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August 14, 1986

To: Members of the Executive Board
From: The Acting Secretary
Subject: International Capital Markets - Recent Developments, 1986

The attached paper provides background material for the paper on "International Capital Markets - Developments and Prospects, 1986" (SM/86/193, 8/5/86), which has been tentatively scheduled for discussion on Wednesday, September 3, 1986.

Mr. Watson (ext. 7350) or Mr. Kincaid (ext. 7356) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

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INTERNATIONAL MONETARY FUND

International Capital Markets: Recent Developments, 1986

Prepared by the Exchange and Trade Relations Department

(In consultation with other departments)

Approved by C. David Finch

August 13, 1986

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I. Introduction

This paper provides background information to the report on "International Capital Markets--Developments and Prospects, 1986" (SM/86/193, 8/5/86). Section II discusses developments in capital markets in industrial countries, focusing on recent developments in financial flows and instruments, and liberalization in selected financial markets. It reviews the implications of this process of liberalization and innovation, especially for the supervision of financial markets. Section III provides information on trends in financing for developing countries. It discusses developments in debt restructuring, banking supervision, outflows of private capital, and direct investment. An appendix provides information on recent activities of the Institute of International Finance. Additional statistical information is contained in an accompanying statistical supplement.

It should be noted that the term "country" used in this paper does not in all instances refer to a territorial entity which is a state as understood by international law and practice; the term also covers some territorial entities that are not states, but for which statistical data are maintained and produced internationally on a separate and independent basis.

II. Financial Markets in Industrial Countries

1. Developments in financial flows and instruments

a. Overview of flows

Total net lending through bank credit ^{1/} and bond markets ^{2/} increased rapidly in 1985, rising by more than \$67 billion to \$310 billion (Table 1 and Chart 1). This increase in capital market activity entirely reflected developments in the industrial countries. There has also been a continuing shift toward reliance on bond markets to finance these flows. In 1985, bond markets accounted for 43 percent of net bond and bank lending (net of interbank redepositing) compared with 13 percent in 1980-81. ^{3/}

^{1/} Total cross-border lending by banks is measured in the Fund's International Banking Statistics as the sum of cross-border interbank accounts by residence of borrowing bank and of international bank credits to nonbanks by residence of borrower, corrected for changes attributed to exchange rate movements. Net lending is calculated as the exchange rate adjusted increase in claims; it is thus net of amortization.

^{2/} Gross issues of international bonds less an estimate of redemptions, repayments, and double counting due to bank purchases of bonds.

^{3/} Estimates of bank lending net of interbank redepositing are prepared by the BIS and shown in Table 1.

Table 1. International Lending, 1980-85
(In billions of U.S. dollars, or in percent)

	1980	1981	1982	1983	1984	1985
International lending through banks and bond markets						
Total ^{1/} ^{2/}						
IMF based	414	433	235	195	243	310
BIS based (gross)	260	294	230	150	185	298
BIS based (net of redepositing)	179	194	144	131	152	176
Bond issues (net) ^{3/}	19	29	49	46	62	76
Bank lending ^{1/} ^{2/}						
IMF based	395	404	186	149	181	234
Growth rate	24	20	8	6	7	9
BIS based (gross)	241	265	181	104	123	222
Growth rate	22	20	12	6	6	10
BIS based (net of redepositing)	160	165	95	85	90	100
Growth rate	24	20	10	8	7	8
International lending to industrial countries						
Total						
IMF based	261	244	162	130	171	268
BIS based (gross)	192	221	180	106	142	243
BIS based (net)	111	121	94	87	109	121
Bond issues (net) ^{3/}	15	22	39	36	51	62
Bank lending ^{1/}						
IMF Based	246	222	123	94	120	206
Growth rate	23	18	9	6	8	13
BIS based (gross)	177	199	141	70	91	181
Growth rate	16	15	9	4	4	8
BIS based (net)	96	99	55	51	58	59
Growth rate	14	12	6	5	5	5
International lending to developing countries ^{4/}						
Total						
IMF based	86	89	54	37	19	13
BIS based	57	55	37	28	14	18
Bond issues (net) ^{3/}	1	2	3	2	3	4
Bank lending ^{1/}						
IMF based	85	87	51	35	16	9
Growth rate	27	22	11	7	3	2
BIS based	56	53	34	26	11	14
Growth rate	22	17	10	7	2	3
Memorandum item:						
Gross bond issues						
Total	38	52	76	77	110	166
Of which:						
Industrial countries	28	39	60	60	91	136
Developing countries	2	4	5	3	5	10

Sources: Bank for International Settlements (BIS); Organization for Economic Cooperation and Development; International Monetary Fund, International Financial Statistics; and Fund staff estimates.

^{1/} IMF based data on cross-border lending by banks are derived from the Fund's International Banking Statistics (IBS) (cross-border interbank accounts by residence of borrowing bank plus international bank credits to nonbanks by residence of borrower), excluding changes attributed to exchange rate movements. BIS based data are derived from quarterly statistics contained in BIS's International Banking Developments; the figures shown are adjusted for the effects of exchange rate movements. Differences between the IMF data and the BIS data are mainly accounted for by the different coverages. The BIS data are derived from geographical analyses provided by banks in the BIS reporting area. The IMF data derive cross-border interbank positions from the regular money and banking data supplied by member countries, while the IMF analysis of transactions with nonbanks is based on data from geographical breakdowns provided by the BIS reporting countries and additional banking centers. Both IBS and BIS series are not fully comparable over time, owing to expanding coverage.

^{2/} Total lending includes offshore centers, international organizations, and other non-Fund members as well as industrial and developing countries.

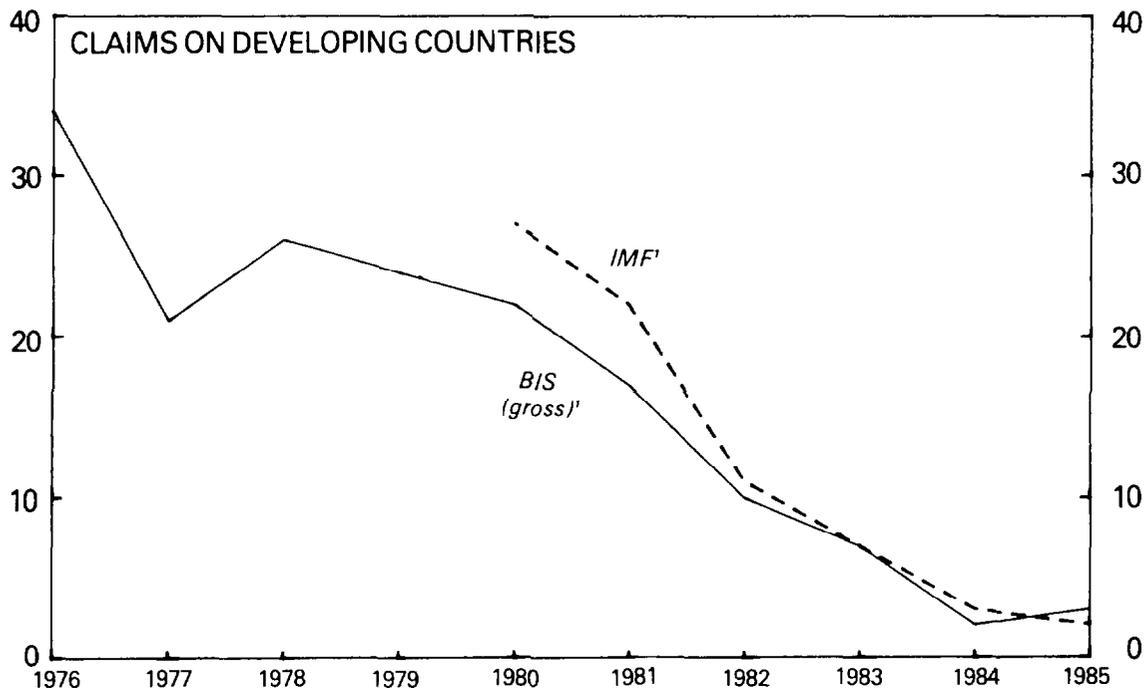
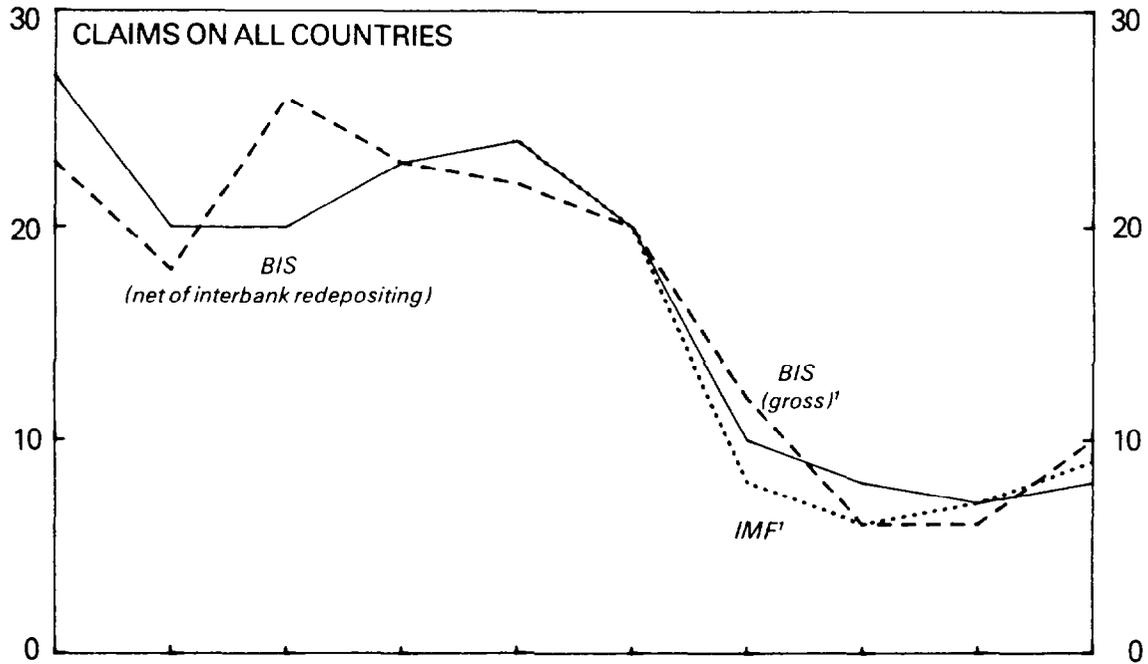
^{3/} Net of redemption and repurchases, and of double-counting due to bank purchases of bonds.

^{4/} Excludes the seven offshore centers, which are: the Bahamas, Bahrain, the Cayman Islands, Hong Kong, Netherlands Antilles, Panama, and Singapore.

CHART 1

GROWTH RATE OF INTERNATIONAL BANK CLAIMS, 1976-85

(In percent)



Sources: Bank for International Settlements, *International Banking Statistics and Annual Report*; International Monetary Fund; *International Financial Statistics*; and Fund staff estimates.

¹ These data do not net out interbank redepositing.



Lending to industrial countries through international bank credit and bond markets grew by \$97 billion in 1985 to \$268 billion, contrasting with a decline in lending to developing countries of \$6 billion to \$13 billion. ^{1/} The growth in financing to borrowers in industrial countries reflected two key factors. The first was the widening current account imbalances among these countries. U.S. banks and nonbanks were the largest net takers of funds from the international banking system, while residents in Japan were net purchasers of foreign bonds on a very large scale. The second factor was the continuing trend toward the internationalization of bond and equity markets and portfolios, and the integration of different segments of the international financial markets.

Bank lending to borrowers in industrial countries, continuing the upswing begun in 1984, rose by \$86 billion to \$206 billion in 1985 (a growth rate of 13 percent based on outstanding claims of \$1.6 trillion at end-1984). This growth was dominated by an expansion in interbank claims, which accounted for 86 percent of net bank lending (Statistical Supplement Tables 1 and 2). The major destinations of interbank lending were the principal financial centers, where a high proportion of world securities market transactions took place. The United States absorbed interbank flows amounting to \$33 billion, while such lending to Japan and the United Kingdom totaled \$42 billion and \$43 billion, respectively.

The United States was the largest recipient of net international capital flows in 1985, as it borrowed abroad to finance its large current account deficit. The increase in net bank claims on U.S. residents totaled \$29 billion in 1985--the same as in the previous year. In addition, foreigners purchased net \$75 billion of securities in the United States. U.S. residents issued (gross) \$40 billion in international bonds and notes, and also arranged another \$4 billion of nonunderwritten facilities, mostly Eurocommercial paper. U.S. residents arranged \$28 billion in international medium-term bank borrowing facilities in 1985, mainly in the form of other long-term international bank stand-by facilities (\$25 billion) (Statistical Supplement Table 3). The U.S. share of total depositing by industrial countries in the international banking system has fallen sharply from 71 percent in 1982 to 13 percent in 1985 (Statistical Supplement Table 1).

The net balance of payments outflow from Japan on account of long-term securities transactions amounted to \$42 billion in 1985. There was also a small increase in net deposits of Japanese residents with the international banking system. At least as striking as these net capital movements was the level of gross flows between residents and nonresi-

^{1/} All references to developing countries exclude major offshore banking centers (the Bahamas, the Cayman Islands, Netherlands Antilles, Hong Kong, and Panama), otherwise country classifications are as defined in the World Economic Outlook, April 1986, Statistical Appendix.

dents of Japan. The gross flows were concentrated in interbank and securities transactions. International interbank lending to Japan rose to \$42 billion in 1985 from \$22 billion in 1984, while interbank deposit taking from banks in Japan increased to \$42 billion from \$11 billion in 1984. Japanese residents purchased some \$60 billion of long-term securities in 1985, while nonresidents acquired about \$18 billion of bonds issued by residents of Japan on the international and domestic markets.

The much larger volume of gross flows is indicative of Japan's emergence as a major international financial center, and the growing importance of the yen in international markets. In 1985, 14 percent of international bank loans were denominated in yen, compared to 12 percent in 1984 and 4 percent in 1982. The international activity of non-banks in Japan appears to be directed mainly toward the securities markets. The preference by Japanese residents for international securities over bank deposits has been a significant factor in the shift in the relative international importance of securities versus banking markets in the last few years.

Interbank lending to the United Kingdom rose to \$43 billion in 1985 from \$32 billion in 1984, while interbank deposit-taking from banks in the U.K. rose to \$37 billion in 1985 from \$19 billion in 1984. Thus, net interbank borrowing declined to \$6 billion in 1985 from \$13 billion in 1984. These interbank inflows may partly reflect the increasing involvement of U.K. resident banks in the rapidly expanding international securities market. While holdings of securities by U.K. resident banks were not recorded in international banking statistics, the U.K. monetary sector acquired nearly \$12 billion in overseas securities in 1985.

International bond issues by U.K. residents rose by \$10 billion in 1985 to \$15 billion. The U.K. Government issued a \$2.5 billion floating-rate note, the largest ever single issue of its kind. U.K. residents also arranged \$10 billion in medium- and long-term international bank credit commitments (compared with \$4 billion in 1984), of which half were other medium- and long-term bank credit facilities (note issuance facilities (NIFs) and multioption facilities (MOFFs)), and a further \$6 billion in nonunderwritten facilities (mainly Eurocommercial paper).

In 1985, Germany replaced Switzerland as the largest net supplier of funds to the international banking markets as it supplied almost \$13 billion net, double the net amount supplied in 1984; most of these funds were provided through the interbank market. In the last four years there has also been a steady expansion in transactions in German securities involving nonresidents. German residents' net purchases of foreign securities rose to \$11 billion in 1985 from \$6 billion in 1984, while foreign investment in German securities increased to \$14 billion from \$6 billion in 1984.

b. Developments in banking markets

Total international bank lending to industrial countries increased to \$206 billion in 1985 from \$120 billion in 1984 (Table 2). Interbank lending rose from \$114 billion to \$178 billion; cross-border lending to nonbanks in industrial countries rose by \$20 billion to \$27 billion, half of the level in 1982 (Statistical Supplement Tables 1 and 2). The greater interbank activity appears to be associated with a number of factors.

First, the further integration of banking activity in individual financial centers as markets have been liberalized has led to larger gross interbank flows, particularly with Japan, Belgium-Luxembourg, and the United Kingdom. Banks have dramatically increased their participation in the bond markets, as both issuers and holders--particularly of floating rate notes--and have greatly expanded their trading in, and underwriting of, various types of note issuance facilities. The increased links between the banking and securities markets may have increased interbank activity, as many banks have funded their portfolios of securities in this market. The large increase in cross-border interbank lending from banks in Japan appears to be related partly to the funding of their overseas branches' holdings of securities where the tax and regulatory treatment is more favorable than in Japan. Banks in the United Kingdom were net absorbers of interbank funds, and this may partly reflect the funding of U.K. banks' holdings of international bonds.

Second, the growth of interbank activity has been boosted by the need for larger forward covering by the banks to avoid open positions associated with the fluctuations in currency values, the shift in currency preferences of borrowers and depositors, and the growing use of the ECU in the denomination of international loans and deposits as a way of hedging currency risks (Table 3).

Third, there has been a change in the importance of different nationalities of banks in international business with a shift toward banks that rely, to a greater extent, on the interbank market to fund their international business. By end-September 1985, the international business 1/ of Japanese banks had expanded to account for the largest

1/ "International" business is defined as the cross border positions of parent banks, their branches, and subsidiaries in 16 reporting countries--Austria, Belgium, Canada, Denmark, France, Federal Republic of Germany, Iceland, Italy, Japan, Luxembourg, the Netherlands, Spain, Sweden, Switzerland, the United Kingdom, and the United States--plus the local foreign currency positions with nonbank residents and non-affiliated banks in these countries and is thus not on a strict residency basis. In addition to the international activities of banks in the 16 reporting countries, the data include the cross-border operations of branches of U.S. banks in the Bahamas, Cayman Islands, Panama, Hong Kong, and Singapore.

Table 2. Total Cross-Border Bank Lending and Deposit Taking, 1982-85 ^{1/}
(In billions of U.S. dollars)

	1982	1983	1984	1985
Lending to ^{2/}	186	149	181	234
Industrial countries	123	94	120	206
Of which:				
United States	61	40	36	54
Japan	...	10	19	42
Developing countries ^{3/}	51	35	16	9
Offshore centers ^{4/}	25	12	21	15
Other transactors ^{5/}	-1	6	6	8
Unallocated (nonbanks) ^{6/}	-12	3	17	-4
Memorandum items:				
Capital-importing developing countries ^{3/7/}	...	31	16	10
Non-oil developing countries ^{3/8/}	41	28	17	10
15 heavily indebted countries	...	11	5	1
Deposit taking from ^{9/}	188	178	195	252
Industrial countries	150	90	113	196
Of which:				
United States	107	32	7	25
Japan	...	15	12	43
Developing countries ^{3/}	4	20	23	16
Offshore centers ^{4/}	25	34	19	31
Other transactors ^{5/}	4	10	3	8
Unallocated (nonbanks) ^{6/}	6	23	37	1
Memorandum items:				
Capital-importing developing countries ^{3/7/}	...	27	25	15
Non-oil developing countries ^{3/8/}	17	26	22	11
15 heavily indebted countries	...	9	14	4
Change in net claims on ^{10/}	-2	-29	-15	-18
Industrial countries	-26	3	7	10
Of which:				
United States	-46	8	29	29
Japan	...	-5	7	-1
Developing countries ^{3/}	47	14	-7	-7
Offshore centers ^{4/}	--	-22	2	-16
Other transactors ^{5/}	-5	-4	3	--
Unallocated (nonbanks)	-18	-20	-20	-5
Memorandum items:				
Capital-importing developing countries ^{3/7/}	...	3	-9	-5
Non-oil developing countries ^{3/8/}	24	2	-5	-1
15 heavily indebted countries	...	3	-9	-3

Note: Owing to rounding, components may not add.

Sources: International Monetary Fund, International Financial Statistics (IFS); and Fund staff estimates.

^{1/} Data on lending and deposit taking are derived from stock data on the reporting countries' liabilities and assets, excluding changes attributed to exchange rate movements.

^{2/} As measured by differences in the outstanding liabilities of borrowing countries defined as cross-border interbank accounts by residence of borrowing bank plus international bank credits to nonbanks by residence of borrower.

^{3/} Excluding offshore centers.

^{4/} Consisting of the Bahamas, Bahrain, Cayman Islands, Hong Kong, the Netherlands Antilles, Panama, and Singapore.

^{5/} Transactors included in IFS measures for the world, to enhance global symmetry, but excluded from IFS measures for "All Countries." The data comprise changes in identified cross-border bank accounts of centrally planned economies (excluding Fund members), and of international organizations.

^{6/} Calculated as the difference between the amount that countries report as their banks' positions with nonresident banks in their monetary statistics and the amounts that banks in major financial centers report as their positions with nonbanks in each country.

^{7/} Consisting of all developing countries except the eight Middle Eastern oil exporters (Islamic Republic of Iran, Iraq, Kuwait, Libyan Arab Jamahiriya, Oman, Qatar, Saudi Arabia, and the United Arab Emirates) for which external debt statistics are not available or are small in relation to external assets.

^{8/} Consisting of all developing countries except the eight Middle Eastern oil exporters (listed in footnote 7 above), Algeria, Indonesia, Nigeria, and Venezuela.

^{9/} As measured by differences in the outstanding assets of depositing countries, defined as cross-border interbank accounts by residence of lending bank plus international bank deposits of nonbanks by residence of depositor.

^{10/} Lending to, minus deposit taking from.

Table 3. International Borrowing Operations in ECUs, 1983-First Half 1986

(In billions of ECUs)

	1983	1984	1985	1986 <u>1/</u>
By instrument				
Bonds	2.49	3.92	9.68	9.45
Of which: Floating rate notes	--	0.57	1.23	--
Syndicated loans	0.72	2.16	3.18	0.46
Other facilities	--	--	0.32	--
Total	3.21	6.08	13.18	9.92
By borrower				
Italy	0.94	1.68	3.29	1.06
France	0.60	0.57	1.84	1.75
EEC institutions	0.62	1.00	0.83	2.06
Other EEC countries	0.23	0.48	1.27	1.68
Other borrowers	0.82	2.35	5.95	3.36
Total	3.21	6.08	13.18	9.91
Memorandum item:				
ECU (as percent of total borrowing) <u>2/</u>	1.7	2.5	4.2	3.0

Source: Organization for Economic Cooperation and Development, Financial Market Trends.

1/ First half 1986 annualized.

2/ At constant (end-1983) exchange rates.

share of total international bank claims and liabilities (about 26 percent each, using the BIS data on international banking activity classified by the nationality of the banks, Table 4). In the first three quarters of 1985, partly reflecting seasonal factors, international claims of Japanese banks grew by \$121 billion, equivalent to an annual rate of 33 percent. By contrast, the international claims of U.S. banks fell by 3 percent at an annual rate in the period to account for only 23 percent of total claims by end-September 1985. ^{1/} Japanese banks, which hold a very large and increasing net creditor position vis-a-vis nonbanks (\$125 billion at end-September 1985), financed their international activity through a large net debtor position in the interbank market. U.S. banks, on the other hand, have traditionally drawn a much larger proportion of their funds used for on-lending directly from nonbanks.

Total international bank commitments to industrial country borrowers in 1985 reached their highest level since 1981, a peak year (Statistical Supplement Table 3). Announcements of new long-term bank credit commitments rose slightly to \$32 billion, as average spreads over reference rates on these loans to borrowers from industrial countries declined further to 41 basis points (Statistical Supplement Table 4), their lowest recorded level. Other international long-term bank credit facilities, excluding merger-related facilities, however, surged to \$47 billion, a 62 percent increase over 1984. This growth of precautionary credit arrangements may have been stimulated partly by the general decline in fees and margins, which has reduced the cost of commitments, and partly by the decline in interest rates on deposits, which has led to the substitution of precautionary credit lines for liquid balances, the returns on which have been reduced.

Deposit-taking from industrial countries increased to \$196 billion in 1985 from \$113 billion in 1984 (Table 2). Interbank deposits accounted for most of this increase (Statistical Supplement Table 1); deposit-taking by nonbanks in industrial countries rose to \$21 billion in 1985 from \$6 billion in 1984. Nevertheless, depositing by nonbanks in industrial countries was only 78 percent of its level in 1983.

c. The Euronote, Eurocommercial paper,
and medium-term note markets

The international securities markets have substantially broadened with the introduction of short-term notes. There are two categories of

^{1/} These figures are, however, distorted, since the data are not adjusted for the effects of exchange rate movements and the decline in the value of the dollar might be expected to have a greater effect on boosting the dollar value of the claims of Japanese than U.S. banks. However, the figures also include the offshore branches of U.S. banks but not of Japanese banks in the totals, which leads to an overestimate of the share of claims held by U.S. banks.

Table 4. International Assets, Liabilities, and Net Position of Banks by Nationality of Ownership, September 1985

(In billions of U.S. dollars)

Parent Country of Bank	Total Claims		Related Offices		Of which, on Other Banks		Nonbanks	
	Sept. 1985	Change during 1985	Sept. 1985	Change during 1985	Sept. 1985	Change during 1985	Sept. 1985	Change during 1985
Total	2,476.7	228.7	551.1	43.5	1,103.6	121.9	780.5	57.4
Of which:								
Canada	90.8	-1.6	22.0	0.8	31.2	-2.3	37.2	0.5
France	221.0	20.3	26.7	2.1	124.4	10.5	63.9	6.9
Germany, Federal Republic of	164.9	21.7	12.7	1.4	87.9	14.6	62.9	5.7
Italy	92.1	1.5	3.7	0.8	62.5	-0.3	25.4	1.0
Japan	639.6	121.3	168.6	30.9	284.8	65.1	179.1	23.6
Switzerland	97.7	14.9	15.3	3.3	48.0	6.9	26.3	2.7
United Kingdom	182.5	14.1	22.5	2.0	85.6	9.2	69.2	2.4
United States	580.3	-14.8	235.8	-2.2	172.4	-14.4	169.1	2.0
Parent Country of Bank	Total Liabilities		Related Offices		Of which, to Other Banks		Nonbanks	
	Sept. 1985	Change during 1985	Sept. 1985	Change during 1985	Sept. 1985	Change during 1985	Sept. 1985	Change during 1985
Total	2,385.9	228.5	547.1	39.0	1,115.1	135.2	482.0	43.6
Of which:								
Canada	97.2	-6.5	11.4	-2.1	36.8	-2.2	38.8	-2.7
France	207.8	13.9	31.2	0.5	134.4	8.5	24.3	2.7
Germany, Federal Republic of	142.8	13.2	17.3	-0.9	81.2	9.9	30.9	3.4
Italy	94.3	2.1	4.9	0.5	78.9	1.3	6.6	0.6
Japan	621.5	127.3	169.3	29.8	337.4	81.2	54.4	14.9
Switzerland	88.4	11.4	32.7	6.2	18.0	5.1	25.1	0.1
United Kingdom	181.5	10.7	23.0	0.7	81.3	1.8	50.3	5.7
United States	545.6	3.4	211.8	-0.9	120.7	2.6	145.4	2.0
Parent Country of Bank	Net Claims/ Net Liabilities		Related Offices		Of which, on/to Other Banks		Nonbanks	
	Sept. 1985	Change in 1985	Sept. 1985	Change in 1985	Sept. 1985	Change in 1985	Sept. 1985	Change in 1985
Total	90.8	0.2	4.0	4.5	-11.5	-13.3	298.5	13.8
Of which:								
Canada	-6.4	4.9	10.6	2.9	-5.6	-0.1	-1.6	3.2
France	13.2	6.4	-4.5	1.6	-10.0	2.0	39.6	4.2
Germany, Federal Republic of	22.1	8.5	-4.6	2.3	6.7	4.7	32.0	2.3
Italy	-2.2	-0.6	-1.2	0.3	-16.4	-1.6	18.8	0.4
Japan	18.1	-6.0	-0.7	1.1	-52.6	-16.1	124.7	8.7
Switzerland	9.3	3.5	-17.4	-2.9	30.0	1.8	1.2	2.6
United Kingdom	1.0	3.4	-0.5	1.3	4.3	7.4	18.9	-3.3
United States	34.7	-18.2	24.0	-1.3	51.7	-17.0	23.7	--

Source: Bank for International Settlements, International Banking Developments.

such note facilities. One type of short-term Euronote is underwritten by banks. These banks commit themselves to purchase Euronotes at predetermined rates if they cannot be placed in the market, for a period generally extending from five to seven years. A second variety of Euronotes is not underwritten (Eurocommercial paper), but is distributed through dealers on a best-efforts basis with flexible amounts and maturities.

Underwritten Euronote facilities grew from \$1 billion in 1981 to \$33 billion in 1985, whereas Eurocommercial paper grew from \$0.6 billion in 1984 to \$16 billion in 1985. The growth in underwritten Euronotes fell to \$3.4 billion during the first quarter of 1986, whereas the growth in Eurocommercial paper was sustained, accounting for a further \$10.7 billion (Statistical Supplement Table 5). Approximately \$20 billion in short-term promissory notes is currently outstanding.

As the market for Euro-facilities has evolved, financial packages have become increasingly complex and the range of participants has expanded. There has been an increase in the volume of "multiple option facilities" from \$8 billion in 1984 to \$18 billion in 1985 and \$8 billion in the first half of 1986 (Statistical Supplement Table 6). These facilities back the issuance of Euronotes or the use of short-term bank advances where the borrower has options to select the maturity, currency, and interest-rate reference.

Borrowers have issued Euronotes and Eurocommercial paper as an alternative or supplement to floating rate notes, syndicated loans, and U.S. commercial paper. In 1985, over two thirds of total facilities were arranged for borrowers domiciled in the United States, Australia, and the United Kingdom, for the most part nonbank corporations. U.S. corporations have been particularly active, raising \$18 billion, or the equivalent of 40 percent of the market. Australian borrowers more than doubled their issues to \$7 billion in 1985, while borrowers from the United Kingdom took in \$5 billion in comparison to \$1 billion in the previous year. The presence of sovereign borrowers in this market declined in 1985, while that of industrial borrowers increased (Statistical Supplement Table 7).

Euronotes have been underwritten largely by commercial banks, particularly those from the United States, France, Japan, Canada, Switzerland, and the United Kingdom. The absence of an active secondary market and the lack of a rating for most issues apparently deterred nonbank investors from holding a significant amount of notes. Principal nonbank investors reportedly include fund managers, corporate treasurers, insurance companies, and central banks.

The cost of tapping the Euronote market consists of the interest paid on the notes and the fees relating to the back-up facility. Prime borrowers, such as the Kingdom of Sweden and the Commonwealth of Australia, have been able to tap the note market at rates below the London Interbank Bid Rate (LIBID), while others have paid rates somewhat

above the London Interbank Offer Rate (LIBOR), but below spreads on syndicated credits. Competition between investment and commercial banks has resulted in a significant reduction in the arrangement and stand-by fees. This development has induced many borrowers to substitute Euronotes for part of their traditional borrowings or stand-by facilities (such as lines of credit) used to back up their U.S. commercial paper program. Underwriting fees usually range from 5 to 15 basis points of principal. Consumer relations and market share appear to be important elements in banks' decision to underwrite facilities at fees that appear small in relation to the banks' funding and credit risk, were they called upon to absorb the notes.

A further addition to the list of new instruments featured in the international market had been the medium-term note (MTN), which was introduced into the Eurodollar market in 1986. MTNs are continuously offered unsecured notes with maturities ranging from nine months to ten years. They are not underwritten, being sold instead on a best-effort basis through dealers. MTN programs emerged in the early 1980s in the U.S. domestic market as a funding tool for high-quality financial companies. The emergence of a liquid secondary market and the flexibility afforded under the Securities and Exchange Commissions (SEC) shelf registration procedures (Rule 415), which allows issuers to tap U.S. securities markets any time after satisfying SEC registration requirements rather than at a single predetermined issue date, gave strong impetus to this market. Strong demand by non-U.S. residents and the possibility of avoiding SEC registration requirements have resulted in actual and proposed Euro-programs of approximately \$5 billion in 1986.

d. Developments in international bond markets

Issuing activity in the international bond market rose sharply in 1985 and the first half of 1986 (Table 5 and Chart 2). Gross international bond volume rose from \$110 billion in 1984 to \$166 billion in 1985 and further to \$210 billion in the first half of 1986 (annualized). The bond markets' expansion is in large part attributable to a substantial decline in long-term interest rates (Statistical Supplement Table 8 and Chart 3), to the access created by new instruments and issuing techniques (in particular interest rate and currency swaps), and to the liberalization of financial markets. The decline in interest rates has also motivated borrowers to prepay high-coupon debt by exercising call options. Early repayments of bonds amounted to \$3 billion in 1984, rose to \$19 billion in 1985 and reached \$36 billion during the first half of 1986. The issue of bonds (gross bond issues less scheduled and early redemptions) grew from \$90 billion in 1984 to \$131 billion in 1985 and rose further to \$164 billion in the first half of 1986 (annualized). As a result of the decline in long-term interest rates, the maturity profile of international bonds has lengthened (Statistical Supplement Table 10) in most countries.

Table 5. Developments in International Bond Markets, 1981-First Half 1986

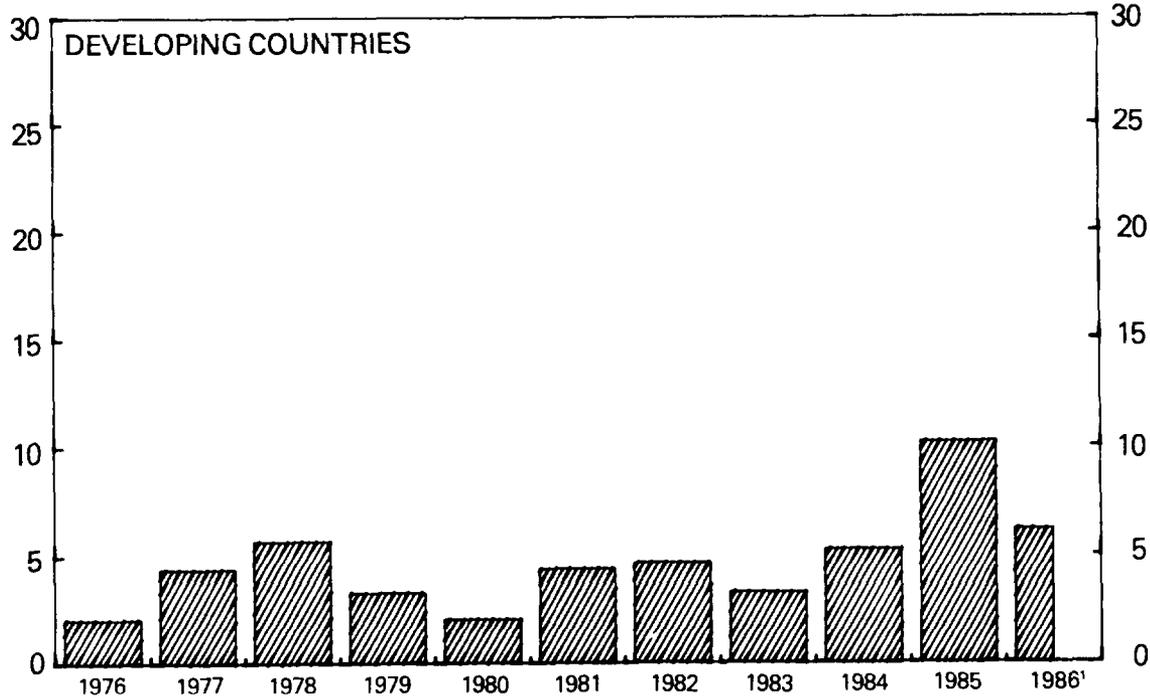
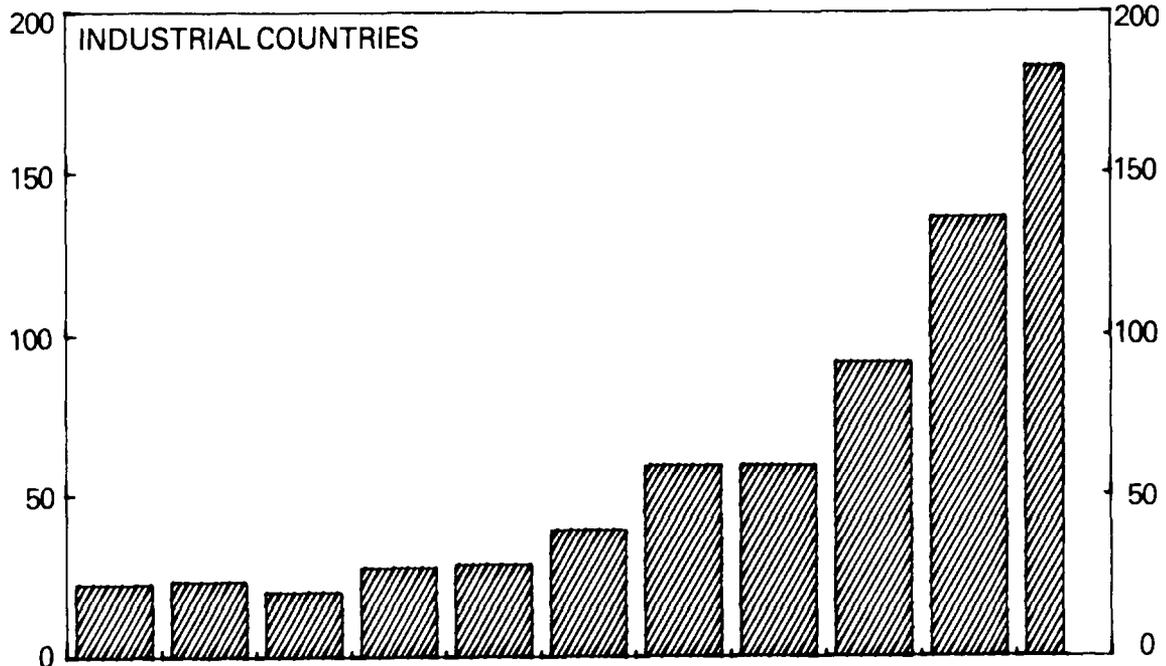
	1981	1982	1983	1984	1985	1986 <u>1/</u>
	(In billions of U.S. dollars)					
International bond issues:						
By category of borrower						
Industrial countries	39	60	60	91	136	184
Developing countries	4	5	3	5	10	6
Other (including international organizations)	8	11	14	13	20	20
Total international bonds	52	76	77	110	166	210
Amortization	16	18	18	20	35	46
Net issues <u>2/</u>	36	58	59	90	131	164
Bond purchases by banks	7	9	13	28	55	...
Net issues to nonbanks <u>3/</u>	29	49	46	62	76	...
Memorandum items:						
Net issues by industrial countries to nonbanks <u>3/</u>	22	39	36	51	62	...
Net issues by developing countries to nonbanks <u>3/</u>	2	3	2	3	4	...
	(In percent)					
By currency of denomination						
U.S. dollar	63	64	57	64	61	53
Deutsche mark	5	7	9	6	7	8
Swiss franc	16	15	18	12	9	10
Japanese yen	6	5	5	6	8	10
Other	10	9	11	12	15	19
	(In percent per annum)					
Interest rate developments						
Euro-dollar deposits <u>4/</u>	13.3	9.5	10.1	9.0	8.0	7.0
Dollar Euro-bonds <u>5/</u>	14.9	13.4	12.5	12.1	10.6	8.9
Deutsche mark international bonds <u>5/</u>	9.2	8.2	8.1	7.4	7.0	6.8

Sources: Organization for Economic Cooperation and Development, Financial Statistics Monthly, and Financial Market Trends; International Monetary Fund, International Financial Statistics, and Fund staff estimates.

- 1/ First half 1986 annualized.
2/ Gross issues less scheduled repayments and early redemption.
3/ Gross issues less scheduled repayments and early redemption and bond purchases by banks.
4/ Three-month deposits.
5/ Bonds with remaining maturity of 7-15 years.

CHART 2 GROSS INTERNATIONAL BOND ISSUES, 1976-FIRST HALF 1986

(In billions of U.S. dollars)

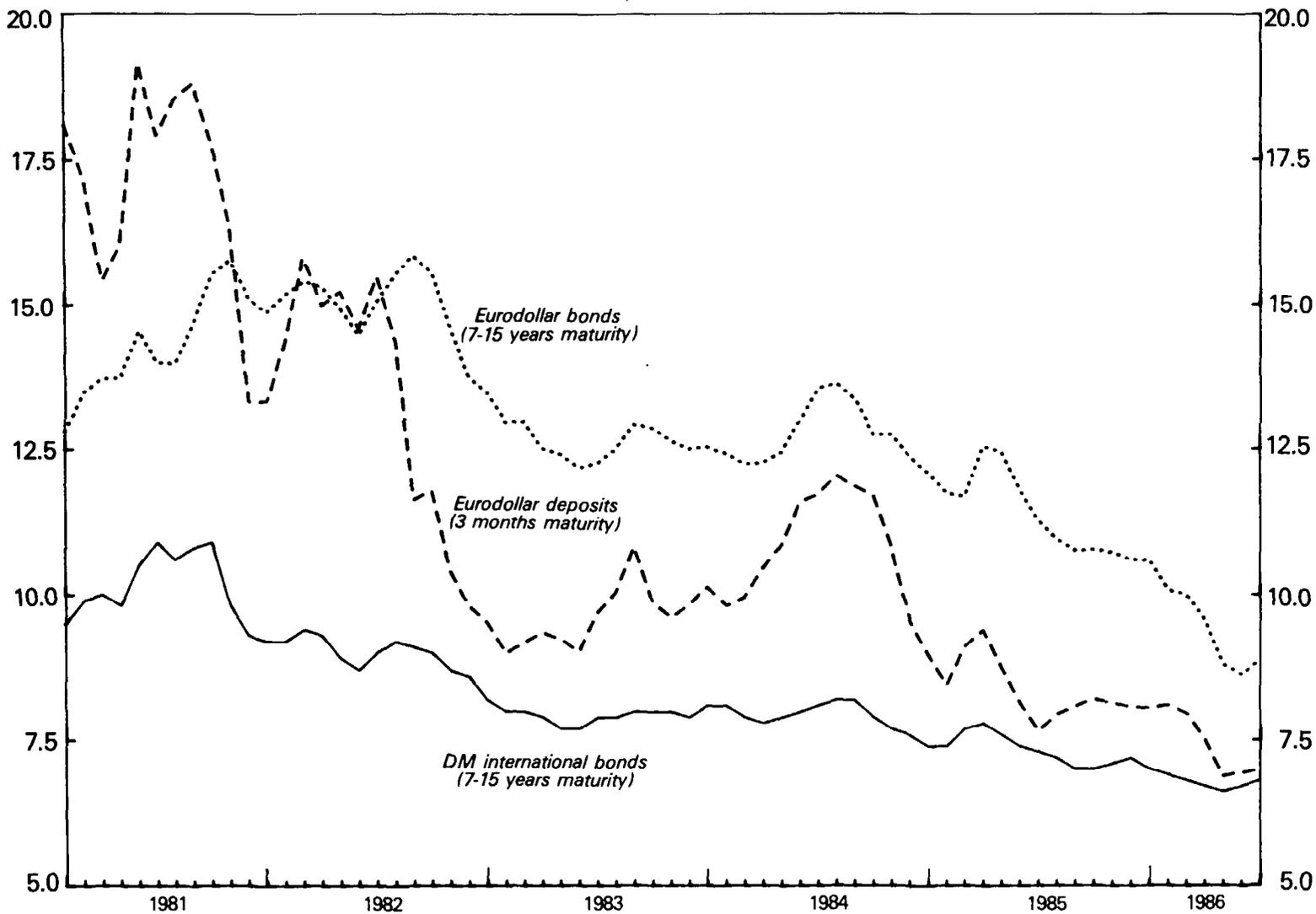


Source: Organization for Economic Cooperation and Development, *Financial Statistics Monthly*.
¹ First half annualized.



CHART 3
INTEREST RATE DEVELOPMENTS, 1981-JUNE 1986

(In percent)

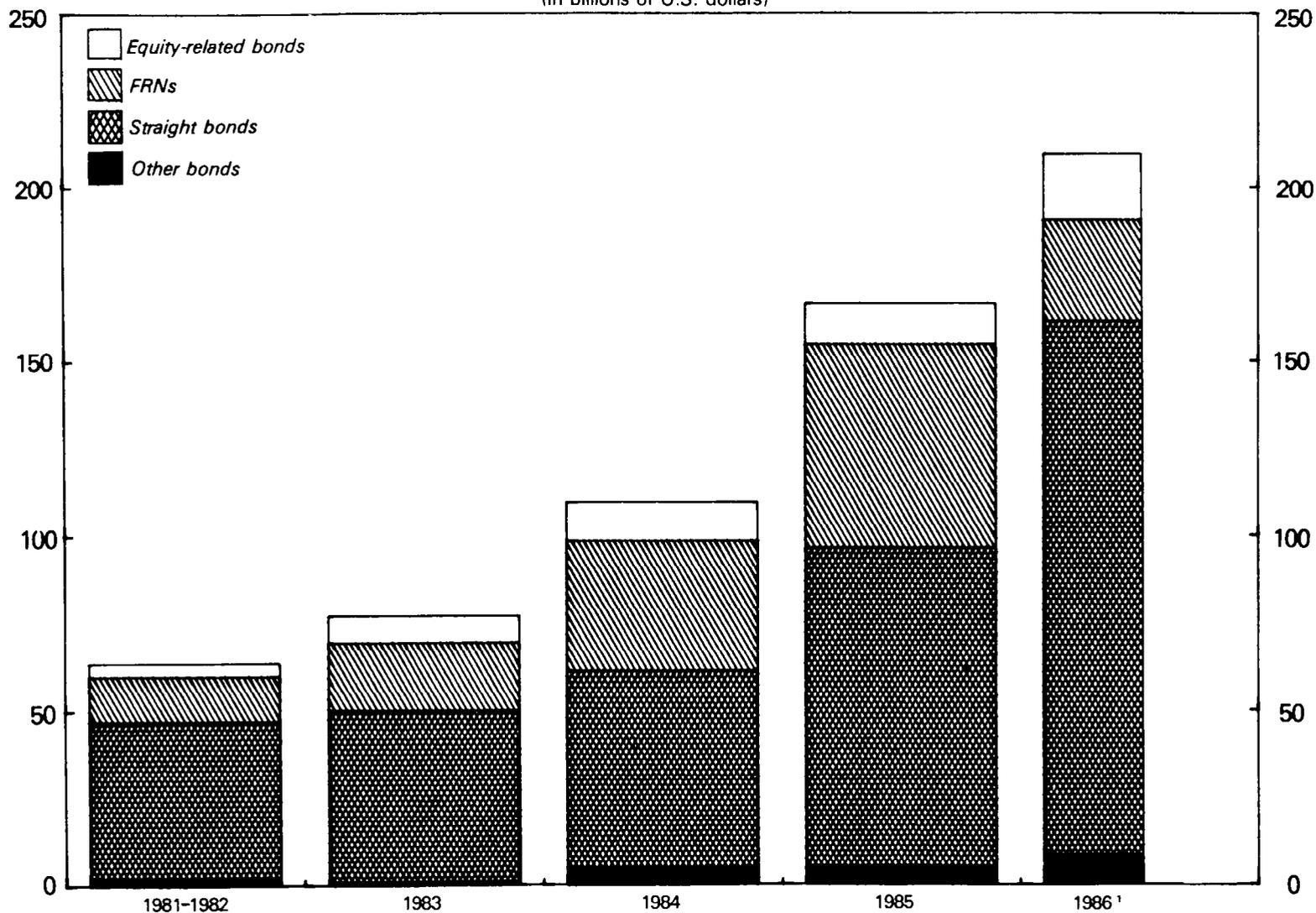


Source: Organization for Economic Cooperation and Development, *Financial Statistics Monthly*.



INTERNATIONAL BOND ISSUES BY MAJOR INSTRUMENTS, 1981-FIRST HALF 1986

(In billions of U.S. dollars)



Source: Organization for Economic Cooperation and Development, *Financial Statistics Monthly*.

¹ First half annualized.



The issue of straight bonds (i.e., fixed-interest rate obligations without options to change its basic characteristic) grew from \$59 billion in 1984 to \$93 billion in 1986 and further to \$161 billion during the first half of 1986 (annualized) (Statistical Supplement Table 11 and Chart 4). The issue of floating rate notes declined from a peak of \$33 billion in the first half of 1985 to \$25 billion in the second half and fell to \$16 billion during the first half of 1986 (Statistical Supplement Table 12). The floating rate note market has benefited, however, from an increase in secondary market liquidity. Average transaction size has increased from \$1 million to \$3-5 million. Bid and ask spreads have halved and now resemble those of other money market instruments. The increase in the relative importance of straight issues (Table 6) was due in large part to the decline in long-term interest rates.

Floating rate note Eurodollar issues totaled 543 in number between January 1983 and December 1985, of which 50 percent were issued by banks, 35 percent by sovereign borrowers, and 15 percent by other borrowers. Floating rate notes have also been issued in nondollar currencies. At the end of 1985 according to market estimates, \$6.5 billion of sterling floating rate notes were outstanding, \$3.5 billion in deutsche mark floating rate notes, \$1.6 billion in ECUs, \$1.0 billion in Swiss francs, and \$0.2 billion in yen. A decline in spreads has induced the early redemption of \$9.8 billion of floating rate notes as compared with \$6.6 billion for fixed-rate bonds.

The currency composition of international bonds (Statistical Supplement Table 13 and Chart 5) has changed away from the U.S. dollar and the Swiss franc toward the yen, ECU, and other currencies. In particular, the share of the U.S. dollar fell from 64 percent in 1984 to 53 percent in the first half of 1986, while the share of the yen doubled to 10 percent during the same period and the share of the ECU grew from 2.7 percent of total issues in 1984 to 6.2 percent in the first half of 1986. The ECU has become the third largest borrowing currency, after the U.S. dollar and the deutsche mark. Borrowers of ECU included in 1985 U.S. corporations (ECU 1.1 billion), Japanese issuers (ECU 0.9 billion), and international development organizations (ECU 0.6 billion), in addition to the traditional EEC borrowers (ECU 5.3 billion). While most of the ECU issues were fixed-rate bonds, a market for ECU floating rate note market developed in 1985 with ECU 1.2 billion of new issues. Floating rate note issues are priced at narrow margins over ECU LIBOR.

The international bond markets have grown significantly faster than the domestic bond markets (i.e., bonds issued by residents in domestic markets) in the major currencies (Statistical Supplement Table 14). In particular, international U.S. dollar bond markets grew by 29 percent in 1985 while the domestic U.S. bond market (public and private) grew by 18 percent; the dollar-equivalent volume in the international yen bond markets grew by 43 percent (Euro-yen 48 percent, foreign yen 24 percent), and dollar-equivalent volume in the domestic yen bond market by

Table 6. Borrowing on International Capital Markets by
Major Instruments, 1981-First Half 1986

(In percent)

	1981-82	1983	1984	1985	1986 <u>1/</u>
Straight bonds	71	64	52	55	73
FRNs <u>2/</u>	20	25	34	35	14
Equity-related bonds	6	10	10	7	9
Other bonds <u>3/</u>	3	1	4	3	4
Total	100	100	100	100	100

Note: All data excluding merger-related stand-bys and renegotiations.

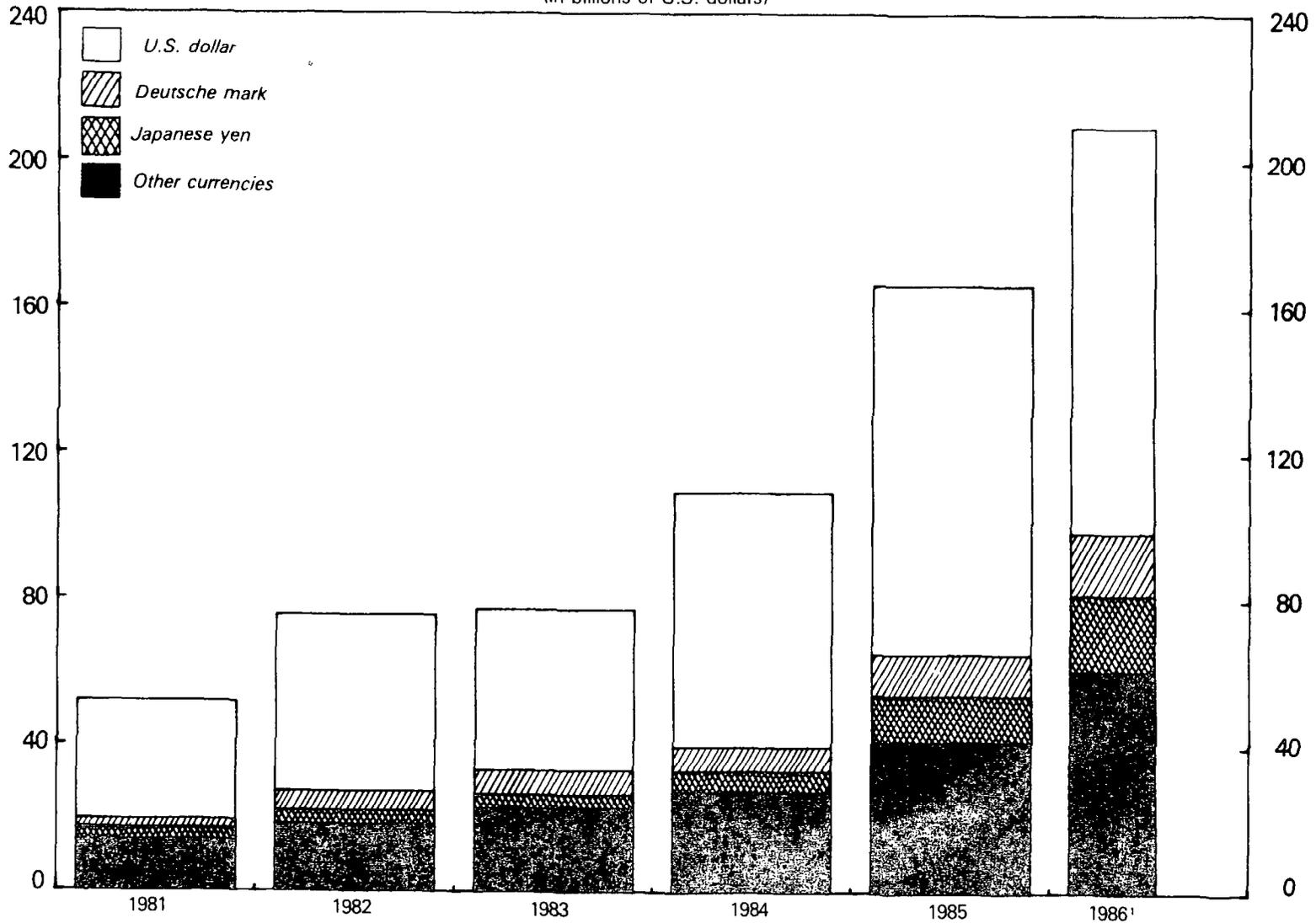
Source: Organization for Economic Cooperation and Development,
Financial Statistics Monthly.

1/ First half 1986 annualized.

2/ Including medium-term floating-rate CDs.

3/ Zero bonds, deep discount bonds, special placements, and bond offerings not included elsewhere.

CHART 5
INTERNATIONAL BOND ISSUES AND PLACEMENTS
BY CURRENCY OF DENOMINATION, 1981-FIRST HALF 1986
 (In billions of U.S. dollars)

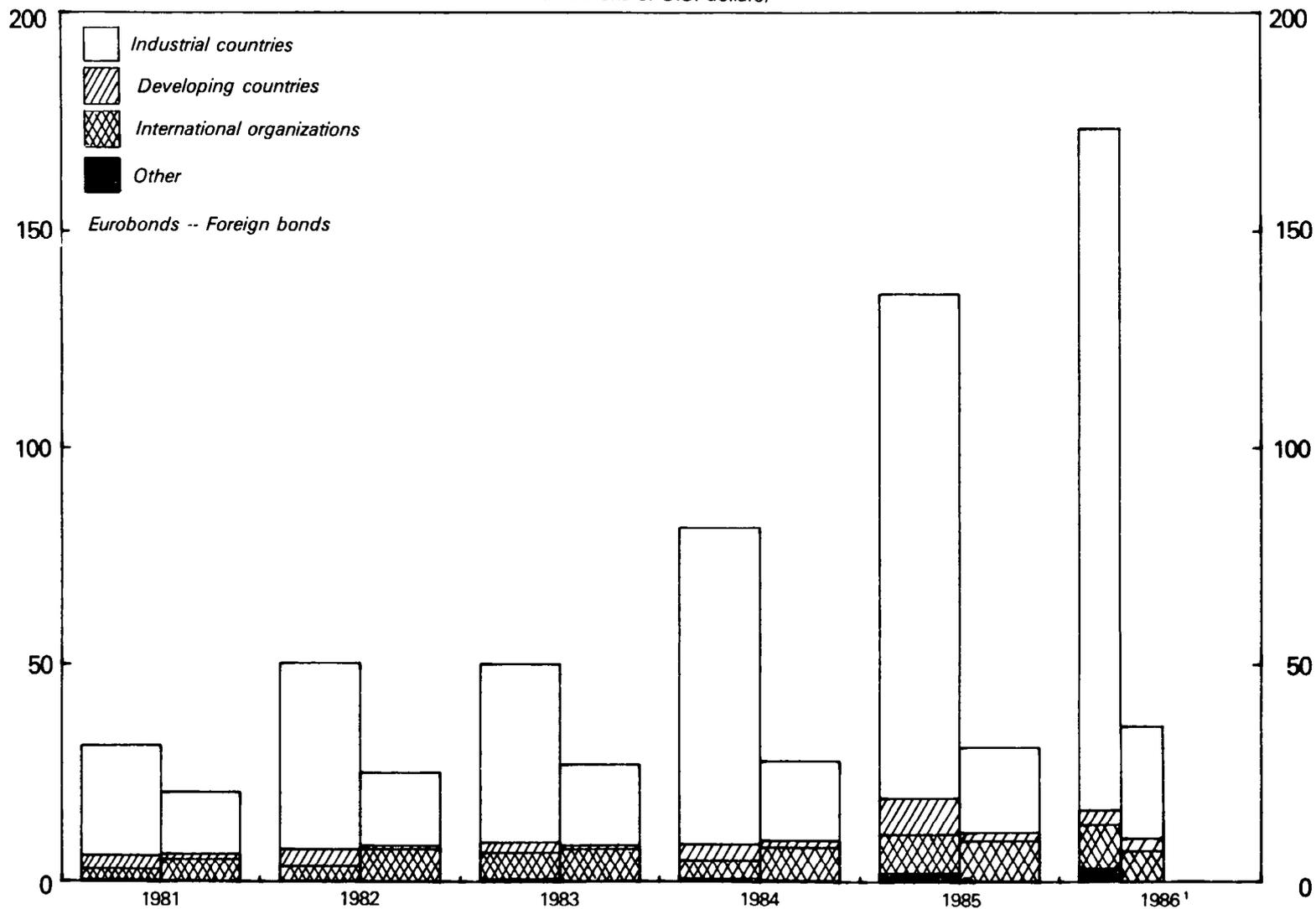


Source: Organization for Economic Cooperation and Development, *Financial Statistics Yearbook*.
¹ First half annualized.

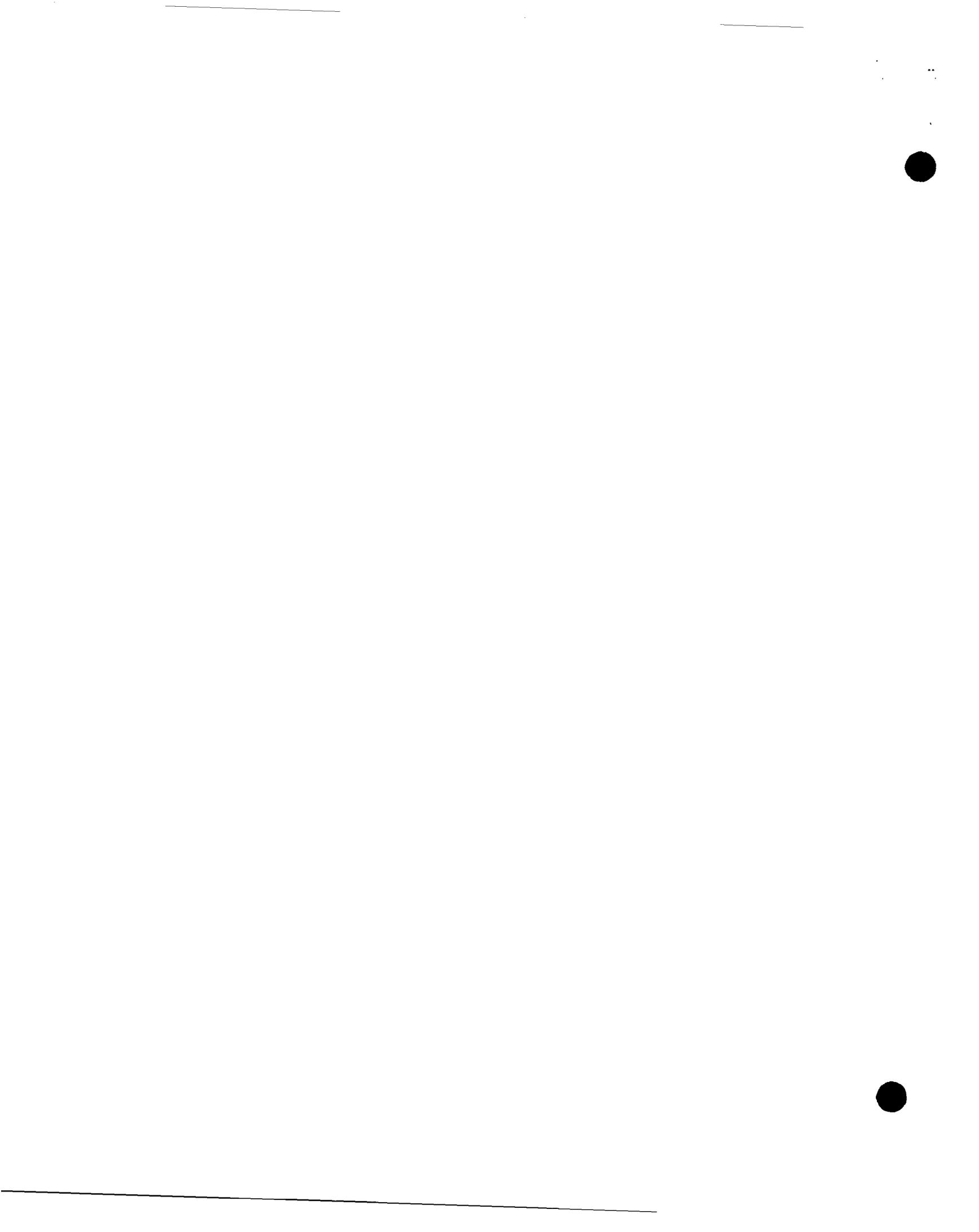


CHART 6
**INTERNATIONAL BOND ISSUES AND PLACEMENTS
 BY GROUPS OF BORROWERS, 1981-FIRST HALF 1986**

(In billions of U.S. dollars)



Source: Organization for Economic Cooperation and Development, *Financial Statistics Monthly*.
¹ First half annualized.



8 percent. The dollar-equivalent volume in the deregulated international deutsche mark bond market grew by 22 percent, while the domestic deutsche mark bond market grew by only 4 percent in 1985.

The geographical distribution of borrowers in the aggregate external bond markets has not changed much during the last several years, with borrowers from industrial countries accounting for about 84 percent in 1984 and 87 percent in 1985. Developing countries increased their access to the bond markets from \$5.2 billion in 1984 to \$10.2 billion in 1985 (Statistical Supplement Table 15 and Chart 6). International organizations borrowed \$12 billion in 1984 and \$19 billion in 1985 in the international bond markets (Table 7). Borrowing by U.S. residents rose from \$25 billion in 1984 to \$41 billion in 1985; while most of this new borrowing (\$29 billion in 1985) took place in the Euro-dollar market, there also was a significant amount of new borrowing in the Euro-yen market, mainly in the form of dual currency issues.

Japanese residents borrowed about \$21 billion on the international market in 1985, much in the form of equity-related issues that frequently are resold to Japanese institutional investors. Borrowing on the external yen bond market doubled in volume during 1985. Most of this increase was in the Euro-yen market which experienced a five-fold increase to ¥ 1,525 billion, half of which were in the form of dual currency issues. The volume of new issues on the Euro-yen market surpassed for the first time the volume of samurai issues, i.e., foreign yen-denominated issues in Japan. The expansion of the Euro-yen market continued in the first half of 1986 when new issue volume grew by ¥ 1,467 billion.

The Euro-yen market is largely made up of borrowers from industrial countries (who frequently swap their yen proceeds against domestic currency or U.S. dollars) while the samurai market is made up of international development organizations (35 percent), developing countries (20 percent), and borrowers from industrial countries (45 percent). The traditional samurai market was supplemented in 1985 by the so-called shogun market (\$700 million), i.e., a market for nonresident issues denominated in a non-yen currency.

Nonresident borrowing on the Swiss bond market grew by 18 percent to an historical high of Sw F 36 billion in 1985 and it grew by Sw F 23 billion during the first half of 1986 (Swiss authorities do not permit an external Euro-Swiss franc market). Japanese borrowers accounted for 40 percent of total nonresident issues with 60 percent of Japanese issues being equity-related.

The issue of external DM-denominated bonds in 1985 was greatly influenced by the implementation of liberalization measures during the same year, which resulted in a 65 percent increase in the volume of new issues to DM 32 billion in 1985 and to DM 21 billion in the first half of 1986. Among the newly authorized instruments, the floating rate notes were the most successful with 27 percent of total issues occurring

Table 7. Gross International Bond Issues and Placements by
Groups of Borrowers, 1981-First Half 1986 1/

(In millions of U.S. dollars)

	1981	1982	1983	1984	1985	1st Half 1985	1st Half 1986
Foreign bonds							
Industrial countries	14,145	16,854	18,693	18,299	19,726	8,092	12,994
Developing countries	1,212	726	894	1,618	1,909	862	1,442
Centrally planned economies <u>2/</u>	--	--	--	--	--	--	--
International organizations	5,030	7,461	7,269	7,580	9,114	4,423	3,532
Other	127	158	194	303	277	73	25
Total foreign bonds	20,514	25,199	27,050	27,800	31,026	13,371	17,993
Eurobonds							
Industrial countries	25,210	42,816	41,015	73,145	116,228	59,177	78,524
Developing countries	3,215	3,970	2,382	3,646	8,329	4,096	1,729
Centrally planned economies <u>2/</u>	30	--	--	--	--	--	--
International organizations	2,486	3,280	6,074	4,218	8,913	4,603	4,982
Other	352	264	627	709	1,961	670	1,506
Total Eurobonds	31,324	50,330	50,098	81,718	135,431	68,547	86,742
International bonds							
Industrial countries	39,355	59,670	59,708	91,444	135,954	67,269	91,518
Developing countries	4,427	4,696	3,276	5,264	10,238	4,958	3,172
Centrally planned economies <u>2/</u>	30	--	--	--	--	--	--
International organizations	7,516	10,741	13,343	11,798	18,027	9,026	8,513
Other	479	422	821	1,012	2,238	743	1,532
Total international bonds	51,807	75,529	77,148	109,518	166,457	81,918	104,735

Source: Organization for Economic Cooperation and Development, Financial Statistics Monthly.

1/ The country classifications are those used by the Fund. Excludes special issues by development institutions placed directly with governments or central banks and, from October 1984, issues specifically targeted to foreigners.

2/ Excluding Fund member countries.

in this market in 1985. The volume of zero-coupon bonds issued, on the other hand, remained modest (DM 1.7 billion). The group of major borrowers consisted of international organizations (DM 4.8 billion), U.S. borrowers (DM 3.1 billion), Japanese borrowers (DM 2.2 billion), and Swedish borrowers (DM 2.0 billion). Three developing countries (China, Malaysia, Korea) issued a total of DM 1.8 billion (Statistical Supplement Table 16).

The international bond markets have provided the field for innovations in instruments and issuing techniques. The volume of zero coupon bond issues rose from \$1.7 billion during all of 1984 to \$3.6 billion during the first half of 1986. Innovation in the coupon reset mechanism led to the introduction of the mismatched floating rate notes in 1984. A mismatched floating rate note has multiple dates for resetting interest rate dates within a single interest payment period; thus, the interest payment may be made semiannually, whereas the interest rate is reset at shorter intervals, e.g., monthly. Approximately 20 percent of all floating rate note issues were mismatched during 1985. The floating rate note market also saw the introduction of perpetuals, which accounted for 12 percent of new issues in 1984 and 16 percent during the first half of 1986. In 1985 almost 80 percent of perpetual floating rate notes were issued by U.K. banks in an attempt to increase their capital for supervisory purposes.

An area of substantial innovative activity has been asset-backed finance in the form of securities backed by mortgages, receivables, or export proceeds. Instead of funding by raising debt or equity, corporations have resorted to the sale of instruments collateralized by their assets. Typically, the assets are put into a trust and used as collateral against floating rate notes. This structure has permitted borrowers to reduce their borrowing costs by enhancing the creditworthiness of their bonds. Similarly, certificates of receivables have been issued by corporations. Such techniques have generally been successfully employed when some of the assets of the firm command a higher credit rating than the company itself.

e. Developments in international equity markets

An important development in international financial markets during 1985 and 1986 has been the growth in international equities and equity-related issues. The definition of international equities is less straightforward than the definition of international bonds because equities are normally categorized by method of issue rather than by type of instrument issued. Euro-equities--issues floated outside domestic markets by way of a Eurobond type of syndication and distribution--are issued in bearer form (Bearer Participation Certificates) and are outside national equity listing regulations. The currency denomination is chosen by the issuer. All other types of international equity issues fall in with the category of foreign equities, such as equity issues floated simultaneously in several established and regulated domestic markets. Although individual tranches are issued in the individual mar-

kets to satisfy national regulations, the equity stock is normally fully fungible among the various markets.

International equities may also be created by transforming registered stock into a form that can be traded in a foreign market as a domestic instrument. The most popular method is the creation of American Depository Receipts (ADRs). Shares are issued by the depository, usually a U.S. bank, against a stated number of foreign securities held by the depository. The SEC requires the registration of ADRs and, in some cases, of the underlying shares. Firms wishing to raise additional equity capital in the U.S. are required to issue sponsored ADRs, in this case, the depository enters into a contract, the deposit agreement, under which the depository issues new ADRs listed on a national exchange.

Unsponsored ADRs resemble a secondary market transfer within the fixed volume of outstanding equity. The issue of unsponsored ADRs is frequently driven by investors' desire to avoid domestic stock exchange turnover taxes. In addition, the ADR format circumvents national provisions prohibiting local companies from establishing a share registry outside their national jurisdiction, as does the U.K. Companies Act; the advantage of the ADR format to investors is their status as local instruments to which restrictions on purchase of foreign registered securities does not apply. Thus, the issuance of international equity has been motivated by the possibility of broadening the market for the issue, of obtaining a lower issuing cost by avoiding regulatory or fiscal requirements, and of exploiting differences in price-earning ratios across various markets.

The volume of new issues of Euro and foreign equities (excluding ADRs and equity-related bonds) has grown rapidly in recent years to \$2.8 billion in 1985 and \$1.2 billion in the first quarter of 1986. Of this amount, about \$1.0 billion of Euro-equity was issued in 1985. Swiss corporates accounted for 99 percent of new Euro-equity issues in 1985. These issues generally found their way back into the portfolios of domestic investors. Total ADR issues are estimated at around 600 covering 20 different countries, data on the volume of ADRs is not yet available as the amount of equity held in this form has fluctuated widely over time due to fungibility. United States corporates were the largest borrowers in the foreign equity market with \$615 million of new issues, followed by German and Dutch borrowers with \$290 million and \$200 million, respectively.

Among types of equity-related issues are convertible Eurobond issues allowing for the conversion of bonds to equity that is fully fungible with the original equity stock. Similarly, equity warrants give the bond holder the right to subscribe at a predetermined price within a fixed period, with the new equity being again fully fungible; this method of issuing new equity has been employed to avoid local restrictions in the form of pre-emption rights. The market for equity-related issues (convertibles and bonds with warrants) grew from

\$10.9 billion in 1984 to \$11.4 billion in 1985, and accelerated to \$10.2 billion in the first half of 1986 (Statistical Supplement Table 17). Japanese borrowers accounted for 60 percent of all equity-related issues, and 67 percent of equity-related issues are denominated in U.S. dollars. Such equity-related bonds are frequently resold to Japanese institutional investors.

f. Hedging instruments

A recent deepening of the market for financial futures and financial options has significantly increased the scope for financial and nonfinancial firms to hedge risk associated with open financial positions. A financial futures contract conveys the right and the obligation to purchase an underlying financial instrument at an agreed price on a specified date. A financial option conveys the right but not the obligation to buy (call option) or sell (put option) an underlying financial instrument at a predetermined price on (European option) or before (U.S. option) a specified date. The development of interest rate futures and options has been complemented by the introduction of currency options and futures. Interest rate and currency futures and options are traded at exchanges in most of the major financial centers (Statistical Supplement Table 18). In addition to the standardized options traded on organized exchanges, there exists over-the-counter trade in options in most financial centers.

The number of different contracts and the volume of contracts traded on the exchanges has expanded significantly. The total open-interest positions in all interest-rate futures contracts at the Chicago exchanges grew from \$66 billion at the end of 1981 to \$192 billion at the end of 1985, with most of the growth being accounted for by futures contracts in Euro-dollar deposits, which grew from \$1.5 billion to \$121.0 billion over the same period (Statistical Supplement Table 19). Similarly, the total face value of open positions in interest rate futures on Euro-dollar deposit traded on the London International Financial Futures Exchange (LIFFE) grew from \$5.2 billion at the end of 1983 to \$21.2 billion at the end of 1985 (Statistical Supplement Table 20).

The total face value of outstanding interest rate options (on three-month Euro-dollar deposits) stood at \$60 billion on the Chicago Mercantile Exchange and at \$4 billion on the LIFFE at the end of January 1986 (Statistical Supplement Table 21). The outstanding value of options traded over the counter is estimated by industry sources to be of the same order of magnitude as the volume of options traded on the exchanges. The average maturity of options outstanding lies between two and six months. Options have enjoyed greater popularity than futures since the potential loss incurred by the holder from adverse movements in the price of the underlying instrument is limited to the purchase price of the option.

Options have generally been written by commercial and investment banks in response to demand by their commercial customers, who seek to hedge an open position in the underlying security. Branches of foreign banks in international financial centers usually write options against the currency of their home countries. The market for OTC currency options is partly retail, consisting of nonbank customers purchasing options contracts to insure themselves against adverse exchange movements, and partly wholesale, consisting of commercial and investment banks trading options to bridge or reinsure the risk incurred in writing options for their customers.

In addition to options and futures contracts, bond issues frequently have contingent features such as interest rate caps or floors on floating rate notes, prepayment or extension provisions, warrants, and equity-related features such as convertible bonds and equity warrants. A currency option bond allows the bond holder to change the currency denomination of the face value of the bond. The advantage of issuing bonds with contingent features is that such features can be securitized by detaching them from the bond and selling them separately. For example, while the borrower pays a higher coupon on capped floating rate notes, the proceeds from the sale of the cap in isolation more than compensate the borrower for the higher coupon rate. In 1985, about 10 percent of all floating rate notes issued were capped and bonds with equity-related contingent features accounted for 7 percent of total bond issues. In the first half of 1986, bonds with equity-related features rose to 10 percent of total bond issues.

A variant on the financial futures contract is the forward rate agreement (FRA) specifying the interest rate to be paid on a deposit of specified maturity at a fixed future settlement date. On settlement day, the difference between the agreed interest rate on the floating rate note and the reference rate, usually LIBOR, applied to the principal determines the value of the contract. About 90 percent of FRAs are denominated in U.S. dollars. The principal dealers are large banks seeking to hedge loan commitments. The FRA market is largely an interbank market with a turnover volume approaching \$10 billion per month.

The introduction of longer-term interest rate and currency swaps has recently complemented the set of short-term hedging and arbitrage instruments. The basic interest swap is an exchange between two counterparties of a fixed interest rate cash flow for floating interest rate cash flows in the same currency; the principal amount remains with the original parties, only the interest payments are swapped. A currency swap is an exchange of interest payments in one currency for interest payments in another currency. In this transaction, the parties also exchange the principal amounts at a negotiated exchange rate. The currency coupon swap combines the interest rate swap with a currency swap.

Currency swaps allow borrowers to hedge exchange risk over maturities extending beyond those available in the currency options or futures markets. Swaps of both types allow for the arbitrage across debt instruments having differing relative scarcity in different markets. Investors in fixed rate instruments generally demand greater creditworthiness of borrowers than investors in floating rate instruments. Hence, two borrowers of differing creditworthiness will be able to reduce their respective borrowing costs by accessing the market in which they enjoy an advantage and then swapping the interest payments. As a result of such cost advantages many high-quality borrowers have issued fixed rate Eurobonds and used swap transaction to acquire floating interest rate funding at a cost below LIBOR.

The growth in currency swaps is partly due to the increased opportunities created by financial deregulation and liberalization in Germany, Japan, and Switzerland. The volume of currency swap-driven primary issues in 1985 expanded to \$20 billion or triple the volume in 1984. Interest rate swaps rose to \$170 billion in 1985. The portion of new nondollar issues that were associated with a swap (i.e., swap-driven) rose from 1 percent in 1981 to 25 percent in 1985. This development was particularly evident in the growth of yen-denominated issues, which accounted for 28 percent of total swap-driven new issues in 1985 as compared with 5 percent in 1984. The U.S. dollar accounted for 19 percent of swap driven issues in 1985. Borrowers (of U.S. dollars and yen) represented nearly half of the swap market in 1985. In some smaller countries the volume of swap-driven transactions has grown to represent a significant portion of the domestic market. In particular, the growth in the Australian and New Zealand markets in 1985 was largely swap-driven; about 60 percent of Australian and 85 percent of New Zealand dollar bonds were swapped.

2. Liberalization in selected financial centers

This section reviews the implementation of measures to liberalize financial markets in the selected financial centers.

a. France

The French authorities have undertaken extensive financial liberalization during the past two years. There has been a substantial deepening and broadening of domestic capital markets through the introduction of new financial instruments and borrowing techniques. Implementation of a new Banking Law in 1984 brought diverse credit institutions under a single supervisory structure. The authorities have also acted to relax exchange controls. French investors in non-French franc securities are no longer required to pass through the devise titre to buy and sell foreign currency for investment purposes. French authorities have announced their intention to abandon quantitative controls on credit (encadrement du credit) by 1987, in favor of interest rate management in their conduct of monetary policy.

In 1985, French authorities reopened the Euro-French franc bond market. Euro-French franc bonds can now be issued by nonresidents and be purchased freely by French residents (though they may not be offered to French investors at the time of issue or listed on the Paris Stock Exchange). Euro-French franc bond issuers have been exempted from the 10 percent withholding tax applied in the domestic market. Foreign banks are allowed to act as co-lead underwriters, and currency swaps and convertible issues are possible in this market. The number and volume of new Euro-French franc issues has been restrained by a monthly ceiling, which is gradually being raised.

The range of financial instruments available in domestic securities markets has broadened since 1982 as the regulations governing the management, portfolio composition, and fiscal status of mutual funds have been relaxed. Mutual fund assets quadrupled from 1982 to the end of 1985, when they reached FF 644 billion, about half of which were concentrated in money-market mutual funds. The money-market SICAVS (Societe d'Investissement a Capital Variable), whose proceeds are invested in floating rate and short-term bonds and short-term treasury issues, accounted for about 70 percent of all money-market mutual fund assets, the remaining 30 percent being accounted for by the smaller and more specialized FCPs (Fonds Communs de Placement).

In addition, French banks began issuing negotiable certificates of deposit in March 1985, the first such issue to be launched in continental Europe. The maturity on these securities ranges from three months to two years and they are mostly held by banks. In December 1985, commercial paper (billets de tresorerie) with maturities ranging from ten days to two years was introduced with the requirement that such paper must be backed by a stand-by line of credit with a bank. The commercial paper market permits French corporations to manage their liquidity with a marketable short-term instrument. The rate of return on these securities is set in relation to the Paris interbank market.

Short-term Treasury securities (bons du Tresor negociables) were made available in 1986 to nonbanks and banks. These securities have fixed coupons and range in maturity from ten days to seven years. Among the instruments and issuance techniques introduced in the longer-term bond market are a series of zero-coupon bonds issued by the Treasury in 1986, perpetual floating rate securities, and extendable bonds. The Treasury has employed the auction technique to raise funds in the long-term bond market. The bons du Tresor negociables, combined with conventional government bonds, provide a complete maturity spectrum of government obligations, thus allowing for the hedging of trading strategies in this market.

The rapid growth of the domestic bond market made possible the opening of a financial futures market (the marche a terme d'instruments financiers or MATIF) in March 1986, providing forward hedging contracts on the basis of a notional long-term government security. A domestic

13-week Treasury bill futures contract was introduced on the MATIF in June 1986.

The Paris Stock Exchange partly replaced a fixed commission schedule with negotiated brokerage commissions in July 1985 and is planning to introduce continuous trading in listed stocks and bonds by late 1986. Negotiated brokerage commissions have replaced a fixed commission schedule since July 1985. The liberalization of the stock exchange was in part due to the growth in international trading of European depository receipts in major French stocks and in part to the increased need of banks and corporations to raise capital in anticipation of their denationalization, which is scheduled to begin by early 1987.

b. Germany

In Germany several measures were taken to extend the range of available instruments, notably in the securities market, and to facilitate international competition. The 25 percent withholding tax on interest payments on domestic bonds to nonresidents was removed in August 1984. New financing instruments and issuing techniques were introduced as of May 1985. German authorities have also agreed to permit foreign banks with subsidiaries in Germany to lead-manage bond issues when the authorities of the foreign bank extend such privileges to German banks. (This requirement has had the effect of excluding Japanese banks, among others, from lead-managing DM issues.) Furthermore, since June 1986, foreign banks have been allowed to join the German government's bond-issuing syndicate (Bundesanleihekonsortium).

In May 1985, the German authorities permitted the issuance of new instruments such as floating rate notes, zero coupon bonds, bonds with debt warrants, dual currency bonds, and interest rate and currency swaps. Convertible bonds and bonds with equity warrants had already been issued. Among the new instruments, the floating rate note has flourished most, as evidenced by the rapid growth in its issuing volume, which amounted to \$3.2 billion by the end of 1985, accounting for 25 percent of the volume of new issues in all of 1985. Issues of zero-coupon bonds have been somewhat limited, in contrast, due to the tax treatment of interest accruing to corporate investors. The possibility of tapping German debt markets and swapping the proceeds into other currencies has enlarged the range of financing sources to both German and foreign borrowers; it is estimated that more than half of all international bond issues in Germany are swapped.

Access to the German capital markets has also been facilitated by the liberalization of the calendar system. Under this system, a committee of representatives of major German issuing banks and a representative of the Bundesbank had full authority to determine the volume and schedule of issues. As of July 1986, banks need only inform the Bundesbank of their intentions two days before the onset of a semi-monthly period.

Traditional money market instruments in Germany have included primarily central bank balances (Zentralbankguthaben), and discountable Treasury notes, with less relevance being placed on Treasury bills and bankers' acceptances. The newly introduced floating rate notes provide investors with a tradable short-term instrument, thereby serving to deepen the money market. In addition, the German authorities have permitted the issuance of negotiable certificates of deposit as of May 1, 1986, thus further enlarging the range of available money market instruments.

c. Japan

During the past decade the Japanese authorities have undertaken extensive efforts to liberalize their domestic financial markets and cross-border financial activities. At the core of the liberalization of domestic financial markets has been the creation of money market instruments. The introduction in 1979 of negotiable certificates of deposit, subject to a limited competitive floating interest rate structure, the removal of restrictions on the interbank call and bill discount markets, and the growth in the bond and certificate of deposit repurchasing (gensaki) markets has significantly deepened and broadened the domestic money markets. This development has been hastened by the growth of primary and secondary markets for government securities, a consequence of large and persistent fiscal deficits since 1975. By March 1986, the four money-market instruments had reached a total of ¥ 36 trillion. Outstanding bill-discounts increased 74 percent in 1985 to ¥ 12.9 trillion, while certificates of deposit rose 19 percent (to ¥ 10.0 trillion), call money increased 42 percent (to ¥ 6.7 trillion), and Gensaki balances were up 62 percent (to ¥ 6.3 trillion).

The spectrum of domestic money market instruments was broadened with the introduction of money market certificates in March 1985, bankers' acceptances in June 1985, and publicly auctioned discount short-term government refinancing bonds (treasury bills) in February 1986. Among these, the money market certificates, a large-denomination negotiable deposit instrument, had grown within a year to an outstanding amount of ¥ 4.7 trillion in March 1986. The bankers' acceptance, in contrast, totaled only ¥ 40 billion by the end of 1985 because the regulated short-term prime lending rate remained below the money market rates; in addition, the bankers' acceptance is subject to an issue and turnover tax. In October 1985, a bond futures market was opened based on a notional ten-year Japanese Government bond contract.

In March 1986, the Bank of Japan began conducting open market operations using certificates of deposit, whose market is open to participation by financial institutions, corporations, regional governments, and institutional investors. This was the first time in 14 years that the central bank adopted a new method for making monetary adjustments; the move was intended to extend monetary policy to the unregulated money-market sector.

The institutional separation of banking and securities market activities is becoming less clear-cut. Since 1985 banks have been permitted to establish securities subsidiaries overseas. In addition, in June 1985, 34 major banks were authorized to deal in long-term government securities in the domestic market, previously the domain of the securities houses. Bank affiliates and insurance company affiliates have been permitted to set up investment advisory firms, whose entrusted funds totaled ¥ 3.3 trillion in September 1985, as compared with ¥ 4.4 trillion for securities house affiliates. Foreign banks, as well as city banks through their affiliation with foreign banks, were authorized in 1985 to manage pension funds, formerly reserved for trust banks and insurance companies. In addition, securities houses have increasingly competed with banks through investment trusts, which are mutual funds usually administered by subsidiaries of securities houses; the total assets of investment trusts grew from ¥ 7.3 trillion in 1981 to ¥ 20 trillion in mid-1985.

The liberalization of domestic financial markets and of cross-border markets has been occurring simultaneously. Internationalization of the yen has helped to promote arbitrage between the existing regulated interest-rate structure in Japan and the unregulated yen interest-rate structures existing in Europe and growing in Japan. Arbitrage opportunities have been exploited through the use of currency swaps and short-term loans, whereby Japanese companies borrow foreign currency for general capital purposes.

In December 1984, the Euro-yen bond market was opened to foreign corporations and in 1985 to Japanese corporations. In June 1986, access to the Euro-yen bond market was extended to foreign banks (Japanese banks remain excluded), which previously had been restricted to Euro-yen certificates of deposit and swaps for accessing yen-denominated funds abroad. New issue volume in the Euro-yen bond market soared to ¥ 1,525 billion in 1985 (a large portion of which was accounted for by dual-currency bonds), as compared with ¥ 1,433 billion in the much older and established samurai market (domestic market for nonresident issuers). In addition, the maximum maturity of Euro-yen certificates of deposit was extended from six months to one year in April 1986. The Euro-yen bond market remains somewhat insulated from the domestic yen markets, due to a seasoning provision which prevents Japanese residents from acquiring Euro-yen securities for a period of 90 days (reduced from 180 days in April 1986) after issuance. Euro-yen dual currency bonds may not be sold in Japan at any time. In 1985, the first yen-denominated obligations were issued in the United States (Yankee yen bonds).

In 1985 and during the first half of 1986, the Ministry of Finance authorized the issuance of Euro-yen floating rate notes, dual currency bonds, currency conversion notes, zero coupon bonds, and deep discount bonds. These were initially made available exclusively to foreign issuers; although the latter two instruments remain restricted to foreign issuers, the others were later authorized for Japanese issuers as well. Dual currency bonds were authorized for issuance in Japan by for-

eign borrowers in April 1986. Much of the new activity in the Euro-yen market has been swap-driven, with Japanese issuers providing floating rate dollar bonds against the fixed rate yen obligations incurred by foreigners.

In Japan, foreign currency denominated bonds have been issued by non-Japanese residents (shogun bonds) since August 1985, while such bonds issued by residents in Japan (sushi bonds) have been available since 1985. Sushi bonds are counted as non-yen securities for regulatory purposes and are subject to the 25 percent limit on investment in foreign-currency denominated securities by insurance companies; however, sushi bonds, residents' foreign currency deposits, and loans in foreign currencies are excluded from the rule that insurance companies invest no more than 25 percent of their assets in securities (yen and non-yen) of nonresidents. These two 25 percent ceilings replaced in 1986 a 10 percent ceiling on investments by insurance companies in nonresident securities (yen and non-yen).

In early 1986, a tax measure was passed into law in order to facilitate the opening of an offshore banking market in Tokyo. Both Japanese and foreign banks will be admitted to the offshore market, under the requirement that their domestic and offshore operations be strictly separated. This market will be free of withholding tax.

d. United Kingdom

The British authorities are currently undertaking a major regulatory reform and liberalization of financial markets in the United Kingdom. The new reform measures include provisions under the proposed Financial Services Bill to create broader and more efficient markets for the securities and investment industries; and provisions to restructure the Stock Exchange, to reorganize the gilt-edged market, and to further extend the range of domestic money market instruments. The main focus of these measures is to improve the efficiency of the financial system through changes in the regulatory structure which are based on the principle of self-regulation rather than on legislated rules. While these initiatives were prompted primarily by concerns for investors' protection and prudential considerations, the competition between domestic financial markets and euromarkets provided additional incentives for financial reform.

Under the basic legislation, the proposed Financial Services Bill of 1985, the Secretary for Trade and Industry will be empowered to authorize businesses to provide financial services. The power to regulate their activities is to be delegated to the Securities and Investment Board and to several self-regulatory organizations (SROs) covering activities in the securities and investment area, including the Stock Exchange, the National Association of Securities Dealers and Investment Managers, the Association of Future Brokers and Dealers, and the Insurance Broker Registration. Since financial institutions can undertake any of several financial market activities provided they

obtain authorization from the respective SROs, the traditional distinction among financial institutions, such as merchant and commercial banks, is likely to disappear. Foreign financial firms will be authorized under a reciprocity requirement. The gilt-edged market will be supervised by the Bank of England.

Simultaneously, the structure of the Stock Exchange itself is being changed. Under an agreement between the Stock Exchange and the Restrictive Practices Court, fixed commissions will be abolished by October 1986, and the Exchange's operations will be liberalized through the introduction of a new trading system. Since March 1, 1986, nonmembers have been allowed to form new member firms, as well as acquire 100 percent ownership of Exchange members. Hence, commercial and merchant banks are permitted to enter directly into the securities brokerage business. In addition, as of October 1986, stock exchange members can deal directly with investors, i.e., buy and sell securities from their own holdings, as well as act as agents matching buyers and sellers under a negotiated commission structure.

The gilt-edged market will be reorganized to resemble the government securities market in the United States. Primary dealers in gilt-edged securities are to be approved by the Bank of England and the market will be facilitated by interdealer brokers under a negotiated commission structure. In addition to the Financial Services Bill, the authorities introduced a new Building Societies Bill in late 1985 in order to redefine the boundaries separating the activities of building societies and commercial banks, which had eroded during the past decade. Ceilings are to be set on the proportion of assets of building societies that can be placed in investments other than mortgages and on the proportion of funds that can be raised in wholesale markets.

The removal of exchange controls in 1979 effectively unified the Euro and foreign sterling markets. Foreign institutions based in the United Kingdom are authorized to lead-manage foreign sterling issues as long as comparable U.K.-owned institutions enjoy reciprocal rights. The application of the new regulatory environment to activities in the sterling as well as nonsterling markets in the United Kingdom means that the previously unregulated Euromarkets in London may for the first time operate within a national regulatory framework.

The already extensive range of domestic money market instruments, i.e., Treasury bills, negotiable sterling certificates of deposit, short-term floating rate gilt instruments, bankers' acceptances and commercial bills, was supplemented with sterling commercial paper in May 1986. Parliament is considering an amendment to the Banking Act, whereby the issuance of commercial paper will no longer be classified as deposit taking. Commercial paper will be exempted from stamp duty and withholding tax and its issue will not require timing consent from the Bank of England. However, commercial paper may have maturities only from seven days to one year and must have a minimum denomination of £ 500,000.

e. United States

The financial system of the United States was significantly deregulated during the 1980s through the removal of interest rate ceilings on deposit liabilities, the gradual weakening of barriers separating securities and banking markets, and the geographic expansion of banking institutions. Financial markets in the United States have traditionally been free to introduce financial instruments and issuing techniques, as long as these comply with disclosure and fiscal rules. As a result, U.S. financial institutions have been a major source of financial innovation.

The most significant liberalization measure has been the virtual removal of the interest ceiling on deposit accounts, which occurred in response to the development of the negotiable order of withdrawal (NOW) accounts and the growth of money market mutual funds. The Depository Institutions and Monetary Control Act in 1980 provided for the phase-out and eventual elimination of limitations on maximum rates of interest and dividends payable on savings deposits and accounts by depository institutions. In addition, the Garn-St. Germain Act of 1982 authorized depository institutions to offer money market deposit accounts, which had no restrictions on interest rates. As of mid-1986, interest rate ceilings have substantially been eliminated.

A weakening of Glass-Steagall restrictions on underwriting and mutual fund activities of commercial banks occurred in 1982, when the Comptroller of the Currency permitted national banks to conduct brokerage business. Furthermore, the Glass-Steagall Act was widely interpreted as not prohibiting subsidiary relationships between state-chartered banks that are not members of the Federal Reserve System and investment banking firms, thus allowing mutual fund organizations to set up bank or trust companies. In 1983, the Comptroller of the Currency authorized mutual fund organizations to acquire national banks that are members of the Federal Reserve System.

In order to avoid the constraints of the Bank Holding Company Act, some of the bank subsidiaries' business was shed to keep the bank from meeting the definition of a bank pursuant to the Bank Holding Company Act. The Comptroller of the Currency has generally allowed securities firms to acquire such "nonbank" banks despite the Federal Reserve Board's objections. While statutory revision will eventually have to resolve such interagency disputes, there has been a considerable reduction in the barriers imposed by the Glass-Steagall Act between the securities and the commercial banking industries.

Geographic constraints on bank expansion have also been significantly modified. Bank holding companies have been able to establish interstate networks of "nonbank" banks, i.e., consumer finance companies, mortgage companies, etc., that do not both accept deposits and make commercial loans. The acquisition across state lines of failing institutions was authorized in 1982. Several states recently

adopted laws that provide for entry of banks from neighboring states under regional reciprocity, resulting in a substantial increase in the level of interstate banking.

In a major initiative in 1982, the Securities Exchange Commission streamlined access to the primary markets for well-established issuers by implementing so-called "shelf registration" procedures that significantly reduced the time required to bring issues to market. The resolution of jurisdictional disputes between the SEC and the CFTC in the regulation of financial futures and options has now created an environment conducive to the rapid growth of trading in these instruments, which have gained virtually universal acceptance as vehicles for management of interest rate and stock market risk.

In general, the regulatory response to new financing techniques has been of a direct and limited nature, apart from proposals, discussed below, to use risk asset ratios for evaluating capital adequacy. For example, the financing of takeovers with subordinated debt including junk bonds was curtailed with a margin requirement promulgated by the Federal Reserve Board. The U.S. authorities have traditionally allowed foreign financial institutions to participate in U.S. financial markets on an essentially equal footing with U.S. institutions. A withholding tax levied on nonresident holders of bonds issued by U.S. residents in the domestic or Euro-markets was abolished in 1984.

f. Other countries

Several other industrial countries, i.e., Australia, Denmark, Italy, the Netherlands, New Zealand, Sweden, and Switzerland, have undertaken a partial liberalization of financial markets. The advances in this field achieved by the Netherlands and Switzerland are discussed below.

The financial authorities of the Netherlands announced an extensive package of liberalization measures effective January 1, 1986, in order to liberalize their capital markets in line with changes in neighboring countries, such as the Federal Republic of Germany. These principally affect issuing techniques, the characteristics of new issues, and new instruments. The authorities replaced the calendar system for new issues with a system of notification of at least two days and not more than one month before the launching date. As a result, delays experienced in bringing new issues to the market have declined significantly, and the opportunities to swap liabilities have been enhanced.

Restrictions have been removed from the maturity, denomination, and volume of domestic guilder bonds issued. Euro-guilder issues may now be underwritten and listed, as well as have a prospectus. Foreign banks also are permitted to lead-manage Euro and domestic guilder issues and underwrite up to one third of offerings if the bank has a capital market presence in Holland and reciprocity exists between their countries of origin and Holland. The distinction between a domestic and the Euro-

guilder market has, therefore, become inconsequential. Generally, the financial authorities treat foreign and domestic banks alike.

New instruments authorized as part of the liberalization package include floating rate notes, for which the Central Bank publishes daily the Amsterdam Interbank Offered Rate. Zero coupon bonds remain prohibited for fiscal reasons, but bullet maturities have been introduced, and debt and equity warrants are now authorized. Index-linked loans continue to be prohibited for counterinflation policy reasons. Guilder commercial paper may now be issued, distributed through brokers, and continuously offered to investors. The Nederlandsche Bank has offered to act as a clearing house for commercial paper. The stock exchange tax has been abolished for certificates of deposit and commercial paper. Futures and options have for some time actively traded (including in ECU) on the Amsterdam exchange. The Dutch financial markets are free of interest rate, credit, and exchange controls.

The financial markets in Switzerland have traditionally been international markets and have remained open to foreign borrowers since 1963. There has not been a calendar for new issues since 1984. However, the Eurobond Swiss franc market has been required to remain within Swiss jurisdiction, as capital export transactions denominated in Swiss francs can only be carried out by banks domiciled in Switzerland. The maximum admissible size of public issues was recently doubled to Sw F 200 million, and there has been some liberalization of the rules governing the issue of, and investment in, private placements denominated in Swiss francs, thereby blurring the financial distinction between public issues and private placements. However, there remains a stamp duty on newly issued securities totaling 0.615 percent.

In principle, the method and form of raising capital has not been restricted, but Swiss markets have been selective in adopting new issuance techniques and instruments. Swiss markets have adopted convertible and option bonds, dual-currency bonds, perpetual bonds, zero coupon bonds, and bonds with swap clauses. Note issuance facilities and floating rate notes have been hampered by the start-up duties and minimum maturity requirements.

3. Sources and implications of recent changes

a. The causes of liberalization and innovation

Liberalization measures in major financial markets have been concentrated in three main areas--interest rate liberalization, relaxation of exchange controls, and permission to introduce new instruments. The removal of interest rate ceilings on deposit liabilities was effected for a variety of reasons. In some countries market interest rates rose relative to regulated interest rates, causing disintermediation from the banking sector into the securities markets, in particular into money-market and bond-market mutual funds. Similarly, the need to finance large fiscal deficits created secondary markets in

government bonds in some countries, placing pressure on regulated interest rates. In addition, concerns about the efficient allocation of loanable funds in financial systems relying in part on regulated rates has contributed to the willingness of the authorities to abandon administered interest rates in favor of market-determined rates.

Relaxation of barriers to international competition in financial intermediation in several industrial countries has significantly reduced or eliminated the financial distinction between foreign and domestic borrowers and investors. Measures taken include removing withholding taxes on interest income accruing to nonresidents, extending the availability of domestic financial instruments to nonresident borrowers and allowing domestic borrowers to access the international financial markets. Foreign ownership of domestic financial institutions has been liberalized and foreign institutions are increasingly allowed to lead-manage securities issues, as well as to acquire membership on stock exchanges. Such liberalization has been undertaken to increase the efficiency of domestic financial markets by exposing them to competition from international markets. A further motivation for liberalizing cross-border activities has stemmed largely from the desire of major industrial countries to retain or regain a role in international financial markets in line with the importance of their economies in the world economy.

The introduction of new types of financial instruments and issuance techniques has been authorized in order to allow borrowers, investors, and financial intermediaries to reallocate risk among themselves. Examples of such instruments are floating rate instruments, stand-by facilities, and hedging instruments (forward, futures, and options contracts). Other instruments have been introduced to permit the domestic banking sector to fund itself competitively (e.g., certificates of deposit), or to ensure that domestic markets are not at a disadvantage vis-a-vis international markets (e.g., swap-driven bond issues, equity-related issues, zero-coupon issues). In addition, a concern to foster competition and reduce intermediation costs has led to the introduction of additional money market instruments (commercial paper, mutual funds, repurchase agreements) and has stimulated reforms of commission structures and stock exchanges. As a result, the regulatory environment has had to be adjusted increasingly frequently in order to prevent the competitive advantages or disadvantages associated with the different regulatory environments from leading to imbalances in market shares among the various financial sectors, i.e., to re-establish a level playing field.

Market incentives for innovative instruments and techniques may be attributed in part to opportunities to avoid or reduce the costs of regulatory restrictions and the taxes on financial activity through the use of new instruments or issuing techniques. Another market factor motivating innovation has been the intensification of competition among financial firms. In this connection, technological advances have promoted competition by making it increasingly feasible to separate the

location of financial activity from the location of the underlying real economic activity, as well as to separate the location of final investor from final borrower.

A further motivation for innovation has been the opportunity for investors to improve their risk-return trade-off possibilities through instruments targeted to new sources of funds or instruments designed to hedge, arbitrage, or reallocate market and credit risk. Finally, a general tightening of balance sheet capital requirements has increased the incentives for banks in many industrial countries to employ new techniques to conduct off-balance sheet financing activities.

Innovations can generally be classified as risk transferring, liquidity enhancing, or credit or debt creating. Risk transferring innovations have occurred in the area of hedging instruments, such as options, swaps, and various other contingent contracts which transfer risk at a market price. Floating rate instruments transfer interest rate risk from the bank investor to the borrower. Similarly, stand-by facilities for the issuance of short-term paper shift funding risk from the issuer to the bank for a fee. New types of insurance contracts, e.g., on swaps, have been employed to shift credit risk. Such voluntary reallocation of risk among market participants may have resulted in a more efficient allocation of risk. Finally, innovations including the multiple option Euro-note facility, Euro-equity issues, and swaps, have facilitated arbitrage of yields and perceptions of creditworthiness between markets.

Liquidity-enhancing innovations in financial markets have come in the form of new marketable securities, principally in short-term markets. In addition, the growth of stand-by facilities has underpinned the liquidity of short-term debt paper, and the increased volume of organized exchanges for contingent contracts has rendered such contracts more liquid. The collateralization of new liquid instruments with existing nontradable assets has de facto made such assets tradable. Furthermore, the introduction of new instruments, the growth in short-term government debt markets have greatly enhanced liquidity.

Credit-generating innovations have permitted borrowers to tap new sources of credit by developing instruments acceptable to those new portfolios, e.g., asset-backed instruments, junk bonds, credit lines backed by home equity, equity participations, thereby generating new financial flows in debt and equity markets. In addition, innovative instruments have expanded credit markets geographically, as in the case of swap-driven transactions.

The liberalization and innovation which have taken place in financial markets during the past two years have induced significant structural changes in the form of securitization of credit flows and the desegmentation and globalization of financial markets. The securitization of international credit flows occurred with the disintermediation of lending from the banking sector to the marketable debt sector. In

the first half of the 1980s the share of marketable debt in total new international credit grew from 31 percent in 1980 to 70 percent in 1985.

Securitization of international financial markets has been spurred largely by a relative reduction in the cost of funding through security markets compared with the cost of funding through bank credits. Bank lenders have also increasingly participated in the international securities markets by buying and selling securities and by increasing the negotiability of their loan assets. For example, the total holding by banks of international bonds and other long-term securities rose from \$47 billion in 1981 to \$158 billion in 1985. At the same time, the volume of securities issued by banks in international credit markets rose from \$5 billion in 1981 to \$45 billion in 1985 (excluding certificates of deposit).

Domestic financial markets have become less segmented due to deregulation, increased competition, and the introduction of new products. In particular, the barriers between banking and securities markets have been blurred through regulatory changes, the securitization of bank assets, and increased bank participation in capital markets. The increased tradability of instruments and the availability of options have diminished the segmentation of markets arising with differences in maturity of instruments, while the use of dual currency bonds, currency option bonds, and swaps has diminished segmentation arising with differences in the currency of denomination. The distinction between debt and equity instruments has also been weakened by the use of equity-related instruments and the issue of debt of indefinite maturity.

The pace of change has not been uniform across countries, reflecting to a large extent upon the existing differences in institutional structures. Countries in which the banking sector has been regulatorily separated from the securities sector are generally witnessing more competition among financial sectors and more pressure for removing restrictions. Nonetheless, the liberalization of financial markets and the innovation in these markets have proceeded simultaneously and to a considerable extent in reaction to each other. Financial markets have become more globalized with the liberalization of cross-border financial activities and the expansion of foreign institutions inside domestic markets. This trend has been confirmed by the growth in international equity issues and the beginning of continuous global trading.

b. The Cross Report and the implications of recent changes

In response to the growth in new financial instruments and to concerns over their effect on financial policy, central banks of the Group of 10 set up a study group in early 1985, chaired by Mr. S.Y. Cross (Senior Vice President, Federal Reserve Bank of New York), to examine the nature of "Recent Innovations in International Banking;" the study group published its findings in April 1986. The Cross Report identified three potential areas of concern resulting from the securitization of

credit flows and globalization and desegmentation of financial markets: diminished transparency with regard to financial conditions; increased uncertainties associated with the use of monetary policy; and increased difficulties in achieving effective supervision of financial markets.

Recent structural changes in international financial markets have reduced both the coverage and the usefulness of currently available international and domestic financial statistics. The securitization of credit flows has meant that a growing proportion of financial flows bypasses the banking sector which has been the traditional source of data in the current reporting system. While the nationality, currency of denomination, and other characteristics of gross new international bond issues have recently become more readily available, information on the characteristics of the outstanding stock of international bonds remains incomplete. In addition, it is not possible to obtain information on the ownership of new or outstanding international bonds. This problem has been made worse by the increasing marketability of bank loans, for example, through the introduction of transferable loan certificates.

The growth in off-balance sheet activities in the banking sector has made measurement of financial exposure particularly difficult in this sector. The displacement of syndicated lending by the issuance of short-term paper under Euronote or Eurocommercial paper programs has further eroded the share of international financial transactions covered by current reporting systems, except when such paper is purchased by banks. These developments have tended to obscure data on credit flows to various sectors of the economy and have made it difficult to ascertain the financial exposure of these sectors.

The increased use of swaps, hedging instruments, and various stand-by agreements has tended to make assessment of financial exposure of various sectors of an economy less reliable. The use of such instruments has variously altered the currency composition and the credit and market risk associated with reported financial positions. Thus, the information content of the available financial statistics has been reduced and its usefulness to monetary authorities responsible for the conduct of financial policy has been impaired.

While desegmentation and globalization of financial markets have contributed greatly to competition in financial markets worldwide and thus have increased the allocative efficiency of financial markets, these two trends are posing a significant challenge to authorities responsible for the conduct of monetary policy. The process of financial innovation has generally reduced the information content of money and credit aggregates in some countries. The introduction of new transaction-type instruments with market-related interest rates has made it necessary from time to time to redefine targeted monetary aggregates in order to maintain a stable statistical relationship between targeted aggregates and nominal spending variables. In addition, the growth in off-balance sheet activities by banks and the expansion in the use of

international financial instruments has weakened the statistical link between domestic credit aggregates and nominal spending aggregates.

A second effect of the structural changes in financial markets on monetary policy has been the increased importance of interest rates relative to direct allocation of credit as a mechanism for transmitting the effects of monetary policy to the economy. In particular, the deregulation of interest rates, the increased use of floating rate instruments, the securitization of banks' assets, and the development of secondary markets has meant that changes in monetary policy have been transmitted more readily through changes in interest rates rather than through availability of credit to specific sectors of the economy. Thus the effects of monetary policy have become more evenly spread and the monetary authorities have lost some of their ability to influence the availability of credit to selected sectors of the economy.

A third effect of the structural changes in financial markets on monetary policy has been the increased mobility of capital arising from the globalization of financial markets. The gradual liberalization of cross-border financial transactions has increased the interest sensitivity of capital flows. The introduction of new instruments such as currency swaps, multi-component note issuance facilities, and Euro-equity issues has facilitated arbitrage between international markets and thus furthered the transmission of disturbances from one national market to another. It is also likely that the increased mobility of capital has--for many countries--increased the magnitude of changes in the exchange rate relative to the changes in interest rates that arise with changes in monetary policy. The consequence of such changes in the exchange rate may limit the role of discretionary monetary policy in obtaining domestic policy objectives.

While, on the one hand, desegmentation and globalization may have reduced the information content of monetary aggregates, increased the role of interest rates as a transmission mechanism, and increased the interest sensitivity of capital flows it has, on the other hand, facilitated the implementation of monetary policy through market measures. In particular, the broadening and deepening of domestic money markets has allowed monetary authorities in some countries (e.g., France and Japan) to rely more on open-market or discount operations rather than credit controls. In addition, the growth in domestic money markets has made it possible for some monetary authorities (e.g., Germany) to supplement discount operations with open-market operations in the form of repurchase agreements.

The Cross Report notes that while financial innovation has in many respects improved the efficiency of international financial markets, changes in the activities of banks and other financial institutions that have both driven and resulted from innovation may have heightened financial market vulnerability and complicated the task of financial market supervision.

Banks have moved increasingly to capital markets activities, many of which have been conducted off-balance sheet and have not been subject to capital requirements. The Cross Report cautions that the rapid growth in financial institutions' ability to transform risk may have led to an underestimation of total risk in the system and an underpricing of new instruments. Systematic underpricing of financial transactions would mean that the earnings generated by such transactions were insufficient to protect participants from the risks of the transactions, as they provided insufficient resources with which capital could be increased against risk of loss.

A common feature of many innovations is that they allow creditors to "unbundle" risk--that is to separate market and credit risk--and to adjust risk profiles more finely than was possible before. For well-informed and well-managed institutions, such increased flexibility may be beneficial, while for the financial system as a whole it may be seen as increasing allocative efficiency. Moreover, the move toward tradable assets may also obscure the underlying level of liquidity risk in the banking system. Banks that hold securities rather than loans may believe that they will be able readily to liquify such assets. However, the ability to do so could be seriously impaired at just the time when holders are likely to want to--when there is doubt about the underlying creditworthiness of the debtor, but when other holders are also trying to sell their securities. Moreover, the quality of banks' assets would determine if high-grade loans are securitized and sold.

To the extent that credit flows are channeled increasingly through capital markets rather than banks, the international banking system could become less responsive to sudden increases in liquidity demand and less able to withstand shocks to the systems. The Cross Report notes that central banks may find themselves increasingly expected to assume some form of residual responsibility for nonbank financial conglomerates, whose international operations often straddle the boundaries of responsibility of different regulatory and supervisory bodies within and across countries.

c. Supervision in adaptive markets

The recent changes in capital markets pose a challenge for supervisors in assessing banks' capital adequacy and liquidity; in judging the overall impact on risk concentration in the system of new instruments--including the impact on nonbanks whose activities have been interlinked with banks; and in defining the boundaries for supervision and associated lender of last resort facilities.

Supervisors have noted that their attempts to regulate one part of the market may often create incentives for banks to expand in less regulated areas, or for nonbank financial institutions to bid successfully for business traditionally carried out by banks. The adaptiveness of today's markets means that supervisory actions may more quickly than in the past create a market response--perhaps in the form of the development of a new instrument--that may reduce the impact of the initial

ruling. In particular, stronger capital requirements in recent years have led banks to search for ways of repackaging risk and building up earnings from off-balance sheet items, which in the past have not been subject to capital requirements.

As regulators have reacted to the recent changes, some have noted that a greater emphasis on supervision, rather than rigid regulation only, can enable supervisory authorities to respond more suitably and appropriately to financial innovation. In the United States there appears to have been, over time, some movement away from regulation toward a more supervisory approach. In the United Kingdom the trend appears to have been in the direction of complementing a supervisory approach with statutory backup.

In response to the challenges posed by market changes, banking supervisors have extended their international coordination, and have indicated the importance of coordination between supervisors of different types of financial institutions and financial markets. In the past year, bank regulators have collaborated in the Basle Supervisors' Committee in studying how they should respond to financial market changes. A key set of issues addressed by supervisors concern the means to extend the progress in raising banks' capital ratios by relating capital adequacy measurements to different types of risk undertaken by banks, both on- and off-balance sheet.

A major development over the past year has been the collaboration between supervisors to improve their knowledge and understanding of the implications of banks' off-balance sheet activities. The Basle Supervisors' Committee has published a report ^{1/} analyzing the nature of the risks involved in the instruments and techniques. The paper has been circulated to supervisory authorities, as well as being available more generally to commercial banks, their auditors, and the general public. It aims to encourage a broadly coordinated supervisory response to the development of off-balance sheet business, that would reduce competitive inequalities between countries. It includes a basic framework for supervisory reporting systems as well as a set of common definitions. In discussions with staff, banks indicated that they found these concepts helpful in analyzing their own risk exposure.

The main conclusion of the paper is that the risks associated with most off-balance sheet activities--broadly, market risk, credit risk and management risk--are no different in principle from those arising from on-balance sheet business. Rather than being treated separately, or excluded altogether from consideration, these risks should be incorporated into banks' overall management of their risk exposure and taken into account by supervisors. Such an integrated approach would also

^{1/} "The Management of Banks' Off-Balance Sheet Exposures: a Supervisory Perspective," Committee on Banking Regulations and Supervisory Practices, Basle, March 1986.

allow banks and others to evaluate more accurately the beneficial impact of off-balance sheet transactions that hedge on-balance sheet exposures.

First, the paper discusses market or position risk, which arises when an institution's open position, or exposure, would lead to losses if the market moved adversely. Liquidity or funding risk--the risk that a bank will be unable to obtain the necessary funds to meet its obligations as they fall due--is analyzed under this heading, as well as foreign exchange and interest rate risk. A brief discussion of the particularly complex measurement of risk involved in options is also included. As far as interest and exchange rate risk is concerned, the report recommends that banks should extend their established procedures for assessing and controlling such risk to off-balance sheet items carrying similar risks.

The report argues that the recent buildup in total commitments--typically carried off-balance sheet--as banks have moved away from traditional lending toward providing underwriting and other back-up facilities, represents a significant additional risk to banks' funding strategies. This, together with uncertainties about the liquidity of the newer markets--for example for options, forward rate agreements, and swaps--should lead banks to take a cautious approach to their liquidity management.

The second type of risk, which is dealt with at more length, is credit risk, which arises when a borrower or counterparty may be unable to meet his obligations. The paper classifies the various types of off-balance instruments by their relative credit risk, using as a yardstick the credit risk involved in a traditional on-balance sheet exposure, such as a loan. When analyzing the new instruments, the report distinguishes between four categories for the purpose of credit risk--guarantees and similar contingent liabilities; commitments; market-related transactions; and advisory, management, and underwriting functions.

Within each functional category, qualitative credit risk weightings--full, medium, or low--are assigned to the different instruments. Thus, for example, both guarantees and performance bonds are analyzed under the category of contingent liabilities but, whereas guarantees are classified as "full" risk, or equivalent to a direct credit substitute, it is suggested that performance bonds should be seen as carrying a "medium" credit risk. The classification system may provide a possible guide to supervisors when determining quantitative weightings to be given to the different instruments in national standards for capital adequacy.

Finally, the paper considers management or control risks which arise when banks fail to apply adequate control and accounting systems to monitor and limit total risk exposure. While risk management is a problem in all banking operations, it may raise particular difficulties in the case of off-balance sheet activities because of the complexity of

many of the instruments, and the absence of the accounting discipline of on-balance sheet exposure.

The Basle Committee noted that the introduction of reporting requirements would be an urgent first step toward the integration of off-balance sheet exposures into overall risk management and capital adequacy standards. Some work is already under way and some of the complex new instruments--such as guarantees--are already being included in supervisory reporting guidelines, but supervisors have said that it may take a number of years before adequate reporting standards are reached.

Partly because of a concern to capture off-balance sheet risks, the use of risk asset ratios for determining capital adequacy is continuing to become more widespread. Such a measure, which assigns different capital weights to categories of assets on the basis of their riskiness, is particularly well suited for the incorporation of off-balance sheet business into capital requirements.

Federal regulators in the United States have circulated a proposal for a risk asset ratio, based on broad categories of borrower (government, commercial, bank), on the residence of the borrower (for example, industrial or developing country government; U.S. or foreign bank), and on the type of instrument. Note issuance facilities would carry a weighting of 50 percent of that of industrial loans. In Japan, the authorities have recently developed a risk asset weighting for banks' international business, which would classify assets mainly by category of borrower, and by type of instrument. A weighting of 30 percent would be applied to borrowing guarantees and medium-term commitments such as NIFs. In France, Germany, and the United Kingdom, where risk asset ratios were already in effect, a weighting of 50 percent has been assigned to NIFs. The Bank of England has also issued a consultative paper on the credit risks arising from off-balance sheet business that closely follows the analysis of the Basle Committee paper.

Supervisors have commented that the risk asset ratio should provide a complementary guide to capital adequacy, and thus yield better information than a gearing ratio alone. However, it should not be viewed as a precise tool for judging assets on a loan-by-loan basis, and still less as a means of integrating into one statistic the totality of supervisors' monitoring requirements.

While pursuing this work in the areas of risk asset ratios and off-balance sheet business, bank supervisors have continued to press for a strengthening of banks' capital positions. In Germany, banks have now reached the target for consolidated capital ratios set for 1991. In Japan, an overall capital ratio of 4 percent of assets has been set to be reached by banks with domestic operations only by 1990. A 6 percent ratio is to be reached in 1987 by banks with foreign branches, and for this ratio, they may include in capital a substantial proportion of hidden reserves. The risk asset ratio for international business (discussed above) complements these straight gearing ratios. In the United

Kingdom and the United States banks' capital ratios increased further in 1985, although a substantial proportion of the capital raised by major banks in these countries during the past two years has been in the form of loan capital rather than equity.

Supervisors from different countries have also been reviewing the definition of capital and the components of capital applied to international banks. Various main layers of capital have been distinguished, ranging from shareholders' equity to subordinated term debt. The "layering" allows for a common analysis between countries despite the considerable national diversity of legal, accounting, and regulatory practices and definitions.

Market pressures and an extension of capital adequacy monitoring to many banks' off-balance sheet business may induce "regulatory arbitrage" whereby business shifts to types of institutions or locations enjoying regulations that apply the least stringent capital weight or other "costs" to particular transactions. For example, security companies can engage directly or indirectly in many activities that are conducted by banks. Widespread liberalization and deregulation has contributed to the integration of financial markets within and across national boundaries, making these considerations more important for bank supervisors.

Supervisors are concerned to provide something rather closer to a "level playing field" for the institutions channeling savings within and among countries, to reduce competitive inequities, and to allocate savings more efficiently, in response to underlying economic conditions. One concern is the different standards applied to nonbank activities. The Bank of England has proposed detailed guidelines for capital adequacy in the gilt-edged market, and has insisted on substantial capital backing for newly established participants in the market, whether these participants are banks or nonbanks.

The overlap between banks and nonbanks has raised, more generally, the issue of supervising financial market participants by function, rather than by institution. Some supervisors noted, however, that the overall soundness of an individual institution may not be clearly analyzed if--under the functional approach--the capital adequacy and the asset quality of various aspects of the institution are judged separately by different regulators, unless possibly a "lead supervisor" were appointed for each institution.

Increased competition between banks and other financial institutions, and the overlap between markets, both nationally and internationally, has led some observers to believe that the coverage of prudential supervision--and of associated lender of last resort facilities--should be extended progressively to nonbank financial institutions. Others have taken the opposite view, at least in part because of concerns about the potential moral hazard engendered by market perceptions of an expanded financial safety net.

III. Financing for Developing Countries

1. Distribution and terms

a. Overview

The current account deficits of capital importing developing countries remained at a low level in 1985 and were covered by nondebt-creating flows and long-term borrowing from official creditors. Total lending to these countries through bank and bond markets amounted to about \$13 billion in 1985, \$6 billion less than in 1984; a significant decline in bank lending was partly offset by slightly larger bond market finance (Table 1). Current account deficits of developing countries are estimated to have increased in 1986; however, information available for the first half of 1986 suggests that lending flows have declined further. During the first quarter, bank claims on developing countries fell, while data for the first six months indicate that new gross bond issues by these countries dropped sharply.

International bank lending to developing countries declined further in 1985 to \$9 billion from \$16 billion in 1984 ^{1/}; the growth in bank claims slowed to 2 percent in 1985 from 3 percent in 1984 (Chart 1 and Table 1). ^{2/} The continued slowdown in bank lending to developing countries since 1982, combined with the resurgence in lending to industrial countries, has diminished the share of lending to developing countries in total international lending to 4 percent in 1985 from 27 percent in 1982 (Table 2). The ratio of claims on developing countries in total

^{1/} In interpreting these flows, it is necessary to bear in mind that the Fund's International Banking Statistics series is based on a balance of payments approach to recording credit flows. Data is obtained from direct reports by a member country's banks and "derived" reports based on the geographical positions of banks located in major banking centers. Overcounting of bank claims in certain developing countries may occur when loan claims on nonbanks are transferred to banks (i.e., the central bank). Such transfers should result in an increase in interbank claims offset by a decline in claims on nonbanks. However, international banks that report their claims on banks and nonbanks may not properly reclassify their claims on nonbanks, which would result in overcounting of those claims and an overestimation of lending.

^{2/} As indicated in Table 1, data published by the BIS estimate bank lending to developing countries (adjusted to a Fund country classification) at \$14 billion in 1985. The difference between the IBS and BIS estimates is distributed over a wide range of developing countries. For the 15 heavily indebted developing countries, both sources show bank lending of less than \$1 billion, although within this group there are differences for individual countries. For a group of countries with significant bank debt, the IBS data has benefited from evaluation by Area Departments to assist in identifying reporting problems such as double counting or misclassification of interest arrears.

international claims has dropped to 22 percent in 1985 from 25 percent in 1983 (Chart 7). Lending to the 15 heavily indebted developing countries declined to \$1 billion in 1985 from \$5 billion in 1984 (Table 8).

However, these data for bank lending to developing countries under-record actual flows. One reason for this underestimation is that official statistics record only partially banks' holdings of bonds, which may have increased by \$1-3 billion in 1985. Other factors, inter alia, are loan write-offs, which reduce recorded claims without a repayment, and the sale of claims by banks to nonbank investors. In light of these factors, actual bank lending to developing countries in 1985 is estimated to have been larger than \$9 billion, and was probably in a range of \$11-15 billion.

This *adjusted flow of \$11-15 billion does not coincide with the change in banks' risk exposure* to developing countries because a significant part of bank lending has been officially guaranteed. An OECD/BIS publication ^{1/} gives information on the stock of banks' officially guaranteed claims on developing countries relative to their nonguaranteed claims, although it does not give an exchange rate adjusted flow. ^{2/} Allowing for this factor, growth in banks' risk exposure to developing countries in 1985 is estimated at \$8-13 billion, or 1 1/2 to 2 1/2 percent (based on a stock of unguaranteed bank claims of about \$515 billion). Since reliable regional estimates are not available for all these factors, the discussion of bank lending that follows does not incorporate any estimate based on underrecording of claims or increases in official guarantees.

Spontaneous lending declined somewhat in 1985, decreasing to \$4 billion from \$6 billion in 1984. Bank lending to most developing countries in Asia and Europe remained spontaneous and, at \$8 billion, was equivalent to 85 percent of total lending to developing countries in 1985. There was a modest increase in bank claims on African countries, while developing countries in the Middle East made net repayments of international bank loans in 1985. There was virtually no new spontaneous lending to countries in the Western Hemisphere, and net bank

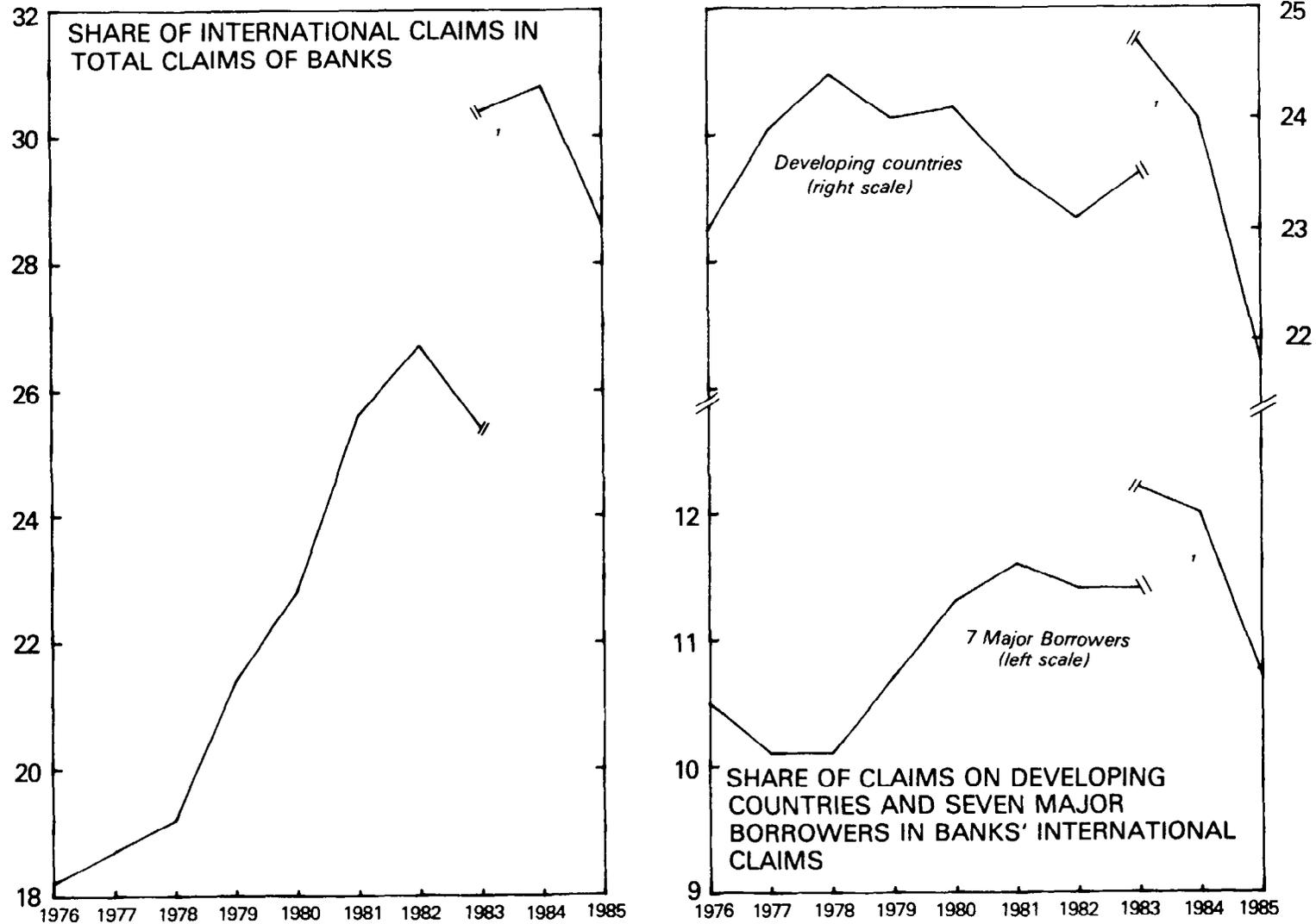
^{1/} Statistics on External Indebtedness: Bank and Trade-Related Non-Bank External Claims on Individual Borrowing Countries and Territories at End-December 1985, BIS/OECD, July 1986.

^{2/} Various assumptions can be made about the currency composition of officially guaranteed claims. If the currency composition was identical to the currency composition of bank claims, then guaranteed bank claims would have increased by \$4 billion in 1985. The currency composition of export guarantees may, however, include a higher share of domestic currency claims than in total bank claims, which would reduce the figure below \$4 billion.

CHART 7

CONCENTRATION OF CROSS-BORDER BANK CLAIMS, 1976-85

(In percent)



Sources: Bank for International Settlements, *International Banking Developments*; International Monetary Fund, *International Financial Statistics*; and Fund staff estimates.
 1 Owing to a change in the coverage of the BIS reporting area, there is a break in the series.



Table 8. Bank Lending to Developing Countries, 1983-85 1/ 2/

(In billions of U.S. dollars)

	1983	1984	1985
Developing countries <u>2/</u> (Growth rate)	34.7 (7)	16.0 (3)	9.2 (2)
Africa	5.0	0.2	1.0
Of which:			
Algeria	0.3	0.7	1.6
Cote d'Ivoire	-0.1	-0.3	0.1
Morocco	0.2	0.1	0.1
Nigeria	1.3	-0.4	-0.7
South Africa	2.9	-1.5	-0.2
Asia	8.8	8.2	4.8
Of which:			
China	0.7	1.0	3.3
India	0.9	0.1	1.7
Indonesia	2.9	1.0	--
Korea	2.2	3.5	2.5
Malaysia	1.9	1.4	-1.4
Philippines	-1.4	0.1	-0.8
Europe	2.8	2.2	3.0
Of which:			
Greece	1.3	1.8	1.4
Hungary	0.9	0.2	1.8
Turkey	--	0.9	0.5
Yugoslavia	--	0.2	0.2
Middle East	3.0	-0.3	-2.1
Of which:			
Egypt	-0.6	0.6	-0.2
Israel	-0.4	-0.7	-0.8
Western Hemisphere	15.2	5.8	2.5
Of which:			
Argentina	2.3	-0.2	1.2
Brazil	5.3	5.2	-0.8
Chile	0.3	1.5	0.3
Colombia	0.6	0.3	0.3
Ecuador	0.2	-0.1	0.2
Mexico	2.8	1.2	0.7
Venezuela	-1.3	-2.2	0.4
<u>Memorandum items:</u>			
<u>15 heavily indebted</u>			
developing countries	11.4	4.8	0.5
Total BIS-based	26.4	11.0	13.8
(Growth rate)	(7)	(2)	(3)
Gross bond issues	3.3	5.3	10.2

Note: Owing to rounding, components may not add.

Sources: Bank for International Settlements (BIS); Organization for Economic Cooperation and Development; International Monetary Fund, International Financial Statistics; and Fund staff estimates.

1/ IMF-based data on cross-border lending by banks are derived from the Fund's International Banking Statistics (IBS) (cross-border inter-bank accounts by residence of borrowing bank plus international bank credits to nonbanks by residence of borrower), excluding changes attributed to exchange rate movements. BIS-based data are derived from quarterly statistics contained in BIS's International Banking Developments; the figures shown are adjusted for the effects of exchange rate movements. Differences between the IMF data and the BIS data are mainly accounted for by the different coverages. The BIS data are derived from geographical analyses provided by banks in the BIS reporting area. The IMF data derive cross-border interbank positions from the regular money and banking data supplied by member countries, while the IMF analysis of transactions with nonbanks is based on data from geographical breakdowns provided by the BIS reporting countries and additional banking centers. Both IBS and BIS series are not fully comparable over time, owing to expanding coverage.

2/ Excluding the seven offshore centers which are: the Bahamas, Bahrain, the Cayman Islands, Hong Kong, the Netherlands Antilles, Panama, and Singapore.

claims rose by less than concerted lending. 1/ Bank lending to the U.S.S.R. and non-Fund members in Eastern Europe amounted to \$4 billion in 1985, about twice the volume recorded in 1984.

Disbursements under concerted lending packages were halved from the 1984 level to \$5 billion in 1985 (Table 9). Over 90 percent, or about \$4.9 billion of these disbursements, went to five countries in the Western Hemisphere (Argentina, Chile, Costa Rica, Ecuador, and Mexico); the remainder was directed to Cote d'Ivoire and the Philippines. During the first six months of 1986, disbursements of concerted bank finance totaled \$1.6 billion and went to Argentina, Chile, and the Philippines.

New long-term bank credit commitments 2/ dropped to \$18 billion in 1985 from \$31 billion in 1984 as a result of a decline in commitments for concerted lending (Table 10 and Chart 8). New concerted packages were arranged for six countries in 1985 (Chile, Colombia, Costa Rica, Cote d'Ivoire, Ecuador, and Panama). Spontaneous commitments remained at about the same level in 1985 as in 1984 (\$14 billion). In the first half of 1986, new commitments were \$8 billion, all of which were contracted spontaneously, as no concerted lending packages were arranged. In late July 1986, Mexico requested from creditor banks a concerted financing package for the equivalent of \$6 billion net. This package would be linked to a mechanism for additional net bank financing if the price of oil falls below a certain price, or a reduction in net bank financing if the price of oil exceeds another specified level. Banks were also requested to participate in a contingency mechanism that would provide additional net financing if economic recovery fails to materialize.

Restructuring agreements were reached in principle with nine countries in 1985 covering their medium-term bank debt amounting to \$15 billion, and a further three new agreements were reached in the first half of 1986 covering \$9 billion of medium-term bank debt. Multiyear restructuring agreements (MYRAs) were agreed with five countries during the 18 months to June 1986 to restructure \$7 billion in medium-term debt falling due. The MYRAs in 1985 and the first half of 1986 included those for Chile, Cote d'Ivoire (the first for an African country), the Dominican Republic, Uruguay, and Yugoslavia. Historical data on bank debt restructurings, reclassified by date of signature, are contained in Statistical Appendix Tables 23 through 26.

1/ Concerted lending (or "new money") refers to equiproportional increases in exposure coordinated by a bank advisory committee.

2/ This analysis is based on data published by the Organization for Economic Cooperation and Development (OECD). The OECD data, however, understate gross bank commitments to developing countries because they do not include commitments corresponding to the restructuring of long-term maturities. These data are also not directly comparable to the data on lending previously referred to in the text, as OECD data are on a commitments basis and cover only new bank credits that are publicized and that have an original maturity of more than one year.

Table 9. Concerted Lending: Commitments and Disbursements, 1983-First Half 1986 ^{1/}

(In millions of U.S. dollars)

	1983		1984		1985		First Half 1986	
	Commitments	Disbursements	Commitments	Disbursements	Commitments	Disbursements	Commitments	Disbursements
Argentina								
Medium-term loan	1,500	500	3,700 ^{2/}	--	--	2,500	--	1,200
Trade deposit facility	--	--	500 ^{2/}	--	--	500	--	--
Brazil								
Medium-term loan	4,400	4,400	6,500	6,500	--	--	--	--
Chile								
Medium-term loan	1,300	1,300	780	780	785	520	--	167
Cofinancing arrangement with the World Bank	--	--	--	--	300 ^{4/}	194 ^{3/}	--	71
Colombia								
Medium-term loan	--	--	--	--	1,000	--	--	--
Costa Rica								
Medium-term loan	--	--	--	--	75	75	--	--
Cote d'Ivoire								
Medium-term loan	--	--	--	--	104	104	--	--
Ecuador								
Medium-term loan	431	431	--	--	200	200	--	--
Mexico								
Medium-term loan	5,000	5,000	3,800	2,850	--	950	--	--
Panama								
Medium-term loan	--	--	--	--	60	--	--	--
Peru								
Medium-term loan	450	250	--	100	--	--	--	--
Philippines								
Medium-term loan	--	--	925 ^{2/}	--	--	400	--	175
Uruguay								
Medium-term loan	240	240	--	--	--	--	--	--
Yugoslavia								
Medium-term loan	<u>600</u>	<u>600</u>	<u>--</u>	<u>--</u>	<u>--</u>	<u>--</u>	<u>--</u>	<u>--</u>
Total	13,921	12,721	16,205	10,230	2,524	5,443	--	1,613

Sources: Restructuring agreements; and Fund staff estimates.

^{1/} These data exclude bridging loans.

^{2/} Agreed in principle with Steering Committee.

^{3/} Expected to be disbursed during the third quarter of 1985.

^{4/} Fifty percent guaranteed by the World Bank.

Table 10. New Publicized Long-Term External Bank Credit Commitments to Developing Countries, 1981-First Half 1986

(In billions of U.S. dollars)

	1981	1982	1983	1984 <u>1/</u>	1985 <u>2/</u>	1st Half 1985 <u>3/</u>	1st Half 1986
Developing countries	48.1	44.6	34.9	31.0	17.9	9.4	8.3
Capital-importing	47.0	42.6	32.6	29.9	16.1	8.6	6.9
Africa	4.1	2.7	2.7	0.5	1.4	1.1	0.8
Spontaneous lending <u>4/</u>	4.1	2.7	2.7	0.5	1.3	1.0	0.8
Concerted lending <u>4/</u>	...	...	--	--	0.1	0.1	--
Asia	12.8	12.6	10.4	10.2	7.5	3.0	4.1
Spontaneous lending <u>4/</u>	12.8	12.6	10.4	9.3	7.5	3.0	4.1
Concerted lending	...	...	--	0.9	--	--	--
Europe	4.7	3.7	3.5	3.4	4.4	2.3	1.9
Spontaneous lending <u>4/</u>	4.7	3.7	2.9	3.4	4.4	2.3	1.9
Concerted lending <u>4/</u>	...	...	0.6	--	--	--	--
Middle East	0.2	0.6	0.7	0.4	0.3	--	--
Western Hemisphere	25.2	23.0	15.3	15.4	2.5	2.1	0.1
Spontaneous lending <u>4/</u>	25.2	23.0	2.0	0.6	0.1	--	0.1
Concerted lending <u>4/</u>	...	...	13.3 <u>5/</u>	14.8	2.4	2.1	--

Sources: Organization for Economic Cooperation and Development, Financial Statistics Monthly; and Fund staff estimates.

1/ Includes agreements in principle with Argentina and the Philippines, and excludes the short-term trade deposit facility for Argentina of \$0.5 billion.

2/ Includes \$0.1 billion for Costa Rica.

3/ Includes agreements in principle with Chile and Colombia.

4/ Concerted lending refers to bank credit commitments obtained during 1983-85 and coordinated by a bank advisory committee (i.e., Argentina, Brazil, Chile, Colombia, Cote d'Ivoire, Ecuador, Mexico, Panama, Peru, the Philippines, Uruguay, and Yugoslavia).

5/ Excludes the extension of a bridging loan of \$1.3 billion to Argentina.

CHART 8

BOND ISSUES AND LONG-TERM COMMITMENTS OF CREDITS AND FACILITIES TO CAPITAL-IMPORTING DEVELOPING COUNTRIES, 1981-FIRST HALF 1986

(In billions of U.S. dollars)

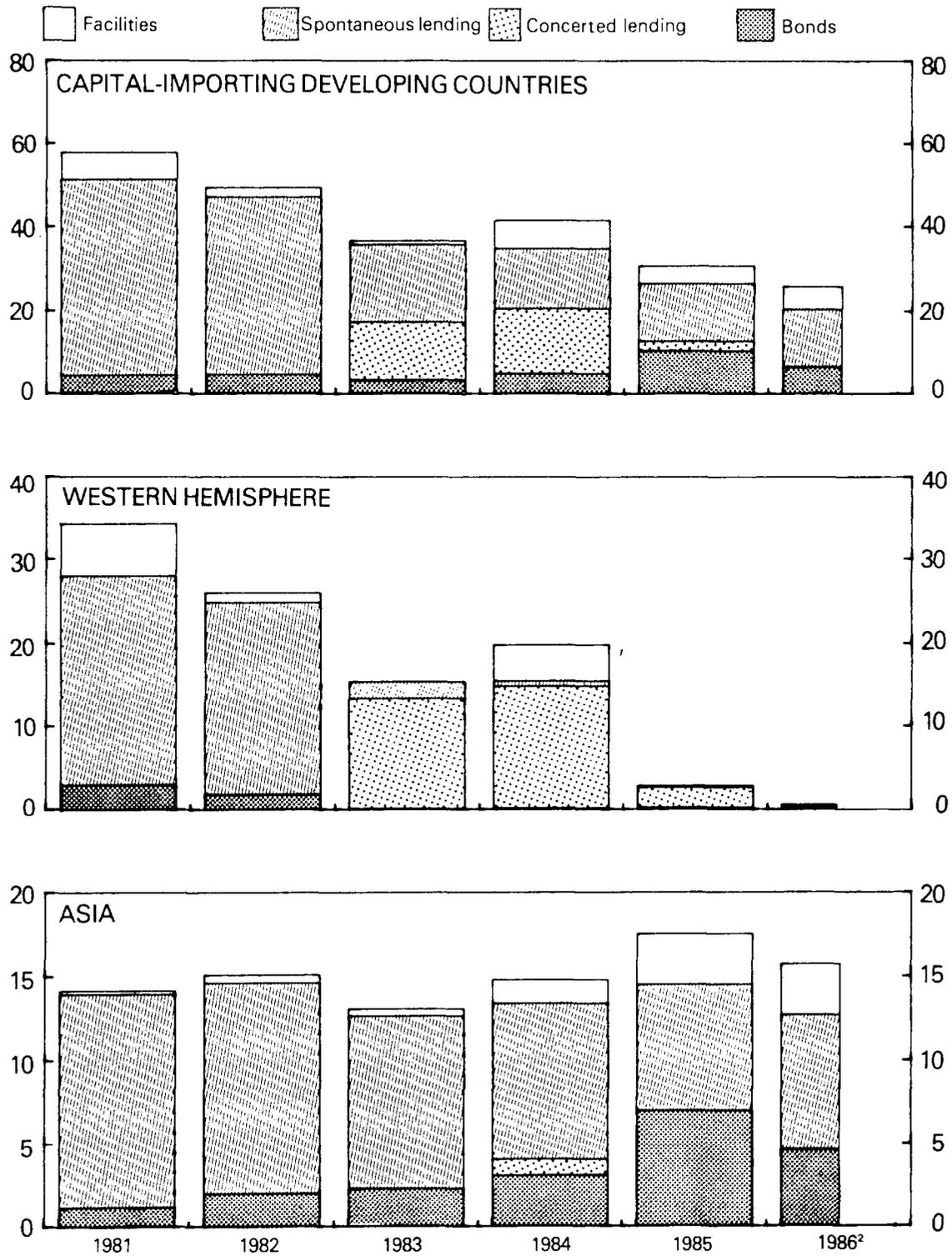
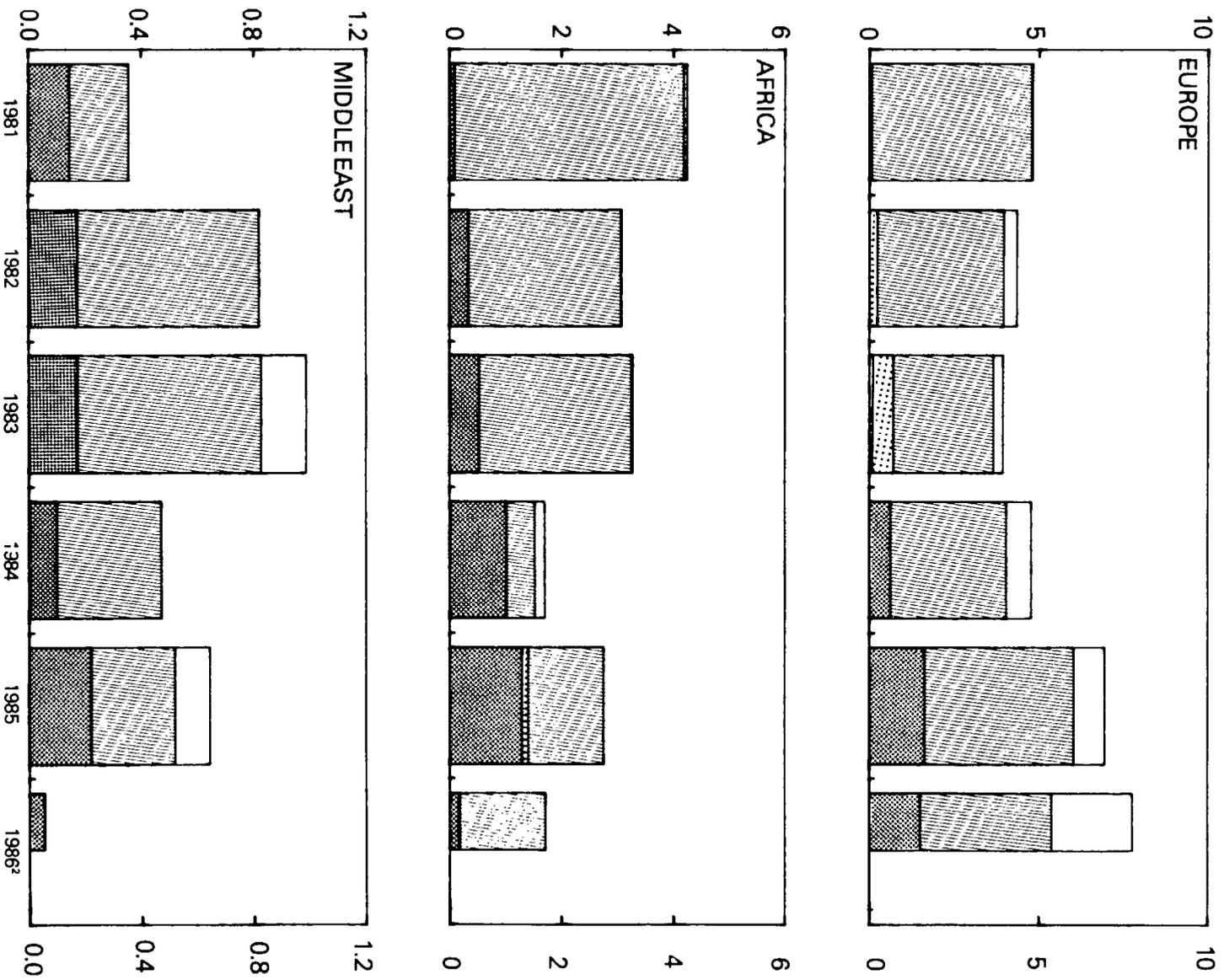




CHART 8
(CONCLUDED)



Sources: Organization for Economic Cooperation and Development, *Financial Statistics Monthly* and Fund staff estimates.
1 Includes a facility arranged for Mexico.
2 First half annualized.



International bond issues by developing countries increased to a record \$10 billion in 1985 from \$5 billion in 1984 (Table 5 and Chart 2). Of the \$10 billion, \$6 billion was in the form of U.S. dollar floating rate notes and may, to a large extent, have been purchased by banks which do not report them as part of their international banking claims, i.e., banks in the United Kingdom, the United States, and Switzerland. The number of developing countries with access to the international bond market increased from an average of 18 in 1983-84 to 21 in 1985. Developing countries from Asia and Europe continued to dominate this market, accounting for 83 percent of the total in 1985. The four largest issuers were all from Asia--Malaysia, Korea, China, and Hong Kong--and accounted for just over one half of all bond issues by developing countries.

During the first half of 1986, international bond issues by developing countries were about half the amount issued during the comparable period in 1985, or about the same level as in 1984. The number of developing countries utilizing this market declined sharply to 11 during the first half of 1986 from 17 countries. The principal borrowers were all in Asia; developing countries in that region accounted for 73 percent of the total. Algeria, Malaysia, South Africa, and Thailand, collectively, had issued \$2 1/2 billion in the first half of 1985, but issued only \$0.1 billion in bonds during the first half of 1986.

Developing countries also arranged \$4 billion in other long-term external bank facilities in 1985, less than the \$7 billion of such facilities arranged in 1984 (Statistical Supplement Table 3). During the first half of 1986, developing countries arranged \$3 billion in bank facilities compared with \$2 billion during the same period in 1985. Only developing countries in Europe and Asia had such facilities during the first half of 1986. In 1985, 13 developing country borrowers arranged note issuance facilities amounting to \$3 billion compared with 10 developing countries in 1984, amounting to \$1 billion. During the first half of 1986, 12 developing countries arranged note issuance facilities for \$4 billion.

Depositing by developing countries with the international banking system was \$16 billion in 1985, or \$7 billion less than in 1984 (Statistical Supplement Table 22). There was a large shift in the composition of depositing in 1985. Interbank depositing was flat after rising by \$21 billion in 1984, reflecting the sharp slowdown in the accumulation of gross official reserves by these countries in 1985. Deposit-taking from nonbanks, however, rose from \$2 billion in 1984 to \$14 billion in 1985, and may signify some increase in capital flight.

b. Regional pattern of financing

The regional pattern of bank lending flows to developing countries became more pronounced during 1985. This development was evidenced on both the debtor and creditor side. Net international bank and bond mar-

ket lending to countries in the Western Hemisphere amounted to about \$3.7 billion in 1985. International bank lending to countries in the Western Hemisphere was \$2.5 billion in 1985, compared with \$5.8 billion in 1984 (Table 8). Disbursements under concerted lending packages were \$4.9 billion in 1985 (including \$0.5 billion in a trade deposit facility to Argentina), compared with \$10.2 billion in 1984. In Argentina, Chile, and Mexico, the increases in bank claims were less than the disbursements of concerted loans.

U.S. banks reduced their consolidated claims on countries in the Western Hemisphere by \$4.5 billion, or 4.7 percent, in 1985 (Table 11). 1/ Nearly half of this decline, however, represented the sale of international loans by one U.S. bank (see below). Large declines in U.S. bank claims were recorded on Brazil and Mexico, while Argentina was the only developing country for which U.S. banks increased significantly their claims. The consolidated claims of U.K. banks on developing countries in the Western Hemisphere fell by \$0.1 billion (1/2 percent) (Table 12).

New long-term international bank commitments to countries in the Western Hemisphere amounted to \$2.5 billion in 1985 of which \$2.4 billion was on a concerted basis (Chart 8). In the first half of 1986, new commitments amounted to only \$0.1 billion, reflecting a commitment to The Bahamas (Table 13).

Developing countries in the Western Hemisphere did not have significant access to the international bond market (Table 14). In 1985, bond issues totaling \$203 million were made by Trinidad and Tobago, Mexico, and Panama. The bond placement by Mexico (a foreign yen placement) was its first since the debt crisis of 1982. Mexico also arranged \$0.1 billion in a note issuance facility, reportedly the first of a series designed to transform interbank lines into marketable securities. During 1986, Brazilian banks were also arranging a note issuance facility for their interbank lines. There were bond issues of only \$0.1 million in the first half of 1986.

Residents from countries in the Western Hemisphere deposited \$4.9 billion abroad in 1985, compared with \$13.2 billion in 1984. Interbank deposits fell by \$3 billion in 1985, in line with a decline in

1/ Data on consolidated bank claims by nationality of banks are regularly published by the United States and the United Kingdom. The Bundesbank publishes some data on the geographical claims of domestic banks and their foreign branches and subsidiaries; consolidated information has been published once for a limited number of countries, but is not published on a regular basis. Data on the currency composition of claims, which can be used to correct the data for the movements in exchange rates in deriving lending flows, are not available for Germany, the United Kingdom, or the United States, and thus the changes in claims derived from these series have to be interpreted with caution.

Table 11. Change in Claims of U.S. Banks on Developing Countries, 1982-85 ^{1/}

(In billions of U.S. dollars; and in percent)

	1982		1983		1984		1985	
	Billions of U.S. dollars	Growth rate						
Developing countries								
All banks	11.5	8.2	6.2	4.1	-3.5	-2.2	-13.2	-8.5
Nine major banks	7.1	8.0	3.9	4.1	-1.4	-1.4	-7.5	-7.6
Next 15 banks	2.9	11.5	2.1	7.5	0.2	0.6	-5.0	-16.1
Others	1.5	5.7	0.2	0.7	-2.3	-8.0	-0.7	-2.7
Capital-importing developing countries								
All banks	11.6	8.5	5.7	3.9	-2.7	-1.8	-11.9	-7.9
Nine major banks	7.3	8.7	3.3	3.6	-0.8	-0.8	-6.7	-7.1
Next 15 banks	2.8	11.4	2.2	8.1	0.3	0.9	-4.5	-15.1
Others	1.4	5.4	0.2	0.8	-2.2	-7.7	-0.6	-2.4
Africa								
All banks	1.3	12.4	1.0	8.5	-0.8	-6.0	-2.8	-22.4
Nine major banks	0.7	8.1	0.9	10.2	-0.8	-8.1	-1.6	-18.3
Next 15 banks	0.5	34.5	0.3	15.4	0.2	11.9	-0.9	-38.2
Others	0.2	17.2	-0.1	-4.7	-0.2	-17.1	-0.3	-23.9
Asia								
All banks	3.8	14.2	1.4	4.5	-3.0	-9.5	-3.4	-11.9
Nine major banks	2.7	14.8	0.3	1.3	-2.0	-9.3	-2.6	-13.5
Next 15 banks	0.4	8.4	0.5	8.2	--	0.6	-0.9	-14.9
Others	0.6	20.9	0.6	17.0	-1.1	-25.6	0.1	4.3
Indonesia								
All banks	0.6	24.2	0.6	19.9	-0.2	-5.0	-0.6	-18.8
Nine major banks	0.5	26.9	0.5	21.0	-0.3	-8.8	-0.5	-16.7
Next 15 banks	--	10.9	--	7.5	0.1	30.1	-0.2	-36.9
Others	--	12.2	--	32.6	--	-14.8	--	3.0
Korea								
All banks	2.1	24.1	0.5	4.1	-1.5	-13.3	-0.8	-7.9
Nine major banks	1.5	26.4	-0.5	-6.8	-1.0	-15.5	-0.5	-9.7
Next 15 banks	0.4	18.9	0.5	20.5	--	0.4	-0.5	-17.0
Others	0.3	22.0	0.5	28.5	-0.5	-24.0	0.2	13.3
Philippines								
All banks	0.4	6.9	0.3	5.5	-0.6	-10.0	--	-0.7
Nine major banks	0.2	6.3	0.1	1.3	-0.2	-4.4	--	0.9
Next 15 banks	--	1.7	--	2.7	-0.1	-4.6	-0.1	-6.8
Others	0.1	22.8	0.2	36.3	-0.4	-42.7	--	2.1
Europe								
All banks	-0.8	-7.5	0.9	9.5	-0.4	-3.6	-0.5	-4.8
Nine major banks	-0.3	-4.6	0.8	12.8	-0.4	-4.9	-0.5	-6.5
Next 15 banks	-0.1	-7.3	0.1	5.7	0.1	6.1	-0.1	-5.0
Others	-0.3	-20.4	--	-3.5	-0.1	-7.6	0.1	6.5
Middle East								
All banks	0.3	8.1	0.3	8.5	-0.4	-9.0	-0.7	-18.8
Nine major banks	0.1	6.0	0.2	8.6	-0.2	-7.8	-0.5	-20.6
Next 15 banks	0.1	19.8	0.1	19.7	--	-0.9	-0.2	-24.7
Others	0.1	7.5	--	1.5	-0.2	-18.8	-0.1	-7.3
Western Hemisphere								
All banks	6.9	8.2	2.1	2.3	1.8	1.9	-4.5	-4.7
Nine major banks	4.1	8.5	1.1	2.1	2.5	4.7	-1.5	-2.7
Next 15 banks	1.9	12.1	1.3	7.3	-0.1	-0.4	-2.5	-13.0
Others	0.8	4.2	-0.3	-1.4	-0.6	-3.0	-0.5	-2.5
Argentina								
All banks	-0.2	-2.0	0.3	3.3	-0.5	-6.2	0.4	5.5
Nine major banks	-0.1	-1.7	0.2	4.5	-0.3	-4.6	0.8	15.1
Next 15 banks	0.1	6.0	0.2	8.4	-0.1	-6.1	-0.2	-13.3
Others	-0.2	-12.7	-0.1	-8.4	-0.2	-13.6	-0.1	-8.6
Brazil								
All banks	3.6	21.5	0.2	1.1	3.2	15.6	-1.1	-4.5
Nine major banks	2.7	25.0	--	--	2.5	18.8	-0.3	-1.6
Next 15 banks	0.9	30.7	0.4	10.3	0.4	10.0	-0.8	-16.6
Others	0.1	1.5	-0.2	-5.8	0.3	9.4	--	-1.2
Mexico								
All banks	2.9	13.4	2.0	8.0	0.2	0.7	-1.6	-6.0
Nine major banks	1.3	11.1	1.3	9.8	0.6	4.0	-0.6	-4.1
Next 15 banks	0.8	18.7	0.2	4.0	--	-0.2	-0.6	-12.0
Others	0.8	14.1	0.5	7.7	-0.4	-5.3	-0.3	-5.3
Venezuela								
All banks	1.1	10.5	-0.3	-2.8	-0.4	-4.0	-0.7	-6.7
Nine major banks	0.8	11.3	-0.2	-2.2	-0.2	-2.6	-0.3	-4.1
Next 15 banks	0.3	18.8	--	1.3	-0.1	-5.3	-0.3	-15.9
Others	--	-1.4	-0.2	-10.6	-0.1	-8.9	-0.1	-6.8

Note: Owing to rounding, components may not add.

Source: Federal Financial Institutions Examination Council, Country Exposure Lending Survey.

^{1/} These data are based on consolidated reports of banks.

Table 12. Change in Bank Claims on Developing Countries, 1982-85 ^{1/}

(In billions of U.S. dollars and in percent)

	1982		1983		1984		1985	
	Billions of U.S. dollars	Growth rate	Billions of U.S. dollars	Growth rate	Billions of U.S. dollars	Growth rate	Billions of U.S. dollars	Growth rate
Developing countries								
BIS semiannual	39.3	10.0	26.0	6.0	4.7	1.0	31.4	6.8
U.S. claims data	11.5	8.2	6.2	4.1	-3.5	-2.2	-13.2	-8.5
U.K. claims data	6.4	11.2	2.3	3.7	-0.9	-1.4	-0.4	-0.6
Capital-importing developing countries								
BIS semiannual	38.2	10.2	21.7	5.3	4.7	1.1	30.7	7.0
U.S. claims data	11.6	8.5	5.7	3.9	-2.7	-1.8	-11.9	-7.9
U.K. claims data	6.2	11.7	2.0	3.3	-0.1	-0.2	-0.5	-0.8
Africa								
BIS semiannual	5.5	10.8	3.1	5.5	-1.0	-1.7	3.7	6.1
U.S. claims data	1.3	12.4	1.0	8.5	-0.8	-6.0	-2.8	-22.4
U.K. claims data	2.9	31.1	0.5	4.1	-0.2	-2.0	-0.8	-6.4
Asia								
BIS semiannual	10.4	17.1	8.7	12.2	3.8	4.7	9.3	10.9
U.S. claims data	3.8	14.2	1.4	4.5	-3.0	-9.5	-3.4	-11.9
U.K. claims data	1.4	16.5	0.4	3.6	-0.3	-3.0	0.2	2.3
Indonesia								
BIS semiannual	2.7	37.5	1.5	15.2	1.1	9.3	1.2	9.5
U.S. claims data	0.6	24.2	0.6	19.9	-0.2	-5.0	-0.6	-18.8
U.K. claims data	0.5	63.6	0.3	26.0	--	2.1	-0.1	-3.0
Korea								
BIS semiannual	3.3	16.6	1.9	8.2	0.3	1.2	2.8	10.6
U.S. claims data	2.1	24.1	0.5	4.1	-1.5	-13.3	-0.8	-7.9
U.K. claims data	0.3	10.8	-0.2	-7.4	-0.1	-2.5	-0.1	-2.0
Philippines								
BIS semiannual	2.4	23.5	0.6	4.8	-1.4	-10.1	0.5	4.0
U.S. claims data	0.4	6.9	0.3	5.5	-0.6	-10.0	--	-0.7
U.K. claims data	0.2	11.7	0.1	4.2	-0.2	-9.6	-0.1	-8.7
Europe								
BIS semiannual	-0.3	-0.7	1.6	3.5	-0.6	-1.2	7.5	15.8
U.S. claims data	-0.8	-7.0	0.9	9.5	-0.4	-3.6	-0.5	-4.8
U.K. claims data	-0.2	-2.7	0.2	3.2	-0.2	-2.5	0.2	3.0
Middle East								
BIS semiannual	3.5	19.7	0.7	3.3	-0.7	-4.5	1.2	8.4
U.S. claims data	0.3	8.1	0.3	8.5	-0.4	-9.0	-0.7	-18.8
U.K. claims data	0.5	32.0	-0.2	-11.2	-0.2	-13.3	--	2.0
Western Hemisphere								
BIS semiannual	19.1	9.6	7.7	3.5	3.2	1.4	9.0	3.9
U.S. claims data	6.9	8.2	2.1	2.3	1.8	1.9	-4.5	-4.7
U.K. claims data	1.6	6.1	1.1	3.9	0.8	2.8	-0.1	-0.5
Argentina								
BIS semiannual	0.9	3.6	0.2	0.8	-1.5	-5.6	4.1	16.3
U.S. claims data	-0.2	-2.0	0.3	3.3	-0.5	-6.3	0.4	5.5
U.K. claims data	-0.3	-7.8	0.1	2.8	-0.1	-1.3	0.3	8.3
Brazil								
BIS semiannual	8.0	15.2	1.7	2.8	4.8	7.9	1.3	1.9
U.S. claims data	3.6	21.5	0.2	1.1	3.2	15.6	-1.1	-4.5
U.K. claims data	1.2	18.2	0.7	8.5	0.7	8.5	-0.2	-2.2
Mexico								
BIS semiannual	5.8	10.2	5.5	8.7	1.6	2.3	0.8	1.1
U.S. claims data	2.9	13.4	2.0	8.0	0.2	0.7	-1.6	-6.0
U.K. claims data	0.2	3.1	0.3	3.8	0.1	1.1	-0.1	-0.9
Venezuela								
BIS semiannual	1.3	5.0	-0.3	-1.1	-0.9	-3.3	0.4	1.7
U.S. claims data	1.1	10.5	-0.3	-2.8	-0.4	-4.0	-0.7	-6.7
U.K. claims data	-0.1	-4.3	-0.2	-5.4	-0.1	-4.2	-0.1	-2.9

Note: Owing to rounding, components may not add.

Sources: Bank for International Settlements, The Maturity Distribution of International Bank Lending; Federal Financial Institutions Examination Council, Country Exposure Lending Survey; and Bank of England, Bank of England Quarterly Bulletin.

^{1/} These data are not adjusted for the impact of exchange rate movements and are based on consolidated reports of banks.

Table 13. New Long-Term External Bank Credit Commitments by Country of Destination, 1981-First Half 1986

(In billions of U.S. dollars)

	1981	1982	1983	1984 ^{1/}	1985 ^{2/}	1st. Half ^{3/} 1985	1st. Half 1986
Industrial countries	44.8	51.6	27.9	29.9	31.6	16.2	14.6
Australia	3.9	5.9	2.7	2.4	0.8	0.2	1.7
Belgium	0.5	2.0	0.1	0.9	0.7	0.2	0.6
Canada	5.1	7.0	2.1	2.7	6.9	4.8	0.3
Denmark	1.6	1.6	2.2	0.7	0.3	--	--
France	0.6	6.6	1.5	2.0	4.0	0.3	0.7
Italy	6.4	5.3	2.8	4.7	4.7	3.5	2.6
Spain	4.8	2.0	2.7	3.5	2.5	1.5	1.4
Sweden	2.5	2.0	2.6	0.4	0.8	0.4	--
United Kingdom	2.6	2.2	0.9	3.3	5.1	2.0	2.6
United States	12.9	10.0	7.3	5.3	3.1	1.3	3.6
Other	3.9	7.0	3.0	4.0	2.7	2.0	1.1
Centrally planned economies	0.7	0.2	0.5	2.2	3.5	1.6	1.1
Czechoslovakia	--	--	0.1	--	0.1	--	--
German Democratic Republic	0.5	0.1	0.4	0.7	1.2	0.6	0.1
Poland	--	--	--	0.3	--	--	--
U.S.S.R.	--	0.1	--	0.9	1.5	0.9	0.9
Other	0.2	--	--	0.3	0.7	0.1	0.1
Developing countries	48.1	44.6	34.9	31.0	17.9	9.4	8.3
Capital-importing developing countries	47.0	42.6	32.6	29.9	16.1	8.6	6.9
Africa	4.1	2.7	2.7	0.5	1.4	1.1	0.8
Cote d'Ivoire	0.6	0.5	--	--	0.2	0.1	--
Morocco	0.6	0.2	0.1	--	--	--	--
Nigeria	2.0	0.4	0.2	--	--	--	--
South Africa	0.3	1.0	0.2	0.2	--	--	--
Other	0.6	0.6	2.2	0.3	1.2	1.0	0.8
Asia	12.8	12.6	10.4	10.2	7.5	3.0	4.1
China	0.5	0.3	0.1	0.2	2.2	0.1	1.1
India	1.0	0.4	0.7	0.6	0.2	--	0.3
Indonesia	1.1	1.1	2.0	1.6	0.1	--	0.7
Korea	3.2	3.6	3.5	3.7	3.6	2.3	1.0
Malaysia	1.5	2.4	1.4	1.0	0.2	0.2	0.2
Philippines	0.9	1.1	0.6	0.9	--	--	--
Thailand	0.8	0.3	0.4	0.8	0.4	--	0.5
Other	3.8	3.4	1.7	1.4	0.8	0.4	0.3
Europe	4.7	3.7	3.5	3.4	4.4	2.3	1.9
Greece	1.0	0.9	1.2	1.1	0.6	0.6	0.5
Hungary	0.6	0.3	0.5	0.8	0.9	0.5	0.4
Portugal	1.7	1.5	1.0	1.0	1.6	0.6	0.5
Turkey	--	0.3	0.3	0.4	1.1	0.6	0.5
Yugoslavia	1.0	0.5	0.6	--	--	--	--
Other	0.4	0.2	--	0.1	0.2	--	--
Middle East	0.2	0.6	0.7	0.4	0.3	--	--
Egypt	--	0.4	0.1	--	0.1	--	--
Jordan	0.2	--	0.3	0.3	0.2	--	--
Other	--	0.2	0.2	--	--	--	--
Western Hemisphere	25.2	23.0	15.3	15.4	2.5	2.1	0.1
Argentina	2.8	1.3	1.8	3.7	--	--	--
Brazil	6.9	7.3	4.6	6.5	--	--	--
Chile	2.3	1.2	1.4	0.8	1.1	1.1	--
Colombia	1.0	0.6	0.4	0.4	1.1	1.0	--
Ecuador	0.3	0.1	0.4	--	0.2	--	--
Mexico	7.9	6.5	5.1	3.8	--	--	--
Peru	0.9	1.1	0.5	--	--	--	--
Venezuela	1.4	4.0	0.2	--	--	--	--
Other	1.7	0.9	0.9	0.2	0.1	--	0.1
Unallocated and international organizations	1.0	1.8	3.9	3.5	2.5	1.3	0.4
Total	94.6	98.2	67.2	66.6	55.5	28.4	24.4

Note: Owing to rounding, components may not add.

Sources: Organization for Economic Cooperation and Development, *Financial Statistics Monthly*; and Fund staff estimates.

^{1/} Includes agreements in principle with Argentina and the Philippines.

^{2/} Includes \$0.1 billion to Costa Rica.

^{3/} Includes agreements in principle with Chile and Colombia.

Table 14. Developing Country Bond Issues in International Markets, 1981-First Half 1986, 1/

(In millions of U.S. dollars)

	1981	1982	1983	1984	1985	1st Half 1985	1st Half 1986
Algeria	--	--	--	--	500.0	500.0	90.1
Argentina	195.3	--	--	--	--	--	--
Bahrain	30.0	--	--	100.0	150.0	150.0	--
Barbados	--	--	--	--	19.2	19.2	--
Bermuda	--	60.0	--	--	--	--	80.0
Brazil	60.8	100.9	--	--	--	--	--
Chile	30.0	--	--	--	--	--	--
China	--	44.5	20.5	81.7	959.9	246.3	1,051.1
Colombia	20.0	35.0	15.0	--	--	--	--
Costa Rica	--	--	--	--	--	--	--
Cote d'Ivoire	--	--	--	--	--	--	--
Egypt	--	65.0	40.0	--	50.0	50.0	--
Gabon	--	33.2	--	--	--	--	--
Greece	30.0	50.0	41.6	200.8	744.7	464.2	204.9
Haiti	--	--	--	--	--	--	--
Hong Kong	123.8	71.7	62.8	185.6	934.4	--	25.6
Hungary	20.0	--	--	40.5	447.1	195.3	163.0
India	281.7	185.0	60.0	297.6	372.8	180.0	248.8
Indonesia	96.5	363.1	365.7	50.0	--	--	300.0
Israel	117.0	110.0	135.0	--	22.0	--	--
Kuwait	25.0	110.0	--	50.0	--	--	--
Malaysia	--	816.8	884.6	1,141.2	2,001.9	894.2	--
Mexico	2,344.1	1,602.5	--	--	49.0	--	50.0
Morocco	--	--	--	--	--	--	--
Nauru	--	--	--	--	--	--	21.3
Panama	--	--	21.0	--	20.0	20.0	--
Papua New Guinea	--	--	--	20.6	20.3	20.3	--
Peru	25.0	--	--	--	--	--	--
Philippines	68.5	30.0	--	--	--	--	--
Portugal	20.0	183.3	76.2	389.4	347.4	177.5	273.9
Saudi Arabia	--	--	--	200.0	--	--	--
Singapore	55.6	125.0	70.0	--	105.0	--	25.0
South Africa	92.0	314.1	532.5	1,013.9	777.9	692.9	--
South Korea	322.8	141.5	546.8	1,056.0	1,700.1	758.6	638.0
Sri Lanka	--	11.3	--	--	--	--	--
Thailand	98.7	62.5	253.5	283.3	861.7	540.6	--
Trinidad and Tobago	--	--	50.0	107.4	133.9	28.8	--
Tunisia	--	--	60.0	--	20.3	20.3	--
United Arab Emirates	--	--	--	25.0	--	--	--
Venezuela	290.8	35.0	--	--	--	--	--
Yugoslavia	--	--	--	--	--	--	--
Other	80.0	145.0	40.0	20.6	--	--	--
Total	<u>4,427.6</u>	<u>4,695.4</u>	<u>3,275.2</u>	<u>5,263.6</u>	<u>10,237.6</u>	<u>4,958.2</u>	<u>3,171.7</u>

Source: Organization for Economic Cooperation and Development, Financial Statistics Monthly.

1/ Foreign bonds and Eurobonds.

gross reserves, with reductions in interbank deposits of residents in Brazil and Mexico being partly offset by an increase in interbank deposits of Venezuela (Statistical Supplement Table 27). On the other hand, nonbanks in the Western Hemisphere deposited \$7.7 billion in 1985, compared with \$3.3 billion in 1984. New deposits of nonbanks were particularly large for residents of Mexico, but less than their average depositing in the previous two years, and of Venezuela, where they were twice the level of 1984 (Statistical Supplement Table 28).

Net international lending through bank and bond markets to developing countries in Asia amounted to nearly \$11 billion in 1985, about \$1 billion more than in 1984 because of larger funding in bond markets. Bank lending to developing countries in Asia declined to \$4.8 billion in 1985 from \$8.2 billion in 1984, partly because of a switch to borrowing in the bond market. The largest bank borrowers were China, Korea, and India. The Philippines experienced a net outflow on account of bank lending of \$0.8 billion in 1985, despite having received \$0.4 billion in concerted lending, partly because the branches of Philippine banks abroad (which were not covered in the restructuring agreements) reduced their claims on the Philippines. Malaysia repaid \$1.4 billion in bank debt, while issuing \$2.0 billion in international bonds, of which 65 percent were in the form of U.S. dollar floating rate notes. The consolidated claims of U.S. banks on developing countries in Asia fell by \$3.4 billion (12 percent) in 1985, while those of U.K. banks rose by \$0.2 billion (2 percent).

New long-term international bank commitments to developing countries in Asia were \$10.5 billion in 1985; all of these commitments were spontaneous. In 1985, the composition of commitments changed, with a decline in borrowing in the syndicated loan market to \$7.5 billion from \$10.2 billion in 1984 and a doubling of the use of other bank credit facilities to \$3 billion in 1985. The major borrower in the syndicated loan market continued to be Korea; however, credits of \$2.2 billion were arranged for China. Hong Kong was the most active user of other bank credit facilities, arranging commitments of \$1.2 billion. Korea also arranged \$0.6 billion in various other bank credit facilities in 1985. In the first half of 1986, new long-term commitments to developing countries in Asia were \$4.1 billion.

Asian countries relied more heavily on international bond markets in 1985 than in 1984; bond issues by these developing countries totaled almost \$7 billion in 1985 compared to \$3 billion in 1984. Malaysia borrowed \$2.0 billion, Korea \$1.7 billion, and China and Hong Kong almost \$1 billion each. In the first half of 1986, bond issues were slightly less than the level during the comparable period in 1985, with the main borrowers being Korea, China, and Indonesia.

Countries in Asia deposited \$7.2 billion in international banks in 1985 (mainly interbank transactions), somewhat less than in 1984. Deposits held by residents in China fell by about \$6 billion in 1985.

International lending through bank and bond markets to developing countries in Europe amounted to about \$4.5 billion in 1985, somewhat more than in 1984. Bank lending was \$3.0 billion, about \$1 billion higher than in 1984 and was mostly to Greece, Hungary, and Turkey, while banks further reduced their claims on Romania.

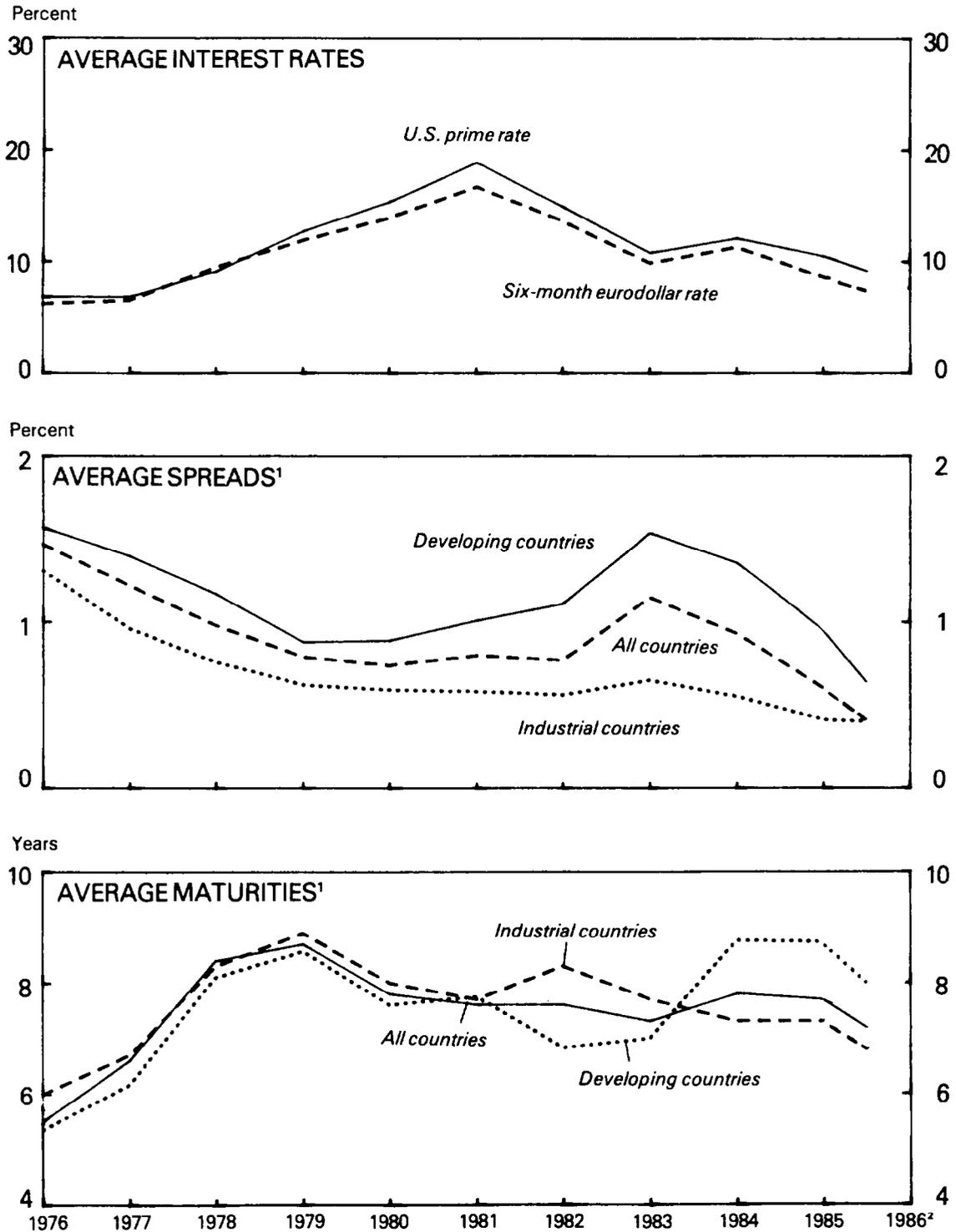
New long-term international bank credit commitments to developing countries in Europe increased by \$5.3 billion in 1985, all of which was on a spontaneous basis, in comparison to \$4.2 billion in 1984. The major borrowers were Greecem Hungary, Portugal, and Turkey. In 1985, \$0.9 billion of new bank commitments were in the form of other facilities, including note issuance facilities for Hungary and Portugal. In the first half of 1986, developing countries in Europe obtained an additional \$1.9 billion in new bank commitments.

Developing countries in Europe issued \$1.5 billion in international bonds in 1985, compared with just over \$0.5 billion in 1984. Almost all of this increase was accounted for by Greece and Hungary; bond issues by Greece rose to \$745 million in 1985 from \$200 million in 1984, while Hungary issued over \$450 million in 1985 compared with \$40 million in 1984. In the first half of 1986, developing countries in Europe issued \$0.6 billion in international bonds, with Portugal the principal issuer. International bank depositing by developing countries in Europe dropped sharply to \$0.9 billion in 1985 from \$3.8 billion in 1984, largely attributable to a decrease in deposits by Romania and Turkey.

International lending through bank and bond markets to developing countries in Africa was over \$2 billion in 1985, compared with lending of about \$1 billion in 1984. Banks lent US\$1.0 billion to African countries in 1985, an increase from \$0.2 billion in 1984. Loan repayments by Nigeria and South Africa were offset by bank lending to Algeria. New long-term international bank credit commitments to developing countries in Africa increased in 1985 to \$1.4 billion from \$0.7 billion in 1984. Bond issues by these countries totaled \$1.3 billion in 1985, compared with \$1 billion in 1984. South Africa and Algeria issued \$778 million and \$500 million in bonds, respectively, in 1985. In contrast, their issues of bonds were negligible in the first half of 1986. Depositing by residents in Algeria and South Africa accounted for more than half of the \$2.7 billion increase in bank deposits from the area in 1985.

Bank claims on developing countries in the Middle East dropped by \$2.1 billion in 1985, accounted for, inter alia, by reduced claims on Kuwait and Israel. New bank credit commitments amounted to \$0.4 billion, about the same as in 1984. Developing countries in the Middle East also issued \$200 million in international bonds in 1985, compared with \$275 million in 1984. Banks received \$0.5 billion in deposits from residents in the Middle East in 1985, compared with a fall of \$2.2 billion in deposits in 1984, as depositing by nonbanks in the region rose to \$2.7 billion in 1985 from virtually zero in 1984.

CHART 9
 TERMS ON INTERNATIONAL BANK LENDING
 COMMITMENTS, 1976-FIRST HALF 1986



Sources: Organization for Economic Cooperation and Development, *Financial Market Trends*; Federal Reserve Bulletin for Prime Rate; International Monetary Fund, *International Financial Statistics*; and Fund staff estimates.

¹ New publicized long-term international bank credit commitments.

² First half only.



As regards the regional distribution of lending by different nationalities of banks, there was a sharp decline in U.S. banks' consolidated claims on developing countries. These claims fell by 8 1/2 percent in 1985 after declining by 2 percent in 1984 (Table 11). However, the U.S. claims for end-1985 have been reduced as the result of the sale by Crocker National Bank of \$3.1 billion of its international loans to Midland Bank. 1/ In 1985, Crocker's claims on Latin America fell by \$2.2 billion amounting to nearly one half of the total reduction of U.S. banks' claims on that region. 2/ U.S. banks' claims fell on all developing country regions, with the largest percentage declines for developing countries in Africa, the Middle East, and Asia. After adjustment for guarantees and other risk transfers, the decline in U.S. banks' risk exposure to developing countries was 6 1/2 percent in 1985.

Consolidated claims of U.K. banks expressed in U.S. dollars declined by \$0.4 billion (0.6 percent) with the fall in these claims concentrated on countries in Africa (6.4 percent) (Table 12). U.K. banks' claims on countries in Asia, Europe, and the Middle East increased by 2-3 percent in 1985. In the Western Hemisphere, U.K. banks' claims expressed in U.S. dollars declined by \$0.1 billion, or nearly 1 percent; this recorded decline was not affected by the transfer of claims from Crocker National Bank. These data probably understate the decline in U.K. banks' claims during 1985, due to exchange rate movements. Guarantees of U.K. bank claims declined slightly in 1985.

German domestic banks show an increase in claims on developing countries of \$2.7 billion (12 percent) in 1985 (allowing for an approximate adjustment for exchange rate changes). This increase may largely reflect a transfer of claims to domestic banks from their branches and subsidiaries abroad, whose claims on developing countries fell by \$0.5 billion (7 percent), and \$1.9 billion (16 percent), respectively. Overall, German banks may have increased modestly their claims on both the Western Hemisphere and Asia in 1985. No geographical analysis of Japanese banks' claims is published. However, a comparison of lending by other major groups of banks indicates a substantial increase in Japanese banks' claims on Asian countries, including purchases of bonds. A modest increase may have occurred in Japanese banks' claims on developing countries in the Western Hemisphere.

c. Terms of lending and restructuring

Average spreads on new bank credit commitments to developing countries dropped to 68 basis points in 1985, from 136 basis points in 1984 and from a peak of 154 basis points in 1983 (Chart 9). Average

1/ Midland Bank Annual Report.

2/ Crocker National Bank Annual Report. Other falls included \$0.5 billion in Asia and \$0.2 billion in the Middle East and Africa.

spreads fell further in the first half of 1986 to 64 basis points. The difference between spreads on developing countries and industrial countries narrowed to 27 basis points in 1985 from 81 basis points in 1984. This differential diminished further to 25 basis points during the first half of 1986. The average maturity of new bank credit commitments lengthened in 1985 but shortened during the first half of 1986. Nevertheless, average maturity for bank credit commitments to developing countries remained more than one year longer than similar commitments to industrial countries.

The improvement in spreads for developing countries during 1983-85 has been mainly for concerted lending packages. OECD data on the spreads on spontaneous bank loans to developing countries indicate that, after having dropped by 35 basis points in 1983, they declined by only a further 10 basis points between 1983 and 1985-86. By contrast, the average spread on concerted lending packages has dropped from 212 basis points in 1983 to 167 basis points in 1985. The difference between average spreads on spontaneous bank and concerted lending to developing countries decreased to 91 basis points in 1985 from 143 basis points in 1983. Maturities of concerted loans have lengthened by 3-4 years between 1983 and 1985 (Table 15).

Average spreads on restructuring agreements fell by about 70 basis points between 1983 and 1985. An examination of spreads on individual restructuring agreements shows that the declines in spreads were similar for different sizes of borrowers. The average spread on restructured bank debt for the four developing countries with the largest bank debt has been consistently 1/8-1/4 percent less than the spread on similar debt for other developing countries. MYRAs represent the clearest example of an overall improvement in terms for developing countries, as spreads were reduced, fees eliminated, and repayment periods extended.

2. Association with policy reform

a. General

Since the onset of widespread debt-servicing difficulties in 1982, commercial banks have generally sought to associate new financing and restructuring with debtor countries' progress in implementing macroeconomic policy reforms. Banks have generally phased their disbursements under new concerted lending packages in line with purchases under a Fund arrangement, thus linking their financial contribution to debtor countries' implementation of macroeconomic policies. Typically, bank debt restructuring agreements have also been conditioned on the existence of an arrangement to use Fund resources or enhanced surveillance.

An exceptional procedure was developed for Colombia wherein the Fund endorsed Colombia's policies as sufficiently strong and comprehensive "to have qualified for access to the Fund's resources under an arrangement in the upper credit tranches," and agreed to monitor observance of

Table 15. Terms of Selected Bank Debt Restructurings and Bank Financial Packages, 1983-First Half 1986

Country	Year of Agreement	Type of Transaction	Grace Period (In years)	Maturity (In years)	Interest Rate (In percent spread over LIBOR-U.S. Prime)
Argentina	1983	New financing	3	4 1/2	2 1/4-2 1/8
	1985	Restructuring	3	10 to 12	1 3/8-1 3/8
	1985	New financing	3	10	1 5/8-1 1/4
Brazil	1983	Restructured	2 1/2 ^{1/}	8	2 1/4-2 ^{2/}
	1983	New financing	2 1/2	8	2 1/8-1 7/8 ^{3/}
	1984	Restructuring	5	9	2-1 3/4
	1984	New financing	5	9	2-1 3/4
	1986	Restructuring	5	7	1 1/4
Chile	1983	New financing	4	7	2 1/4-2 1/8
	1983	Restructuring	4	8	2 1/8-2
	1984	New financing	5	9	1 3/4-1 1/2
	1985	Restructuring ^{4/}	6	12	1 3/8
	1985	New financing	...	10	1 5/8-1 1/4
Costa Rica	1983	Restructuring	3 1/4	6 1/2 to 7 1/2	2 1/4-2 1/8
	1985	Restructuring	3	10	1 5/8-1 5/8 ^{5/}
Cote d'Ivoire	1985	Restructuring ^{6/}	2	7	1 7/8 - 1 5/8
	1985	Restructuring ^{7/}	3	8	1 7/8 - 1 5/8
	1985	New Financing	3	7	1 7/8 - 1 5/8
	1986	Restructuring ^{8/}	3	9	1 5/8
Dominican Republic	1983	Restructuring	1	5	2 1/4-2 1/8
	1985	Restructuring ^{8/}	3	13	1 3/8
Ecuador	1983	Restructuring	1	7	2 1/4-2 1/8
	1983	New financing	1 1/2	6	2 3/8-2 1/4
	1984	Restructuring ^{8/}	3	12	1 3/8
	1984	New financing	2	10	1 5/8
Jamaica	1984	Restructuring	2	5	2 1/2
	1985	Restructuring	3 ^{9/}	10	1 7/8
Mexico	1983	Restructuring	4	8	1 7/8-1 3/4
	1983	New financing	3	6	2 1/4-2 1/8
	1984	New financing	5 1/2	10	1 1/2-1 1/8
	1985	Restructuring ^{8/}	0 to 1	14	7/8 in 1985-86 1 1/8 in 1987-91 1 1/4 in 1992-98
Philippines	1984	Restructuring	4 to 5	10	1 5/8
	1984	New financing	5	9	1 3/4
Venezuela	1984	Restructuring ^{8/}	--	12 1/2	1 1/8
Yugoslavia	1983	Restructuring	3	6	1 7/8-1 3/4
	1983	New financing	3	6	1 7/8-1 3/4
	1984	Restructuring	4	7	1 5/8-1 1/2
	1985	Restructuring ^{8/}	5	11	1 1/8

Sources: Restructuring agreements; and press reports.

^{1/} First principal payment due 30 months after rescheduling.

^{2/} The spreads over LIBOR/U.S. prime rate are 2 1/8 percent/1 7/8 percent for amounts on deposit with the Central Bank or--as generally acceptable maximums--for loans to public sector borrowers with official guarantee, Petrobras, and Companhia Vale do Rio Doce (CVRD); 2 1/4 percent/2 percent as the generally acceptable maximums for public sector borrowers without official guarantee, private sector borrowers with development bank guarantee and for commercial and investment banks under Resolution 63; 2 1/2 percent/2 1/4 percent as generally acceptable maximums for private sector borrowers.

^{3/} The Central Bank stands ready to borrow the committed funds at either 2 1/8 percent over LIBOR or 1 7/8 percent over U.S. prime rate. For loans to other borrowers, the spreads agreed must be acceptable to the Central Bank, which indicated the following maximums for spreads over LIBOR/U.S. prime rate to be generally acceptable: public sector borrowers with official guarantee as well as Petrobras and CVRD--2 1/8 percent/1 7/8 percent; public sector borrowers without official guarantee, private sector borrowers with development bank guarantee, and Resolution 63 loans to commercial and investment banks--2 1/2 percent/2 percent; private sector borrowers, including multinationals--2 1/2 percent/2 1/2 percent. Brazil is also prepared to pay a 0.5 percent commitment fee on undisbursed commitments, payable quarterly in arrears, and a 1.5 percent flat facility fee on amounts disbursed, payable at the time of disbursement.

^{4/} Restructuring of public and private debt due in 1985-87.

^{5/} 1 5/8 percent over "domestic reference rate," equal to: U.S. dollar certificate of deposit rate adjusted to reserves and insurance; or a comparable yield for loans denominated in other currencies.

^{6/} Debt due in December 1983 and in 1984.

^{7/} Debt due in 1985.

^{8/} Multiyear debt restructuring agreement.

^{9/} The repayment schedule is 4 quarterly payments of \$1 million starting October 15, 1988 with the remainder to be paid in 25 equal quarterly installments.

negotiated performance criteria. In this case, banks have linked their disbursements of concerted new loans to observance of those criteria.

One important recent development is that commercial banks have sought to link their financing to structural and sectoral reforms implemented with the support of the World Bank, in addition to their traditional association with the Fund. Banks have thus tied some disbursements of concerted loans and some restructuring agreements to World Bank involvement. In Chile and Uruguay, the World Bank assisted in catalyzing commercial bank financing through formal cofinancing arrangements. A second recent development has been the wider application of bank restructuring agreements, such as MYRAs, which cover a consolidation period beyond the period of an existing Fund arrangement. In these cases, banks have sought to ensure that the restructuring of maturities falling due in the later years of the consolidation period would be conditional on satisfactory policy implementation. They have thus included in their agreements conditions relating to future Fund involvement. These developments are discussed in detail below.

There has been considerable diversity in the types of linkage to World Bank activities that have been incorporated in commercial bank financing packages. The linkage may be broadly defined, with commercial banks requiring evidence of "progress" in negotiation or implementation of structural reforms. In other cases, the linkage to World Bank loans has been based on certification by the World Bank that debtor countries have borrowed a specified amount by a particular deadline. In some cases, all commercial bank disbursements under a new money package have been tied to performance under both Fund- and Bank-supported programs, while in still other cases linkage to the World Bank applied to only one disbursement from a new money package.

In Chile's new money agreement signed in November 1985, in addition to certification from the Fund, banks required a notification from the World Bank before each disbursement confirming that Chile's Structural Adjustment Loan (or "comparable facility") was in effect, and that Chile had drawn the full amount (which needed to occur by specified dates) expected to be available to it under the SAL.

In addition to linkage to the Fund, one commercial bank disbursement under Colombia's new money agreement of December 1985 was contingent on confirmation from the World Bank that Colombia would have access to the second tranche of an IBRD trade policy loan.

In 1985, commercial banks conditioned their restructuring and new money agreements with Costa Rica on the implementation of a World Bank SAL, as well as on a Fund program. Successive delays with implementation of the SAL and the Fund stand-by arrangement meant that the second disbursement of new bank money--expected originally in mid-1985--was made in November 1985.

For Cote d'Ivoire, disbursements under a 1985 new money agreement were conditional on a statement by the Bank on the eligibility of the borrower for drawdowns under a SAL and indicative statements about future loans. The restructuring agreements for 1984 and 1985 maturities also contained refinancing conditions involving both the Fund and the World Bank. The World Bank condition was not met, as the 1985 SAL was not signed as expected, and banks waived that condition during 1985 in order to continue the refinancing.

In addition to conditions involving the Fund, Panama's new money agreement for 1985-86 required certification from the World Bank regarding progress in negotiating and implementing a structural adjustment loan. The double linkage to the Fund and the Bank created difficulties in this case. Although the Fund program was on track, commercial banks did not make the first disbursement when it was scheduled, because adequate progress had not been made with the World Bank. Some months later, progress had been made with the World Bank, but Panama was no longer in compliance with the Fund program, and so the initial disbursement by commercial banks was again delayed.

Monitoring arrangements for MYRAs have raised the issue of bank linkage to policy implementation in future years. In some cases, where banks have restructured more than a single year's maturities, the consolidation period has been covered by a multiyear Fund arrangement (e.g., Chile). In other cases, banks have been willing to restructure maturities beyond the period of an existing Fund arrangement, but they have sought to include in the loan agreements some continuing Fund involvement. As discussed in the following section, in four of these cases (Mexico, Ecuador, Venezuela, and Yugoslavia), enhanced surveillance has been proposed to the Executive Board. Thus, commercial banks have been able to link their restructuring to Fund involvement in the form of enhanced surveillance.

Enhanced surveillance has remained an exceptional procedure. In some cases, banks have concluded MYRAs with countries for which the Fund Board has not approved the use of enhanced surveillance. Fund management has confirmed to banks its willingness to propose to the Executive Board, upon request from a member country, further stand-by arrangements if needed, or enhanced surveillance, within the Fund guidelines. However, Fund management and staff have also made clear to banks that the Fund's Executive Board would not be bound by conditions specified in loan agreements involving procedures that have not been agreed to for a specific member by the Fund's Executive Board. The Fund does not participate directly in negotiations between banks and a member country and banks do not always provide draft clauses relating to the Fund for review by the Fund staff when agreements are in preparation. In a number of cases where such clauses have been discussed with the Fund management and staff, banks have modified the clauses.

b. Enhanced surveillance

In 1984 and early 1985, when MYRAs were discussed between creditor banks and debtor countries, it became evident that some form of Fund monitoring could be helpful in restoring normal market access for certain indebted countries. The procedure of enhanced surveillance was therefore developed to improve a country's capacity to design, implement, and monitor economic policies and to provide information about those policies to creditors; to support banks' risk evaluation through timely and comprehensive information, and through the Fund's forward-looking assessment of domestic policies; and to foster a shift in responsibility for lending decisions back to commercial banks by avoiding on/off financing indications from the Fund. Enhanced surveillance was conceived as an exceptional and temporary adaptation of Fund procedures and practices for countries with a good record of adjustment and in a position to present an adequate quantified policy program in the framework of consultations with the Fund; it was not intended to become a substitute for stand-by and extended arrangements.

Experience with the four cases of enhanced surveillance--Venezuela, Mexico, Ecuador, and Yugoslavia--has been limited, since no staff reports have been distributed to creditor banks. There are close similarities between the bank monitoring arrangements in these four cases. (Ecuador and Yugoslavia have monitoring arrangements with official creditors also.) All of these bank monitoring arrangements foresee the provision of annual reports by the Fund on the countries' quantified financial program and semiannual reviews of the implementation of that program. These semiannual staff reports would be released by the member countries to their creditor banks. There are some variations of detail in the monitoring procedures but, in each case, key policy areas such as monetary and fiscal policy are to be reviewed.

The effectiveness of enhanced surveillance depends crucially on creditors performing their own assessments of the debtor country's policies and, if necessary, seeking to influence these policies in a timely fashion. The move toward serial MYRAs, rather than block restructuring, has reflected banks' desire to apply conditions separately to each proposed segment of a restructuring. In a serial MYRA, banks have successive opportunities to halt the restructuring if they are not satisfied that adequate policy implementation has taken place, whereas in a block restructuring, the conversion of maturities falling due in the future could only be halted by an event of default.

In a serial MYRA, banks have made the approval of each annual restructuring conditional on some form of satisfactory Fund involvement, which may be defined as a Fund arrangement or enhanced surveillance or--more broadly--as adequate monitoring procedures. In such cases banks may reconsider at the time of each tranche of the restructuring the specific form of monitoring procedures and policy programs that are satisfactory. The following background information focuses on the overall duration of enhanced surveillance and linkage between the monitoring arrangements and the continuing implementation of restructuring.

Venezuela's request for enhanced surveillance was approved by the Board in May 1985 to support a bank MYRA that covers 1983-88 maturities. Enhanced surveillance is scheduled to continue through 1997, until the final amortization of the restructured debt. Because the Venezuelan MYRA restructures a complete block of maturities, the agreement does not include a specific provision for a date on which banks may vote to discontinue the restructuring. At any time, however, two thirds of the banks may call an event of default if they consider Venezuela's economic program unsustainable. Also, a decrease in the operating reserves of the central bank below \$2 billion would trigger an event of default. The Executive Board has discussed three staff reports on Venezuela under enhanced surveillance. However, because the bank MYRA with Venezuela has not been implemented, banks have not as yet received any of these reports.

Enhanced surveillance for Mexico was due to begin in January 1986, after the extended Fund facility had expired, and will continue through 1990 or 1994, depending on the date of final repayment of the 1983 new money package. The MYRA restructures maturities falling due during 1985-90 in two blocks of three years each. In addition, in the event of Mexico's economic situation or prospects deteriorating to the point that it would be unable to meet its financing requirements through normal market channels, it agreed to seek financing from other sources, which could include a request to use Fund resources. The Mexican authorities have recently announced their intention to request the use of Fund resources.

Ecuador agreed with its bank creditors to request in support of a MYRA that restructures maturities due in 1985-89 with final repayment in 1996. For the restructuring of the 1985-86 maturities, Ecuador was required to be under a stand-by arrangement through both years. After 1986, the restructuring is "serial," insofar as there is explicit provision for a majority of banks to halt the restructuring in any year, if Ecuador's financial program is judged inadequate by the banks, or if its external situation or prospects deteriorate. The bank MYRA does not envisage enhanced surveillance beginning until after the existing Fund arrangement expires in mid-1987.

The bank MYRA for Yugoslavia covers restructuring of maturities falling due in 1985-88, with the final amortization payments in 1996. Enhanced surveillance for Yugoslavia began on the expiration of the Fund arrangement on May 16, 1986 and is to continue through 1991. The Executive Board will have an opportunity to discuss the first staff paper under enhanced surveillance for Yugoslavia prior to discussion of this paper. A novel aspect of the bank MYRA with Yugoslavia was the inclusion of a trigger mechanism to indicate likely difficulties in meeting future repayments. The major purpose of this mechanism is to shorten the time lag between implementation of remedial action, if needed, and the diagnosis of such a need, and to facilitate the assessment of the situation by creditor banks. Remedial action could potentially lead to an approach to the Fund by the authorities. The trigger clauses agreed between the

creditor banks and the authorities apply to external reserves and export earnings. The experience with these triggers is yet to be tested.

3. Developments in restructuring packages

Last year's report on international capital markets (SM/85/280, 10/17/85) discussed the introduction of new forms of financing techniques in new money packages. Arrangements such as currency redenomination, relending and on-lending, loan sales and swaps, and conversion of debt to equity have been introduced as ways of diversifying modalities in some financing packages and allowing banks to match their claims more closely to their long-term business interests and customer relations. New money packages have also included trade facilities or commitments to provide trade financing, partly reflecting banks' preference to provide financing that is linked to trade, which may also support the operations of the domestic business clients. Some recent points of interest in restructuring packages are reviewed below.

a. Currency redenomination

Under several recent restructuring agreements banks have been permitted, at their option, to redenominate existing loans in their domestic currencies or the European Currency Unit (ECU). Such redenominations reduce, for non-U.S. dollar-based banks, the funding risk and the effect of future exchange rate movements on the banks' claims relative to their domestic currency capital. Banks do not need to elect to redenominate their loans before the restructuring agreement is signed, or for a specified period thereafter. The period for such conversions has varied, extending up to four years. Between 50 and 100 percent of existing loans denominated in currencies other than the banks' home currency have been eligible for redenominations. In the case of Venezuela, an additional effective ceiling limits conversions to about one seventh of the total debt restructured.

Some banks consider a currency redenomination option as an incentive to participate in financing packages. For debtor countries, the benefits from currency diversification are difficult to predict. Possible savings on interest payments have to be weighed against the potential increase in debt and debt service payments from a further dollar decline. During 1985, the timing of a currency redenomination from U.S. dollars into one of the other major currencies would have been crucial in determining the overall gain or loss for a debtor.

Currency redenomination options exist in the restructuring agreements with Argentina, Mexico, the Philippines, Uruguay, Venezuela, and Yugoslavia. Discussions with banks suggest that where options have already been exercised, banks in Japan and Switzerland have taken advantage of such schemes to redenominate their claims; U.K. banks have redenominated about half of eligible claims, and Italian banks have in some cases switched loans into ECUs.

The agreement between Argentina and the banks envisages that almost a quarter of the debt restructured is eligible for redenomination. Significant amounts of restructured debt are believed to have been redenominated from U.S. dollar into yen and deutsche marks although the exact amounts are not known.

In the case of Mexico, about half of the restructured debt is covered by a currency redenomination option; of this portion, a maximum of 50 percent is eligible for redenomination. Mexico's creditor banks seem to have maintained the U.S. dollar-denomination of their assets to a large extent, although banks estimate that up to \$5 billion, or 7 percent, of Mexico's debt may have been redenominated largely into sterling, yen, and deutsche mark claims.

In the case of the Philippines, the currency composition of the first tranche of new bank money indicated a continuing strong preference for the U.S. dollar, with a share of 70 percent, but also a considerable interest in yen (18 percent) and ECU (5 1/2 percent) denomination. The MYRA agreement for Uruguay permits banks to redenominate the principal restructured at each annual advance. This selection can be changed prior to each annual advance date during the consolidation period.

The restructuring agreement with Venezuela, which includes a redenomination option, had not been implemented by mid-1986. The Venezuelan authorities have indicated that they expected that many Japanese banks and German banks could eventually elect to redenominate their loans into their home currencies, and that the overall ceiling of \$3 billion could be reached. The MYRA agreement for Yugoslavia permits banks to redenominate the restructured debt at each refunding date into one of a list of "preferred" currencies.

A different form of currency redenomination has taken place with Sudan where, at the option of the debtor, all of the restructured bank debt (almost \$1 billion) was converted into Swiss francs from U.S. dollars. This transaction was part of a modification of the 1981 restructuring agreement and was signed in October 1985. The main reason for this transaction was to reduce the interest obligation on the restructured debt. The conversion was undertaken at a Swiss franc/U.S. dollar exchange rate of 2.17; at end-June 1986, the Swiss franc/U.S. dollar exchange rate was 1.80.

b. On-lending/relending

On-lending and relending both involve the reallocation of credit to a different debtor within the same country. On-lending occurs when the lender and the original borrower agree that the proceeds of a new money loan will be transferred to a new obligor who takes over the obligation to repay from the original borrower. The latter, however, often guarantees repayment of the loan. Relending involves the repayment of an existing debt by the original borrower to the lender which lends the proceeds to other borrowers in the country. Relending and on-lending

enable banks to maintain or develop business relationships with clients in developing countries, to support the export activities of their customers, and, more generally, to reallocate the credit risks among different borrowers within a certain country. However, switching in the direction of lending under these arrangements can only be accommodated to a modest extent within the framework of a financial program.

Provisions for on-lending and relending in restructuring or new money packages in Argentina, Brazil, Chile, the Philippines, and Venezuela were described in last year's capital markets paper. In Brazil, relending under the 1983 and 1984 restructuring and the 1985 interim arrangement, and on-lending under the 1983 and 1984 new money packages amounted to \$8.8 billion in 1984 and to \$5.5 billion in 1985. Since September 1985, the Central Bank of Brazil has been reluctant to approve new applications for relending and on-lending and no more than \$1 billion is expected to take place in 1986. Under Argentina's \$3.7 billion new money agreement signed in August 1985, \$510 million were estimated to have been on-lent up to July 1986. In Mexico, a modest amount of on-lending has been permitted, while in the cases of Chile and the Philippines no significant relending or on-lending has taken place (despite the provisions in the respective restructuring and new money agreements). The Venezuelan MYRA allows relending, but the process may only start in 1987.

c. Loan swaps/sales

Banks in various countries have engaged in sales and swaps of loan claims to eliminate their claims on a certain country and to concentrate claims on a country where prospects and future relations were viewed more favorably. In addition, some major banks have assembled packages of loans from banks with small exposures to provide finance for industrial clients to make investments in certain developing countries through debt to equity swaps.

No standard practice exists in the banking community on the treatment of new money obligations associated with sold or swapped loans. For some banks, the major reason for selling such loans appears to be reluctance to participate in future concerted lending packages. In certain instances, however, banks discovered that, even though they had sold claims on particular developing countries, they had not been released from obligations to contribute to new money packages. Banks observed that it would be crucial that legal arrangements clarify that the potential new money obligation of a "selling" bank had been extinguished in a manner definitive and satisfactory to all partners.

One factor that has kept the market for loan sales small and inhibited larger banks from participating is the potential impact of discounted sales on the valuation of existing assets by auditors and bank supervisors. Banks are concerned that loan sales or swaps on a large scale could require, at a future stage, that the value of comparable assets be marked down. Nevertheless, in discussions with banks it

appeared that the loan sale and swap market is expanding. Estimates by market-makers of how much debt has changed hands in this market so far range from \$10 billion to \$15 billion (counting both sides of the transactions), compared to over \$300 billion of bank debt outstanding of countries which have restructured since 1982.

Discounts associated with loan sales have ranged from 10 percent to 90 percent; variations between countries, and over time for some countries, have reflected the perceived creditworthiness of the debtor countries and the levels of provisioning and write-offs. Debt of the major debtor countries in the Western Hemisphere has traded at 20-40 percent discounts, according to market participants, while discounts between 70 percent and 90 percent have been observed for those countries in the Western Hemisphere with severe debt problems, such as Bolivia and Peru, and for some sub-Saharan African countries.

Although debt of all major developing countries that have recently restructured their bank debt seems to have been traded at times, the quoted discounts may not be representative insofar as relatively few transactions have taken place. Also, information on the amounts of traded debt for individual countries is limited, except in cases such as Chile, where sold or swapped debt subsequently converted to local currency through formal arrangements requires either Central Bank approval or the intermediation of Chilean financial institutions (see below). Thus, much of the \$274 million of debt conversions in Chile between June 1985 and March 1986 involved debt bought at a discount. Discounts on this debt appear to have been on the order of 30 percent.

To facilitate the trading of bank claims on certain developing countries that have restructured their bank debt, some banks have studied the possibility of securitizing trade and interbank lines that have been effectively frozen as part of financing agreements. A few Mexican banks have issued bonds to replace their interbank lines, and some Brazilian banks were also in the process of arranging a note issuance facility for this purpose.

d. Debt to equity conversions

In recent years, countries have adopted various arrangements to allow the conversion of loans into domestic currency to meet local currency obligations and make local investments. The most fully developed scheme is that of Chile, where government regulations allow both for nonresidents to convert loan claims (which as noted above may have been bought at a discount) into equity, and for Chilean residents to repatriate capital through the exchange of loan claims for domestic

currency. ^{1/} In the first nine months of operation of the two in Chile, transactions under both amounted to \$274 million. Of these, \$91 million involved direct investment conversions with remittance rights.

In Brazil, conversion of debt to equity was \$731 million in 1984, but declined in 1985 to \$530 million. These conversions may have involved the debt of a parastatal enterprise. Although there has not been a new formal scheme introduced in Brazil, market sources have stated that a large European bank recently arranged for the pooling of loan claims sold at a discount by other banks, and the subsequent sale of these claims to a large corporate client which wished to expand its investments in Brazil. Conversions of debt to equity in Brazil are estimated by market sources at \$600 million for 1986.

Considerable interest was expressed by banks in the debt-to-equity conversion clause in Mexico's restructuring agreement. This clause has been applied on an ad hoc basis, with a number of separate negotiations between claim holders, potential investors, and the Mexican authorities. As in Chile, the Mexican authorities seek to ensure that investors provide additional foreign exchange inflows.

A debt-to-equity swap was completed in May 1986 with Nissan Motor Company of Japan. Nissan bought approximately \$50 million of loan claims from a number of banks and negotiated the exchange of these claims for pesos, which were then invested in Nissan's Mexican subsidiary. As provided for in the bank agreements relating to Mexico's debt restructuring, the new shares may not be sold until 1999. Market participants have indicated in discussions with the Fund staff that a number of other banks and brokers were attempting to arrange similar conversions.

Information has recently become available on a debt-to-equity conversion scheme for Nigeria. Nigeria restructured outstanding uninsured arrears by issuing promissory notes. Holders of such notes have the option of redeeming the notes in Nigerian naira at any time on such terms as may be mutually agreeable between the holder and the Nigerian Central Bank. If an approved long-term investment in Nigeria is made with those proceeds, the investment will be treated as having been made in foreign currency and be accorded approved status for purposes of taxation and repatriation of dividends and capital in accordance with relevant laws in Nigeria in force at the time. However, there are no indications that this option has been used to a significant extent.

The bank debt restructuring agreement for the Philippines allowed for the early repayment in pesos of public sector obligations, subject to

^{1/} Appendix III of the report on Chile's Recent Economic Developments (SM/86/165, 7/8/86) provides a detailed description of the debt conversion mechanisms, incorporating changes made through June.

the approval of the Central Bank. The Central Bank has allowed the conversion of debt into equity to meet local currency obligations and to make local investments; at the end of May 1986, a total of \$26 million had been converted. Recently the Government has also submitted to banks a new scheme of debt equity conversion modeled after the Chile experience. Under this plan loans which are acquired at a discount can be converted at face value into long-term peso investments. The plan makes a distinction between preferential sectors where the Government wants to encourage foreign investments and other nonpreferential sectors. More favorable conditions with regard to repatriation of dividends and conversion fees will apply to investment in preferential sectors.

In addition to equity conversions initiated and supported by the authorities in debtor countries, individual bank creditors have swapped loan claims into equity on a private basis. A further possible mechanism for converting debt to equity is under study in the International Finance Corporation. This would involve the use of a trust fund that would pool loan claims from a number of banks in order to purchase investments, or shares, in private companies in debtor countries. Such schemes may be particularly appropriate where countries have a developed private sector and stock market.

In discussions with staff, banks indicated that conversions could in the future allow countries to extinguish some of their external indebtedness and for banks to eliminate unwanted loan claims. They noted, however, that there was still considerable uncertainty about the scope for possible debt-to-equity conversion. Commercial banks' attitudes toward debt-to-equity conversion differ according to banks' long-term interests in developing countries. In addition, they may be influenced by national banking regulations (as described in Section 4). Some banks indicated their interest in debt-to-equity conversion in order to develop relations with financial institutions in debtor countries, to expand existing operations and obtain new nonbank customers, or simply to diversify existing claims. Other banks noted that while they were interested in arranging for the brokering of loan claims between banks that wish to dispose of their debt and corporate clients who wished to invest in a debtor country, they did not contemplate using their own loan claims for such transactions. Concern over the valuation of remaining claims was usually cited in this context.

The success of such schemes depends crucially on available investment opportunities in debtor countries and on banks' willingness either to dispose of loan claims at a loss or to accept a longer-term commitment to a debtor country in the form of equity participation. Typically, conversion schemes approved by debtor countries will involve restrictions on profit remittances and on the repatriation of investment capital for a period of time. In Chile, for example, such restrictions are designed to have similar impact to that of the terms of the debt restructuring.

Some debtor countries have developed mechanisms to capture part of the discount at which their claims are being sold in the secondary market, and to avoid subsidizing foreign investments that would have taken place anyway. Countries have also placed ceilings on the total amount of conversions, so as to limit excessive monetary expansion through the provision of local currency counterparts to redeem loans and to avoid squeezing economic activity on account of this early repayment of debt.

e. Semi-spontaneous lending

A few countries that have experienced debt difficulties since 1982 have been able to move toward arranging loans from a limited group of banks with longer term business interests. In Cote d'Ivoire, Ecuador, and Uruguay, such "semi-spontaneous lending" has been viewed as a step in the direction of a return to normal market relations between debtors and creditors. Banks have noted that for such loans to be successful, banks must have confidence in the economic policies and prospects of the debtor country and that its financing needs are relatively small. Some banks expressed concern that participation in semi-spontaneous lending packages would not lessen their contribution to a future concerted lending package if such lending would again be required.

Semi-spontaneous bank financing has been successful where it has been confined to banks wishing to develop their business interests. Banks said that they prefer to have their lending linked to particular projects or trade operations in countries where they have close business ties, rather than to advance general medium-term balance of payments financing. Banks also noted that in some cases, semi-spontaneous lending could be facilitated by cofinancing with the World Bank.

In both Uruguay and Cote d'Ivoire, semi-spontaneous lending was arranged in the context of a cofinancing with the World Bank. In the case of Uruguay, commercial banks are to provide \$45 million of a \$90 million energy loan. As of July 1986, the loan had been oversubscribed by banks and was said to be nearing completion. The forthcoming paper on activities of multilateral development banks provides more detail on the loan. The banks' approval of the cofinancing was dependent on agreement on the MYRA, which was signed in early July.

In Cote d'Ivoire regional ties of some banks, together with a World Bank cofinancing, facilitated a semi-spontaneous loan involving fewer than a dozen banks. These banks disbursed a \$32 million loan in April 1986. The loan, cofinanced with the World Bank, was in support of a large highway project, which is also being supported by a regular World Bank "A" loan, by a loan from the African Development Bank, and by some bilateral official creditors.

A somewhat different arrangement has been pursued in Ecuador. In this case, Ecuador is seeking a revolving trade facility from a limited group of banks to prefinance oil exports. A mandate has been given to a

commercial bank to syndicate the 18-month facility which would be for about \$160 million (the precise amount will depend on the price of oil) and would finance all Ecuador's foreign oil sales. At the same time, Ecuador plans to increase its use of existing trade lines to provide a further \$100 million balance of payments finance this year.

In the context of semi-spontaneous lending, the staff also discussed with banks how innovative techniques could be used to facilitate re-entry to international capital markets for countries with debt-servicing difficulties. Banks pointed to the recent borrowing experience of Turkey and Hungary (although Hungary has not needed to restructure its debt), as illustrating how new techniques have been used by developing countries. For Turkey, short-term bond issues--placed mainly with banks--were a part of its return to spontaneous financing. Turkey has now entered the Eurocommercial paper market, following its use of note issuance facilities in early 1986. In June 1986, Turkey mandated Bankers Trust to arrange a \$125 million loan facility to back up issues of commercial paper to be guaranteed by Fuji Bank of Japan.

Hungary recently borrowed in the Eurobond market through the issuance of \$250 million in the form of 20-year floating rate notes which were "collateralized" by a zero coupon U.S. Treasury bond of 20-year maturity and a cash reserve fund that will be invested in short-term U.S. dollar securities. This collateral is intended to secure both the principal of the notes--through the zero coupon bond--and the interest payments expected to fall due after an estimated 12-15 years. In those later years the combined value of the cash reserve fund and the zero coupon bond would cover the principal due on the Eurobond. In addition, earnings on the cash reserve fund in those later years would be used to pay the interest payments on the floating rate notes. Market participants believed that the arrangement had enabled Hungary to obtain longer term bond finance, but at a higher effective spread than on more traditional medium-term issues.

Some banks also noted that "transferable loan facilities," which allow banks to increase the tradability of their assets, have been used by several countries in recent years, including countries that have refinanced their debt and other developing countries that have retained access to spontaneous flows. These instruments are a hybrid between a loan and a bond, and have generally been held by banks in anticipation of a future increase in countries' creditworthiness, rather than transferred. About \$11 billion of transferable loan facilities (including both transferable loan certificates and transferable loan instruments) have been established.

Broadly, banks have indicated that they place great importance on developing the financing techniques described above so that the diversity of banks' interests in developing country business may be recognized as debtors regain access to spontaneous finance. They cautioned, however, that a premature move away from concerted financing could prove

costly for debtors and make it difficult for them to generate sufficient private finance.

f. Private sector debt

Since 1985, no new arrangement has been implemented to facilitate restructuring of private sector debt. In Venezuela, however, within the context of the existing RECADI scheme new regulations were recently introduced for the servicing of the private sector debt. Under the RECADI scheme, private debtors were to have preferential exchange rates for debt-servicing upon signing a five year contract with the Central Bank of Venezuela. The new regulations limit access to the preferential exchange rate of Bs4.3 per U.S. dollar to the first two quarterly payments under the five year contract. For the remaining private external debt the Government's Exchange Compensation Fund will issue dollar-denominated bonds with a maturity of no less than 15 years and an annual interest of no more than 5 percent which debtors may purchase at Bs7.50 per dollar. These bonds may then be transferred to foreign creditors in settlement of their foreign obligation.

Creditor banks have objected to the introduction of these new regulations without consultation with external creditors to the extent that their interests may be affected. The authorities, however, have stressed that Venezuelan private debtors may agree on additional payments to compensate for any losses to the creditors that may arise from the use of the bonds to settle external obligations.

4. Banking supervision

Since the onset of the bank debt crisis in 1982, bank supervisors have sought to strengthen banks' balance sheets. In strengthening balance sheets, the quality and diversification of earnings are the first defense against potential future losses. Increased provisioning against country risk exposure and, more generally, a buildup in banks' capital have also taken place.

a. Provisioning

Provisioning practices and the role of the supervisory authorities differ across countries according to their regulatory and accounting framework, and the tax treatment of loan loss reserves. Supervisors in the G-10 countries and Switzerland review and compare provisioning levels on a regular basis in the Basle Committee. They have noted that considerable variations exist in national provisioning practices and levels, despite efforts to coordinate the strengthening of banks' balance sheets and a generalized move toward higher provisioning.

In some countries, such as the Netherlands and the United States, banks are required to make specific provisions against their claims on each debtor, reflecting the risk associated with a particular type of claim on an individual sovereign borrower. Specific provisioning also

allows for different categories of loans to the same country to be treated differently, according to the debt-servicing record. In both the Netherlands and the United States, for example, trade finance may be excluded from provisioning requirements where it has been regularly serviced. Under such a regime, loans may also be upgraded as a result of an improved assessment of countries' creditworthiness, and of the likelihood that the loans will be repaid.

Some other countries, for example Canada and Japan, do not estimate directly the risk attached to claims on individual countries, but instead require banks to make "basket" provisions against a number of countries. Typically, countries are included in the basket for a number of years after a debt rescheduling or moratorium. If this approach is adopted rigidly, loans to the group of countries in the basket are treated uniformly regardless of the type of loan and the current prospects of the country. If such a basket rule is in operation, there may be a particular advantage to MYRAs, as these allow for an extended period of restructuring but without necessarily prolonging the time of inclusion in the provisioning basket.

For other industrial countries, the provisioning regime falls somewhere between these two approaches. Typically, a judgment on the adequacy of an individual bank's overall level of loan-loss reserves is made initially by the bank management and then by the external auditors. Supervisory authorities then review bank practices and may recommend, or (where provisioning is mandatory) require, increases in provisioning in individual cases, taking into account banks' experience and the general judgment within the banking community of the riskiness of particular overseas exposure. In principle, this approach allows for trade financing to be treated more flexibly and for banks' claims on individual debtor countries to be upgraded if commercial banks and their auditors recognize an improvement over time in the quality of such assets.

From a supervisory perspective, the advantage of basket provisioning is that it limits the need for judgments about individual countries. Banks noted, however, that mandatory basket provisioning, if implemented rigidly for a fixed number of years, could inhibit new lending--including spontaneous trade credits--to countries in the basket and may provide inappropriate signals to countries which are implementing adjustment measures. In Japan, however, there is some evidence of resumed lending to at least one country still in the provisioning basket, while trade finance in the form of bills is not included in the basket. The disadvantages attributed to the basket approach are also possible where any provisioning practices are applied by the authorities without regard to the borrowers' economic performance and payments record.

There are marked differences within many countries in the provisioning levels of different domestic banks, as supervisors have allowed time for individual institutions to build up their reserves. Some banks

indicated that they intend to continue to build up reserves against their exposure to those countries that have experienced debt-servicing difficulties, even without pressure from supervisory authorities. In other cases, banks noted that the need to make an immediate set aside out of current income for a proportion of any new loan is an important disincentive to lending.

For an individual bank, decisions concerning provisioning reflect a number of factors in addition to the assessment of risk involved in loan exposure. Such factors include the impact of an increase in reserves on cash flow and on the ability to distribute dividends, as well as the expected attitude of the supervisory authorities. Tax treatment has been an important factor influencing loan-loss reserves. In some countries, banks are able to claim large tax deductions on the basis of their provisioning against country risk. For profitable banks in these countries, it has been worthwhile to make substantial provisions in order to benefit from tax deductibility. For countries outside the United States, the recent sharp decline in the value of the U.S. dollar has recently tended to raise the value of existing provisions (which are generally made in local currency) when measured in relation to U.S. dollar-denominated cross-border loans.

Average provisioning levels against a group of countries that have experienced debt-servicing difficulties are now in excess of 20 percent or more of banks' loan claims for some continental European countries, while at the other end of the spectrum, the supervisory regime in the United States--which places emphasis on capital and general reserves rather than specific provisions--has led to a low average level of provisioning against country risk. However, the differences in provisioning levels among banks within a country--which in some cases are substantial--may perhaps be of greater significance for the robustness of financial markets than differences in national averages.

Cohesion among commercial banks may be more difficult to achieve because of disparities in loan loss reserves. Banks that are generally better provided against their exposure to debtor countries, and thus presumably better able to withstand losses on such claims, may have less incentive to participate in new money packages than those with smaller provisions. However, the interlinking of the banking system means that all banks have an interest in the continued strength of the financial system as a whole. Moreover, although there are some banks with high provisioning levels, authorities and bankers generally have indicated that the average level of loan-loss reserves in most national banking systems is not so high as to make banks indifferent to the success of the debt strategy. Finally, even in cases where loans have been written down, banks will benefit from improvements in the creditworthiness of debtor countries.

b. Capital adequacy

There has been a general strengthening of banks' balance sheets relative to their claims on developing countries since 1982. All size categories of U.S. banks continued to increase their capital in 1985 (Table 16). As a result of this increase and a small decline in U.S. banks' claims on developing countries, there was a further drop in the ratios of claims on developing countries to U.S. banks' capital to below the levels in 1977 (Chart 10 and Statistical Appendix Table 29). The ratio for the nine money center banks decline to 203 percent in 1985 from 246 percent; the ratio for the next 15 largest U.S. banks decreased to 117 percent in 1985 from 158 percent in 1984; and the ratio for regional banks declined to 51 percent from 58 percent. The depreciation of the U.S. dollar during 1985-86 and a continued buildup of capital and provisions for banks outside the United States has reduced considerably these banks' exposure to developing countries relative to capital and provisions. Consequently, the unprovisioned exposure of banks in industrial countries to developing countries relative to capital has diminished sharply since 1982.

The ultimate safeguard against banks' potential losses on international lending, as on any other credit risk, is capital. There is growing agreement among supervisors that solvency ratios need to recognize that exposure to some sovereign borrowers may be more risky than to others. Risk asset ratios that require different capital backing for different assets provide regulatory authorities with such a tool. While these ratios typically treat all commercial and industrial loans in a similar manner regardless of the country of residence of the borrower, they do sometimes give a higher weight, and thus require higher capital backing for loans to sovereign borrowers in developing countries. This approach--termed "zoning"--provides a buffer against the transfer risk believed to be inherent in claims on this broad class of borrower.

In discussions with staff, supervisors acknowledged that the boundary between groups of countries would inevitably be arbitrary and, at least for the time being, not based on a country-by-country risk assessment. They noted that risk asset ratios involve only the broad classifications of assets into a relatively limited number of simply defined categories. As described above, a more detailed measurement system could effectively amount to credit allocation. For domestic commercial loans, the designation of the same risk weighting indicated that banks were expected to make their own judgments of credit risk and lending opportunities between individual borrowers. While the impact of zoning on borrowing costs for individual developing countries is hard to gauge, some supervisors have commented that it is likely to be slight.

Risk asset ratios are already used in some European countries. These ratios vary in their treatment of sovereign risk and in the relative capital weighting that they accord to different borrowers. The risk-asset ratio proposed by the United States and circulated for comment in early 1986 would assign a higher risk weight to loans to

Table 16. Capital-Asset Ratios of Banks in Selected Industrial Countries, 1978-85 ^{1/}

(In percent)

	1978	1979	1980	1981	1982	1983	1984	1985
Canada ^{2/}	3.3	3.2	3.0	3.5 ^{3/}	3.7	4.1	4.4	4.6
France ^{4/}	2.3	2.6	2.4	2.2	2.1	2.0	1.9	2.2
Germany, Federal Republic of ^{5/}	3.3	3.3	3.3	3.3	3.3	3.3	3.4	3.5
Japan ^{6/}	5.1	5.1	5.3	5.3	5.0	5.2	5.2	4.8
Luxembourg ^{7/}	...	...	3.5	3.5	3.5	3.6	3.8	4.0
Netherlands ^{8/}	3.9	4.3	4.2	4.3	4.6	4.7	4.7	4.9
Switzerland ^{9/}								
Largest 5 banks	7.8	7.6	7.6	7.4	7.3	7.1	7.1	7.8
All banks	7.8	7.6	7.6	7.5	7.5	7.3	7.4	7.8
United Kingdom								
Largest 4 banks ^{10/}	7.5	7.2	6.9	6.5	6.4	6.7	6.3	7.9
All banks ^{11/}	5.2	5.1	5.0	4.5	4.1	4.4	4.5	5.5
United States								
Nine money center banks ^{12/}	4.7	4.5	4.5	4.6	4.9	5.4	6.2	6.8
Next 15 banks ^{12/}	5.4	5.4	5.5	5.2	5.3	5.7	6.6	7.2
All country reporting banks ^{12/13/}	5.5	5.3	5.4	5.4	5.6	5.9	6.5	6.9

Sources: Data supplied by official sources; and Fund staff estimates.

^{1/} Aggregate figures such as the ones in this table must be interpreted with caution, due to problems of consistency across national groups of banks and over time in the accounting of bank assets and capital. In particular, provisioning practices vary considerably across these countries as do the definitions of capital. Therefore, cross-country comparisons may be less appropriate than developments over time within a single country.

^{2/} Ratio of equity plus accumulated appropriations for contingencies (before 1981, accumulated appropriations for losses) to total assets (Bank of Canada Review).

^{3/} The changeover to consolidated reporting from November 1, 1981 had the statistical effect of increasing the aggregate capital-asset ratio by about 7 percent.

^{4/} Ratio of capital, reserves, and general provisions, to total assets. Data excludes cooperative and mutual banks (Commission de Controle des Banques, Rapport).

^{5/} Ratio of capital including published reserves to total assets. From December 1985, the Bundesbank data incorporate credit cooperatives (Deutsche Bundesbank, Monthly Report).

^{6/} Ratio of reserves for possible loan losses, specified reserves, share capital, legal reserves plus surplus and profits and losses for the term to total assets (Bank of Japan, Economic Statistics Monthly).

^{7/} Ratio of capital resources (share capital, reserves excluding current-year profits, general provisions, and eligible subordinated loans) to total payables. Eligible subordinated loans are subject to prior authorization by the Institut Monetaire Luxembourgeois and may not exceed 50 percent of a bank's share capital and reserves. Data in the table are compiled on a nonconsolidated basis, and as a weighted average of all banks (excluding foreign bank branches). An arithmetic mean for 1985 would show a ratio of 9.3 percent. Inclusion of current-year profits in banks' capital resources would result in a weighted average of 4.3 percent for 1985. Provisions for country risks, which are excluded from capital resources, have been considerably increased in the last few years, with a quadrupling of the level of provisions between 1982 and 1985.

^{8/} Ratio of capital, disclosed free reserves, and subordinated loans to total assets. Eligible liabilities of business members of the agricultural credit institutions are not included (De Nederlandsche Bank, N.V., Annual Report).

^{9/} Ratio of capital plus published reserves, a part of hidden reserves, and certain subordinated loans, to assets (Swiss National Bank).

^{10/} Ratio of share capital and reserves, plus minority interests and loan capital, to total assets (Bank of England).

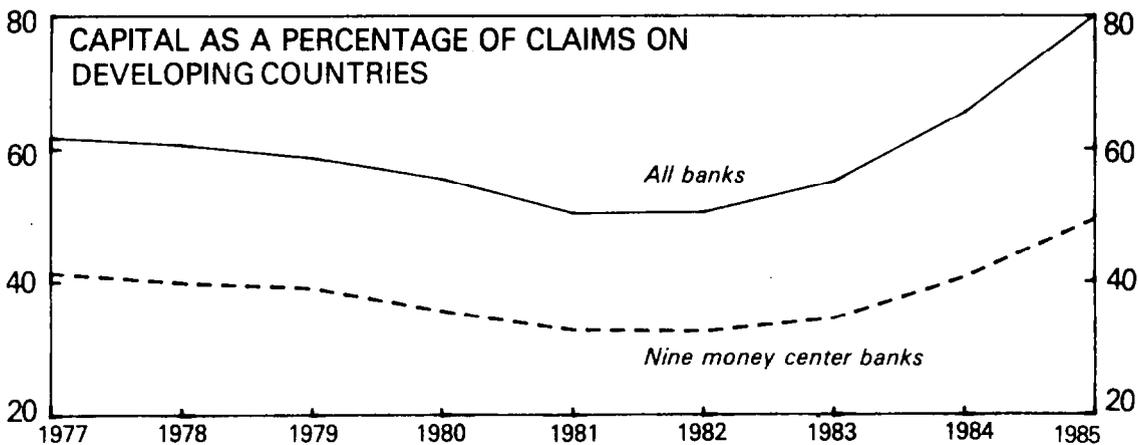
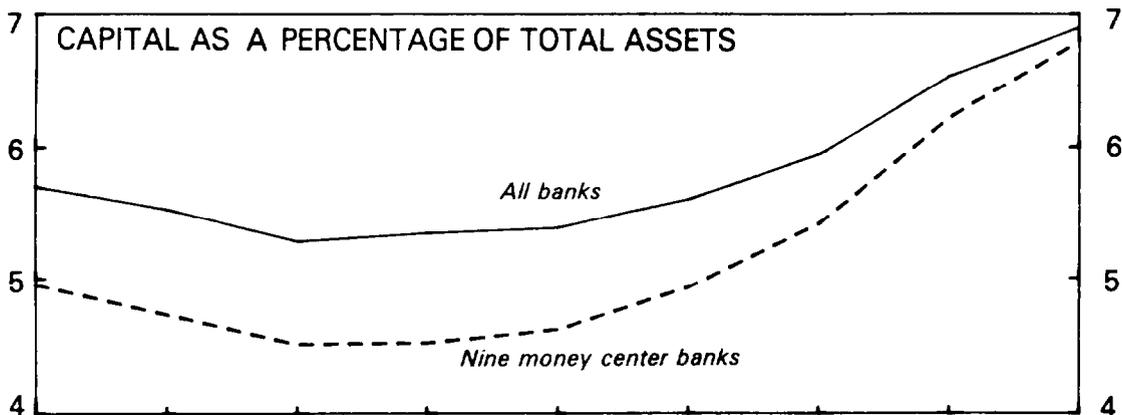
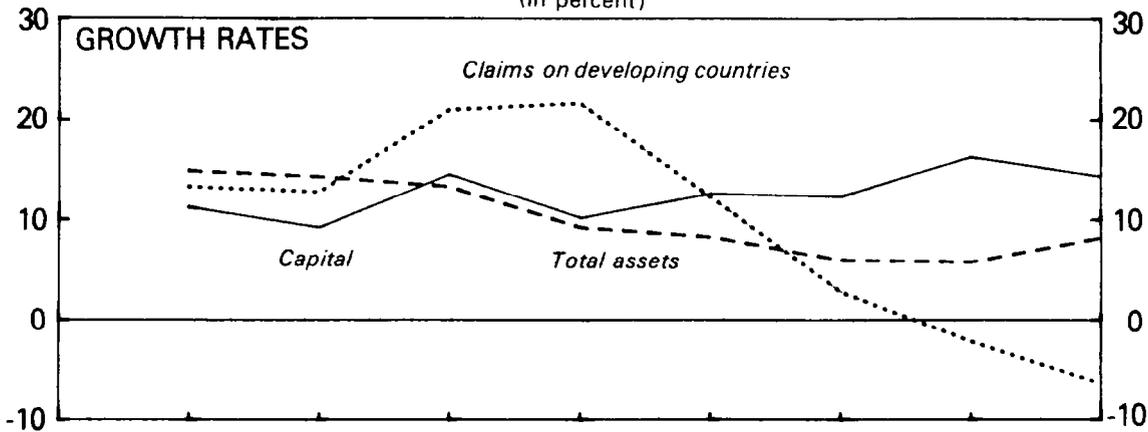
^{11/} Ratio of capital and other funds (sterling and other currency liabilities) to total assets (Bank of England). Note that these figures include U.K. branches of foreign banks, which normally have little capital in the United Kingdom.

^{12/} Ratio of total capital includes equity, subordinated debentures, and reserves for loan losses, to total assets.

^{13/} Reporting banks are all banks which report their country exposure for publication in the Country Exposure Lending Survey, Federal Financial Institutions Examination Council.

CHART 10 SELECTED BALANCE SHEET DATA FOR U.S. BANKS, 1977-85

(In percent)



Source: Federal Financial Institutions Examination Council, *Country Exposure Lending Survey*.



sovereign borrowers from developing countries than to industrial countries. The U.S. regulators proposed initially to use the Fund's country classification. In a letter to the U.S. federal regulatory authorities, the Deputy Managing Director stated that the Fund's country classification was devised for "economic analysis and not with a view to prudential concerns," and that "judgments of prudential classifications are in the final analysis based on assessments made by supervisory authorities."

A limit on the concentration of assets to a particular borrower, type of borrower, or group of economically related borrowers, is another common method of regulating capital cover for particular assets and avoiding concentration of risk. Such limits on large exposures do not generally appear to have inhibited lending to developing countries, partly because typically more than one borrower is involved in banks' sovereign lending.

c. Other issues

Banks' interest in financing techniques such as loan sales and swaps and the conversion of debt to equity, and their attitudes to alternatives to concerted lending such as interest capitalization, can be influenced by supervisory and accounting practices.

Exchanges between creditors of existing loan claims, or conversion of loan claims into a different kind of asset, may change the valuation of these claims and, potentially, have an impact on the valuation of similar claims. Banks have indicated some concern that if a secondary market in loans became well developed, the discounts applied in such transactions might call into question the value of banks' remaining claims on the same borrower. For this reason, few institutions with large exposures to developing countries have engaged directly in discounted disposals of loan claims, although a number have been involved in brokering sales by other banks. The banks participating in the secondary market for loan sales and swaps have tended to be banks with smaller exposures that have sought to eliminate completely their exposure to a particular country, or to concentrate their holdings in a few countries.

Supervisory treatment of interest capitalization and concessional interest rates also varies across countries, with experience so far mainly limited to domestic loans. In continental Europe, capitalized or deferred interest would not generally be accrued or--if accrued--would be provided against. Under the U.S. regulatory system, banks may be able to continue to accrue such income if loans are well-secured in due process of collection. A proposed change in the United States' treatment of renegotiated farm and energy loans which carry below-market interest rates suggests that these loans should not be treated as "substandard" as long as the principal is deemed recoverable over the life of the loan.

The conversion of debt to equity involves further issues including the valuation of the equity claims, if banks hold these themselves; the changes that may be generated in banks' capital requirements by a switch from debt to equity; and the legal or supervisory restrictions on banks' holdings of equity participation in nonbanks. Treatment of equity holdings in general varies considerably across countries, from those where there is a long tradition of banks or bank-holding companies having equity in nonfinancial companies (e.g., Germany, France) to others where such equity participation is much less usual, or even prohibited under existing regulations. In a number of countries, there are restrictions on the proportion of a nonbank company that may be held by a bank.

In cases where equity holdings are allowed, the regulatory treatment for the purpose of assessing capital adequacy may vary. In some cases, it may be treated as more risky than a loan and in other cases as less risky. In Germany, for example, no capital cover is required--at least in principle--for holdings of listed securities. In the United Kingdom, investments in subsidiaries and associated companies, and trade investments, are treated like a fixed asset and must be deducted from capital.

In general, most supervisory regimes allow banks to take a noncontrolling interest in a foreign nonfinancial company under at least some conditions. Such interests would typically require a higher capital backing than would a loan, unless those interests involved listed securities that may be readily sold on a stock exchange, which is not usually the case with the type of equity that may be obtained by banks in exchange for their loan claims on developing countries. The more usual form of equity participation by a lending bank in a developing country would be in a local bank or other domestic financial company.

5. Outflows of private capital

Outflows of private capital have often been associated with the concept of "capital flight." However, "capital flight" is not easily defined or measured. Some observers have defined "capital flight" broadly, including all acquisitions of foreign assets by the private sector. Such a definition, however, measures all outflows of private capital, including a number of transactions that would not normally be termed flight capital, notably the extension of trade credits, transactions balances in overseas banks held by local firms engaged in international trade, direct foreign investment, and certain portfolio diversification. This subsection discusses the approaches taken in some recent studies to measuring outflows of private capital and estimating the impact of various factors on such outflows.

a. Measuring outflows of private capital

There have been a number of efforts by various observers to measure outflows of private capital, with a particular view to identifying

"capital flight." In practice, such outflows are often unrecorded in balance of payments statistics, and comprehensive information is not available on the foreign asset holdings by residents of developing countries. Estimates of outflows of private capital in developing countries have been derived in various studies from banking statistics, balance of payments data, and external debt statistics, based on three basic methodological techniques.

Outflows of private capital have been defined as the change in deposits with foreign banks by nonbank residents. During 1980-85, international bank deposits held by nonbanks in developing countries rose by about \$80 billion to \$183 billion at end-1985, amounting to 31 percent of these countries' bank debt or 21 percent of their total debt. Depositing by nonbanks from developing countries has shown an uneven pattern during 1982-85; such depositing slowed from \$13 billion in 1982 to \$2 billion in 1984 before increasing to \$14 billion in 1985.

These deposits include foreign currency working balances of firms engaged in trade, tourism, or transportation (such as airlines or shipping), which would not generally be considered "capital flight." At the same time, this approach does not capture all forms of "capital flight," for example, acquisitions of securities or real estate. Depositing data are available on a quarterly basis and with relatively short delays.

Short-term capital outflows and net errors and omissions have been summed to obtain an estimate of total private capital outflows based on balance of payments data. Cumulative private capital outflows from capital-importing developing countries during 1980-85 totaled \$135 billion, equivalent to 25 percent of their bank debt and 15 percent of total external debt. Annual private capital outflows declined by this measure from a peak of \$37 billion in 1982, to \$10 billion in 1985.

This methodology incorporates a broader definition of private capital outflows, but it may not fully measure such outflows due to deficiencies in the data on balance of payments, especially for the capital account. For example, if any balance of payments receipt was overstated or payment understated, then errors and omissions would increase correspondingly, as would the defined measure of private capital flows. Some private capital outflows may not be captured in the balance of payments statistics at all due to overinvoicing of imports or underinvoicing of exports and to offsetting unrecorded capital flows. Errors and omissions, on the other hand, include discrepancies unrelated to private capital movements. Balance of payments data in many countries are available only on an annual basis and with substantially longer lags than for banking statistics.

Private capital flows have also been defined as a residual by subtracting from the increase in external debt, the accumulation of foreign assets by the domestic banking system and recorded current account deficits, and adding to it net nondebt-creating flows such as

direct investment. Total external debt of capital importing developing countries grew by \$400 billion during 1980-85, while the recorded current account deficits, less nondebt-creating flows, plus the increase in foreign exchange reserves amounted to only \$250 billion during 1980-85. Based on this method, the acquisition of foreign assets by private residents of developing countries in 1980-85 may have amounted to \$150 billion. This estimated acquisition of foreign assets was equivalent to 27 percent of the debt owed to commercial banks at end-1985 and 17 percent of total debt. According to this definition, private capital outflows declined from \$50 billion in 1982 to \$19 billion in 1985.

This residual approach is likely to produce an inaccurate estimate of private capital movements for several reasons. Private capital flows would be understated to the extent that there is overinvoicing of imports and underinvoicing of exports. An appreciation in the value of the U.S. dollar relative to other major currencies would decrease the U.S. dollar equivalent of debt denominated in other currencies, with no corresponding balance of payments flow, and would lead to an downward bias in the estimate of capital outflows. This bias may be partly offset by a countervailing movement in the foreign assets, due to similar valuation effects. Because developing countries are generally net debtors, a stronger U.S. dollar would tend to lower the estimate of private capital outflows, while a weakening in the U.S. dollar would have the opposite effect.

These estimates of private capital flows are not accurate indications of the magnitude of "capital flight." Any under-reporting of current account deficits by developing countries would automatically increase private capital outflows. This approach also defines as flight capital certain acquisitions of foreign assets by domestic residents (e.g., extensions of trade credits, increases in working balances held in foreign exchange) that are not normally viewed as "capital flight." Any transaction not explicitly subtracted from the increase in external debt is considered "capital flight."

The three methodological approaches discussed above result in substantial differences in annual and cumulative data for private capital outflows from developing countries. Notwithstanding these differences, two common features emerge. First, cumulative private capital outflows for developing countries on these measures amounted to between 15-21 percent of total external debt. Second, these capital outflows declined between 1982-83 and 1985, albeit to different degrees depending on the methodology employed.

In addition to the approaches outlined above, one recent study attempts to distinguish between flight capital and other foreign assets held by domestic residents by excluding from the measure of flight capital, foreign assets that result in interest payments recorded in the balance of payments.

Various estimates of "capital flight" for five developing countries for the period 1976-85 are provided in Table 17, based on several recent studies and the Fund's international banking statistics. The sources used, and the main characteristics of the authors' methodology, are identified in the table. While private capital flows in other developing countries were also studied by these authors, this list has been confined to those developing countries reviewed in all studies.

Comparisons of these studies are hampered by differences in definition, methodology, countries covered, and time periods reviewed. Even when these differences are adjusted for, however, the different studies show substantial variations in the magnitude and even in the direction of private capital movements.

b. Factors affecting private capital outflows

Two of the studies cited in Table 17 (Cuddington and Dooley) have attempted empirical analysis of the factors influencing private capital flows in selected developing countries. These studies suggest that private capital movements were affected by factors that shape residents' attitudes toward domestic financial assets. These factors included exchange rate movements, domestic inflation, interest rate differentials, and risk premiums, although the importance of those factors differed among the developing countries studied.

Cuddington ran separate regressions of the real exchange rate, domestic inflation, and the differential between domestic and U.S. dollar interest rates on "capital flight" for eight developing countries. He concluded that the "most important contribution to "capital flight" seems to be the extent of disequilibrium of the real exchange rate." The exchange rate had a statistically significant impact on private capital outflows in the developing countries that had substantial private capital outflows, but did not appear to have been a major factor in the remaining developing countries, which had relatively smaller amounts of private capital outflows. High inflation also was shown to encourage private capital outflows. According to Cuddington, the incentive for private capital outflows was also "greatly exacerbated in economies suffering from repressive financial policies that keep real rates of interest in the domestic economy considerably below those prevailing abroad." He concluded that capital controls "significantly reduced" private capital outflows in some of the cases studied. He added, however, that effective capital controls did not mean that such controls are a good idea. He suggested that a durable solution to private capital outflows needs to address the underlying causes of such capital movements, such as expansionary fiscal monetary policies and exchange rate overvaluation.

Table 17. Studies on "Capital Flight" in Selected Developing Countries, 1976-85

	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1976-85
(In billions of U.S. dollars)											
Argentina											
Cuddington (1)	0.3	-0.6	1.5	-1.7	2.3	8.7	5.0	...	...	...
Cuddington (2)	-0.2	0.9	3.0	1.7	6.7	7.7	-0.4	...	...	...
Dooley	...	...	2.0	4.7	-1.1	6.2	9.7	0.2	-0.5	...	
Morgan	...	...	...	...	...	...	...	...	...	...	26.0 <u>1/</u>
IIF	...	...	...	1.6	7.4	8.2	6.9	1.6	-0.2	-1.3	
IBS	...	...	0.2	3.0	-0.5	1.0	0.4	0.9	-0.2	0.5	
Brazil											
Cuddington (1)	-0.5	0.6	-0.3	-1.2	0.4	0.4	0.4	...	...	...
Cuddington (2)	-1.6	2.4	4.4	1.1	1.8	-0.2	0.2	...	...	...
Dooley	...	...	4.8	-4.9	0.4	1.5	-4.5	1.7	6.0	...	
Morgan	...	...	...	...	...	...	...	...	...	...	10.0 <u>1/</u>
IIF	...	...	...	-0.4	0.4	0.7	2.4	3.4	4.0	1.1	
IBS	...	...	3.9	-1.8	-2.3	0.7	0.3	4.0	0.2	0.1	
Chile											
Cuddington (1)	-0.3	-0.5	-0.3	-0.4	-0.5	-0.9	0.8	...	...	...
Cuddington (2)	-0.4	-0.7	-0.8	0.6	-0.2	-0.4	0.9	...	...	...
Dooley	...	...	0.3	0.3	-0.3	-1.7	-1.0	2.2	-1.3	--	
Morgan	...	...	...	...	...	...	...	...	...	...	-1.0 <u>1/</u>
IFS	...	...	...	0.1	-0.1	-0.2	-0.1	-0.1	-0.2	-0.3	
IBS	...	...	0.4	0.5	0.7	0.4	0.3	0.6	-0.2	0.3	
Mexico											
Cuddington (1)	3.3	0.9	0.5	1.5	4.8	11.5	7.6	...	...	...
Cuddington (2)	3.5	4.3	0.9	2.8	7.1	8.2	6.9	...	...	...
Dooley	...	...	-0.1	1.5	6.9	7.9	2.1	11.2	2.1	--	
Morgan	...	...	...	...	...	...	...	...	...	...	53.0 <u>1/</u>
IIF	...	...	...	5.5	9.2	8.3	12.4	5.6	4.8	3.2	
IBS	...	...	1.0	1.6	1.5	3.8	1.3	2.3	1.7	1.2	
Venezuela											
Cuddington (1)	-0.4	-1.7	-0.9	-2.4	3.4	5.0	7.5	...	...	...
Cuddington (2)	-0.3	-0.9	0.9	4.8	4.7	7.4	8.3	...	...	...
Dooley	...	...	0.4	8.2	5.5	-0.2	-1.2	9.7	2.7	--	
Morgan	...	...	...	...	...	...	...	...	...	...	30.0 <u>1/</u>
IIF	...	...	...	0.1	1.9	3.3	6.5	2.5	1.5	1.7	
IBS	...	...	--	2.7	2.2	3.7	-5.2	0.9	1.2	1.7	

Sources and definitions: in J.T. Cuddington (1) ("Capital Flight: Issues, Estimates, and Explanations," World Bank, March 25, 1985 mimeo), capital flight is measured as errors and omissions plus certain categories of "other short-term capital, other sector" from the IMF's Balance of Payments Yearbook; in J.T. Cuddington (2), capital flight is measured as gross capital outflows defined as changes in external indebtedness plus the net inflow of direct foreign investment minus the current account deficit and the change in total foreign reserve assets less gold plus net foreign assets of commercial banks; in M.P. Dooley, ("Capital Flight: A Response to Differences in Financial Risks" Staff Papers forthcoming) capital flight is measured as the difference between the estimated stock of total external claims (defined as sum of capital outflows, excluding direct investment, plus errors and omissions from the balance of payments plus the difference between external debt as calculated by the World Bank and external debt cumulated from the balance of payments) and "interest earning" claims measured as the capitalized value of investment income receipts; in Morgan Guaranty Trust Company ("LDC Capital Flight, World Financial Markets, March 1986, pages 13-15), capital flight is estimated as increases in gross external debt less current account deficits and less the building up of foreign assets by the banking systems and official monetary authorities plus net direct investment flows; in Institute of International Finance (IIF), ("External Asset Transactions by Residents of Debtor Countries, Working Party on the Future of International Lending" Note, June 12, 1986), net private sector asset flow is estimated as debt-creating flows less the current account balance, and recorded official and monetary sector flows; and using the International Banking Statistics, capital flight is defined as deposit taking from nonbanks in developing countries.

1/ Sum of flows during 1976-85.

Dooley also empirically tested the determinants of private capital outflows, using a group of seven developing countries over the period 1976-85. His results suggest that net private capital outflows were most likely "in circumstances where residents perceive risks to income derived from domestic claims but nonresidents perceive relatively smaller risks on credits to the country studied." Risks to residents as measured by domestic inflation and domestic financial repression are found to have a positive influence on the level of private capital outflows, while the reluctance of nonresidents to acquire claims on the country, as measured by the risk premium on such claims, are found to have the expected negative affect on net private capital outflows.

6. Direct investment

During 1984-85, foreign direct investment averaged US\$10 billion, or only somewhat less than the sharply reduced level of bank lending during those years. Nonetheless, these investment flows were considerably below their average of \$15 billion before the onset of widespread debt-servicing difficulties and significantly below the average level of bank lending (\$80 billion) during 1979-82.

Staff discussions with multinational corporations, and comments by banks concerning attitudes of their corporate customers, have indicated that they consider direct investment an appropriate form of finance for developing countries. Also, a number of developing countries consider that there may be broad advantages in greater reliance on foreign direct investment, and thus are studying or undertaking measures to encourage such flows. The Multilateral Investment Guarantee Agency (MIGA) and the International Finance Corporation (IFC) are expected to assist in attracting nondebt-creating flows to developing countries.

a. Developing countries' direct investment policies

Foreign direct investment in developing countries has been concentrated in a few countries, predominantly the higher-income countries of Asia and Latin America. A review of recent changes in foreign direct investment regulations in some of these countries, as well as in a few selected countries where significant changes have occurred is given below.

In Argentina, the authorities have recently liberalized investment policies in the petroleum sector, increasing the percentage of foreign equity participation. In Mexico, the authorities have indicated, in their letter of intent to the Fund of July 1986, "that they have conducted a selective policy, during the past four years, of promoting foreign investment, with special emphasis in areas related to non-oil exports and the transfer of technology, within the current legal framework. During the period 1983-85, more than 150 projects with 100 percent foreign-owned capital have been approved. Steps have been taken recently, and will be strengthened in the future, to streamline the administrative procedures for initiating and approving foreign investment

projects so as to increase the flow of foreign capital in appropriately selected sectors. In particular, approval of investment projects fundamentally oriented to export markets will be granted automatically if, after a period of 30 days, no contrary decision has been reached. Special efforts also will be made to facilitate an enlarged access to the Mexican market by small- and medium-sized foreign companies."

Five Latin American countries--Bolivia, Colombia, Ecuador, Peru, and Venezuela--are members of the Andean Pact. Decision No. 24, adopted December 31, 1970 by the Commission of the Cartagena Agreement, established rules for the common treatment of foreign direct investment, which act to discourage these flows. Some countries interpret the provisions liberally, or have taken steps to liberalize this decision. Thus, in Bolivia, foreign investment has recently been permitted in mineral smelting, transport, retail of refined oil products, and petrochemicals. Colombia has taken steps within the past two years to liberalize its investment regime. Ecuador has taken some measures to improve the regulatory climate, including a decision to join the International Center for Settlement of Investment Disputes (ICSID). It has also opened up its petroleum and mining sectors to foreign direct investment and has been loosening profit remittance and ownership transformation rules. In a decree issued in June 1985, Venezuela introduced a greater degree of flexibility in relevant laws. Specifically, the decree liberalized foreign investment in four sectors of the domestic economy (agroindustry, agriculture, construction, and tourism).

As regards Asian countries, the authorities in Korea have taken a number of steps aimed at broadening the scope of foreign direct investment. The Amended Foreign Capital Inducement Act (1983), which came into effect on July 1, 1984, provides that foreign investment will be allowed in all industries except those specified in a "negative" list; previously, investment was only allowed in those areas detailed in a "positive" list. In addition, the scope for foreign direct investment was expanded; foreign participation became freely permitted in 660 industrial sectors, or 66 percent of the total, compared with about 61 percent previously. In October 1985, an additional 102 industries were removed from the negative list, raising the liberalization ratio to 76 percent. Partnership with local firms is no longer required of foreign-invested companies. Since July 1984, the repatriation of foreign capital has also been freely permitted.

In Malaysia, foreign investors in general could own up to 70 percent of equity in a Malaysian company, provided that such investment was export oriented. In January 1986, authorization was granted for Singapore investors to retain up to 70 percent of the shares in their companies in Malaysia, even if such investment was not export

oriented. For companies serving the domestic market, foreign shareholdings are required not to exceed 30 percent after 1990.

In June 1986, Indonesia almost doubled the number of sectors open to foreign direct investment. Under the Government's new investment priority list projects in agricultural, industry, mining, public housing and road construction sectors, which previously had been reserved for Indonesian companies, are now open to foreign investors. To encourage foreign investment, the Government of Thailand has waived the growth restrictions specified in the Alien Business Law for most activities until the end of 1986.

In India, foreign collaboration approval procedures were simplified in August 1985. The Government has also encouraged investment of private capital, including foreign capital, in infrastructural projects that had hitherto been reserved almost exclusively for the public sector. Since September 1985, foreign firms offering advanced technology are allowed to invest up to 25 percent in equity capital of existing industrial units subject to certain conditions, in addition to the 40 percent foreign equity participation already allowed in new ventures.

In China, the State Council announced in 1984 that foreign direct investment would be permitted in 14 selected coastal cities. In early 1985, new plans to open four large industrialized regions to foreign investment and trade were announced. It was also announced in 1985 that foreign oil companies would be allowed to participate in exploration and development of oil and gas reserves in nine provinces and one autonomous region. Also, in August the establishment of the first foreign branch bank office in the country since 1949 was approved, and, in December, a joint venture bank, the first with foreign capital participation, was opened.

In the last few years, important changes have occurred in the policies on foreign direct investment in Turkey and Yugoslavia. The authorities in Turkey have actively encouraged foreign direct investment since late 1983, when a decree granting foreigners permission to invest in certain activities not categorized as industrial was introduced. The free transfer of profit and capital repatriation for all approved investment was extended to such investments. In Yugoslavia, a new law on joint ventures was approved in November 1984 which significantly liberalized previous regulations. A number of important restrictions were lifted, and administrative procedures were simplified. Further, as part of the policy to stimulate foreign investment in Yugoslavia, the limit on profit remittances contained in the foreign exchange law was liberalized somewhat in December 1984.

There have not been major changes in recent years in policies on foreign direct investment in Middle Eastern and African countries, where foreign direct investment in general plays a smaller role than in other regions. On the occasion of the 1986 budget speech, the Minister of

Finance of Nigeria waived the requirement which had been in effect since January 1, 1985 that dividends due to nonresidents could be reinvested in new companies only provided that an additional amount equal to half of the remittable amount was imported. Such amounts can now be reinvested without this import requirement.

b. Foreign portfolio investment

Portfolio investment has not yet become an important source of finance for developing countries, although its contribution has grown for some countries. Staff contacts with investment banks in major financial centers have pointed to an interest in portfolio investment in selected developing countries by some clients as part of a general diversification strategy. In some cases, private sector firms in developing countries have issued bonds convertible into equity. More generally, in some recent bank debt restructuring agreements, provision has been made to permit the conversion of debt into equity (see Section III 3c). The limited size of national stock markets and small turnover in these markets in most developing countries have made portfolio investments in such countries less attractive to foreign investors. The size of the equity markets, in terms of number of listings, market capitalization and trading volume, in selected developing countries is shown in Table 18.

Foreign exchange restrictions in many developing countries prohibit listings of foreign companies. The exceptions include, inter alia, Singapore, where many Malaysian stocks are listed, together with some other foreign stocks, and Hong Kong, where many international stocks are listed and actively traded. In several countries (for example, Mexico and Nigeria), the local subsidiaries of foreign companies were among the earliest listings. International investors are of major significance only in Hong Kong, Malaysia, and Singapore, whose markets have been used for many years by internationally-oriented mutual funds and other institutional investors. Foreign individual investors have also invested in a number of locally incorporated funds in these countries. Korea and India have introduced country funds to international investors in recent years.

In January 1981, the Korean Government announced a four-stage capital market liberalization program, with the intent of completing the liberalization process by the early 1990s. The first stage allowed foreigners to acquire Korean securities indirectly through investment trusts. Five open-ended investment trusts had been established by mid-1986, with a total capitalization of \$140 million, and one closed-end fund, the Korea Fund, has been established. The second phase was inaugurated in November 1985, when the Government authorized qualified Korean companies to issue convertible bonds and depository receipts abroad. Although 14 companies now meet the Government's eligibility requirements, the only offering to date has been for \$30 million of convertible bonds by Samsung Electronics Company.

Table 18. Equity Markets in Selected Developing Countries, 1980 and 1985

	Listings		Market Capitalization		Trading Volumes	
	1980	1985	1980	1985	1980	1985
			(In billions of U.S. dollars)		(In billions of U.S. dollars)	
Latin America						
Argentina	278	227	3.9	1.4	1.1	0.5
Brazil	1,040	1,144	9.2	42.9	5.4	13.4
Chile	265	227	9.4	2.0	0.5	0.1
Colombia	193 <u>1/</u>	102	1.6	0.6	0.1	--
Mexico	271	162	13.0	4.2	2.7	4.4
Venezuela	98 <u>1/</u>	116 <u>2/</u>	2.7	2.0	0.1	0.1
Asia						
India	2,265	5,751	10.4	29.4	2.8	5.7
Korea	352	342	3.8	7.4	1.9	4.1
Malaysia	249	283	12.4	16.5	2.6	2.3
Philippines	196 <u>1/</u>	138	2.1	0.7	0.6	0.1
Singapore	261	316	24.4	33.5	3.7	2.9
Thailand	77	100	1.2	1.9	0.3	0.6
Africa						
Nigeria	90	95	3.1	2.6	--	--
Morocco	78	77 <u>2/</u>	0.4	0.2	--	--
Zimbabwe	62	55	1.5	0.4	0.2	--
Europe						
Turkey	314 <u>1/</u>	373 <u>2/</u>	0.5	1.0 <u>2/</u>	--	-- <u>2/</u>

Sources: IFC Emerging Markets data base.

1/ 1982.

2/ 1984.

Investment funds have also been established in other countries. The Mexico fund, which can invest in a broadly diversified portfolio of Mexican shares, was introduced in 1981 for an amount of \$120 million. International investors can buy into this fund without the usual restrictions on portfolio investment. It is listed on the New York and London stock exchanges. In Thailand, foreign investors can as an alternative to investment in individual firms invest in the Bangkok Fund--a mutual investment fund. Investments are limited to listed securities or to securities of companies intending to list their shares at a later date. The size of this fund is about \$10 million. Plans are underway for the launching of a separate "on-shore" Thai Fund, for \$30 million, to be sponsored by the IFC. An equity mutual fund for India was launched in July 1986 for about \$100 million. The Indian Fund is a closed-ended unit trust that enables Indian nonresidents to invest in listed shares on the stock exchanges in India. It is expected that the portfolio would initially emphasize the fertilizer, chemical, pharmaceutical, electronics, telecommunications, and computer industries.

c. The role of the World Bank and the IFC

The IFC often assists developing countries in drafting or revising investment codes, laws and regulations that govern private direct or foreign investment. Further, acting directly as an investor, the IFC promotes the flow of foreign investment to developing countries and seeks to stimulate the domestic private sector, and it provides services that help to bring domestic and foreign investors together. Its presence often serves to raise the confidence of foreign investors, and as a neutral partner it helps to structure projects so that the benefits are shared equitably among local public and private investors and foreign interests.

The IFC has also stimulated foreign portfolio investment in developing countries, e.g., through the development of local markets by establishing specialized equity funds for individual countries. The Korea Fund is one example. This fund is a closed-end investment company registered with the U.S. Securities and Exchange Commission and listed on the New York Stock Exchange. It is expected that normally at least 80 percent of the fund's assets will be invested in Korean listed stocks. The IFC acted as one of the co-lead managers of the underwriting. The capitalization of the Korea Fund has risen to \$100 million. In addition to country specific funds, earlier this year the IFC set up a \$50 million mutual fund--the Emerging Markets Growth Fund (EMGF)--to invest in publicly listed shares in a number of developing countries. This closed-end fund, which is to be capitalized from 7 capital exporting countries, is expected to select about 25 companies initially, in 9 emerging stock markets in Asia and Latin America (Argentina, Brazil, Chile, India, Korea, Malaysia, Mexico, the Philippines, and Thailand). The IFC envisages that, over time, the EMGF's capital could be increased to over \$500 million, with investments in some 20-25 developing countries.

The World Bank has also taken some international initiatives on foreign investment. The establishment of the International Center for the Settlement of Investment Disputes (ICSID) in 1965 has helped to improve the framework for direct investment by providing acceptable procedures for the settlement of disputes between foreign investors and their host countries. The membership now totals 78 countries, with four other signatories expected to become members soon.

A Multilateral Investment Guarantee Agency (MIGA) under the auspices of the World Bank has been established. The MIGA would seek to improve the investment climate in developing countries through issuing guarantees for foreign investment against noncommercial risks and supplementing the activities of the Bank and IFC in promoting such investments by carrying out research, providing information, rendering technical assistance, and encouraging policy cooperation. MIGA will finance itself from its own revenues, notably from premiums charged for its guarantees. It will have its own share capital and will become operational when a certain number of capital-exporting and capital-importing countries have ratified the Convention.

With the signing of the Convention by the United States on June 18, 1986, enough signatures have been collected to permit establishment of a preparatory committee for the agency. The World Bank plans to convene a preparatory conference in September to formulate MIGA regulations and policies. Signatories of the convention totaled 31 at end-June 1986, of which 26 were developing countries. Signature of the Convention indicates an intention to join the agency, but only ratification, which normally entails a legislative process, constitutes a binding commitment. The MIGA convention will enter into force upon ratification by 5 capital-exporting and 15 capital-importing countries representing at least one-third of the authorized capital of \$1.1 billion.

Activities of The Institute of International Finance, Inc.

Established in 1983, The Institute of International Finance (IIF) now has a membership of about 200 financial institutions. Most of these are international commercial banks, which are full members, but a few official agencies and multinational corporations have also joined as associate members.

The IIF's primary role is to collect and disseminate information and analysis on the economic and financial situation, policies and prospects of developing countries having substantial debt to the banking community. It makes this information available to its members in the form of country reports and through an on-line country data base displaying a substantial range of relevant statistical information on some 40 developing countries. The objective is to provide members with a factual basis to evaluate country risk in making their international lending decisions.

The country data base provides information on approximately 150 category line-items, including fiscal and monetary policy, the domestic economy and external trade, liabilities to main creditor groups, and debt servicing. It is revised on a continuous basis, with major updates after an IIF mission to the country concerned. The mission team generally includes one or two IIF economists accompanied by representatives of member banks. By the end of 1986, the IIF will have sent missions to 32 debtor countries and issued 140 country reports, updates, and summaries. Both the number of missions and country reports are projected to increase during 1987.

An Economic Advisory Committee (EAC), comprised of the chief international economists of a broad grouping of member banks, advises the IIF on all aspects of its economic work and its working hypotheses regarding world economic growth, trade flows, commodity prices, exchange rates, and interest rates, among other areas. The advisory committee also studies original discussion papers and research materials on matters such as alternative scenarios for the world economy and their implications for international lending and the resolution of the debt situation. The IIF regularly provides its members with two surveys: a "Survey of Debt Restructurings by Banks" and a "Survey of Official Reschedulings and Balance of Payments Support."

The IIF also promotes improved information and debates in the banking community on issues relating to the developing country debt problem, including the role of commercial banks. This area of activity encompasses, for example, encouraging proposals designed to expand bilateral government and multilateral development institution finances to promote capital formation in the debtor countries. The IIF also plays a role as a liaison between its members and the multilateral development banks and national regulatory authorities in order to improve the process of international lending. To encourage communication among the major participants involved in the international lending

process, the IIF relies particularly on discussions held in the framework of two regular bodies: the Working Party on the Future of International Lending and the Task Force on the Regulatory, Accounting, and Tax Treatment of Cross-Border Lending.

The Working Party, which comprises representatives from a broad cross-section of member banks, meets twice a year for two-day sessions to review and address the substantial developments in international lending--such as prospects for near- and medium-term lending and global economic growth; the process of multiyear reschedulings; legal and regulatory developments affecting the lending environment; the role of official lenders; international capital markets; cover policies of export credit agencies; alternative lending options; and questions stemming from new mechanisms or initiatives and which have included among others counter-trade, off-balance sheet financing, and the effect of dollar movements on debt servicing capacity. Supplemental study groups can be formed to examine a specific topic in closer detail, such as a recent study group on Insurance and Guarantees for Banks' Loans to Developing Countries, or a study group on capital flight.

The Task Force on the Regulatory, Accounting, and Tax Treatment of Cross-border Lending brings together on a regular basis representatives of member banks, the accounting and legal professions, national regulators, and officials from central banks and the multilateral lending agencies. The Task Force's main objective is to find potential ways to overcome distortions and impediments to international bank lending activities resulting from differences in creditor nation policies, procedures, and practices, as they relate to cross-border lending. It has discussed such matters as reserves for transfer risk, risk-based capital systems, regulatory treatment of cofinanced loans, tax law developments, and supervisory and external auditor relations.

The IIF also holds two membership meetings each year, one in the Spring, and the other in the Fall to coincide with the annual meetings of the Fund and the World Bank. Membership meetings allow bankers from all over the world to discuss issues of common interest and to participate in country seminars.

Just prior to the Spring meetings of the IMF Interim Committee and the World Bank/IMF Development Committee, the Managing Director of the IIF has sent a letter to the Chairmen of the Interim Committee and Development Committee of the IMF and the World Bank. The letter highlights members' views and concerns on the main issues to be addressed by the Interim and Development Committees in working towards a longer-term solution of the debt problem and on the various factors affecting the future of international lending.

