FOR AGENDA

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November 16, 1989

To: Members of the Executive Board

From: The Secretary

Subject: International Capital Markets - Developments and Prospects, 1989

Attached for consideration by the Executive Directors is a report on developments and prospects in international capital markets, which is scheduled for discussion on Monday, December 11, 1989. Issues for discussion appear on page 26. The papers "International Capital Markets - Developments and Prospects, 1989 - Background Material" (SM/89/207, 10/12/89), "Capital Market Financing for Developing Countries - Recent Developments" (SM/89/160, 8/3/89), "International Banking Activity in the First Half of 1989" (forthcoming), and "Systemic Financial Risk in Payments Systems" (forthcoming), will provide background information for the discussion.

As in previous years, it is planned that this report and the related background papers will form the basis for publication in the Fund's World Economic and Financial Surveys series. The revised text will reflect Executive Directors' comments and delete certain sensitive material.

Mr. Allen (ext. 8381) or Mr. Collyns (ext. 7359) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

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INTERNATIONAL MONETARY FUND

International Capital Markets, Developments and Prospects, 1989

Prepared by the Exchange and Trade Relations Department

(In consultation with the Research Department)

Approved by L.A. Whittome

November 15, 1989

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I. Introduction

This paper presents the annual survey of international capital market developments and prospects. 1/ Section II of the paper reviews recent capital market trends, putting them into the context of capital account flows. Section III discusses three of the main determinants of capital market developments: the progressive integration of markets, related trends towards the globalization of investor behavior, and the influence of taxes. Section IV considers some policy issues emerging from the above, including the promotion of an efficient and stable system of international capital markets, the process of trade liberalization in the financial services sector, and the relationship of developing countries to the system. The paper concludes with some possible issues for discussion by Executive Directors.

II. Recent International Capital Market Developments

1. Overview

Developments in international capital markets in 1988 and the first part of 1989 included both a recovery from the relatively low levels of activity in some markets following the October 1987 equity market break and the continued process of integration of major capital markets which has been underway for the past decade. Net international bond issues in 1988 increased to US$145 billion from US$105 billion in 1987 but were still below their peak level of US$163 billion in 1986. The net increase in cross-border portfolio holdings of equity also rebounded strongly from US$4 billion in 1987 to US$21 billion in 1988, although still below the record US$32 billion registered in 1986. Cross-border bank lending, which had rapidly expanded in 1987, slowed in 1988 but recovered during the first quarter of 1989, particularly in the interbank market, although there are signs of renewed weakness in the second quarter.

1/ The paper reflects discussions held by a staff team with international institutions, national authorities, and market participants in Belgium, Canada, France, Germany, Japan, the Netherlands, Switzerland, the United Kingdom and the United States in May and June 1989. The background documents to the present paper are "International Capital Markets, Developments and Prospects, 1989 - Background Information" (SM/89/207), "Capital Market Financing for Developing Countries, Recent Developments" (SM/89/160), "Capital Market Financing for Developing Countries--Market Views" (SM/89/159), and "Systemic Financial Risk in Payments Systems" (forthcoming). See also "International Banking Activity in the First Half of 1989" (forthcoming). The papers, "International Coordination of Tax Policies: Some Issues" (SM/89/212) and "Tax Harmonization in the European Community" (SM/89/211) are also relevant to the discussion.

The trend toward international diversification of investment portfolios and increased integration across national boundaries, continued apace over the past year, with the latter perhaps most visibly reflected in the steps being taken toward the establishment of a single European market. The past year also offered interesting evidence of rapid investor responsiveness to changed parameters, such as modification in taxation practices.

2. The macroeconomic background 1/

a. Economic indicators

Activity in international capital markets during 1988 reflected a continued strong economic expansion in most industrial countries, a high global level of investment activity, an increase in the volume of world trade, and an environment of relatively stable exchange rates and moderate inflation.

The broad exchange market stability of 1988, which reflected in part the resolve of the G-7 authorities to stabilize exchange rates in the wake of the Plaza agreement, meant that nominal interest rate differentials had a greater influence than in 1987 in determining the currency composition of financial market instruments. However, as a result of the sustained rise in the U.S. dollar during 1989, uncertainty regarding exchange rate developments has become again a major factor in capital market decisions. With the parities of the EMS currencies unchanged since January 1987, the flow of capital during the year from the surplus to the deficit countries within the system promoted a convergence of EMS interest rates.

In response to concerns about underlying price pressures, the stance of monetary policy in major industrial countries was tightened during 1988 and early 1989, and this was reflected in a widespread increase in short-term interest rates. However, longer-term interest rates have generally remained stable and yield curves have consequently flattened or even inverted, which could be attributed in part to market participants having more confidence in the authorities' longer-run determination to control inflation. During 1988, interest rate differentials gradually widened in favor of the U.S. dollar, in particular in terms of the Japanese yen, and this contributed to the strengthening of the U.S. dollar. From the second quarter of 1989, there have been some reductions in U.S. interest rates, but interest rates have been increased in the major partner countries.

1/ A more detailed discussion of the topics in this section is found in the latest World Economic Outlook and in SM/89/207, the background paper to this report.

b. Balance of payments context

The sum of the external current accounts of industrial countries in balance of payments deficit, an indicator of the required net movement of capital through the system, increased somewhat from US$183 billion in 1987 to US$199 billion in 1988, and is projected to increase further to US$223 billion in 1989. 1/ These deficits, of which in 1988 three quarters were accounted for by the United States and the United Kingdom, represent over three-fourths of the sum of current account deficits in the world.

During 1988 there were some changes in the sizes of current account imbalances of the major industrial countries, although, apart from the emergence of a large deficit in the United Kingdom, the broad pattern was not fundamentally altered (see Table). The current account deficit of the United States was reduced by about US$16 billion to US$127 billion and Japan's surplus was also reduced, by about US$7 billion to US$80 billion. However, the German surplus increased by US$3 billion to about US$49 billion and the deficit in the United Kingdom widened by about US$22 billion to US$27 billion.

The composition of the financing of these current account imbalances changed significantly in 1988 and the first half of 1989. While in 1987 large scale intervention by central banks in currency markets had played a major role in financing current account imbalances, during 1988 there was a substantial return to autonomous financing through the capital account, associated with the relative stability of exchange rates among the major currencies. An exception to this change was Germany, where outflows through the capital account, particularly through bond markets, rose sharply, causing such pressure on the deutsche mark that the reserve accumulation of some US$19 billion in 1987 was replaced by net reserve use of US$15 billion in 1988. For the major industrial countries as a group, the reduced role of financing through official reserves continued in the first half of 1989, but the large amount of intervention in the third quarter may change the picture for the year as a whole.

The return to financing through autonomous capital account flows in 1988 was embodied in strong increases in net direct investment and net financing through international bond markets. By contrast, financing through equity markets (a concept that includes cross-border trading in equity claims on a third-country resident) played less of a role than in the past, and so did net lending through the banking system, except in the case of the United Kingdom.

1/ In view of the persistence of the world current account imbalance, caution is needed in interpreting these figures.

Table. United States, Japan, Germany, United Kingdom: Capital Accounts, 1987-88

(In billions of U.S. dollars)

		1987				1988			
		United States	Japan	Germany	United Kingdom	United States	Japan	Germany	United Kingdom
1.	Current account	-142.3	86.9	45.4	-4.8	-126.9	79.6	48.5	-26.6
2.	Net direct investments	2.7	-18.2	-7.2	-17.4	40.9	-34.7	-8.7	-13.1
3.	Financing need (1+2)	-140.6	68.7	38.2	-22.2	-86.0	44.9	39.8	-39.7
4.	Change in official reserves	9.0	-38.0	-21.3	-19.9	-4.2	-16.5	15.6	-4.9
5.	Acquisition of liabilities by foreign monetary authorities	34.0	--	2.8	23.3	24.1	--	-0.6	7.1
6.	Residual financing need (3-4-5)	-97.6	30.7	19.7	-18.8	-66.1	28.4	54.8	-37.5
Financing									
7.	Portfolio investments 1/	31.7	-91.6	-2.3	16.7	40.4	-52.9	-43.6	-12.9
7.a.	Public sector bonds	-2.5	-63.0	11.8	3.1	27.1	-107.0	2.5	0.4
7.a.1	Assets	(--)	(-71.9)	(--)	(--)	(--)	(-84.4)	(--)	(--)
7.a.2	Liabilities	(-2.5)	(8.9)	(11.8)	(3.1)	(27.1)	(-22.6)	(2.5)	(-0.4)
7.b	Other bonds	16.1	30.9	-13.0	4.7	14.7	50.7	-39.0	-9.4
7.b.1	Assets	(-7.2)	(--)	(-13.8)	(3.2)	(-6.9)	(--)	(-31.2)	(-10.9)
7.b.2	Liabilities	(23.3)	(30.9)	(0.8)	(1.5)	(21.6)	(50.7)	(-7.8)	(1.5)
7.c	Corporate equities	18.1	-59.5	-1.1	8.9	-1.4	3.5	-7.1	-3.1
7.c.1	Assets	(2.0)	(-16.9)	(-0.1)	(-0.1)	(-0.9)	(-3.1)	(-10.3)	(-7.5)
7.c.2	Liabilities	(16.2)	(-42.5)	(-1.1)	(9.1)	(-0.5)	(6.6)	(3.1)	(4.4)
8.	Deposit money banks 1/	46.8	62.1	-7.6	-18.3	14.6	38.8	-3.4	19.1
8.a.	Long term, net	0.6	-9.8	-1.1	1.8	10.5	-6.1	6.9	1.0
8.b	Short term	46.2	71.9	-6.6	-20.1	4.1	44.9	-10.3	18.1
8.b.1	Assets	(-39.9)	(-107.6)	(-8.7)	(-86.9)	(-56.7)	(-148.5)	(-16.5)	(-37.2)
8.b.2	Liabilities	(86.1)	(179.5)	(2.1)	(66.8)	(60.8)	(193.4)	(6.2)	(55.3)
9.	Other	18.2	2.3	-10.6	0.4	20.8	-7.1	-8.4	6.7
10.	Errors and omissions (6-7-8-9)	0.8	-3.5	0.8	20.0	-9.6	2.8	0.6	24.8

Source: IMF, Balance of Payments Statistics.

1/ Excluding liabilities held by foreign monetary authorities.

The increase of cross-border flows of net direct investment during 1988 was connected in part to the continued high level of mergers and acquisitions and was particularly strong between the United States and Japan. Net inflows into the former, which increased sharply from US$3 billion in 1987 to US$41 billion in 1988, were accompanied by net outflows from the latter, which grew from US$18 billion in 1987 to US$35 billion in 1988. Germany and the United Kingdom also registered net outflows of direct investment in 1988 (US$9 billion and US$13 billion, respectively) but at levels comparable to those in the previous year.

The revival of cross-border financing through bond markets during 1988 was also reflected in large net inflows into the United States and large net outflows from Japan, Germany, and the United Kingdom. While net bond financing flows into the United States rose by US$28 billion, mainly due to larger net purchases by foreigners of U.S. Treasury bonds, net outflows from Japan and Germany increased by US$24 billion and by US$35 billion, respectively. The United Kingdom, for its part, and despite the substantial widening of its current account deficit, shifted from being a net importer of US$8 billion of capital through bond markets in 1987 to a net exporter of US$9 billion in 1988.

Although changes in portfolio investment in corporate equities played less of a role in the financing of current account imbalances during 1988, there were wide swings in these flows, as investors retreated to their home markets following the developments of October 1987. For instance, the United States shifted from being a net importer of US$18 billion of capital through equity markets in 1987 to a net exporter of US$1 billion in 1988. Conversely, Japan shifted from net purchases of US$60 billion of international equity in 1987 to net sales of about US$4 billion in 1988.

According to balance of payments statistics, net inflows through commercial banks in the United States and Japan, which had reached a peak of US$47 billion and US$62 billion, respectively, in 1987, declined substantially in 1988, to US$15 billion and US$39 billion, respectively. And while net outflows from German commercial banks continued in 1988, albeit at a reduced rate compared to 1987, there was a sharp swing in this category of flows in the United Kingdom, as net outflows of US$18 billion in 1987 gave way to net inflows of US$19 billion in 1988. In effect, these latter inflows, together with US$25 billion of other unidentified inflows, provided the bulk of financing for the large current account deficit that emerged in the United Kingdom in 1988.

3. Developments in major market sectors

The decline in cross-border bank lending to industrial countries from US$538 billion in 1987 to US$478 billion in 1988 was concentrated in the interbank market. 1/ Lending to nonbank entities was broadly unchanged, with the share of lending related to mergers and acquisitions increasing significantly and thus compensating for the fact that companies received a greater proportion of their regular finance from the securities markets. The decline in interbank transactions was pronounced and can be attributed to various factors. The new capital adequacy standards gave an incentive to banks to reduce the size of their balance sheets to economize on capital, causing some banks to re-evaluate the profitability of their interbank exposure. With the portfolio adjustments associated with the creation of the Tokyo Offshore Market coming to an end, in 1988, unlike 1987, there was no large flow of funds to that market. The further liberalization of the domestic money market in Japan in November 1988 reduced the need for Japanese banks to fund their operations through the foreign interbank market. The smaller amount of official intervention lowered the need for banks to readjust their positions through interbank activities. Finally, the flat or inverted yield curves reduced incentives to fund medium- and long-term investment through short-term interbank borrowing. Data for the first half of 1989 indicate that a rebound in interbank lending across OECD countries in the first quarter was followed by a marked slowdown in the second.

There was a surge of activity in international bond markets in 1988, with the level of new issue activity of US$227 billion equaling the 1986 peak. This high level of activity continued in early 1989. Net of repurchases, however, the flow of funds through the international bond markets at US$145 billion, although substantially recovered, still remained below the 1986 level of US$163 billion. The revival of activity in bond markets was facilitated by the further expansion of the swaps market, allowing the needs of borrowers and lenders to be more easily matched. The relative stability of exchange rates stimulated growth in fixed-rate bond instruments at the expense of floating-rate paper, and was associated with a shift in investor's preferences towards currencies with high nominal interest rates. Demand was thus strong particularly for U.S. dollar bonds (in fact, net purchases of U.S. Treasury securities by foreigners during the last three quarters of 1988 reached the highest level in recent history), but also for Canadian, Australian, and New Zealand dollar bonds, as well as for higher interest rate currencies in Europe, such as the pound sterling, the French franc and the Danish krone. In the first half of 1989, the appreciation of the U.S. dollar was accompanied by a sharp increase in the share of U.S. dollar-denominated bonds in total gross issues.

1/ Based on revised data continued in "International Banking Activity in the First Half of 1989"; these data cover a broader definition of banks than do the balance of payments statistics.

One important development has been the successful issue by the IBRD of the first global bond. The elimination of capital controls in a number of markets has meant that the borders between the domestic and euromarkets for instruments in those currencies are now blurred, with the continued market segmentation resulting mainly from divergent market traditions and practices. The IBRD global bond represented an experiment to see if these practices could be reconciled and the differences overcome, allowing the borrower simultaneous access to a large pool of investors and, by creating a much more liquid instrument, reducing its borrowing costs. As part of this effort, the Bank also hoped to tap the most liquid market segment in the United States, by being classified along with U.S. government agencies, thus giving it a similar status to that which it has always enjoyed on the Euromarket. 1/ The bond was finally launched simultaneously in Europe and the United States on September 18, 1989. The issue size was US$1.5 billion, the bond was oversubscribed, trading in the secondary market well within the Bank's normal spread.

Equity-linked bonds--primarily used by Japanese corporations as a means of issuing equity without incurring the costs of floating it directly on the Tokyo market--declined from 24 percent of the bond market in 1987 to 18 percent in 1988. However, the recovery of the Tokyo stock market generated further interest in these bonds, and they accounted for no less than 34 percent of the total in the first half of 1989. After expanding very rapidly for some years, cross-border equity flows in 1988 were more subdued than in 1987. However, by early 1989, growth had resumed in this area, as investors have sought to diversify their portfolios, while companies have sought a broader and more liquid market for their stock.

1/ In its effort to tap the Eurobond and Yankee bond market simultaneously, many details had to be solved. One issue was whether the bond should be a registered security (the U.S. practice) or a bearer bond (normal for the Eurobond market). It was decided to make it the former, with the institutional demand for Euromarket paper considered to more than compensate for the loss of that portion of the individual investor market that shies away from registered bonds. The second major issue was to establish some form of link between the Euromarket's Euroclear and Cedel systems and Fedwire to allow the bonds and associated payments to pass freely between Europe and U.S., without investors being subject to excessive delays on the transaction. Thirdly, with different bond marketing practices on the two markets, it was decided to emulate U.S. domestic sales practices by soliciting bids from an issuing group, as has recently been done for some other Eurobond issues, rather than distributing at par through a syndicate as is normal for Eurobonds. Finally, considerable work had to be done to create the legal documentation that accorded with the practices of the two markets and to ensure the bond's tax-free status.

The number of financial futures and options contracts (derivative products) traded internationally and the volume of outstanding open positions has continued to grow rapidly. Apart from foreign exchange contracts, there are now markets in futures and options covering interest rates in most of the major government bond markets, both at the short- and at the long-end of the maturity spectrum. Contracts on interest rates on private sector instruments have been slower to develop, reflecting the less homogeneous nature of the underlying contracts, but markets for three-month eurodeposits have been established in U.S. dollars, and more recently in the yen and deutsche mark. One interesting development in the past year has been the introduction of "diff" contracts on the future spread of interest rates between different currencies, which allow hedging foreign currency interest exposure at a lower cost than through the simultaneous use of interest rate and exchange rate futures. Only in the area of derivative products based on stock indexes has there been some decline in activity in 1988, following the more subdued stock market sentiment and a decline in the popularity of trading strategies utilizing such instruments.

With the growth in the derivative product markets, there has been an intensification of competitive pressures. Identical or virtually identical contracts are being traded on several different exchanges. In an attempt to gain business, exchanges are extending trading hours to compete with exchanges in different time zones, or making cooperative arrangements with exchanges in other parts of the world to allow contracts to be opened in one market and closed in another, thus enhancing the liquidity of contracts. Automated screen-based trading systems are also being developed with the aim of capturing world-wide business.

4. Transactions with developing countries

As discussed in "Capital Market Financing for Developing Countries - Recent Developments" (SM/89/160, 8/3/89), the participation in international capital markets of developing countries, particularly outside Asia, has been rather limited, and remains well below the levels recorded at the start of the decade. Flows of spontaneous market lending to developing countries as a group (excluding offshore banking centers) has declined sharply, although there has been some increase in bond financing but almost exclusively for countries that have not restructured their debt in recent years. Portfolio equity flows, in particular through investment funds, have also increased, although, as with bond financing, the total remains limited. However, the potential for raising foreign financing through the expansion and further opening of securities markets in developing countries is substantial. 1/

1/ For details see Section VI of the Background Paper (SM/89/207).

III. Factors Underlying Developments

While the previous section discussed recent market developments and their relation to the capital account flows between the major countries, this section considers some of the more fundamental processes that underlie developments. The first process is a deepening of the linkages between the individual markets, thus integrating national economies and providing a deeper market for instruments of different natures and maturities. The second, and related, process is one of globalization, where market participants operate freely in the various segments of the market, treating it as an integrated whole. This process is looked at in this report from the perspective of the investor, although similar processes have been at work for some time on the borrower's side. The final influence on the structure of capital markets that is considered here is that of taxation, which has a profound influence on the precise way in which flows pass from savers to the users of funds.

1. The integration of markets

Underlying the activity in international capital markets above has been a process of integration between countries, between different market sectors, between institutions, and between maturities and instruments. This process is leading to a structure of closely linked capital markets, through which savings and investment can in principle be intermediated more efficiently, reducing the cost of capital to firms and increasing the returns to savers. These markets allow the pricing and reallocation of an increasing spectrum of risks, increasing the scope for, and the efficiency of, international and intertemporal resource allocation. However, this process may be creating new risks that are not fully understood, and the interlinked network of markets allows shocks and disturbances to be transmitted very rapidly. This situation poses a number of difficult issues for those managing the system, some of which are discussed in the subsequent section.

The process of liberalization of capital markets has been discussed in previous reports in this series. During the last year, the trend has continued with measures both to reduce the degree of financial repression on domestic capital markets and to open markets to foreign competition. In Japan, the program to free interest rates has continued, with a further reduction in the minimum size of deposits bearing full market rates. Measures have been taken to promote the development of a domestic commercial paper market and to liberalize Euroyen lending. In Europe, the elimination of certain restrictions on the eurocurrency markets in Germany, the Netherlands, and the United Kingdom has further promoted the merging of domestic and offshore capital markets.

The process of market integration has also been encouraged through the entry of foreign banks and financial institutions on domestic markets, an action that tends to make domestic markets more competitive. Foreign financial institutions usually lack a domestic retail base, so they tend to do most of their business with institutional customers or other banks. While the industrial countries are all party to the OECD code on freedom of capital movements, some continue to have reservations about the takeover of larger domestic banks and securities houses by non-residents. Some of the prudential issues that such mobility gives rise to are discussed below.

Dramatic strides towards the international integration of financial markets are being taken under the U.S.-Canada Free Trade Agreement and within the European Community. Several steps have already been taken towards the establishment of a single European market in financial services, including a decision to eliminate all capital controls by the end of 1992. Already virtually all capital controls have been eliminated by Denmark, Germany, the Netherlands, and the United Kingdom; Belgium, France, and Italy are to eliminate controls by June 1990, and the remaining countries by 1992. The Second Banking Directive will allow a bank established in one Community country to perform throughout the community all the functions it is able to do in its home country. The Solvency Directive harmonizes the capital adequacy standards for the banks in the Community, and the Investment Services Directive should do the same for investment houses. Finally, the Directive on Undertakings for Collective Investment on Transferable Securities (UCITS) allows the sale of unit trusts and mutual funds throughout the European Community.

Within the European Community, remaining restrictions designed to give national authorities control over domestic currency markets (such as restriction on the nationality of lead managers for eurocurrency issues or on the taking over of large financial institutions by institutions from other countries) will be increasingly difficult to maintain. The freedom of capital movements and of establishment throughout the EC will put pressure on the authorities to harmonize taxes and other regulations, or at least to reduce differences to such an extent that their effect on factor movements is minimal.

Another tendency prevailing in international capital markets is towards the blurring of distinctions between different instruments. The distinction between syndicated loans and bonds remains, but syndicate banks are becoming more like underwriters, selling off participation in loans to other institutions and keeping little on their own books.

The process of securitization represents a channel whereby a portfolio of loans can be converted into bonds and removed from banks' books. The flexible note issuing programs that are now available to corporate borrowers provide the pass through to investors of the sort of finance that, in the past, a bank would have provided.

The growth of the derivative product markets is a sign of the increasing integration and efficiency of financial markets both nationally and internationally. At the national level, these markets facilitate the integration of the pricing of instruments with different maturities and risk characteristics, by creating means by which arbitrage opportunities can rapidly be seized. They also permit participants on financial markets to adjust quickly the amount of risk they take on and to restructure their portfolios rapidly, including through the use of program trading. Internationally, these markets permit the linking of national financial markets both at the short end of the maturity spectrum and now increasingly at the longer end. While this implies the more rapid transmission of disturbances from market to market, in the normal course of events, it also permits a more rapid, consistent, and efficient adjustment of markets to changing international conditions.

2. Globalization and investor behavior

Over the last few years, large institutional investors have come to dominate the demand for assets issued on international capital markets. These investors consist primarily of insurance companies, pension funds, mutual funds and other investment trusts. Institutional investors have certain characteristics that might be expected to lead to a different pattern of behavior than private investors. Firstly, they can be expected to be more diversified in their asset holdings, and have the capability to follow developments and analyze investment prospects for a wider variety of borrowers and markets. Secondly, they are generally regulated by the authorities as the price for receiving certain tax concessions and in order to protect those holding claims on the institutions. Thirdly, institutions may be expected to respond more rapidly to market developments than individual investors, in part because they have lower transactions costs. Technological developments allow institutions to follow market developments closely and to execute their decisions promptly; they are better placed than individuals to utilize the derivative product markets to adjust their portfolios or take positions on market developments; they are also under intense competitive pressure to perform. Finally, these very factors that allow a rapid response to market developments may also mean that institutional investors have a shorter time horizon than do individuals, although the evidence for this is not unequivocal.

Over the last decade, these institutional investors have increasingly turned to foreign assets as a means of reducing the volatility of their returns while increasing their earnings. In most countries, regulations, often originally imposed for prudential reasons, have usually limited the nature of the investments that insurance companies and pension funds were permitted to make, and in particular the amount of foreign assets they could acquire. However, the demand for an expansion in permitted investments has been large and there have been sound prudential reasons to accommodate this desire. Countries have accordingly been relaxing their restrictions on this activity. Thus, for example, the ceiling on the foreign securities holdings of Japanese non-life insurance companies has been raised recently from 10 percent to 30 percent.

As part of this world-wide trend, the share of foreign equities and bonds in the total portfolio of U.K. pension funds, for example, is estimated to have risen from 5 percent in 1979 to 20 percent at the end of 1988. In the United States, where overseas investments of pension funds were virtually unknown ten years ago, by mid-1988, the top 20 fund managers had an estimated US$50 billion invested abroad. Foreign assets of German investment funds (Kapitalanlagegesellschaften) at end-May 1989 amounted to US$31 billion, or 60 percent of total assets. In Japan, the share of foreign securities in total securities holdings of life insurance companies rose from 15 percent in 1981 to 31 percent in 1988, of non-life insurance companies from 8 percent to 22 percent, of trust banks from 4 percent to 15 percent and of securities investment trusts from 4 percent to 14 percent.

The move by large institutional investors worldwide to increase the share of their portfolios in foreign assets has greatly facilitated the financing of the large current account imbalances of recent years. One issue concerns the limits on this process. While the evidence suggests that the process of diversification into overseas portfolios has considerably further to go, market shocks could lead to a retreat back to investors' domestic markets. This was already clear in market developments of October 1987, during and following which, investors tended to sell their foreign assets before their domestic assets, although it was less evident in October 1989. It has taken time for investment in overseas securities to regain the pre-October 1987 level. Loss of confidence in a major currency or in the immediate prospects of a major deficit country could lead to very sharp adjustments in asset prices and to rapid shifts in exchange rates. It could also result in a movement away from cross-border financing through the longer-term securities markets towards the use of official and short-term bank flows, complicating the process of monetary management.

Developments in financial, information, and communications technology have played a major part in the move towards globalization and changing the roles of institutional investors and financial intermediaries. Financial engineering, the transformation of the claims that the investor wishes to hold into the sort of liability the borrower is prepared to take on, has always been the basic function of financial intermediaries. The development of the derivative products markets and the advances of communications technology, together with the wholesale market power of the institutional investors, have greatly increased the scope and reduced the cost of such engineering, allowing the creation of customized products for both borrower and investor. In this process, the financial intermediary can offset virtually as much of the risk as it wants through the derivative products markets. This has led to a rapid growth of the private placement market in many countries, where institutional investors can obtain tailor-made claims that are not available to the general public. Because of this, borrowers typically face lower disclosure costs than would be incurred through public placement in the markets. Private placements have also been helped by the gradual relaxation of restrictions on this market.

Information and communication technology are beginning to allow institutional investors direct real-time access to capital markets. Their ability to follow market developments through the same communications networks as the banks and securities houses enables them to express their demands at an earlier stage in the intermediation process, increasing the pressure on the market to respond and position itself quickly to changes in information. The technology is also being developed to let large institutions bid directly on securities as they are issued, thus circumventing the middleman function of the securities houses. In the future, corporate treasurers may be able to raise funds from institutional investors directly, using screen-based auction systems, leaving the securities houses to compete for paper to sell on the retail market.

While the trend to broader international portfolios is most evident among institutional investors, small investors have also diversified. The announcement and subsequent introduction of a withholding tax on interest income in Germany, as discussed in the following section, led to a massive shift of funds abroad by domestic German investors. Similar tax-related motivation has led Belgian residents to invest heavily in Luxembourg funds. Among the legacies of this process have been an increasing awareness by small investors of the different returns to be earned in different currency instruments, and a broader international perspective on their portfolios. This process should be accelerated throughout Europe by the entry into force of the recent UCITS directive. As banks in one European country try to position themselves in the retail markets of others, awareness of cross-border investment opportunities should increase.

The October 1987 market developments were factors in dissuading small investors from venturing abroad into markets in which they might not feel familiar. Since then, however, there has been a large effort to induce such investors to return. The increasing competition in retail banking is also expected to facilitate the process. Costs to the small investor may have been reduced by the deregulation process, although in the past some activities may have been cross-subsidized from institutional clients. The move to privatize a number of state enterprises in some countries, particularly the United Kingdom, may also have led to a spread of shareholding in the population. In any case, as incomes rise, small investors are likely to look for different risk-return configurations, and this is likely to promote an increasing internationalization of shareholdings.

3. The influence of taxes on capital flows

National tax systems, and the differences between them, have always been a major influence on the structure of international capital flows and the relative attractiveness of different capital market instruments. The increasing freedom of capital movements among the industrial countries and the continuing advances in capital market technology make it possible for market participants to respond to differential incentives established by national tax systems more rapidly and on a much larger scale than hitherto. This regulatory or tax arbitrage is putting growing pressure on national authorities to harmonize that part of their tax systems that affects capital transactions.

Taxes only affect the current account of the balance of payments to the extent that they alter the savings and investment balance in the economy. 1/ This particular effect is not the main focus of this paper. To explain the structure of gross capital flows and the form taken by market instruments, it is more relevant to look at two other forms of tax impact: the effects of taxes on portfolio preferences of borrowers and investors, and the effects on the location of financial activity.

As far as borrowers are concerned, the cost of raising capital or borrowing on different markets can be influenced by taxes on fund-raising activities, as well as the costs of complying with regulations and the customary practices of different markets. Thus, for example, Japanese companies can incur lower costs by raising capital abroad than in Tokyo. The tax treatment of the investor will also influence where the borrower seeks to raise funds, since he may be able to obtain more favorable terms when the investor or lender is able to receive a higher return because of tax advantages. In addition, the tax treatment of different forms of servicing liabilities may vary, with interest often being treated as a tax-deductible expense, while dividends are usually subject to tax, thus altering the incentives for issuing different forms of instruments.

On the side of the investor, many factors determine the tax treatment of instruments. Income from domestic sources and that from foreign sources may be subject to different treatment, depending in part on the nature of double taxation treaties. Taxation of interest income, dividends, and capital gains may differ, giving an incentive to hold assets in one form rather than another. There may also be special tax advantages to holding claims on certain financial institutions, such as insurance companies or pension funds, and these in turn may be subject to special tax regimes. This can create a large market for instruments with appropriate characteristics.

All these factors may have an effect both on the level of savings and investment and thus the net size of the capital account, but they also influence the form in which assets and liabilities are held. This effect can generate large cross-border capital movements, with offsetting transactions elsewhere in the capital account.

1/ See Section III of the Background Paper (SM/89/207).

One interesting example of this effect in the last year has been the impact of the German withholding tax. In view of the difficulty of ensuring full reporting to the tax authorities of interest and dividend income paid to private investors, many countries withhold such tax at source and allow tax payers to claim a rebate if this tax is a too high a rate. While the imposition of a withholding tax may imply a small increase in the present value of tax payments, its main function is to ensure that at least minimum taxes are paid on such income. The mere announcement in October 1987 that a 10 percent withholding tax would be levied as of the start of 1989 on interest income paid by German borrowers led to abrupt changes in bond yields.

Many German borrowers withdrew plans for bond issues on the local capital market, preferring to raise funds through their offshore subsidiaries. Investors seeking deutsche mark assets flocked to bonds issued by non-German entities or by German borrowers on the eurobond market. As a result, domestic bond yields rose, increasing the cost of borrowing for German residents, including the German government, over the cost for non-residents. Thus, yields on World Bank deutsche mark bonds moved below those on German government bonds, rather than trading at the normal 30-40 basis point premium.

German investors thus moved massively into foreign bonds, both directly and through the use of investment funds abroad. These funds, often established by German banks' foreign subsidiaries, offered German investors a chance, not only to invest in deutsche mark assets without being subject to the withholding tax, but also to diversify their portfolios into other currencies, including in particular those with higher yields. The withholding tax reinforced a tendency, which was also related to a market perception of the relative weakness of the currency, to an outward movement of capital, which in turn contributed to the downward pressure on the deutsche mark despite the size of the current account surplus.

The German authorities announced in April 1989 that the withholding tax would be abolished with effect from July 1. This has led to a return of relative yields on deutsche mark assets to their normal levels and to a staunching of the capital outflow. However, during the episode, considerable capital flight occurred, and it will be interesting to see whether it now comes back. Several observers consider that the episode has revealed a deep-seated distrust of the fiscal authorities, and that many of those who utilized offshore funds now see no particular reason to repatriate their assets for the time being. The offshore fund managers offer a good service, and their use has hastened a process of globalization of the small investors' portfolios, alerting them to the possibilities of non-deutsche mark assets.

Another lesson of the incident is the speed and the scale on which even small investors react on open capital markets to the news of possible small changes of yields. This has spurred the European

Community to discuss the possibility of a Community-wide withholding tax, or alternatively the harmonization of disclosure requirements when capital controls are removed.

Another way in which taxes can have an impact on international capital flows is by influencing the location of trading in instruments. Stamp duties on trade in financial instruments have the most pronounced effect, in some cases leading to the emigration of a substantial part of a market. Thus, it is estimated the Dutch stamp duty has led to between 30 and 50 percent of all trading in Dutch state bonds to be done in London. Similarly, the Swiss stamp duty has contributed to a significant part of Swiss franc bond trading being done in London and equity placement being underwritten there. In the case of Switzerland, the problem is complicated by the substantial role the stamp duty plays in total Federal Government revenue. Transactions taxes can also have a particularly marked effect on derivative product markets, encouraging their growth in offshore centers.

IV. Concerns of the Official Sector

National authorities have several objectives when determining financial market policies. Firstly, they wish to ensure that their financial markets constitute efficient channels between savers and investors, and provide the financial services needed by the economy; secondly, they wish to ensure that their financial markets are stable; and thirdly, that there is adequate protection for investors and depositors. These goals are interrelated: for a financial system to provide consistently the services the economy needs, it must operate efficiently and be able to withstand financial shocks; measures to enhance stability, for example, the prevention of bank runs, may be essential elements of depositor protection; clearing and settlement systems, which can smoothly accommodate a large volume of transactions, serve the goals of both efficiency and stability. On the other hand, there can also be trade-offs among these objectives: action to protect depositors, for example, deposit insurance, may discourage the correct pricing of risk, and thus make the efficiency objective harder to attain; supervisory action to ensure institutions have sufficient capital backing, and adequate systems to limit risk-taking, may inhibit financial institutions from using their capital optimally or taking on an efficient amount of risk.

The liberalization of domestic capital markets, and the removal of barriers to the cross-border provision of financial services or the establishment of financial institutions, has been largely in search of more efficient and better structured financial systems. At the same time, the increased attention being paid to prudential regulation in banking and securities markets has been largely designed to promote the objectives of stability and depositor and investor protection. Competitive pressures which may enhance efficiency in the short-run may also lead to greater volatility and damage investors and depositors. The next two subsections deal with some of these issues.

1. Containing systemic risk

With the rapid increase in the size of financial markets, both domestic and international, the remarkable structural change that has been occurring in these markets, and the evidence of their increased volatility, policy makers have come to devote more attention to the issues of stability and systemic risk. If financial crises are to be prevented, sound macroeconomic policies and appropriate coordination is needed to create a stable environment for the functioning of these markets. At the microeconomic level, the authorities have sought to ensure that the financial system is sufficiently robust to cope with shocks.

Over the last decade, the international capital markets have financed relatively smoothly a pattern of unprecedentedly large current account imbalances. This has been possible in part because of the internationalization of investors' portfolios described above. The gross two-way flows of direct investment, bank lending, and portfolio investment in bonds and equities have been so large that they have generally been able to absorb the net finance required by the current accounts. It seems probable that the process of portfolio internationalization has much further to go, and thus may be able to continue to accommodate substantial imbalances for some time. 1/

Nevertheless, there is also a danger that a change in market sentiment could disrupt the process. If asset holders suddenly wished to change the composition of their portfolios, for example, to reduce the holdings of U.S. dollar assets, their attempt to do so might result in a sudden and sharp depreciation of the U.S. dollar. A scenario of this sort, and its possible consequences, are sketched out in the World Economic Outlook (p. 30). Thus one concern is how to prevent such a shift in sentiment from emerging in a sudden and destabilizing way. The financial markets tend to react suddenly to some news trigger at a time when there is underlying unease about the sustainability of particular exchange and interest rates. Since the actual trigger of market shifts is unpredictable, the attention of the authorities has to be directed to ensuring that the economic fundamentals are not such as to engender disquiet.

Market confidence in the soundness of underlying economic policies, and in the resulting pattern of exchange and interest rates, can promote a longer-term pattern of intermediation, characterized by the use of the long-term bond and equity markets. If such instruments are taken up by

1/ See Michael Dealtry and Jozef Van't dack, "The U.S. External Deficit and Associated Shifts in International Portfolios", BIS Economic Papers No. 25, Basle, September 1989.

nonbank institutions, this can contribute to the overall robustness of the system, as any shock will be less likely to threaten the survival of financial intermediaries. The relative stability of exchange and interest rates in 1988 was reflected in the strength of the bond market, relative to bank flows. However, equity flows were subdued in the wake of October 1987, and concerns were expressed about the relative shift of corporate financing in some countries from equity to debt, and the concentration of high-yield, high-risk debt in the hands of certain financial institutions.

Understanding the way economies are integrated through the capital account is hindered by the poor quality of capital account data. Since this has become the primary channel for the transmission of disturbances between countries, it is important to improve the basis for analysis. The structure of capital flows is also greatly complicated by the influence of taxes: greater harmonization of taxes would help ensure that the pattern of capital flows is both transparent and rational.

Action to promote robust international financial structures takes several forms, among which are: ensuring an adequate capital base for financial institutions, placing limits on the amount of risk an institution can take on, and ensuring that clearing and settlement systems function efficiently and safely.

The most important move to strengthen the capital base of financial institutions has been the agreement on capital convergence agreed by the Basle Committee of Bank Supervisors in July 1988. This multilateral agreement sought to bring the minimum capital bases of banks up to common and generally higher standards by the end of 1992. Since then, the standards have been incorporated in national regulations, and banks have been active in floating new capital in world markets. 1/ The EC is working on establishing a uniform minimum solvency ratio for banks based in the Communities, and this is unlikely to differ significantly from that agreed in Basle. The Basle Committee standards generally fix the minimum amount of capital that a bank must have as a function of the credit risk it has incurred. However, there are other sorts of risks which, if taken to excess, can, and have had serious consequences for the solvency of banks. Thus work is proceeding in the Basle Committee on the treatment of such forms of market risk as interest rate and foreign exchange risk. However, there are difficult technical problems that remain to be resolved in these areas.

Work has also been continuing on the appropriate capital base for securities houses. This work, conducted by the International Organization of Securities Commissions (IOSCO), has in some ways paralleled the work of the Basle Committee in the area of banking. Just as the agreement of the latter was facilitated by agreement between the United States and the United Kingdom on a common approach, an agreement

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1/ For a further discussion see SM/89/207, pp. 47-51.

that was later joined by Japan, so in the area of securities houses, the convergence of the system of capital adequacy in the United States with that in the United Kingdom and Japan, has been a major impetus to IOSCO's work. At its meeting in Venice in September 1989, IOSCO supported a number of recommendations of its working group on capital adequacy for securities firms covering the need for capital and its level in relation to the risks that securities firms take on. One problem in this area, from a competitive viewpoint, is that of equivalent standards for different types of institution undertaking the same business. In some countries, virtually all securities market activity is done by banks, in others both banks and securities houses, and possibly other institutions do such business, while in some (notably Japan and the United States for the time being) there is a strict demarcation line. To the extent that different institutions, being supervised on a different basis, may be required to put up different amounts of capital, or to constrain their risk-taking in different ways, there is a danger of giving some institutions competitive advantages and distorting the market.

A further area of cooperation among supervisors is that of derivative product markets. In this sector, contacts are less well established than in the banking and securities areas, and the prudential issues are less well understood.

Another subject of considerable attention by national authorities has been clearing and settlement systems. 1/ Clearance and settlement systems form part of the "plumbing" for the functioning of financial markets, and any breakdown can have serious consequences for the stability and efficiency of the system. The enormous volume of transactions over clearance systems at times of market disturbance can overwhelm the capacity of systems to process orders. In normal circumstances, the use of clearance systems generates the extension of credit among participants and by the public sector of magnitudes that may be difficult to assess. At times of system overload, credit risks can increase significantly as the completion of transactions may be in doubt.

When a participant in a clearance system fails, there are two possibilities. Either the bad debt of the failed institution to other participants is covered by the guarantor, which may be the clearing house itself or the authorities, or all transactions involving the failed participant have to be unwound. In the former case, the willingness of the authorities to take over the risks runs the danger that participants are not charged appropriately for the risk, and it is therefore socialized. In the United States, concern has been expressed about the amount of settlement credit and its pricing. At present on the Fedwire system, banks have to borrow sufficient funds to cover their positions at the end of the day, but may now run large imbalances during

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1/ See "Systemic Financial Risk in Payments Systems" (forthcoming).

the day. As a result, consideration is being given to limiting the "daylight" overdrafts, or collateralizing exposures. Having sufficient resources in the clearing house, to act effectively as guarantor, may be so expensive that the market would not of its own provide sufficient clearing facilities for the system. The solution of unwinding all transactions with the failed participant may leave another unexpected pattern of uncovered exposures, leading to more failures. This possibility of secondary failure constitutes a negative externality, as it is difficult for an institution to cope with, since it is impossible to know in advance to which institutions the bank will be exposed at the end of the settlement period.

The approach adopted so far has concentrated on efforts to strengthen settlement systems through improvements in liquidity and the capital positions of participants. In addition, it has been proposed to reduce credit risk in securities transactions by shortening settlements periods. In the case of the securities markets, the report of the Group of 30 has recommended movement of all systems to a three-day settlement period by 1992. This should prevent prolonged doubt about the solvency of counterparties. Other issues include the integration of different payments systems. When two instruments are exchanged, there may be credit risk if one side of the transaction is settled before the other. This may occur within a country if the two markets have different settlement periods, and may also occur internationally, where for example the yen side of a payment originating in Japan can be finalized in Tokyo at the end of the day, but the dollar side will have to await the closure of the U.S. business day. Supervisors are considering ways of resolving these difficulties and dealing with any problems that failure to complete such transactions may involve.

A further issue in promoting confidence in the financial system is that of establishing a system of managing a crisis when it occurs. This involves the provision of general liquidity by a lender of last resort to prevent unnecessary failures of financial institutions resulting from a sudden drying up of liquidity in the system and possible support of particular solvent but illiquid institutions whose failure could have a catastrophic effect. With an increasingly international financial system, there is scope for confusion about which national authorities are responsible for injecting liquidity in the event of a crisis, and the danger that delayed or insufficient action in one country could lead to the spread of problems to others. While there is public agreement on the responsible prudential supervisors for banks and their subsidiaries located throughout the world, and there is emerging agreement on the division of supervisory responsibility in the area of security houses, the extent of agreement to provide liquidity or to rescue institutions in the event of a crisis is not public knowledge. This is understandable, given the fear that knowledge of the circumstances in which a financial institution would be rescued might prompt its management and its creditors to behave with less prudence.

2. Liberalization of trade in financial services

Liberalization of domestic financial markets, the removal of barriers to the cross-border provision of financial services, and the freedom of establishment of foreign financial institutions have been seen by governments, particularly but not exclusively in the industrial countries, as ways of making the financial sector more efficient. This allows the lower cost provision of services to the rest of the economy, lowers the cost of capital, ensures its more efficient allocation, and gives savers better returns on their savings. However, liberalization of the financial services sector is complicated by its sui generis nature, and the authorities have been concerned that some forms of liberalization might result in less systemic stability or weakened protection for investors or depositors. 1/

A large part of the impetus for liberalization in many countries has been domestic. In some cases, the authorities have been convinced of the unilateral advantages of a more open system. In some of these cases, the corporate nonfinancial sector has pressed for it as a consumer of such services. In other cases, the removal of barriers has been pressed on a bilateral basis, as one or both countries' financial sectors saw advantages in access to the market of the other. In general, the growth of international business and the expansion of the activities of corporations abroad, partly the result of liberalization of trade in nonfinancial services, have naturally entailed pressure for the banking sector to follow its clients.

The main framework for multilateral trade liberalization in the financial services area has been the OECD. The codes on liberalization of current invisible operations and of capital movements constitute binding legal agreements under which signatories are committed to the progressive elimination of restrictions. Since the cross-border provision of certain financial services involves exchange transactions, and possibly exchange restrictions, the codes explicitly defer to the Fund' articles which bind its members in this area.

The current Uruguay Round of multilateral trade negotiations within the GATT is aiming at producing a general agreement on trade in services, and one issue has been the extent to which this agreement should cover trade in financial services. Negotiations on the general framework for liberalizing trade in services have proceeded slowly, since each subsector has its special features. As far as the financial services sector is concerned, apart from the issues of systemic stability and investor and depositor protection mentioned above, there has been concern that negotiations on some trade barriers in this sector could disrupt or destabilize financial markets as participants rushed to respond to a new expected incentive structure, that the principle of reciprocal exchange of equivalent concessions as applied within the GATT

1/ See Section V of the SM/89/207.

is inappropriate for the financial services sector, and that monetary and development policy considerations preclude the surrender of national freedom of action.

Some of the basic principles governing negotiations in the services sector agreed after the December 1988 meeting in Montreal do not fit the financial services sector very well. The principle of transparency of regulations could conflict with the obscurity in which monetary authorities are compelled to cloak some of their actions, in particular those related to lender of last resort facilities. Even the advance notification of regulatory measures, as is expected to apply to other service sectors, poses problems. The principles of nondiscrimination, market access, and increasing participation of developing countries could conflict with the need to maintain investor and depositor protection and to ensure that participants on the domestic market maintained adequate prudential standards. Nondiscriminatory market access is seen to require the acceptance of the adequacy of the prudential and other standards imposed by the home country of the financial institutions in question. For this reason, the precondition for a single market in financial services in the European Community is harmonization of minimum standards and mutual recognition of other standards. Finally, the experience of financial liberalization in the OECD countries has been that the effective cross-border provision of financial services is closely linked to the freedom of financial institutions to establish themselves in the other market. Some participants in the Uruguay Round are unwilling to see concessions extended to the area of inward foreign investment.

Whatever the outcome of the financial services negotiations in the Uruguay Round, the pressures for liberalization in this sector will continue. As the process is under way, the need to harmonize regulations becomes more intense. Among the areas that will command increasing attention is the need to harmonize taxes, to reduce their distortionary effects on international capital flows and to remove the competitive disadvantage some institutions suffer from. To some extent, open capital markets will force a degree of harmonization, as business migrates to jurisdictions where the tax burden is less. This has been the case in the United States, where the market limits interstate tax differentials. The same process may also occur within the EC, regardless of the Commission's attempts to harmonize matters by central decision.

3. Integration of developing countries in the system of international capital markets

The degree of integration of most developing countries in the international financial system, when measured in terms of gross capital flows, is less now than it was at the start of the decade. This, of course, largely reflects the market's reappraisal of the risks involved in bank lending to the public sector of the now highly indebted countries. This experience has also had an effect on the bond markets, where the volume of bonds issued by developing country borrowers is less than it was at the start of the 1980s. Against this, however, there are some more positive developments: the amount of foreign direct investment in these countries has been rising over the last few years, some of which is related to debt-equity conversion schemes; there is increasing interest in portfolio investment in developing country equity markets, as indicated by the number of investment funds being established; and some countries, particularly in Asia, have continued to expand their links with the international financial markets, both as users and suppliers of funds.

The processes described in this and earlier papers create both problems and opportunities for developing countries. Policy-makers in developing countries face the issue of how to respond to the massive expansion of global financial markets that is occurring: should they actively seek to integrate their own economies in the process; what dangers does the process hold for them; how can they benefit from what is happening?

The increase in capital mobility that appears to be occurring world-wide, and the increasing competition on financial markets, mean that developing countries will need to ensure that their policies foster their becoming and staying creditworthy, if they are to be able to tap these markets. International business demands an environment of financial liberalization if developing countries are to compete with the investment opportunities available elsewhere. At the same time, domestic savers and investors are also affected by the more global outlook and the investment opportunities abroad. Since the process of financial liberalization and technological development has made capital movements easier, including movements of funds out of developing countries, the need to raise domestic financial market standards is increasingly important as a means of discouraging capital flight.

Will financial markets that are more integrated with those of the rest of the world inevitably result in the transfer of savings abroad? If on a risk-adjusted basis, returns are higher domestically than abroad, the integration of domestic capital markets should pull capital in from abroad. In any case, if domestic savings do flow abroad, it will be because returns to the saver are higher there: the stream of income to residents of the country and their accumulation of assets will also be higher. Such income may, however, be less accessible to the tax authorities than if it were the result of payments from a domestic investment, and this may be one of the factors that creates the higher risk-adjusted rate of return. Furthermore, the linkages between this flow of income and the domestic economy may be weaker than in the case of domestic investment. However, restrictions increasingly fail to stop the flow of funds abroad in response to differential returns. If the authorities can promote confidence in their domestic markets and convince residents and nonresidents that investments will not be expropriated or investment income excessively taxed, then reducing restrictions on outward capital movements, while it may lead to some increase in outflows, may also increase the willingness of residents to be frank about their external sources of income. Nevertheless, the experience of many industrial countries, including the withholding tax episode in Germany, would seem to indicate the strength of resistance by taxpayers to identifying those of their assets that are beyond the reach of their authorities.

The aim of the domestic authorities must be to ensure that the relative incentives to domestic savers to invest abroad and at home reflect the true returns on the underlying investments. Thus, they need to look at the factors that dissuade domestic savers from keeping their money at home. One important factor may be the degree of financial repression: savers may simply not be allowed to earn the rate of return domestically that users of funds are willing to pay. Another factor may be the degree of confidence and investor protection provided on the market. Here domestic investors are motivated by the same factors as foreign investors, and the measures taken to persuade the former to invest at home are those that will convince the latter to invest in the country. Establishing confidence may take a long time, but since it is necessary for sustained growth and development, the sooner the process starts the better. Past capital flight or residents' portfolio diversification has by now for many countries created a considerable pool of "informed" capital which might well come back in part if such confidence could be established. In this connection, the application of the Basle capital adequacy standards by some developing countries and offshore centers is an encouraging development, as is their participation in the work of IOSCO.

The more global outlook of investors and the freer movement of funds offer considerable opportunities to developing countries. The underlying rates of return on many investment projects in such countries are high, and if they can avoid allowing this return to be counteracted by country risk, many stand in a good position to attract the capital they need. The trend to globalization and the increased importance of institutional investors also stands to benefit receptive developing countries. Not only are investors becoming more internationally minded about their portfolios, but within the enormous total of funds devoted to cross-border investment there is scope for investors to devote at least a small part to higher-risk, high-yielding investments, such as those developing countries might well offer. One sign of this interest is the premium over underlying asset values of several closed-end mutual funds which invest in such markets. A relatively small movement of institutional investment funds into such assets could have a major impact on the supply of capital available to developing countries.

More efficient domestic financial markets can both mobilize more savings (an important consideration if the supply of foreign savings is limited) and direct them to the most productive uses. Since one of the main causes of the current debt-servicing difficulties of some developing countries was the insufficiently productive way in which the money borrowed was spent, better functioning domestic financial markets have an important contribution to make to ensuring this does not happen again. The added value contributed by the financial sector can largely be seen in terms of this enhancement of the efficiency of resource allocation. In this context, if the industrial corporations of developing countries are to compete successfully in the international economy, a more efficient domestic financial system and its integration with the international market network should be important assets.

There are two main obstacles to a fuller utilization of the international financial markets by developing countries and their participation in them: the problem of creditworthiness, and the standards of domestic financial markets. The reestablishment of creditworthiness is essential if the element of country risk that domestic borrowers are forced to pay is to be reduced to a minimum. In some cases, debt and debt-service reduction is needed before there can be assurance that the remaining obligations can be met. In other cases, however, the problem is to give existing and potential creditors confidence that the authorities will do nothing to prevent the implementation of contractual terms on financial obligations.

Lack of creditworthiness is a very serious obstacle to new financial flows. Banks which wish to acquire a claim on any one of a number of developing countries can do this by acquiring existing claims through the secondary market at a very low price. This reflects a high risk premium that contractual obligations will not be met and one which is reflected in the return that new lenders and investors will require. Measures that serve to return secondary market prices to par will reduce the premium that domestic borrowers have to pay.

Foreign investors are also looking for similar standards of protection on developing country markets that they can obtain elsewhere. These include strong bank supervision to give confidence in the creditworthiness of domestic financial partners. If investors are going to channel funds through the equity markets of developing countries, they will need assurance that markets there operate efficiently and transparently, and that international standards of investor protection are met. Finally, they need to be sure that their claims will receive protection that meets international standards in the courts of the country, and that they will not be subject to arbitrary treatment or discrimination on account of being nonresidents. The establishment and activities of the Multilateral Investment Guarantee Agency (MIGA) are in part designed to give this confidence.

Developing countries have a vital interest in international financial market developments and in the safety and soundness of the international financial system. These markets offer them the possibility of attracting the funds they need for their development, and in a form that is more appropriate than the balance of payments lending of the 1970s. There is considerable pressure from domestic residents, both savers and borrowers, to have access to these markets. Rightly used, and by keeping domestic market standards up to international ones, these forces could provide the impetus for the reintegration of many developing countries in the international financial system in the 1990s, serving to promote both market efficiency and the inflow of correctly priced and directed capital that these countries need.

V. Issues for Discussion

In its September 1989 communiqué, the Interim Committee called for further study of the measurement, determinants, and systemic consequences of international capital flows. The annual review of international capital market developments and prospects is one of the primary vehicles for such work. Directors are also aware of the proposal to launch a study on the measurement of international capital flows, and a staff study on the determinants and systemic consequences of such flows is scheduled for completion by June 1990. Directors may wish to comment on the appropriate priorities in the staff's work in this area, and which aspects are likely to have the greatest impact in understanding the linkage of economies through their capital accounts.

Directors may also wish to discuss some or all of the following issues:

--the effectiveness with which the international capital markets have mediated the current account imbalances between industrial countries over the last year;

--the relationship between macroeconomic policies and the stability of the system of international capital markets;

--the relative emphasis to be placed on issues of systemic stability and market efficiency in the process of liberalizing trade in financial services on a multilateral basis;

--the need for and the process of harmonizing taxes on income from capital and on financial transactions and services as part of a move towards freer international capital flows; and

--the relationship between developing countries and the international capital markets, the advantages of increased integration, and the appropriate policies to promote this.