NOT FOR PUBLIC USE

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 83/88

3:00 p.m., June 20, 1983

J. de Larosière, Chairman
W. B. Dale, Deputy Managing Director

Executive Directors	Alternate Executive Directors
	W. B. Tshishimbi
	H. G. Schneider
	A. Le Lorier
	M. Teijeiro
R. D. Erb	
M. Finaish	Jaafar A.
	T. Yamashita
	M. Casey
	J. R. N. Almeida, Temporary
G. Laske	
G. Lovato	C. P. Caranicas
	C. J. Batliwalla, Temporary
	J. E. Suraisry
J. J. Polak	
	K. G. Morrell
G. Salehkhou	O. Kabbaj
	E. I. M. Mtei
	J. L. Feito
J. Tvedt	
	C. Taylor
Zhang Z.	Wang E.

L. Van Houtven, Secretary
B. J. Owen, Assistant

Also Present
Exchange and Trade Relations Department: C. D. Finch, Director; D. K. Palmer, Associate Director; W. A. Beveridge, Deputy Director; S. J. Anjaria, R. K. Abrams, S. Eken, M. Guitian, P. M. Keller, A. Pera, R. C. Williams. External Relations Department: D. M. Cheney. Fiscal Affairs Department: D. C. Mcdonald. Legal Department: G. P. Nicoletopoulos, Director, J. K. Oh. Research Department: C. P. Blackwell, D. Folkerts-Landau, D. Mathieson, I. Zaidi. Treasurer's Department: S. I. Fawzi. Bureau of Statistics: C. Briançon. Office in Geneva: C. E. Sansón, Director. Advisor to the Managing Director: E. W. Robichek. Personal Assistant to the Managing Director: N. Carter. Advisors to Executive Directors: A. A. Agah, S. M. Hassan, P. Kohnert, I. R. Panday, P. D. Péroz, P. Péterfalvy. Assistants to Executive Directors: E. M. Ainley, L. Barbone, R. Bernardo, J. Bulloch, M. B. Chatah, T. A. Connors, G. Ercel, I. Fridriksson, H. Kobayashi, P. Leeahtam, V. K. S. Nair, Y. Okubo, J. K. Orleans-Lindsay, G. W. K. Pickering, E. Portas, J. Reddy, J. Schuijer, Shao Z., J. C. Williams, A. Yasseri, Zhang X.

1. INTERNATIONAL CAPITAL MARKETS - DEVELOPMENTS AND PROSPECTS, 1983

Executive Directors considered a staff paper on developments in international capital markets in 1982 and early 1983, and on the prospects for market financing in 1983 and 1984 (SM/83/74, 5/10/83; and Sup 1, 6/8/83). They also had before then a paper containing background material (SM/83/117, 6/7/83).

The Director of the Exchange and Trade Relations Department made a statement informing Executive Directors of some new developments since the issuance of the staff papers.

> As expected, the Basle Committee of bank supervisors has issued a new version of the Concordat. Its content is very much in line with the expectations expressed in the staff papers.
>
> As shown in SM/83/74, new international bank loan commitments in the first quarter of 1983 were somewhat below those of the first quarter of the previous year and also below those of the last quarter of 1982. Data for April and May suggest that the pace has slowed further. On the other hand, bond issues during the first five months of 1983 were even above the volume recorded in the same period a year ago.
>
> As regards lending to non-oil developing countries, in the first five months of 1983, new medium-term commitments amounted to close to $16 billion, of which nearly $11 billion was accounted for by commitments extended in conjunction with debt reschedulings under programs supported by the Fund (Mexico, $5.0 billion; Brazil, $4.5 billion; Chile, $1.3 billion). "Spontaneous" new lending to non-oil LDCs proceeded at a much slower pace than in the same period of 1982. There are now indications that regional banks in some instances are again participating in syndicated lending to selected developing country borrowers where payments conditions are normal.

Mr. Taylor said that the key issue raised in the staff paper was in fact the extent to which the banks would continue their international lending, in particular to the developing countries, and the implications that the banks' decisions would have for the countries concerned and for the Fund itself. The staff was forecasting net bank lending to non-oil developing countries in 1983 and 1984 in the range of $15 billion to 20 billion, which would amount to an increase in total lending of about 5-7 percent. Nevertheless, the banks' exposure to LDC borrowers would be less than projected by the staff in the January World Economic Outlook exercise. It was too early yet to assess from the facts whether that projection was being realized. Firm information on the actual rate of disbursement of bank loans in 1983 would not become available until the Bank for Internatinal Settlements provided data for the first quarter, but it did seem possible from the information already at hand that there would be little net lending to non-oil LDCs in 1983, beyond what had been called "unspontaneous" loans associated with rescheduling agreements.

In that connection, it might have been helpful if the staff had developed the underlying causes for the more pessimistic forecast of new lending, despite its inevitably tentative nature, Mr. Taylor added. There was clearly no change in the demand for loans; the plans and behavior of the suppliers of funds seemed more likely to have changed. The staff had recalled that banks had in general been reducing their exposure in the interbank market, and had also noted that certain smaller banks and regional banks were adopting a more defensive position on lending to developing countries. One question that might have been dealt with more specifically concerned the relative shares of different nationalities of banks in the provision of funds; some banks--mainly if not exclusively continental European banks--seemed to be offering greater resistance to pressure to maintain their international lending. The implications, for those exceptional cases when the Fund, in the person of the Managing Director, felt obliged to seek advance agreements from banks to ensure that the Fund's programs were fully financed, might be that other nationalities of banks would have to be asked to do proportionately more by way of restoring their exposure, in the interests of equitable burden sharing.

A second question arising from the forecast that lending would be lower in the future, Mr. Taylor continued, related to the distribution of available funds among the borrowers. It was already known that $12 billion had been committed so far in 1983 for loans to developing countries engaged in debt reschedulings, in large part through the persuasive offices of the Fund. Thus, according to the projections in the World Economic Outlook, no more than $3 billion to $8 billion would be left for commitment as spontaneous loans. Possibly otherwise creditworthy countries might find themselves squeezed out of the market because of the weight of nonspontaneous lending in total loans. His own view, however, was that there was not necessarily a one-for-one trade-off between the two types of lending, and that in fact the intervention of the Fund could still call forth additional bank financing. Furthermore, as confidence revived, the more creditworthy countries that did not need Fund programs might find themselves able to raise finance more directly, say, through the bond markets. In that connection, the staff suggested that it might take a considerable time for developing countries to return to capital markets. Meanwhile, it would be important for all debtor countries to receive an adequate flow of bank financing to enable them to keep up the pace of adjustment. Throughout the past decade, developing countries had become particularly vulnerable to the essentially short-term characteristics of banking flows, and all possible steps would have to be taken to diminish the volatility of those flows.

At the same time, Mr. Taylor noted, a fuller long-term solution would have to be sought in a stronger revival of capital markets, and in the direct issue of bonds and equities. To what extent did the staff see nonspontaneous lending as likely to crowd out the flow of spontaneous lending? As confidence was restored, did the staff foresee a movement on the part of larger developing countries to have greater resort to long-term capital markets?

If, as the year moved forward, banks suddenly cut back the flow of lending, it would obviously be much more difficult to resolve the international debt problem smoothly, Mr. Taylor observed. A number of factors would be relevant, not least the pace of economic recovery and the progress that countries made with their adjustment programs. According to the latest world economic outlook forecast, the average growth rate in the industrial countries throughout the coming 18 months would be 3 percent, while other recent research seemed to suggest that 3 percent would be the critical figure if the debt problem was to be solved by a recovery of world output. The other essential condition, of course, was that the banks would have to be persuaded to provide a reasonable level of new financing.

It would surely be vital for the Fund to maintain its ability to facilitate orderly progress in adjustment by countries, Mr. Taylor continued. Executive Directors seemed to have fairly widely accepted that to do so it would have to undertake additional borrowing in the fairly near future because it seemed unlikely that the Fund's resources would be sufficiently replenished through repurchases to sustain the enlarged access policy throughout the period in which it would still be required. While his authorities had in mind negotiation of loans from official sources, they maintained their view that market borrowing on a significant, albeit moderate, scale could not be ruled out. The relevant point for the present discussion was that any market borrowing by the Fund for onlending should not and would not simply be a substitute for bank lending. In helping countries to design and implement credible adjustment programs, the Fund had a unique part to play in fostering an improvement in the confidence of the banks. But Fund support should not be seen as relieving the banks of their due share of responsibility for financing developing countries during the difficult period of adjustment ahead of them.

In assessing developments in international capital markets, Mr. Taylor observed, people found it difficult to be completely unaware of the public debate on the security of the international banking system. It was a delicate subject, but one that the staff should manage to tackle, perhaps not in its papers on developments and prospects in the international capital markets, which would be published, but possibly in a companion paper. The process whereby the Fund had been breaking new ground over the past year in developing its catalytic financial role had so far gone quite well, but it would no doubt be widely agreed that not all the rescue packages were fully and securely in place. It would obviously be important for the Fund and its management to persist in securing a firm underpinning in the form of adjustment programs in those countries where an arrangement was associated with a financial package. As the staff had pointed out on page 22 of SM/83/74, nothing would be more damaging to market confidence than a growing perception that countries were not implementing their adjustment programs assiduously and that the programs were thus not succeeding. The Fund should not expect an impossible degree of adjustment, but, without tangible evidence of progress, the countries involved might lose heart, and the public might begin seriously to ask whether the painful adjustment effort was worthwhile. If there were even isolated cases in which unilateral debt rescheduling was seen as the only viable, if desperate, alternative to a reasonably smooth process of adjustment, whatever the consequences, the banking system might react with consternation.

In conclusion, Mr. Taylor said, the Fund would have to work hard, in cooperation with the authorities concerned, to achieve a smooth process of adjustment. He had no strong grounds for thinking that the process was not going well on the whole; he only hoped that at any rate the staff should take into account the points that he had made in preparing papers for the Executive Board on adjustment financing.

Mr. Laske stated that by and large his authorities shared the staff's views, especially with respect to developments in international capital and credit markets over the past 12-18 months. However, he had one slight reservation.

At present, the world economy seemed to be in a period of transition from the phase of recycling the surpluses of oil exporters to deficit countries to a phase of consolidating the indebtedness incurred in the process, Mr. Laske continued. The uncertainties inherent in that transition had led a number of people to wonder whether the adjustment process could be financed in an orderly fashion. Similar concerns had been voiced after the second oil price shock, when the question had been whether or not the world's monetary system would manage to finance the current account imbalances that had emerged so as to prevent the disruption of international trade, of economic growth, and of development. In the event, the recycling of petrodollars had taken place, and in too many cases, the recycling had perhaps been overdone. It had probably not been fully realized at the time that the enormous shift in the stock of international assets would have longer-run implications for foreign indebtedness and consequently for the growth potential of the borrowing countries.

The events of 1982 had demonstrated that there were limits to a country's ability to incur foreign debt, Mr. Laske observed. The existence of such limits might have been disregarded for too long by both borrowers and lenders. Even though the international distribution of current account deficits had improved from 1981 to 1982 and was likely to improve further, countries carrying a high level of external indebtedness and confronted with heavy debt service burdens were still under constraint. The failure of the world economy to grow as fast as it had previously done and the present high interest rates were two elements of that constraint. Another contributing factor was the noticeable change in attitude by the banking community toward foreign lending, and in particular to the so-called sovereign risk, which for a long time had been considered negligible or even nonexistent. Consequently, a stronger decline had been recorded in the rate of growth in international bank claims than had been expected on the occasion of the Executive Board's previous discussion of international capital markets. At that time, the staff had expected bank lending to increase by 16-17 percent in 1982, whereas the actual increase had been only 10 percent.

Furthermore, as indicated in the statement by the staff, syndicated lending might be significantly less plentiful than it had been in 1982; a recent press report had mentioned that in 1983 it might amount to only two thirds of the volume registered in the previous year, Mr. Laske noted. In addition, as the staff had pointed out, the 10 percent increase in bank claims recorded in 1982 disguised the fact that banks had actually withdrawn capital from a number of countries. The total increase in lending had also been heavily affected by the extension of sizable new loans in the framework of multinational rescue operations to some highly indebted countries when their liquidity situation had become critical.

Among the specific features of the new attitude to international bank lending, Mr. Laske commented, apart from the overall reconsideration being given to balance of payments financing, was the regionalization syndrome. Banks were also obviously shifting their lending activities in non-oil developing countries toward trade and project-related financing. As the recently published Annual Report of the Bank for International Settlements had said, the clock was being turned back to where it had been before the first oil shock. As for balance of payments financing, the liquidity crises that had shaken the financial world in 1982 had given rise to new forms of cooperation between commercial banks, governments, central banks, and the International Monetary Fund. It might be premature to attempt to assess the longer-run implications of that novel relationship, but the Fund was certainly presented with a challenge, especially in discharging its surveillance function.

The prime function that he foresaw for the Fund as part of the increased interdependence of financial institutions, Mr. Laske went on, was to assure creditors that the adjustment efforts undertaken by member countries in need of bank credit were designed and implemented so as to give reasonably firm assurance of return to a viable external position within a reasonable time. Needless to say, determined action by the authorities of the countries concerned would be crucial for an improvement of the prospects for urgently needed medium-term credit. Although the commercial banks were fully aware of the global economic situation, and specifically of the macroeconomic framework within which they were operating, their individual behavior was to a large extent influenced by microeconomic considerations, such as profitability, liquidity, and solvency. For the individual bank, therefore, macroeconomic and microeconomic considerations sometimes conflicted.

Three observations could thus be made with respect to the modified pattern of behavior displayed by commercial banks in international credit markets, Mr. Laske stated. First, banks had realized the increased repayment and transfer risk inherent in their exposure to highly indebted countries and the potential consequences for their own liquidity and solvency. Second, a dilemma might well exist between the apparent desire of commercial banks not to increase any further--or perhaps even to reduce--their exposure to debt-ridden countries on the one hand, and the maintenance of an orderly flow of financing for adjustment programs on the other hand. To withdraw credit from a country whose creditworthiness had suffered seemed to be a reasonable reaction by an individual bank; however, if practiced by the entire banking community, credit withdrawal could have detrimental effects on the pursuit of an orderly adjustment policy. Similarly, a massive shift to the provision of primarily short-term rather than medium-term and long-term financing, as had taken place in 1981 and 1982, would certainly create maturity structures that were beyond the capacity of countries to service.

Third, Mr. Laske added, it was just as important to pay attention to the stance adopted by supervisory authorities charged with preserving the soundness and solvency of national banking systems as it was to watch the behavior of the banks themselves. As the staff had pointed out on page 18 of SM/83/74, the rapid asset growth of internationally active banks had increased the concern of supervisory authorities about the adequacy of bank capital. As reported in the press, concern about asset/equity ratios had led the U.S. authorities to take action with respect to a number of the largest U.S. banks. In Germany, legislation that was well advanced would enable the authorities to monitor and limit more effectively excessive credit exposure by individual banks, and by their branches and subsidiaries.

Both past and future changes in supervisory rules might well constrain a bank's ability to expand its lending, Mr. Laske remarked, unless it was able to strengthen its capital base. In that respect, the staff had rightly noted that the market for bank equity had not been buoyant recently, a feature clearly indicating the limitations faced by banks. Moreover, a deterioration of asset quality, not only in the foreign but also in the domestic field, had eaten up some of the profits made by banks in the past year that would otherwise have strengthened their capital base.

It was such considerations that had led him to question the full validity of the staff's statement that "...the prospects for future bank lending will depend more on the willingness of the banking system to intermediate internationally rather than its ability to do so," Mr. Laske went on. That statement might well be true for individual banks, which had ventured into foreign lending only recently and wished to return to more traditional and safer lines of business; for the banking community as a whole, the picture was different. There could be no doubt that collectively banks would have to continue to provide balance of payments financing to highly indebted countries that had run into difficulties, as well as to other countries. Otherwise, the adjustment process would not be orderly, and the banks' own assets might be adversely affected. Thus, it was in the banks' own interest to provide new money.

In recent months, Mr. Laske remarked, the Fund had become deeply involved in putting together financing packages for countries confronted with sudden liquidity crises. Argentina, Brazil, and Mexico came immediately to mind. Without the Fund's participation, it was likely that some precarious situations would not have been dealt with so successfully. It had to be recognized, however, that the success was not yet complete; in Brazil in particular, the banks' financing package had run into difficulties, and the country's adjustment policies were less satisfactory than they should have been.

The Fund would also have to play an important role in the future in arranging financing packages where necessary, Mr. Laske added. The primary task he envisaged for the Fund in those endeavors was providing information to the banks on countries' immediate situations, on the character and extent of the adjustment needed, and on the external financing required to make that adjustment feasible. As he had mentioned earlier, a country's own contribution in terms of its adjustment effort would have to be the major element of such a multipronged common undertaking. In the past, he had repeatedly advocated closer cooperation between the Fund and the commercial banks in financing adjustment programs. It should go without saying that the Fund would have to respect the confidentiality of the information at its disposal. But by providing adequate information and analysis, the Fund could help banks to form their own judgment about how much and what kind of financing they should make available. But the final decisions had to be left to the banks. Encouragement and moral suasion on the part of the Fund might however not be out of place. The Fund would have to walk a very fine line and must not overstretch its own financial resources.

Miss Le Lorier remarked that 1982 would no doubt go down as the year in which the markets had been subjected to unprecedented pressures which, perhaps to the surprise of some, they had nonetheless survived. Another source of comfort, looking ahead at the prospects for 1983 and beyond, was that countries that had run into severe financial difficulties in 1982 were generally making progress in the direction of a more balanced external position. The road would obviously be long for some of them, but the fact that those countries had demonstrated ability to make the necessary adjustments, provided financial support was not lacking, was extremely encouraging when viewed against the backdrop of the fears of 1982.

Not all the signs of what might be in the offing were necessarily encouraging, however, Miss Le Lorier continued, as a few sobering features mentioned in the staff report suggested. Considerable risks and difficulties remained, and financial authorities--creditors and borrowers alike, and institutions like the Fund as well--would have to remain alert for some time to come. While pessimism could easily become a self-fulfilling prophecy, overconfidence could also present major risks.

She would emphasize two factors on the plus side, Miss Le Lorier commented. First, the distribution of external imbalances should continue to improve over the near future, reflecting in part efforts by heavily indebted countries to reduce the relative level of their indebtedness by improving their current account position. It also reflected the consequence of the fall in real terms of oil prices, which of course accounted for the elimination of oil surpluses but also for a new distribution of surpluses and deficits in industrial countries that should, by and large, promote a better pattern of exchange rates or at least correct some of the present aberrations.

Second, there seemed to be real prospects of a gradual worldwide recovery, Miss Le Lorier stated. Caution appeared to be in order, but there were unmistakably encouraging signs. Recovery in the largest industrial country was an accepted fact, and one of the conditions of a durable recovery in the rest of the industrial world thus appeared to be met. In addition, there seemed to be a reasonable chance that the emerging recovery would essentially be a noninflationary one, which should have two positive effects on developing countries. First, significant room should be provided for a gradual pickup in primary commodity prices, without the risk that it would lead to sharp increases in the level of prices in industrial countries and to a subsequent downward movement in commodity prices as had been observed during the preceding period. Second, noninflationary growth, coupled with rising primary commodity prices, should provide the ideal framework within which to deal with the issue of external indebtedness and external financing. The recent past had clearly demonstrated that borrowers' problems unavoidably tended to become lenders' problems, and vice versa. The only way out therefore seemed to lie in a simultaneous improvement in the situation of both lending and borrowing countries. Growth coupled with sufficient stability of prices in industrial countries, and increased demand for primary products coupled with adjustment, would presumably create the necessary conditions for such a global improvement.

At the same time, Miss Le Lorier declared, it should also be clear that serious difficulties would remain with respect to the behavior of financial markets. One cause for concern was of course the extent of the reluctance of banks to expand their global exposure and their desire to limit exposure or even to reduce it for certain countries or groups of countries in a given area. The figures were hard to interpret, but the flight to quality on the part of depositors had also been visible on the lending side, and there was decidedly a risk that such an attitude might still be observed in 1983. Table I-7 in SM/83/117 could raise fears about the willingness of banks to take a leading role, should the quality of claims remain uppermost in the minds of bankers. Although new net bank lending in relation to the current account deficit of the countries covered in that table had declined sharply--from 66 percent in 1981 to 32 percent in 1982--the ratio of bank claims outstanding to GDP had shown a steep increase from 26.8 percent to 30.6 percent, and bank claims as a proportion of exports had risen from 174 percent to 197 percent between 1981 and 1982. Those contrasting trends indicated that preoccupation with risk had led to a decline in the rate of lending but that the quality of the claims had not been improved as a result; it had possibly become worse.

The pressures on banks, for prudential reasons, to intensify the slowdown in the growth of their claims, perhaps to the point of reducing their absolute exposure, could therefore continue to develop in 1983 with respect to certain categories of borrowers, Miss Le Lorier continued. The phenomenon might well be reinforced, somewhat paradoxically, by the one foremost positive development of the recent period, namely, the recovery in industrial countries. Presumably, one of the main effects would be to increase the demand for bank credit from domestic corporate borrowers, whose credit ratings would improve significantly because the resumption of activity should improve profits. The incentive for banks to reallocate part of their limited resources in favor of domestic and presumably more reliable and profitable borrowers could thus adversely affect other foreign borrowers.

That incentive might be reinforced by the possibility that the sharp expansion in the net issue of international bonds--one encouraging development in 1982--might not prove durable, Miss Le Lorier remarked. There was reason to fear a sharp reduction in the rate of issue of international bonds, leading to further pressure on bank lending. Euro-investors might lose interest in bonds as expectations of a further appreciation of the dollar receded. In addition, prospects for further sizable declines in interest rates were rather slim and, with them, the prospects of capital gains. Such a negative view should however be balanced to some extent by the existence of a positively sloped yield curve in the United States and in other financial markets as well.

The overall conclusion to be drawn from the staff's papers and from recent developments, Miss Le Lorier considered, was that the situation on financial markets would remain quite tense. Clearly, an improvement in the international credit climate should not be predicated solely on an improvement in the economies of debtor countries. The key seemed rather to be found in an improvement of the economic climate in all countries, irrespective of their status as borrowers or lenders. In that respect, a prompt reduction of present strains in capital markets would depend as much on the capacity of creditor countries to get their economies moving again, as on the degree of adjustment carried out by large debtors. Even if the improvement in the world economic situation was the fundamental factor in an orderly resolution of the so-called debt crisis, willingness to lend would also play an important part. After all, there could be no growth without financing. The staff had taken the view that it was more the willingness to lend than the ability to do so that was at present the main potential difficulty. Such a view relied on the assumption that supervisory authorities would refrain from enacting new regulations that could eventually hamper the ability of banks to lend. A delicate balance would have to be struck between preoccupations about bailing out the banks, avoiding the repetition of past errors, and not placing unnecessary obstacles in the way of an already fragile willingness to lend or of a much needed decline in lending rates. In that respect, she wondered whether the staff or Mr. Erb would care to elaborate on the changes in the supervisory rules currently being considered by the U.S. Congress.

The Fund had been instrumental in the recent past in spelling out the minimum amount of financing required for successful adjustment in heavily indebted countries, Miss Le Lorier observed. The risk had been--and perhaps still was--that the Fund would be viewed as assuming a moral responsibility in the lending decisions of the banking system. A situation in which nearly half of the lending by banks to developing countries was tied to Fund programs was an exceptional one. The difficulty was that spontaneous financing was unlikely to be resumed at an adequate level for two or three years. In such a situation, international cooperation would be needed, and she reiterated her authorities' support for a flexible and pragmatic coordinating role by the Fund.

Finally, Miss Le Lorier stated, in light of the depletion of reserves in the borrowing countries, broad support should be forthcoming within the Executive Board for a new allocation of SDRs. Such a move would help to accelerate the return to more orderly conditions, which was the objective of the numerous adjustment programs that had been put in place. Equally essential would be the maintenance of sufficiently large access to the Fund's resources, more specifically for member countries whose access to markets in present circumstances was limited.

Mr. Schneider commented that with the growth of external indebtedness of developing countries having continuously exceeded the growth of current receipts in the second half of the 1970s, it was obvious that lending to them would slow down sooner or later. That was what had happened in 1981 and 1982, when current receipts had stagnated or even declined. As a result, there had been a dramatic increase in debt/export ratios, which in turn had raised serious doubts in the financial community as to whether or not the past lending pattern could be sustained. The previous expansion of credit had taken place primarily in the form of commercial bank lending to developing countries, whereas flows of direct investment, official transfers, and official loans had increased only marginally. Moreover, the expansion of credit had gone hand in hand with a number of shortcomings, such as insufficient evaluation of the loans, inadequate monitoring of interbank exposure, as well as the use of short-term funds obtained in interbank markets to fund medium-term lending. The rather dramatic increase in bank lending in the 1970s had beem followed by an abrupt winding down of lending activity once the crisis had come to the fore, forcing the Fund to intervene heavily in a number of member countries to avoid a collapse of the world financial system.

He would agree with the staff, Mr. Schneider remarked, that the reaction of the banks had been due to the increased perception of risk rather than to the nonavailability of funds. Therefore, it could be assumed that the banks had established a much more conservative international lending policy. The Fund had been able more or less to avert an abrupt reduction of lending in a number of cases in which it had intervened, but, as Mr. Taylor and Mr. Laske had already pointed out, only the first round had been won. The data on new commitments to non-oil developing countries in the first quarter of 1983 were worrying because they seemed to imply a substantial decline in the pace of lending, especially for those countries not having programs supported by the Fund. A new relationship would have to be forged with the commercial banks; the Fund could deal with problem countries only in close cooperation with the private banking sector.

Similarly, the figures for the first quarter of 1983 suggested a considerable reorientation in the lending policy of the banks, Mr. Schneider noted. The reorientation appeared to be based somehow on two beliefs: first, that the deficit countries would not have made such an effective adjustment if they had been able to obtain more financing, and, second, that the reduction of the banks' exposure had become imperative once the balance of payments and earnings of developing countries had deteriorated beyond a certain point. Those notions, if they were rational, would in turn imply not only that the situation of developing countries would not improve within a short enough period to be taken into account in portfolio decisions; it would also imply--somewhat paradoxically--that even increased lending would be ineffective in correcting the situation.

Thus, Mr. Schneider concluded, the Fund should assume an educational role and demonstrate that the complementary bank loans necessary to ensure the implementation of adjustment programs would enhance the possibility of earlier repayment of existing loans and open up the way to further business for banks under restored financial and economic conditions. The Fund could play that role by putting the adjustment efforts of the countries concerned in a medium-term balance of payments perspective, so that banks would have a better perception of their advantage in continuing to lend and of the way in which they could best monitor the profile of debt reimbursement. By tying their lending operations more closely to Fund programs, the banks would have better assurances that the resources made available would be used appropriately. In that way, international bank lending could be brought more in line with economic developments in the world, although it would expand at a slower rate than in the 1970s. If at the same time the shortcomings within the banking sector could be overcome, a gradual return to more normal conditions could be expected.

Mr. Lovato considered that the staff papers should be published as a complement to the Executive Board's recent discussion of external debt problems as well as to the recently issued World Economic Outlook. The papers gave a vivid account of the events that had changed the functioning of international capital markets in past months. They also made it clear that developments were still at too early a stage to ascertain the precise shape of the new system.

Nevertheless, Mr. Lovato remarked, a few recent characteristics deserved attention. As the staff had pointed out, besides a general unwillingness on the part of many banks--particularly small and regional banks--to maintain their exposure toward sovereign borrowers, the further extension of credit to non-oil developing countries would probably be based on project and trade-related loans. While that development might pose additional problems for a few countries, particularly since it came after a remarkable increase in general balance of payments financing loans in previous years, it could be viewed as positive on the whole. Funds thus obtained would be more directly geared to productive uses and presumably to creating foreign exchange earnings, and they would not provide a means for delaying adjustment, as had happened so frequently in the past, with notorious consequences.

In a rapidly changing environment, the Fund had come to play a much more significant and pivotal role, Mr. Lovato observed. Everyone knew how difficult it had proved, in some important cases, to secure the necessary financing to permit the execution of Fund-supported adjustment programs. The fact that the banking community had come to look at Fund assistance as an important condition for restoring countries' solvency, and had therefore started to request the Fund's agreement as a precondition for rescheduling for the further extension of credit, was in a sense quite a positive development. On the other hand, some of the most conspicuous activities of the Fund in that field had been motivated by the exceptional character of the crises, and they could not be expected to recur in the future, if the economic situation improved. It was to be hoped that assessment by the banks of country risk would again become a matter of objective consideration of each case. In that context, although with the same degree of skepticism shown in the staff paper, he was waiting to see what impact, if any, the Institute of International Finance would have.

The staff had raised a series of interesting questions, Mr. Lovato continued, such as the effect of the change in the current account position of the oil exporting countries on the willingness or ability of the banking system to continue its role of financing non-oil developing countries, and its effect on the spread on loans to "better-quality" borrowers. He tended to agree with the view that there was probably no direct causal link between the reduction in the OPEC surplus and changes in the banks' intermediation function. The composition of payments imbalances per se should not affect the supply of funds to the banking system; rather, it was the changing perception of risks that had brought about the reduction in the flow of lending to developing countries. As for the effects on interest spreads, even for "good" borrowers, the staff had advanced quite telling arguments why the spreads were not likely to decrease substantially, but might even increase, with rather ominous implications.

Finally, the staff paper had shown that the capital adequacy of the banking system was still an open question, Mr. Lovato noted, but that developments had been uneven across countries. Of course, the figures in that respect were subject to great uncertainty. Recent moves on the part of supervisory authorities augured well, but it appeared that the situation was still far from satisfactory.

All in all, Mr. Lovato considered, the staff paper gave a fairly good account of prospects for the immediate future. He could not but join in the words of caution spelled out at the end of the paper. There were too many imponderables, as witnessed by the record of the Executive Board's discussion on the same subject in 1982; it would therefore be advisable to refrain from overconfident statements. The major policy lesson to be drawn was probably for the role of international organizations and the Fund in particular. In times when the role of the private banking system in financing imbalances was shrinking, multilateral organizations had to fill the void. To quote from the recently published fifty-third Annual Report of the Bank for International Settlements: "The International Monetary Fund must be in a position to pursue its policy of substantial, but tightly conditional lending to deficit countries--and the emphasis is as much on 'substantial' as on 'tightly conditional.' Large amounts are necessary...because the days are gone when small Fund disbursements could be expected to trigger an immediate favorable market response. Today, the Fund's leverage is much weaker, in the sense that larger amounts of financial support are necessary to induce additional private financing flows."

Mr. Casey remarked that what seemed to emerge from the staff's account of developments in 1982 and early 1983 was that, after a critical period in the previous year, the stability of the international banking system had improved in the past several months. There was even the suggestion that the non-oil developing countries might in time regain their access to the banks, based on favorable assumptions with respect to global recovery and adjustment.

Both borrowers and lenders had clearly received a considerable shock in 1982, Mr. Casey added, a shock that could have become a crisis if the Fund had not intervened in a timely way. Valuable lessons had been learned, and various improvements were already in hand, including more pointed Article IV surveillance by the Fund and the establishment of the Institute of International Finance. In addition, the banks were making greater provision for loan losses, reflecting the deterioration of asset quality; and more attention was being paid to risk analysis, capital adequacy, and mismatching of maturities. Useful and imaginative techniques to smooth the workings of the interbank market had also been put in place. In addition, there was closer cooperation among national supervisors, the work of the Cooke Committee being a good example.

But as other Directors had noted, Mr. Casey went on, the global debt problem was not solved. Further debt reschedulings--say, for Venezuela and some other countries--could involve more mismatching problems for the banks. The tendency of banks to treat countries in a given region in the same way was still posing difficulties. The changing global structure of payments imbalances had reduced the availability of funds to the banks. In that respect, all industrial countries in relatively strong balance of payments positions should play a greater role in recycling, either directly or through the Fund. The lack of willingness by banks to lend internationally should not be allowed to needlessly squeeze out countries that were following genuine adjustment policies. In that connection, he asked the staff whether it considered that lending might be constrained too much by new and tougher regulations. Consideration could perhaps be given to informal discussions with regulatory agencies during Article IV consultations.

The tendency of banks to shift toward project-related and export-related financing did seem to indicate that banks were prepared to increase their exposure, albeit selectively, Mr. Casey remarked. That tendency was consistent with adjustment because it emphasized investment and exporting activities. However, the more selective attitude of banks could also easily squeeze out deserving countries that were not large enough to pose a threat to the system as a whole, or even to the balance sheets of individual banks. It might be useful at some stage to review the experience of banks in countries that had experienced severe debt servicing problems. For instance, assuming that rescheduling operations for a country progressed as planned, how soon could bankers be expected, on the basis of previous experience, to resume financing voluntarily rather than as part of officially supported and Fund-supported programs? Although the present global debt problem made it difficult to generalize, rough guidelines could perhaps be drawn up from historical experience or from the views of bankers.

Consideration had been given in his office, Mr. Casey commented, to some form of self-insurance schemes for the banks. Clearly, loan loss provisions were a type of insurance in which the cost was borne by the borrower. His question was whether other self-insurance schemes had been envisaged, and he wondered whether the staff could offer any information in that respect.

According to Table 3 of SM/83/74, Mr. Casey noted, spreads for OECD countries had been stable during 1982, whereas those for LDCs had widened significantly, suggesting greater discrimination on the part of banks. However, the staff had implied that even when banks lent to industrial countries, they were also inclined to widen spreads as a form of insurance against possible losses on other loans. Would the staff agree that spreads were likely to widen for all countries in future? The profitability of banks would of course thereby be increased, and capital adequacy be ensured through the attraction of more equity.

It was difficult to draw one overall conclusion from the staff's reports on developments in international capital markets, Mr. Casey remarked, but his impression was that the perturbations were much less severe than they had been. The avoidance of crisis had been due in large measure to the timely and well-executed intervention of the Fund in a number of exceptional cases. Needless to say, it was vital that the adjustment programs for the countries in question stayed on track, and he shared Mr. Laske's concern about the Brazilian program. The banks themselves had adapted fairly well to changing circumstances, no doubt recognizing that the Fund could not--and indeed should not--provide a complete safety net. However, it did seem as if the international financial system had coped fairly well so far and should be able to cope with any so-called second wave of demands for financing in the near future. Much would depend, inter alia, on global economic recovery, the continuation of adjustment policies, and the cooperation of all industrial countries in relatively strong balance of payments positions.

Mr. Tvedt said that he assumed that the more general policy issues related to the matter under discussion would be dealt with when the World Economic Outlook was discussed in the near future. When the Executive Board had held a similar discussion of international capital markets in 1982, the lack of up-to-date information on financial flows had led many Directors to draw the wrong conclusions. While some optimism about prospects in the international capital markets had been expressed at that time, it was in fact the end of a period during which banks had overextended their international lending and a number of countries had overexpanded their economies. As a result of decisive action by governments, banks, and international institutions, the acute liquidity problems that had emerged toward the end of the year had been quickly solved. A number of uncertainties still remained, however. The main question--and the one to which it was most important to find an answer--was in his view how to make the banks keep on lending to developing countries. As pointed out in the staff paper, net lending to non-oil developing countries had come to a standstill in the third quarter of 1982, but had since shown a moderate upturn, mainly as the result of rescheduling arrangements in connection with Fund-supported stabilization programs.

He tended to agree with the staff that the availability of funds was not placing a major constraint on bank lending, Mr. Tvedt continued. But experience had led banks to make a more realistic appraisal of sovereign, transfer, and funding risks, which would have a bearing on their lending policies and on their willingness to lend to certain countries and regions. Banks had clearly already shifted their preferences toward short-term lending explicitly linked to trade transactions.

Whether bank lending to developing countries would be maintained in the years to come would depend very much on the success of the various stabilization programs that had been and would be introduced, Mr. Tvedt remarked. It was a matter of some concern that certain smaller banks were reducing their loan exposure to developing countries, particularly if the "lemming instinct" of the banks prevailed. In the past, that instinct had resulted in first an excess and then a deficiency of credit. For that reason, the behavior of the banks had been compared with the well-known hog cycle in economic theory: centralized information serves to dampen the fluctuations of the hog cycle. But that theory did not necessarily hold true for bank lending. The new Institute of International Finance, from which all the banks would draw the same information, might therefore tend to reinforce fluctuations in bank lending to particular countries or regions. However, he had been relieved to learn from the staff paper that the Institute would avoid making credit judgments.

One development mentioned in the staff's papers, Mr. Tvedt noted, was the heightened public interest and perhaps anxiety concerning the debt situation, reflected inter alia in the press and in debates in national assemblies. The Fund's responsibility was thereby increased because it must ensure that accurate and objective information was available and accessible. It became even more important to prevent misrepresentation and misinterpretation of facts that could have a serious impact on the still fragile international situation.

Mr. Almeida observed that the staff had enunciated a strongly pessimistic view about the likelihood that bank lending would reach the same level in 1983 as in 1982. That alone would be cause for great concern, but, in addition, there had clearly been a change in the composition of lending because some commercial banks had expressed the intention of concentrating their new international lending on trade-related and project-related financing. The balance of payments financing of LDCs would thus be placed in double jeopardy; he wondered why the staff had not put forward any firm suggestions for alleviating those unfavorable trends. Incidentally, he had also not found any reference in the staff papers to the share of trade-related and project-related financing in total bank lending, and he would appreciate further information in that respect.

He had been glad to note that most of the ideas suggested by his chair during the 1982 discussion of international capital markets had been incorporated in the staff papers under discussion, Mr. Almeida remarked. But he would like to emphasize that a table showing total bank lending by country would be helpful, there being no data in that respect in either of the staff papers. Clearly, LDC borrowers had been tightly squeezed on private markets in 1982; their aggregate current account deficit had been reduced by 19 percent, but their borrowing through private markets had declined by 48 percent. For the first time, non-oil developing countries of the Western Hemisphere had lost reserves, in the huge amount of $11 billion. The squeeze had certainly been influenced by the increase in real interest rates--for the fifth consecutive year--and by a decline in the average maturity of loans. Perhaps the staff could provide further information on those important aspects.

Mr. Finaish said that the Fund's policies on certain aspects of the subject under discussion had already been taken up by the Executive Board during its discussion in April on external debt servicing problems. Before raising a few specific questions, he made the general remark that recent developments in international capital markets and the crisis atmosphere that had engulfed a large segment of those markets in 1982 illustrated clearly the growing degree of interdependence in the world economy and the vulnerability of less developed countries in particular to changes in international trade and finance. Those developments had also strengthened the contention that market sources of finance and international bank credit in particular could not by themselves provide for a smooth adjustment in the international economy. That was especially true when the magnitude of external imbalances was as large as it had been during the current recession. Indeed, it could hardly be disputed that certain aspects of banks' international lending policies had themselves been a significant factor in the international debt crisis of 1982. A shift of policy from overlending to excessive caution could cast uncertainty over future accessibility to international bank credit by developing countries, and of course it would have implications for the system as a whole.

The staff seemed to share the opinion that one of the major reasons for the emergence of the international debt crisis in 1982 was the extreme concentration of private bank exposure in a few countries and the ensuing debt servicing problems of those countries, Mr. Finaish observed. The factors governing bank lending policies in international markets thus became a matter for consideration, on which he would welcome the staff's comments. The concentration of exposure could perhaps be attributed partly to errors of judgment by banks about the economic outlook of the borrowing countries; for interbank participants, the concentration might also be due to the inadequate monitoring of sovereign risk implicit in interbank exposure.

Apart from new lending by banks as part of the debt rescheduling arrangements coordinated with the Fund, Mr. Finaish noted, new lending to developing countries had declined sharply in the second half of 1982, apparently partly on the basis of a perception of increased risk, even in countries that had experienced no serious debt servicing problems in the past. The perception or misperception of risk could also be seen in the decline in the share of developing countries in the international bond market, from 6 percent in 1981 to 3 percent in 1982, although those countries had continued to meet payments of interest and principal on their bonds. In most instances, bond issues had also been kept outside any rescheduling agreements pertaining to other debts. While caution on the part of investors was understandable, it was obviously necessary to improve the efficiency of international credit markets and to reduce the need for creditors to rely on generalized perceptions in making their lending decisions.

Despite the lack of adequate data on interbank operations, Mr. Finaish added, the staff had estimated that between two thirds and three quarters of international bank claims were actually interbank claims. In light of the major disturbances in the interbank market in 1982, and the increased awareness of sovereign risk that might be involved in interbank transactions, he wondered whether the staff could give some indication of the relative weight of that segment of the international capital markets in the overall decline in credit, particularly to developing countries, and whether a change in the manner of operation of the interbank market would cause a secular decline in accessibility to international bank credit.

It might also be helpful, Mr. Finaish remarked, if the staff could elaborate on the significance of the trend toward trade-related and project-related financing and why it had been confined so far to banks in continental Europe. The Annual Report of the Bank for International Settlements and other publications had also mentioned that phenomenon.

It might have been helpful if the staff had considered the implications for international capital markets of different assumptions with respect to global economic activity and the degree of success of the adjustment programs of countries involved in debt rescheduling, Mr. Finaish concluded. Although the staff's assumptions were not unusually optimistic, it was important not to ignore different or worst case scenarios, especially at a time when so much depended on the success of debtor countries' adjustment programs, which in turn depended on sustained and robust recovery from the current world recession. Anything less than such a recovery would make it extremely difficult for a large number of countries to improve their external imbalances and could at the same time potentially lead to a second wave of international debt difficulties.

Mr. Salehkhou considered that among the fundamental trends in international capital markets pointed up in the staff papers was the regionalization of lending, which had been discussed extensively by the Executive Board in 1982. Apparently, concern about the ability of a few major borrowers to pay their debts had spread among commercial banks to such an extent as to affect access to credit by all developing countries, borrowers or not. Indeed, net borrowing by developing countries from international capital markets had dropped to only 31 percent of their aggregate current account deficit in 1982, compared with 46 percent in 1981. Bank borrowing, therefore, had provided a smaller portion of the external financing of those countries. Net lending to the non-oil developing countries slowed down substantially after the emergence of the debt crisis in 1982 as the market became affected by the sudden emergence of debt servicing difficulties in Mexico, Argentina, and Brazil. Some lending had been resumed on a moderate scale, but only to countries in Asia and Europe, which were outside the regionalized risk areas. Hence, developing countries had had either to draw down their foreign exchange reserves substantially to balance their accounts, or to rely on trade credit, grants, or loans from multinational institutions or governments. Official sources were also gradually becoming more difficult to tap. Another major development that had been fully expected was that in 1982, oil exporting developing countries had become net users of international capital on an even greater scale than non-oil developing countries.

A significant trend had been the emergence of industrial countries as major suppliers of funds, taking over from oil exporting developing countries, Mr. Salehkhou observed. There had consequently been a sharp decline in actual lending by banks and a hardening in the terms of borrowing such as maturities, fees, and charges. In fact, there was a widespread consensus in financial circles that the fees and margins applied by commercial banks as a price for rescheduling the debt of developing countries had been unusually high, and that, as a result, those banks had actually improved their own earnings profile. That development stood in dire contrast to the needs of developing country borrowers, which required more concessional finance to help ease the burden of adjustment. The International Monetary Fund should continue to demonstrate to commercial banks, in no uncertain terms, the dangers that such a lack of international cooperation would eventually entail. Apart from a stiffening of terms, there had also been a decline not only in actual lending but in new loan commitments to developing countries, if Brazil and Mexico were excluded.

No significant deterioration in the capital/asset ratio of commercial banks was revealed in Table 5 of SM/83/74, Mr. Salehkhou noted, except that greater emphasis had recently been placed on write-offs and provisions for loan losses in some countries. Therefore, the staff had a valid point in mentioning on page 8 of SM/83/74 that capital inadequacy had not been a constraint on international lending during 1982. However, the change in the geographical source of funds might have made banks more cautious. Indeed, the interbank market, which had been a useful source of credit for many developing country borrowers, had also been seriously disturbed in 1982 and its growth severely curtailed.

The problem clearly stemmed not so much from the inability of banks to lend but from their unwillingness to assume their international responsibilities, Mr. Salehkhou remarked. The banks' singleminded attitude had been amply demonstrated by the recent suggestion that the Fund should buy at a discount all, or at least the more risky, loan portfolios of commercial banks in developing countries, and then try to draw up adjustment programs with those countries so that repayment plans could be worked out. A prominent European banker had added a further touch of sophistication by suggesting a sharing of the risk between international banks and international institutions: the Fund should assume some of the banks' risks. Such a self-centered stand would clearly impose additional strains on the concerted international effort at cooperation because it would shift responsibility without addressing the real problem.

The prospects for 1983 were not very certain, Mr. Salehkhou commented. On the one hand, the market was apparently waiting for economic recovery in industrial countries to acquire sufficient momentum to improve the quality of assets. Considering the large budget deficits projected for some industrial countries and the prevailing consensus that interest rates would stay firm in the foreseeable future, an early hope of recovery might be illusory. On the other hand, the same market was banking on a recovery in commodity prices, and hence on the resumption of export growth of the developing countries so that those countries would become more able to service their debt. The upshot was considerable confusion about the future course of events.

Such uncertainties underscored the central and fundamental role of the Fund in directing the future course of the financial markets, Mr. Salehkhou stated. Only by means of a comprehensive, Fund-directed approach that would safeguard the global economy, could a multidimensional, all-purpose solution emerge.

Mr. Feito said that the staff had rightly identified the major issues and disruptive forces driving the international capital markets. On the supply side, banks were attempting to arrest the steady erosion of their capital/asset ratios, in particular the ratio of their capital to external assets, and to reduce the actual or perceived risks of concentrating assets in some regions of the world. To attain those objectives, banks were increasing lending spreads and management fees, generally in proportion to the degree of indebtedness of the country, and the investment activity of banks was shifting away from highly indebted countries and regions toward safer assets in industrial countries and toward domestic customers. On the demand side of the market, a large number of major developing countries were looking for funds to finance their strong efforts to adjust their economies to achieve a sustainable balance of payments position. Those developing countries were undergoing a severe cutback in their standards of living, and it was difficult to see how they could carry out their adjustment programs, should there be a further reduction in available external resources.

Market developments in the short run were thus unlikely to follow a smooth cycle, Mr. Feito remarked. To be specific, major developing countries might be unable to carry out the adjustment effort imposed on them by the decline of financing flows without alterations in the social and political order. There could be little doubt that that possibility posed one of the gravest threats to the international economy. In approaching the issue, the staff in its concluding observations had taken a cautious but optimistic stance; it considered that the increase in bank exposure that had taken place in 1983 might well be repeated in 1984, provided that the world economy continued to improve and that adjustment programs in major borrowing countries continued to show steady progress. While he fully shared the staff's view of the importance of successful adjustment, he was not sure that the recovery of the international economy would give rise to an increase in bank lending to developing countries. In the past, the recession in major industrial countries in contrast to the relative buoyancy of the economies of developing countries had contributed significantly to the growth of international financial intermediation, and in particular of international lending to developing countries. For instance, there was evidence that lending by U.S. banks to developing countries had slowed down by the end of the 1970s, in response to a recovery of the demand for private credit in the U.S. economy. Aggregate lending to developing countries had kept rising, however, owing to the entrance into the markets of new participants, i.e., European, Japanese, and smaller U.S. banks.

For the future, therefore, the supply of lendable funds in the international capital markets might prove to be negatively related to the growth of economic activity in larger industrial economies, Mr. Feito indicated. A sustained recovery of the economies of major industrial countries could lead, at least during an initial period, to a slowdown of cross-border lending in favor of domestic lending in general, and a further reduction of lending to LDCs in particular.

Given the conflicting aims of lenders and major borrowers in international capital markets, it was not necessary to be very pessimistic to discern explosive or undesirable paths of market behavior in the months ahead, Mr. Feito considered. Under the circumstances, the question was whether the outlook could be improved by some sort of intervention, including the regulation of certain segments of the market both at the international and national levels. The view of his authorities was that, at the international level, the Fund should stand ready to activate the confidence-creating mechanisms at its disposal. Thus, as Miss Le Lorier had pointed out, the SDR should be allowed to play its proper role in the current circumstances of the world economy, and access to the Fund's resources by developing countries should be in line with the adjustment efforts that they were carrying out. In addition, and more important, the ambiguities currently surrounding the General Arrangements to Borrow should be dispelled.

To conclude, Mr. Feito pointed out that the staff might perhaps have taken a more normative approach in its analysis of international capital markets, and have put forward its views of adequate, or ideal, policies of intervention in the financial system, both national and international, to cope with the risks posed by the current situation.

Mr. Suraisry stated that the position in international capital markets had changed markedly since the Executive Board's discussion one year previously. Against the background of continuing recession, stagnant world trade, and high interest rates, a large number of countries had had to seek debt rescheduling. The emergence of acute debt servicing problems in the major borrowing countries had heightened the markets' perception of country risk. The banks had scaled back their balance of payments financing in general, and their lending to the non-oil developing countries in particular.

That more cautious approach had been reinforced, as Mr. Laske had mentioned, by a number of actual or potential constraints on the banks' ability to continue lending, Mr. Suraisry continued. Banks and banking supervisors were understandably paying more attention to capital adequacy ratios and loan loss provisions, given the deterioration in the quality of domestic as well as international assets. The recent difficulties in the interbank market had also increased the funding risks for some of the smaller, non-dollar-based banks.

The central question was what would happen next, Mr. Suraisry remarked. On the one hand, it was important to keep the problems in perspective, as the Managing Director had emphasized in recent speeches. The major debtor countries had embarked on extensive adjustment programs supported by the Fund. Concerted financing arrangements had been put in place, with the cooperation of the banks. According to the staff's estimates, a large proportion of the new commercial finance required by non-oil developing countries in 1983 had already been committed. The recent recovery in the international bond markets was also an encouraging sign, even though the access of most developing countries to those markets remained limited.

On the other hand, Mr. Suraisry added, while the capital markets seemed more stable than a few months previously, they remained highly vulnerable to new shocks. There was already talk in the press, and in some official circles, of a possible second wave of debt problems if one or more of the loan packages ran into difficulty. It was not clear how much financing the banks would provide if there was another round of debt rescheduling packages. Some of the smaller and regional banks in particular appeared increasingly reluctant to maintain their international exposure. It was possible, as Mr. Taylor had said, that some smaller countries could be squeezed out of the markets through no fault of their own.

It was clearly essential that the banks should continue to lend on a scale compatible with orderly adjustment in the borrowing countries, Mr. Suraisry considered. That would require what the BIS in its Annual

Report had called "steady nerves" on the part of the banks. It would also require cooperative efforts by debtor and creditor countries, the Fund, the BIS, and supervisory authorities.

The continued availability of commercial flows would depend in great part, Mr. Suraisry noted, on the implementation of adequate and convincing adjustment policies in the borrowing countries. That was obviously a necessary condition for increased exposure by the banks. However, the adjustment efforts under way would be successful only if the hoped-for recovery in the world economy took place. The industrial countries had a responsibility to promote that recovery, particularly by removing protectionist barriers and providing adequate flows of concessional assistance, especially to low-income countries.

The Fund had played, and would play in future, a central role in restoring confidence in the banking system, Mr. Suraisry said. In a growing number of countries, new commercial lending had been linked to the existence of, and adherence to, a Fund program. The Fund therefore had an important responsibility for maintaining the quality of its programs and for providing sufficient resources to underpin those programs. To do that, the Fund required the full support of all those members in a position to provide the needed resources, as Mr. Casey had indicated. The other recent initiatives taken by the Fund--to improve its surveillance over members' debt policies, to improve the availability of information on debt, and to expand its technical assistance--could also give a valuable early warning of potential problems and help to avoid future crises.

He welcomed the closer coordination among central banks and the BIS, Mr. Suraisry said, and their action to ensure the stability of the system. BIS credits had proved to be an important source of bridging finance while countries negotiated a Fund program; and central banks had rightly encouraged banks not to withdraw abruptly from international lending. The revised concordat recently issued by the G-10 central banks appeared to close some of the gaps in the supervision of banks' international activities that had recently come to light. It would however be helpful if the staff could explain the issue more fully.

Mr. Mtei remarked that the basic issue was the familiar one of whether or not international banks would be able and willing to continue lending programs to countries facing external payments difficulties at a level that would sustain an orderly adjustment process. In recent months, the issue had assumed a new dimension as some of the oil exporting countries had begun to face a weakening in their current account positions in the wake of the decline in the volume and price of oil exports. In fact, oil exporting developing countries, which had been net providers of funds to the international banking system, had become large net borrowers by 1982. For non-oil developing countries, the cutback in the flow of resources from international banks had been substantial in 1982; total net new lending had amounted to less than one half of the 1981 total, precipitating a drawdown of the foreign exchange reserves of those countries by some $7 billion. In the worst situations, such countries had simply refrained from importing even essential requirements. It was also important to note that the distribution of lending had been skewed in favor of countries in certain regions in which lending was perceived to be less of a risk. In that respect, the staff had made mention of Latin America and Eastern Europe as areas that had been adversely affected by the perceived regionalization of risks. He wondered to what extent countries in Africa had been similarly affected.

For the immediate future, banks were more likely than not to maintain their cautious stance, Mr. Mtei observed. Their operations had come under intense public scrutiny, while supervisory authorities had begun to stress the need for adequate bank capital to match sovereign risk. He noted that the staff expected some recovery in bank lending to non-oil developing countries from the low level reached in the second half of 1982. However, the problem of financing for those countries would remain difficult and bank lending to them was likely to fall far short of the $25 billion recorded in 1982.

The question seemed to be what the international community could do to improve the situation, Mr. Mtei commented. To his mind, the answer would require going back to the root causes of the problem: prolonged recession in the international economy had adversely affected export markets, and relatively high interest rates had contributed to the emergence of severe balance of payments difficulties and heavy debt servicing burdens for many countries. Thus, efforts should be directed at ensuring a sustained recovery in industrial countries; that recovery would be crucial for the growth of export markets for borrowing countries. At the same time, the major countries also had to make concerted efforts to reduce interest rates.

Finally, Mr. Mtei mentioned the need to recognize that borrowing countries also had a responsibility, namely, to pursue prudent adjustment policies. In that respect, the Fund had an important role to play in providing the necessary financing to ensure a smooth adjustment process and to assist member countries with weaker economies in developing programs appropriate to deal with the special problems that they faced.

Mr. Erb noted that the staff papers had been helpful in providing the right background for considering developments in international capital markets. He could support the publication of the contents as an occasional paper.

One point that he would like to emphasize, and that the staff had highlighted in several parts of its report, was the important link between Fund programs and increased exposure by banks, Mr. Erb continued. A large proportion of new bank lending was explicitly or implicitly linked to agreement on and the implementation of a Fund program. That underlined the importance of the Fund's making known to all parties involved the uncertainties that surrounded any stabilization program and the need in many programs to make further adjustments along the way. But it also underlined the importance of the successful implementation of adjustment programs by countries if their access to financial markets was to remain open, and indeed to become possible without the crutch of an IMF program. The staff was correct in its perception that bankers, regulators, and shareholders would be scrutinizing international lending. Thus, borrowing countries should not underestimate the importance of maintaining or restoring confidence through appropriate policies and the provision of timely and accurate economic data.

Looking to the future, Mr. Erb mentioned his hope that the Fund's emphasis would shift from financing to surveillance activities. But as many Directors had noted, the future was uncertain, and the world financial situation remained precarious. Nevertheless, he would prefer to take an optimistic view.

Miss Batliwalla stated that her chair supported the publication of the staff's documents, which focused on key developments in international bank lending. When the Executive Board had discussed the subject in June 1982, the staff had been cautiously optimistic about the short-term ability of the financial system to operate under strain. Events had proved otherwise. A financial crisis, which had developed with such rapidity that even the staff could not have envisioned it, had been averted with the help of massive official support programs tied to continued bank lending. It was the cooperative effort of all parties concerned to overcome the difficulties in the international financial markets that had prevented the crisis from spreading. The central banks, under the aegis of the BIS, had extended bridging credits; the Fund had provided conditional finance to enable deficit countries to undertake adjustment of their economies to the changed environment; commercial banks, under the threat of default, had reluctantly agreed to continue their exposure, and governments in their own self-enlightened interest had agreed to the increase in IMF quotas and to an enlargement of the GAB.

Thus, the situation in 1983, as depicted in the staff paper, was significantly different from the one envisaged in mid-1982, Miss Batliwalla continued. The storm had blown over, but it was difficult to say whether the calm that had descended was illusory or reflected an underlying strengthening of the financial system. The staff had noted that the health and stability of the banking system had improved, but it nonetheless remained skeptical of continued international lending by banks to developing countries. In taking stock of the international financial situation, she had seen some improvements in supervisory and information-gathering activities, but other signs of disorder had not disappeared. Volatile exchange rates were causing distortions in the flow of trade and capital. The massive debt problem was regarded by many as a time bomb that could explode and shatter the stability of the financial system. The large debt overhang, the growing number of reschedulings, and uncertainties about continued commercial bank exposure, were all elements that pointed to a potentially fragile situation. In short, there was much less room for complacency than in 1982.

Although the mounting external debt burden might to some extent be attributed to policy decisions in some of the affected countries, Miss Batliwalla remarked, it had to be conceded that the origin of the present debt crisis was in the main to be traced to the pressure exerted on the balance of payments position of developing countries from disturbances in the world economy. As the recent Annual Report of the BIS had rightly pointed out, the process of disinflation had dramatically brought to the fore problems that had been building up for some time. Irrefutably, the explanation lay in the prolonged and severe world recession, the slack in the demand for imports by industrialized countries, growing protectionism, the collapse of primary commodity prices, and the worsening terms of trade that had aggravated the real value of debt. What was more, the sharp shift from negative to high positive real short-term interest rates had had a crippling impact on current balances of countries that had incurred substantial debt. There had been a quantum jump in the costs of servicing external debt. Non-oil developing countries' interest costs alone had risen from $11 billion in 1978 to $43.5 billion in 1982, an increase in interest payments that had deprived those countries to a large extent of the fruits of their adjustment efforts. In fact, the large interest payments implied that new borrowings no longer provided additional capital resources but simply helped to finance part of the cost of servicing existing debt. Another new dimension of the instability was the maturity profile of debt, with its heavy short-term bias. The "regionalization syndrome" had also compounded the problem, as the staff had pointed out.

The worsening debt problem in a way underlined some of the deficiencies of the international monetary and financial system in its ability to deal satisfactorily with balance of payments problems in the context of a prolonged slowdown in the growth of world output and trade, Miss Batliwalla stated. Management of the debt crisis would require a suitable strengthening of international institutions, which would have to continue to be involved more aggressively in financing adjustment problems, a task requiring an expansion of their operations. The Fund would have to keep on playing its role as the coordinator of the financial support operations of governments and commercial banks by underpinning adjustment efforts, if the present regionalized crisis was not to explode into a banking crisis of global dimensions. Any backtracking from the policy of enlarged access to the Fund's resources would give a wrong signal at the present critical juncture. The Fund should be able to satisfy its members' legitimate needs for financial support.

The policy attitude of private commercial banks would continue to have an important bearing on the level of financial flows to developing countries, at least in the immediate future, Miss Batliwalla observed. It was therefore essential for private banks to continue to extend credit to those countries. Regrettably, according to the staff's statement, spontaneous new lending to non-oil developing countries had been much lower in early 1983 than in early 1982. Nevertheless, as the staff had rightly emphasized, the flow of lending would be facilitated by world economic recovery, a much improved international trading environment, and an alignment of exchange rates that better reflected underlying economic realities. The prime responsibility for a better economic environment thus rested with the major industrial countries. A real improvement in the international credit climate could be brought about, not only by the pursuit of stronger adjustment policies by debtor countries, but also by an improvement in the world economic climate, including appropriate trade policies in the industrial world that would sustain the growth of exports of debtor nations.

The need for closer coordination of macroeconomic policies, as a rule rather than as an exception, and as much in countries' own interest as in the interest of the world economy, could hardly be overlooked, Miss Batliwalla remarked. The Williamsburg communiqué had recognized the imperative need for such an approach. It was also necessary for both the Fund and the concerned central banks to continue to give prudent advice to commercial banks about not unwinding credit in aggregate terms or preventing its growth. Otherwise debtors would find themselves in hopeless situations, despite sincere efforts at adjustment. If banks were unwilling, even when able, to reschedule due debts and increase their lending commitments, they would have to bear in mind that interest payments on existing loans would also be in jeopardy. The result could be an adverse impact on banks' outstanding claims, together with a financial crisis that would harm the banks themselves and moreover pose a threat to world economic recovery.

Finally, Miss Batliwalla referred to one of the staff's concluding observations, namely, that "it was the increased perception of risk, rather than the availability of funds, which in the second half of 1982 slowed markedly the net flow of finance to the developing countries." For 1982 as a whole, external lending had declined to $95 billion from $165 billion in 1981, a fall shared by industrial countries and developing countries alike. Thus, the question was whether the fall in lending to industrial countries was also due to enhanced risk. Had there not rather been a significant impact on banks' lending operations as a result of the decrease in the surpluses of some countries that had previously been readily channeled to banks? Another aspect of the reduction in bank lending concerned the extent to which the fall in interest rates during 1982 had had an impact. Apart from the risk factor, the deceleration in the growth of resources of international banks, together with the larger domestic demands thereon that might be expected from industrial countries where a moderate recovery was on the way, and from oil exporting countries whose current account deficits were likely to grow, would make it even more difficult for non-oil developing countries to secure adequate bank financing. The current situation, as the Managing Director had rightly said in his speech before the sixth session of UNCTAD, presented both opportunities and risks. The task of the financial system's policy makers was to ensure that the opportunities were exploited and the risks averted.

Mr. Teijeiro recalled that when the debt crisis had begun in 1982, it had been envisaged that there would be a return of interest rates to more normal levels and, accordingly, world economic recovery and an improvement in the terms of trade. The normal response of external accounts to those parameters had allowed the crisis to be judged one of liquidity and not of solvency. At the same time, to deal with the immediate and urgent liquidity problem, there should be serious adjustment by affected countries, some financing on the part of the Fund, and an increase in bank exposure.

As far as the latter prong of that strategy was concerned, Mr. Teijeiro said, by any reckoning, it would have to be concluded that bank exposure had increased by less than had initially been considered necessary. That could be seen in general from the fact that adjustment programs had effectively been tougher than predicted, particularly in terms of GDP. The failure to obtain greater bank financing was attributable not to the Fund, but rather to the existence of several channels of financing that countries could not control or tap.

The fact remained that the degree of adjustment would soon be much more significant than initially envisaged, Mr. Teijeiro continued. The staff paper gave an alert of the greater difficulties ahead in stating on page 27 that "while there is considerable support in key banking circles for the coordinating role of the Fund in these 'exceptional' cases, there is still some uncertainty as to the scale of financing the banks will provide on the next round." The outcome of course would depend not only on the willingness of the banks, but also on the regulatory measures that might be taken, along the lines of the U.S. legislation related to the quota increase.

But the banks themselves had created a new problem that could affect the medium-term solvency of countries, Mr. Teijeiro considered, by increasing the spread of charges. The two sources of that increase were, first, the current explicit rate of interest, and second, several implicit elements taking the form of front fees, government guarantees, and a change in the reference base for adjusting interest rates from use of LIBOR to the prime rate. It would be most useful if the staff could prepare a short paper on recent developments in that respect. The conclusion might be that the increase in spreads for new loans to the main debtors would be seen to have grown by as much as 3 points compared with the spreads existing two years previously.

He looked forward to discussions in the Executive Board in two areas, Mr. Teijeiro stated. First, the discussion of the World Economic Outlook should provide a better background for evaluating prospects for interest rates, world recovery, and the development of the terms of trade. The second crucial discussion would be that relating to access limits under the Fund's enlarged access policy.

At the present stage, Mr. Teijeiro remarked, the fundamental issue was whether the combination of a slow reduction of interest rates and a slow improvement in the terms of trade, the significant increase in spreads that had occurred, and the continuous reduction in bank lending, would not place most of the burden on adjustment beyond what was justified by the goal of achieving a sustainable long-term situation. If so, the Fund might have to pick up where the banking system was leaving off, and increase its financial support to members.

Mr. Morrell considered that the good descriptive review in the staff papers of broad developments in international capital markets could perhaps have been complemented by a fuller assessment of prospects for the coming year, although he recognized the inherent perils in such exercises. He could support the proposal for publication of the present set of papers, which would certainly be useful for banks, supervisors, and authorities in debtor and creditor countries alike.

Many lessons could be drawn from the experience of 1982, Mr. Morrell remarked, the year when many fears about sovereign borrowing had become reality, although concerted action had kept the situation under control. Continued management of the situation would hinge on a number of necessary and interdependent conditions, including the continuation of the global economic recovery, the ability of the Fund to encourage new flows to debtor countries and to oversee the required adjustment process, and continued new lending by private markets.

There was clearly a need for a decline in interest rates, Mr. Morrell added. Nothing could be as important in sustaining the economic recovery needed to enable debtors to earn foreign exchange for the servicing of external debt. Already, record levels of real interest rates imposed a debt burden that was extremely difficult to service. An essential condition for a fall in interest rates was the reduction in fiscal deficits, particularly in the United States, as the staff had pointed out. Continued lending by banks was necessary not only for debtor countries but to protect the international monetary system and to nurture the incipient recovery through the continued financing of international trade. According to the staff, the actual growth in international bank assets for 1982 of 10 percent had fallen short of the demand-oriented forecast of 12 percent, the difference being explained as the result of impaired willingness to continue lending. A similar situation was envisioned for 1983. He wondered whether the staff could provide some estimate of the shortfall from the growth in projected demand of 18 percent.

Like others, Mr. Morrell mentioned the observed tendency for lenders to generalize the debt problem regionally as well as globally. The fallacy of composition was at work on two levels: first, the suggestion that exposure be reduced for one country was applied to all countries; second, what was good for one bank--namely, reduced exposure--was said to be good for all banks. The use of those fallacious premises would precipitate the very event that was to be avoided. Adjustment by borrowing countries was clearly an important element in the immediate restoration of confidence in order to encourage resource flows and more fundamentally to deal with the causes of financial imbalance. The requirement of adjustment encompassed a need to consider interdependences; collective and abrupt restriction in demand could jeopardize the incipient global recovery, to the general detriment. Adjustment would have to be carried out over an appropriate time span. In the absence of substantial private flows to assist the process, financing from official sources was all the more essential. Indeed, the lesson of past years could be that the capital markets were not self-correcting, or at least insufficiently so. The exuberance of lending in past years was destined to be corrected by underlending in the coming few years, with serious consequences. The staff had suggested in its paper that banks and bond markets might be both unwilling and unable to finance long-term adjustment. If that proved to be accurate, all members would have to dwell upon the serious implications for the future role of the Fund.

Mr. Polak remarked that he would prefer to take up the broader issues in the context of the world economic outlook.

The staff papers were suitable for publication, Mr. Polak considered, although if the staff prepared a single paper for publication and for Board discussion, there was an inherent risk that the material would be written for publication. That risk had not materialized with respect to the papers under discussion; but, should the staff ever face that dilemma, he hoped that it would present both a paper for publication and, for the Board, its open and frank views.

The Director of the Exchange and Trade Relations Department observed that the staff intended to consolidate its contacts with supervisory authorities in order to represent countries' needs for continued support properly. Those contacts had already been strengthened in the course of recent debt negotiations. In general, as the Executive Board had correctly sensed, the staff had been suggesting in its paper the need to counter the overreaction by banks that was at the core of the present problem. The aim was to find ways to moderate the constraint on countries that were being pressed. It was the need for a general response along those lines that was being emphasized to supervisory authorities, rather than the attempts of individual banks to unwind credit.

Growth in the industrial countries would indeed be one of the major ways of improving the debt situation, the Director noted. Greater stress could perhaps have been placed on the need for the continuation of open trading policies in the industrial countries. There was no point in urging continued use of the private credit markets for the transfer of resources if the countries receiving those funds were unable to have ready access to markets for the product of their investment.

More official financing was needed, the Director remarked. Possibilities were being explored for coordinating debt relief more closely with continued access to export credit for those countries with programs supported by the Fund.

Support for the Fund, including the quota increase, was a critical element underlying market confidence, the Director said. In that respect, the staff did not think, as had been suggested by some Directors, that unspontaneous financial support for countries implementing Fund-supported adjustment programs would be at the expense of spontaneous lending to other developing countries. The staff view was that the more funds that could be provided to permit the larger debtors to cope with their problems--as part of the general cooperative effort, and with the support of the supervisory authorities--the better the prospects for maintaining the flow of credit to other member countries.

It was of paramount importance for the staff to communicate its views to the Executive Board, the Director of the Exchange and Trade Relations Department stated. If, as Mr. Polak had suggested, there was ever an issue unsuited for publication, it would be dealt with in a paper for consideration by the Executive Board alone.

The staff representative from the Exchange and Trade Relations Department noted that the January World Economic Outlook had suggested that the flow of net bank lending to non-oil developing countries would be $20 billion-25 billion in 1983. The difference between the forecast made at that time and the somewhat more cautious view taken in the staff papers under discussion was not primarily a matter of the availability of bank finances for the developing countries. There had been no intention to convey the idea that the attitude of bankers had become even tighter since the beginning of the year. In January, the aggregate current account deficits projected for the non-oil developing countries had been larger, and the scale of financial flows to some developing countries in the midst of debt rescheduling negotiations had become less certain.

As to whether or not, as confidence returned, the larger developing countries would turn to long-term capital markets, especially to the bond markets, the staff representative explained that, historically, their use of those markets had been marginal. There were a few exceptions among the non-oil developing countries, including some in payments difficulties, but it would take some time before even the larger borrowing countries in the developing world would be generally perceived to have returned to viable payments positions and before they obtained any significant access to those markets.

Several Directors had cited the statement in the concluding observations of SM/83/74 that the prospects for future bank lending would depend more on the willingness of the banking system to intermediate internationally than on its ability to do so, the staff representative commented, even though that statement had been qualified by the remark that the distinction between willingness and ability was less clear as a result of recent developments. In considering the question of ability alone, one could certainly take the view that the pace of lending that had characterized much of the 1970s would not be repeated, a view suggesting that, in the near term, the operable constraint would be willingness. The rate of expansion of lending to developing countries would probably be significantly below the rate of increase in banks' capital in the near term. Although capital constraints did play a role, as did other kinds of prudential considerations and supervisory attitudes, it was the attitude of bankers that seemed to be the controlling influence at present.

The regulations on capital ratios that had come into effect in the United States on April 13, 1983 applied only to the 17 largest multinational banks, the staff representative said. All other U.S. banks had been subject, for the past two years, to a capital ratio regulation. Most of those 17 banks appeared to have already attained the 5 percent capital ratio by March of 1983, and the others were close to reaching that level.

In fact, for more than a year U.S. bank regulators had been urging these banks to strengthen their capital positions. Many of the banks were clearly in a strong position, based on current share prices, to increase their capital. Thus, the staff did not consider that the new regulations would be a significant factor in bank decisions to lend either domestically or internationally. Developments in other countries also suggested that new regulations were unlikely to disrupt the flow of bank financing to the developing countries.

As to whether the adequacy of bank capital would improve if spreads rose for all countries, the staff representative mentioned that there was some evidence of an across-the-board increase in spreads for international loans. Part of the increase was direct, over LIBOR, and part was more indirectly the result of a technique under which some tranches of loans were priced over the U.S. prime rate. That technique had been partly designed to make some loan packages attractive to smaller and particularly to U.S. regional banks, which had in fact increased their participation in some of those packages recently.

It should be easier in the future, the staff representative said, particularly when the Fund's broader reporting system on commercial bank claims was fully operational, to meet Mr. Almeida's request for a table showing the actual level of financing flows to individual countries adjusted for exchange rate changes. The BIS data were adjusted for the exchange rate for broad groups of countries only; the staff had not had information from the BIS on the currency composition of individual claims, and it had seemed advisable not to present a separate series of unadjusted flows to individual countries that would not add up to the total.

Broadly speaking, the staff representative considered, developments in the interbank market had not been a major factor reducing the scale of bank lending to developing countries. A number of domestic factors in the industrial countries had been influencing the interbank markets, as well as changes in the perception of risk in lending to some participants in the interbank markets. But by and large, those markets were not a major source of finance for developing countries in the aggregate, nor had developments in those markets impeded either the ability or the willingness of banks to lend to developing countries, other than in a secondary or tertiary way. The attraction of trade-related and project-related financing to the banks was essentially because of the banks' linkage to their own domestic clients.

The idea that developing country borrowers might be crowded out as a result of recovery in the industrial world was interesting, the staff representative from the Exchange and Trade Relations Department noted, because the financial community was largely concerned at the present stage about the failure of the world economy to recover fast enough. The fear was that the export prospects of developing countries would suffer, as would their debt carrying capacity, which would impede bank lending to those countries. In general, the crowding out argument had been overstated. There was not a fixed pool of funds, which would be allocated between industrial and developing countries. If there were good prospects for lending, and if the banks were confident of being able to manage the risks, there need be no great concern that they would not do so merely because they were simultaneously lending more to their domestic clients.

The Chairman said that he had noted the support given to the publication of the paper, with the proviso mentioned by Mr. Polak, which he accepted.

The main issue addressed by the Executive Board, the Chairman noted, had been whether international capital markets and the private banking system would play their part in financing balance of payments deficits in the years to come, especially in developing countries. A number of points had been made in that connection. The first obvious point was that the banks would have to continue to lend, on a nonvolatile basis; if they were to cut back their lending drastically or abruptly, the debt situation would become intractable, and organized adjustment efforts would become so difficult to implement that they might well fall apart. Hence, the security of the banks' existing assets depended largely on the continuation and continuity of their lending.

Second, the Chairman remarked, the fact that bank lending had essentially been marshaled through concerted packages, which had not been very spontaneous, following the sharp cutback in lending in the second part of 1982, had led Directors to voice a number of concerns that he would mention, although he did not share them all:

(a) Some small banks and regional banks were becoming reluctant to maintain their exposure, particularly in certain countries.

(b) Some financial packages, even though they had been put in place, had been difficult to organize and in some cases were not working out as expected.

(c) The interbank market had contracted considerably.

(d) Banks had shown a tendency to overreact globally and regionally.

(e) Countries that were not such large debtors, and whose economic performance was quite satisfactory, might well be excluded from new lending as a result of concerted packages for other countries, owing to the existence of quantitative internal limits on banks' lending.

(f) An increase in supervisory regulations might, if those regulations were not applied in a flexible fashion, constrain the willingness or even the capacity of some banks to continue their lending.

(g) With the recovery taking off, the expansion of credit to the corporate sector in industrial countries might crowd out developing countries.

(h) The spreads being demanded by banks in negotiations with developing countries were too high and were thus exacerbating already high interest rates and complicating the adjustment process.

A third point that he had noted, the Chairman continued, was that it was essential for Fund programs to be implemented and for tangible progress toward medium-term balance of payments viability to be observed. Mention had been made in that respect of Brazil's program. It had been generally agreed that the role of the Fund was crucial, initially in devising realistic and firm adjustment programs with the interested countries to convey the necessary reassurance to the international banking community. The Fund's role was also instrumental in providing objective information to international banks on economic conditions in member countries, on their adjustment programs and the way in which they were being implemented, and on the financial requirements needed to make those programs work. In that connection, the Fund should continue to take flexible and pragmatic action, in relationship with the banks, and member country governments. A number of Directors had also referred to the importance of the Fund's being financially equipped to play its catalytic role and to have the means of reinforcing its liquidity.

Among other more general points that had been made, the Chairman observed, the significance of the world economic recovery had been viewed in slightly different ways. He had already mentioned the view that the recovery might not automatically benefit developing countries. The second view was that recovery was essential if trade markets were to revive and commodity prices to strengthen, so that developing countries' terms of trade would improve; the importance of a durable and sound recovery in the industrial countries had thus been stressed, as had the need for that recovery to lead to lower interest rates.

He had taken note of the idea that the Fund's financial support to member countries should not be seen as relieving the banks from their own efforts, the Chairman said. The Fund could not be a substitute for lending by banks. Numerous references had been made to the shift by banks more toward trade-related and project-related financing. The tendency to revert to the more classical banking practice of relating credit to physical transactions, and away from more generalized balance of payments assistance, would have to be taken into account in the Fund's assessment of countries' balance of payments financing needs.

A number of voices had been raised in favor of keeping and reinforcing the Fund's policy of enlarged access, the Chairman noted. There had also been some support for SDR allocations.

Several practical suggestions of interest had been made, the Chairman considered. He had taken note of the suggestion that the staff should prepare a companion paper, for the Executive Board, on the security of the international banking system, giving quantified indications of the capital/asset ratio and other significant ratios, and analyzing the policies pursued in a number of countries by the banking community and the supervisory authorities. Second, he had noted Mr. Teijeiro's suggestion that a short study be prepared on the recent development of spreads and various forms of borrowing costs. Another suggestion put forward by Mr. Schneider had been that more thought should be given to how the Fund could convince the banks that it was in their interest to continue to lend, because only in that way could they make possible the repayment to themselves of future debt.

The Executive Board took the following decision:

> The publication of staff papers on International Capital Markets - Developments and Prospects, 1983 (SM/83/74, 5/10/83; Sup. 1, 6/8/83; SM/83/117, 6/7/83; EBM/83/88, 6/20/83), amended in the light of suggestions made by Executive Directors, is approved.

Adopted June 20, 1983

APPROVED: November 2, 1983

LEO VAN HOUTVEN
Secretary