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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 93/71

2:30 p.m., May 14, 1993

R. D. Erb, Acting Chairman

Executive Directors	Alternate Executive Directors
M. Al-Jasser	A. A. Al-Tuwaijri
	J. M. Abbott, Temporary
	F. Moss, Temporary
	A. Törnqvist, Temporary
	N. Tabata
	T. P. Thomas, Temporary
	S. Narube, Temporary
D. Kaeser	K. Link
	M. C. B. Arraes, Temporary
	G. Bindley-Taylor, Temporary
	G. Y. Glazkov, Temporary
G. Lanciotti	
	P. Bonzom, Temporary
	P. A. Merino, Temporary
	A. Galicia, Temporary
	M. A. Hammoudi, Temporary
	B. S. Dlamini
D. Peretz	J. Dorrington
	R. Thorne, Temporary
	O. Havrylyshyn
	B. A. Sarr, Temporary
	B. Esdar
	Y. Y. Mohammed
	G. F. Murphy
	A. M. Tetangco, Jr.
	G. J. Matthews, Temporary
	Duan, J., Temporary
A. G. Zoccali	A. F. Jiménez de Lucio

L. Van Houtven, Secretary and Counsellor
R. I. Vera-Bunge, Assistant

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2. Dominica - 1993 Article IV Consultation . . . . Page 33

Also Present

IBRD: A. Peuker, Latin America and the Caribbean Regional Office. External Relations Department: J. Morrison. Fiscal Affairs Department: T. Lybek. Policy Development and Review Department: J. T. Boorman, Director; C. V. A. Collyns, P. C. Leme, J. P. Pujol, P. J. P. Szymczak. Research Department: M. Mussa, Economic Counsellor and Director; M. Goldstein, Deputy Director; D. Folkerts-Landau, S. M. Fries, P. M. Garber, T. D. Lane, F. Larsen, E. L. Rojas-Suarez, G. J. Schinasi, G. H. Spencer, S. S. Sriram. Secretary's Department: A. Leipold, A. Mountford. Treasurer's Department: A. J. Richards. Western Hemisphere Department: S. T. Beza, Counsellor and Director; J.-P. Amselle, S. Kawar, E.-G. Lim, O. Nyawata, C. J. Richardson, B. C. Stuart. Advisors to Executive Directors: R. F. Cippa, J. Jamnik, J. W. van der Kaaij. Assistants to Executive Directors: H. M. Al-Atrash, S. Al-Huseini, D. A. Barr, T. Berrihun, M. Blome, J. A. Costa, C. D. Cuong, D. Desruelle, H. Golriz, N. P. Hahnemann, M. E. Hansen, T. Kanada, W. C. Keller, R. Kibria, T.-M. Kudiwu, K. J. Langdon, B. M. Lvin, J. Mafararikwa, S. C. McDougall, F. A. Sorokos, A. Viirg, S. Vori, Wang X.

1. INTERNATIONAL CAPITAL MARKETS - DEVELOPMENTS, PROSPECTS, AND KEY POLICY ISSUES

The Executive Directors continued from the previous meeting (EBM/93/70, 5/14/93) their consideration of the second part of the 1993 staff report on developments, prospects, and key policy issues in international capital markets. Part II examined recent banking problems in several industrial countries, risks associated with the rapid growth of off-balance sheet activities in the major banking systems, and trends and issues in developing countries' access to international capital markets (EBS/93/63, 4/20/93). They also had before them a staff paper containing background material (SM/93/84, 4/21/93).

Ms. Arraes made the following statement:

Before commenting on the specific issues suggested by the staff for discussion, I wish to thank the staff for the excellent description of the main systemic issues of the international capital markets, and I would like to stress one aspect of it. Financial liberalization and the integration of financial markets mean that the markets increasingly require and insist that countries' economic policies be compatible to avoid major market disturbances. In this regard, the Fund will increasingly have powerful allies in the markets themselves in exercising its surveillance function.

I would like to take up the first issue for discussion, that of the deterioration of bank balance sheets. The staff paper shows that the international debt crisis had less damaging effects on the banking system of industrial countries than did some domestic loans. Such losses were caused by cyclical movements of the economy and unanticipated changes in economic policy in an environment of increased competition among banks and other financial intermediaries that resulted from the liberalization of financial markets. Cyclical movements in the economy should not be impossible to forecast with some accuracy and should be taken into account in portfolio choices. Changes in economic policy are more difficult to predict. However, one cannot ignore the point that perhaps the system of implicit or explicit guarantees provided by governments to the banking system is not giving the right incentives to banks in their risk management.

More important, perhaps, is the lesson learned from the recent experiences with banking crises in industrial countries. After the experience of the southern cone countries in the 1970s, it was widely acknowledged that stabilization was a precondition to the success of the liberalization of financial markets. Now, there is a lesson to be given on the need to strengthen the prudential framework before financial liberalization takes place. This recommendation should be taken to heart by all countries, and it should be conveyed by the Fund, without hesitation, as conventional wisdom in the design of programs or the provision of technical assistance.

On the issue of the growing involvement of banks in derivative finance, efforts should be devoted to adapting regulatory regimes and supervisory practices to the revolution caused by the development of derivative tools in financial markets. An important consequence is the increase in linkages between different markets, with an obvious increase in systemic risk. There are different positions on this issue. One is to keep on extending the framework of supervision to new activities and to all the participants in the markets. This course implies a need for similar regulation across countries and entities; otherwise, economic agents will attempt to shift positions to escape regulation, which is not a desirable outcome. Another position is to limit the regulatory framework to the basic activities of commercial banks. This option would entail a need for separation of traditional commercial bank activities from the nontraditional ones, and one would hope that market discipline will take care of the latter.

We have doubts about the viability of both approaches, but we would tend to favor the first and more comprehensive one, because we consider the separation of activities even less viable. Technology, as already mentioned in the discussion today, can be the key element to cope with the task of strengthened supervision.

On the issue of the access to international capital markets by developing countries, capital flows are not always a blessing. Thus, in countries undertaking an adjustment program, the temporary use of capital controls could be justified, in certain circumstances. Our chair has commented on this point before.

An important point under this subject is the somewhat arbitrary distinction made by the Basle Accord among countries with a zero percent weight and those with a 100 percent weight in the calculation of risk-weighted credit exposure. The alternative of having an internationally agreed credit rating is an even worse solution. Evaluation of risk is at the core of financial intermediation, and the difference in perceived risks is the essence of business in international financial markets. Perhaps the main need is for agreement to be reached on criteria for a more rapid graduation process from a high-risk classification.

Finally, I would like to offer a specific remark on Chapter VII of the background paper on the sample countries chosen to illustrate the current state of developing country capital markets. It is curious that Brazil was not included in the analysis in Table 8, "Financial Indicators for Selected Countries, 1991," on page 67. The inclusion of Brazil would have made the analysis more balanced, because, in the same chapter, one can find an extensive analysis of capital flows directed to it. Furthermore, the text refers to the Brazilian stock market as being one of the ten best performing stock markets in the world in that same year, according to the "Emerging Stock Markets Factbook" of the International Finance Corporation.

Mr. Zoccali made the following statement:

The causes of the banking crisis are eloquently reflected in the staff papers presented for this discussion. Financial liberalization and innovation, coupled with explicit or implicit government guarantees both for depositors and the banking industry as such, generally led banks to alter their behavior to avoid a loss of market share and a decline in profitability, which in turn resulted in excessive risk taking and a concentration of exposures. The tightening of monetary policy in major countries in the late 1980s and early 1990s precipitated the ensuing correction of asset prices and accentuated the deterioration of bank balance sheets.

The rapidly evolving nature of international capital markets warrants, therefore, a comprehensive and ongoing analysis by the staff, leading to operational conclusions, which should be a regular by-product of the exercise.

This said, some specific comments are in order. First, the dynamics of innovation in the wake of deregulation and the changes in the microeconomic behavior of financial institutions call for prompt and continuous responses on the part of supervisory agencies, so as to adapt prudential regulations and practices to new market trends and their risk implications. To expect full anticipation of such developments and restructure bank supervision accordingly prior to financial market liberalization is, however, an unrealistic expectation. I concur with Mr. Havrylyshyn that some editing changes on this point would be useful for the version of the paper that will be published. While risk management and the management of information systems should be emphasized, the importance of inappropriate macroeconomic policy mixes in major countries and of inadequate policy coordination as primary determinants of renewed banking difficulties should equally not be downplayed. Cross references to the world economic outlook analysis on asset inflation are deemed useful.

Second, the recent banking problems in the Scandinavian countries demonstrate that governments ultimately serve as guarantors of the financial system, regardless of whether explicit commitments exist in this regard or of the relative importance of private banking. This situation calls for an in-depth intercountry comparison and assessment of the efficiency of the different guarantee schemes and methods of recapitalizing the banking system in terms of preserving the efficiency of intermediation, the use of public resources, and the avoidance of the moral hazard problem.

Third, the need for an adequate methodology to gauge the magnitude of risks of nonperforming loans and risks in maintaining the stability of the macroeconomic environment is crucial for an appropriate policy response. The range of estimates of nonperforming loans in the case of Japan, with the highest number calculated at 7.5 percent of GDP, highlights the importance of this point. While we generally agree that the strategy of buying time for the banks to earn their way out of a crisis increases the costs of its resolution, forbearance based on cultural and institutional considerations serves a purpose, provided that competitive pricing, reduction of spare capacity, and improvements in the quality of loans are being observed.

Fourth, the fact that the structural components of fiscal deficits in industrial countries have reached unprecedented levels and that sovereign loans to OECD/GAB governments carry a zero-risk weight under the Basle Capital Accord gives new meaning to the shift in the asset portfolios of commercial banks toward government securities. U.S. commercial banks' holdings of treasury securities showed, for example, a substantial increase since 1988 and represented 22 percent of total bank loans in 1992. The augmented interest rate risk and the potential crowding-out effect on private sector activities suggest, therefore, that some prudential regulations may have more than a marginal effect on market trends. If tax incentives are also considered, then the declining trend of international medium- and long-term bank lending to developing countries, despite lower systemic risks associated with strong macroeconomic and structural reform policies, should not come as a surprise or be attributable solely to the banks' more prudential reorientation of their commercial activities.

Although the assertion on page 96 of the background paper, regarding the relative flexibility of provisioning standards in several industrial countries is attributable to the opinion of bank representatives, it contrasts markedly with that expressed in the 1992 capital markets report, in which the constraints to bank lending to developing countries from risk weighting were observed, the fact that some industrial countries had not yet established any kind of graduation procedures was noted, and more discriminating standards for loan-loss provisions were called for. The additional impediments to investment flows, including the rules on where pension plans can invest, which Mr. Peretz mentioned, warrant a more in-depth analysis. Otherwise, an undesirable antigraduation bias in prudential standards and tax codes could take hold.

Fifth, while the participation of developing countries in the international bond and equity markets has increased strongly, continued reliance on enhancement techniques points to the difficulties in establishing investment grade credit ratings. Sustaining these more volatile flows requires, first and foremost, consolidation of political and macroeconomic stability in the countries concerned, as well as the ability to disseminate adequate information to potential investors. In addition, structural reforms in those countries, particularly in the area of privatization and social security administration, should also help to accelerate the graduation process for domestic borrowers by helping to broaden investor interest and improve country-risk perceptions. Nevertheless, avoiding the saturation of current investor portfolios, confined generally to flight capital and high net worth investors, and facilitating the participation of mainstream institutions also involve a timelier recognition on the part of securities regulators of the new prevailing realities in these countries.

In closing, the growing involvement of banks in the over-the-counter (OTC) derivative business, while broadening the possibilities for borrowers and lenders to improve the management of risks and boosting their returns, complicates the prudential examination of banks' off-balance sheet activities and could radically increase the systemic risks mentioned in the papers. The challenge is not to curtail the participation of commercial banks in this field, but rather to improve the solvency and liquidity of markets. The Fund could serve a useful role, particularly for those members that have already liberalized their financial activities but do not participate directly in the Bank for International Settlements (BIS) Group, in transferring technical expertise and harmonizing the approaches that are being developed for better assessment and control of that segment of risk.

Mr. Al-Jasser praised the staff for very good papers, which were of interest to many bankers and economists and were written to help draw lessons from the recent global difficulties in the financial markets. However, the only drawback to the staff papers was that those countries that had not suffered from those difficulties had not been studied.

On hearing the speakers in the Board and reading the staff papers, Mr. Al-Jasser said, he had assumed that the original reason for developing financial markets had been to satisfy the needs of investors and savers in the real sector. He hoped that continued to be the case. However, it appeared that the original purpose of financial deepening and intermediation had expanded. There were a multitude of financial assets and instruments whose relationship to real economic activities was increasingly loose. Financial operations varied from one extreme, based on the conservative principle of direct finance, to the other extreme that bordered on gambling. Between those extremes, financial innovations were resulting in new instruments appearing almost daily. The comments on derivative markets specifically were alarming, not because those markets were not playing a useful role--they clearly were--but because their transactions had risen dramatically out of no particular purpose.

In the past five years, derivative markets activity had expanded by 500 percent, even though real economic growth throughout the world did not fare as well. Mr. Al-Jasser said. That looser connection between the real economic sector and the financial sector was interesting to examine, and the staff papers had not addressed that issue, which probably had not been included in the papers' terms of reference. The measure of risk that supervisors and regulators had to take into account when making decisions seemed to underestimate that relationship between the real and financial sectors. The staff should comment on that relationship and on what could be learned with respect to the riskiness of the new instruments that were developing.

His remarks did not mean that the liberalization of the financial markets should be slowed, Mr. Al-Jasser noted. Instead, liberalization should take a form in which it addressed first and foremost the needs of the real sector, rather than the needs of speculators in the financial markets, because that was where difficulties such as risk arose and bubbles developed.

Supervisors and regulators in financial markets would have an arduous task because innovation, by its very nature, was often fast, and never more so than in the financial sector. An earlier speaker had suggested that supervisory activities should probably be proactive, rather than reactive to financial innovations. However, financial innovation took on a life of its own. The problem was that, with financial development, deepening, and liberalization, there could be too much of a good thing.

Mr. Thorne concurred with Mr. Al-Jasser and added that his chair's intervention had been one of the most supportive of derivative markets and their benefits. Nevertheless, it was important that, in their relation with its customers in the real sector, banks should treat people as customers and not as graphs on a computer. That relationship benefited both the lender and the borrower.

The motivation for the Big Bang in 1985, Mr. Thorne continued, was to reduce commissions for investors and borrowers throughout the market. However, as an immediate result of the Big Bang, financial intermediaries all over London had built plush offices on the back of those reduced commissions. Thereafter, of course, the stock market crash of 1987 had occurred.

Mr. Al Jasser remarked that Mr. Thorne's comments reflected his own concern that, between the saver and the ultimate user of resources, there appeared to be increasing layering that generated greater risk and made the financial system more fragile. Thus, the benefits accruing to the ultimate investor and saver seem to be of diminishing importance in the development of the financial system.

The intermediate layers seemed to be taking on a life of their own, Mr. Al-Jasser said. That development seemed to contradict the conclusions of economists like Joan Robinson, who had stated that finance was only a veil: where enterprise leads, finance follows. Hence, the expansion of finance was not seen to be a cause for concern in the process of economic development because it was considered as a follower. The problem now, according to the staff papers under discussion, was that there was probably too much finance at certain points in the development process. Where could supervisors and regulators intervene to ensure that the riskiness of the process was not exaggerated?

Mr. Abbott remarked that, well before the time of Gurley, Shaw, and Robinson, Adam Smith had written on the roundabout means of production that had enhanced the prosperity of the world.

Mr. Glazkov made the following statement:

> Uncertainty is a fundamental feature of the economy. No state regulations can eliminate this uncertainty. What the authorities can actually do is to cushion short-term risks at the expense of rising risks for midterm and long-term economic decisions. This has been strongly proven by the recent turmoil in the European Monetary System (EMS). Furthermore, we must take into account the staff's observation that the Basle Accord on capital adequacy has not really influenced banks' behavior.
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> It would appear as though the market was often smarter than the authorities in inventing special mechanisms for voluntary risk distribution. The derivative business phenomenon is probably the most vivid example of such mechanisms. Having emerged beyond the area of state regulation, and sometimes despite the regulation, it can play a really positive role in risk allocation. I would disagree with Mr. Al-Jasser on this point.
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> We should acknowledge that the principal reason for the problems that appeared after the deregulation of banking activity was the inconsistency of this deregulation. The very existence of

a real or even implied financial safety net could, by itself, provoke market agents to implement high-risk operations. However, the difference here is that the beneficiaries of the social safety nets are not the impoverished but the shareholders and managers of banks.

It is not easy to imagine the ideal means of implementing prudent state supervision. On the one hand, deregulation cuts the state's opportunities to supervise, and the development of international financial markets makes the subject of supervision vague and complicated. On the other hand, state supervision implies state intervention in the case of crises, which actually means state help. This is vividly shown in the staff paper's description of the recent banking problems in some industrial countries.

Perhaps the most effective way to arrest the use of "implied" state help in financial operations and achieve actual risk control is by renewing mandatory supervision. Supervision and transparency would certainly become a natural market value--a part of the assets--and these assets would be created by the market, as they are created now in the insurance and auditing sectors.

I believe that what has been said can be confirmed by the events in developing countries. On this point, I would disagree with Mr. Mirakhor's statement. The origin of capital (the return of capital flight--the current situation--or oil capital, as in the 1970s) makes no difference here. Securitization of borrowing provides much better sustainability of the fiscal situation.

The agents who buy the developing countries' securities do so at their own risk; hence, in practice, they have no opportunity to delay a crisis and subsequently share its burden with someone else. The fluctuations of these securities prices, like those of the exchange rates of national currencies, appear to be the best indicators of the authorities' policies. Certainly there is, as was noted by Mr. Mirakhor, divergence in the access of the developing countries to international financial markets. But the reasons are not misbehavior of market agents, but rather the different economic policies of the countries concerned.

Among the three alternative solutions offered by the staff to resolve the banking crises--higher interest rate spreads, prompt closure of insolvent institutions, and direct government injection of capital--I am in favor of the second one. As for deregulation, I would concur with Mr. Esdar that we cannot remove financial safety nets overnight. However, we should always keep in mind that maintaining state guarantees inevitably leads to economic crisis. With respect to the derivatives market, it should be seen as serving as a kind of special institution for risk assessment, in line with the provision of a form of insurance for investors.

Mr. Abbott remarked that, for the past two years, he had followed the discussions of capital markets carefully and enjoyably, and he had noted that all the reports prepared by the staff had received great praise from the Board for their professional competence and analytical sophistication. In that regard, at the previous meeting (EBM/93/70), he had been surprised to hear Mr. Tabata indicate that the section of the report on Japan was fairly riddled with mistakes and misunderstandings. In his own view, the staff report had done a fairly good job of delineating between the official views told to the staff during its visit to Japan and its own attempts to round out the analysis more fully. There seemed to be more of a difference of assessment rather than a misunderstanding, and there ought to be an opportunity to try to sort out any differences between the Japanese authorities and the staff before the paper was published. However, it was neither desirable nor even appropriate to suggest that a staff mission return to Japan to discuss the official view. The previous mission had been part of the surveillance process. The integrity of that process required that the staff be given the latitude, within what the Board was prepared to support, to present a disinterested, arm's-length analysis of the situation, and, if the Board supported it, to go forward with its recommendations. He hoped that Mr. Tabata would consider withdrawing his request.

Mr. Lanciotti remarked that a number of Directors had said that a few industrial countries had not been affected by the recent strains in the banking system related to land and real estate financing, and he would welcome the staff's comments on that point. One of those countries was Germany, and Mr. Esdar had singled out the universal banking system as one of the relevant factors. Perhaps the staff should consider a country-specific profile of Germany and Italy and the financial sector tradition shared by those two countries, namely, legislation on mortgage credit institutions. It was that specialization that had made the creation and development of securitized credit markets and institutions unnecessary in those countries, unlike the Anglo-Saxon systems.

Mr. Tabata said that he continued to feel strongly that the staff should return to Tokyo to hold discussions with the authorities. At the previous meeting, he had used the term "misunderstanding" several times. However, his authorities had pointed out that the papers contained more than 50 factual mistakes. The staff should return to Tokyo to discuss those mistakes.

The economic situation in Japan was in reality at a midpoint between the estimates made by the Japanese authorities and the staff, Mr. Tabata remarked. The authorities had commented several times to him that it had been extremely difficult to communicate well with the staff during its mission to Tokyo during the autumn of 1992.

Mr. Peretz said that, although he did not have strong views on the subject, he wished to point out that several speakers had expressed concerns about the section of the staff paper on the European currency unit (ECU) markets. He could have expressed himself more strongly, but had not. He hoped that for both the section on ECU markets and the section on Japan, it would be possible to sort out differences and reach agreement at the Fund, rather than require missions to go to either Europe or Japan.

Mr. Esdar said that he agreed with Mr. Abbott and Mr. Peretz. All speakers had had certain problems with particular parts of various staff papers discussed by the Board in the past. For example, during the recent review of the world economic outlook, there had been much discussion on Germany's monetary policy. Perhaps it would be possible to find ways that were more cost effective to overcome differences in views and avoid misunderstandings by asking the Japanese authorities to comment on the text of the staff paper and make proposals so that the text could be rewritten in a way that was acceptable to the authorities.

Mr. Bonzom said that he concurred with the position expressed by Mr. Abbott for the reason he and other speakers had explained.

The Deputy Director of the Research Department remarked that the speakers had raised a number of interesting questions, comments, and suggestions on a wide range of issues, and that the staff would discuss them not only at the meeting but also on a bilateral basis to receive detailed comments and suggestions for changes prior to publication.

With regard to the criticism that the staff's estimates of nonperforming loans in the Japanese banking system were too high, the official estimates that Mr. Tabata had cited referred to the aggregate of nonperforming loans at 21 major Japanese banks, the Deputy Director observed. The official totals referred to the lending of those banks to bankrupt companies and to loans on which no interest had been paid for six months. The official estimate was fine, but it had a number of limitations.

Mr. Tabata stated that the official figure was not an estimate. The Japanese authorities had been clear on that point. It was, in fact, a real figure that covered 21 banks.

The Deputy Director of the Research Department said that, with respect to trust banks, the official figures covered only the nonperforming loans that were explicitly backed or guaranteed by the trust banks. Unbacked trust account loans, the nonperforming loans of regional banks, and the restructured loans of all banks had been excluded by the authorities. The reason that a broader concept of nonperforming or troubled loans might be desired was that that concept included the troubled loans of the entire banking system, or even the financial system, and, therefore, it was the most relevant for measuring macroeconomic performance. That did not mean that the figures on the nonperforming loans of some subset of the nonfinancial sector were not useful and viable.

The staff estimates attempted to extend the official figures for nonperforming loans to include those of the regional banks and unbacked trust accounts, as well as restructured loans, the Deputy Director continued. To that end, the staff had assumed that the ¥ 12 trillion of nonperforming loans of the 21 major banks arose from the approximately ¥ 37 trillion increase in their loans outstanding to the construction, real estate, and nonbank sectors from 1986 to 1992. Thus, about one third of the increased credit to those sectors hardest hit by the collapse of the asset bubble had become nonperforming. Therefore, if that same ratio of one third was applied to the comparable increase in loans outside the regional banks and unbacked trust accounts, there was an additional ¥ 8 trillion in nonperforming loans. That figure, plus the original ¥ 12 trillion for the 21 major banks, gave a total of ¥ 20 trillion.

To gauge the figure for the amount of restructured loans, one could look at the total value of loans outstanding at end-1992 that carried interest rates below the short-term prime rate of 4.5 percent, the Deputy Director noted. Such loans amounted to ¥ 21 trillion. Thus, the staff's estimates for the overall problem loans of Japanese banks was ¥ 32.7 trillion, or 7.6 percent of total loans. The staff would not pretend that the estimate had been made with great precision, but it was, nevertheless, an honest estimate of what the staff thought nonperforming loans might be, using a methodology similar to that used for the entire banking system. There were other methodologies that could be used to get a similar definition. For example, attempts had been made to assess the equilibrium ratio of urban land prices to national income--for example, comparing the figures for 1958 with those for 1986-91--and then examining the increase in direct and indirect exposure to real estate lending by Japanese banks over that same period. That method required that some judgments be made about the equilibrium level of land prices. Those judgments had been made by the staff and by other independent bodies. Those methods generally yielded higher estimates, in the range of ¥ 50 trillion.

The estimate of ¥ 32 trillion, which the staff considered reasonable, was based not only on the information gathered in the October 1992 capital markets exercise, but also on the information that had been compiled during the recent Article IV consultation, the Deputy Director added. That was a consensus estimate of the mission staff, without any pretense of being very precise. Nevertheless, it had been carefully discussed with the staff of other departments in the Fund. One of the members concerned had been present at the capital markets mission in October 1992, and one of the staff on the capital markets had been present at the recent Article IV consultation mission to Japan.

It had been suggested by Mr. Tabata that the staff ignored the information and explanations given to it by the authorities, the Deputy Director remarked. In fact, the staff had made its best estimate based on the data and the views given to it by the authorities. That did not mean that, after talking to the authorities, the staff would necessarily arrive at the same estimate as that of the authorities, or that the staff had misunderstood what had happened in the area under discussion. Of course, the staff would welcome an opportunity to discuss those points further and would try and iron out any differences, regardless of where those discussions might take place. It would be pleased to do so in order to try to reach a broader agreement.

The staff estimates of nonperforming loans in the banking system were certainly in the same ballpark as estimates made by other independent observers, the Deputy Director remarked. For example, IBCA, Limited, the well-known bank credit rating agency, had recently estimated the amount of nonperforming and restructured loans of the Japanese banks as ¥ 39 trillion.

There had also been market signals of the weakness of the Japanese banks, the Deputy Director remarked. A significant signal had been the presence of a Japanese premium in the international interbank market. According to market participants, the interbank borrowing rate for Japanese banks was between 18 and 25 basis points above that of comparably rated non-Japanese institutions. The premium had been in effect since mid-1992. While there was some tiering of institutions, a premium existed for all internationally active Japanese banks. As noted in the staff report, only one Japanese bank currently carried a AAA rating. Of course, that was not the same as the staff estimates on nonperforming loans, but it was a market indication.

It should be recognized that whatever formal or legal definition of nonperforming loans was adopted, what was really being searched for was an economic concept or indicator of the likely future loan losses of banks, the Deputy Director noted. In that connection, a measure that simply considered whether interest was being paid could be misleading if banks continued to extend new loans to troubled borrowers so that they could keep current on their obligations. The staff had seen a great deal of that interest capitalization during the debt crisis. With respect to bank lending patterns in Japan over the past year or two, there had been a number of developments. For example, over the period September 1991 to September 1992, bank lending to real estate, construction, and nonbank finance companies had grown at the same rate as the rate of interest, while bank lending to the rest of the economy had been stagnant. Similarly, during the more recent period of January-February 1993, bank lending to those sectors was about 6 percent versus more than 3 percent in the rate of overall lending. Mr. Tabata was right in saying that the bank lending pattern was consistent with several explanations: lending to local government land development entities to buy parcels of land; support for cash-strapped private real estate developers; assistance to companies in selling their real estate assets as part of restructuring efforts; and financing of the redemption of equity, such as bonds issued by private companies. The staff was looking for a definition of nonperforming loans that went beyond the official one and that had some advantages for assessing what future loan losses would be and what the risk was in the system.

Finally, given the enormous correction in asset prices in Japan as a result of the collapse of the asset bubble and the well-known magnitude of lending that had been made to support real estate activity, it would be a miracle, indeed, if the lending institutions involved did not suffer some serious losses, the Deputy Director of the Research Department said. There had been no surprises in that area.

Mr. Peretz said that, as the staff's estimate of nonperforming loans was of great sensitivity to the Japanese authorities--Fund estimates had a different standing from other estimates in the market--he hoped that the staff would be prepared, as it normally was, to adapt the text of the published version of the report to take account of Japanese sensitivities. Everyone in the Board would agree with that.

Mr. Tabata said that, as to the estimate of nonperforming loans, the difference between the staff's estimate of ¥ 35 trillion and the official Japanese figures was one of definition. He had also stated that the official figures did not include the loans of local banks or trust account. The figure estimated by the staff of those loans was ¥ 10 trillion, but, according to the authorities' unofficial figures that had been compiled from local banks, the actual figure was approximately one fifth of the staff estimate.

Of course, the type of measure used was up to the staff of the Fund and research institutions, Mr. Tabata noted. Nevertheless, taking into account the sensitivity of his authorities to those figures, it was necessary to confirm whether those estimates were close to the real figures. Therefore, it was necessary to ask the authorities for their opinion. The Japanese authorities had asked that the staff do that.

There were also divergences in estimates of the figures on restructured loans, Mr. Tabata continued. The major share of the staff's figure for restructured loans consisted of lending by Japanese banks to the housing loan corporations. The actual figure had not been published or made available. Not all of the bank lending was for restructured loans. However, the actual figure for restructured loans was very low compared to the staff's estimate. The Japanese authorities had explained that to the staff, and, in their opinion, the staff's estimate was exaggerated.

As to the increase in lending by the Japanese banks to the real estate and construction industries, Mr. Tabata observed, the lending had been to public corporations owned by provincial governments and had been used to buy land for public use. That lending practice had been going on for the past 25 to 30 years and had not been to support the real estate markets' present situation, including the extremely high land prices. It had been common for not only local or provincial governments, but also the Central Government to buy land for public purposes.

There were many mistakes in the staff papers, but he wished to point out two in particular, Mr. Tabata said. On page 9 of the international capital markets background paper, in the second paragraph, the staff had said that the authorities had proposed "... several measures aimed directly at strengthening the banks and at boosting real estate and equity values." There had been no intention for the measures in question to be aimed directly at strengthening the banks or boosting equity values. Furthermore, on page 11, of the same in the second paragraph, the staff said that some of the banks' investments dated from "...the early 1960s, when the Ministry of Finance encouraged banks to purchase equities in an attempt to forestall a sharp drop in share prices." That was completely wrong. The so-called hidden reserves related to equity holdings by Japanese banks were bought mostly in the 1950s, when Japanese capital accumulation was still very low. At that time, the banking sector was the only sector that bought the equity of growing industries. That was the main part of the equity purchased by Japanese banks. In the 1960s, when the security companies were in difficult straits, private cooperative security companies bought equity.

Mr. Al-Jasser stated that he agreed with Mr. Peretz that Mr. Tabata should submit his comments in writing to the staff, and then meet with it to discuss them in detail, rather than discuss all the important details at the Board meeting.

Mr. Tabata said that Mr. Al-Jasser's proposal was one of several possible ways to handle the issue, and that he was willing to follow that proposal. However, the best solution was to have a small staff mission travel to Japan.

The Acting Chairman said that, as a number of Directors had recommended, it would be best to first make the effort to resolve the issues at the Fund through an exchange of correspondence between the staff and Mr. Tabata, and then see whether a trip to Tokyo was necessary. He hoped that the issue could be resolved at headquarters.

Mr. Al-Jasser noted that if there were a mission to Japan, it could be misinterpreted as a sign that there were difficulties between the Fund and the Japanese authorities. That impression should be avoided. There were honest differences of interpretation of the statistics, but that matter could best be handled at the Fund. It was best to try to handle the matter at headquarters.

Mr. Tabata said that the Japanese authorities were concerned about not only the staff figures, but also some of the ideas that were in the staff papers--for example, the comparison of the Japanese situation with that of the savings and loan crisis in the United States. On May 13, 1993, the Governor of the Bank of Japan and the Managing Director had discussed in Tokyo the Japanese business and banking situation. The Governor of the Bank of Japan had stated clearly that the Japanese situation was completely different from the savings and loan situation in the United States. In addition, as he had already declared in his statement, the Japanese authorities had no intention of injecting government money into the banking system.

The Deputy Director of the Research Department said that, in solving a banking problem, each alternative approach that could be taken involved some cost. For example, if banks were permitted to earn their way out of trouble by maintaining higher interest rate spreads, it was the depositors and borrowers who dealt with those banks who would bear the cost. Usually, the smaller depositors and the smaller and medium-sized firms that did not have ready alternatives and were captive to the banking system bore the burden of the costs. For a household sector with balance sheet problems, the higher spreads could sometimes be difficult. Similarly, if investment were already depressed, the higher costs could also be troublesome for investment. However, if public capital was injected into the banking system, the taxpayers would bear the cost. If there was a large budget deficit, the high interest rate spreads would sometimes add to it. While each approach involved costs, costs were not always a bad thing. Certainly in the resolution of banking crises, one would want the owners and managers of the firms that had caused the trouble to bear the costs. That was a means of achieving some discipline. One of the factors that led at times to a repetition of those crises was that the managers of those institutions had not borne the costs, and thus the right pattern of incentives was not set up.

A number of Directors had referred to the operating conclusions that could be drawn from the staff's analysis, the Deputy Director noted. In its operating conclusions on pages 30 and 31, the staff recommended the following: movement toward comprehensive risk-weighted capital for on- and off-balance sheet positions, including the incorporation of market risks; strengthened bank supervision over domestic and international activities, including the supervision of international financial conglomerates, which sometimes proved to be difficult; increased transparency of financial relations; broader disclosure requirements; and more timely action to close insolvent institutions.

With respect to bank financing versus bond and equity financing, bank financing was not necessarily the best choice because of the costs involved in that financing, the Deputy Director commented. The costs must take into account how reliable the financing's availability was. Experience suggested that bank financing was subject to particularly large swings from one extreme, with excessive bank lending, to another, as the banks overextended themselves, ran into loan losses and actual losses, and had to cut back on capital and lending. In contrast, with bond and equity financing, there was at times a decline in the price of the instruments, but because the holders of bonds and equity often tended to be better diversified, a decline caused them to suffer only a small drop in their wealth. Hence, there might be a change in the terms under which that financing could be obtained, but there would not be extreme swings.

A problem with bond and equity financing was that it was not available to all developing countries, only for the most creditworthy ones, the Deputy Director said. In a situation in which bank lending was fairly stagnant, there was a subset of developing countries that were not receiving adequate financing for their private markets and, therefore, had to turn more to official flows; that was another reason why debt relief was often very important.

Looking beyond the question of costs in the issue of bank financing versus bond and equity financing, during the debt crisis the staff had noticed that spreads on bank loans were often lower and less differentiated than those on bond instruments, the Deputy Director remarked. A plausible explanation for that was that investors with assets in the banks involved expected that those banks would be bailed out. Therefore, the appropriate pricing of risk was not showing up in the markets. Sometimes the pricing of even those assets had to be observed.

As to the progress made in general in restoring balance sheets, it was still too early to comment on that, the Deputy Director said. However, in one case, that of the United States, which was one of the first countries to have experienced banking problems, there had been a significant improvement in profitability owing to the cyclical drop in interest rates, and the money center and main regional banks had increased their core capital substantially. At the same time, U.S. banks had shifted the composition of their assets significantly, with a much greater share going to treasury securities. Although the strengthening of bank balance sheets was necessary from a prudential perspective, the main determinant of bank profitability over the longer run would be the ability of the banking system to scale down its size as alternative forms of financial services became available.

There should be some constructive ambiguity in terms of the support that authorities would give institutions in order to minimize the moral hazard problem, the Deputy Director added. However, there was one proviso: institutions would be examining not only what the authorities said, but also what they did. In fact, looking at the actual experience in aiding large institutions, there were very few such institutions that had been closed. The New York Federal Reserve had concluded an interesting study of assistance to institutions, looking at the differences in bank deposits and deposit insurance schemes and examining the actual assistance provided and the cases in which large institutions were closed down. There were not many cases to be found. The closing of Drexel-Burnham in the United States was one of the few exceptions in which a large institution had been closed down with a positive effect, because the market got the signal that, in some circumstances, banks would indeed be closed down.

Biases in the tax system in favor of borrowing could be an important factor in fueling excessive credit demand, the Deputy Director added. The objective of prudential requirements was not to affect competitiveness. The staff was trying to make the point that, in some cases, if there was a large change in regulatory standards--for example, if there were much larger capital requirements on OTC derivative positions for banks--there would inevitably be some competitive effects and, therefore, investors would look at those effects to see how quickly they could move into the market.

As to why the staff's assessment of capital markets had not been more comprehensive, the simplest answer was that, in assessing market developments, the staff had traveled some two months, the Deputy Director noted. If the staff had gone to the countries with serious banking problems, instead of those with the most serious problems, it would have had to travel even more extensively. Thus, the coverage was really a factor of how much time the staff had available in a given period.

As to the issue of the real sector and gambling, there was no means for restricting or getting closer to transactions that were productive and involved the real sector, the Deputy Director from the Research Department remarked. The staff had examined that issue for a long time, and proposals of various types had been suggested to keep track of the financial engineering that went on. However, keeping track often involved making difficult judgments about the motivations involved--for example, whether short-term maturity transactions alone were less productive than long-term ones. If long-term transactions alone were considered productive, the adverse liquidity effects would have to be taken into account. It should be recognized that some people would use instruments for productive purposes, while others would use them for what might be called speculation. Basically, if investors did take risks, they should hold adequate capital against them. One should take measure of that rather than limit financial transactions and their use. The distinction between speculative and more productive uses turned out to be very difficult to make in practice.

The staff representative from the Research Department said that a number of lessons had emerged from the evolution of developing countries' capital markets over the past decade. The first lesson was that a sound banking system with a credible, independent banking supervisory agency was an absolute prerequisite for the efficient functioning of financial markets. That condition was necessary for the efficient mobilization of savings, as well as for the proper pricing of credit for commercial and project lending.

The second lesson was that the development of government securities markets, particularly the short-term markets, helped in the management of liquidity by central banks, provided a benchmark for pricing, and helped in the establishment of interbank and other short-term markets, the staff representative remarked. The third lesson in importance was that the development of more sophisticated markets, such as corporate debt markets, equity markets, and derivative markets, required the functioning of a credit rating agency, the control of insider trading, a consistent accounting framework, and settlement and clearing systems; the debt markets in some Southeast Asian countries were probably good examples of how progress could be achieved, but also how slow and difficult it was.

The last lesson that had been learned was that derivative markets that operated successfully required a banking system that could deliver good funds, the staff representative said. For successful operation of the derivative markets, central bank reserves had to be made available on the same day that they were needed in order to satisfy margin requirements. A payments system that could safely channel and execute a large number of payments, and a clean and open underlying market, such as that for government securities, was also required.

All those requirements were not met even in some industrial countries, the staff representative continued. For instance, some European countries did not have deep corporate debt markets. Meeting those requirements in developing countries was a long way down the road. The structure required for the successful operation of derivative markets was complicated.

When things went wrong in derivative and similar markets, they went seriously wrong, as those markets were heavily leveraged and frequently required extensive and immediate intervention to set them straight, the staff representative added.

The question of why a few of the European countries, particularly Germany, had been free of major banking crises, was difficult to answer, the staff representative said. A partial answer was that the structure of those countries' financial systems had been gradually liberalized over the past 15 to 20 years. Those systems tended to be dominated by a handful of large, integrated universal banks that undertook a wide variety of financial activities in addition to banking, such as securities and insurance activities. They tended to be well capitalized and had very close relations with their industrial and commercial customers. As a result, the competition from nonbank financial firms for banking franchises that had been so pronounced in other countries, such as the United States, had been contained. Furthermore, foreign competition had been mostly confined to the wholesale banking sector and was far from penetrating the retail banking sector in a significant way, owing partly to the ownership structure of those banking systems; savings banks in Germany tended to be owned by the lenders and by the states, and cooperatives tended to play a large role. It was difficult for a foreign bank to buy into those banking systems and acquire a retail network. Furthermore, retail banking involved name recognition and long-term relationships and was therefore very difficult to penetrate. Therefore, it was fair to say that those banking systems had managed to avoid a decrease in net profit margins and, thus, had been able to manage the liberalization and restructuring of the financial sector better than if assistance had been possible.

Moreover, the banking systems of those Central European countries had a relatively conservative attitude toward risk, although that was of course difficult to measure, the staff representative added. In evaluating the different banking systems, one measure that could be considered was the spreads between bank deposit and lending rates. For example, those in Germany were greater than those in the United States, although that might point to a less efficient delivery of financial services in Central European countries than in the United States--to some extent, a tax on the saver and the borrower. However, there was a trade-off, as it had not been necessary for countries to use public sector funds to assist a troubled banking system, as had happened in the United States.

Those choices had not been a deliberate policy decision, the staff representative from the Research Department continued. Much of those differences had come about because of the evolution of banking systems in the postwar period. It was not as if an authority had a choice to pick one banking system over another; these systems had evolved, and now the question was how to deal with them.

Mr. Esdar remarked that the German banking system was often described as being dominated by a few large banks. However, in reality, there was a great deal of competition among large private commercial banks, savings banks, cooperative banks, and Landesbanken, all of which offered similar widespread services to customers. In fact, those banks were more alike than the smaller banks.

It was useful to consider the most effective way of defining efficient competition, Mr. Esdar continued. Using an extreme example, it could be argued that the air cargo industry in the United State was efficiently competitive, although the outcome of that competition was that a large number of companies had had to file for bankruptcy under Chapter 11. Therefore, were spreads in certain countries that were sufficient to generate an adequate capital base an indicator of efficient competition?

He would be interested in knowing the extent to which the regulatory framework affected the stability of the financial system, Mr. Esdar remarked. A regulatory framework could include precautionary regulations, such as generating hidden reserves, or other regulations that protected either the banks' shareholders or their creditors against losses.

There were enormous differences between the German and, to a certain extent, the European regulatory systems on the one hand, and the U.S. system and some other systems on the other hand, Mr. Esdar noted. The main underlying objective behind the regulatory framework in Germany, Austria, and Switzerland was to protect the creditors of banks--those who lent money to the banks. In the United States, the regulatory framework's objective was more to provide protection to the shareholders.

The staff representative from the Research Department said that the statistical evidence pointed clearly to the existence of larger interest rate spreads in the German financial system than elsewhere. That was not necessarily an indication of inefficiency. Those spreads might be the way the system broke down the delivery of financial services and the segmentation of markets. For example, commercial banks in Germany did not play as significant a role in private saving as banks in the United States. The savings industry in Germany had a specialized set of institutions to take care of savings accounts and they tended to be active locally.

As to relationship banking and the resolution of debt difficulties giving a certain stability, that was clearly true, the staff representative said. In Germany in particular, the incidence of corporate crises and insolvencies was extremely small, as the bank officers served on the boards of large corporations and assisted in resolving financial difficulties. Thus, there was a disciplining element in that banks had greater surveillance over companies' management and would not allow a company to run off with the banks' money.

In the Central European countries, the staff representative from the Research Department continued, the tax system tended to favor more the writing off of bad debts, which contributed to favorable financial results.

Mr. Törnqvist noted that, in the Nordic countries, the structure of the financial systems was extremely similar to the German and Central European systems and did not resemble the Anglo-Saxon systems. Thus, the explanations given by the staff were difficult to apply to the Nordic countries.

Mr. Peretz commented that, in the United Kingdom, the retail banking sector was dominated by a handful of large domestic banks, and there was no foreign competition in the retail sector. Those were the common factors between the U.K. and German banking systems, which had actually developed in very different ways.

For whatever reason, financial liberalization and full financial competition had yet to happen in Germany, Mr. Peretz remarked. That situation had a good side, in that it had avoided the problems of instability that had followed deregulation elsewhere; and it had a bad side, as the staff had pointed out, in that it meant lower-quality and more expensive service to customers. That fact, of course, explained why many customers throughout Europe went to the City of London to buy financial services, rather than buying them at home.

Mr. Abbott said that he did not fully agree with Mr. Esdar's comments on the difference in orientation of the regulatory system in Central Europe and the United States. The United States would not be in the situation it was at present if the authorities had not gone to so much trouble to ensure the position of depositors.

Mr. Esdar noted that the German tax system allowed much larger write-offs compared to the U.S. system, and that generated hidden reserves, which strengthened the financial system. However, in describing the German system, he had not meant to say that it was better than others or more efficient. Different systems had different experiences, and it was worthwhile considering which particular experience could be used to draw lessons for the overall system. Hidden reserves might be considered a means to protect the overall system, but that certainly had its price.

Mr. Peretz remarked that the U.K. banks once had had hidden reserves, and that he greatly doubted whether hidden reserves were useful. They did not make the banking system more transparent; because they were hidden, the reserves did not allow investors in banks to discriminate properly among banks. Thus, in general terms, hidden reserves had little merit. In any event, it was inconceivable that they could continue to exist in a truly competitive system. They were incompatible with a genuinely liberalized competitive financial system, under which there would be great pressure to declare those reserves from the government and shareholders, who would want to know their companies' net worth. Hidden reserves could exist only in a system that was not yet fully liberalized and competitive.

The staff representative from the Research Department said that, in comparing some of the Nordic countries to Germany, it was useful to note that liberalization had happened more quickly in Norway, Finland, and Sweden than in Germany. For those Nordic countries, the banking system and the supervisory agencies were getting used to their new environment, as was described in the staff report. There were many segments of the German financial system that were not yet fully liberalized, particularly in comparison to the U.K. market.

As to the impact of the single European market on the financial structure and activities in Europe, it was generally believed that the opening of European markets would greatly enhance competition at all levels of activity, and, to some extent, that had occurred, particularly at the wholesale level, the staff representative noted. Currently, there was a European-wide wholesale financial market in equities, corporate bonds, and, to a degree, government securities. However, it would take time for the enhanced competition to reach the retail level. The United Kingdom could be taken as an example of being open in terms of foreign acquisition of domestic institutions. Nevertheless, there were no major foreign banks operating a large chain of branches in the United Kingdom. Name recognition was important for business there.

It was probably fair to say, when looking at countries' financial systems as a whole--and Germany in particular--that there would be restructuring during the coming decade, the staff representative said. Throughout that restructuring process, excess capacity in banking systems would be removed and interest rate spreads would narrow. The challenge was to accomplish the restructuring without running into the kind of difficulties that had been seen in other restructuring efforts.

OTC activities had more systemic risk than standard organized exchanges, the staff representative remarked. For example, OTC instruments, particularly swaps, which were the major generic instrument, were essentially equivalent to a string of futures contracts. In a case of a currency swap, for example, a U.S. borrower would borrow deutsche marks, a German borrower would borrow dollars, and they would agree up front that the U.S. borrower would meet the dollar obligations of the German borrower and the German borrower would meet the deutsche mark obligations of the U.S. borrower. If the swap were a ten-year obligation, there would be basically quarterly payments for ten years at the then-prevailing exchange rate. That arrangement was equivalent to a futures contract. On organized exchanges, there would be a whole set of mechanisms, such as margin calls, settlement arrangements, share liability, and risk sharing among the clearing house members, that would go a long way toward eliminating the kind of systemic risk that was considered present in OTC markets. That was the basis of thinking about OTC versus organized exchanges.

OTC markets had grown in notional value over a very short period to overtake the organized exchanges, and the staff had wondered what had caused that rapid growth, the staff representative said. Had a hidden subsidy within the banking system allowed it to occur? Did the structure of capital requirements applied to OTC instruments give the banking system an edge over the organized exchanges? Was there perhaps an implicit sort of backing out by banks into safety nets that permitted them to become major players in the OTC markets? The staff had not taken a position on the answers to those questions.

An important point that should be made, the staff representative considered, was that, taking into account financial history including financial catastrophes, it was one thing for a large bank like Deutsche Bank or J.P. Morgan to be involved in OTC markets, and it was another thing for a regional bank in Boise, Idaho, or in Bremen to be involved. As those activities were fairly widespread in the banking system, and were not necessarily limited to the top five or ten institutions, one tended to have an uneasy feeling about them. The question of whether capital requirements were properly structured was not an easy one because it implied the fundamental question of what the architecture of the system should be. That, in turn, involved the question of what the size of the banking system should be versus the size of the organized exchanges and their intermediaries. That fundamental question was currently being addressed in a number of fora; the Group of Thirty, for example, was undertaking a major study, and its conclusions would be made fairly soon. The BIS, of course, had made proposals to deal with that question. Other agencies had also issued proposals; the United States Banking Agency had put out a study recently on the subject. He hoped that over the next decade those proposals would be sorted out in a way that would remove some of the concerns about OTC activities.

There was a great deal of controversy over the definition of market risk, the staff representative remarked. Recently, the Basle Committee on banking supervision had released its proposals for common minimum capital requirements for the activities of banks and securities markets--the so-called market risks. One of the main difficulties had been how market risk was defined. Looking at both sides of the balance sheet and at net positions, were hedge positions to be included? If so, how would they be treated in the event of a possible liquidity problem? Thus, there were a number of difficulties with applying that method of defining market risk.

Furthermore, there was no agreement among securities regulators that were organized under the International Organization of Securities Commissions as to what the capital requirements ought to be for securities houses, the staff representative from the Research Department continued. It would be an important task to coordinate that agreement internationally and get a level playing field. The recent Basle proposals were a first step; the next step would be to make them consistent with the EC directives that dealt with securities and the securities regulators themselves.

The staff representative from the Policy Development and Review Department noted that, for developing countries, securities flows could not fully substitute for bank lending. Banks would continue to play an important role in providing financing for those countries, particularly in the areas of trade and project financing, in which banks enjoyed a comparative advantage in terms of credit risk assessment and customer relationships. It was encouraging that, although general purpose bank lending had declined in recent years, there were indications that there was increasing exposure through trade and project financing, which was not perhaps fully captured in the staff's statistics; in reading the press coverage and talking to market participants, one had the feeling that there was increasing activity in that area.

Securities financing was generally more costly than bank lending, the staff representative remarked. Looking at the aggregate numbers, there was a higher average interest rate spread on bond issues than on syndicated bank lending. The difference in spreads in 1992 was approximately 280 basis points for bond issues, whereas for bank lending it was about 80 basis points. However, for individual countries that had access to both bank lending and the markets, such as Malaysia, Thailand, or China, that difference disappeared. The difference in spreads at the aggregate level resulted in part because a number of countries--for example, Brazil, Mexico, and Argentina--had access to bond financing on expensive terms but had no access to bank financing.

Flight capital had been extremely important in providing financing for securities flows in developing countries and, in particular, in facilitating the re-entry of Latin American countries into capital markets, the staff representative observed. Flight capital continued to remain important and currently probably accounted for perhaps 50 percent of those capital inflows. However, increasingly, Latin American countries were gaining attention from institutional investors. In Asian countries, which did not have a flight capital base, capital flows had been primarily from institutional investors, as well as a few wealthy investors, throughout the 1980s and early 1990s. It was important that the investor base continue to increase. The key to doing so, as a number of Directors had stressed, was to sustain financial policies, particularly if they bolstered investment grade credit ratings, which would send strong signals to international investors.

The staff representative agreed with the Directors who considered that there was a need to review regulatory frameworks in creditor countries to identify possible impediments to securities and bank flows to developing countries. That point had been made in the staff paper. Nevertheless, one should not expect too much in that area.

When the staff visited capital markets, it asked institutional investors and securities regulators about the constraints on capital inflows, the staff representative remarked. In general, there were no ready answers. Under the regulatory systems in place, there were few binding constraints on portfolio flows to developing countries. Most of the rules applied to the quality of the portfolios of institutional investors, rather than on the destination of the funds that they were investing in. Moreover, if there was an institutional constraint on institutional investors who wanted to invest in a country, they would usually find a way around that constraint, either by moving offshore or through some other mechanism. Thus, one could not expect that constraints could be easily enforced; nor would easing regulations turn the situation around in most developing countries.

Similarly, with bank provisioning, bank regulators in most creditor countries had been rather flexible in recent years, the staff representative continued. In a number of countries that were mentioned in the staff report, the staff had found that regulators were normally fairly flexible in looking at particular deals that market participants wanted to set up. In recent months there had been reports of further flexibility in other countries as well. Bankers seemed to feel that the main impediment to their providing financing to developing countries was their assessment of the credit risk of those countries, not their concerns about the regulatory framework, the provisioning framework, or the Basle capital adequacy guidelines.

On a broader point, the staff representative noted that developing countries still faced systemic financing problems. That point had been made several times in the staff papers, and the staff did not feel complacent about it. Nevertheless, there was a great deal of evidence at present--especially Asian countries over the past decade and Latin American market re-entries more recently--that middle-income countries with strong stabilization policies and strong private sectors were able to attract substantial private financing on reasonable terms. Of course, the situation remained fragile, and, if countries did not use the funds prudently, they might have problems in the future. Also, it was important to make sure that the market structures were appropriate. However, as a systemic problem, the emphasis should be more on the problems of the low-income countries that, even though they followed sound policies, still found themselves unable to obtain private financing. That problem clearly did raise important issues for financing.

The staff continued to be concerned about debt issues as well as financing issues, and it was now preparing its annual report on the debt and financing situation of developing countries, the staff representative from the Policy Development and Review Department noted. That report would be available to the Board for discussion prior to the Annual Meetings, and it would address a number of the issues raised by Mr. Mirakhor and other Directors, for example, the appropriate role of the Fund in the transitional period after graduation from the use of Fund resources. Finally, a separate paper would be circulated shortly on the issues raised by recent heavy capital inflows into a number of developing countries.

Mr. Esdar said that the reference to the bank provisioning procedure with respect to developing countries suggested the difference in attitudes between Central European and U.S. banks. In Germany, in discussions between banks and the Ministry of Finance, the question sometimes arose as to whether banks were making too many provisions for developing country credits, because those provisions were a form of tax credit. In the United States, the question that arose was whether provisioning was sufficient and whether there was an incentive to make provisioning at least a minimum standard in the regulatory framework. That difference was not a question of competition, but rather merely of different regulatory, and even political, approach, to a possible problem. German banks clearly would never have to be forced to make provisioning, because they were so interested in making it on their own initiative in order to obtain these tax credits.

The staff representative from the Policy Development and Review Department said that he had not meant to downplay the regulatory differences between countries. Nevertheless, banks in the United States and Germany had the same attitude toward providing new financing to developing countries. In fact, in both countries, these provisions had been declining in recent years, as regulators had recognized improvements in the economic situation of the countries that the banks were lending to, and banks had seen opportunities in those countries. On that basis, there had been an increase in bank lending by those countries, and that was encouraging.

Mr. Esdar commented that, in the German case, it was in the taxpayers' interest to raise provisioning standards, not to keep them down; thus, the attitude was different from that in the United States. He asked whether there was any example of successful foreign competition in the banking retailing sectors of any country. There did not appear to be any market where the retail sector was suffering as a result of foreign banking competition.

The staff representative from the Research Department said that the term "successful" with respect to foreign competition could be defined in different ways. For example, in the United States, Japanese banks played a large role in California in the retail banking sector, having taken over American banks and run them as if they were American banks. In European countries, the number of foreign-owned retail banks was very small. There were several reasons why such differences existed from country to country. In Germany, it was clearly the ownership structure that made foreign ownership difficult. The banking sector consisted of four very large banks. It would be inconceivable to take over a bank like Deutsche Bank with $300 billion in assets. As to the regional banks, many of them were cooperative banks that were owned by cooperatives or savings banks that were owned by the lenders. From the consumers' point of view, for the local or regional banks, recognition was important. Furthermore, there were numerous subtle competitive practices that impeded foreigners tying into the payment system and into the general financial structure of the country. Some countries were not very hospitable to foreign banks that wished to enter their banking systems.

Mr. Peretz remarked that even in the case of the United States the amount of foreign-owned retail banking was small. One British bank had had a retail banking investment in California, but it had left. There were not many places in the world where the retail banking sector was penetrated by foreign competition. Hong Kong was one of the few examples where a large proportion of the retail banking sector was foreign owned, such as by the Standard Charter Bank.

The Deputy Director from the Research Department noted that there were different attitudes toward risk. In Germany, banks that underwrote securities had a more "paternalistic" attitude toward their customers than banks in the United States. If the German banks made an offer to a customer and it went bad in the end, they considered themselves responsible. In the U.S. markets, the general view was that the customer had been informed that the more expensive a security was, the higher the yield and the greater the compensation; if the price dropped, the attitude was that the customer was responsible for his own actions. That attitude was not shared in some parts of Europe.

Mr. Merino noted that on page 5 the staff alluded to countries with banking problems that were considered more severe than those described in the staff paper. The countries referred to in that paper were Japan, the United States, and a group of Nordic countries.

The Deputy Director of the Research Department said that the staff papers had examined the most severe cases--for example, several Nordic countries in which there had been substantial injections of capital by their governments and losses in excess of a specified percentage of GNP--rather than the entire group of countries with banking problems. That would be a much larger group, well beyond what the papers had discussed. If the staff had not included a country in its report, that did not mean that the country did not have any banking problems whatsoever, and if a country was included, that did not mean that its problems were more severe than others.

Mr. Merino remarked that, in describing the different causes of the present banking problems, the staff report stressed that the competitive environment had been the main cause of the increased in risk in banking. How important was that factor in comparison to the changes in technology and monetary policy, and the large exposure by banks to real estate together with the liberalization of the market? Had the ties of banking with real estate had something to do with the more competitive environment?

The Deputy Director of the Research Department replied that activity in real estate by itself did not lead to that conclusion. What the staff was saying was that, in looking at the history of banking problems over a couple of decades and over a wide spectrum of countries, one of the things that stood out was that, when banks suffered from particularly sharp changes in competition, they tended to try to resist downsizing and would undertake more risky activities, ranging from leverage buy-outs, to investment in tankers, to overlending to developing countries. Real estate by itself was not a problem. As a number of Directors had mentioned, there were many factors in the real estate problem. However, in comparison with the other banking problems and looking over a very long period and a wide spectrum of countries, a general lesson could be drawn.

Mr. Tabata said that the main reason for the banking crisis was the monetary relaxation that had occurred in the late 1980s, when monetary policy was aimed at an intermediate target of maintaining a particular exchange rate to support international policy coordination--for example, to stop the free fall of the U.S. dollar. That specific goal had been mentioned in the communiqué of the Group of Seven (G-7) in the Christmas agreement of December 1987. What was the staff's assessment of the cause for the excess relaxation of monetary policy in the late 1980s?

The Deputy Director of the Research Department said that that it was difficult to generalize about the causes of the monetary relaxation in the 1980s. Monetary policy in most industrial countries was influenced by a number of objectives or factors. Of course, in some countries that had fixed exchange rate arrangements, the exchange rate objective took precedence over everything else. The three largest industrial countries, at least with respect to their exchange rate relations with each other, did not have fixed exchange rate regimes. However, occasionally exchange rate considerations were more important than others, and exchange rate objectives had to be balanced against other objectives, such as inflation, growth, or concern about structural problems of one type or another in the financial sector. Thus, exchange rate considerations might have affected monetary policy, but, as a whole, they had not played an important role in the design of monetary policy.

Mr. Peretz remarked that the exchange rate had played only a small role in U.K. monetary policy in the 1800s.

Mr. Esdar remarked that, with regard to the exchange rate, the G-7 agreements had had clear political backing. The G-7 considered interventions and monetary policy instruments as an inducement, but only in exceptional circumstances. There had always been a clear agreement that exchange rate policy could not be influenced by intervention alone. There had always been a clear agreement that a policy mix was needed. There had not been any agreement that there would be a general relaxation of monetary policy.

Mr. Abbott said that, if monetary policy had been too easy during the 1980s, perhaps fiscal policy had been too tight.

The Acting Chairman made the following summing up:

Executive Directors welcomed the opportunity to continue their review of developments and prospects in international capital markets. The discussion today focused on three central issues: recent banking problems in a number of industrial countries; the systemic risks associated with the rapid growth of off-balance sheet activities in banks; and the implications of the evolving pattern of developing country access to international financial markets.

Directors noted that the frequency and widespread country distribution of banking problems merited close attention, given the significant costs that resolving these problems can entail for taxpayers and the constraints that financial fragility can pose for the stance and effectiveness of macroeconomic policies. In discussing the common forces responsible for the deterioration of bank balance sheets, Directors noted that the extensive financial liberalization of the 1980s had opened up financial markets to intense competition and induced some banks to increase their tolerance for risk in order to maintain their earnings and market share, particularly when such risk was effectively underwritten by implicit and explicit government guarantees. As a result, during that period, bank balance sheets had expanded rapidly, concentration in single-risk classes had grown, and banks' activities in the over-the-counter derivatives markets had mushroomed.

Directors, however, also stressed that increased competition was not the only factor determining banks' attitude toward risk taking and their related earnings performance. They noted that the current bout of banking problems--particularly their large real estate component--also owed a great deal to cyclical factors, which are related to an accommodative monetary policy that helped fuel asset price inflation, and to the subsequent unwinding of these asset price excesses in the face of the widespread slowdown in economic activity. As noted at the time of the world economic outlook discussion, several Directors felt that this experience indicated the need for adequate attention to movements in asset prices in the formulation of monetary policy.

Directors agreed that supervisory guidelines that are suitable for a less competitive environment may not be appropriate to a more competitive and rapidly changing financial environment. Indeed, most Directors pointed out that a key lesson learned from the recent banking problems in industrial countries is that financial liberalization needs to be accompanied--and, as some emphasized, if possible, preceded--by a strengthening of the supervisory and regulatory framework. This lesson, it was noted, is equally applicable to developing countries with related implications for Fund advice on the pace and sequencing of financial reforms in such countries. A number of Directors noted that a review of the experience of industrial countries that had largely avoided banking problems could also provide some useful insight. Stressing the importance of preventive measures, Directors welcomed the progress made in many countries in strengthening the capital base for banking and securities activities and they reiterated their support for the international efforts aimed at achieving a level playing field in the application of supervisory and regulatory initiatives. With regard to methods of coping with existing banking strains, Directors noted that a range of approaches has been applied in individual countries, and that the specific response would need to vary according to circumstances. Several Directors placed particular emphasis on the importance of prompt action in closing insolvent institutions, although the difficulties of implementing such closures where they have potential systemic effects were recognized. Many Directors saw the approach of "buying time" for troubled institutions to allow them to earn their way back to health as carrying the risk of delaying adjustment and of undermining the incentives for the banking sector to reduce capacity, lower costs, and control risk. Nevertheless, the point was made that this approach, when implemented under rigorous supervision, could be helpful, given both the special role that banks played in the financial system and the lack of attractive alternative policy actions. Directors were generally critical of the recourse to artificially high interest rate spreads as a response to strains in the banking system.

Directors also noted the drawbacks of direct government injection of capital into institutions facing difficulties, and several speakers advised that such an approach should only be used as a last resort to avoid systemic difficulties in the financial system as a whole. It was also generally agreed that this method of recapitalizing troubled banks should be made conditional on the appropriate downsizing, cost-cutting, and increased efficiency of the affected banks, and that it was important to avoid placing the remaining solvent institutions at an undue disadvantage. It was also pointed out that the managers and shareholders should not be protected from losses in the event of any restructuring of banks.

Turning to the unprecedented growth in the financial derivatives markets, Directors pointed out that these activities were clearly serving a useful function in hedging the risk of price changes, in separating and redistributing market risks to those better able to manage them, and in increasing the day-to-day liquidity of the underlying instruments. At the same time, however, Directors saw those markets and the growing involvement of banks in the over-the-counter segment as also representing a potential source of systemic risk. In particular, several Directors noted that the growth of these markets had added to the interaction and linkages of financial markets, which in turn posed the risk that disturbances could spill over rapidly across the financial system. Directors thus welcomed the mechanisms that the organized derivatives exchanges had established to reduce systemic risks, as well as the efforts undertaken under the auspices of the Basle Committee and by the authorities in several countries to strengthen the prudential supervision of banks in the area of off-balance sheet exposures. A number of Directors felt that not much of a reduction in risk could be obtained by channeling more of the over-the-counter business to the organized exchanges. The staff was encouraged to continue its study of developments in the financial derivatives markets.

Directors welcomed the resurgence of private financing to developing countries over the past year, but they observed that market developments had been neither smooth nor uniform, with several important sectors suffering setbacks and access remaining geographically limited to a relatively small number of developing countries. This experience served as a timely reminder that the recent re-entry into private capital markets by a number of developing countries remained fragile, warranting continued study and monitoring by the staff. Directors observed that the investor base was still relatively narrow and largely based on the return of flight capital so that, for market access to be sustained, borrowing countries would need to diversify their financial resources. Perseverance with sound macroeconomic policies, as well as market reforms that foster a strong private sector that was open to international trade and free capital flows, would be the key to increased participation by a broader range of investors. Directors commented that it was also important to ensure that flows take place within a financial framework consistent with the adequate dissemination of information and an appropriate matching between risks and return. This would require efforts by developing countries to improve the transparency and integrity of domestic financial markets. It was also noted that the Fund should play a greater role in helping countries during the period of transition between graduation from the use of Fund resources and access to private capital market financing.

As regards international bank lending to developing countries, Directors noted that this remained on a declining trend, reflecting the difficult financial situation of many large banks and the lingering effects of the debt crisis. Directors welcomed the fact that a number of creditor-country bank regulators had reviewed the application of provisioning requirements in light of the progress made by some debtor countries toward improving creditworthiness. However, some Directors expressed concern about the risk weight scheme applied under the Basle capital-adequacy accord to bank lending to developing countries. They observed that the present scheme did not adequately reflect the intercountry differences in credit risk, and argued that it could serve unduly to discourage new lending to creditworthy countries. They urged that consideration be given to ways of linking the risk weights more directly to creditworthiness. Other Directors took the view that the current risk weights system had not had a significant impact on bank credits to developing countries and stressed the complexities of trying to introduce a more differentiated system of weights.

In line with the usual practice, it was agreed that the staff, after taking into account the comments and suggestions of Directors that had been made, would prepare a version of the papers discussed today for publication in the Fund's World Economic and Financial Surveys series.

2. DOMINICA - 1993 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1993 Article IV consultation with Dominica (SM/93/65, 3/25/93). They also had before them a background paper on recent economic developments in Dominica (SM/93/77, 4/16/93).

Mr. Murphy made the following statement:

Dominica's small economy and narrow export base imply a high degree of vulnerability to both economic and natural disturbances of which my authorities are fully aware. With policy constrained inherently by Dominica's membership in the currency union of Eastern Caribbean States, my authorities agree with the staff on the importance of maintaining strict fiscal discipline, encouraging export diversification, and containing cost pressures. My authorities have no significant adverse comments on the staff report and in general endorse its analysis and recommendations, although they have some reservations on government financing, which the report reflects faithfully.

In 1992, real output grew at slightly over 2 percent, roughly the same as in the previous year, but only--as the staff report points out--about half the average growth rate that was posted in 1986-90. While output growth in 1992 was below my authorities' expectations, some progress was achieved relative to the previous year. Inflation moderated, with the consumer price index declining to 5.3 percent from the 6.2 percent posted in 1991, while wages in both the private and public sectors have followed a similar trend. Moreover, the overall deficit of the public sector was cut by more than half, to less than 4 percent of GDP in 1991/92.

The second year of relative weak real GDP growth stemmed chiefly from developments in the banana sector, and a weak external environment also contributed to the weak growth.

Uncertainties about the continuation of the Caribbean States' preferential access to the European market continued to inhibit investment and production of bananas in Dominica. My authorities believe, however, that the uncertainties have been reduced sufficiently to contribute to a strong pickup in Dominica's banana production in 1993 and 1994, following the recent decision of the European Community to preserve to some extent the Caribbean's preferential access. The authorities have also taken several steps to enhance cost competitiveness in the banana sector, including charging individual growers for boxes in order to reduce waste. Furthermore, product quality has been improved by introducing a new system of cleaning and packing bananas. In addition, investment has been made in offshore refrigerated storage for other fruits in transit to overseas markets. These actions are expected to contribute to an overall improvement in the performance of the agricultural export sector.

Nevertheless, my authorities are well aware of the precarious nature of the EC agreement and that a possible phasing out of preferential access at some time in the medium term must be included in their planning. With this in mind, they continue to pursue a development strategy that seeks to promote export product diversification and tourism by fostering an economic climate conducive to private sector investment.

With regard to public finances, my authorities recognize the strains on available external concessionary financing, and they have placed added importance on mobilizing additional public savings in order to help fund needed investment in infrastructure to support growth over the medium term. Several measures were taken in the 1992/93 budget, including raising various fees and charges, increasing port tariffs, reducing import tariff exemptions, and lowering subsidies to banana growers. Wage negotiations with the public sector unions have not yet been concluded, however, adding some uncertainty to the outlook for public finances.

As the staff report notes, my authorities are committed to a re-examination of the public sector pay system, which was recommended by the World Bank in order to improve the operations and efficiency of the civil service. Although Dominica's labor relations have been acrimonious at times in the past, my authorities note that, given the general weakness of the outlook, a consensus with the unions appears to be developing.

Although my authorities are somewhat more optimistic than the staff about the impact of the budgetary measures on public savings and the availability of external financing, they have indicated that should shortfalls arise, some of the planned capital expenditure would not be implemented. Being in agreement with the staff that the potential recourse to raising taxes is rather limited, and being mindful that a stable tax system helps promote private investment, my authorities are generally receptive to the staff's suggestions for further savings through partial cost recovery in the areas of health and education. In their view, however, this could not be expected to contribute to additional public savings in the very near term. They believe that it is important to sensitize the populace to such a change in policy prior to any enactment.

In conclusion, my authorities wish to express their sincere appreciation to the staff for its careful analysis and objective assessment of Dominica's economic situation.

Mr. Dorrington made the following statement:

When the Board discussed Dominica in 1992, there remained considerable uncertainty about Dominica's future access to the European banana markets. The position is now much clearer, following the EC agreement of February 13, 1993, and the new regime is expected to come into force on July 1, 1993. One of the effects of this agreement is to encourage an increase in the quality of Dominica's bananas. While good progress has been made on this in recent years, it is clear that producers must continue to work for further quality improvement to help their competitive position. In this respect, some of the recent measures adopted by the Dominica Banana Marketing Corporation outlined in the background paper, especially changes in packaging to avoid damage caused by loosely packed boxes, are helpful. I welcome the fact that the Banana Marketing Corporation is now charging growers more fully for its services. Indeed, this chair has in the past called for such measures. However, I understand that there effectively remains a subsidy on banana production, and this should be eliminated. Indeed, now that the uncertainties with regard to the EC have been resolved, it would appear possible for the public sector to divest itself of this function altogether, and I wonder whether this is being considered.

Regardless of the trade regime for bananas, export diversification is clearly desirable. One possibility would appear to be to export empty boxes, as well as boxes filled with bananas. Could the staff please say a little more about the prospects for diversification? Other people could put other things in those boxes.

Of course, the greatest help that the Government can provide would be by limiting its demands on commercial bank borrowing and creating a stable and noninflationary environment to promote a favorable business climate. With monetary policy effectively exogenous, overall economic viability crucially depends on keeping a tight rein on the fiscal stance.

While more recent fiscal developments and projections through 1993-94 show an improving trend, particularly with regard to the proportion of the overall balance that is financed from domestic borrowing, the need to finance significant infrastructure repairs and new investment means that, even with the proposed measures to increase public sector savings, there are identifiable gaps in public finances. Greater efforts need to be made to rationalize current expenditure. This seems to have been a Pandora's box for Dominica in the past, in the sense that better revenue performance has tended to leak into high wage growth.

I agree with the staff on the need to examine ways of rationalizing public sector employment and keeping wage growth firmly in check. This is particularly necessary when the real effective exchange rate appreciates--as has been the case during the past 12 months--as the EC dollar appreciated against the currency of its major export market, that is, sterling.

At the previous discussion, this chair raised the possibility of introducing more indirect taxes and, in particular, the feasibility and desirability of introducing a value-added tax to boost revenues. Has this or some other form of tax on expenditure been taken any further?

Finally, on a more parochial matter, responsibility for work on the Caribbean countries in general, and members of the Eastern Caribbean Bank in particular, is now spread among a number of divisions of the Western Hemisphere Department. I obviously do not wish to express a view of the general desirability of this, but I am concerned that there must be a risk of less cohesion in the advice the Fund gives in this area. Perhaps the staff could reassure me, for example, that there has been close cooperation with regard to the effects of the new banana policy and will continue to be in other areas.

Mr. Bindley-Taylor made the following statement:

The Dominica economy, after growing at an average annual rate of around 5 percent, has recently shown signs of slowing down considerably, with the rate of real GDP growing by a little over 2 percent in 1991 and 1992. The possibility of improving growth performance through the revival of public and private sector investment is constrained by the impact such activity would have on the already weakened fiscal position, on the one hand, and by supply bottlenecks in the private sector on the other.

The deterioration of the overall balance of the public sector can be traced to the rapid rise in capital expenditure, even as current revenue and foreign grants, as a percent of GDP, were declining. The growing overall deficit position was financed largely by increased levels of both concessionary foreign financing and domestic financing.

Clearly, any effort to increase the rate of real GDP growth would require an additional effort to raise savings. We welcome the measures that the authorities have taken to increase public sector savings in 1992 as well as the other pending fiscal measures, such as the withdrawal of exemptions from payment of import duties and a more rigorous approach to expenditure control and the filling of vacancies. This notwithstanding, substantial unfinanced gaps are identified in this fiscal year and beyond. Deferring capital expenditure to solve this problem is at best temporary and at worst self-defeating.

We would urge the authorities to seek additional avenues for raising revenue and reducing expenditure. Tax administration may be an area that can be strengthened, and further reductions in the number of enterprises exempted from import duties could be implemented. We can endorse Mr. Dorrington's suggestion on the possibility of introducing a value-added tax. In the rest of the public sector, adjusting procurement prices to export prices would reduce the deficit of the Banana Marketing Corporation. In the overall public sector, we note that wages represent almost 40 percent of total expenditure and that negotiations for the period 1991-1994 are ongoing. In this context, we wonder to what extent the authorities may have some political leeway to balance pay increases against staff reductions in the public sector. We believe that this may be necessary, as we are uncertain about the authorities' assumption that they will be able to limit public sector wage increases to an average of 1 percent per year. Our uncertainty is strengthened by the 1991 legislation on the arbitration of wage disputes. We note that experience with such arbitration laws in some countries has led to binding wage awards that can have disastrous consequences for fiscal policy.

In the monetary sector, it is critical that public sector borrowing be reduced if the external reserve position is to be strengthened further. In passing, we note in the banking system certain oligopolistic tendencies that allow the banks to reduce interest rates on deposits, while maintaining lending rates, thereby allowing banks to enjoy a large financial spread in a captive market. We would like to know from the staff whether there are any barriers to other domestic or foreign banking institutions entering the banking system.

In the medium term, the issue of preferential treatment for bananas continues to be unresolved. The newly approved framework of the EEC Agricultural Council on banana imports, which is due to become effective on July 1, 1993, may now be derailed owing to actions by other members of the Community. Perhaps the staff can update us on the latest position on this issue. In any event, even if the arrangement were put in place as scheduled, it is intended to be transitional and to be phased out by the year 2000.

In short, Dominica, which has enjoyed the advantage of selling bananas in a closed market, must now find a way to be competitive in an open market system. Its major advantage is that it is a small producer with an already established market; its disadvantages lie in the quality of the product and the cost of production. It is in these two areas that efforts must be made if the major export is to survive in the near future, and we welcome the authorities' efforts to enhance productivity and improve storage and handling facilities.

A recurring question in small open economies such as Dominica is that of diversification. In reality, the opportunities for diversification are limited by physical space, technical skills, and the natural resource base. In essence, there seem to be really two major areas open to diversification. The first is agricultural production, excluding bananas. The market for fresh vegetables and certain tropical fruits already exists. The problem is to overcome the internal constraints that affect production volume, marketing arrangements, labor shortages, and transportation. A second opportunity seems to exist in the area of ecotourism.

In conclusion, the Dominican authorities have generally followed a path of sound macroeconomic management. At present, they must address the need to improve growth and investment while increasing domestic saving and promoting diversification. This is no easy task, but the authorities' track record indicates that they will most certainly rise to the challenge.

Mr. Matthews made the following statement:

On the face of it, the improvement in the overall balance of the public sector in 1991/92 was quite impressive. However, this improvement came about almost exclusively from a reduction in capital expenditure. Current expenditure remained at the high level recorded in the previous year, and government revenue rose only modestly. This situation does not appear to be sustainable over the medium term, because, as the staff quite rightly points out, substantial investment in infrastructure will be required to meet the authorities' growth objective. In this regard, I would appreciate some advice from the staff on what it sees as the priority areas for investment in the period ahead.

The package of fiscal measures planned by the authorities for this year goes some way in addressing this problem, but substantial external financing requirements for the next several years will remain even if this is fully implemented. While I agree that capital expenditure will need to be contained by the authorities such that domestic financing of the budget deficit is obviated, they should also strive to introduce additional fiscal measures to make room for the much-needed investment expenditure. The case for additional fiscal measures is particularly strong when one considers the uncertain outlook for external financing over the next several years. Most of the additional measures suggested by the staff appear to be worthy of further consideration by the authorities, although I am unsure of the necessity of increasing user charges for education and health; perhaps the staff could provide some details on what it has in mind here.

The staff appears not to favor external financing of infrastructure spending at other than concessional rates of interest, but in cases in which the rate of return on investment is sufficiently high, market-based financing may be entirely appropriate. Of course, the susceptibility of Dominica to external shocks, both natural and man-made, argues for maintaining a low debt-service ratio, but this ratio is currently very low.

Monetary policy in Dominica is essentially governed by the fixed exchange rate regime and conservative operations of the Eastern Caribbean Central Bank. To date, these arrangements appear to have provided a reasonable degree of stability in monetary conditions. However, the real effective exchange rate has been on an upward trend over the past few years, stemming in part from excess demand in the food and housing markets. These developments underscore the need to improve the supply performance of the economy--for example, through enhanced public investment in infrastructure--to provide the foundations for sustainably strong economic growth.

Improving the supply performance of the economy will be particularly important if production of the primary cash crop in Dominica is to become world competitive. Like many countries in this part of the world, banana production in Dominica represents a good example of the inefficiencies that develop when production techniques develop behind a wall of protectionism. We can hardly blame the Dominicans for this; they have been effectively boxed into producing according to the price and demand signals that they face. Nevertheless, it is clear that many improvements will need to be made if the viability of this important industry is to extend past the point at which preferential importing rights are reduced and eventually eliminated. The changes required will need to be wide-ranging and far-reaching and to include increasing the average acreage of plantations, improving yields and quality, and enhancing the effectiveness of transportation, boxing, and marketing.

In this regard, the improvements made in the boxing and handling process to reduce fruit degradation, and the expected increase in investment in field maintenance and production infrastructure are welcome. It will be important, however, to ensure that this increased investment is not solely in response to assistance from the Banana Marketing Corporation. It would not be desirable for the implicit subsidies provided at the moment by the United Kingdom--or should I say, the EC--to be simply replaced by subsidies within Dominica. Not only would this encourage the continuation of inefficient production techniques, but it would also place a direct and unproductive financial burden on the country.

Diversification of the productive base of the economy will need to be another component of the strategy to deal with lower banana exports. In this area, recent developments are encouraging, particularly as far as the rapid increase in tourism is concerned. Even though much of the recent increase in tourist numbers has been from cruise visitors, who typically only spend a short time in the country, total tourism expenditure has increased by over 60 per cent in the past three years. While Dominica may not be endowed with the same pure-white beaches as some of its neighbors, it does possess lush tropical rainforests and a natural beauty that would appeal to many tourists. Continued development of this industry, together with a focus on other areas of comparative advantage, particularly in tropical fruit production, would help to provide a sound foundation for the economy and increase confidence at a time when the future of the market for Dominica's primary cash crop is being determined by a boxing match within the EC.

Mr. Abbott made the following statement:

As a small, open economy, with a narrow resource base and a fixed exchange rate, Dominica is highly vulnerable to external shocks, but its policy choices are rather limited. Policy constraints are not necessarily a bad thing, however, as long as the shocks are not too great, domestic policies--notably fiscal policy--remain on an even keel, and domestic cost pressures are kept boxed in.

This being said, the weakening of the Government's fiscal position in recent years, owing to the generous public sector wage settlement in 1990 and the boom in capital expenditure, gives cause for concern. Although the situation seems to have improved somewhat with the winding down of some capital investment, the uncertain outlook for the 1991-94 wage deal and the likelihood of lower external assistance in future years suggest that further efforts are needed to put government finances back on a sound footing.

Reaching agreement on a moderate wage settlement appears to be one of the most pressing domestic issues, given its potential impact on government financing needs, domestic inflation, export competitiveness, and direct foreign investment. The Government's projections of a 1 percent per annum increase in public sector wages in 1991-1994 contrast sharply with the union demands for 10 percent pay raises annually over the period. This suggests that the authorities may need to get up on the soap box, if necessary, to convince the public of the importance of wage moderation and the direct effect that immoderate wage increases can be expected to have on the country's economic health and future employment.

Another area that we believe bears particular attention is the Government's support to the banana sector. It may be argued that the large deterioration in the financial position of the Banana Marketing Corporation was largely due to the exceptional rehabilitation costs following Hurricane Hugo. However, if the experience of other countries is any guide, the authorities' failure to adjust procurement prices downward, in line with international prices, threatens to open a Pandora's box of fiscal strain and inflationary pressure.

If prices for Dominica's bananas are likely to decline, as Appendix I of the background paper suggests if the new EC marketing arrangements are implemented as envisioned, then this is all the more reason why the authorities need to ensure that price declines are automatically passed through, lest producer prices become viewed as inviolable and government losses mount. In any event, smaller, more frequent producer price reductions are probably easier to implement than large, infrequent ones.

We read with interest the background paper's description on page 10 of the Banana Marketing Corporation's new systems for charging producers for banana boxes to reduce wasteful box usage and packing boxes more densely to reduce the damage to fruit arising from loosely packed boxes. We welcome these efforts to containerize the costs and boost the marketability of Dominica's main export crop. However, we urge the authorities to recover from beneficiaries the cost of these and any other initiatives, such as the provision of ice boxes on neighboring islands for storage of other perishable fruits bound for foreign markets.

The authorities appear to believe that there is considerable scope to boost tourism receipts, notwithstanding the reported dearth of attractive beaches. It would be interesting to hear from the staff what Dominica sees as its niche in the Caribbean tourism market. We understand that Dominica is still relatively unspoiled by some of the boxy hotel construction that litters some other vacation destinations in the region. Indeed, there have been some reports that Dominica has potential as a destination for "ecotourists." If so, is this consistent with the island's recent construction boom and plans for further hotel construction?

Dominica has done well, so far, in keeping most of its external debt on highly concessional terms and its debt-service burden at a manageable level, and we hope that it will continue to manage its external debt prudently.

The staff representative from the Western Hemisphere Department noted that, with respect to export diversification, the authorities recognized the problems associated with dependence on bananas. Already they had made investments to improve transport arrangements and provide cold storage, and intended to set up facilities for sorting, grading, and packaging nontraditional agricultural products. The authorities expected that those actions would increase the profitability of, and encourage diversification into, nontraditional agricultural exports.

As to the consistency of the advice that was being given to the different Caribbean islands following the reorganization of the Western Hemisphere Department, there was considerable coordination between the different divisions that had operational responsibilities for those countries, the staff representative commented. Moreover, the Department's Front Office maintained close supervision over the briefing papers and reports.

The staff had discussed with the authorities the structure of the tax system, the staff representative continued. The authorities felt--and the staff tended to support them--that because the tax in Dominica was on the high end of the scale for the Caribbean region, it would not be wise to introduce new taxes, such as a value-added tax, and that efforts should focus on curbing current expenditures further. The staff had recommended the introduction of charges on education and health, which it regarded as an expenditure-reducing measure, and had not pressed the authorities to introduce new taxes. However, as the staff report indicated, there would be tax changes as a result of the adoption of the Caribbean market's common external tariff. The authorities had indicated that they would compensate for the expected reduction in import duties under the common tariff by increasing domestic consumption taxes. However, the staff estimated that the net change in the tax effort would be minimal.

The current education and health systems in Dominica were provided essentially free of charge, the staff representative elaborated. Students paid only minimal charges for their books and school uniforms. There were flat charges for such health services as hospitalization, tests, physician visits, and those charges were minimal. For example, a hospital stay was EC$5 per day for a bed. As Mr. Murphy had indicated in his statement, the authorities agree that there is a need to increase the charges. The staff did not offer a specific recommendation on the level of charges. However, in light of the extremely low level of charges at present, there would seem to be significant scope for adjustments that would reduce the current transfers to the school system and hospitals.

With regard to the authorities' proposal of raising wages by 1 percent a year against the union demands of 10 percent a year, some of the unions appear to appreciate the difficult fiscal position that the Government is in, but the main unions do not, the staff representative said. The Government hoped to obtain general consent to its proposals by implementing a wage increase in conjunction with regarding civil service salaries. The regrading exercise had been under preparation for many years, and there would be significant increases in the grades of some employees. The Government was hopeful that the unions could be convinced that a small wage increase effected in conjunction with regrading would be an acceptable substitute for an across-the-board large wage increase.

There appeared to be no barriers to entry into the banking system, the staff representative noted. Despite the large spreads between the lending and deposit interest rates, the staff's experience in the Caribbean area was that several foreign banks had found the profits unattractive and had left, which indicated that they did not regard the spreads as being very significant.

A number of South American banana producers were holding discussions with the EC on the proposed quotas on imports, which they regarded as detrimental to their interests, the staff representative remarked. The staff could not predict the outcome of the discussions, but the indications were that the quotas would become effective on July 1, 1993. A more serious threat to the implementation of the quotas was posed by the objections made by some German importers of bananas who were threatening to sue or who might have already presented a case to the European Court of Justice claiming that the new system was not justified under the Community agreements.

The staff and the authorities agreed that Dominica's main investment priority should be infrastructure, the staff representative continued. There was a need to renew investment in electricity generation. Large investments had been made over the past four years, but consumption had grown more than had been expected. If the new hotels currently under construction were to operate effectively, they would need to be assured of a reliable electricity supply. Also, a major investment was required in the water system, parts of which were so old that they could not guarantee water delivery. Furthermore, to improve profitability in the agricultural sector, investment in roads and agricultural was needed.

Generally, in May of each year, the authorities increased the banana prices for the summer season, as prices were higher in Europe during the summer, the staff representative remarked. However, for the present year, they had deferred the increase, because of the weak financial position of the Banana Marketing Corporation. That deferment had generated considerable resentment among farmers. Nevertheless, the authorities had stuck to their decision not to increase the seasonal price.

Given the attractive mountain ranges, lakes, and scenery in Dominica, there were good prospects for growth in the ecotourism industry, the staff representative from the Western Department noted. There were also good prospects for diving. The diving shelf off the Dominican coast was deep, and the diving business had grown well in the past four years.

Mr. Jiménez de Lucio made the following statement:

We are in broad agreement with the staff's appraisal; therefore, we will limit our intervention to a few comments on aspects of the report that deserve emphasis. Dominica's economic performance deteriorated in 1991/1992. Growth of real GDP declined, unemployment rose, and inflation increased. More important, public finances weakened during the period. The authorities intend to reverse this trend and aim at a real GDP growth level of 3.5 percent to 4 percent a year in 1993-95, an outcome that would require substantial investment in infrastructure. Under current conditions, the staff considers that additional savings in the amount of 5.5 percent of GDP a year are necessary to implement the public investment program without recourse to domestic bank credit. In other words, the investment program for the next three years is deemed inconsistent with the current structure of public finances.

The report states that the authorities would address the problem by deferring planned capital expenditures. This alternative would probably seem attractive in the short term; however, it would adversely affect Dominica's development over the medium term, as the country would become less attractive to private investors. In particular, the prospects for diversifying the production and export base would become less favorable. Consideration should be given instead to implementing some of the staff's suggestions for increasing public sector savings.

Mr. Galicia made the following statement:

The economic performance of Dominica was less favorable during 1991 and 1992 than in previous years. At the time of the previous Article IV consultation, the authorities envisaged real GDP growth for 1992 of close to 4 percent, a figure in line with the average of the period 1986-90. Contrary to expectations, the growth of real GDP declined to about 2.1 percent in 1991/92. These results coincide with the completion of major public investment projects, suggesting, in a way, that the engine of the economy is notably the public sector.

In this context, it is very important to promote private investment more aggressively and diversify exports as soon as possible, advice that has been reiterated on many occasions. These two goals could be probably attacked at the same time.

Owing to the current restrictions on the private sector, we concur with the staff that to get GDP growth to recover to about 3.5-4 percent a year in the medium term would require substantial further investment in infrastructure, financed with public sector savings equivalent to at least 4 percent of GDP a year over the medium term.

The measures outlined by the authorities and the suggestions by the staff to raise public sector savings seem reasonable. However, as to the suggestion of introducing a fee to partially recover the costs of education, we concur with the authorities that, if there is a strong need to implement a fee like the one suggested, the public should be sensitized before any action is taken.

The present situation of Dominica is very peculiar, basically because government spending is a strong complement of the private sector. At this moment, owing to the small size of the economy, it is up to the Government to foster growth by investing in infrastructure and to promote private sector activity. What concerns us is that, although the Government is well aware of this vital task, the investment program beyond the 1992/93 fiscal year is not adequately developed, as the World Bank staff has suggested. We would like to urge the Dominican authorities to reconsider their investment program and put greater emphasis on the repair and maintenance of existing infrastructure, as the World Bank staff has further suggested. When available resources are not abundant, there is more reason to use them efficiently.

As to the limited availability of credit, we share the concerns of the authorities, even though they only emphasize credit availability for housing. We would like to know whether the staff has taken into account this situation and could present the views of the Eastern Caribbean Central Bank in this respect. A private investment program, particularly one focused on micro and small enterprises, could be appropriate for Dominica in the near future. Some comments from the staff on that subject would be welcome.

To conclude, we would like to encourage Dominica's authorities to persevere in their adjustment efforts and to improve their investment program. They now face the task of fostering a long-term development strategy.

Mr. Link made the following statement:

Dominica is subject to extraordinary natural hazards, as demonstrated by the damages caused by Hurricane Hugo in 1989. Its economy has to periodically bear the costs of reconstruction, resulting in additional risks for investment and economic development. It is heavily dependent on one major export crop.

Sluggish banana production reflects Dominica's difficult international competitiveness for this product, which is compounded by reduced investment in the sector, partly as a consequence of the uncertainties about continuing preferential access to the markets of the European Community.

However, there are bright spots, such as the development of tourism, since 1990 in particular. Furthermore, Dominica's participation in the Eastern Caribbean Currency Union provides it with monetary stability and a predictable external framework for foreign investment. In this respect, there remains, however, some scope for streamlining the internal regulatory environment.

It is encouraging to note the Government's awareness of the problems it faces. I endorse the strategy to achieve economic growth by giving priority to public investment in agriculture, transportation, and handling, in order to improve the base for private investment and economic diversification, as well as confront rampant unemployment. I fully share the Government's trust in relying less on scarce international financing at concessional terms in the future, and more on higher public savings. However, I have some doubts about the Government's ability to fine-tune public investment expenditure according to the financial means at hand. I would like to add that the authorities should put enough emphasis on the repair and maintenance of the existing infrastructure.

The staff report identifies the necessary steps to increase the public resource base; full cost recovery on public services, an increase in charges for health and education, the avoidance of expenditure slippages in the agriculture sector, a rigorous wage stance, and reform measures with regard to tariffs should be pursued in order to reach the objectives. In my view, the economic success of an open small economy like the one of Dominica will depend mainly on the discipline that the private and public sectors manage to maintain on wage developments.

With the expected decrease in foreign assistance, I would encourage the Fund, together with the World Bank, to closely monitor possible unattended needs for technical assistance.

Mr. Havrylyshyn made the following statement:

At our February 1992 discussion on Dominica, we noted this country's need to diversify, make more competitive its output and exports base, and take some measures toward fiscal consolidation.

From the staff report, it appears that the authorities have indeed taken a number of measures in 1992 in the direction suggested, with some improvement being registered in the financial imbalances faced at the end of 1991. This is gratifying, as is the fact that further measures are envisaged by the authorities. However, as noted in the staff report, the imbalances in the medium term, even if reduced by the measures proposed by the authorities, are still relatively large, and the recommendations by the staff for additional measures should be seriously considered. In addition to this general comment, let me make a few small points.

First, I am a little skeptical as to whether the projected level of growth of real GDP is going to be achieved in the medium term. In this respect, I note that, despite an 8.0 percent increase in banana production, a 29.0 percent increase in tourism, and a 2.7 percent increase in manufacturing, GDP grew by only 2.1 percent in 1992. Over the medium term, a 3.5 percent yearly increase is expected based on banana output, with tourism growing by only 4.0 percent per annum and manufacturing by 5.0 percent annually.

Second, I am a little surprised at the relatively small growth of 4.0 percent projected by the staff for banana production. I would have expected more, given that the EEC clarification on the preferential treatment of banana imports would suggest that Dominica's quota would permit it more growth in this period. On the whole matter of quotas, I regret their existence at all, as they box in global trade. Indeed, proclivities to quotas are so strong, I worry that, if Mr. Dorrington's suggestion about exporting empty boxes is followed, the surge of imports of empty boxes from Dominica into the EC would call forth a new system of quotas and frustrate diversification.

Third, while the staff has noted the importance of restraining wage increases in the public sector, its report is rather limited in dealing with the recent faster growth of private sector wages, which are expected to increase at rates well in excess of the growth of GDP in the medium term. Does the staff consider that these higher increases in the private sector are justified? If so, why? If not, what can the staff tell us with respect to government policies to encourage restraint in the private sector, too!

Finally, I notice that property taxation is almost nonexistent in Dominica. Although I appreciate the Government's belief that promoting house ownership and mortgage obligations induces regular work attitudes, I wonder whether property taxes might not be a source for increasing government revenues, in addition to that suggested by staff of partial recovery of health and education services. As a property tax could be structured to catch the wealthier propertied groups of the population, it would also have a beneficial distributional effect.

Mr. Moss made the following statement:

As I am in broad agreement with the thrust of the staff appraisal and having heard the comments of the lead speakers, I can limit myself to one question, not unrelated to an issue just raised by Mr. Havrylyshyn. In view of Dominica's history of labor disputes on the one hand, its objective of achieving a high rate of output growth and, hence, an increasing demand for labor on the other hand, I would like to obtain from the staff some clarification on the labor market issue, an area for which, admittedly, few reliable data are available.

The staff report seems to convey the message that wage increases and tight labor market conditions in Dominica over the past two years have gone hand in hand with an increase in unemployment. The background paper, on the contrary, provides indications that, in real terms, wage growth has fallen back to zero, after having displayed a 2 percent annual growth rate in the second half of the 1980s. Hence, wage developments do seem to have responded to the economic slowdown of the 1990s in Dominica. Could the staff elaborate on which of these two seemingly contradictory assessments is the more relevant one?

The staff representative from the Western Hemisphere Department said that the main problem at the current stage in Dominica's development was the ability to finance the required public investment; a number of speakers had emphasized that point. The authorities had taken the position that, in the event of difficulties in financing, they would defer public investment. The staff had recommended not to delay investment since that may jeopardize future growth prospects.

A growth rate of 3 1/2 percent of GDP growth was feasible in the medium term and was not inconsistent with the low rate of growth that was assumed for banana production, the staff representative added. The rate of overall growth was based on a pickup in manufacturing and construction; if the expected investment in hotel construction and public infrastructure takes place, a considerable pickup in construction would be expected.

As the staff report noted, banana production, even at the highest level the staff envisaged--68,000 tons by 1995--would still be below the historic peak achieved in 1988 before Hurricane Hugo, the staff representative observed. One explanation was that, in order to raise productivity, some of the banana-growing areas were being taken out of production in preparation for replanting. That effort may slow the growth of production over the near term, but provided a better basis for subsequent growth.

Wage settlements in the private sector had resulted in large annual increases, the staff representative noted. However, the public sector could only hope to set an example by the increases that were offered in the public sector. The private labor market was quite open, and the staff did not consider that the Government should impose any restrictions on private wage agreements.

Currently, the yield from property taxes was very low, the staff representative observed. If collections from such taxes were to be increased, on grounds of achieving greater efficiency, that would have to be balanced by reductions in other taxes in order to maintain an overall tax burden at a comparable level with the other islands and not impede flows of external investment. Foreign external investment was critical for Dominica. That was why the authorities had little leeway in deviating in their overall tax effort from that of the neighboring islands.

Taking into account the higher inflation rates of the past two years, real wages had hardly changed, the staff representative remarked. Some decline should have been expected, given the pressures in the labor market. The weak activity in the economy and the rise of unemployment should probably have led to a slowdown in nominal increases and a decline in real terms.

There were limited possibilities for the authorities to obtain medium-term financing, the staff representative from the Western Hemisphere Department said. They had preferred to rely on the domestic commercial banks. As to making the legal system more conducive to banks' extending medium-term lending, the public sector bank--the Agricultural Industrial Development Bank--did engage in some medium-term lending to small craftsmen and farmers, but the resources of that bank came almost entirely from external donors. It would place an extra burden on the public sector to divert government resources to augment the resources of that institution to permit it to increase its medium-term lending activities.

Mr. Murphy noted that speakers had emphasized the need to re-examine the investment program and the manner in which it should be prioritized and financed. Emphasis had been placed also on the future role of the Marketing Board and on ensuring that it did not become a substitute for other forms of subsidy within the agricultural sector.

Novel points made by Directors, including a proposal to develop packaging as an industry, the coordination of work on Caribbean economies within the Fund, new forms of taxation, and an examination of oligopolies in the banking sector, would be passed on to his authorities, Mr. Murphy said.

The Acting Chairman made the following summing up:

> Directors endorsed the thrust of the appraisal contained in the staff report. They noted the slow growth of the economy in 1991 and 1992 and the weakness of the public finances after several years of high growth of output and substantial public

sector savings. Directors encouraged the authorities not to delay the adoption of measures to strengthen the public finances.

Directors were of the view that, in order to raise the growth of output, a strengthening of domestic savings was required, inasmuch as the availability of concessionary external financing was likely to be lower over the medium term than it had been in recent years. They took the position that deferment of public investment plans in response to insufficient foreign financing could only be a temporary expedient and may undermine the achievement of Dominica's growth objectives. Thus, Directors stressed the need to increase public savings so as to avoid recourse to domestic bank credit, and to use these scarce resources carefully for well-selected investments in infrastructure.

To increase public sector savings, Directors emphasized the critical importance of wage restraint. They also suggested raising tariffs for public utilities and services and possibly other taxes, including property taxes, and they recommended trimming employment in the civil service, curbing expenditures of the Banana Marketing Corporation, strengthening tax administration, and abolishing tax exemptions.

Directors noted that the new banana export regime to the European Community would become effective in July 1993, and that this underscored the need to improve the quality of banana exports and, also, the need to broaden Dominica's narrow production and export base to increase reliance on other agriculture and tourism. Directors encouraged the pass-through of international price changes in the banana sector and cautioned that the Government should not use other means, such as the Marketing Board, to subsidize banana production.

Directors emphasized the importance of attracting foreign private investment in Dominica and considered that this would contribute to the needed diversification of the economy. They noted the helpful role played by Dominica's stable political conditions but they added that strong macroeconomic policies and simplification of procedures for approving applications would assist in increasing foreign investments.

Directors were of the view that Dominica's membership in the Eastern Caribbean Currency Union and the pegging of the Eastern Caribbean dollar to the U.S. dollar had served the country well. However, noting the upward trend in the nominal effective exchange rate in recent years, they stressed the importance of wage moderation in all sectors of the economy for improving external competitiveness.

It is expected that the next Article IV consultation with Dominica will be held on the standard 12-month cycle.

APPROVED: February 14, 1994

LEO VAN HOUTVEN
Secretary