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November 10, 1988

To: Members of the Executive Board

From: The Secretary

Subject: Final Minutes of Executive Board Meeting 87/158

The following corrections have been made in the final minutes of EBM/87/158 (11/18/87):

Page 17, item 2, para. 1, lines 2 and 3: for "capital markets (SM/87/246, 10/22/87; and Sup. 1 (10/27/87)"
read "capital markets (SM/87/194, 8/5/87)"

line 4: for "financial markets (SM/87/194, 8/5/87)"
read "financial markets (SM/87/246, 10/22/87; and Sup. 1 (10/23/87)"

A corrected page is attached.

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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 87/158

3:00 p.m., November 18, 1987

M. Camdessus, Chairman
R. D. Erb, Deputy Managing Director

Executive Directors	Alternate Executive Directors
A. Abdallah	E. T. El Kogali
	J.-C. Obame, Temporary
	A. G. A. Faria, Temporary
	Song G., Temporary
C. H. Dallara	M. K. Bush
	D. C. Templeman, Temporary
	E. L. Walker, Temporary
	G. Seyler, Temporary
	E. Feldman
M. Finaish	A. M. Othman
	S. K. Fayyad, Temporary
	B. Goos
J. E. Ismael	Hon C.-W., Temporary
A. Kafka	J. Hospedales
	J. R. N. Almeida, Temporary
	C. Enoch
	D. McCormack
Mawakani Samba	C. V. Santos
	K. Yao, Temporary
Y. A. Nimatallah	I. A. Al-Assaf
	L. Filardo
	L. V. Fernândez, Temporary
J. Ovi	I. Puro, Temporary
H. Ploix	D. Marcel
G. A. Posthumus	
	C.-Y. Lim
	O. Kabbaj
A. K. Sengupta	L. E. N. Fernando
	M. Sugita
	N. Kyriazidis

L. Van Houtven, Secretary and Counsellor
S. Woolls, Assistant
R. Gaster, Assistant
K. S. Friedman, Assistant

Also Present

IBRD: H. W. Messenger, Africa Regional Office. African Department: A. D. Ouattara, Counsellor and Director; E. L. Bornemann, Deputy Director; J. Artus, J. Kakoza, M. C. Niebling, R. C. Williams. Central Banking Department: C.-J. Lindgren. European Department: D. C. McDonald, P. M. Nagy. Exchange and Trade Relations Department: J. T. Boorman, Deputy Director; A. Ariyoshi, C. Atkinson, H. B. Junz, L. A. Whittome, Counsellor and Director; G. R. Kincaid, C. Puckahtikom, K. P. Regling, L. M. Valdivieso, C. M. Watson. External Relations Department: A. F. Mohammed, Director; J. C. Roushdy. IMF Institute: W. L. Hemphill, O. B. Makalou. Legal Department: F. P. Gianviti, General Counsel; T. M. C. Asser, J. K. Oh. Research Department: A. D. Crockett, Deputy Director; M. Goldstein, Deputy Director; N. M. Kaibni, M. S. Kumar, D. J. Mathieson, P. R. Menon, R. Pownall. Secretary's Department: C. Brachet, Deputy Secretary. Treasurer's Department: M. P. Blackwell, P. B. Clark, S. E. Nocera. Western Hemisphere Department: S. T. Beza, Director; A. G. Santos. Bureau of Statistics: K. M. Meesook, R. T. Stillson. Advisors to Executive Directors: M. B. Chatah, A. R. Ismael, A. Ouanes, P. D. Péroz, N. Toé. Assistants to Executive Directors: N. Adachi, A. R. Al-Abdullatif, F. E. R. Alfiler, A. A. Badi, H. S. Binay, R. Comotto, E. C. Demaestri, W. N. Engert, S. Guribye, M. Hepp, L. Hubloue, A. Iljas, J. M. Jones, S. King, K.-H. Kleine, K. Kpetigo, M. A. Kyhlberg, V. K. Malhotra, T. Morita, C. Noriega, L. M. Piantini, S. Rebecchini, S. Rouai, V. Rousset, G. Schurr, H. van der Burg, Wang X., R. Wenzel.

1. PEOPLE'S REPUBLIC OF MOZAMBIQUE - 1987 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1987 Article IV consultation with the People's Republic of Mozambique (SM/87/ 245, 10/21/87). They also had before them a background paper on recent economic developments in the People's Republic of Mozambique (SM/87/256, 11/5/87).

Mr. Abdallah made the following statement:

> The 1987 Article IV consultation with Mozambique was conducted only a few months after the Executive Board approved Mozambique's request for use of Fund resources under the structural adjustment facility. Accordingly, the discussions focused on the progress of implementation and the appropriateness of policy measures in 1988 and in the medium term.
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> The authorities had initiated an Economic Recovery Program in 1986 in the face of a severe and protracted decline in economic activity and a buildup of enormous financial imbalances. A number of exogenous factors were partly responsible for these conditions, including adverse weather conditions. This situation was aggravated by the activities of armed bandits who continue to receive external support. The convergence of these and other factors brought the central planning machinery under considerable strain, particularly in light of the shortages of trained manpower. Accordingly, the objective of the program was not only to promote stable financial conditions, but also to stimulate the country's productive potential through appropriate price signals.
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> The staff papers have been very candid in reporting the progress achieved so far, and there are early indications that the economy is responding favorably to these policy initiatives. For example, there was an upturn in production in 1986, following the launching of the program, with a modest recovery in the production of cashew nuts and cotton. A further recovery is anticipated in 1987, particularly in the industrial and construction sectors, which are benefiting from the availability of imported inputs and this will result in a substantial increase in capacity utilization. At the same time, inflationary pressures started to subside somewhat in 1986. However, in 1987, price developments have reflected the devaluation of the metical, the freeing of a wide range of administered prices, and substantial increases in official prices.
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> The rehabilitation is under way in many sectors of the economy. Although there has been some delay owing to lags in the disbursement of external aid, the reorganization of the operations of electricity and petroleum distribution and the textile industry has already begun with the assistance of the

World Bank. Furthermore, at the enterprise level, managers have been given greater autonomy to initiate efficiency-promoting measures, including cost reductions and price increases that do not require the prior approval of the Government. To this end, employment in some of the parastatals is already being reduced to economic levels, and the Government is combating with the problem of dislocation by offering alternative occupations, particularly through resettlements in the rural areas.

The Government's financial position is broadly on track, although concern has been expressed about the revenue estimates. The authorities expect expenditures to remain well within target limits, even though the security situation continues to exert pressure on the budget. However, it is anticipated that shortfalls in capital outlays are likely to be encountered, because of the slow pace of foreign aid disbursements. In order to strengthen revenue performance, the authorities are expecting a technical assistance mission to study new revenue sources to broaden the base. Once the results of the study are ready, appropriate action will be promptly taken. At this stage, the authorities stand ready to take additional action to ensure that the program remains on track.

Credit expansion in the first half of 1987 was well within the program's benchmarks, with the Government's reduced recourse to bank credit. The authorities are confident that the annual benchmarks will be met despite the strong demand for credit by enterprises in the productive sectors, resulting in part from the effects of the devaluation. It is noteworthy that owing to the measures adopted by the Government, including the adoption of commercial-oriented assessment procedures in the granting of credit, enterprises have already started to exercise greater caution in their recourse to borrowing. Nevertheless, the corporations' overall credit requirements will be met from budgetary allocations, as was agreed under the program.

The implementation of a flexible exchange rate system was central to the adjustment program. Apart from the realignment of relative prices, exchange rate action was in part aimed at reducing the differential between the official and the parallel market rates. To this end, the metical was devalued twice, in January and in June 1987, from Mt. 39 to Mt. 404 to the U.S. dollar, representing a cumulative devaluation amounting to more than 90 percent in foreign exchange terms. To ensure effectiveness, these were accompanied by a full pass-through of their effects to domestic prices, some of which were raised by as much as 500 percent in the case of agricultural commodities. It is worth noting that the parallel market experienced an appreciation of roughly about 35-40 percent, leading to a significant narrowing of the gap with the official rate.

Mozambique's balance of payments is still dominated by a very heavy debt burden, and substantial arrears had been accumulated. In the event, the program was designed to regularize debt servicing while endeavoring to mobilize additional external resources. The authorities have made considerable progress in rescheduling their loan commitments both within the Paris and London Clubs as well as with other creditors. Although the terms have been generally favorable, the authorities regret that it has not been possible to obtain concessional interest rates on rescheduled debts. Hence, despite these rescheduling arrangements, the debt service ratio, estimated at about 40 percent of export earnings, remains high. The viability of the external payments situation will therefore depend to a large extent on the level of external assistance.

Both for 1988 and the medium term, the authorities intend to maintain and, wherever possible, strengthen the adjustment effort as enunciated in the policy framework paper. They still find the general thrust of policy measures appropriate. For example, fiscal policy will continue to emphasize the strengthening of budgetary revenues so that they are more responsive to the growth of national income while streamlining and containing the overall growth of expenditure. As regards the speed of adjustment of the exchange rate and the general price levels, the authorities intend to monitor developments closely with a view to assessing their social impact and the adequacy of the administrative capacity.

In sum, it is encouraging that despite the persistence of insurgency activities, the adjustment program remains on track. The authorities remain fully aware that this program calls for their continued determination over the medium term. The improvement of the security situation and the availability of foreign assistance on highly concessional terms and on a timely basis would contribute greatly to the implementation of the program.

Mr. Obame said that in June 1987, when the Board discussed the economic program supported by the structural adjustment arrangement, it had been clear that Mozambique was confronted with deep-seated internal and external imbalances that could be corrected only over a long period through the implementation of a comprehensive structural adjustment program. Despite the positive results derived from the strict implementation of appropriate pricing and exchange rate policies, economic and financial challenges remained. He broadly agreed with the staff appraisal, and would comment only on the balance of payments prospects.

Table 5 in Appendix IV of SM/87/245 showed that the balance of payments prospects, particularly the trade balance, would remain difficult for the next five years, with exports averaging only 17 percent of imports over the period 1987-92, Mr. Obame noted. At the same time, the debt service ratio would remain substantially high, despite the debt relief that had been granted recently by the Paris and London Clubs and other creditors. The debt burden underscored the need to fully implement the economic and structural reforms in the ongoing programs that had been worked out with the Fund, the World Bank, and other financial institutions. Continued implementation of a realistic exchange rate policy and a producer-pricing policy that would boost production and exports was particularly important.

The authorities' efforts to reduce the volume of parallel-market operations in urban areas and to improve the performance of public enterprises through a more flexible system of cost and price determination were welcome, Mr. Obame said. However, it was evident that there was no quick and easy solution to Mozambique's protracted economic problems. As Mr. Abdallah had rightly pointed out, the authorities' determination was required to direct the economy in a more sustainable growth path over the medium term; the timely support of the international community was also required.

Mr. Fernández made the following statement:

> I am struck by the extent to which the measures taken by the authorities respond to the recommendations that were made by the Executive Directors during the latest review of the structural adjustment arrangement, in June 1987. The authorities' continued efforts to implement a comprehensive and ambitious program are commendable, especially in light of the very difficult political situation in southern Africa and the internal security problems in Mozambique, which pose major noneconomic impediments to the functioning of the economy. Furthermore, the support provided by the international financial community has significantly contributed to the highly successful implementation of the program so far.
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> The major corrective measures taken thus far seem to be contributing to a reversal of the declining trend in production experienced during recent years, and there are clear indications of economic rehabilitation. The major adjustments in the exchange rate and other official prices are particularly welcome. Indeed, these adjustments are important steps toward the elimination of the severe financial imbalances and extensive parallel markets. However, although such measures are already contributing to restoring the predominance of private markets for goods and foreign exchange by increasing the supplies to these markets and decreasing the differential between official and parallel market prices, much remains to be done. In these circumstances, it is extremely important that the authorities persevere with the planned course of action.
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> It is very encouraging to see that the program's fiscal targets are expected to be met, but my authorities remain concerned about the financial situation of many public enterprises. The authorities should continue their current path of fiscal

adjustment and take full advantage of the recently concluded study sponsored by the World Bank on public enterprises. Given the serious financial limitations facing the country, it is important to establish clear priorities in the investment program.

As a result of the implementation of the current rehabilitation program, Mozambique's economic situation and prospects have greatly improved. However, my authorities remain concerned about the medium-term outlook. Although the financing gap of the balance of payments for 1987-88 could be closed by debt relief and concessional financing, the structure of the balance of payments remains weak. Thus, in order to consolidate the progress already attained in different areas, Mozambique's donors and creditors will have to make extraordinary efforts, and Mozambique will continue to require financial assistance on concessional terms for many years.

Mr. Fernando said that he commended the authorities for implementing the program supported by the structural adjustment arrangement and IDA rehabilitation credit, which had unlocked a substantial amount of international support from multilateral institutions and other creditors. Many actions had already been taken in vital areas of the economy to restore incentives for production, savings, and investment and to reduce financial imbalances. Resolute implementation was continuing, as was evidenced by the recent measures undertaken on the exchange rate and producer prices. Consequently, his comments would focus on problems and policies in 1987.

The serious problem with compiling economic and financial statistics posed many challenges for measuring and monitoring progress, Mr. Fernando remarked. Appendix III of the staff report had drawn attention to the many deficiencies with respect to the accuracy, comprehensiveness, timeliness, and internal consistency of financial records. Comparability between periods was overly complex, raising important questions about the program's design. Because of the shortcomings in the reporting system, considerable variations from the benchmarks or targets could arise, and in that event, the Board would have to stand ready to help. A reliable reporting system was important, especially in assessing economic factors, such as exchange rate policy. Even though the future direction of the exchange rate could be clear, determinations of the pace and degree of change could be contentious. For example, there was the difficulty in accurately assessing underlying cost/price trends. Prices were subject to a high degree of variation, owing to price controls, pent-up demand, and anticipation about exchange rates and inflation. The parallel-market rate was a very imperfect guide, because it reflected several noneconomic elements that were difficult to quantify. Under the circumstances, he wondered whether frequent small changes in the exchange rate were preferable to large periodic corrections.

The program design for Mozambique should focus on policy-based performance criteria rather than on quantitative targets, Mr. Fernando continued. Admittedly, the payoff period for structural change would be longer than for financial programming, but the benefits under that approach were likely to be substantial. In the future, other enhanced structural adjustment facility requests would arise for countries where shortcomings in data could impose limitations on certain aspects of program monitoring. Therefore, the policy-based aspects of the program should be adequately examined.

The program to rehabilitate the economy, increase efficiency, and reduce imbalances was based on a number of studies, Mr. Fernando noted. Two important studies supported by the World Bank were on public enterprise reform and a review of public expenditure. It was difficult to overemphasize the crucial role of competent managerial and administrative talent in a successful public enterprise reform, and of competent accounting personnel in keeping public expenditure within the financial program. As to the public enterprises, the staff reported that managers of enterprises had been given greatly enhanced responsibilities in the quest for efficiency and productivity. However, some enterprises had been affected by the price deregulation that had been simultaneously initiated, and the managers had not been consulted about their enhanced responsibilities. Moreover, fundamental changes in the style and attitude of management needed to be supported over long periods with competent personnel, and the responsibility fixed for implementing reform. It was hoped that the manpower requirement would be recognized and that adequate provisions to meet it would be made. In addition, it would be some time before tangible results could be expected. In that connection, the authorities should address the issue of attracting and retaining competent personnel through realistic remuneration packages, and he agreed with the staff that the necessary finances should come mainly from savings attained through shedding surplus staff in the civil service. Moreover, the workers made redundant should be encouraged to move into other areas of economic activity, such as the agricultural sector, where there was considerable growth potential. The securing of administrative capacity to carry through on major policy initiatives would be an important factor in determining the speed of adjustment.

External assistance in the form of both debt restructuring and new financing commitments would serve two immediate tasks in the medium term, Mr. Fernando added. External assistance would help to provide a level of imports that would be supportive of the reform effort, including inputs essential to increase both capacity utilization in industry and agricultural production. The marginal efficiency of such capital investment was high, owing to the underutilization of existing capacity and the fact that much higher production levels had been attained in the past. In those circumstances, the authorities' responsibility to strengthen the incentive framework for production could not be overemphasized. An adequate supply of consumer goods could underpin the effectiveness of rural policies and help to moderate initial consumer agitation against reform.

External assistance would also help to secure the sustainability of debt servicing, Mr. Fernando went on. Mozambique's adjustment effort deserved the continuing strong support of the international financial community. The staff had rightly drawn attention to the long delay that would occur before export receipts could support growth and help meet financial obligations. In that connection, it would have been helpful if arrangements existed for the removal of export licensing.

Workers' remittances provided valuable support to the balance of payments, and he wondered whether the receipts achieved through official channels were sufficiently near the export potential, Mr. Fernando said. Many other countries, even those with a liberal payments system, had successfully operated special schemes to attract and retain workers' remittances. He wondered whether there were any new initiatives envisaged in that regard. Finally, he supported the proposed decision.

Mr. Enoch said that during its June 1987 discussion on Mozambique, the Board had recognized the exceptional circumstances of that country, and had extended an arrangement under the structural adjustment facility, without having the prospect of medium-term balance of payments stability. In response to the Fund's support, the authorities had apparently undertaken some very difficult adjustment measures, particularly in the areas of the exchange rate and domestic pricing. The authorities' commitment, framed within a Fund-supported program, had drawn considerable responses from the international community, helping Mozambique to meet its external financing requirement for 1987 and most of 1988. The Fund's exceptional assistance in Mozambique's case demonstrated the catalytic effect of Fund support, as it had brought about the first Paris Club meeting organized solely on the basis of a structural adjustment arrangement. The Paris Club had agreed to a rescheduling which provided for the repayment of eligible official debt over 20 years with a 10-year grace period. International support had allowed a vital degree of import decompression, and the signs of a revival in economic activity resulting from improved incentives and a revival of imports was now becoming apparent. The acid test would be the performance of agriculture during the 1987/88 crop year.

However, the economic situation was still extremely serious, Mr. Enoch commented: security problems continued; despite the rescheduling, the debt burden remained heavy--a situation to which the U.K. Chancellor's Paris Club proposals were addressed; and Mozambique would remain greatly dependent on exceptional financing for the foreseeable future. Meanwhile, *economic imbalances were being reduced merely to manageable levels.*

The authorities were to be commended for the bold steps they had taken thus far, and they should persevere with the recovery program, Mr. Enoch continued. The authorities should be congratulated on having achieved greater than expected GDP growth--albeit from a low base--and for the pricing measures that had fully passed through the impact of the devaluations. The success of those measures might be seen in the relative stability of parallel rates. In addition, the authorities' intention to eliminate external arrears in 1988 was welcome. The next steps planned might prove much more difficult to take than the initial policy actions. The devaluations that reduced the exchange rate differential from

4,000 percent to 200-250 percent; the rates had been so misaligned and irrelevant, that a significant element of the correction had been merely a catching up with reality. However, the next move toward exchange rate unification was likely to have significant consequences.

Therefore, it was important for the authorities to maintain the momentum of their efforts, Mr. Enoch went on. The authorities should move rapidly toward exchange rate unification, supported by interest rates that were clearly positive, at least in terms of the underlying rate of inflation. As a counterpart to exchange rate unification, the authorities should continue the adjustment of domestic prices and intensify their decontrol of the price system.

A reform of public sector enterprises, particularly the score of enterprises that had accounted for the major share of operating losses in 1982-85, should be targeted for special attention, both as a fiscal measure and to improve the performance of the economy as a whole, Mr. Enoch added. In that respect, he would be interested in the results of the World Bank study on public enterprises which was to be completed in October 1987. In addition, he strongly endorsed the staff recommendation for the urgent prioritization of public investment.

The importance of statistics was worth stressing, and there was a particular need to address the area of external debt management, Mr. Enoch remarked. The apparent discontinuity between debt records and other accounts was disturbing.

The close monitoring of the fiscal situation was clearly vital, and the authorities needed to pursue revenue enhancement as a vital component of a longer-term fiscal stabilization, Mr. Enoch said. In that connection, the authorities' stated intention to strengthen the revenue base and limit current expenditure was particularly welcome.

Mrs. Walker made the following statement:

> My authorities welcome this discussion of Mozambique's Article IV consultation, particularly because it comes at an opportune time to review the progress attained thus far in the first year of the arrangement under the structural adjustment facility. This arrangement is important because the Paris Club has agreed to reschedule external debt on the basis of the arrangement, and, as Mr. Enoch noted, that rescheduling has resulted in substantial economic assistance. The Board does not conduct formal reviews of structural adjustment arrangements. However, in the context of an Article IV consultation, it would be appropriate and logical to discuss economic policies taken in the context of the structural adjustment facility arrangement and their impact on the economy. While this has been done to a certain extent in the staff report, it would have been more helpful if the Table 1, "Summary and Time Frame for Implementation of Macroeconomic Structural Adjustment Policies, 1987-89,"

included in the staff paper on the request for the structural adjustment arrangement (EBS/87/101), could have been updated, particularly to include some areas in which the World Bank is involved.

Thus far, it appears that Mozambique has progressed well with its economic recovery program. The task of economic recovery for Mozambique is a difficult one, owing to the security situation and other factors. Continued determination on the part of the authorities to implement the program is needed to ensure that it remains on track and, most importantly, that the economy responds in the desired way.

There are a few areas where continued attention is required. In the fiscal area, action must continue. Although it appears that this year's fiscal targets may be met, it is difficult to fully project revenue receipts for the remainder of the year because of the price changes and tax reforms. Therefore, the authorities should take any measures needed to ensure that the fiscal targets are met. The fact that net transfers of state enterprises are to be kept within their target levels is welcome. Rehabilitation of these enterprises will be critical to improvements in the fiscal situation, and, therefore, I would be interested in knowing more about the progress that has been made in the review of the 40 enterprises that was to be undertaken with World Bank assistance and completed by October 1987. Implementation of actions to reform this sector should be taken as soon as possible. In addition, any information on the detailed review of public expenditure that was to be carried out with donor and World Bank assistance would be welcome, as this review is very important.

Credit expansion has remained on target, and the new criterion for assessing enterprise credit requests should contribute to more efficient credit allocation. The revision of accounts and monetary data that has been introduced should replace the old plan as soon as possible to obtain the full benefit of the new system.

Pricing policy has generally gone in the right direction, that is, to allow full pass-through of the effects of exchange rate changes to the pricing system. But pricing policy is still too rigid, and more efforts need to be made to loosen control of prices altogether to allow for more direct market determination of prices. I look forward to continued reduction of the number of products on the fixed price list. The fact that managers can change prices to reflect costs of goods on a regulated price list without prior approval is welcome. However, it appears that the Government was involved, possibly too greatly, in assisting this effort. I would be interested in any information the staff could provide on the progress made in agricultural and industrial pricing policy that was not covered in the staff report, but which was included in the first year's structural adjustment arrangement.

As other Executive Directors have noted, there has been significant progress on the exchange rate, which is critical to the success of the economic recovery program. It is clear that while there is still some way to go, the differential between the official and parallel exchange rates has been substantially reduced, which is a positive sign. However, further effort on the exchange rate front is needed.

A review of trade and foreign exchange management was also to take place to continue the process of opening marketing channels by allowing enterprises to import and export directly as well as through trading companies. This review was to be completed by the World Bank by the end of 1987, and I would be interested in the progress that has been made thus far; it will be important that the exchange and trade systems are liberalized as the exchange rate becomes more flexible to ensure the desired improvement in the balance of payments. Improved debt management is also important, given the heavy debt burden. The collection of statistics in this area needs improvement to ensure that debt management proceeds in the right direction.

Economic recovery in Mozambique is no easy task, but the current program is a good beginning. The fact that the authorities are following the adjustment program diligently is also encouraging, and I hope they will maintain the momentum of their efforts.

Mrs. Ploix made the following statement:

I am particularly impressed with the authorities' determination, as was demonstrated in their timely implementation of the many and varied measures of the program supported by the arrangement under the structural adjustment facility. It is quite encouraging that in areas such as the agricultural and manufacturing sectors, production has picked up as a result of these reforms. As regards the impact of the program on the population, the analyses of the authorities and the Fund differ somewhat on the impact of the rate of inflation on the low-income groups, but it is certainly noteworthy that the availability of goods to consumers has increased and that living conditions in rural areas have improved.

These positive results should encourage the authorities to pursue their program along the lines of the policy framework paper approved in June 1987, particularly the reform of the public enterprise sector, the banking sector procedures, and the further liberalization of prices and trade. My authorities do not underestimate the difficulty of this task and are aware that only limited results can be achieved in the short term. Indeed, many structural constraints cannot be loosened quickly, regardless of the strength of the program. In this respect, I appreciate the frankness of the staff report in mentioning such constraints as the size of the market, the length of time necessary to rebuild the industrial sector, and the lack of trained manpower.

Apart from the security problems, the lack of manpower at the managerial and technical levels could be a major bottleneck in the implementation and effectiveness of the program. There is a very high-quality team in charge of the Government; however, detailed decisions, effective implementation, and monitoring of the many measures included in the adjustment program will require manpower that has been trained in management techniques. The Fund is providing technical assistance, and such initiatives as the organization of a two-week seminar on economic analysis in Maputo are noteworthy; however, such assistance is limited. I would be interested in the staff's plans to accelerate the pace of training programs for managers; perhaps the World Bank could be of some help in this respect.

I agree with Mr. Fernando about the advantages of smaller and more frequent exchange rate adjustments as opposed to larger annual adjustments.

The staff report mentions some differences of opinion between the authorities and the staff on two issues: the social cost associated with the depreciation of the metical, and the forecast for imports and exports. While these issues are important, the lack of data on Mozambique's economy and the recent far-reaching reforms make it extremely difficult to accurately estimate the evolution of domestic prices and to forecast imports and exports. Nevertheless, I understand the authorities' concern about the social cost of this adjustment program; that concern should be addressed. The staff appraisal mentions that the situation of lower-income city dwellers should be carefully monitored; I would be interested in the staff's plans to monitor these conditions and what action, if any, will be taken as a result of this monitoring. I am confident that these problems will be sorted out during the Fund's forthcoming mission to Mozambique, and I hope that the discussions will facilitate the conclusion of a second arrangement under the structural adjustment facility.

The staff representative from the African Department said that the staff would continue to discuss with the authorities the impact of the social costs of adjustment, lower-income groups in urban areas and appropriate steps that might be taken to alleviate short-term strains.

The unification of the official exchange rate and the parallel market rate was progressing, the staff representative from the African Department added. As the official rate was becoming more realistic, most of the transactions--and certainly the legal transactions--conducted in the parallel markets would be absorbed into the official market, although not necessarily at the same pace.

With regard to the question of whether more frequent, modest exchange rate adjustments were preferable to major annual adjustments, the staff shared the view expressed by Mr. Fernando and Mrs. Ploix, that in principle frequent adjustments appeared to be more beneficial, the staff representative remarked. However, in the current circumstances, the most fundamental question was how realistic the exchange rate target was. Until recently, the exchange rate management strategy had been to achieve the desired target as quickly as possible. The authorities hoped that the gap between the official exchange rate and the parallel-market rate would have narrowed considerably in 1988, and serious consideration could then be given to establishing a flexible exchange rate system, or at least a system in which more frequent, smaller changes could be made to support the process of liberalization of trade and payments.

On public expenditure priorities, the studies currently being carried out with the assistance of the World Bank were absolutely crucial to policy formulation in the years ahead, the staff representative said. One such project was a study of 40 major public enterprises, with a view to providing both specific recommendations for policy actions during 1988, and the framework for a broader study to cover a larger number of enterprises. The other project, which was not expected to be completed before late 1988, was a major review of public expenditure priorities; it was very closely linked to the program supported under an IDA rehabilitation credit. It was crucial that the recommendations in the study on expenditure priorities be put into effect as quickly as possible. However, in the interim, the result of the continuing dialogue between the Fund and the World Bank staffs should be reflected in the expenditure program that was to be included in the 1988 budget.

The World Bank-IDA technical assistance credit included training in economics and financial management and the provision of advisors, the staff representative noted. Technical advisors from the Fund's Central Banking Department had arrived in Maputo the previous week, and they would assist the authorities in organizing and training bank management. Consultations between the Fund and Mozambique regarding the financial sector would probably continue for some time.

The staff had taken note of the Executive Directors' views regarding the statistical base in Mozambique, the staff representative concluded. Under the present circumstances, it was very difficult to make adequate adjustments in the data for GDP and other economic variables. During the staff's latest mission in August 1987, the Fund's Bureau of Statistics staff assisted the authorities in compiling balance of payments statistics, and the staff's efforts to help gather statistical information would continue.

Mr. Abdallah said that, in considering Mozambique's very weak export base, particularly the trade balance over the medium term, it was useful to bear in mind that, if the aid that had been promised by the Southern African Development Committee for the front line states was forthcoming, the authorities would try to improve the transport and communications systems, and Mozambique could resume its traditional role of providing transport services for other African countries, such as Zambia, Zimbabwe, and Malawi. The rehabilitation of the transport sector would definitely generate new jobs and foreign exchange, and help to strengthen the export base.

The cashew nut industry could be rehabilitated without much difficulty, Mr. Abdallah added. The trees were in place, and the cashew nut sector had performed well the previous year, because prices had been encouraging. If prices remained high, restoring that industry would simply be a question of rehabilitating the factories. Mozambique had tremendous economic potential, and, if security could be improved even marginally, the results would become apparent in the external accounts.

The Acting Chairman made the following summing up:

> Executive Directors expressed agreement with the thrust of the staff appraisal and commended the Mozambican authorities for their steadfast determination under particularly difficult circumstances of internal security to implement the comprehensive program of economic rehabilitation and structural adjustment initiated early in 1987. This economic program had drawn widespread support from the international financial community. The implementation of the program appeared to be largely on track, and the decline in production and consumption had been arrested, with early signs of recovery. Directors noted that it was necessary that momentum be maintained in policy execution and were therefore encouraged that the authorities were preparing a second-year program for continuing structural adjustment facility support.
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> Directors remarked that although much remained to be done, the two substantial rate adjustments, accompanied by corrective domestic price measures, signified substantial progress toward eliminating price distortions and restoring appropriate incentives. Reflecting the execution of prudent demand-management policies, the parallel market exchange rate had reportedly appreciated considerably and parallel market prices for goods had begun to stabilize. The authorities were encouraged to pursue a flexible exchange rate policy and domestic price reform to stimulate supply responses, improve further resource allocation, and strengthen the external accounts.
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> Directors commended the authorities for their cautious wage and employment policies, which would continue to be required in support of program objectives.

Measures to cushion the transitional impact of adjustment measures on those bearing undue hardships, within the constraints of available budgetary and external resources, could be warranted. Directors noted that, while the fiscal program was on target for the first half of 1987, there were some uncertainties for the year as a whole. In view of the central importance of fiscal adjustment to the program, the situation should be monitored closely, and the authorities should promptly take additional actions if necessary. Directors noted the urgent need for public expenditure review, and encouraged the authorities to take early steps in this area, within the framework of the continuing dialogue with the Fund and the World Bank staff, as effectively setting priorities of expenditures, particularly development expenditures. Despite price increases and enhanced managerial autonomy, the position of many important public enterprises remained difficult. The authorities had wisely placed enterprise subventions under budgetary control and constraint. The findings of the recent Bank-sponsored study of some 40 important enterprises should provide the basis for an action program for early implementation.

The major corrective steps taken in 1987 and increased donor support, Directors felt, had clearly led to improved prospects for Mozambique's external financial position, compared with the situation prevailing a year ago. The structure of the balance of payments, nevertheless, remained very weak. With exports covering less than 20 percent of imports, reforms would take time to show their benefits, and the external debt burden was very heavy. Directors, therefore, recognized that a need for substantial external financing in support of continued domestic adjustments would continue for many years. Finally, Directors noted the need for improvements in the statistical base of Mozambique, and urged that greater priority be given to that matter.

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

The Executive Board then took the following decision:

1. The Fund takes this decision relating to the exchange measures of the People's Republic of Mozambique subject to Article VIII, Sections 2 and 3, and in concluding the 1987 Article XIV consultation with the People's Republic of Mozambique, in the light of the 1987 Article IV consultation with the People's Republic of Mozambique conducted under Decision No. 5392-(77/63), adopted April 29, 1977, as amended (Surveillance over Exchange Rate Policies).

2. As described in SM/87/245, the People's Republic of Mozambique continues to maintain restrictions on payments and transfers for current international transactions in accordance with Article XIV, Section 2. In addition, exchange restrictions evidenced by external payments arrears are subject to approval under Article VIII, Section 2(a). The Fund welcomes the authorities' efforts under their present adjustment program toward the elimination of these restrictions, and at the same time urges the authorities to eliminate the restrictive features of the bilateral payments agreements that the People's Republic of Mozambique maintains with Fund members.

Decision No. 8732-(87/158), adopted
November 18, 1987

2. INTERNATIONAL CAPITAL MARKETS - DEVELOPMENTS AND PROSPECTS, 1987, AND FINANCIAL MARKETS - INNOVATIONS AND INSTITUTIONAL CHANGES

The Executive Directors considered staff papers on developments and prospects in 1987 in international capital markets (SM/87/246, 10/22/87; and Sup. 1, 10/27/87), and on innovations and institutional changes in financial markets (SM/87/194, 8/5/87).

The staff representative from the Research Department made the following statement:

This note reviews some implications for financial markets of the recent fall in equity prices. It discusses the immediate market impact and factors that have respectively weakened or strengthened the transmission of disturbances to other financial markets. Finally, it draws some tentative implications for resource allocation, macroeconomic policies, international reserves, and market supervision.

1. Impact on financial markets

Two recent incidents in financial markets--the sharp fall in prices in global equity markets in October 1987 and the collapse in December 1986 of the Eurodollar perpetual floating rate note (FRN) market--provide examples of financial shocks that have affected other markets to differing degrees.

While the staff statement at Informal Session 87/5 on November 13 examined the responses of the major domestic securities markets to the decline in equity prices, spillover effects were also evident in the Eurobond markets, which resulted, for example, in greater tiering of interest rates for different borrowers. Although the Eurobonds issued by sovereign governments and international institutions performed relatively well, the yields on corporate Eurobond issues by companies with less than the highest credit rating have risen to as much as 160 or 170 basis points over comparable maturity U.S. treasury bonds. In addition, activity in equity-related Eurobonds apparently has come to a standstill.

The events in the equity markets illustrate that the liquidity of various markets under conditions of strain has been considerably different. For example, during the recent episode, equity markets in the United States experienced both record price declines and record volumes, while many other markets--including the secondary Eurobond markets--saw a sharp reduction in the volume of transactions. The disappearance of market makers during a crisis period has been a factor in this loss of liquidity.

There is some analogy--in terms of market responses--in the episode in December 1986, when market making in perpetual FRNs virtually ceased as prices fell sharply and liquidity vanished. These difficulties spilled over into the market for dated (fixed maturity) notes. Thus, total issues of FRNs declined to $6 billion during the first three quarters of 1987 compared with $41 billion during the comparable period of 1986. There was, however, little adverse spillover into other financial markets.

2. Factors influencing the scope of market disruptions

Some factors have acted to limit the spillover of market disruptions (e.g., higher margin requirements, high capitalization, government actions), while other factors may have heightened the spillover to other markets (e.g., global portfolio management, program trading, telecommunications). These factors are discussed below:

The impact of the recent decline in equity prices may have been reduced by the fact that margin requirements on stock purchases are relatively high, except for options and futures contracts. Credit lines extended by banks to mutual funds and other institutional investors have helped them meet redemptions or margin calls without forcing further equity sales.

While information on the distribution of losses resulting from the recent fall in equity prices is incomplete, many of the major securities houses appear to have experienced losses that are small relative to their capital bases, although some smaller securities houses and broker-dealers have closed and others are expected to be merged. In some countries, losses experienced by commercial banks were limited by regulatory restrictions on their holdings of equity. In some other countries, where universal banking prevails, commercial banks frequently had substantial amounts of "hidden" capital reserves. In the case of the perpetual FRN market the losses were primarily sustained by major banks and institutional investors that were relatively well placed to absorb such losses.

During the periods surrounding these recent market disturbances, significant risk existed that affected institutions would be unable to obtain funding for their portfolios. Indeed, some securities houses, especially smaller firms whose solvency had been called into question, faced liquidity shortages. Investor protection measures relating to the operations of securities houses or broker-dealers have helped prevent a general withdrawal of funds from those institutions. In addition, the clear commitment by major central banks to provide adequate liquidity to the financial markets has been a key factor preventing the emergence of widespread funding difficulties. Also, although the difficulties were experienced in some settlement systems (e.g., equities and Euro-FRNs), settlement systems for government bonds and interbank transactions have functioned well, in part reflecting official policies designed to limit to the extent possible the credit risks involved in these systems.

These factors that tended to limit recent market disturbances need to be seen in the context of other factors that can potentially enhance "ripple" effects. Major institutions now manage trading operations on a global basis, and market response to economic or political development can be quickly transmitted across markets and time zones. Moreover, technological advances have increased the speed with which markets respond to new information. While the desirability of having available hedging instruments has been illustrated by recent events, a particular question has arisen about the effects of large-scale computer generated and executed transactions ("program trading") which facilitate the arbitrage of future contracts for equity price indexes with the stock market, and the defensive hedging of equity portfolios.

Overall, major financial systems have shown, at least in the short run, a significant capacity to absorb historically large shocks without extensive major institutional failures or contagion. Many of the earlier reforms of financial systems appear to have added stability. The long-run consequences of recent events will depend significantly on the response of macroeconomic policies and the related expectations of market participants.

3. Implications for market stability

The financial shocks that have occurred have implications for the full range of issues raised in the papers under discussion.

a. Resource allocation, market access, and market stability

A first issue is whether the loss of intermediation routes may result in credit rationing, excess savings, and a higher cost of capital with attendant macroeconomic implications.

Floating rate notes, noninvestment grade bonds, and--at least temporarily--equity issuance have indeed become relatively less attractive channels for intermediation, but to varying extents alternative instruments and markets may be providing substitutes. In particular, in the Euromarkets commitments of syndicated loans have increased for the first time since 1982, while issuance of short-term paper has expanded.

In the past, concerns have been expressed by some observers about the possible underpricing of risks associated with price volatility, illiquidity, and counterparty failure, especially in the markets for new instruments, although the existence or scope of such underpricing is debatable. Following the recent financial shocks, some evidence of reappraisal of these risks can be found in the higher prices for financial futures and options, wider spreads, and greater tiering in bond markets. This reappraisal might be beneficial for resource allocation

To the extent that macroeconomic and competitive influences remain unchanged, any reversal of the trend toward securitization, in favor of "relationship" banking, may be a cyclical rather than a secular reversal. However, a number of banks and securities houses were re-evaluating the scope of their activities in the Euromarkets even prior to October, and recent developments may have accelerated plans to reduce the scale of their commitment. Heretofore a major factor in the expansion of the Eurosecurities markets has been the significant growth in the number of financial firms entering the market, which supported demand as inventories were accumulated for trading purposes.

As regards implications for the heavily indebted countries, their access to the affected markets has recently been meager, and the direct effect of the recent shock on access appears limited. However, a resultant weakening in economic activity in industrial countries and, respectively, lower international interest rates, could have major implications for these countries. A secondary effect relevant to the debt situation is that the collapse of both the perpetual FRN and equities market may make it more difficult and expensive for commercial banks to raise capital to support future lending. Finally, the heightened volatility of prices for claims on industrial country borowers may increase their perceived relative risks, making claims on developing countries relatively more attractive. Since October 19, 1987, secondary market prices of bank claims on major debtors have increased, although this may largely reflect progress in current debt negotiations.

b. Formulation and effectiveness of macroeconomic policies

The staff statement and the informal Board session on November 13 provided Executive Directors with the opportunity to discuss the macroeconomic implications and policy responses to the fall in equity prices. Some observations, however, require specific emphasis in the present context.

Recent developments in financial markets have vividly underscored the growing integration of financial markets described in the staff papers, which appears to have progressed beyond the level previously envisaged by most market participants. This interdependence has, as discussed in the staff papers, important implications both for the formulation of national monetary policy and for the coordination of such policies across countries.

The flight to liquidity/quality that occurred after the October fall in equity prices has led at least temporarily to an increased demand for money and other claims on government. Such sharp changes in the demand for financial assets complicates the task of monetary management, as discussed in the staff papers--perhaps especially in judging the extent and timing of withdrawals of liquidity provided to ease the market shock.

Finally, in a world of increasingly integrated global financial markets, greater asset price stability will depend importantly on the pursuit of policies in major countries that promote stable macroeconomic conditions, without major sectoral imbalances.

c. Foreign exchange reserves, SDRs, and international financial markets

Recent financial shocks have underscored the concerns that a largely private international reserve system may be vulnerable to financial market disturbances, making it more difficult to obtain borrowed international reserves. However, the recent environment of rapid reserve growth in industrial countries, reflecting heavy foreign exchange intervention, makes it difficult to identify separately the influence of these disturbances on the reserve process.

Two offsetting considerations may be relevant. First, while the contraction in the Eurobond market potentially limits the ability of countries to borrow international reserves, the continued rapid expansion of cross-border bank lending and the revival of the syndicated loan market implies that alternative channels for borrowing foreign exchange are available, although the maturities may be shorter and the margins higher. Second, recent developments in the Euromarkets--a flight to quality--may have been to the relative advantage of sovereign borrowers perceived as creditworthy. Secondary market bid/offer spreads on sovereign bonds rose substantially less than the spreads for corporate bonds, while the liquidity of sovereign bonds was also greater.

d. Coordination of supervisory and regulatory policy

The impact of several financial innovations on price volatility in markets is being re-examined in the wake of recent developments. Transactions in financial futures and options are the subject of several official studies, and it appears premature to assess the need for any regulatory changes--whether in margin requirements, official limitations on activity, or strengthening of self-regulation--pending these studies.

The heightened integration of financial markets--both within and among countries--has highlighted the need for greater coordination in the supervision of nonbank financial institutions and banks. For example, securities houses are closely integrated with wholesale money markets, while liquidity support arrangements also exist between banks and other intermediaries and financial exchanges. Such linkages present the possibility that problems with nonbank financial institutions could spread by contagion to the banking system. The recent liquidity pressures experienced by some securities houses apparently reflected market concerns about these firms' capitalization in the face of unprecedented price declines as well as the absence of formal access to lender of last resort facilities. These latter concerns were quietened by statements from some central banks affirming their readiness to serve as a source of liquidity to support the economic and financial system.

Finally, while implications for coordination in supervision may be drawn from recent events, it remains important to note that the long-run effectiveness of both supervisory and lender of last resort arrangements depends crucially on maintaining market discipline and on policies to secure a stable financial environment.

Mrs. Filardo made the following statement:

During the November 13 discussion of the paper entitled "The Implications of Recent Developments in Financial Markets," the main conclusions reached were: first, the most important element for the stability of the financial and monetary system continues to be the medium-term implementation of sound macroeconomic policies and structural reforms by both industrial and developing countries; second, the integration of financial markets is greater than expected and, as a consequence, the transmission of major shocks could spill over rather quickly across the full range of debt and equity; third, there is therefore an urgent need for cooperation among all major industrial countries, but that cooperation should be universal; fourth, this cooperation should be developed within the Fund; and fifth, it is too soon to gauge the effect of the crisis, and at this juncture it is crucial to build confidence in the system in order to prevent devastating effect on the market and the world economy.

The two papers and the opening statement by the staff basically summarize financial market trends, the debt situation, and the implications for financial market stability of recent asset price variability. These documents transmit a view that the financial market has grown in complexity and sophistication as a result of competition, technological advances, and of liberalization. Yet despite these developments and the increase in the volume of transactions, the market remains highly volatile and rather vulnerable.

As we will hold a discussion on the debt problem in the near future, I will limit my comments to the different sources of market disturbances and the implications of those disturbances for policies that are in the interest of the Fund.

It is argued that financial liberalization and innovations have produced an efficient allocation of resources by channeling those resources to activities that yield the highest risk-adjusted return. The question emerges as to whether the market adequately prices different instruments in order to allocate credit to the most productive use, given the possibility of incorrect market decisions, the presence of official regulations, and the incidence of various economic factors. The staff papers state that recent trading losses could indicate institutions' inadequate evaluation of risk, mainly as a consequence of macroeconomic imbalances and the difficulties of assessing the evolution of these disequilibria.

While the staff papers emphasize that the liberalization of capital flows has had positive results, that liberalization contrasts with the increase in protectionism. Thus, in the view of the staff, the key to maintaining sound financial markets lies in the liberalization of trade and, particularly, in the implementation of consistent macroeconomic and structural policies in both industrial and developing countries. Perhaps the staff could further elaborate on some issues related to the Fund's interest in exchange rate policies and surveillance over exchange rates, and monetary and fiscal policies.

The primary sources of disturbances could be macroeconomic disequilibria, exacerbated by industrial countries' economic policy implementation; and the lack of synchronization between the liberalization of exchange and interest rates, capital controls, and financial and computer innovation. Let me mention some examples supporting these points.

First, the abandonment of the Bretton Woods system of fixed exchange rates was the result of an increased disequilibrium among industral nations, which were similar but of smaller magnitude than present ones.

Second, the establishment of the floating exchange system coincided with the first oil shock, which contributed to enormous external imbalances. The method of the recycling of the oil surplus to industrial and developing countries indicates that commercial banks did not evaluate the associated credit risk adequately. There were no market mechanisms which would provide an incentive for banks to limit their exposure within reasonable bounds.

Third, the oil shocks and the rise in inflation during the 1970s caused great volatility in exchange and interest rates. The change in the management of U.S. monetary policy in 1979--which permitted a large increase in interest rates in order to control inflation--was especially important, as it caused the recession of 1982-83 and, as a consequence, tremendously affected indebted countries, whose debt-servicing costs increased sharply, bringing about the debt crisis of 1982.

Fourth, the curtailment of financial resources to developing countries had a major impact on the distribution of credits through the financial markets. Lending among industrial nations reached a peak in 1986 through bank credit and bond markets, while lending to developing countries came to a halt. In spite of the adjustment programs implemented by developing countries, the deterioration of their terms of trade in addition to the shortage of external financial resources made them extremely vulnerable to external shocks. This has had an impact on secondary market prices of bank claims on debtor nations--reflected in larger discounts--which essentially has not been accepted or registered by commecial banks. This problem implies another imperfection of the market.

Fifth, although commercial banks' credit exposure has declined through the increase in their capital, provisioning, and the reduction of lending to developing countries, banks remain vulnerable because the developing countries' portfolio is being deeply discounted in the secondary market at the same time as banks' domestic portfolio are causing servicing problems, while commercial banks are linked to investment banks and brokerage houses. Furthermore, any interruption of interest payments by indebted countries could seriously affect the stability of the market. By the same token, the collapse of perpetual floating rate notes and equity markets may make it more difficult and expensive for commercial banks to raise capital to support future lending. That development would have very adverse consequences for the prospects of developing countries, and the staff is too optimistic when discussing these prospects. For instance, on page 4 of its statement, the staff notes that "since October 19, 1987 secondary market prices of bank claims on major debtors have increased." However, current prices are as much as 40 percent below those prevailing in May 1987.

Sixth, the availability of resources to industrial countries made it possible for them to finance their fiscal deficits and, therefore, to postpone adjustment. Further integration of markets caused a large expansion of interbank credit to finance bond trading portfolios held by branches and subsidiaries of the banks located in financial centers. In this regard, it is interesting to observe that borrowing by Japanese banks in this market reached $148 billion--exceeding their deposits--despite shrinking private savings in major industrial countries.

Seventh, financial and technological innovations have made the management of monetary policy more difficult. The Bank for International Settlements stated in 1986 that as a consequence of financial innovations and market integration, the timing and incidence of monetary policy had become less certain and that the meaning of monetary aggregates as an indicator of monetary policy was being eroded in a number of countries. Given the recent events in financial markets, these developments have important implications for the industrial countries' formulation and coordination of monetary policy.

Eighth, the recent financial crash and the continuous volatility of prices in the different markets are the result of market perceptions that economic imbalances between the main industrial countries are not sustainable and that cooperation is no longer effective. The timing of and contradictions between the measures that must be taken to correct the imbalances are now the main source of instability.

These and many other questions related to the collapse of the stock and currency markets, its spillover effect, its impact on the implementation of macroeconomic policies, and, in particular, its implications for the relations of these elements to the solution to the debt problem are a matter of serious concern. For instance, the stock exchange in one country in my constituency--which had adjusted well through its adjustment policies and structural reforms--was seriously affected by the spillover effect.

Although this world crash is perhaps different from the one in 1929 because the system is more able to absorb the shock, there remain fundamental sources of disturbances that have to be cautiously assessed. In this regard, while I agree with the staff that supervisory and regulatory policies should be enhanced, I wish to stress strongly that it is the Fund's responsibility to evaluate the situation, exploring different avenues to enhance the surveillance exercise; otherwise, as Mr. Sengupta said recently, the Fund will continue to serve only developing countries.

Mr. Hon said that he generally agreed that developments in the financial markets had been in the right direction. While the innovation and institutional changes in the financial markets represented a response to the macroeconomic disturbances and technological advances, they were also a reflection of the increasing interdependence of individual countries. An evolving world financial system was complementary to the world trading system.

The financial markets had provided an efficient mechanism for the allocation of global savings and investment, as well as for the financing of payments imbalances of the industrial and developing countries, Mr. Hon considered. However, the efficient and smooth functioning of the markets had enabled certain countries to pursue unrealistic policies and to delay the necessary structural adjustments of their economies. In that respect, he agreed with the suggestion that the markets had sometimes underestimated the risk involved in those financing operations.

The financial markets also served a useful function in allowing countries with access to the markets to supplement their reserves, Mr. Hon remarked. While that phenomenon had led to increased risk for the reserve management of the countries involved, it also subjected these countries to market discipline, with the knowledge that continued access to the market depended on the pursuit of realistic macroeconomic and fiscal policies. That did not, however, preclude the need for an additional allocation of SDRs. A proper balance between owned and borrowed reserves had to be maintained to minimize the risk to reserves that might arise from a major market disturbance.

While innovations and liberalizations had given rise to a more efficient financial system, they had also led to increased risks in the market, Mr. Hon continued. The efforts of major industrial countries to improve and enhance supervision and regulation had tended to reduce such risks, and international efforts to streamline and standardize supervision and regulations had also contributed to the stability of the system. International cooperation in that area had been satisfactory, in sharp contrast to the futile attempt at developing an international coordinated macroeconomic policy. The Fund could play a more active role in complementing the international search for a more uniform supervisory system.

The internationalization of domestic financial markets had accelerated and complicated the international transmission effects of monetary, exchange rate, and fiscal policies, Mr. Hon concluded. Internationalization had led to increased volatility in the world financial markets, and had subjected the financial system to increased instability. Therefore, it was all the more important that coordinated and compatible policies be pursued by major countries, to safeguard the stability of the world financial system; in that connection, enhanced surveillance by the Fund could certainly play an important role.

Mr. Lim said that the previous Board discussion of developments and prospects of international capital markets had indicated that despite progress in assembling financing packages for some debtor countries, the outlook for bank lending to countries with external payments difficulties remained bleak. Banks intended to press forcefully for actions by debtor and creditor governments that would minimize the banks' exposure. The paper on innovations and institutional changes in financial markets underlined once again that regardless of the types of financial instruments and techniques that might evolve, once access to markets had been adversely affected by perceptions regarding the borrower's creditworthiness, it would be difficult to regain that access. Furthermore, the greater degree of integration in financial markets meant that even countries which still had limited access to those markets might be indirectly affected by adverse developments.

The papers traced some of the innovations and liberalization measures to the need to finance larger fiscal imbalances, Mr. Lim remarked. That had allowed some countries to delay the needed fiscal adjustments, and might also have rechanneled resources away from financing investments in developing countries. Given the present general reluctance of banks to lend to perceived high risk countries, and the increase in demand for funds from low risk major industrial countries, the prospect for commercial financing of adjustment programs might be bleak.

The staff might be correct in noting the importance of regulatory changes by creditor countries in allowing financial institutions to respond more flexibly to a greater demand for credit from borrowers seriously pursuing adjustment efforts, Mr. Lim continued. He, however, continued to believe that the main ingredients for the restoration of access were the adjustments undertaken by debtor countries themselves.

The increased degree of integration and efficiency of financial markets make it all the more imperative that macroeconomic adjustments in major economies be well coordinated and in the right direction, Mr. Lim considered. Indeed, the globalization of financial markets had narrowed the margin of error in policy implementation--for example, that of fiscal adjustments. The effects of changes in domestic monetary policies were more likely to be transmitted rapidly to other countries through movements in exchange rates, interest rates, and capital flows. If increased volatility in the movement of those variables was to be avoided, increased coordination of macroeconomic adjustments of major economies would have to be pursued. He therefore supported a greater role for the Fund in multilateral surveillance of monetary, exchange rate, and other macroeconomic policies of major economies.

Regarding the concerns raised about the stability of a reserve system predominantly dependent on borrowed reserves, he agreed that an adequate amount of owned reserves could reduce the vulnerability of such a system, Mr. Lim said. However, that vulnerability was in itself an insufficient indication of a long-term global need for reserve supplementation. His Korean authorities had maintained that they were prepared to support an SDR allocation to reduce the vulnerability of reserves to disturbances in financial markets by providing countries with a sufficient stock of owned reserves that would be available even during a crisis period.

Mr. Yao noted that since the early 1970s, the international financial markets had been undergoing fundamental changes resulting from the liberalization of capital movements, the introduction of new financial instruments, and the use of advanced technology. Those changes had contributed to the integration of domestic and international financial markets and to the rapid expansion of activity in the international financial market, mainly because of the latter's low costs in providing financial services. The size of the international market had enabled major industrial countries to finance their deficits at a low cost, and many other countries to supplement their owned reserves with borrowed reserves. The increased depth and efficiency of the international markets were welcome developments, and future efforts to increase access to them should be encouraged.

While increased market efficiency had lowered the cost of borrowing, there were risks associated with a number of innovative instruments used as hedges, Mr. Yao remarked. The low pricing of such instruments reflected an underestimation of the risk involved, and financial institutions involved in those risky but profitable activities should have to disclose those activities on their balance sheets, thus increasing the accuracy of assessments of their exposures. Macroprudential policies could stave off a chain liquidity crisis in the system, but the potential costs of such a rescue operation should also be kept in mind.

The integration of the international financial markets had led to a delay in economic adjustments in major industrial countries, Mr. Yao considered. Largely as a consequence of their access to the international financial markets, developed countries had been unwilling to make the required fiscal adjustments and had used the international markets to finance their budget deficits. As a result, the share of credit in relation to GNP absorbed by the public sector had increased significantly in many countries, and had contributed to the maintenance of real interest rates at a relatively high level. Therefore the major industrial countries should undertake the necessary adjustments so as to free financial resources for other purposes.

It was regrettable that overall developing countries had not benefited from such an efficient financial market, Mr. Yao noted. Their difficulties in servicing their debt had obviously been a contributing factor. However, the markets should be forward looking, in the sense that they should consider the favorable impact of the adjustment programs being implemented by developing countries. In that regard, the supervisory and regulatory agencies of industrial countries could play a crucial role by providing incentives to financial institutions to undertake new loans. Those agencies could encourage provisioning or debt/equity swaps by providing tax incentives on losses and by not requiring that the assets held in institutions' portfolios be discounted. His authorities also wished to reiterate their concern over the continuing outflow of capital from sub-Saharan African countries.

Mr. Sugita made the following statement:

The paper on the development and prospects of international capital markets summarizes and provides an assessment of recent changes in the financial markets in a comprehensive and balanced way--a useful exercise that should be followed by further studies. Among the topics for further study suggested by the staff, I attach particular importance to the pricing in market responses to disturbances. In general, I agree with the staff's overview and assessment.

The focus on pricing in the staff paper is entirely proper. Indeed, the benefit to the whole financial system arising from its improved efficiency can be assessed only in relation to the risks involved, and if pricing does not reflect these risks properly, the system may become subjected to enormous dangers. In the real world, of course, risk assessment and pricing can be made only on a trial and error basis, but given the rapid pace of innovation and globalization in financial markets, errors may be discovered too late to contain the consequences within one institution or even a group of institutions. That could easily lead to systemic difficulties. While no one now can definitely determine whether pricing is accurate, there is a strong need to monitor pricing in the markets very carefully. I am not sure whether the Fund is well placed or equipped to undertake firsthand studies in this area, but it is important at least to keep up with outside studies.

Capital flows have become increasingly sensitive to interest rate differentials and to changes in exchange rates. This point is recognized by the monetary authorities of major countries, and serious attention is now being paid to it in the conduct of daily monetary policy. At the same time, however, difficulties and challenges presented to the monetary authorities in this new environment should not be overlooked. Timing is particularly important for monetary policy: monetary authorities have to respond to changes and disturbances in financial markets, and to other developments in the economy--daily or even hourly. The causes of central bank reactions are only occasionally and partly known to the markets. An information gap always exists, leaving market participants guessing about the intentions of a central bank. This information gap has, however, recently been magnified by the globalization of financial markets, and the probability of policy actions being misinterpreted has increased in parallel. Without drawing any hasty conclusions, it is important to recognize that this expanded information gap will present particular difficulties to monetary authorities in the conduct of monetary policy during the period ahead. The timing of monetary policy also has an important bearing on the process of policy coordination; comprehensive assessments of the world economy or a national economy are made only on an annual or semiannual basis, while the changes and disturbances to which monetary authorities have to react take place on a daily or hourly basis.

Given the unstable financial situation associated with innovation and deregulation, the SDR may have a role to play as a safety net in dealing with severe financial difficulties. However, I fail to understand fully the argument often presented in discussions on SDRs--that international financial markets' judgment on creditworthiness is imperfect and has to be corrected by a new allocation of SDRs. Is there any particular reason why judgment on creditworthiness by international financial markets is inferior to that of domestic financial markets? While this is a question best raised during Board discussions of SDRs, it may have a bearing on today's discussion to the extent that the answer relates to the nature and performance of international financial markets.

All the issues raised by the staff on supervision and regulation are important and worth further reflection and action on the part of national authorities. However, while new financial instruments allow market participants to hedge and thereby reduce risks, the instruments also allow them to take on additional risks if desired. Careful monitoring of risk concentration by market participants, financial institutions, and nonfinancial enterprises alike is therefore important. New statistics may have to be developed and collected, covering, for instance, off-balance sheet transactions of nonfinancial institutions. That need will increase if the demarcation between banks and other financial institutions becomes further blurred.

Mr. Seyler made the following statement:

The papers before us provide the historical background of recent innovations in the financial markets, and should be helpful for those who wish to understand the changes that have overtaken the markets and the wide range of instruments now used by market participants. I therefore support its publication in the Fund's World Economic and Financial Surveys series.

This paper also serves very well as background for a detailed study of the impact of these financial innovations on the Fund's policy recommendations to members, particularly their implications for the conduct of financial and monetary policies.

Since credit restraint no longer works because of the great increase in the mobility of capital, authorities are forced to rely much more heavily on interest rate policies. But because demand is relatively inelastic in response to interest rate changes, their desired effects on final spending require much larger interest rate changes than would have been needed if they were combined with credit restraint. This seems to be one of the reasons for the present very high real interest rates.

In addition, it has become nearly impossible for the central banks to influence relative interest rates, because changing the general level of interest rates causes all market-related interest rates to change.

Monetary policy thus tends to become such a blunt instrument that it can no longer selectively control the supply of individual types of credits and deposits and its usefulness is open to serious question. Moreover, the use of interest rates as a mechanism for the transmission of monetary policy has had disastrous exchange rate effects in recent years and has reduced the Fund to the humble role of a passive observer.

The Fund needs to strengthen its role and to regain the authority that it has lost as a result of members' easier access to financing for current account and fiscal deficits, which has enabled governments to delay needed policy adjustments far longer than would otherwise have been possible.

The ease of financing the present imbalances in the world economy demonstrates how mobile international capital has become. There is no guarantee, however, that these mobile financial flows will act to serve the macroeconomic policy goals of the governments concerned.

The increased mobility of capital, with the concomitant risk of exchange rate swings, requires a higher stock of central bank reserves to insure against unanticipated shocks. Here the Fund should take the initiative in convincing world opinion of the usefulness of an SDR allocation. The current reserve system characteristically favors countries that do not need reserves and penalizes countries that do, because the cost of borrowed reserves increases as market access shrinks.

A further problem is risk concentration. One of the forces driving the emergence of new kinds of financial instruments is economic agents' need to hedge their financial risks by transferring them to other agents with an offsetting exposure on their balance sheets. To the degree that the markets really function in this fashion, total systemic risk is reduced, because the new instrument which is created matches offsetting real exposures. But the transactions performed for this purpose themselves create new risks, since the two agents involved in the transactions are linked through an intermediary and the financial health of all is therefore made to depend on the health of each. The regulatory authorities have become concerned about the rapid growth of these kinds of transactions, especially since the financial intermediaries seem to be expanding their involvement in hedging operations--which often takes place off their balance sheets--much faster than they are expanding their capital.

I wish to draw attention to the widening gap between the fast growth of the financial markets and the very slow growth of the real economy, and to the stagnation of international trade. What we are confronting, in fact, amounts to a decoupling of financial activities form the real economy. The structure of the financial sphere can be considered functional if it permits efficient allocation of financial resources toward investment needs, by dividing and scattering the risks inherent in every project, or by ensuring that those risks are borne by financial agents strong enough, and well enough motivated to accept them.

Although this mode of operation is still visible, the increased velocity of circulation of financial assets has contributed to the growing prevalence of very short-term perspectives, and the overreactions which increasingly characterize judgemnent in and the effervescent behavior of today's financial markets. The free circulation of goods and services--which it was once the first priority of the international community to ensure--is today threatened by erratic exchange rate movements that determine the return on commodities and the competitiveness of industrial production. Resource flows toward enterprises are no longer invested in long-term productive projects, but are used for short-term financial placements or for speculation in equities. The allocation of resources is being distorted by the exploiters of the new financial techniques, who are focusing excessively on the remuneration of capital. This misallocation of resources also contributes to an unsustainable disparity between the remuneration of work and equity investment. A further examination of this topic during the world economic outlook exercise might prove interesting.

The recent crash of the equity markets has signaled the beginning of the correction of these distorted relationships. At the heart of the problem lie the official budget deficits, which undermine the confidence of the markets, and generate upward pressure on interest rates. The deficits have created this financial bubble, and must eventually be reduced in order to eliminate it.

The markets have clearly sent a signal to the authorities that these official deficits are responsible for the overheating of the financial sphere and need to be replaced by debts connected with more productive investments. If agreement can be found to gradually retire these debts, rather than allowing a massive default, the resources thereby liberated could usefully be absorbed through borrowing by the large international institutions.

Mr. Kabbaj made the following statement:

The recent volatility in international equity and financial markets highlighted the issues analyzed in the staff papers before us. Increasing uncertainties regarding economic prospects, along with a lack of effective responses by major industrial countries to their macroeconomic imbalances induced a series of widespread shocks. I hope that this time the perception of the gravity of recent developments is sufficient to lead industrial countries to develop a more cooperative approach to eliminating their structural imbalances, and to recognize the negative impact of growing protectionism. Such cooperation is now all the more important if one compares the rapid liberalization and integration of financial markets in recent years to the lack of coordinated actions to prevent the emergence and rapid spread of disturbances.

Publication of the paper in the world economic and financial surveys would be more comprehensive and accurate if they are complemented by a paper similar to that distributed to the Board for its informal meeting of November 13, 1987, dealing with the implications of recent developments in financial markets.

During the first half of 1987, activity in international financial markets was still characterized by a net flow from developing countries to international banks. While a net flow of $32 billion from international banks to all countries was recorded, net repayments by developing countries amounted to $15 billion. On the other hand, developing countries' issuing activity in international bond markets declined: to make matters worse, the recent turbulences in financial markets are now expected to lower growth in developing countries by 0.25-0.5 percent in 1988 and 1989. Overall, while the development of financial markets and the adoption of new issuance techniques and new instruments has--as indicated by the staff--allowed some countries to finance their fiscal imbalances and to delay adjustment, developing countries have not shared this opportunity and have been adversely affected by all the negative developments in these markets.

The papers point out that the expansion of activity in international financial markets was sustained by an increasing deregulation and liberalization of domestic financial markets, and by the use of a variety of new instruments and techniques. In response to this internationalization, efforts were also undertaken to strengthen and harmonize supervisory policies. However, macroeconomic imbalances among major industrial countries induced persistent instability in financial markets--as evidenced by recent development. Furthermore, current trends suggest that the access of developing countries to these markets is unlikely to be restored in the near future. Developing countries will therefore continue to rely on borrowing from official sources as well as from multilateral institutions, and in this regard, the pertinent suggestions of the G-24 report should be taken into account. Promotion of the Fund's role requires a substantial increase in its lending activity, a review of its facilities, and an improvement of its resources notably through an increase in quotas. Moreover, even though the Fund is not an operator in international financial markets, its role in safeguarding the international monetary system must be strengthened, given the globalization of financial markets which has increased the international dimension of the financial crisis, as evidenced by recent developments.

In this regard, Article IV consultations and the world economic outlook exercise should remain the principal tools for Fund surveillance. Indicators could also be used with special emphasis on assessing the impact of industrial countries' policies on the developing countries. However, such instruments would be ineffective if they were not sustained by the political will of industrial countries to implement the required corrective actions.

Since market access for developing countries will take a long time to restore, and will be limited to a few countries, the need for an allocation of SDRs is urgent and deserves more political support among some industrial countries. The staff correctly indicates that "SDR allocations could reduce the vulnerability of the reserve system to disturbances in financial markets by providing countries with a sufficient stock of owned reserves that would be available even during a crisis period."

The expansion of financial markets and the emergence of new instruments and new techniques have increased the need for an international supervisory system. Proposals for new international regulatory standards for the capital adequacy of financial institutions are steps in the right direction, and I also welcome the staff proposal to review the efforts by national authorities to achieve a more coordinated approach in this area. However, more remains to be done, given the rapid expansion of new instruments--options, futures, swaps, forward markets and program trading--and the remaining gaps between domestic markets which allow banks to relocate their operations rapidly across international markets.

Finally, while a global capital market is emerging constituted by the major financial centers with an increasing set of new instruments, financial markets in developing countries remain archaic and poorly equipped to drain domestic savings. The ongoing reforms in these countries--to increase reliance on private initiatives, to privatize public enterprises and to offer some debt conversion schemes--will be difficult to achieve in the absence of efficient domestic financial markets. In this respect, technical assistance from the World Bank and the Fund would be of great help to these countries.

Mr. Templeman made the following statement:

The staff papers contain an excellent review of trends and innovations in financial markets and of the forces that have led to institutional change since the mid-1970s. This material should provide useful background for the staff, the Board, and the financial community.

The major developments reviewed in the staff papers concern the liberalization, securitization, and internationalization of financial markets, and the strengthening of supervisory and regulatory procedures. Liberalization has taken several useful forms, notably cross-border liberalization, the increased freedom for foreign institutions to participate in domestic markets, the creation of new financial instruments, and the deregulation of pricing and quantity controls over some financial variables. I particularly welcome the growing acceptance of the principle of national treatment and the progress in deregulating interest rates.

This opening up of financial markets should contribute significantly to greater economic efficiency. However, these innovations have combined with macroeconomic developments and continuing differences in regulatory, tax, accounting, legal, and disclosure systems in major countries to put pressures on the markets and on policymakers. For example, the exercise of monetary policy has been complicated by the emergence of new financial instruments which are included in various measures of the money supply, but whose behavior is not yet fully understood, or predictable. At the same time, macroeconomic uncertainties with regard to energy prices, commodity prices, and interest rates, and the emergence of very large external and domestic imbalances in some countries have tended to create instability in the markets.

The globalization and integration of international capital markets has significantly increased the interdependence of countries. The experience of recent weeks is evidence of this fact and is a vivid reminder of the need to pursue market-oriented macroeconomic policies. Careful assessment is now under way of the impact of these events and of their implications for regulatory arrangements. The Fund has an important role to play in the monitoring of world and country-specific economic developments, as well as in helping the major industrial countries to strengthen international economic cooperation.

Financial market innovations and developments in recent years have posed a challenge both to the management of macroeconomic policy and to the supervision and regulation of financial markets and financial institutions. In the latter case, some steps have already been taken at the national level to strengthen the system of regulation and supervision, in order to achieve and preserve the aims of financial market stability, protection for savers and investors, and encouragement of an efficient and competitive financial system. Some safeguards already exist: the lender of last resort role of central banks; banking supervision; regulation of securities markets (including disclosure requirements); and some forms of deposit and credit insurance. For instance, major gains have been achieved in strengthening the capital base of banking systems, and important efforts are under way to achieve a degree of international consistency and commonality in the supervisory framework for banks. However, major differences remain in the accounting, tax, and legal environments within which financial institutions must operate.

Therefore, further efforts are likely to be needed by both banking and securities regulators to enhance prudential arrangements. In this connection, serious discussions on a risk-adjusted capital rule are under way among major creditor nations. I hope and expect that an accord will be approved by all the member countries of the BIS-Cooke Committee. Such multilateral proposals for improving capital adequacy are designed to strengthen the financial situations of internationally active banks and to provide some convergence in capital standards across countries. But it is widely appreciated that remaining differences in national accounting and tax policies limit the possibility of achieving a completely level playing field.

More generally, I believe that the basic responsibility for regulatory and supervisory issues belongs to the individual member countries, complemented by coordination either through the BIS or through cooperation between securities regulators. In the absence of a more formal organization in the securities area to carry on the international coordination function equivalent to that of the BIS in the banking field, bilateral cooperation will be centered in the OECD and the International Organizations of Securities Commissions.

Developments in financial markets are having significant effects on a number of areas of activity in which the Fund has an important interest, including the transmission of monetary, exchange rate, and fiscal policies; the formulation and implementation of monetary policy; the financing of fiscal and balance of payments deficits; and exchange rate movements. Similarly, the effects of financial market developments on such policies are also having an impact on a number of economic objectives about which the Fund is concerned, such as the allocation of savings and investments; the effectiveness of monetary, exchange rate, and fiscal policies; the adequacy of international liquidity; the stability of the international monetary system; the international coordination of supervisory and regulatory policies; and Fund surveillance over exchange rate and other macroeconomic policies of member countries, including Fund assistance in international economic cooperation efforts. I would also note the effect of financial market developments on the debt strategy--discussed at some length at the Board meeting on September 4, 1987.

In the area of future financial market developments, the Fund's broad responsibilities are for monitoring the economic fundamentals, rather than to have a direct involvement in the evolution and regulation of financial markets per se. The Fund should focus principally on developments in the economies of member countries and the interaction of these economies with one another, through the Fund's monitoring and surveillance activities in the context of the world economic outlook, Article IV consultations, Fund financing arrangements, and the assistance that the Fund provides to the major industrial countries' efforts to strengthen international liquidity, and the overall stability of the international monetary system. Unless sound macroeconomic policies are being pursued by the Fund's membership and due attention is paid to the effects of those policies on other countries, more narrowly focused technical efforts to strengthen the structure and operation of the financial markets will surely prove insufficient. Indeed, many of the innovative instruments developed in financial markets in recent years are the results of governments' failures to pursue appropriate macroeconomic policies.

The Fund has an important role to play in following developments in--and relationships among--markets, and in working to promote greater openness and efficiency. This should include attention to developments in offshore markets. To the extent that other bodies--such as the BIS, OECD, or national organizations--are active in a given area, the Fund should avoid duplication. However, the Fund should further examine developments in the financial markets of the newly industrialized countries.

Finally, I will comment on some specific issues mentioned at the end of the staff paper on financial markets. First, sound macroeconomic policy formulation and implementation is clearly the key to financial market stability, although not the sole determining factor. The Fund has an important role to play in that area. Second, the Fund has become an important source of information, and further work on offshore markets and on the flow of funds among markets is worth pursuing, within available resources. Third, the Fund regularly examines the adequacy of international liquidity in the context of possible SDR allocations and the management of international reserves. Sufficient attention is being given to this matter. While coordination efforts are going on elsewhere with regard to supervision and regulation in the financial area, the Fund does have a comparative advantage in studying the effects of regulation of the debt strategy. Those effects may be worth continuing attention.

Mr. Kyriazidis made the following statement:

Notwithstanding its long-run benefits, the process of financial innovation is not without costs and problems for the stability of markets and the international monetary system as a whole. The existence of some negative side effects calls for policy action on the part of the authorities both at the microeconomic and macroeconomic levels. I will comment on these side effects and policy actions.

At the microeconomic level, I see three main sets of problems. First, financial markets undergoing innovation are not necessarily evolving toward the perfectly competitive structures envisaged in economic theory. Markets are not always efficient in pricing securities, and financial markets can clearly be significantly affected by speculative bubbles, bandwagon effects, or movements unwarranted by fundamentals.

Second, it appears that the process of financial innovation has been accompanied by increasing variability in asset prices and yields. The increased uncertainty deriving from such variability is creating real costs for the system--such as the costs to enterprises of managing higher exchange rate and interest rate volatility, and the costs of forgone investments due to greater uncertainty. At a different level, there are the costs to investors caused by insider trading practices, or by the use of short-term defensive strategies for avoiding unwelcome takeover bids.

Third, the assessment of risk may have been made more difficult by the innovation process. The increasing number of intermediaries may loosen the link between lenders and final borrowers, making reporting requirements less effective and reducing transparency; ultimately risks might turn out to be underpriced and undetected. This problem is particularly important given the volume of off-balance sheet liabilities of banking institutions.

Since the process of financial innovation obviously cannot--and should not--be reversed, all of the above considerations highlight the need to modify and improve supervisory and regulatory activity, in order to ensure financial stability and sound financial practices. I can offer three sets of suggestions. First, supervision and regulation should be extended to monitor the new financial processes and products, in order to ensure full disclosure and appropriate risk pricing. Off-balance sheet operations in particular should be better monitored, along the lines indicated in the Cooke Committee report. Second, in an increasingly integrated system, regulatory and supervisory measures should be adopted so as to avoid discrimination among markets and operators. The objective of such measures should be to ensure a "level playing field." Attempts to regulate only part of the system can jeopardize global stability because of crises starting in unregulated segments. Moreover, placing some operators at a disadvantage will only cause erosion of market shares or circumvention of the regulations. A necessary corollary of these considerations is the need to coordinate and harmonize supervisory practices across countries, as the U.S. and the U.K. authorities have recently done. Third, some scope might exist for further curbing unsound market practices--such as insider trading--and precluding certain types of takeover bids and some forms of financial strategies based on computer trading, in order to reduce uncertainty and misallocation of resources.

As for the macroeconomic implications of financial innovation and the required policy action on the part of the authorities, I wish to emphasize two considerations raised by this chair at the time of the November 13 Board discussion on capital market developments.

First, the process of trade liberalization has to move forward at the same pace as financial liberalization. Differences in the mobility of capital and the mobility of goods and services in different countries are likely to result in increased exchange rate volatility. It is, therefore, worrisome that in the present period of financial liberalization, the dismantling of trade restrictions is not proceeding as it should. Indeed, trade liberalization is in danger of receding as protectionist pressures resurface.

Second, financial innovations call for the strengthening of international economic policy coordination. Global financial markets tend to speed up the transmission of policy actions among countries and, even more importantly, tend to amplify the adverse effects of inconsistent policies in the major countries. In a world increasingly characterized by high capital mobility and free trade, the autonomy of domestic policies is constrained. Independent domestic policies can only be carried out at the cost of excessive or disruptive exchange rate movements and--as we know--protracted exchange rate misalignments have real effects that are not easily reversible.

Finally, I wish to make two points prompted by the staff statement on the effects of recent developments on the financial markets. First, I would be interested to know from the staff whether the extension to foreign currency markets of hedging strategies utilizing program trading is possible or likely in the present regulatory and institutional circumstances. Given the questionable consequences that might flow from the use of this technique, such a development would be a matter of serious concern, and would require prompt action by the authorities if its negative side effects were not to extend into the currency market.

The consequences of recent developments on the cost of capital for the firm might be substantial--perhaps not so much for the "blue chip" corporations, which might substitute equity financing for bond financing, as for noninvestment grade corporations. Such corporations account for a sizable portion of the sales and investments of all U.S. corporations. The virtual disappearance of the market for bonds issued by such corporations--the "junk bonds" market--is likely to cause an overall net increase in the cost of capital to the issuers, which is in turn likely to affect their levels of investment. In fact, it is difficult to see how additional financing for such firms could be provided exclusively by the credit sector, given the conditions prevailing before the stock market collapse. Notwithstanding the temporary reduction in interest rate levels, banks might still be constrained in expanding their lending by the difficulty of raising additional capital.

The Fund can make an essential contribution in coping with the problems arising from the process of financial innovation through the promotion of policy coordination which can greatly benefit the stability of the system as a whole.

Mr. Vasudevan made the following statement:

Today's discussion is important not only because there have been considerable liberalizations, innovations, and technological advances in the 1970s and 1980s with an impact on financial integration, but also because the continuing structural changes in the financial markets have wide-ranging policy implications for different countries and for the Fund. The staff paper on financial markets has succinctly described the sharp expansion of the major domestic and offshore financial markets, the main trends in the international financial markets, and the forces that generated changes in financial instruments, financial institutions, and regulatory structures during the last decade. It has also pointed out, albeit too briefly, that developments in 1986 and 1987 showed some departures from the trends seen in much of the 1980s. For instance, there has recently been a more rapid expansion of bank lending relative to bond issuance, in contrast to the events of previous years. The floating rate note market nearly collapsed during the past two years, and lending to developing countries--especially to those experiencing debt-servicing problems--continued to decline.

In the current circumstances, questions arise as to whether the developments in financial markets are adequate and desirable with respect to resource allocation and the stability of the financial system; whether these developments provide adequate indications to policymakers; and whether markets should continue to evolve as they do now, or on rather different lines. The relative importance of developments in the financial markets and on the real side of the economy could also bear some scrutiny.

These are difficult questions. We have to approach them with humility, since our experience with liberalizations is recent. The appropriate pricing of financial instruments and the minimizing of risks associated with trading activity suggests that resource allocation is efficient. But the recent large expansion of markets under the impetus of liberalization has not led to appropriate pricing--an outcome reflected in the existence of official regulations such as interest rate ceilings, and guarantees, such as deposit insurance or the availability of a lender of last resort. The risks too seem no less severe, despite the recent propensity of many financial institutions to make large provisions, and the efforts of regulatory and supervisory institutions to promote the integration of off- and on-balance sheet risks. So long as hedges against risks exist, markets cannot be efficient, however much they change with innovations. Nor have innovations and institutional changes ensured an optimally efficient distribution of savings and investment across countries. Moreover, efficient resource allocation is difficult to achieve if macroeconomic imbalances among the major countries exist, as these give rise to uncertainties about movements in exchange, inflation, and interest rates.

The hedging of both liquidity and credit risks reflects the instability of the current financial system. An extreme form of such hedging is the unwillingness of financial institutions--particularly commercial banks--to provide credit to debtor countries that have adopted strong adjustment policies, often with the Fund's advice. Reduced access of these countries to international financial markets implies the need for increased official flows and nondebt creating flows--for instance, foreign direct investment--to meet the financing requirements of these countries. If such a shift in the source of financing does not take place on appropriate terms and in sufficient amounts, strong import compression is likely in most indebted countries. That could mean defaults on, or suspensions of, past debt and current interest payments, and a tendency toward deflation. That in turn would have important adverse effects on the development and stability of international banking. If taken to the extreme, central banks would be required to assume their function as lenders of last resort sooner rather than later.

This scenario has not received due attention in the staff paper, on financial markets, but it is not altogether impossible. In fact, this scenario can be expanded: if the external gaps are not financed, reductions could occur in trade and economic activity, and depending on the magnitude of financing gaps, these reductions could spread internationally. If the markets perceive that the situation is likely to lead to financial crises, there could be strong contagion effects. In such circumstances, it would not be enough to rely on supervisory and other regulations. The Fund could play a role in avoiding such an outcome by reducing the vulnerability of the reserve system--which is based so predominantly on borrowing--to disturbances in financial markets through SDR allocations. But this now seems more of a political question, in the sense that the judgment of the need for reserves can have operational significance only if all member countries agree to an SDR allocation.

The critical question is whether stability could be promoted by pursuing macroeconomic policies in addition to what might be described as macroprudential policies. Here there are serious doubts about individual countries' abilities to formulate policies, because the channels of transmission of the policies and their effects are not clear in the existing state of high financial integration and openness of economies: it is extremely difficult to interpret with certainty the effects of financial liberalizations and innovations on major monetary and financial variables. Policymakers in individual countries cannot take policy actions in the belief that the domestic market effects could be isolated: such actions are bound to have repercussions on the international market as well, and these could become more unpredictable if there are simultaneous policy actions by other national authorities. Thus, adjustments in policies, especially in interest rates and exchange markets, must reflect the markets' view of the best possible policy mix in both the national and international contexts. Central banks' roles have in particular become very critical and sensitive, as the banks have to be seen as ready to intervene or to function as lenders of last resort without defining and publicizing the specific circumstances and rules under which those actions would be taken. Such ambiguity in defining the rules need not necessarily reflect caution; it is, in fact, the only option, since liberalizations and innovations have made monetary policy effects somewhat weak and uncertain. It is therefore probably important to pay more attention to developments on the real side of economic activity. Output, demand, and employment have to be promoted in order to prevent recessions.

In view of the close interdependence of economies--in sharp focus after the plunge of the New York stock market on October 19, 1987--well-defined coordination of economic policies is necessary among the major players in the international arena. However, in practice, coordination is not as easy to achieve as one would like to believe, in view of domestic pressures on policymakers. Coordination efforts should therefore not be conducted by the major parties among themselves: coordination should be more open and transparent, and subject to multilateral surveillance.

The indicators' exercise in multilateral surveillance is expected to provide insights into the areas on which such surveillance should be focused. For such surveillance to develop into a full-fledged and dependable mechanism, continuous monitoring of information and analysis of the effects of transmission based on such information would be essential. The Fund's role is critical in this process, but how far and how effectively it could play that role depends on the cooperation of major countries. However, the experience of the past few months reveals that much of multilateral surveillance could become confined to generalities and to semiannual discussions in the framework of the world economic outlook papers. It would probably be worthwhile to give serious thought to the nature and depth of multilateral surveillance as it has evolved to see if it could be reoriented to reflect the continuing structural changes in international financial markets and their growing liberalization.

Mr. Posthumus made the following statement:

The evolution, growth, and changing in character of international financial markets are of the utmost importance to the Fund and the staff has given us an informative analysis of them. Most striking are the many interdependencies: differences in regulatory environments, macroeconomic imbalances, and technology have all contributed to the evolution of the markets, but that evolution itself has had important feedback effects on all those fields. Of special importance, of course, is the interaction between financial markets and financial economic policies. This subject is highly topical--especially in the context of the European Economic Communities, where negotiations have just begun on introducing complete freedom of capital flows within the EC by 1992.

The fundamental questions are the extent of financial markets' influence on the real economy, and the extent to which the way monetary policy can or should be conducted has changed.

Macroprudential supervision of the market is in itself not a Fund responsibility, and there is considerable activity in this field by other institutions. However, a smoothly functioning international monetary system depends on the absence of major shocks and chain reactions of failing financial institutions. The Fund should contribute to the balanced economic development essential to ensure the lasting stability of the monetary system.

Among the least positive kinds of financial innovation are those that take advantage of differences in supervisory frameworks among financial centers. In the context of prudential supervision, it is especially important that the pricing of new instruments adequately reflects the risks involved in their use. Risks in the markets tend to change in character, as does the exposure of financial institutions. Supervisors can be helpful by identifying the risks concerned, and the annual Fund missions regarding international capital markets are also useful in this respect. Of course, the responsibility for the risks taken by financial institutions rests with the management of these institutions, and it is important that the authorities not specify exactly what they are prepared to do in cases of emergency.

The Fund should not see the financial and capital markets as phenomena completely external to it. In various areas the Fund competes--to some extent--with the markets, and it is useful to recognize that fact, although I hesitate somewhat in using "compete"; the Fund is, of course, "above" the financial markets, but it cannot isolate itself from them--it influences and is influenced by the markets. For instance, Fund quotas basically compete with other possible investments for official reserves. Of course, market considerations do not dominate when quota increases are determined, but in the end, the monetary character of the institution depends on these other considerations not being valued too highly above market factors.

Significantly, the Fund may be seen to compete with the markets in the use of its resources. In some respects the competitive position of the markets is strong; but we may have forgotten an old law: bad money drives out good money. Markets can offer a variety of terms and conditions on credits to member countries, and the absence of conditionality is an attractive feature. But conditionality is absent only so long as markets consider a country creditworthy; once that reputation has vanished, no amount of adjustment measures will restore access in the short term. The successful competitive position of the markets vis-à-vis the Fund in the 1970s generated the debt problem, and we can hope that the creativity of modern markets will contribute to finding solutions to this problem as well. Meanwhile, the Fund's position has strengthened enormously. The markets themselves now belatedly attach great importance to Fund conditionality, as should all member countries.

As far as industrial countries are concerned, the international markets tend to be highly efficient in providing for their financing needs. Industrial countries with balance of payments problems seem little inclined to draw on the Fund--thus repeating the experience of many developing countries in the 1970s--as the international financial markets allow countries to give priority to their national considerations and targets and to delay needed fiscal adjustments. The Fund has an important task in analyzing the consequences of such behavior and in bringing them to the attention of its members.

In a way, the Fund also competes with the markets for international reserves. Borrowed reserves are now much more important than they used to be, and the adequacy of international reserves has consequently become increasingly threatened by instability in the financial markets. This development underscores the importance of maintaining a safety net through annual allocations of SDRs--but such allocations should be of a moderate magnitude in conformity with long-term global reserve requirements.

The growth of financial markets and the relative freedom of participants in these markets imply that exchange rates now seem to be more dependent on capital flows than before. There is a risk that exchange rates could move so much out of line with purchasing power parity and the maintenance of competitive positions that protectionism would become a real danger. Of course, the answer to this problem is not to reregulate capital flows, but to coordinate policies so as to avoid adverse exchange rate movements.

While necessitating more coordination, in one respect the developments in financial markets make coordination more difficult in the interpretation of monetary developments. One area needing further study is the interaction between capital flows and monetary aggregates. It is of utmost importance to analyze monetary aggregates in order to judge monetary developments in different countries. For the sake of policy coordination, it is crucial to judge where monetary policy is lax and where it is tight.

I agree with the staff that the integration of financial markets and increased capital mobility make the coordination of economic policies all the more important. During the last few weeks, conflicting economic policies in different countries led to quicker and sharper adjustments in interest rates and exchange rates. Monetary policy now operates to a larger extent than hitherto via the exchange rate and the balance of payments, and the large volume of potential capital flows means that interventions without appropriate interest rate adjustments are of limited use; capital flows depend both on relative interest rates and on confidence in national policies. In this respect, markets tend to respond to any available signal, and coordinated policy measures therefore have a much greater impact on both domestic and international economies than unilateral policies. These considerations are crucial to the Fund's surveillance function and to the working of the international monetary system. The Fund could best concentrate its further work on these areas.

Mr. Almeida made the following statement:

I will focus my comments on those matters more directly related to developing countries.

The staff should provide information regarding the secondary markets for the commercial bank debt of developing countries on a regular basis; the data could be included in the periodic papers on international banking activity, and perhaps a description and analysis of the new techniques utilized in these markets could be included in the regular staff papers on international capital markets. The regulation of debt conversion schemes in specific countries should also be addressed on a more regular basis. The last paper on these matters is almost two years old, and most of the recent information--aside from that in DM/87/3--is only partially available in reports for Article IV consultations.

The staff could also analyze the integration of stock exchanges in developing countries with world capital markets, and the possibilities of selling stocks of developing country companies in world stock exchanges, either directly or through stock market funds registered in international stock exchanges--as those funds that the IFC has recently assisted in establishing for several countries.

It would be interesting to know if the staff could explain how the recent innovations in financial instruments have helped to reduce the cost of credit.

The recent disturbances in the stock market have shown that central bank lending to commercial banks can still be effective in stabilizing markets. Perhaps the staff could, nevertheless, explore the prudent reinforcement of the stabilizing function of central banks in the securities markets of different countries.

The international dimension of financial crises has been enhanced by the growing integration of financial markets, as the recent disturbances in the stock markets have shown. I do not mean to suggest that there should be a specific role in this area for the Fund, which will, of course, have a stabilizing role in safeguarding the international monetary system from the repercussions of crises however induced, whether by speculation or other short-term factors.

An overview of the world financial situation cannot be provided solely through a country-by-country analysis; more emphasis should be given to the study of institutional changes in the international capital markets, and to the flow of funds within and across countries. It would also be useful if the staff could prepare a paper stressing the best uses of the new range of financial instruments for developing countries.

The staff should participate in reviewing and analyzing the efforts of national authorities to achieve a coordinated approach to the international supervision of financial markets.

Mr. Enoch said that the staff paper on recent innovations and institutional changes in financial markets contained a thorough and cohesive historical analysis. The timing of the report was especially appropriate in view of the shocks to the financial markets in October. He broadly agreed with the staff's analysis and conclusions.

He had been slightly surprised at the staff reference--in its statement--to two recent events in the financial markets: the fall in equity prices in October, and the collapse of the Eurodollar perpetual floating rate note market, Mr. Enoch remarked. While the fall in equity prices was clearly systemic and had effects on the real economy--effects that might be difficult to quantify but about whose direction there could be no arguments--the collapse of the perpetual floating rate note market was a completely different type of event. That market had been relatively small; it had perhaps developed as a particular niche market, initially in response to supervisory regulations, and its demise had been brought about by expected changes in those regulations; and it had never had a retail base. There had been some suggestion in the papers that by looking at particular examples a picture of the whole could be viewed, and there was a risk that false trails might be followed in that regard. In a period such as the recent very rapid change in financial markets, particular instruments underwent meteoric expansions and equally precipitous declines in their employment. It was important to distinguish those changes from the real thrust of developments, and it was easy to get lost in examining particular details.

The staff's statement also seemed to question the importance of mispricing of risks, and perhaps even its existence, Mr. Enoch noted. Attention should however be drawn to the BIS study, which looked at mispricing in considerable detail. The study concluded that there was a major concern that when instruments were being developed that implied new types of risks, it was difficult to quantify the actual risks involved; and where new markets were highly competitive, led by highly diversified financial institutions that were trying to maximize market shares, there had to be a tendency toward underpricing the risks. Thus, the benefits of financial innovations were generally welcome, but more recognition could perhaps have been given to the fact that central banks had for some time been aware of the risks involved in those innovations, had watched developments closely, and had voiced their concerns in that area.

Innovations had enabled the financing of larger and more sustained imbalances than was possible previously, Mr. Enoch noted. The causality attributed to those developments by the staff could however be questioned: larger imbalances could have stimulated innovations, and, indeed, the imbalances and the innovations were probably mutually reinforcing. It was however interesting that some of the innovations and deregulation had in fact been a response to public sector deficits and private sector surpluses, and a better analysis could be made if the focus was placed on the interactions between innovations and deregulation rather than perceiving the innovations as an entirely autonomous force.

As to the suggested items for the work program, the staff's intention to direct more resources to further research on institutional changes and innovations in the financial sector was welcome, Mr. Enoch said. It was important for the Fund, as a monetary institution, to work on the monetary and financial areas--especially their interrelation with macroeconomic developments. It might however be inefficient to look closely at subjects that were already a focus of attention elsewhere. Of the four topics in the paper on financial markets, the relationship between financial stability and macroeconomic policies was clearly of interest to the Fund, and was certainly essential to its concerns. However, the suggestion that "there could also be consideration of the role of the Fund in safeguarding the system from such financial market shocks" seemed to imply more consideration of the SDR, and as there were already several papers on the SDR in the work program for the coming months, work in that area might be incorporated within the work already ongoing.

The second work program topic mentioned was the need to provide more information; work in that area would be very useful, Mr. Enoch considered. Information was always welcome and papers such as those before the Board and the regular six-monthly papers on developments in banking markets were extremely useful. Beyond that, however, there was again a risk of duplicating work that was being done at the BIS. If the Fund was going to increase monitoring of such topics, that should be done in collaboration with, or at least in full awareness of, the efforts of the BIS. The BIS was particularly involved in statistical work in that area. The final point on the coordination of supervisory functions was also a significant topic, Mr. Enoch noted, but work seemed to be proceeding at the national level in that area, and progress was indeed most likely at the national level.

Mr. Puro made the following statement:

The paper on innovations and institutional changes clearly depicts recent tendencies in financial markets. Although these developments have also been systematically described in other contexts--for instance, in the BIS study--the staff paper sheds some interesting light on them from the viewpoint of the Fund.

The rapid changes in the financial markets have increased the difficulties of both the national authorities and the international community in trying to assess policies and their likely outcomes. The only way to improve assessments and recommendations is to base them on a better understanding of the facts. Therefore, further analysis of innovations and institutional changes in financial markets is certainly useful.

The question is where this work most effectively could, and should, be undertaken. Most of the necessary work on financial innovations and supervision apparently is already being performed by the OECD and the BIS. The Fund should take full advantage of that, and, taking particular account of the work load of the Fund staff and the Board, the Fund could probably best confine its role in this exercise to the drawing of conclusions from the changes taking place, and the assessment of their impact on the international monetary system and the Fund's work in general.

The questions raised on pages 50-51 of the paper on financial markets are largely interrelated and are all worthy of further work, although within the existing resource limits. Some of these subjects may be particularly difficult to study, as the existing theoretical frameworks may not be fully capable of providing a definitive basis for understanding the phenomena. Insufficient data may also hinder analysis, and technical missions of both the World Bank and the Fund should pay due attention to this problem. In addition, many problems--for instance, the pricing of instruments in relations to possible risks--involve a considerable degree of judgment. Thus, as a result of insufficient theoretical and empirical frameworks, final conclusions may become largely a matter of judgment.

The first--and essential--topic is whether stability in financial markets can be assured by macroeconomic policies. I agree with the staff and Mr. Sugita that, in this context, the question of whether market prices appropriately reflect risks is an important one. In addition, the Fund's role in safeguarding the system is significantly affected by member countries' policies.

Currently, the primary role of the Fund is probably to exercise more effective surveillance and to enhance the formulation of coordinated policy actions to cope with foreseeable instabilities.

More attention could be paid to evaluating institutional and regulatory changes, perhaps in a separate chapter in the WEO exercise with appropriate assessments of the consequences for the global financial environment and for the different country groups.

The third topic concerns the role of international financial markets in supplying reserves; the Fund's recent work has focused rather heavily on this area, particularly in the numerous SDR discussions. More practically, the Fund could indeed--at the request of members--intensify its advisory role by providing concrete advice to the individual developing countries on taking advantage of new financial instruments in managing the countries' reserves.

The fourth topic is the role of supervisory and regulatory policies. The staff should monitor the efforts of national authorities and the BIS to achieve a more coordinated approach to the supervision of institutions and financial markets. Although these efforts are conducted largely outside the Fund, the Fund must form a coherent view of their implications for the international monetary system. Such an assessment could be of some value as an input into the coordination process.

Finally, the international community must focus on the means and extent of further dramatic growth in the new financial instruments. Although the exceptional economic circumstances of the early 1980s may be unique, long-lasting forces support the development and growth of financial innovations even in a more stable environment. The underlying broader forces of the global integration of overall economic structures require close monitoring. It is particularly important to understand the process taking place at the level of financial institutions and individual firms, especially in transnational corporations. Their financial administrative bodies should be carefully scrutinized to increase our understanding of how their intellectual reasoning shapes the evolution of new financial instruments and mechanisms. Only better information about microlevel operations can help us to understand the existing innovative process, and its future perhaps predicted.

Mr. Al-Assaf made the following statement:

I welcome this discussion of innovations and international changes in the financial markets, which I hope will allow the

Board to improve its understanding of numerous changes that have taken place in most financial centers over the past five to ten years, and of the possible implications of those changes for the Fund.

I would like to focus my comments on two issues: implications of financial innovations for the conduct of monetary policies, particularly in the developed countries where innovations and deregulation have proceeded most rapidly; and the international coordination of the activities of national supervisors and regulators.

The main problem for the conduct of monetary policies seems to be that the ever-increasing number of financial instruments available to borrowers and lenders alike have made the traditional measures of money gradually less relevant. Consequently, it has become extremely difficult to control the evolution of monetary aggregates--as evidenced by the evolution of most monetary aggregates in the United States, the United Kingdom, and Germany, particularly in 1986.

While all the causes and the consequences of the tendency for many monetary aggregates to outgrow their original targets are not yet fully understood, the traditional link between the growth of money in one period and prices in the following period is clearly not as strong as it used to be. Therefore, the monetarist approach to monetary policy may have to be re-examined, as--to an extent--it already has been in many industrial countries. Further research would be warranted in this area, and it would be particularly interesting to see whether increased reliance on interest rates and exchange rates in the monetary field has led to greater instability.

The second issue relates to the coordination of supervisory policy. Supervision has not kept pace with innovation, and the gap between the two--despite efforts in various countries--is not being narrowed rapidly enough, if at all.

Part of the problem may be that too few regulators have a clear perception of current events in the markets. The understanding of new financial techniques and instruments needs to be improved in order to promote the required adaptation on the part of the supervisory bodies. That improvement would probably go a long way toward filling a number of gaps in the supervision of markets, gaps presently blamed on the failure of existing structures to adapt. Improvement, however, may require a greater allocation of resources to the supervisory function of existing bodies, for instance, central banks.

However, one should not overlook the difficulties ahead. It is difficult to coordinate standards and procedures across borders, once such standards and procedures have been updated in all relevant countries. While some progress has recently been made in this direction, much clearly remains to be done. A second obstacle could also be the fears of national supervisory bodies of undermining the competitiveness of their own financial institutions through a tightening of standards. The reluctance to introduce new rules, especially when it is not always clear which rules are appropriate, could effectively slow down the pace of progress in this area. Given the likelihood that the period ahead may not be especially quiet for financial markets worldwide, progress should be made as rapidly as possible. The staff correctly listed this point among those worthy of further analysis.

Mr. Faria made the following statement:

The two staff papers taken together provide a comprehensive and focused treatment of the structure of, and trends in, international financial markets over the past decade--particularly of those aspects relating to developments within or between industrial countries. The recent massive stock market shocks provide a graphic illustration of the speed with which equity price adjustments precipitated by policy failure in one country can be transmitted to other money center countries because of an underlying lack of coordination. It is still too early to gauge the second round effects of the shocks on all real and financial variables. More worrisome are the likely effects on lending to developing countries--lending that is already shrinking disturbingly--and the discounting of the existing bank debt.

Clearly, any extensions of the staff analysis of capital markets must be considered in light of the Fund's role as a monetary institution acting to ensure the stability and effectiveness of the international monetary system. The Fund's surveillance function--especially in consultations with the G-7 member countries--does need wider implementation to take account of structural changes in financial markets. The reduced segmentation of domestic and international financial markets has permitted delayed fiscal adjustment, made the evaluation of monetary policy more ambiguous, and has at the same time facilitated more rapid transmission of changes in uncoordinated national monetary policies on global portfolio and spending decisions--through destabilizing movements in exchange rates, interest rates, and capital flows. Moreover, the blurring of distinctions at the individual country level between banks and other financial institutions, and--because of the former's growing real size and influence--between offshore and domestic markets, are likely to have significant implications for the provision of services as lender of last resort during crisis periods.

Against this background, the Fund should undertake a wider evaluation of underlying macroeconomic and financial policies in the context of the annual consultations, the world economic outlook exercise, and the associated development of new indicators. One legitimate extension of the staff analysis is the global adequacy, distribution, and management of international reserves, because that area entails some judgment of the potential reserve supplementation role of the SDR in reducing the vulnerability of the reserve system to disturbances in the financial markets, particularly for very open developing countries. Nonetheless, despite warranted concerns about the ability of financial markets to self-manage an increasingly complex and rapidly changing financial market, and the differential rates of movement exhibited by the goods and financial markets, the evaluation and reform of supervisory and regulatory policies in the area of asset under-pricing and related liquidity and credit risks are matters best left to the relevant country authorities. That work does not fall within the Fund's mandate and/or competency, and is probably more efficiently handled in the OECD and BIS--in both of which such work is ongoing.

The staff papers have perhaps not given sufficient importance to analysis of the facilitation of greater resource flows to developing countries by innovations and institutional change in the financial markets. During the Board's discussion of this matter in early September, this chair expressed disappointment that developing countries as a whole, and low-income sub-Saharan African countries in particular--although laboring under onerous debt burdens--had derived little benefit from the menu of innovative financing modalities, because they had limited access to capital markets as a result of adverse market perceptions. The statistical appendix to the September 1987 World Economic Outlook confirms that the share of international private capital in the external debt of sub-Saharan Africa has approximately halved, from 13 percent in 1979 to 7 percent in 1986, reflecting stagnation in the absolute amount, at $5-6 billion, while the total external debt of those countries has about doubled to $74 billion.

As prices are not likely to increase, and net transfers from official sources will likely decline, the importance of innovative mechanisms in international capital markets--to ensure the medium-term external viability of sub-Saharan Africa--is increased. However, the Board discussion of the effects of recent structural changes in international financial markets on the market's relationships with developing countries was somewhat abbreviated and nonspecific. Some data to support the conclusions reflected in the two following quotations from the paper on financial markets which bear on the level of foreign exchange reserve, would be welcome. The staff says that on page 35 of SM/87/246 that "the difficulties of the developing countries in obtaining external finance of their current account imbalances stands in sharp contrast to the ability of some major countries to obtain external financing of their fiscal deficits." Paradoxically, the staff also notes that "the introduction of new types of investment instruments may have increased the relative attractiveness of external assets for residents of developing countries."

I look forward to a fuller discussion--in relation to the forthcoming paper on issues in managing the debt situation of the scope for increased private capital inflows to alleviate the existing debt situation in developing countries, particularly through a widening in the secondary market for their external bank debt. Nevertheless, I would hope that future analyses of developments in capital markets--especially in the money centers--would provide more comprehensive data on capital flows to developing countries, perhaps using the World Economic Outlook's established categories, as well as an evaluation of these countries' prospects for obtaining new financing to fill ex ante financing gaps in the context of Fund-supported programs. Such information would undoubtedly help the Fund to fulfill its catalytic role--at present limited largely to official financing, including rescheduling--by enabling it to assist countries to develop realistic programs of growth with adjustment, underpinned by new longer-term money packages. In this way, the Fund would help low-income countries to overcome their restricted access to spontaneous borrowing from international capital markets, thus reducing the onus on bilateral and multilateral lending.

Mr. Fayyad said that he generally agreed with the staff's analysis. By expanding the possibilities for portfolio diversification, recent innovations and institutional changes in the international financial markets had resulted in much higher elasticities of capital flows with respect to differentials among countries in yields on assets. Since the expected yield was a function of, inter alia, expectations vis-à-vis exchange rate movements and prospective macroeconomic policies, those higher elasticities had in turn led to increased interdependence among countries, as they had tended to strengthen the effects of a given country's policies on other countries, and had accelerated the transmission of the effects of changes in domestic macroeconomic policies to other countries through movements in exchange rates, interest rates, and capital flows. Thus, in an environment of increased international capital mobility, the perception by market participants that macroeconomic policies--especially those of the major financial centers--were not mutually reinforcing, could lead to sharp and rapid adjustments in interest rates and exchange rates, with the attendant costly real economic effects. The substantial increase in international capital mobility that had occurred over the past few years clearly called for a strengthening of macroeconomic policy coordination, especially among the major industrial countries.

The introduction of new financial instruments had affected the information content of monetary aggregates, making the control of monetary expansion more difficult, and thus rendering highly questionable the usefulness of the aggregates as intermediate policy targets, Mr. Fayyad continued. Various attempts to redefine the aggregates in a number of countries had led to the adoption of broad aggregates, but the procedure generally used for the purpose of constructing monetary aggregates assumed perfect substitutability among components. Several empirical studies had clearly shown that that assumption did not hold for component monetary assets, and that it especially distorted broad aggregates.

He shared the staff's concerns about the vulnerability to financial market disturbances of a reserve system that was heavily dependent on borrowed reserves, Mr. Fayyad remarked. SDR allocations could reduce that vulnerability by providing countries with a sufficient stock of owned reserves.

The staff had usefully identified a number of areas that could be the subject of further inquiry, Mr. Fayyad noted. It would be instructive to pursue those inquiries, as they should permit a careful assessment of the potential gains and instabilities associated with innovations and institutional changes in the international financial markets. In view of the recent sharp decline in equity prices and the ensuing instability in international stock markets, he was especially interested in further examining whether the stability of increasingly integrated financial markets was ensured by the establishment of appropriate macroeconomic policies, or whether additional measures were required--particularly with reference to the role of the Fund.

It was most important to prevent disruptive actions by major reserve currency countries that hindered the smooth functioning and stability of the international monetary system, Mr. Fayyad considered.

Mrs. Ploix made the following statement:

> Today's discussion on capital markets could offer an opportunity to broaden the preliminary exchange of views that took place last Friday on the implications of recent financial developments. The paper on innovations and institutional change thoroughly describes the major trends which take place in those markets. We can now explore the effects of last month's stock market crash on the trends described in that paper. The other staff paper is largely devoted to debt problems, and as we discussed that issue before the Annual Meetings, I shall not dwell on it today.
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> The recent internationalization or globalization of capital markets is best illustrated by the synchronization of movements in equity and debt markets throughout the world. Given the responsiveness of this transmission mechanism, all national authorities should be aware of the need to minimize systemic

shocks. In that connection, the Fund has an obvious role to play, as the institution which can provide the global view required for effective coordination. The new world economic outlook exercise currently under way will be very helpful in this respect, giving the Fund's assessment of the recent developments and short-term prospects.

The internationalization process is also likely to affect firm concentration. The increase in the volume of complexity of financial transactions tends to push production costs upward, if only through personnel expenditures. At the same time, deregulation and enhanced competition has reduced the income of many financial institutions. As a result, small financial institutions tend to disappear or be taken over by larger ones, and the recent crash could well accelerate this concentration process. However, even if the creation of a few worldwide institutions is a lasting trend, this restructuring should be kept under review in order to maintain an adequate degree of competition.

The introduction of new instruments and innovative techniques has accelerated over the last few years, and they have produced positive results. Overall, they can be considered a major contribution to more cost-effective financial intermediation. Likewise, the range of financial operations has been widened for borrowers, and simultaneously investors have been offered more diversified conditions. However, this improved efficiency may have been achieved at the expense of market stability. The increased instability which seems associated with innovation might be attributable to less cautious risk management. That could prove detrimental, as recent developments show that the risks involved in some innovations can be considerable. In addition to the current "flight to quality," other developments are possible: a clearer perception of market volatility could affect the securitization process, while institutional investors might prove more reluctant to hold this type of asset. The demand for securitized assets could, however, be maintained through increased use of hedging techniques, but options or futures would have to be more volatile, which could result in prohibitive pricing. To the extent that the recent crash could affect the development of securitization, what is the likelihood of a reintermediation process?

Deregulation is the last element generally associated with the modernization of financial markets. My authorities remain committed to this approach which, together with internationalization, they consider the best way to maintain an adequate level of competitive pressure. The staff paper contains many references to the French experience in this area; let me only confirm that the capital of French broker-dealer firms will be progressively opened to investments by nonresidents.

With respect to the debt issue as the situation has not changed significantly since our last meeting in September, I will not return to the main points I made then. The recent DM paper on debt-equity swaps is a comprehensive and informative document which gives some support to fears about their shortcomings; in particular, the study confirms our misgivings about the nonadditionality of foreign investment flows that a swap does not generally translate into a net increase in external financing. This does not mean that we should be overly skeptical about the scope of this innovation. Specifically, these limits should not be an excuse for caution on the part of debtor countries, which would risk a return to a more inward-looking approach. As long as debt-equity schemes reflect a will to cope with external difficulties, they can be helpful as a supplement to more far-reaching solutions.

Mr. Goos made the following statement:

The staff papers give an excellent insight into the evolution of the financial markets and the actual and potential issues involved. I broadly agree with the analysis and conclusions.

The enormous expansion of the financial flows among the industrial countries in recent years is clearly a matter for concern. Experience suggests that growth at the rates observed, inter alia, for bank lending and international bond issues is unhealthy and probably unsustainable. At the same time, it appears that an unprecedented financial superstructure is developing that has increasingly lost touch with the real economy. Making matters worse, there are clear indications that the expansion is breeding risks--in particular through the rapid development of financial innovation--that are difficult to identify, let alone to assess and evaluate properly. It is sometimes claimed that these risks are the price that must be paid for substantial gains in the "efficiency" of financial intermediation. I am far from sure that this is really so, as I cannot ascertain the actual beneficiaries of the alleged increase in efficiency: the real economy hardly benefited, given the comparatively low rates of real growth in the industrial countries which paralleled the expansion of financial markets.

The notion of "efficiency gains" also appears rather dubious, given the overrecycling of surpluses to deficit countries in the recent past and the subsequent abrupt changes in market sentiments in the opposite direction which, on the whole, have caused tremendous economic disruption and costs. Moreover, financial developments have complicated monetary policy and have reduced its effectiveness as a tool of national policy, as Mr. Sugita noted. In the light of these developments--and given the exclusion of many developing countries from international capital market activities, it is tempting to call for the reintroduction of market regulations and controls.

However, the staff has convincingly argued that such market interference would be tantamount to treating the symptoms instead of the underlying causes. Clearly, there is an urgent need for the supervisory and regulatory authorities to press ahead in their efforts to identify and appropriately assess the risks involved both in the rapid expansion of the markets and in the use of various new financial instruments. That assessment must of course be translated into appropriate adaptations of the regulatory framework. In this context, I should also underline the staff's concerns about what appears to be an insufficient supervision of security houses. To the extent that the regulatory framework itself is giving rise to financial innovations as a result of "regulatory arbitrage," better harmonization of regulatory policies appears to be a pressing task. Moreover, the authorities should be free to examine the extent to which it might be appropriate to discourage the use of certain financial innovations that might add little in terms of efficiency but that have potentially destabilizing effects on financial markets.

Supervisory and regulatory efforts alone will clearly not suffice to stabilize financial markets. Rather, the most recent turmoils in the markets reinforce the staff's conclusion that the financial problems are driven in the first instance by macroeconomic imbalances that reflect incompatibilities among national economic policies.

These considerations highlight the critical importance of economic cooperation among the major countries, including the Fund's role in multilateral surveillance. I should stress, however, that such cooperation--to be effective in stabilizing the financial system--must take place on the basis of sustainable national policies, which underlines the crucial importance of the Fund's surveillance of national exchange rates and economic policies. It would certainly be counterproductive to coordinate national policies at a level of domestic financial imbalances that would propel inflationary forces. Subject to this clarification, I endorse the staff's observations on page 41 on the formulation and effectiveness of macroeconomic programs.

I could also go along with the analysis that follows, but that does not alter my basic view on the appropriateness of SDR allocation in the present circumstances. On the contrary, the information provided in the papers gives little ground for the assumption that there might be a "global need."

Notwithstanding the substantial uncertainties, disturbances and potentially serious economic repercussions connected with recent developments, it is reassuring to note the remarkable resilience shown by the financial system. Moreover, international economic cooperation--including supervision and regulation--has made substantial progress, and is moving in the right direction. Cooperation has contributed to impressive results in terms of growth and inflation performance. Nonetheless, it is clear that developments in the financial markets--including the ongoing structural changes--will have to remain under close scrutiny in order to forestall undesirable developments.

I therefore welcome the staff's willingness to undertake further analysis in future papers on capital markets. However, in view of the scarcity of the Fund's resources, we must be selective in extending our agenda. In general, the staff should concentrate on widening the analysis of capital market developments as suggested under the second topic for consideration. Studies could include in particular developments in financial markets of newly industrializing countries.

As to topics 1 and 2, many of the issues suggested by the staff for further study have, I understand, already been taken up and are indeed at the center of the work done by the Cooke Committee and other committees associated with the OECD and the BIS. Therefore, I recommend that we rely as much as possible on the results produced by those groups, and avoid unnecessary duplication of work.

The Deputy Director of the Research Department said that the desirability of financial innovation was subject to conflicting considerations. Such innovations--and the accompanying increase in the international mobility of capital--could make the application of national policies more difficult and could often limit their scope, particularly in the supervisory and regulatory area. Financial innnovation could, for example, make it more difficult to interpret monetary aggregates, could reduce the impact of some credit policies, could extend the task of stabilizing exchange rates, and could alter the traditional channels of transmission of microeconomic policies--magnifying the effect, in particular, on the external sector. Thus, innovations could be frustrating for national authorities and could encourage international policy coordination.

On the other hand, the same innovations could help to overcome some of the traditional barriers to the more efficient allocation of capital--including barriers that related to transaction costs, and differing expectations, the Deputy Director noted. Thus, innovation did increase efficiency. Some worried, however, that the risks sometimes associated with it were not always priced correctly, which could increase systemic risks. The volatility of asset prices--over at least a decade--was also a matter of some concern, the Deputy Director continued. That trend was visible not only in equity prices; it could also be seen in the behavior of exchange rates, interest rates, and commodity baskets. Regardless of the measurement methods used, the volatility of asset prices since at least 1973 had substantially increased, which raised the question of possible causes. In that regard, he agreed with Mrs. Filardo that there were many sources of volatility, including large energy price shocks, the failures of some financial institutions, intercountry differences in the mix of macroeconomic policies, on occasion the absence of market makers, and sometimes the absence of stabilizing speculation. The decade from 1973 had been turbulent, as all asset prices had been very volatile, so he also agreed with speakers who had stressed that such turbulence made it all the more important that policy actions be stabilizing, sound, and framed in an international context.

The risks involved in private credit markets raised the question of whether the provision of international reserves should be based exclusively on those markets, the Deputy Director noted. The credit judgments of private markets did not have to be inferior to those of official institutions, but it might be better to ask whether private markets should be relied upon almost exclusively for providing reserves to the system, or whether the market should be supplemented by some owned reserves that were internationally managed. That issue was closely linked to the SDR, and even if it was believed that private markets performed well on average, it might still be sensible to have another source of credit available as a safety net or supplement.

The staff had received a large number of suggestions for further work and would consider them carefully, keeping in mind the need to avoid duplication and to conserve resources, the Deputy Director from the Research Department concluded.

The staff representative from the Research Department said that new issuance techniques had tended to reduce--for large borrowers particularly--the fixed costs of borrowing. New instruments, like swaps had also allowed borrowers to arbitrage different types of portfolio preferences across national markets, and to issue instruments that were attractive to savers in those national markets that effectively allowed institutions to borrow funds at a lower cost, so those instruments had been of considerable value to many of the larger borrowers, including multilateral banks such as the World Bank.

It was still too soon to understand fully the effects of recent market disturbances on the securitization process and reintermediation, and also on different classes of borrowers, including especially those with lower quality credits, the staff representative continued. The staff had been monitoring events in both the Eurocurrency and the major national markets. The pronounced tiering of interest rates that had existed immediately after the mid-October events had been moderated to some degree, but still existed. Credit risks were evaluated by the market, which tended to require higher margins over, for instance, treasury bills, than it had before the October events. To some extent, alternative channels were opening for lower quality credit risks. There had been a sharp increase in bank lending relative to security issuance since mid-October, although it was not yet clear whether that development was permanent. Even in the markets for noninvestment grade bonds, the short-term credit constraint fell more on the underwriters of those bonds than on the firms selling the bonds, because if the bonds could not be marketed after a fixed period, the underwriters were obliged to provide the funding to the firms.

Program trading had basically originated in the foreign exchange markets, the staff representative remarked. Arbitrage in the foreign exchange futures and spot markets had always been highly sophisticated, and in many respects the use of trading programs in equities markets was an attempt to emulate that sophistication, although somewhat different instruments were used.

The staff would certainly examine in some depth the perception that markets seemed to perform differently during crisis periods than at other times, and would seek to explain those differences, the staff representative continued.

The use of the perpetual floating rate note market and the equities market as examples of market disruptions had been a deliberate attempt to contrast the two, the staff representative said. Thus, the floating rate note disturbance, had been analyzed quite explicitly as a specific market event, not as a general systemic disturbance.

The Fund had an ongoing interest in the implications of the recent innovations for developing countries and examined them further, the staff representative from the Research Department concluded.

The staff representative from the Exchange and Trade Relations Department said that in the future the staff would pay more attention to the ways in which developing countries could benefit from innovations, including the management of reserves, and from the development of financial markets, including equity markets within developing countries.

The staff noted the Board's wish for more frequent information on price developments in the secondary market in the debt of developing countries, the staff representative continued. The quarterly staff paper on international banking developments might be one way to provide that information. Mrs. Filardo's comment that the recent upturn in secondary market prices had been small compared with the decline that had taken place since May, seemed accurate. Nonetheless, prices did appear to have reached a trough in early October, as the prices of loans to Argentina, Brazil, and Mexico indicated. The staff would also continue to follow the development of regulation and supervision in international markets, and would report to the Board on developments in that area, especially as they affected the debt situation.

A number of Directors had referred to coordination of regulation and supervision in the industrial country markets, the staff representative noted. He had participated in some informal discussions with staff of the BIS and the OECD in the past two weeks, and subsequently had attended a meeting of the OECD committee on financial markets at which the topic had been discussed. The chairman of that meeting had emphasized that the OECD--like the Fund--was not engaged in operational supervision, but sought instead to underline how much the effective coordination of supervision mattered from a macroprudential standpoint. The Cooke Committee had held a meeting in November at which significant progress had been made concerning the adequacy of capital convergence in the industrial countries, and some published material might be expected soon in that area.

The coordination of the supervision of banks and nonbanks such as security houses was a troubling area, the staff representative from the Exchange and Trade Relations Department considered. Even within individual industrial countries, the coordination between self-regulatory bodies, stock exchanges, departments of industry, central banks, and bank supervisory authorities could be problematic, and in some cases such coordination was in its infancy. Internationally, there had been coordination in investor protection--for instance, in the International Stock Exchanges Group and in the Wilton Park Group. Those international discussions had not progressed at all into the area of prudential supervision. For example, assessment of the capital adequacy of nonbanks on a consolidated basis, or the filling of gaps in domestic and international supervision, seemed untouched areas that should be followed carefully. That conclusion had also been reached by the recent committee meeting at the OECD.

The Chairman made the following summing up:

Directors' comments focused primarily on the broad economic issues stemming from financial market developments, in particular, from the macroeconomic implications of the growing international integration of markets as well as the growth in innovation in the financial markets. Directors recognized that there were widespread benefits from both integration and innovation--for instance, in reducing costs and improving efficiency--but there were two broad areas of the discussion that I would like to highlight: the interaction between financial market developments and macroeconomic developments; and the interaction between the financial market developments and risk and market instability.

As a number of Directors put it, there has been a close interaction between macroeconomic developments and financial market innovation and integration. Some Directors were interested in the question of cause and effect: have macroeconomic developments driven financial market integration and innovation, or has it been the other way around? I think, as many Directors agreed, that the two elements were interrelated: that broad macroeconomic developments contributed to the growth of both financial integration and innovation. In turn, the growing use of international financial markets--and concern was expressed in particular with respect to the financing of financial imbalances within a number of countries and groups of countries--had contributed to certain innovations; for instance, the reduction of risks that might be associated with the growth of financial imbalances.

With respect to the macropolicy implications of those developments and the interaction between the two, I would make two observations from the discussion. More generally, it was recognized that financial innovation and integration had complicated the interpretation of monetary conditions and aggregates, and the management of monetary policy. It was noted, first, that a number of countries have been able to use financial markets to delay necessary macroeconomic adjustments. That was seen as undesirable. At the same time--and on the surface paradoxically--Directors also expressed the view that financial market integration has also worked to limit the degree of policy freedom. For example, Mr. Lim commented that once a country lost its credit standing it was very difficult to regain that credit standing. Thus, a second general policy implication emphasized in the dicussion was the need for greater collaboration and coordination of macroeconomic policy.

A second major subject of discussion was the interaction between financial market developments and risk and market instability. Here again it was recognized that innovations had improved efficiency in the markets and had reduced the costs of borrowing, but concern was expressed about the risk, and the possibility of greater instability, caused by market innovations. In turn, the possibility of risks had in many cases stimulated the development of financial market innovations.

A number of Directors expressed concern that in the early stage of development of new instruments, and until full experience could be gained with them, it was difficult to assess the risks associated with the instruments. Specifically, several Directors expressed concern that the markets might underprice the risk associated with innovations, in particular in circumstances in which competition among financial institutions might lead them to seek rapid entry into a new market.

The policy implications of those interrelationships related mainly to the activities of supervisory and regulatory authorities. There was a general view first, that innovation and integration required the adaptation of regulatory and supervisory procedures and practices to changing conditions. Second, that greater innovation and integration had also increased the need for more collaboration and coordination among regulatory authorities--and among tax authorities so as to establish a more level playing field among national entities--in order that differences in supervisory practices and in the nature of regulatory authorities would not contribute either to changes in market conditions or to increased risk in the markets.

A third major area of discussion was the implication of financial market innovation and integration for the Fund. A number of Directors emphasized that it was important that the Fund not duplicate either the statistical work or the analytical work carried out by other international organizations--particularly the OECD and the BIS--but that there was an important role for the Fund to play in a number of areas. To the extent that the Fund drew on the work not only of other institutions but also on the data and statistics that were developed within the Fund, it was important for the Fund to be in a position to draw the broader macroeconomic implications from financial market developments. In that connection, Directors attached great importance to the role of surveillance, particularly in the context of assisting the major industrial countries to improve collaboration and the coordination of economic policies.

Another implication of financial integration and innovation concerned the role of the SDR in the context of providing international reserves to those countries that might not have full access to the international capital markets. A number of Directors expressed concern about the vulnerability to financial market disturbances of a reserve system that was heavily dependent on borrowed reserves, a concern that led them to reinforce their view that there was a role for the SDR to play, and a need for an allocation of SDRs.

Finally, a number of Directors asked whether the Fund could not be of greater assistance in helping developing countries to learn how to better utilize the opportunities created by innovations in the capital markets and greater integration. Technical assistance and other support could also help developing countries to develop capital markets within their own economies--markets that would encourage domestic savings and improve investment allocation, and would also improve the linkages between national financial markets in developing countries and the international markets.

3. COMPENSATORY FINANCING FACILITY - REVIEW

The Executive Directors resumed from the previous meeting (EBM/87/157, 11/18/87) their consideration of a staff paper on the review of the compensatory financing facility and proposals for concessional compensatory financing and an external contingency facility (EBS/87/165, 7/28/87; and Sup. 1, 7/30/87).

The Chairman said that in the light of a careful review of the comments made during the discussion on the review of the compensatory financing facility, he wished to modify two parts of his summing up. Before doing so, he wished to stress that, as virtually all speakers had emphasized, the discussion had been preliminary in nature. Accordingly, his summing up was not meant to lead the Executive Board, at the present stage, to make premature or excessively precise judgments or to reach premature conclusions.

The first three sentences of the second paragraph of his summing up, the Chairman continued, could read as follows:

> It would be fair to say that, while all Directors were willing to consider the issues involved in establishing an external contingency facility, the large majority of Directors also felt that any broader treatment of contingencies should not be at the expense of diminishing the vital role played by the compensatory financing facility in Fund operations. They emphasized that the compensatory financing facility's traditional role of compensating for past deviations of export receipts had proved most valuable and should be retained. At the same time, many Directors felt that various aspects of the compensatory financing facility could be improved by modifying some of its features.

The section on a contingency facility, the Chairman went on, could read as follows:

> Our preliminary discussion on a possible contingency facility has been very broad ranging and stimulating. I shall be guided by your views in suggesting the direction of our further work on this topic. There was a broad consensus that contingent access to the Fund's resources based on developments in external factors over which members exercise little or no control could contribute to the success of adjustment programs in the present difficult and unpredictable external environment.
>
> The majority of Directors were not in favor of replacing the compensatory financing facility by a contingency facility, but a few Directors supported consideration of this idea and some others were willing to consider integrating an external contingency facility with the compensatory financing facility. Those Directors in favor of retaining the compensatory financing facility supported further consideration of a contingency mechanism within the framework of a stand-by or extended arrangement so long as it did not interfere with the ability of members to utilize the compensatory financing facility....
>
> My sense of the meeting is that Executive Directors wish the staff to examine in detail the technical aspects of approaches to contingent use of Fund resources and the modalities of their possible operation, taking into account the views expressed at this meeting.

Mr. Nimatallah considered that the next paper on the compensatory financing facility should present the various possible options for modifying the facility--for example, the different proposals for reducing the lower tranche. The various issues that had been raised during the present discussion could then possibly be resolved during the next discussion. He continued to prefer to leave the compensatory financing facility essentially as it was. In order to make progress on the review of the facility as quickly as possible, the body of the facility should be left unchanged, and the next staff paper should review the various proposed modifications that had been discussed during the present debate. As to contingent financing, the staff should explore whether contingencies could be useful and whether a contingency mechanism could be integrated into the compensatory financing facility. The staff should explore possible amendments to the contingency mechanism proposal that would make it workable and should consider whether a contingency mechanism should perhaps be established separately, in addition to the compensatory financing facility, and the implications of and requirements for such a step. The staff should also consider what a contingency facility would look like in the light of the proposal by the U.S. authorities and Mr. Dallara's latest statement. In that connection, it should be assumed that the compensatory financing facility would continue to stand on its own.

Mr. Dallara noted that the Chairman had stated that "the large majority of Directors also felt that any broader treatment of contingencies should not be at the expense of diminishing the vital role played by the compensatory financing facility in Fund operations." He wondered whether the word "supplanting" might not be more appropriate than "diminishing." As to Mr. Nimatallah's procedural suggestions, the purpose of the present discussion was to provide guidance to the staff in its follow-up work. Any attempt at the present stage to identify particular steps in that follow-up effort might well be going beyond the objectives of the present discussion. Executive Directors had expressed a wide range of complex views on various matters and, as was the case with every preliminary discussion of policy issues, the next step was for management and staff to determine the appropriate follow-up work to undertake.

The Chairman remarked that a number of Executive Directors had used words like "diminished," but not "supplant." Hence, he preferred to leave the text in question as it was. As to the next staff paper, it should of course reflect the main concerns that were expressed during the present discussion. In addition, the Executive Directors might benefit from an opportunity to meet informally to discuss possible common grounds for constructive solutions before the next formal Executive Board discussion on the matters at hand.

Mr. Dallara said that it was true that the word "supplant" had not been used during the discussion, and another word might well be needed to reflect the idea he had in mind, namely, that a number of Executive Directors, representing nearly half the voting power, were clearly willing to consider either replacing the compensatory financing facility with an external contingency facility, or a melding of the two that might imply some diminution of the scope of the current compensatory financing facility. The word "eliminate" might be more appropriate than "supplant" in capturing the idea that he had in mind.

Mr. Nimatallah commented that the compensatory financing facility provided timely assistance and had low conditionality at a certain level of assistance and slightly more conditionality at a higher level. Most Executive Directors apparently wished to maintain, not diminish, those characteristics; any possible changes in the access limits would diminish the facility itself. Therefore, the present wording of the summing up's text was fully appropriate.

Mr. Ovi said that the use of the word "diminishing" was acceptable. He had expressed a willingness to consider a contingency mechanism or facility, but he had stressed that he supported the basic characteristics of the present compensatory financing facility. He was willing to go along with the staff proposals, which would imply some reduction in access but not a substantial one. His openness toward a contingency mechanism was based on the condition that such a mechanism would be in addition to the basic present compensatory financing facility. He could not accept the use of the word "eliminate" or "supplant" instead of "diminish."

Mr. Dallara said that Mr. Nimatallah's clarification of his interpretation of the use of the word "diminishing"--namely, that the spirit and cooperative nature of the compensatory financing facility should not be diminished--was helpful and made him feel more comfortable with the use of the word "diminishing" in the summing up.

The Chairman's summing up, as modified, was:

> In this most useful discussion of the compensatory financing facility, Executive Directors considered two sets of issues: the first set dealt with possible operational modifications of the facility so as to better adapt the facility to today's environment. The second set addressed two important recent proposals--one concerning concessional assistance under the compensatory financing facility to low-income countries, and the other exploring the possibility of introducing a broader treatment of external contingencies, either by extending the compensatory financing facility or perhaps even by replacing that facility with a new external contingency facility. I should note at the outset that many Directors stressed that their interventions at this stage should be considered tentative in nature. There was a wide divergence of views on the issues before the Board, and in this summing up I will attempt to reflect the range of views that were expressed on these subjects.
>
> It would be fair to say that, while all Directors were willing to consider the issues involved in establishing an external contingency facility, the large majority of Directors also felt that any broader treatment of contingencies should not be at the

expense of diminishing the vital role played by the compensatory financing facility in Fund operations. They emphasized that the compensatory financing facility's traditional role of compensating for past deviations of export receipts was a valuable one that ought to be retained. At the same time, many Directors felt that various aspects of the compensatory financing facility could be improved by modifying some of its features. Therefore, let me first turn to the issues surrounding such modifications. Following that, I will attempt to summarize the views of Directors on the two previously mentioned proposals regarding concessional assistance and a broader contingency mechanism.

In reviewing compensatory financing conditionality, Directors noted that the interpretation of the current guidelines had been such as to greatly reduce use of the lower tranche of the facility and to make access to the upper tranche virtually dependent upon having a contemporaneous stand-by or extended arrangement with the Fund.

One group of Directors took issue with the inference that strict conditionality was needed because the compensatory financing facility had been a major factor in the growth of overdue obligations. They argued that the emergence and growth of overdue obligations could be found in the difficult state of the world economy. These Directors were not persuaded that the proposals in the staff paper to divide compensatory financing purchases into three tranches, instead of the present two, would promote operational flexibility of the compensatory financing facility. While they understood that the intention was to ensure greater use of the proposed new lower tranche, they thought that in practice this tranche would again become the subject of negotiations and there would be no effective easing of conditionality governing purchases from this tranche. In general, they felt that an increased number of tranches would reduce the effectiveness of the facility in providing timely compensation for export shortfalls and that phasing would undermine the stabilizing role of the facility. At the same time, they did not feel that directly associating the two proposed upper tranches with performance under stand-by or extended arrangements would assist greatly in reducing the incidence of overdue obligations. It is probably fair to conclude that these Directors were of the view that the current conditionality is already too tight, with some strongly urging an interpretation of the guidelines that would allow more timely compensation for export shortfalls and reduced association between stand-by arrangements and the use of the compensatory facility that has characterized the recent past. A few Directors could go along with the phasing arrangement proposed by the staff provided total access was raised.

Another group of Directors reaffirmed their position that safeguarding the revolving nature of the Fund's resources was--and should continue to be--an important concern in governing access to the compensatory financing facility. They believed that the 1983 guidelines had been overtaken by changes in the global economic environment. They were concerned that potentially large compensatory financing purchases at the outset of adjustment programs could leave the Fund in a seriously exposed position and put additional strain on a member's debt-servicing capacity. It was these concerns that led this group of Directors to express a preference for moving toward some form of phased access for compensatory financing purchases. They considered that overall, the tranching proposal in the staff paper represented a reasonable solution to their concerns, but some proposed that the lower tranche should be reduced to 25 percent of quota and the second tranche raised to 58 percent of quota. In general, these Directors remained concerned, however, that the proposal for a more liberal access to the reduced lower tranche, by providing it at the stage of discussion of an arrangement, would involve no effective conditionality and would provide little in the way of genuine safeguards for Fund resources. Some Directors were not in favor of allowing a compensatory financing purchase up to 50 percent of quota for a member with a program in the first credit tranche, but would in exceptional cases allow a purchase accompanied by an arrangement approved in principle. For the third tranche, purchases by members with a structural adjustment arrangement would be allowed on a case-by-case basis.

In concluding this part of our discussion, I think it would be helpful to recall the rationale underpinning the proposal contained in the staff paper. It should be stressed that, as with current practice, access up to the maximum quota limit would continue to be made available for members where the only source of balance of payments difficulty is the effect of the temporary export shortfall. For countries with shortfalls superimposed on longer-term balance of payments difficulties, use of the reduced lower tranche would be applied more flexibly than at present, with the effect that the lower tranche would become more accessible, thereby ensuring that the facility would continue to fulfill its intended role of providing timely compensation for export shortfalls. Release of the upper tranches, however, would be more closely linked with the adoption and the implementation of needed adjustment. I would conclude from the discussion that Directors wish the staff to continue to explore ways of incorporating various ideas that have been put forward, as well as the views reflected in my summing up of the March 1987 discussion--both with regard to compensatory financing and contingency arrangements--into proposals that could lead to a consensus by the Board.

On the more technical issue concerning the calculation of shortfalls, some Directors agreed that the setting of a ceiling on export projections would provide a suitable solution to the problem of compensation in the case of rapid export growth either in the shortfall year or in the postshortfall period. They also agreed that a lower projection limit was not warranted, since the present formula has a built-in safeguard against compensation in case of an accelerating decline in exports. Some Directors did not consider that the staff suggestions go far enough, while others did not see a need to change the present calculation method.

On the issue of overcompensation in successive purchases, most Directors agreed with the inherent logic of reducing the size of a second purchase which fell within the projection period (i.e., roughly two years) of an early purchase where those projections had proved to be optimistic. Failure to make such a deduction was indeed contrary to the spirit of the compensatory financing facility. Reasons of symmetry would suggest, however, that any undercompensation of the first purchase should also be corrected if found to be the case when calculating eligibility for the second purchase. Some Directors also thought it entirely appropriate to make an adjustment for overcompensation even after a longer period, when a member requests a purchase while an earlier purchase is still outstanding.

While not all Directors addressed themselves to the proposals concerning the cereal decision, a number of them were in favor of either the relaxation of the three-year rule under the cereal decision or the establishment of a separate facility. Other Directors did not support any change in the current arrangement with some reiterating their general opposition to a facility oriented toward a specific component of the balance of payments. Thus, it is too early to draw the sense of the Board on this matter.

Directors commented favorably on the motivation behind recent proposals to provide compensatory financing on concessional terms, encompassing both the rate of charge and the repayment period, for low-income members. A number of Directors thought that it would be appropriate for members embarking on the long process of structural adjustment supported by Fund lending under the structural adjustment facility to receive compensatory financing assistance on similar terms. I think that it is fair to say, however, that in our discussion, the majority of Directors thought that there would be considerable merit in channeling concessional assistance through augmentation of the resources under the structural adjustment facility. Nevertheless, some Directors felt that the concessional use of the compensatory financing facility should remain under consideration, with one Director suggesting examination of the possible use of structural adjustment facility resources to provide concessional compensatory financing.

Our preliminary discussion on a possible contingency facility has been very broad-ranging and stimulating. I will be guided by your views in suggesting the direction of our further work on this topic. There was a broad consensus that contingent access to the Fund's resources based on developments in external factors over which members exercise little or no control could contribute to the success of adjustment programs in the present difficult and unpredictable external environment.

The majority of Directors were not in favor of replacing the compensatory financing facility by a contingency facility, but a few Directors supported consideration of this idea and a few others were willing to consider integrating an external contingency facility with the compensatory financing facility. Those Directors in favor of retaining the compensatory financing facility supported further consideration of a contingency mechanism so long as it worked alongside the compensatory financing facility.

Some Directors were opposed to contingency mechanisms that would be triggered by specific balance of payments components, as this would run counter to the purpose of the Fund to provide overall balance of payments support. Some Directors were also of the view that the inclusion of interest rates in a contingency mechanism would not be appropriate, or that such inclusion would pose a number of operational problems and could have a damaging effect on the Fund's liquidity position; on the other hand, some other Directors not only favored the inclusion of interest rates but a broadening of the contingency concept to include a growth contingency.

My sense of the meeting is that Executive Directors wish the staff to examine in detail the technical aspects of approaches to contingent use of Fund resources and the modalities of their possible operation, taking into account the views expressed at this meeting.

I would propose that a further round of discussion of the issues considered at this meeting be conducted in February or early March 1988. It remains my view that we should complete the review of the compensatory financing facility before the April 1988 meeting of the Interim Committee, in keeping with our mandate from the Committee as expressed in its most recent communiqué.

APPROVED: July 13, 1988

LEO VAN HOUTVEN
Secretary