
		59 966 449 459	*59 966 449 459*

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 1993 and of its profit for the year ended on that date. We have obtained all the information and explanations which we have required. The Bank has kept proper books, and the Balance Sheet and the Profit and Loss Account are in agreement with them and with the information and explanations given us.

Basle, 30th April 1993 — *PRICE WATERHOUSE*

Profit and Loss Account

for the financial year ended 31st March 1993
(in gold francs)

Net interest and other operating income		211 683 340
Less: Costs of administration		
Board of Directors	755 908	
Management and Staff	32 182 425	
Office and other expenses	16 317 288	49 255 621
Net operating surplus		162 427 719
Less: Amounts transferred to		
Provision for Exceptional Costs of Administration	3 295 256	
Provision for Modernisation of Premises and Renewal of Equipment	19 237 046	22 532 302
Net Profit for the financial year ended 31st March 1993		139 895 417

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: 240 Swiss francs per share on 473 125 shares	38 895 417
	101 000 000
Transfer to General Reserve Fund	30 300 000
	70 700 000
Transfer to Special Dividend Reserve Fund	5 000 000
	65 700 000
Transfer to Free Reserve Fund	65 700 000
	—

Movements in the Bank's reserves

during the financial year ended 31st March 1993
(in gold francs)

I. Development of the Reserve Funds resulting from allocations for the financial year 1992–93

	Legal Reserve Fund	General Reserve Fund	Special Dividend Reserve Fund	Free Reserve Fund
Balances at 1st April 1992, after allocation of Net Profit for the financial year 1991–92	30 070 313	672 816 157	42 530 055	603 066 872
Add: Allocations for the financial year 1992–93 .	—	30 300 000	5 000 000	65 700 000
Balances at 31st March 1993 as per Balance Sheet	30 070 313	703 116 157	47 530 055	668 766 872

II. Paid-up Capital and Reserve Funds at 31st March 1993 (after allocation) were represented by:

	Paid-up Capital	Reserves	Total
Net assets in			
Gold...	295 703 125	366 352 433	662 055 558
Currencies..	—	1 083 130 964	1 083 130 964
	295 703 125	1 449 483 397	1 745 186 522

Board of Directors

Bengt Dennis, Stockholm
Chairman of the Board of Directors,
President of the Bank

The Rt.Hon. Lord Richardson of Duntisbourne, London
Vice-Chairman

Bernard Clappier, Paris
Dr. Lamberto Dini, Rome
Dr. W.F. Duisenberg, Amsterdam
Dr. Antonio Fazio, Rome
Prof. Dr. Leonhard Gleske, Frankfurt a/M.
Jacques de Larosière, Paris
The Rt.Hon. Robert Leigh-Pemberton, London
Dr. Markus Lusser, Zurich
Prof. Dr. Helmut Schlesinger, Frankfurt a/M.
Alfons Verplaetse, Brussels
Philippe Wilmès, Brussels

Alternates

A.D. Crockett, London, or
T.A. Clark, London
Hervé Hannoun, Paris, or
André Robert, Paris
Jean-Jacques Rey, Brussels
Dr. Carlo Santini, Rome
Dr. Hans Tietmeyer, Frankfurt a/M., or
Dr. Wolfgang Rieke, Frankfurt a/M.

Management

Alexandre Lamfalussy	General Manager
Rémi Gros	Assistant General Manager, Head of the Banking Department
Dr. Giampietro Morelli	Secretary General, Head of Department
Dr. Horst Bockelmann	Economic Adviser, Head of the Monetary and Economic Department
G.M. Gill	Deputy Head of the Banking Department, Manager
Marten de Boer	Manager, Operational Security, Accounting and Budgeting
Dr. Renato Filosa	Manager, Monetary and Economic Department
Prof. Dr. Mario Giovanoli	Legal Adviser, Manager
Jean Vallet	Deputy Secretary General
André Bascoul	Deputy Manager, General Secretariat
Dr. Kurt Spinnler	Deputy Manager, Banking Department
Dr. Joseph R. Bisignano	Deputy Manager, Monetary and Economic Department
Jean-Claude Dagassan	Assistant Manager, EMCF Agent
P.C. Bridge	Assistant Manager, Banking Department
Jean-Marc Andreoli	Assistant Manager, General Secretariat
Yukio Iura	Assistant Manager, Banking Department
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