Also Present

Administration Department: H. Wiesner. African Department: C. H. Fisher, R. A. Franks. Asian Department R. J. Corker. Exchange and Trade Relations Department: L. A. Whittome, Counsellor and Director; T. Leddy, Deputy Director; M. Allen, A. Basu, E. Brau, J. J. Clark, Jr., C. V. A. Collyns, G. G. Johnson, M. G. Kuhn. External Relations Department: R. J. Bhatia, Director of the Fund Office in the United Nations; P. E. Gleason. IMF Institute: O. B. Makalou. Legal Department: W. E. Holder, Deputy General Counsel; T. M. C. Asser, P. L. Francotte. Middle Eastern Department: M. F. Melhem. Research Department: J. A. Frenkel, Economic Counsellor and Director; M. Goldstein, Deputy Director; P. Gajdeczka, Y. Harada, D. J. Mathieson. Treasurer's Department: S. E. Nocera. Western Hemisphere Department: J. C. Di Tata. Bureau of Statistics: J. B. McLenaghan, Director; J. A. J. Bové, V. Galbis, M. S. Gill, R. T. Stillson. Personal Assistant to the Managing Director: H. G. O. Simpson. Advisors to Executive Directors: J. O. Aderibigbe, M. Eran, J.-L. Menda, Z. Iqbal, J. M. Jones, B. S. Newman, J.-C. Obame, P. Péterfalvy. Assistants to Executive Directors: H. E. Codrington, E. C. Demaestri, A. Y. El Mahdi, M. A. Hammoudi, L. Hubloue, M. E. F. Jones, C. Y. Legg, S. Rouai, D. Saha, H.-J. Scheid, J.-P. Schoder.

1. REPORT BY MANAGING DIRECTOR

The Managing Director noted that a Fund mission was in Poland, working closely with the authorities in designing an ambitious and drastic adjustment program to stabilize the economy, and then transform it from a centrally planned system into a market economy. Despite the formidable policy challenges--particularly in formulating the 1990 budget--the authorities had an extremely good attitude toward economic change. While many economic variables were not under adequate control, including subsidies, wages, relative prices, credit, and interest rates, the authorities had taken a variety of important steps in those and other areas. On its part, the Fund would specify a substantial number of significant preconditions, in budget policy in particular, before agreeing on a stand-by arrangement. It was planning a multistage adjustment strategy, with the likely stand-by arrangement in 1990 to be followed by a more comprehensive, growth-oriented structural adjustment effort, possibly supported by an extended arrangement. Considering the formidable uncertainties in the Polish economy, the Fund would continue to work with the authorities and follow closely the various developments in the economy, and would review the program in several months' time. Close cooperation should enable both the Fund and the authorities to learn from experience and to readjust policy measures as necessary in the challenging task ahead. Much determination and open-mindedness would be required.

He would visit Poland on December 9-11, 1990, to help advance the negotiations in a few areas, the Managing Director continued. Subsequently, on December 13, 1990, he would participate in the ministerial meeting of the G-24 western industrial democracies, to inform Ministers of the most recent developments in Poland and to indicate the likely size of Fund financial involvement, which would help clarify the contribution that the G-24 countries would need to make.

In another connection, he wished to reassure Directors that, contrary to recent press reports, negotiations had not broken down with the Hungarian authorities, although the discussions continued to be difficult, the Managing Director added. The next day, the Deputy Director of the European Department would meet with the Prime Minister, and further progress in the negotiations would likely be achieved by year-end.

Mr. Schioppa remarked that he wished to thank the Managing Director on behalf of the Polish authorities for his active participation in the ongoing discussions with Poland.

2. STUDY ON MEASUREMENT OF INTERNATIONAL CAPITAL FLOWS

The Executive Directors considered the staff paper on a proposed study on the measurement of international capital flows (EBAP/89/269, 11/15/89).

Mr. Nimatallah, Mr. Posthumus, Mr. de Groote, and Mr. Landau indicated briefly that they supported the terms of reference of the proposed study.

Mr. Fogelholm remarked that the various studies to be undertaken by the staff on international capital flows were somewhat confusing. The Interim Committee had requested that the Board continue to improve the analytical and empirical framework underlying multilateral surveillance, including the measurement, determinants, and systemic consequences of international capital flows. Directors had before them the outline for a study on the measurement of international capital flows, which, in accordance with its title, would basically deal with the data aspects of such flows. Yet, in the main staff paper for the discussion on developments and prospects in international capital markets in 1989, the staff had referred to a further study on the determinants and systemic consequences of international capital flows, scheduled for completion by June 1990. There did not seem to be any information available on the content of the latter study, a study that seemed to be more in line with the formal proposal made by Mr. Duisenberg, President of the BIS, to the Interim Committee. The staff could usefully comment on the relationship between the studies on the measurement of international capital flows and on the determinants and systemic consequences of such flows. The latter was clearly the more important of the two studies, regardless of the fact that the statistical base was not perfect.

It was important that the study on the measurement of international capital flows focus on the central capital account items, or those with the greatest volume and largest statistical discrepancies, Mr. Fogelholm added. Not much emphasis was needed on foreign direct investment, as the data base for such investment seemed to be adequate and the data discrepancies minor. In contrast, greater work would be needed on portfolio investment and short term capital flows. He was not sure that the staff's current outline reflected properly those considerations.

Mr. Goos said that he could support the outline of the proposed study. The study would need to be cost effective and not overlap other related studies, and it would be useful in that connection if the staff could provide a breakdown of the costs of the study. The measurement problems in the study were apparently extremely complex, and one should, of course, therefore not raise the objectives of the planned work unrealistically high.

Mr. Yamazaki commented that he could support the proposed study, but that the staff should avoid unnecessary overlap in it with the studies under way in other institutions, such as, inter alia, the OECD.

The Chairman indicated that the study would be conducted in close collaboration with the BIS, the OECD, and the EC, with which the Fund had already had preliminary contacts. Given the phenomenon of financial globalization and the loopholes in capital flow statistics, those institutions had indicated that they would be pleased to share with the Fund their preliminary findings within their areas of competence.

Mr. Dawson stated that he too supported the terms of reference of the proposed study, and he inquired whether the important question of capital flight would also be considered in the study.

Mr. Quirós remarked that he supported the proposed study and wished to highlight his chair's concern--particularly vis-à-vis the working party of outside experts that would undertake a study on international capital flows--that offshore banking centers were an important factor in financial globalization, and also could have contributed somewhat to the world current account discrepancy. In the study, there was a need to reconcile the questions of bank secrecy, or bank confidentiality, and adequate availability of information. The distinction should also be kept in mind between information that was required for policymaking decisions at institutions such as the Fund, and information that could be used for other purposes.

Mr. Schioppa indicated that he supported the staff's important study. The staff should investigate portfolio investment in great detail, as it was the area in which most of the statistical difficulties were encountered and in which substantial growth was occurring each year. Substantial work should also be done to try to achieve some comparability between the balance of payments statistics and international banking and capital market statistics. Only if there was consistency between those two sets of statistics could the Fund analyze the evolution in capital markets, taking into adequate account the underlying real factors. Moreover, some attention should be devoted to achieving a geographical breakdown of capital flows. While that would be extremely difficult to achieve, the Fund could work with Eurostat, which had done some work in breaking down portfolio investment by region. It was a cause for concern that some important countries were unable to provide geographical breakdowns of portfolio investment, the reasons for which, and possibility of correcting, should be an aspect of the staff study.

Mr. Enoch said that he could support the proposed study, especially after the Chairman's assurance that overlap with the work done by other institutions would be avoided. The study should concentrate on capital flow items and discrepancies in which the most progress could be expected, and he would join Mr. Goos in expressing an interest in the breakdown of the study's cost.

Mr. Mawakani said that he supported the proposed study, and hoped that the technical and administrative problems facing developing countries in compiling statistics on international capital flows would be addressed. In that respect, he was reassured to note that the staff envisaged involving in the study experts from a wide geographical background. Given that the staff paper mentioned taking into account similar studies by other institutions, he inquired whether the staff had investigated the possibility of sharing the cost of the proposed study with the BIS, OECD, and UN.

Mr. Férnandez Ordóñez, Mr. Zhang, and Mr. Ghasimi remarked that they supported the proposed study.

Mr. Chatah said that he supported the proposed study and that he agreed with the comments made regarding the need to ensure the cost-effectiveness of the study. For comparison, could the staff provide information on the cost of the Report on the World Current Account Discrepancy?

The Director of the Bureau of Statistics noted that Directors' several important suggestions would be taken into account in the proposed study.

The staff had been in contact with the BIS, OECD, and the EC, which had been conducting studies in the area of international capital flows, the Director pointed out. Those organizations were greatly interested by a number of questions relating to the proposed study under the auspices of the Fund, and had assured the Fund that the results of their studies would be made available as inputs for the staff's work. Those organizations' studies had covered, in particular, direct investment and some aspects of portfolio investment, and they would provide a good basis for the study on the measurement of international capital flows. The 1987 Report on the World Current Account Discrepancy, the Esteva Report, had cost about $1.7 million over three years, which would be comparable with the expected cost of the study on the measurement of international capital flows, estimated by the Administration Department to cost about $2.07 million, the Director indicated. The estimates by the Administration Department showed that about two thirds of the $2.07 million would comprise the salaries of the Chairman of the Working Party, who would be engaged on a part-time basis, and of the technical staff, consisting of a Director and several consultants, and support staff. The remaining cost would be for travel by members of the Working Party to the meetings to be held over a two-year period, and for some travel by the technical staff for consultations with officials in capital markets countries.

The question of capital flight would indeed be considered in the study, the Director added. Moreover, the staff paper before the Board indicated that the question of offshore banking centers had been a prominent one in the Report on the World Current Account Discrepancy in terms of its treatment of investment income flows. He expected that those centers would again figure importantly in the new study on the measurement of international capital flows.

The recommendations of the Working Party resulting from the study would hopefully lead to improvements in the collection of statistics and to better coverage of cross-border capital flows, the Director continued. They should certainly also promote consistency in national statistics, in terms of stock and flow data, investment positions, assets and liabilities positions, and to improved linkages in domestic economic statistics in general. At the level of the Fund, the staff would use the recommendations of the Working Party as a means to improve the Fund's balance of payments statistics on a global basis, and as a follow up to the recommendations in the Report on the World Current Account Discrepancy.

The proposed study would be centered on measurement questions, while the other study on international capital flows, included in the current work program, would focus on the determinants and systemic consequences of such flows, the Director of the Bureau of Statistics observed. Those studies should be seen as complementary. One difference between the two studies would be that the measurement study would clearly take considerable time to prepare--given that the Working Party, its technical experts, and the various sub-studies required would all have to be assembled. The study on determinants and systemic consequences would be prepared by the staff, and would be submitted to the Board by June 1990.

The Chairman added that an outline of the study on the determinants and systemic consequences of international capital flows would be circulated to Directors in the near future. He wished to thank the Board for its support for the ambitious, albeit overdue, study on the measurement of such flows. In view of the globalization of financial markets in the 1980s, and the Fund's responsibility for the continued effective functioning of the international monetary system, it was important for the institution to update its knowledge of international capital flows. The substantial loopholes in the Fund's knowledge in the area had presented a problem for the credibility of the Fund's work in a variety of spheres, including on the world economic outlook. While the study would present greater difficulties to the working party than had been the case for the Report on the World Current Account Discrepancy, the two studies would be complementary. While it might not be possible to gain a highly accurate picture of capital transactions, the study would help to put the Fund into a better position for fulfilling important surveillance responsibilities. He would inform Directors periodically of the progress with the study.

The Executive Board then took the following decision:

> The Executive Board approves the proposal to undertake a study on the measurement of international capital flows along the lines set forth in EBAP/89/269 (11/15/89).

Adopted December 6, 1989

3. INTERNATIONAL CAPITAL MARKETS - DEVELOPMENTS AND PROSPECTS, 1989; AND OFFICIALLY SUPPORTED EXPORT CREDITS - DEVELOPMENTS AND PROSPECTS

The Executive Directors considered the staff paper on developments and prospects in international capital markets in 1989 (SM/89/239, 11/16/89); background papers on those topics (SM/89/207, 10/12/89), and on international banking activity in the first half of 1989 (SM/89/249, 11/21/89); and a paper on recent developments in capital market financing for developing countries (SM/89/160, 8/3/89). They also had before them a paper on developments and prospects for officially supported export credits (SM/89/219, 10/27/89).

Mr. de Groote made the following statement:

Assessing the effectiveness of the intermediation function of international capital markets is no easy task. Indeed, each current account imbalance poses anew the fundamental question of what evolving blend of financing versus adjustment will be appropriate over time; and the determination of the adjustment by financial markets. The efficiency of the financial markets' performance could therefore be judged by their ability to match ex post financing resources with ex ante financing needs. However, this theoretical approach would seem to have little relevance to the major imbalances between industrial countries, as suggested by the staff: for instance, the United Kingdom has succeeded in finding the resources demanded by its current account deficit in the category of "errors and omissions," and in "other" flows, whereas the United States is assured of finding, somehow, the resources its deficit requires.

Over the past year and a half, the international capital markets have generated the financial resources needed by the major industrial countries with surprising ease. They do not, however, merit full credit for this accomplishment, which was instead mainly and directly the result of apparently convincing effects of the policy measures adopted by major industrial countries in favor of their adjustment to, and therefore the sustainability of, their existing current account imbalances.

Helpful as the separation between financing and adjustment may be, it could be argued that this distinction is in the process of being blurred by a particular type of international capital flow that expanded rapidly in 1988, and probably has continued to do so in 1989, namely, foreign direct investment. At least two points must be made in this connection. The first has to do with the classification of financing flows, and the second with the adjustment effects of this particular type of flow.

From the standpoint of the balance of payments, direct foreign investment flows are generally classified as long-term operations, generally by companies engaged in international business, and thus as mainly autonomous in nature. Recent U.S. experience, however, has cast some doubt on such clear-cut classifications. The cross-border flows of net direct investments in connection with mergers, acquisitions, and leveraged buyouts might seem to call into question the long-term character of these flows; moreover, they show that nowadays direct foreign investment operations cay no longer be regarded as purely autonomous. Indeed, the continued U.S. current account deficits--especially in light of their high correlation with bilateral commercial imbalances--seem to be generating cross-border direct investment flows toward the deficit country. These flows are clearly of a compensatory nature, since they occur in response to the past, and present, "above the line" imbalances that they are intended to reduce, and to serve as a means for addressing the mounting protectionist pressures that large, persistent surpluses, and their corresponding deficits, are bound to generate. But the compensatory and financial nature of these direct investment flows is even more pronounced if one considers that the balance of payments data reproduced on page 4 of SM/89/239 show substantial fluctuations in net direct investment flows from the first year to the second; this volatility reflects short-term considerations, which themselves possess a high degree of volatility, such as "market confidence in the soundness of underlying economic policies, and in the resulting pattern of exchange and interest rates," as the staff puts it. This tentative conclusion would probably not only require revision of what we thought to be the correct taxonomy of balance of payments operations, but could also change our perception of the motivations and underlying features of direct foreign investment flows. If this is so, there would be merit in clearly spelling out this conclusion and its implications.

Moreover, foreign direct investment flows, formerly autonomous but now increasingly compensatory in nature, are not only to be considered as a financing vehicle; they also represent an instrument of adjustment for underlying current account imbalances. This adjustment effect is quite evident when the manufacturing sector is involved, and when the domestic input and employment content of manufactured goods production is reasonably commensurate with the benefits of participation to the foreign investor. This adjustment effect is less evident when foreign real estate investment, particularly conspicuous forms, is involved. However, the "pump priming" or "pump reinforcing" effects on tourist receipts--and the concomitant improvement in the current account--of foreign investment flows should not be underestimated. In the final analysis, we should recognize the beneficial effects, in terms of internal and external adjustment, that accrue from foreign direct investment flows; and again, if this is true, I believe we should clearly spell out these effects.

The same line of reasoning can generally be extended to cross-border holdings of equity. These have already increased considerably in the recent past, and are expected to continue increasing, driven by international portfolio diversifications not only on the part of well-informed institutional investors, but also on the part of private investors through the privileged vehicle of investment funds. But even diversified portfolio holdings are subject to adjustments as new information and new judgments become available. These portfolio shifts may be accomplished gradually or suddenly, as the October 1987 stock exchange break clearly showed. This raises the pertinent issue of the effects of portfolio diversification and adjustment on the overall stability of international capital markets, since foreign equity holdings will be the first candidates for rapid sell-off if a stock market crisis recurs, which, to say the least, cannot reasonably be excluded. Given such behavioral patterns, must we conclude that an equiproportional international diversification of equity holdings would result in a world financial system potentially less stable than one without such diversification? I am tempted to answer "yes," but, at the same time, I hasten to add that we should not draw from this the conclusion that cross-border portfolio diversifications as such are undesirable--their otherwise beneficial effects are too well known for me to belabor. Let me simply add that these potentially disturbing effects could be categorized as inevitable "transitory adjustment costs," entailed by the process of transferring from a less diversified to a more diversified portfolio stock.

I characterized these "transitory adjustment costs" as potential. Two further remarks remain to be made. In real life, no equiproportional international diversification of equity holdings has occurred, because portfolio adjustment was embedded in a process of current account deficit financing that reinforced the adjustment, in a biased manner. The potential "transitory adjustment costs" might therefore be higher if a crisis situation emerged. This conclusion is reinforced by the emergence and subsequent growth of the derivative product markets, toward which the staff takes a lenient attitude even though it admits that that emergence "implies the more rapid transmission of disturbances from market to market, in the course of normal events." The last six words of this sentence should be given special emphasis, particularly since they come from an institution whose very purpose is to prevent or to deal with courses of events that are not normal. This observation brings me to my second remark. The process of world financial integration and globalization has not only been profound, but also rapid. Moreover, it took place during a period of prolonged and unprecedented current account imbalances. Obviously, we currently live in a financial world fundamentally different from that of a decade ago, a world in which financial and systemic risks have changed and, even more worrisome, can no longer, or, at least, not yet, be clearly identified. In such an unfamiliar world, caution must prevail, and I can much agree with the staff that "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." Indeed, there can be no escape from adjustment.

The movement toward globalization and integration of world financial markets is, by its very nature, an evolutionary movement, proceeding over time. At this stage, we cannot make an assessment benefiting from "hindsight," since we are still in a stage of "variable geometry." The ongoing Uruguay Round is clearly in the background to keep us mindful of this truth. Increased competition, both among traditional market participants, and from new actors entering the national and international financial markets--if such a distinction is still valid--id not in and of itself a desirable result. Rather, it is the increased financial market efficiency promised by increased competition that has made the latter appear desirable to many national authorities: competition leads to efficiency in the sense that it prevents any market participant from making abnormally high profits. Also, efficient markets mean that resources flow to the most profitable areas in which they can be employed, and increased competition must not be allowed to lead to worrisome financial fragility, by squeezing profit margins. At this point, the more general issue surfaces of what level of financial stability is desirable to maintain during a series of profound changes leading to increased efficiency. J. Schumpeter has captured the idea perfectly in saying that the competitive process leads to "creative destruction." But in the financial sector, and particularly in in the field of banking, can we be sure that the result of competition is not more destructive than creative, at least during a transitional period of unknown duration? Or, to put it otherwise, is there something special about the banking field that distinguishes it from the other fields of economic activity? In my view, this is precisely the case in modern economies, because of the financial sector's special role in the intermediation process between savings and investment--both for flows and stocks--and in the payments mechanism. The distinctive feature of the financial sector is that it is entrusted not only with private, but also with public goods. Therefore, in the process of change under discussion, the trade-off between stability and efficiency has to be balanced in favor of stability; in this context, stability has to be regarded as an objective in itself which is worth some loss in efficiency.

Finally, let me turn briefly to the staff paper on officially supported export credits. Seven years after the currently in a much better position than the commercial banks to resume their activities on behalf of debtor countries that implement sound policies. The export credit agencies' success in regaining such a portion is due not least of all to the fact that, from the outset, this group of creditors actively explored rescheduling solutions that supported, instead of delayed, the return to normal business relations. It is not clear why the banks did not take similar advantage of their successive rescheduling rounds to establish a subordination of old debt to new debt, by the introduction of such techniques as cut-off dates. Their more systemic use of such techniques could have placed them today in a position in which it would have been easier to subject the stock of old debts to such regimes as debt reduction, without impairing the possibility of simultaneously resuming new lending on an adequate scale. Be that as it may, the official sector has again demonstrated--currently in this particular area--a degree of creativity that is a model for the private sector. I have questions on two aspects of the current export credit policies:

From the outset, these agencies have refrained from including short-term credit in their consolidation exercises, in order to enable them to keep open their coverage of this type of business activity. The staff suggests that this type of coverage is indeed important for ensuring that countries will have continuous availability of essential imports, while brief interruptions in medium- and long-term business would be less damaging to the operation of their economies. This raises the question of whether such a preference for short-term over long-term business should still be advocated with the same vigor in the current situation--in which the availability of adequate credit flows is bound to be constrained for an extended period, while the need for long-term capital assistance to support the diversification of the debtor countries' economies has become even more pressing.

The staff cautions against the export credit agencies' exploration of a more systematic use of escrow accounts in the conduct of their business. While the reservations of the World Bank and the Fund against the use of such instruments are well founded, the question arises as to whether creditors that are prepared to invest in countries' long-term economic prospects have a viable alternative at their disposal under all circumstances. giving up all direct claims on the foreign exchange flows generated by a specific project--as the staff would have the agencies do--confronts potential investors with the risk that they might have to share the foreign exchange earnings with those holders of old debt that are not prepared to extend their exposure by a modest expansion of their lending, so that new investments may finally not be forthcoming. It would have been preferable if the staff had also given some attention to this "free rider" aspect of the escrow account issue, and I invite them to reflect further on criteria for seeking satisfactory solutions on a case-by-case basis.

Mr. Nimatallah remarked that he wished to confirm his view that member countries should make every effort to liberalize and strengthen international capital markets, because a free, more integrated, and deepened international capital market would facilitate the smooth functioning of the international monetary system. Assuming that measures to liberalize and improve the measurement of capital flows were eventually taken, he saw three objectives that needed to be pursued: promoting stability in financial markets, insulating the international economic system from financial market disruptions, and improving crisis management.

The staff had mentioned two requirements for meeting the objective of sustaining international economic stability. The first was that governments in both industrial and developing countries had to adopt and sustain appropriate macro- and microeconomic policies to minimize uncertainties and to leave no cause for market participants to react disruptively. The current, persistent imbalances, both domestic and external, were examples of factors that could produce uncertainties. In developing countries, where increased participation in international capital markets was currently highly desirable for both investors and borrowers, it was crucial that their governments follow policies that encouraged confidence among both parties. He very much agreed with the staff that governments in developing countries needed to pay serious attention to improving the creditworthiness of borrowers and to improving the standards of domestic financial markets for investors. Given that the Fund had already been helping industrial countries to coordinate macro- economic policies and developing countries to improve their creditworthiness, the institution could also help, together with the Bank, to improve the standards of domestic financial markets in developing countries.

The second means to ensure the stability of the international economic system was to minimize tax differentials on returns from financial assets, in view of the fact that such differentials could create incentives for sudden investment portfolio shifts, Mr. Nimatallah continued. Indeed, the staff had given several examples of how tax differentials could lead to sudden shifts in investment and to concealment by investors of those shifts to avoid payment of certain taxes. He therefore strongly recommended that those countries coordinate tax reform in general, and harmonize taxes on financial assets in particular. To fulfill its responsibility of ensuring exchange market stability, the Fund should help its members to ensure local financial and capital market stability through the various means mentioned above.

In regard to insulating the international economic system from financial disruptions, Mr. Nimatallah noted the various international efforts to strengthen banks and securities' houses capital bases and prudential standards, and the considerable attention being paid to strengthening regulations for clearing and settlement systems. Those efforts were appropriate, and all members should indeed attempt to strengthen domestic capital bases and clearing and settlement regulations. The efforts of the Basle Committee of Bank Supervisors and the EC's efforts to establish a uniform minimum solvency ratio for banks should be endorsed and possibly refined by international organizations with wide memberships, such as the Fund and the Bank, so that those ratios could be accepted more globally.

The question of how to ensure appropriate crisis management was the most difficult one, as such management required not only coordination in the field of the timing the implementation of the steps needed to face a crisis, but also involved the need for the confidentiality of those steps, particularly in the case of a threat to liquidity, Mr. Nimatallah explained. Central Banks were not supposed to reveal their criteria for determining which financial institutions could be saved and which could not in cases of liquidity crises. That difficulty arose from there being two irreconcilable objectives, that of encouraging the private financial sector to operate freely, and that of insulating the international economic system from sudden financial disruptions. There had to be minimum standards of behavior set out by regulators and supervisors for normal times of financial market stability, and there had to be a set of well-coordinated steps in place to help contain crises when they arose, and thereby to insulate and protect the international economic system. It was clear that, in 1987, central banks had managed the stock market crash better than had been the case in 1929, and they had certainly managed the stock market break in 1989 better than they had in 1987. He hoped that central bank authorities would learn more about crisis management from sources such as the Fund, in addition to the experience they gain in actual crises.

Official credit institutions would have an important role to play in the future as trade flows expanded, Mr. Nimatallah remarked. The Fund should therefore encourage any measures to strengthen those export credit agencies in any country. In view of the problem of many developing countries' impaired creditworthiness, he encouraged export credit agencies to emphasize, for the time being, the financing of exports for viable projects, and lending or provision of credit guarantees to the private sector, more than to the public sector. Moreover, export credit institutions in industrial countries should look for projects that were partly financed by equity guarantees by the Multilateral Investment Guarantee Agency (MIGA), in addition to co-financing with the World Bank. Developing countries should strengthen the capital base of their export credit institutions in order to help expand the possible markets for their exports, and he favored coordination between multilateral trade credit institutions, such as the Islamic Development Bank and the Arab Monetary Fund. Those institutions should cooperate with their multilateral counterparts in other countries with a view to increasing the efficiency of both their operations, thereby to reduce costs for borrowers, and to explore avenues that would encourage trade flows despite problems with countries' creditworthiness.

Mr. Yamazaki said that he generally agreed with staff's views and that he supported the constructive proposal for a study on the measurement on international capital flows.

Despite the stagnant activity in capital markets following the stock market decline in October 1987, he welcomed the fact that international capital markets had recovered sharply in 1988 and in the first half of 1989, Mr. Yamazaki continued. While many factors had contributed to the resilience in capital market activity, he generally believed that strong growth, coupled with price stability in industrial countries, had been essential in restoring the confidence of market participants. In that connection, he stressed the importance of strengthened policy coordination among major industrial countries.

Equally important was the fact that the process of integration of major markets had continued and strengthened, Mr. Yamazaki added. In fact, one of the recent most salient features in international capital markets was the high degree of integration and interdependence among international markets, such as New York, London, and Tokyo. Consequently, transactions in leading financial instruments, such as the equity of multinational enterprises and government bonds of major industrial countries--including in futures transactions--could be made 24 hours a day in the same manner and with the same speed. In the circumstances, he believed that the words "international markets" had become somewhat obsolete, because they presupposed the existence of separate and independent markets. In fact, Peter Drucker, in his most recent book, had stressed that the world economy had changed from being international to transnational.

That being said, it should be stressed that not only did the liberalization of individual markets contribute to increasing transaction volume, but it also enhanced the transparency of the market by decreasing the need for "detour" transactions caused by regulations on domestic markets. A good example was the remarkable decline in Japanese banks' funding operations in overseas interbank markets after the further liberalization of the domestic interbank market in November 1988, as described on page 6 of the main staff paper.

As the staff had rightly pointed out, however, the rapid globalization of international financial and capital markets had necessitated changes in the supervisory framework of individual financial authorities Mr. Yamazaki stated. In particular, direct and quantitative control of the activities of market participants had become inefficient and sometimes irrelevant, and more attention had to be paid to the prudential aspect of authorities' regulatory and supervisory role. That tendency was often referred to as reregulation as opposed to the concept of deregulation. However, he wished to stress that reregulation was a result of deregulation, and that it should not be interpreted as returning to old regulations. Consistent with that new development, the Japanese authorities had steadily reviewed the regulatory and supervisory framework of capital and financial markets, with a view to enhancing the prudent management of market participants. His authorities had been among the most active participants in the discussions of the Basle Committee of Bank Supervisors, as well as in the recent work of the International Organization of Securities' Commissions (IOSCO). Furthermore, the Bank of Japan had recently launched a new financial network system called the BOJ NET, aimed at enhancing the efficiency of the fund transfer system while at the same time reducing the risk associated with the large volume of financial transactions. Also, both the Ministry of Finance and the Bank of Japan had strengthened the system of daily information exchanges with the authorities of major industrial countries.

Under the new regulatory and supervisory framework mentioned thus far, authorities should attach particular importance to monitoring closely the daily movements of markets with sufficient insight into the highly sophisticated mechanisms behind the market transactions, Mr. Yamazaki indicated. Given globalization, authorities should also seek, through the new regulatory and supervisory framework, to enhance the transparency and consistency of financial transactions in order to restore the confidence of market participants. Nonetheless, the unique characteristics of financial services needed to be taken into account, in which confidentiality and anonymity of transactions often played an essential role. Similarly, the efficiency of monetary and credit policy required a certain degree of obscurity in monetary authorities' operations. A delicate balance should therefore be struck between those seemingly conflicting interests in constructing a new supervisory framework for financial services. In view of those considerations, his authorities fully supported the staff's critical view, on page 21 and 22 of the main staff paper, of the liberalization of trade in financial services. His authorities strongly agreed that some of the principles of the GATT could not be applied directly to the financial services sector, because of what the staff called the "sui generis" nature of financial transactions. In that connection, he was concerned by the fact that insufficient attention seemed to have been paid to the unique characteristics of financial transactions in the context of the Uruguay Round. While his authorities had not yet finalized their position regarding the sectors to be included in the discussion on liberalization on trade in the Uruguay Round, they generally believed that, in view of the special and technical character of financial services, a separate framework should be employed if those services were to be discussed in that forum.

Regarding the integration of developing countries into international capital markets, he joined the staff in stressing the importance of efforts by developing countries to restore the confidence of the international financial community in their creditworthiness, through implementing strong adjustment policies, including, inter alia, maintaining positive real interest rates and taking measures to encourage foreign investments, Mr. Yamazaki went on. The role of the Fund and of the Bank in that area could not be overemphasized.

He broadly shared the staff's views in the paper on official export credits, Mr. Yamazaki indicated. Despite the substantial effect of official export credits on the flow of funds to developing countries, Directors were not highly familiar with that issue because they had lacked information thus far. He therefore welcomed the staff's efforts to keep the Board informed of the most recent developments regarding official export credits.

He wished to raise a minor point that, while the staff had referred to Japan's policy of "recycling its current account surpluses," his authorities had never used such terminology, Mr. Yamazaki pointed out. The staff's terminology was relevant to the "good old days" when, in principle, only the official sector could accumulate foreign exchange claims, and international capital transactions in the private sectors were limited to exceptional cases. All Directors would recognize, however, that in the current world economy, the flow of capital was independent from that of goods and services. Furthermore, the size of private capital flows exceeded the flow of goods, services, and of official capital by a large margin, thereby largely obscuring the relationship between the balance of the current account and the flow of official capital. The staff's terminology was also inconsistent with the Japanese authorities' commitment to reducing Japan's current account surplus, and with the fact that the surplus had declined sharply in recent months. Accordingly, he proposed to change the expression to "recycling its capital."

Mr. Enoch made the following statement:

Once again the staff has produced a review of international capital markets that is thorough and that provides, in the background paper, a useful update of important market and regulatory developments. I have a number of detailed technical remarks that I can give to the staff bilaterally.

One of the dominant themes of the staff paper is the efficient way in which private markets have been able to finance large current account imbalances between industrial countries, when aided by stability in interest and exchange rates and confidence in authorities' policy stances. Supporting these factors is progressive deregulation, which removes constraints on capital flows. But the less attractive counterpart to this development are the risk factors: first, there is the risk of divergent macroeconomic policies that could cause a wholesale and sudden change in investors' perceptions of an economy and its currency; second is the changing nature of investors--if they increasingly consist of institutions, are they also perhaps increasingly driven by short-term factors?

But even more disturbing than these two elements are the more systemic risks: increased international integration of markets increases contagion from one financial center to another. And as distinctions between instruments become blurred, the danger of "cross-infection" of markets grows. There is also the contagion risk that arises from settlement systems, not only as the number of international clearing and settlement systems multiply, but also as the links between markets and centers increase, so that a breakdown in the settlement system of one market is increasingly likely to have spillover effects in others.

In this connection, a point that struck me as being absent from the staff paper's consideration of systemic risk was the influence of program trading in an international context. This element might be worth looking at in the future, despite some recent indications that market players are perhaps becoming disillusioned with this instrument.

A supporting theme in the financing of external imbalances is the increase in international portfolio diversification. In combination with the reduction in natural "firebreaks," this diversification has increased the covariance of price movements between equity markets in different centers. Yet despite this, and despite the increased opportunities available for hedging, it is clear from the staff paper that events in October 1987 led to a very large amount of investment repatriation, which was subsequently reversed as confidence re-emerged in 1988. I wonder if this apparent paradox might not warrant some closer scrutiny, looking for example at exchange rate concerns and also at the relative safe-haven attractions of temporary domestic "homes" for financial resources at such times.

As well as describing a blurring of market boundaries, the staff paper also highlights the increasing continuity in the spectrum of instruments. But one of the greatest influences in this process, securitization, receives scant attention in this year's paper. Also, perhaps next year's paper could look more closely at the systemic implications of international merger and acquisition activity, and leveraged financing. Recent studies have shown that a number of major banks are more exposed to this activity than to debt in less developed countries.

Both the main paper and the background paper devote considerable attention to the influence of taxation on market structure--most importantly, on the location of financial activity--and on market behavior. But, as the background paper recognizes, taxes do not on their own generate net capital flows. Of perhaps more fundamental importance for a fully international capital market is agreement between national authorities on equivalent regulation for market participants, to achieve a level "playing field." Such harmonization, based on appropriate prudential standards, is essential for allowing participants to operate fully in the international markets. As the staff paper recognizes, the need for progress in this area will become ever more pressing as progress is made in liberalizing of trade in financial services.

The staff paper concentrates on capital flows between a few major economies. The background paper's report on emerging stock markets is interesting, but serves to emphasize the limited nature of such markets in terms of geographical coverage, capitalization, and dependence on a few stocks. Looking at markets more generally, the main paper notes how the increasing international aspect of markets presents developing countries with both problems and opportunities. Clearly, facing up to these challenges must begin in the domestic context, with appropriate macroeconomic policies, and improved domestic financial markets. The staff paper prepared for the Board in August on market financing for developing countries (SM/89/159, 8/2/89) was useful, but the situation may develop quite rapidly in some areas, and it could perhaps be helpful if in next year's paper, the staff devoted some more attention to the scope for innovative financing techniques for developing countries, such as funds collateralized on assets or commodity revenues.

The papers on officially supported export credits provide a useful survey of recent developments. There are three areas in which I want to make specific comments. The first is the place of export credits within the debt strategy. The discussion in the paper usefully draws out the central importance of a fixed cut-off date for rescheduling to allow the extension of new credits; the limited data available tend to confirm that such cut-off dates have been helpful. I join Mr. de Groote, however, in noting that it is perhaps regrettable that commercial banks did not opt for this route. But official credit agencies' rescheduling of obligations that were incurred before the cut-off date--especially when they included rescheduling of interest--has nonetheless imposed a significant burden on those agencies, and, given the constraints under which they operate, it has limited the availability of new funds. The staff paper notes the importance of burden sharing between the official and private sectors, particularly at a time when the commercial banks are withdrawing from providing finance for heavily indebted countries. Related to this is the export agencies' legitimate concern that debt reduction schemes for the banks that exempt a large portion of their claims from future rescheduling may effectively subordinate the claims of remaining lenders. This could imply an undue transfer of risk over the longer term.

My second comment concerns the increasing trend by authorities to relate official export credits more toward market forces. The staff paper identifies a shift toward allocation through price rather than quantity, with risk reflected in premia scales rather than quantity limits. Nevertheless, one should not exaggerate the extent of this trend. As the paper recognizes, managing portfolio risk requires some quantity restraints and, in addition, business in some high-risk areas may be exceptionally price inelastic. Nonetheless, more flexible pricing has facilitated the flow of new credits by relating cost to risk. This greater differentiation of business has been seen also in improvements in both country and project vetting.

More precise monitoring of business has been thwarted in part by a shift in emphasis toward cover for transactions with private sector operations, about which, as the staff paper notes, information can be difficult to come by. Nevertheless, efforts to develop this shift further must continue, possibly through the use of financial intermediaries to support the increasing emphasis on private sector development in adjustment programs, and in order to encourage projects that will be based on commercial criteria. A number of new techniques of cover provision are interesting, and they will no doubt be further refined. As for the escrow account mechanism, I have some sympathy with adopting this route, if it allows a viable project to proceed in the face of sovereign risk. But I also recognize the problems generated for the international financial institutions, particularly the implications of such a process for their preferred creditor status. Perhaps a compromise solution is feasible, in which only a portion of foreign exchange earnings are channeled to the escrow account, with the remainder becoming a part of general reserves. It is worth noting in this regard that escrow accounts do not protect export credit agencies from rescheduling. Paris Club practice is to sweep up all special payments mechanisms in a rescheduling unless they are protected by the cut-off date.

My final comments concern subsidization of exports and transparency of information. Part of the move toward a greater role for market forces has come through a reduction in subsidization by export credit agencies. This has been supported by a consensus in the OECD, but more might yet be achieved to make agency accounting transparent. Mixed credits are particularly difficult, in that they serve to direct aid funds into trade competition rather than directly to the poorest countries, to which the staff paper draws appropriate attention. The background paper provides a helpful analysis of statistical problems in this area. Under pressure from their overseers, progress has been made in some agencies' accounts with cash flow deficits being made explicit and requirements being specified that provisions be made in relation to the probability of collecting an obligation. These improved accounting practices will in turn assist and improve policymakers' understanding of the workings of export credit agencies, and will enable them to operate the agencies with more sensitive regard to the needs and changing circumstances of their customers.

Mr. Nimatallah commented that he agreed with Mr. Enoch that, in its next review of international capital markets, the staff should include the question of securitization, a process that might usefully help commercial banks to strengthen their assets.

The Chairman agreed that it would be important for the staff to pursue the question of securitization, even though it was hard to obtain precise data in the area.

Mr. Landau said that the staff papers before the Board provided Directors with important information for reviewing recent developments in international capital markets, but that some of those developments, and their role in matching international investment and savings flows, seemed relevant to the Fund's general "surveillance" function and could perhaps therefore have been linked more closely to the world economic outlook exercise. He wished to focus his remarks on three issues; the main developments and factors underlying recent changes in international capital markets; the role of those international markets in accommodating savings-investment imbalances, and their consequences; and the role of the financial markets in developing countries.

It was clear by now that the stock market crash of 1987 had not lead to stagnation in international financial markets, Mr. Landau continued. Activity in the international bond market had been buoyant in 1988 and 1989, and despite some slowing down in international bank lending, such banking activity had remained strong. However, gross figures were sometimes misleading; for instance, the slowdown in international banking activity, had been the result mainly of developments in the interbank market, although, at the same time, a significant slowdown in credit growth had taken place despite buoyant economic activity. In contrast to those developments, certain sectors in international financial markets had expanded strongly, for instance, the syndicated credit facilities, which, driven by corporate takeover activity had expanded at the record rates of the early 1980s. A further important point to note was the reduced role of bank lending in financing current account imbalances. Moreover, "recovery" seemed the proper word to describe recent developments in the bond sector, at least as far as gross activity was concerned. However, during the last quarters of the year, bond issues had been driven largely by equity-related bonds, depending heavily on Japanese borrowers.

Despite the shock in 1987, innovation in international markets and those markets' subsequent globalization had not slowed down, and continued to be impressive, Mr. Landau stated. But, as the staff paper clearly indicated, innovation and globalization might also be creating risks that were not fully understood. The first of those risks was, of course, the quick transmission of shocks and disturbances, which made the question of establishing a system for crisis management an increasingly central issue. In that context, he saw a further reason for reaffirming and reassessing the role of the Fund if needed, particularly through the Ninth General Review of Quotas, which could secure the Fund's continued effective role of safeguarding the international financial system. The question of appropriate regulation for containing systemic risks was of paramount importance, and the adoption of common standards and regulatory measures was therefore clearly essential. In that context, the efforts within the EC, which were well described in the staff paper, were important. Furthermore, the Basle Committee's adoption of common standards for capital adequacy for banks showed the concern of authorities for limiting risks and ensuring fair competition between countries.

Authorities' efforts in the regulatory area should not be seen as incompatible with the further liberalization of trade in financial services through, in particular, the negotiations in the GATT, Mr. Landau pointed out. While he agreed that some forms of liberalization might result in reduced stability of the financial system, he wondered why most of the basic principles governing the GATT negotiations could not easily be applied to the financial services sector, which the staff seemed to have implied. In particular, the staff could explain more clearly its views on why the principle of transparency in regulations might conflict with the conduct of monetary policy: even though monetary authorities might have to disguise some of their actions, regulations in themselves still had to remain transparent. His views on the question therefore differed with those of Mr. Yamazaki.

Globalization and integration of international markets, particularly the development of free capital movements, had placed greater emphasis on the role of tax systems in affecting the transaction process, Mr. Landau pointed out. He saw a real threat from competition that could develop between countries over tax rates, which could have a major negative impact on government revenues. Moreover, freedom in capital movements did not mean freedom for fraud, and procedures for cooperation between countries in that area had to be further enhanced.

It seemed clear by now that the increasing integration of international financial markets had enabled large current account deficits to be financed for protracted periods, Mr. Landau stated. His chair had already expressed the view that that situation might lead to a loosening of economic and financial discipline in those countries in which domestic savings clearly needed to be increased. Furthermore, the stability of protracted financing depended heavily on investor confidence. As mentioned by the staff, international investors could, in the case of market shocks, be very quick in withdrawing their funds back to their own domestic markets. He had been especially struck by the fact that three quarters of the aggregate current account deficits were concentrated in two countries, and that the financing of those imbalances had been facilitated greatly by the increased holdings of foreign assets in the portfolios of institutional investors, facilitated further by the progressive relaxation of controls on foreign investment by such investors. He wondered if that trend toward increased holdings of foreign assets by institutional investors would continue with the same pace in the future, and what the limits were to that process.

It was clear that the process of reintegrating developing countries into world capital markets would be a long one that would depend on those countries' efforts to implement sound policies and those of the banking system to help the developing countries alleviate their debt burdens, Mr. Landau considered. He was concerned by decreased bank lending to those countries, and it was indeed the case that the new debt strategy could not be entirely successful without the provision of new money, which could not be provided by official creditors alone.

He had been greatly interested by the staff's analysis of the role of financial markets in developing countries, Mr. Landau added. He fully shared the staff's view that the improvement of those financial markets could play a most welcome role, at least in two issues: helping to raise the level of savings, and assuring a better allocation of those savings in an economy; and in helping to attract investment by foreigners, by offering them greater opportunities for diversifying their assets. That implied, however, the need for a broad range of reforms in developing countries to ensure the soundness and the security of their financial markets.

Mr. Dawson thanked the staff for its comprehensive review of capital market developments and noted that he could support publication of an edited version of those papers, provided the papers reflected the Board discussion.

The global financial market was a reality from which there was no turning back, and to which governments would therefore need to adjust accordingly, Mr. Dawson continued. Markets, nonetheless, had not always functioned as smoothly as one would wish. In October 1987, shocks had been transmitted quickly across countries and markets, while in October 1989, the lessons from 1987 appeared to have been learnt, with the result that the disruptions were less dramatic and more contained than in the earlier episode. Capital flows, moreover, sometimes contributed to exchange rate movements that did not appear consistent with underlying economic fundamentals, a problem that required concerted action by authorities to avoid adverse effects on the adjustment process. On balance, however, he believed that the global financial market had allocated savings and investment effectively and efficiently in the face of large external balances between the major industrial countries.

The key to greater stability in the international financial markets remained the pursuit of sound and consistent economic and financial policies, Mr. Dawson remarked. The emergence of a global financial market would, like the integrated world economy, require closer cooperation in financial policies in order to complement macroeconomic coordination. However, cooperation did not mean harmonization on the basis of the least common denominator. The system had to be sufficiently robust to accommodate differences in institutional arrangements, preferences regarding the level and composition of taxes, and the desired balance between efficiency, stability, and protection in financial markets.

Progress had been made in achieving closer cooperation in financial policies, Mr. Dawson added. For instance, the agreement reached on capital adequacy was a major step forward, and there was work under way for dealing with the issues associated with "position risk" or the risks associated with changes in prices or interest rates, and with risks related to clearing and payments systems. Work was also under way on reaching agreement on appropriate capital bases for securities houses; and the OECD had been strengthening and extending the Code on Liberalization to eliminate cross-border barriers to capital flows. It was important to build on that progress, and he would note that the inclusion of financial services negotiations as part of the Uruguay Round would represent a critical opportunity. Given the unique character of financial markets, the basic principles used in the trade area might need to be modified to facilitate financial market liberalization. He stressed the importance of national treatment as the excepted standard in the financial services area. It was important, moreover, that the EC, in implementing the 1992 directives that would foster a common European financial system, avoid actions that could discriminate against non-EC countries.

He recognized the concerns that changes in tax rates could alter after tax rates of return on financial assets and influence capital flows, Mr. Dawson indicated. In reaching decisions on taxes, governments would need to factor financial market consequences of tax changes into their assessments to a greater degree than they had in the past. The nature of the problem had grown with global integration, but it was not a fundamentally different one from that in the 1960s. He recalled the controversy over the effects on border adjustments and competitive positions of the shift in Europe from turnover to value-added taxes. He questioned whether it was practical to harmonize tax practices, given the differences in tax systems and tax philosophies. Indeed, countries might simply have to live with the exchange rate consequences of tax differentials and/or take offsetting measures in other areas to ameliorate undesired effects. The wrong approach would be to impose capital controls, which would likely be unworkable and harmful in terms of efficiency.

The staff's review of recent trends in capital market financing for developing countries confirmed the sharp cutback in new lending, which required a strengthening of the debt strategy and greater emphasis on debt and debt-service reduction transactions, Mr. Dawson continued. It was clear from the staff's data that the maintenance of the status quo was not a viable option. Moreover, international support for new market-related financing techniques was clearly needed to facilitate the development of new instruments and to assure that reductions in debt were reflected in an improved financial position of debtors.

As the creditworthiness of developing countries improved, there would be increased scope for integrating those countries more fully into the global financial market based on a diversified financing approach, Mr. Dawson said. Sound economic and financial policies were, of course, a prerequisite for such integration. Debt and debt-service reduction transactions would also help by providing a more diversified means for commercial banks to provide financing. However, other measures would also be needed. In that regard, there was increased foreign interest in investing in some developing countries, a process that should be encouraged by opening up investment regimes and providing adequate protection for foreign investors. Mexico's recent efforts in that area were a good example, which were contributing to increased capital flows. As the staff had noted, action to strengthen domestic financial markets would also be required, including the adoption of market-related interest rates to intermediate between savers and investors.

A resumption of export credit lending to developing countries would also provide increased resources, and he was pleased to note that there had been increased activity by the agencies concerned, Mr. Dawson stated. That activity reflected export credit agencies' move toward a more differentiated approach to developing countries, based on improved country risk assessment, more thorough project analysis, and risk differentiated pricing. As the staff paper pointed out, an essential precondition for the increase in export credit agencies' lending had been the Paris Club's policy of debt subordination, or its refusal to change cut-off dates. Without the assurances that new financial obligations would be serviced, he doubted that the increase in financing flows to low-income countries, indicated in the staff paper, would have occurred.

Mr. Férnandez Ordóñez made the following statement:

The staff's excellent papers clearly describe recent developments, contain an interesting account of the main determinants of those developments, and have elaborated the most interesting policy issues in the area.

I would stress the importance of the links between taxation and capital movements. I will not elaborate on this link, as I am looking forward to the coming discussion on international tax harmonization. The papers for that discussion appropriately contain more information and analysis than those currently before Directors.

However, I would like to connect the question of taxation with the questions discussed in the last part of the paper on capital market financing for developing countries. More specifically, the Fund needs to study further the relationship between taxation and so-called capital flight from developing countries. While tax disincentives are probably not decisive in explaining the flight of capital, they do explain much of why assets do not return. The behavior of economic agents in developing countries regarding taxes is most likely not much different from that in developed countries. Sometimes the only difference is that analysts name the phenomena "capital outflows" instead of "capital flight." For instance, it is not apparent how Germany's experience with the withholding tax will end up, but once citizens have tasted the "delightful fruit" of not paying taxes, it is difficult to convince them to return their capital, because, they fear that they might be forced to pay taxes in the future.

I will not advance any detailed comments on the most serious issue raised by the staff concerning system risk, because of the forthcoming studies announced by the staff. But, I would like to make a suggestion. In view of the fact that the enormous changes in international capital markets prevent a year-by-year analysis from giving an adequate perspective of the significance of developments, a historical perspective could help much in analyzing those changes. Certainly, it is difficult to find precedents for the globalization of capital markets, but we could analyze other phenomena in the past with analogous structures, and study, for example, the similarities and differences in the development of national financial systems before central banks were established and endowed with supervisory powers. To my knowledge, some work in this area has been done in Italy and in the United Kingdom, and it would be interesting to review that literature.

Even though I will suggest some changes in language, I want to encourage the staff to continue following up the development of EC regulations on capital markets. The staff paper mentions all of the recent directives adopted that aim at coordinating financial regulations.

On these issues, the EC can be used as a laboratory for the rest of the world. The EC noted at an early stage, for example, the problems involved in the loss of statistical data. It has also seen how different questions can be connected: for instance, one country has linked its entrance into the exchange rate mechanism of the European Monetary System with the liberalization of capital movements, and other countries have linked the liberalization of capital with a certain degree of tax harmonization. Certainly, the rest of the world does not intend to become a political union, which is the ultimate purpose of the 12 members of the EC. The EC does not feel proud of all the solutions it has found, but its experience remains interesting and relevant to an effort to detect the problems that all countries will encounter when they confront increasing integration.

There is one sentence in the paper that could be deleted, because it is inexact, and because its language might suggest that the staff has taken a position on a serious issue of debate inside the EC that has not yet been decided. On page 22 of its paper, the staff states that "to some extent open capital markets will first force a degree of harmonization as business migrates to jurisdictions where the tax burden is less," and that "the same process may also occur within the EC regardless of the Commission's attempts to harmonize matters by central decisions." This sentence is not entirely accurate, because, according to the position of some member countries, failure to harmonize will not make them favor open capital markets. Moreover, not only the EC Commission favors tax harmonization, but also many countries in the EC. In addition, all EC members want to harmonize taxes by mutual agreement and not by "central decisions."

A more important point, however, is that many European governments do not share the idea that introducing market mechanisms will solve existing problems. The market is a good institution for producing nonpublic goods, but it has proved to be unacceptable in reconciling differences between governments. Without any doubt, the market can be efficient in achieving solutions, but the solution cannot be agreeable to all countries, and in the end, therefore, they would not be agreeable to the people represented by those governments. The idea that competition in the market will decide the level of taxation means, in effect, that all countries should accept that the existing degree of homelessness, faulty education, and poor health conditions have to be set according to conditions in the country where the tax burden is least. We cannot share this view; it could be a case of "noncreative destruction," to paraphrase Schumpeter. Apart from the question of the correctness of various views, I insist that this is a debate that has not yet been decided in the EC, and I do not see the advantage of a Fund publication taking a position on the questions involved.

As on previous occasions, the staff paper on officially supported export credits is an excellent one summarizing recent developments in this field. On page 1 of that paper, the staff points out that there was an increase in new commitments to developing countries in 1988 for the first time since 1982. It states that this partly reflects the fact that the agencies have become increasingly market oriented in their operations. The increase in commitments to developing countries is a positive development, and all Directors would agree that market orientation usually produces good results. However, I do not believe that the market has had anything to do with the change in export credit agencies. The reason these agencies have increased their commitments has to do with political decisions to increase the flow of external resources to developing countries, even if "country risk" has not improved. As Mr. de Groote states, the official sector has again demonstrated a degree of creativity that is a model for the private sector.

We suggest that the information on competition from private insurers be organized to distinguish, on the one hand, the impact of competition on credit to industrial countries--where business is clearly shifting from official insurance agencies to private credit institutions--and, on the other hand, the competition in medium-and long-term credit to developing and socialist countries. In the latter case, competition continues to be restricted to a few countries, indeed, such as the Soviet Union and China. In the case of the Soviet Union, the commercial banks seem to have been even more cautious during the past several months.

Would it not also be relevant to mention the competition from public insurers? In some countries, the public agencies want to continue insuring short-term operations in OECD countries without observing the provisions necessary for insurance companies. This is a case in which the private sector is asking the public sector to obey the law, or to be privatized.

The section of the staff paper devoted to the consequences for official export credit agencies of the single European market is vague, although it probably well reflects the current situation. The Commission wants to create a common European agency, although the member countries prefer to harmonize their export credit policies. The relevant question, however, is how can export credit policies be harmonized when there are still 12 different export policies?

Mr. Quirós commented that he wished to express his recognition for the staff's excellent papers. For the next year's review of international capital markets, the staff could usefully incorporate or expand its consideration of a number of additional areas, such as the questions of: the advantages and disadvantages for the international financial system of the possible single market in the near future for financial services in the European Community; the status of international and regional banking centers throughout the world; the continued trend toward privatization of equity by transfers from public to private enterprises in many countries; projections of future stock markets in certain developing countries; the continued increase in fixed interest rate bonds as against floating rate issues and their impact on long-term interest rates; the concerns of public sectors in pursuit of needed financial services in their respective economies, the guarding of stability in their financial markets, and the need for adequate protection ofinvestors and depositors; and the increased capital needs of countries that were making the transition from centrally planned economies into market-oriented ones. He shared the view that the reality of both globalization and increased volatility of financial markets called for, at the least, the maintenance of the Fund's size in relation to the international monetary system.

In the recent past, Directors had also been presented with interesting analysis by the staff on the relationship between taxes, capital flows, and certain aspects of debt management, particularly in highly indebted countries, Mr. Quirós continued. For instance, the staff's survey of international capital markets of April 1989 had noted that banks in certain countries became interested in participating in new lending to less developed countries only after definite agreements on tax issues had been obtained. Such agreement had been important because new money had always been and would continue to be a basic element in the overall treatment of debt and debt-service management. Furthermore, the question of taxes and capital flows, had repeatedly reminded Directors of not only the importance of fiscal policy, but also of its close relationship with monetary policy, and with some of the basic purposes of the Fund, such as facilitating the expansion of balanced growth of international trade and the promotion and maintenance of high levels of that indicated that those purposes were not being fulfilled, it should be a matter of great concern not only to the country or countries involved, but also to the institution.

Mr. Goos said that he broadly endorsed the views expressed in the staff papers. With respect to the effectiveness of international capital markets in financing current account imbalances, one had to bear in mind some exceptional or "temporary" features in assessing the return to normalcy in financial markets in 1989 after the disruptions in the fall of 1987. The good growth performance of most industrial countries appeared to have provided the external deficit countries with substantial scope for setting attractive interest rates, with a view to attracting capital flows. Those flows had been stimulated further by the relatively low interest rates prevailing in Japan, and the substantial outflow from Germany associated with the German withholding tax. At times, the resulting overall capital flows had exceeded the external financing needs of the major deficit countries by substantial margins. Clearly, a slowing of growth in the deficit countries would confront those countries' monetary authorities with the dilemma of having to choose between external and domestic policy requirements. It was easy to see how that dilemma could again unsettle international financial markets.

Another consideration bearing on the effectiveness of international capital markets was the question of to what extent international capital flows associated with current account imbalances were demand or supply determined, Mr. Goos pointed out. If one considered the identity between the current account and domestic savings and investment balances, as well as the fact that investment activity would normally take place only after necessary financing had been secured, it was reasonable to assume that the emergence of current account deficits would depend in large measure on the prior willingness of external creditors to make the necessary financing available. Seen in that light, it appeared that the increased availability of foreign financing as a result of the growing integration and globalization of financial markets had, in and of itself, contributed to the emergence and perpetuation of external current account deficits. That would, of course, raise questions about the efficiency of international capital markets. And in so far as that was the case, the current situation was reminiscent of the overcycling of the oil surpluses in the 1970s, which had enabled deficit countries to postpone necessary adjustment. The possibility of current account imbalances being supply determined also raised questions concerning the effectiveness of national monetary policy in securing an adequate degree of domestic financial restraint. Considering the cost of delayed adjustment, the urgent need for the major deficit countries to correct their financial imbalances was therefore self-evident. By the same token, the finding in the main staff paper "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," gave little cause for complacency. That point was quite obvious if one kept in mind that the external current account eficits in themselves, and the resulting deterioration in the net international reserve positions of deficit countries, were gaining in importance in the portfolio decisions of international investors.

He could endorse the view of Mr. de Groote in regard to the appropriate emphasis on systemic stability versus market efficiency in the process of multilateral liberalization of financial services, Mr. Goos stated. He would add, in particular, that a point meriting special attention was that prudential regulations for ensuring the stability of national and international financial systems had to be designed in a non-discriminatory manner that would provide a level playing field to all competitors in the financial services sector, regardless of the existing differences between national banking systems. In that context, his authorities were especially concerned about efforts to introduce differing equity adequacy standards for trade in securities by commercial banks and securities firms. His authorities were concerned that those efforts might introduce competitive distortions into the financial system and would induce securities markets to move into areas of more lenient regulatory standards. In view of those concerns, his authorities considered that the issue should be given more attention in the published version of the staff paper.

He wished to emphasize that stability of the financial system would have to rely to a considerable extent on the responsibility of market participants, Mr. Goos pointed out. More specifically, monetary and regulatory authorities would have to concentrate first on improving the transparency of the risks associated with new financing techniques, rather than on raising unrealistic and probably counterproductive expectations in regard to their possible role as lenders of last resort. The huge cost to be borne by the American taxpayer for rehabilitating failing U.S. savings banks should serve as a deterrent.

The staff's analysis of tax harmonization ought to differentiate between the structure of gross capital flows and the taxes that affected domestic saving and investment performance, and, hence, the size of the net capital flows that were the counterparts of the external current account balances, Mr. Goos continued. The relevance of that point had been highlighted by the staff's discussion in the background paper on the negative impact on U.S. domestic saving of preferential tax treatment of owner-occupied housing and social security benefits. The point was of course related further to his earlier comment that the causes of current account imbalances had to be examined first, including the effect of taxes on the current account balance and associated net capital flows. The experience of Germany with the withholding tax had certainly been an excellent case in point illustrating the consequences of taxes for gross capital flows. It might be relevant for Directors to know that his authorities had decided recently to abolish by January 1991 the turnover tax on equity and security transactions, as well as the corporate tax on the issuance of equities, which were driving a substantial portion of those transactions to other financial centers in Europe.

He wished to endorse the staff's finding in its paper on the international coordination of tax policy that "uncoordinated national tax systems can potentially compromise global efficiency, inter- and intro-jurisdictional equity, and the stability of the monetary and trading system," Mr. Goos remarked. He could also support the suggestion in that paper that the Fund, in order to improve monitoring of international capital flows, should develop indicators to enable it to better quantify the international consequences of taxation.

The staff's views on the relationship between developing countries and the international capital markets were appropriate, Mr. Goos added. It was clear that developing countries would have to join in the ongoing efforts at liberalization and harmonization of financial markets if they were to benefit from the growing supply of funding provided through international financial markets.

He did not have any comments to make on the paper on export credit agencies, Mr. Goos said, other than to note that he broadly agreed with the staff's views, and particularly with its positive overall assessment of official export credit insurance and its skepticism vis-à-vis the future role of such insurance.

Mr. Hon made the following statement:

> I am pleased to note the satisfactory performance of the international capital markets in mediating the large current account imbalances between industrial countries in the past 18 months. It is a welcome development that autonomous financing through capital accounts could speedily replace central bank intervention as the major source of funds in the intermediation process, in a period when relative stability in the foreign exchange markets reduced the need for intervention. The increased roles of net international bond issues and foreign direct investment during this period are welcome, in view of their contribution to the further integration of international capital markets.
>
> In this connection, I am glad to note that the process of integration, liberalization, and innovation in international capital markets has been progressing steadily, and that a structure of closely linked capital markets has evolved. While these developments have greatly enhanced the efficiency of the intermediation of international savings and investment, they have also resulted in additional risks that have yet to be understood fully or to be reflected in the pricing structure. In particular, the notable growth of derivative products in the market during the past few years--while facilitating the customizing of risk assumption by investors--has led to an increase in systemic risk. Such buoyant activities in the

futures and options markets could greatly speed up the transmittal of disturbances in the international capital markets.

Regarding the emergence of large institutional investors as a dominant force in the demand for assets issued in international capital markets, I tend to believe that those investors are typical, long-term ones who will serve as a stabilizing element to the markets. The diversified portfolios of the institutional investors will, in general, tend to help them not to overreact. However, I agree that occasional shifts in their portfolio preferences could become a temporary and large destabilizing force in the market because of the inherent large volume of transactions.

In response to an initiative by the Bank for International Settlements, good progress has been made in the past few years to strengthen the capital base of financial institutions and to place limits on the amount of risk they could assume. Regarding in particular the strengthening of the settlement system, I welcome the Group of Thirty's recommendation to set up a uniform three-day settlement rule by 1992. Moreover, in regard to international cooperation in managing crises, I commend national authorities for their efforts in the wake of a major equity market correction, which began in New York in October 1987. Quick and determined actions by national authorities have proved to be effective in containing damage as well as influencing market expectations.

The staff has highlighted the limited progress made in the negotiations on the liberalization of trade in services at the Uruguay Round of The GATT. I can understand the reservations expressed by developing countries concerning the liberalization of the financial services sector. Before any liberalization and admission of foreign participants to the domestic financial sectors of developing countries can be contemplated, those sectors have to be strengthened to enable the effective operation of domestic financial policies. The staff has also mentioned the role of Multilateral Investment Guarantee Agency (MIGA) in giving confidence to investors. I wonder if there are any concrete examples where MIGA has been a factor in investors' decisions.

I commend the staff for its timely and informative analysis of emerging stock markets. While overall developments in these markets were less than perfect, a good start has already been made, and rapid progress toward raising financial market standards has been achieved in a number of the emerging markets. The staff has clearly indicated that a large pool of financial resources from industrial countries is available for investment in developing countries, as soon as the latter begin to implement credible macroeconomic and financial policies. The provision of these resources has so far been limited to only a select few countries. I do believe, however, that foreign portfolio investment could play a major role in accelerating growth in developing countries, and in enhancing the debt strategy.

Mr. Gronn made the following statement:

Of the factors influencing capital flows, I note in particular the trend toward increased diversification of investment by institutional investors. While this development undoubtedly improves market efficiency, it may, at the same time, increase market volatility, although the evidence is not conclusive. It is clear from the staff papers that the question of different tax regimes may also have substantial effects on capital movements and on the pricing of assets in different markets. This question could warrant further emphasis in future staff papers.

While looking at the effect of capital market developments on different country groupings, it is obvious that market access and financing opportunities differ markedly. The possibilities for raising needed external financing are excellent for countries with good credit standings; those countries can choose between different financial instruments as well as currencies, as long as the markets remain confident of their creditworthiness. If the borrowing terms deteriorate in one market segment, another segment is at their disposal.

In the current situation, it would also seem that the liquidity situation in the largely integrated financial markets allows for the financing of the current account deficits of industrial countries. However, we should not be misled into believing that this will always be the case. Given the current substantial global imbalances, which carry an increased risk for volatility in the international financial markets, economic policy adjustments will continue to be important.

Nonetheless, the situation of indebted countries continues to be precarious. The financing provided by commercial banks to those countries has been reduced, and it is tied largely to foreign trade and to project financing. Furthermore, owing to a lack of creditworthiness, the developing countries do not have any access to securities markets either.

The evolution toward more liberalized and international capital markets therefore underlines the need for economic adjustment in developing countries, particularly if savings are to be invested domestically, if foreign savings are to be attracted, and if flight capital is to be repatriated.

Efficient domestic capital markets would, no doubt, facilitate favorable economic development in those countries. A study of the long-term impacts of financial integration on the financing possibilities for developing countries as a group could, in this context, be interesting.

The staff papers on officially supported export credits show how export credit agencies can contribute to increasing import financing for indebted countries, and enhance those countries' creditworthiness step by step. The staff papers note further that short-term export credits are currently available to most indebted countries. However, to ensure that these credits are used by developing countries, the Paris Club should consider removing them from rescheduling.

The export credit agencies have opened medium-term credits for several indebted countries whose debts have already been rescheduled under the Paris Club. The prerequisite for rescheduling has been that the countries in question are pursuing strong economic adjustment programs. With more flexible pricing and cover policies, it would seem possible to increase the number of countries whose credits can be guaranteed. The export credit agencies' precondition for continuing to offer cover is that all creditors should remain committed to keeping the cutoff dates fixed. This chair agrees with this view, and believes that it is important to maintain the principle of fixed cutoff dates.

Regarding mixed credits, I am of course aware of the fact that it is sometimes difficult to distinguish between export credits and development aid. Export credits are largely regulated and should, as a matter of principle, not be used as means of development financing. Therefore, concessional financing should primarily take place outside the framework of export credit agencies, to ensure that the different objectives of export credit and development aid are met.

We note the staff's remark that the use of escrow accounts runs contrary to debt subordination--which has been the basis for the debt strategy of official creditors--as such accounts could subsequently pose problems for preferred creditors. Escrow accounts should therefore be applied only in exceptional cases.

Miss Powell made the following statement:

Perhaps the most important point that can be made about developments in 1988, and apparently in 1989, is simply that international capital markets performed with about as little volatility as could reasonably be expected. In particular, financial asset prices and exchange rates did not experience the sort of abrupt changes for which 1987 and 1985 will be remembered.

The key issue to consider is what underlies the apparent ease with which current account imbalances among the major industrial countries have been financed over the past couple of years. In my chair's view, this relates further to the issue of whether capital account flows should be regarded as having been essentially driven by current account developments or vice versa. While it is true that in an ex post accounting sense, there is no distinction between these perspectives, a case can be made over the past two years, at least--that autonomous capital flows, rooted in private sector savings and investment behavior in major industrial economies, have been a driving force behind, rather than a passive response to, current account and exchange rate developments.

The impact of the U.S. fiscal deficit on national savings and on U.S. interest rates must be considered a principal factor behind the pattern of international capital flows in the past two years. Demographic differences in the major industrial economies may also be providing an important impetus for an underlying flow of savings from Japan and the major European economies toward North America. Such flows have been facilitated by the relaxation of limits on the share of foreign assets in the portfolios of large institutional investors, particularly in Japan. The fact that the resulting outward flow of savings from Japan and Europe has tended to be directed toward North America, in preference to other potential sites for investment, no doubt reflects both political and economic factors, such as investor confidence that monetary authorities are not willing to tolerate chronic inflation, the relative ease of direct investment in the United States and Canada, and, not least, the ample supply of government debt available for purchase. The greater willingness to use long-term as well as fixed rate instruments undoubtedly also suggests a greater degree of investor confidence in the medium-term economic prospects of major industrial economies than in 1987. Although the U.S. fiscal deficit remains a source of concern, capital market prices and choices of instruments do indicate that investors generally believed that the monetary restraint exercised in 1988 and 1989 will be effective in dampening inflationary pressures.

The confidence of investors in the conduct of macroeconomic policies in the major industrial countries is clearly essential to maintaining stability in international capital markets. This is likely to be even more the case as restrictions on international capital flows are progressively eased, and as technological advances accelerate the ability of markets to respond to new information. While this unquestionably poses some risk, such as bandwagon responses to new information, there are also considerable efficiency and intertemporal welfare gains to be reaped from open capital markets.

It should also be noted that open capital markets--and the possibility of large and disruptive capital flows--may exercise a healthy discipline on policymakers and exert indirect pressure for greater harmonization of taxes on capital and financial transactions and services. Investors' response to the prospective German withholding tax is a case in point. Another example is the reduced likelihood of a change in investor sentiment leading to a sudden and sharp depreciation of the U.S. dollar, if the stance of monetary policy is unambiguously anti-inflationary and a policy of fiscal reduction is pursued diligently.

It cannot be emphasized often enough that, for there to be any prospect of an easing in current financing constraints, an essential element of policy has to be the pursuit of macroeconomic policies consistent with sustained noninflationary growth in developing countries. In most countries, structural reforms are also a necessary part of the policy package. In this connection, we would especially emphasize the need for developing countries to maintain positive real interest rates and to institute measures to liberalize and improve the functioning of their own financial markets. Such policies are essential to strengthen domestic savings and investment, and are also the basis for the return of the confidence needed for attracting capital inflows.

We can appreciate the concern that increased integration of the financial markets of developing countries with those of the rest of the world runs the risk of a greater transfer of savings abroad. However, we agree with the staff that, if risk-adjusted domestic returns are higher in developing countries than those obtainable elsewhere, the integration of domestic capital markets with the rest of the world will attract capital. Moreover, given the magnitude of the capital flight that has occurred, it would not appear that restrictions on capital transfers are especially successful. Indeed, a reduction in restrictions, combined with a reasonable degree of confidence in domestic markets, could well lead to a return of flight capital, not to greater outflows.

We would agree with the staff that, in some cases, debt and debt service reduction is needed before there can be an assurance that remaining obligations will be met, and before balance of payments viability can be restored. However, in more borderline cases, there has been some questioning of the extent to which debt and debt service reduction facilitates a return to creditworthiness, or whether it may even hinder it. The staff could usefully comment on how its views on this question have evolved in light of recent experience.

We view the more market-oriented approach to officially supported export credits, and particularly, the increased flexibility in premium structure and cover policy for rescheduling countries, as having been an appropriate response by the agencies. We also welcome their greater concern for the quality of loans. We appreciate the staff's concerns about changing cutoff dates and agree that adding to the stock of commercial debt in ever larger amounts is not a viable solution. At the same time, we are not sure exactly what the staff had in mind in proposing that, if problems arise in servicing post cut-off date debt in countries with strong adjustment programs, additional funding on "appropriate terms" would need to be found. We would not feel that concessional financing from export credit agencies would be appropriate.

Mr. Lombardo made the following statement:

We are pleased by some recent positive developments within international capital markets, which reflect a partial recovery in market activity after the October 1987 stockmarket crash, and the continued process of capital market integration. However, we also recognize that, despite the general improvement in international capital markets, the benefits have not been distributed equitably among countries. The economies of developing countries have not received an equitable share of benefits, nor have they profited from greater availability of credit. As pointed out by the staff, the degree of integration of most developing countries into the international financial system, when measured in terms of gross capital flows, is currently less than it was at the start of the decade. In particular, developing countries experiencing external debt problems have seen a decrease in their participation in international capital markets.

To promote greater participation of these countries, changes in attitudes and modifications of policies are needed. Specifically, creditor countries should continue to coordinate their policies, commercial banks should be better prepared to agree upon financial packages that include debt and debt service reduction operations, and developing countries should implement economic policies that will improve their external creditworthiness. Above all, adequate and lasting integration of indebted developing countries into international financial markets will require a definitive and comprehensive solution to their external debt problems.

Creditor countries should strive to better coordinate macroeconomic policies aimed at promoting growth, at reducing real interest rates, and at eliminating protectionist practices, especially those that limit the ability of developing countries to export products to developed countries. As pointed out by the staff, export credit agencies continue to play a critical role in the flow of external finance to developing countries. While the activity of these agencies has concentrated on those developing countries that do not have debt service difficulties, highly indebted countries should also receive their financial support. This support will be especially necessary in the case of those countries that are implementing adjustment programs and that have had their debts to official creditors rescheduled. Creditor countries should encourage export credit agencies to provide this needed financial support. Creditor countries should also implement financial and tax reforms in order to induce commercial banks to make funds available to developing countries. These reforms should also encourage commercial banks to reduce the level of debt and debt service payments by indebted countries.

To date, the involvement and participation of commercial creditor banks in the debt strategy has been disappointing. Commercial banks have been making considerable efforts to reduce their overall exposure to developing countries with debt servicing problems. This is reflected in a decline in bank lending, combined with increased provisions that limit the ability of developing countries to obtain bank loans. Banks have expressed no enthusiasm for concerted new money packages; in fact, several commercial banks have already determined that any additional lending to developing countries facing debt problems has no place in their strategies. Most commercial banks will not see the financing of developing countries as a priority in the years to come. At the same time, banks show no enthusiasm for agreeing upon financial packages that include debt and debt service reductions. A change in banks' attitude is essential if developing countries are to increase their participation in international financial markets.

Considering the recent expansion of global financial markets, I agree with the staff that developing countries should aim at increased participation in this process by integrating their economies into international capital markets. To achieve this objective, developing countries should try to reduce their perceived risks by implementing economic policies aimed at stabilizing their economies, laying the basis for sustained growth, and making domestic financial markets more efficient.

For developing countries, to reduce the risks that inhibit their participation in the enlarged international capital markets, it is necessary to promote growth by means of increased domestic and foreign investment. Besides their own efforts to increase domestic savings, developing countries need external financing. However, this external financing is not fully available to indebted developing countries, because their perceived country risk does not allow them to participate in international capital markets. Country risk in indebted developing countries stems not only from financial restrictions, but also from social and political problems. This represents a vicious circle, of which the external debt problem facing highly indebted countries is the primary factor.

Experience shows that a definite solution to the debt problem and the development of a cooperative approach among debtors and creditors, including successful implementation of debt reduction techniques, cannot be left to bilateral negotiations or to pure market mechanisms. A definite solution to the debt problems facing developing countries, and therefore a successful integration of these countries into the international capital markets, would result only from concerted action by all of the parties involved in the debt strategy. Undoubtedly, to assure such concerted action, the Fund should play an important role in harmonizing the individual and collective interests of creditors and debtors. The much needed additional financial resources should also be provided by the Fund and other multilateral organizations.

I would appreciate staff comment on the effects of the substantive political and economic changes in Eastern Europe on the integration of developing countries into international capital markets. In the future, I recommend that the staff examines the implications of those important changes on the economic outlook for developing countries. Particular emphasis should be placed on analyzing how the debt strategy, and the integration of indebted developing countries into the system of international capital markets, are affected by the changes occurring in Eastern Europe. Although we understand that these issues will require careful and detailed analysis, I would appreciate receiving a first impression from the staff regarding the matter.

Mr. Posthumus made the following statement:

The developments in international capital markets are admirably described and analyzed in the staff papers. The Fund's work in the area is a major contribution to the understanding of the significance for the world economy of the liberalization and integration of international capital markets. While the contribution of such liberalization and integration to market efficiency is obvious--and, the reason for freeing international capital flows--the systemic consequences are not at all clear yet. These consequences, however, are the subject of the forthcoming staff study announced in the most recent work program, to be available for discussion by the Board in mid-1990. By then, it should be possible to determine which vehicles, the annual review of capital markets, or the biannual world economic outlook, can best be used for the Fund's multilateral surveillance work in the field of capital flows.

International capital markets are not only effectively mediating current account imbalances between countries, but are also, in some cases, prolonging or exacerbating such imbalances. When there is the perception that exchange rates will be stable, high interest rates may attract substantially more capital than monetary authorities find acceptable. While sound macroeconomic policies--and perhaps appropriate coordination--is needed to create a stable environment for the functioning of capital markets, the question arises as to which policies are needed in cases where such a stable environment does not [yet] exist.

On the staff's chapter on the integration of developing countries into international capital markets, two points should be mentioned. First, the combination of freer international capital markets and the diminishing priority that the larger industrial countries give to development assistance highlights the damage in many developing countries that lack of sound macroeconomic policies has done to their economies. Second, in any free market, whether in trade, labor, or capital, weaker partners are at a disadvantage which underlines the need to adjust, not a need to restrict or manage capital flows. It also underlines the need for industrial countries to increase the priority of development assistance in support of growth-oriented adjustment, not as compensation for lack of adjustment.

I note, in reaction to the concern of many Directors that banks are little interested in providing loans to developing countries, that the experience of the 1970s--I had thought--had taught us that bank financing of development was not a suitable form of financing, as it was too short term and too volatile in nature. A resumption of those flows on any large scale is not a solution. I therefore wonder whether the text on page 22 of the main staff paper, just quoted by Mr. Lombardo, on the degree of integration of most developing countries in the international financial system compared with the situation at the beginning of the decade, does not misrepresent the situation somewhat.

My Netherlands authorities consider that the staff has done important work in its study on officially supported export credits. They have a number of specific remarks that I would like to give the staff in writing. However, they have one more general remark to make. It is generally recognized that export credit agencies are increasingly extending credits to countries that have rescheduled debts and that are implementing adjustment programs. My authorities believe that a Paris Club rescheduling following the approval of a Fund program is not a sufficient condition for reopening cover for new credits: a track record of regular repayment has to be established, if only to prevent piling officially guaranteed debt on officially guaranteed debt.

In addition to this, I suspect that my non-Netherlands authorities, however, look at officially supported export credits in another manner: they would perhaps regard guaranteed export credits, which are sometimes even subsidized, as distorting trade in products that many developing countries export. The staff paper might perhaps acknowledge this aspect of the question, if not give some attention to it.

Mr. Monyake made the following statement:

The staff papers draw attention to the continued integration and liberalization of capital markets, and the opportunities that have been created for the relatively easy flow of finance across international borders. The papers also focus on the structure of current payments imbalances among industrial countries and its effect on the flow of capital. Evidently, the distribution is highly skewed, as there has been a process in which a large number of developing countries have been decoupled from the international capital market. The data show that the integration of developing countries into the world capital market--in terms of gross capital flows--is currently less than at the beginning of the decade. The debt crisis has contributed to the problem, driving a wedge between the availability of capital and the access of a large number of developing countries. A recurring theme in the staff papers is that the market considers the risk involved as being too high in the heavily indebted countries.

Regarding the effectiveness of capital markets in accommodating current account imbalances among industrial countries, the data show that direct investment, bank lending, and portfolio investment in bonds and equities have been large enough to keep the international financial system functioning reasonably well so far. It seems likely, moreover, that such autonomous flows could accommodate large imbalances in the near future. Does this mean that one should not be concerned about the unprecedentedly large current account imbalances? The international community must remain alert to the possibility that, even though autonomous flows have emerged as the main conduit for financing imbalances, the resulting equilibrium might be an unstable one, such that a change in market perception could provoke major disruptions in the system. The staff alludes to this by referring to what it regards as "systemic risk," which must be contained through the pursuit of sound economic policies, or the need to keep economic fundamentals right. This is especially relevant to the major deficit countries. Meanwhile, the fact should not be missed that the high interest rates, which have helped major deficit countries attract external funds to finance their large external deficits, have invariably added to the debt service burden of many heavily indebted countries that have limited capacity to carry such a burden. This is another reason why deficit countries should work toward implementing prudent economic policies that will produce, inter alia, lower interest rates within a coordinated approach between themselves and other industrial countries. In this connection, the surveillance role of the Fund cannot be overemphasized.

Concerning the advantages of increased integration of developing countries into international capital markets, it is difficult to argue against the suggestion that these countries stand to gain from such a move. In particular, it is likely that as the economic situation improves in developing countries--and the experience of the newly industrializing countries points in this direction--they stand a good chance of attracting larger inflows from the pool of investible funds in industrial countries. In SM/89/207, for instance, the staff discusses the potential for emerging capital markets to tap the considerable resources of institutional investors. However, it is conceivable that problems might ensue from rapid integration of developing countries into world capital markets, as a result of the vast difference in the level of development between capital markets in developing and industrial countries. Clearly, at this stage, integration would be between two greatly unequal partners; the tendency might be for capital to flow in one direction, namely, toward developed countries. The question of integration and the liberalization of capital markets in developing countries must also take account of the limited resiliency of these economies to shocks that could precipitate massive capital outflows. While an industrial country might have less difficulty in recovering from such a situation, a developing country could easily fall into a vicious circle of economic and financial instability. If the stock market break in the United States in 1987 had occurred in a developing country, it is unlikely that the relative ease of the U.S. market's recovery would have been matched in the developing country.

In an international context, I should caution that the possible growth of capital markets in developing countries must be kept in some perspective: first, considerable progress has to be made in solving the debt crisis; second, it must be recognized that the potential to develop capital markets in low-income countries will remain limited for a long time. I agree with the staff, however, that appropriate policies should be designed in developing countries with a view to attracting direct investment. In addition to direct private investment, it must be stressed that low-income countries need concessional financial flows for public sector investment in such areas as infrastructure, health, education, or, in other words, those areas in which economic returns are either difficult to quantify and/or take time to be realized.

The private sector in developing countries can certainly benefit from increased foreign direct investment, as well as from foreign investment in partnership with local entrepreneurs. These might be areas in which export credit agencies could be encouraged to expand their operations. Cofinancing arrangements with the World Bank and the International Finance Corporation should be pursued, which should help to spread the risks that export credit agencies are concerned about. Means should also be found to strengthen cooperation between these agencies and commercial and development banks in developing countries.

Mr. Ghasimi made the following statement:

We continue to find the staff's papers on recent developments and prospects in international capital markets informative and useful. The current analysis on emerging stock markets in developing countries and that on the relationship between developing countries and international capital markets are particularly interesting and pleasing.

Regarding emerging stock markets, it would be useful if the staff continued this section in its subsequent papers on international capital markets, and also if it expanded its analysis in the area. We support the publication of these analyses in the Fund's world economic and financial survey, to benefit a wider audience. We are indeed encouraged by the staff's conclusion that "emerging stock markets offer foreign portfolio investors strong growth potential, attractive returns, and widened opportunities for risk diversification." However, it must be kept in mind that the growth in the size and activity of these emerging stock markets has been somewhat uneven in developing countries, with two of them accounting for about 60 percent of the markets' total capitalization by the end of 1988. Furthermore, as indicated by the staff, the majority of emerging stock markets show a high degree of market concentration compared with more developed markets.

These two characteristics, namely, the concentration of emerging stock markets in particular countries, and within individual markets, highlight the importance of developing countries enhancing the performance of their stock markets. It is clear that the development of open stock markets to outside investors is best conducted in the context of ongoing structural and institutional reforms. If properly implemented, along with the improvement of the regulatory and supervisory framework in developing countries, the reforms can ensure investors' protection. The emphasis given in the design of these reforms to improving resource allocation and enhancing competition among various sources of financing will be crucial. In this context, needless to say, financial sector deregulation in developing countries will help in sustaining the necessary shift from bank financing to other forms of financing.

It is by now rightly acknowledged that structural reforms in the financial sector must be complemented by sound macroeconomic policies aimed at sustaining a viable overall economic environment, and particularly at promoting market stability. To this end, the design of these reforms should benefit from the Fund and World Bank's technical assistance, given that capital markets in many developing countries--apart from channeling savings for financing investment--are currently playing a crucial role in privatization efforts, and in many debt reduction schemes. The benefits for developing countries of greater integration into international capital markets can hardly be denied. These markets can potentially provide developing countries with the financing they need, foster the revival of direct foreign investment, and maintain competitiveness between domestic and international capital markets. Integration of developing countries into international capital markets requires them to maintain creditworthiness, to maintain a high degree of confidence on the part of both domestic and foreign investors. In this connection, the implementation of strong adjustment programs, combining appropriate structural reforms and sound macroeconomic policies, has rightly been recognized by many developing countries as the best avenue to achieve increased openness of their economies.

It is, of course, clear that the process of increased integration into international capital markets cannot apply to all developing countries. In fact, for many low-income developing countries, financing from international capital markets continues to be fairly negligible. Given the existing structures of their economies, these countries remain heavily dependent on official support on concessional terms. The experience of other developing countries shows also that, even with successful adjustment programs, regaining access to international capital markets will be a difficult task to achieve in the foreseeable future. At the same time, the recent emergence of new high yield financing instruments, as well as the surge in banks' involvement in risky but profitable areas, such as leveraged buyouts, are serving to diminish the attractiveness of investment opportunities in developing countries. In that situation, export credit agencies' current debt strategy needs to be sufficiently supportive of developing countries' adjustment efforts. Therefore, it is of paramount importance that international financial institutions, particularly the Fund, stand ready to support adjustment programs in the event that the already prolonged decline in private lending to developing countries persists.

Mr. Evans made the following statement:

The papers before Directors are of high quality, and I endorse their publication. I would note one small caveat to that general endorsement, in respect of the part of the papers dealing with recent market developments, which reads like a description of data that, having been collected, needed to be described, notwithstanding that the data appear to have little information content and that the description provided little insight for policy. The analytical sections of the papers, however, are well done.

I would note at the outset that the staff is correct to refer repeatedly to the importance of sound economic policies in both industrial and developing countries, if those countries are to obtain the full benefit of international capital markets. Going beyond that general comment, it is important, as Mr. Yamazaki noted, to keep in mind that the volume of activity in international capital markets bears little, if any, relationship to underlying economic activity and international trade. The bulk of the transactions in such markets reflects pure income generation based on the search for arbitrage returns. Two implications flow from this general observation. First, while it is true, as the staff notes, that the liberalization and growing internationalization of financial markets has increased the speed with which shocks are transmitted through those markets, it is also true that economic activity has become much more immune to those shocks: the 1987 equities market collapse--and the preceding buildup in equity values--provide good examples. The second implication is that one can take a more sanguine view regarding the regulation of such markets than one might in virtually any other sphere where markets are more closely related to activity levels. In that regard, I would make two particular comments. First, on page 19 of the main staff paper, there is a short reference to the need for more work in the area of supervisory and prudential controls for derivative product markets. The brevity of that reference belies the importance of this issue. If there is a threat of greater systemic instability, it is most likely linked to the fact that the proliferation of such financial instruments--including, inter alia, swaps, futures, and options--has outpaced the ability of both supervisory authorities and the market participants to assess adequately the various forms of risk, and, hence, to price these instruments correctly. This is linked to the popular, but incorrect, perception that such instruments allow the market to reduce overall risk exposure, when in fact the risk is merely passed on--sometimes unknowingly--to someone else.

Second, I would like to comment on the question of tax harmonization. The recent experience of Germany with interest withholding taxes, which has precedents in other countries, including Australia, indicates that the growth of international capital markets has placed a constraint on unilateral action directed as was in the case of Germany, at quite well-motivated policy objectives. This is regrettable in more than one sense, not least because financial institutions are extraordinarily adept in the practice of tax avoidance and, not infrequently, tax evasion. This problem represents a systemic threat to tax bases in all countries.

Recognition of this constraint on unilateral action has, not unnaturally, heightened the interest in tax harmonization. It is a moot point, however, whether such harmonization, if restricted to a small group of countries, can present any solution to the problem. As long as there are countries outside of the group, the difficulties would seem to remain.

These issues require further consideration than Directors can give them at present, and I would hope that the papers on the topic prepared by the staff will be brought before the Board in the not too distant future. It is not clear that the Fund is the best forum for discussing such issues, but I would be inclined to reserve judgment on that question until Directors have had, at least, a first round discussion of the papers.

Mr. Mawakani said that he had found the paper on international capital markets to be informative in describing recent trends and the main underlying factors. Activity in capital markets during 1989 had reflected strong world trade and investment performance, in an environment of relatively stable exchange rates and moderate inflation. The combined effects of those factors had led to an increase in cross-border flows of direct investment and other forms of financing, mostly between major industrial countries. The number of financial futures and options contracts in the foreign exchange area and the number of government bonds traded internationally had continued to grow rapidly. Those favorable developments in international capital markets underscored the continued integration between industrial countries, market sectors, institutions, and of new financial instruments and maturities. However, it was disappointing to note that the participation of developing countries in those markets--outside of Asia--had been limited, and had remained well below the levels recorded at the beginning of the decade. Indeed, flows of spontaneous market lending to developing countries had continued to decline sharply, and prospects for such lending did not seem bright, considering that the commercial banks were becoming increasingly reluctant to increase their exposure.

In regard to the relationship between macroeconomic policies and international capital markets, he shared the staff's view that more attention should be devoted to the issues of stability and systemic risk, in view of the rapid increase in the size of financial markets, Mr. Mawakani considered. He could agree that the best means to prevent crises was for the major industrial countries to, at least, implement sound macroeconomic policies and foster policy coordination with a view to creating a stable environment for the efficient functioning of capital markets. It went without saying that the Fund had an important role to play in that area, through its multilateral surveillance function. It also appeared that action aimed at promoting strong international financial structures were of equal and paramount importance. As emphasized by the staff, those actions should aim at ensuring an adequate capital base for financial institutions, placing limits on the amount of risk that they could assume, and ensuring that the clearing and settlements systems performed efficiently and safely.

The degree of integration of most developing countries in the international financial system had continued to weaken, as reflected by the decreasing volume of bonds issued by those countries, Mr. Mawakani noted. The staff had pointed out two main obstacles to fuller utilization of international financial markets by developing countries, namely, the problem of creditworthiness and standards in domestic financial markets. First, he continued to believe that economic recovery through growth-oriented adjustment programs was the best means for developing countries to achieve creditworthiness. While sustained implementation of structural reforms was needed, the restoration of external viability and creditworthiness required that those reforms be matched with an alleviation of the debt overhang facing many countries, including through the provision of new loans on concessional terms.

Regarding the second obstacle to increased participation by developing countries in international capital markets, it had been proved that savings flowed abroad in response to greater returns and better protection in foreign markets, Mr. Mawakani stated. He could therefore agree with the staff that domestic and foreign investors needed to have similar standards of protection in developing country markets than elsewhere. Developing countries had to be encouraged to take steps to adhere to international standards of investment protection to attract foreign investment and, at the same time, to institute domestic measures aimed at promoting savings and discouraging capital flight. In that respect, the activity of the Multilateral Investment Guarantee Agency was important.

He welcomed the information provided by the staff on the halt in the downward trend of new commitments of medium- and long-term cover to developing countries in 1988, and the fact that most export credit agencies had resumed their cover operation, Mr. Mawakani said. However, there had been some alarming trends with respect to the increasing share of short-term credit in the overall increase, and the higher reliance on market-based premia for regulating credit supply, especially for low-income countries experiencing debt difficulties. Although those adaptations were necessary policy responses in view of the sharp cutbacks in the supply of funds and the increased restrictiveness of commercial bank lending to developing countries, the trends would need to be monitored closely in order to avoid adding to debt burdens and to avoid making rescheduling of short-term debt inevitable.

The export credit agencies' views toward the new debt strategy were worrisome, as they were not in line with the flexible approach to Paris Club rescheduling announced by the G-7 leaders at the Paris Economic summit, and reaffirmed more recently by the Interim Committee, which had called for flexibility based on the case-by-case approach. Modification of cutoff dates and rescheduling of short-term credit should remain options, to be viewed in the context of a flexible approach under the new debt strategy, and especially in cases where those modifications were essential for countries' return to external viability.

He welcomed the emerging improvements in the operations of export credit agencies, particularly the upgrading of their project appraisal capability and the use of independent consultants to provide a longer-term perspective of projects under consideration, which should contribute to a more effective role by those agencies, Mr. Mawakani indicated. In addition, the use of instruments such as BOOT projects and EXCEL facilities seemed to be better alternatives to increasing interest rates and restricting coverage, and would, at the same time, improve the agencies' portfolio and their contribution to capital flows to developing countries on more appropriate terms. Developing countries could benefit from the resulting changes, particularly via the structural reforms that a number of them were undertaking with a view to removing most of the domestic impediments to rapid use of the above innovations. The recent modifications introduced by the Export-Import Bank of Japan to channel untied resources to privatized companies in developing countries were a good example of possible adaptations of new instruments to the changing economic environment in the 1990s.

Mr. Shao made the following statement:

Developments in international capital markets were generally satisfactory in 1988 and in the first half of 1989. Bond issues greatly increased in 1988, although they were still below their level in the peak year of 1986. The net increase in across-the-board portfolio holdings of equity also increased significantly compared with 1987, and across-the-board bank lending recovered somewhat in early 1989.

Several favorable economic developments have contributed to the recovery in international financial activities. These include, economic expansion in the industrial countries, buoyant investment, a higher volume of world trade, relatively stable exchange rates, and a moderate rate of inflation. These positive indicators reflect joint efforts by the international community. However, despite the recovery in capital markets, some unfavorable and unbalanced developments still exist that merit Directors' close attention.

Even though buoyant activity in the international financial market is an encouraging sign, we note that most developing countries have been excluded from such activity. Access by the developing countries to financial markets has fallen sharply, and commercial banks have been reluctant to channel resources to these countries, particularly to the heavily indebted developing countries.

The drain of resources from developing countries is a matter for serious concern. The Board knows that many of these countries, especially the heavily indebted ones, are currently implementing strong, growth-oriented programs and are making great efforts to restore their repayment capacities. Their determination to implement these programs to the best of their ability therefore merits the support and encouragement of the international financial community. Since it is in all parties' best interests that the ongoing adjustment programs in developing countries are not interrupted because of insufficient resources, it is of paramount importance that the international financial community recognizes the urgent need to revive financing flows in support of these countries' adjustment efforts. Could the Fund play a further role in channeling resources between debtors and creditors?

According to the staff, most developing countries are less integrated into the international financial system at present than earlier in the decade. This reflects mainly the fact that developing countries are participating less in bond markets than at the start of the 1980s. Given that the world economy is more integrated than ever before, such decreasing participation is surely against the best interests of the world community as a whole. In this regard, we are in general agreement with the staff's analysis. Greater participation by developing countries in international capital markets is beneficial for all parties concerned, and we therefore must work together to provide these countries with better access.

There is a close relationship between the macroeconomic policies of major industrial countries and the stability of the overall financial system. In recent years, efforts--and subsequently progress--have been made in moderating inflation and in stabilizing exchange rates. These efforts have contributed to the sustained development of international financial markets. We hope that the major industrial countries will continue to stabilize the markets through their macroeconomic policies. In particular, they should further reduce their large external imbalances as soon as possible in order to ensure market confidence.

I stress that greater participation by all parties, and through any means available, will benefit everyone and will result in a more efficient utilization of world resources.

The staff representative from the Exchange and Trade Relations Department said that the staff was grateful for Directors' suggestions on the topics that should be covered in further staff papers. Suggested amendments to the published versions of the staff papers would also be appreciated.

With increased cross-border holdings of equity, domestic markets would become less stable than in the past, if there was a tendency for investors to withdraw their equity holdings from foreign markets first when uncertainty increased, the staff representative observed. It was interesting, in that context, to compare the stock market events of October 1987 with those of October 1989. Following the October 1987 market break, investors had fled both to quality instruments, such as government bonds, and back to the familiar--their domestic markets. However, following the October 1989 market break, there had been less of a shift into government bonds and much less of a flow back into domestic markets. The different aftermaths of the two stock market breaks, and the fact that the break in 1989 had been much smaller and more quickly reversed than the one in 1987, might have meant that investors had learned in the intervening period that increased co-variance between markets had made it no safer to repatriate capital in times of widespread stock market crises than to stay put; and investors might have become more familiar and confident with foreign instruments. As the globalization of financial markets continued, institutional investors would presumably no longer feel more at home in domestic markets than in foreign ones, with the possible implication that the recent cases of flight from foreign equity markets had been simply a temporary aspect of the ongoing process of globalization.

It was certainly desirable that regulations in the financial services sector be as transparent as possible, and that, where regulations or principles could be published, they should clearly be available to all market participants, the staff representative continued. Nonetheless, some aspects of the financial services sector needed to remain confidential and some financial institutions would have to be treated differently from others. That was especially the case with respect to the provision of lender-of-last-resort facilities. Authorities would never wish to have it known which commercial banks might be rescued in a crisis, or what precisely the circumstances would have to be for lender-of-last-resort facilities to be made available. Otherwise, there would be a tendency for private financial institutions to assume greater risks than were appropriate, with the costs falling on the public sector. Moreover, monetary intervention by authorities might have to be carried out quietly in order to keep markets guessing about the extent of the intervention and other details, which might militate somewhat against having complete transparency in the financial services sector. More generally, the staff's view of the discussions on financial services in the Uruguay Round was that further, broad-based liberalization in that sector was highly desirable. While complex issues were emerging in that field, their resolution would not be impossible.

In the current early stage of the strengthened debt strategy, the picture was a mixed one as to whether debt reduction had been helping countries to regain their creditworthiness, the staff representative stated. There had been relatively substantial debt reduction in the case of Chile over the past few years; the outlines of a debt-reduction package for Mexico had been fairly clear to the market; and debt reduction for several other middle-income countries was becoming an increasingly clear possibility. While there had been several encouraging developments in those areas, particularly the return of domestic confidence in Mexico, attributable to debt reduction, there had also been some disturbing developments. For instance there had been a round of accelerated provisioning by U.K., U.S., and Canadian banks, which presumably indicated the view that the servicing of remaining claims remained problematic, at least claims on some countries. Secondary market prices of bank claims on developing countries were at their lowest levels ever. The process of debt reduction, however, had not hindered various countries that were not involved in such operations--such as Algeria, Indonesia, and Hungary--from continuing to tap international financial markets. Innovative market approaches to the financing of developing countries were also beginning to emerge, with some Chilean and Mexican enterprises, for instance, having been able to borrow in international capital markets. Such borrowings had often been collateralized in some form, or had involved the prefinancing of exports. Perhaps that had been the start of the subordination process, referred to by Mr. de Groote, in which new financing flows were protected by collateralization, while the secondary market prices of old stocks of debt remained depressed.

A sufficiently large pool of private funds should be available to meet the financial needs of Eastern European countries without diverting resource flows away from developing countries, the staff representative considered. He would hesitate to make any further reflections on the wider economic implications of developments in Eastern Europe.

The staff was not yet in a position to assess the impact of the operations of the MIGA, because of that agency's relative youth, the staff representative added. The staff would look into the question in the future. In a separate vein, he would draw Directors' attention to a useful quarterly review of emerging stock markets published by the International Finance Corporation.

A second staff representative from the Exchange and Trade Relations Department said that it would certainly be desirable for emphasis to shift from short- and medium-term credit to longer-term credit. The tendencies in financial markets were indeed working in that direction, particularly with respect to the more market-oriented strategy in the provision of medium-term credits. It was another question, however, whether countries could, in effect, choose to access either short- or medium-term credit. The countries with more questionable track records tended to get short-term credit, and he was not sure whether they could regain access to medium-term credit. That had been the reason for the emphasis on excluding short-term credit from consolidations, with the view, in particular, of keeping essential funding flowing.

Over several years, the staff had held a number of discussions with export credit agencies on the question of escrow accounts, the staff representative continued. Those agencies would indeed not wish to see their debts lumped with old debts, which was the purpose of the cutoff date strategy that subordinated older debt. The staff was concerned that escrow accounts might create the inverse problem of new debt being subordinated to old debt. The new debt might well be to the Fund or the World Bank, and its possible subordination could create serious difficulties for those institutions' ability to collect the financial obligations owed to them. Partial escrow accounts in, for example, the area of direct investment might be feasible, however. In the staff's most recent discussions with export credit agencies, the agencies had pointed out that they could see the staff's reservations with escrow accounts in cases of the agencies lending to public sector entities, but not in cases of them lending to the private sector. The issues involved in export credit agency loans to either sectors were different, and there might be a role for escrow accounts in cases of loans to private entities. The staff remained concerned, however, that additional loans to public sectors in already heavily overindebted countries might be given a preferred status over existing, older debt.

The role of developing countries' export credit agencies had evolved substantially, the staff representative added. The Berne Union of such agencies and the OECD's export credit group had recently arranged a special meeting with representatives of a number of Asian economies--which had highly active export credit agencies--with a view to reaching a consensus that would demonstrate the important function of the agencies in general.

There had not yet been cases in which there had been such a critical shortage of funds that the question of rescheduling postcutoff date debt had arisen, the staff representative pointed out. The debt subordination strategy of the Paris Club had been critical, and there was serious concern about the possible systemic effects of any change in cutoff dates, concern about the possible systemic effects of any change in cutoff dates, because changing even a single cutoff date for one country could make export credit agencies have serious doubts about the wisdom of further lending to any country. If the problem of servicing postcutoff date debt became a major problem, some means would have to be found for dealing with that difficulty other than simply rescheduling the affected debt. A wide variety of more imaginative financial solutions could be found. In that connection, a Director had been correct in noting that it had been inappropriate to describe the function of Japan's export credit bank as that of, inter alia, "recycling account surpluses." The staff, nonetheless, had been impressed by that institution's truly imaginative approach to channeling additional resources to developing countries. Directors' continued suggestions would be helpful to the staff in revising the papers for publication, the second staff representative from the Exchange and Trade Relations Department concluded.

The Acting Chairman made the following summing up:

Directors noted the recovery of activity, particularly in securities markets, from relatively low levels following the 1987 market break. This recovery took place in the context of continued integration of financial markets, the globalization of investor behavior, and the development of new financial instruments. Directors also observed that, in contrast to 1987, continued large current account imbalances between the major industrial countries have been financed mainly through autonomous private capital flows, rather than through official intervention.

Directors commented that recent trends in international capital markets set various challenges for policymakers. They noted that increased integration of markets could raise the efficiency of financial intermediation, but cautioned that the consequences for market volatility were not yet clear, and that disturbances could be transmitted more quickly between markets. In light of the heightened degree of systemic risk, Directors generally agreed that sound policies and the reduction of existing imbalances among major industrial countries could play a key role in strengthening market stability. At the same time, it was important to strengthen supervision of both the banking and securities industries. Directors commended recent initiatives in this area, aimed at improving national regulatory systems and at increasing international coordination of such systems. Directors also pointed to the need to strengthen clearance and settlement systems, and international understandings on the division of responsibility for the lender of last resort. Directors' comments suggested that it was unclear whether, and to what extent, increasing degrees of capital mobility would promote the progressive harmonization of national tax systems, and whether that was desirable per se. The ingenuity shown and the delight that human beings found in seeking opportunities for tax avoidance was also noted.

A number of Directors expressed support for the proposed liberalization of trade and financial services currently being negotiated in the context of the Uruguay Round of multilateral trade negotiations within GATT. Others reiterated their reservations in that area. It was emphasized that liberalization of financial services raised complex issues in the monetary and prudential spheres that should be addressed. Directors noted the progress toward establishing a single market for financial services in the European Community, and commented that this had been achieved on the basis of the harmonization of the minimum regulatory standards.

With regard to developing countries, Directors remarked that a number of these countries were now less well integrated into the international financial system than at the beginning of the decade, with spontaneous lending to this group as a whole having declined sharply--largely as a result of a reappraisal of risks involved in bank lending to the public sector. Directors noted, however, some positive recent developments in this area, including increasing direct and foreign portfolio investment flows. They commented that sound domestic policies, including financial reform, removal of barriers to foreign investment, and increased standards of investor protection would be necessary to encourage this process. A number of Directors emphasized that the provision of new money by the banking community remained an essential element of the debt strategy; this responsibility could not be borne alone by the official sector.

Officially Supported Export Credits

Directors welcomed the fact that in 1988, the long decline in commitments of officially supported export credits that had occurred since the early days of the debt crisis seemed to have come to an end. While most new commitments have gone to countries that have been able to avoid debt- service difficulties, there have also been substantial commitments to a number of countries that have been rescheduling their debt. Directors remarked on the extent to which the debt subordination strategy of official creditors, which focuses on maintaining fixed cutoff dates, has permitted new flows to rescheduling countries that were pursuing sound adjustment policies. That contrasted with recent policies or practices of commercial banks; and Directors encouraged official creditors to persist in their strategy.

Directors welcomed the innovative approaches being adopted by export credit agencies in their efforts to improve the quality of their lending. A better focus on high-quality projects meant that export credits would contribute to successful development in countries that maintained or restored a sound macroeconomic environment. Directors encouraged agencies to continue increasing their focus on supporting export credits to the private sector.

Several Directors expressed concern about the diversion of official concessional assistance to subsidize mixed export credits, and emphasized that the objectives of development aid and export promotion should be kept separate.

APPROVED: August 3, 1990

LEO VAN HOUTVEN
Secretary