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November 1, 1985

To: Members of the Executive Board

From: The Secretary

Subject: International Capital Markets - Developments and Prospects, 1985 - U.S. Treasury Initiative on Debt

The attached supplement to the paper on developments and prospects in international capital markets presents the U.S. Treasury proposals.

This subject has been scheduled for discussion by the Executive Board on Wednesday, November 6, 1985.

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 Capital Markets: Developments and Prospects, 1985-- Supplementary Material: U.S. Treasury Initiative on Debt

(In consultation with the Western Hemisphere Department)

Approved by C. David Finch

November 1, 1985

## I. Introduction

In his address to the 1985 Annual Meetings of the Fund and World Bank, the Honorable James A. Baker III, Secretary of the U.S. Treasury, proposed a "Program for Sustained Growth" to strengthen the present international debt strategy. The Treasury Secretary noted the recent difficulties experienced by debtor countries in implementing successful economic policies and in generating the financing needed to support essential economic reforms. In the light of these problems, Mr. Baker proposed a three-point plan that would build upon the flexible, case-by-case debt strategy developed in the past three years. This paper summarizes aspects of the plan that are particularly relevant to capital markets.

The first element in the U.S. proposal is the adoption by principal debtor countries of comprehensive macroeconomic and structural policies to promote growth and balance of payments adjustment, and to reduce inflation. The second element is a continued central role for the IMF, in conjunction with increased and more effective lending by multilateral development banks. The third is increased lending by the private banks in support of comprehensive adjustment programs.

The proposal is aimed primarily at stimulating the process of growth and adjustment in heavily indebted developing countries and encouraging new financing flows from both official and private sources to reinforce this process. In addition to the continued application of macroeconomic policies to deal with economic and financial imbalances, the U.S. proposal envisages increased emphasis on medium- and long-term supply side policies to promote growth, savings and investment. The plan recommends that the Fund, in close cooperation with the World Bank and other multilateral development banks, give greater attention in debtor countries to structural and institutional measures such as tax reform, market-oriented pricing, the reduction of labor market rigidities, and the opening of economies to foreign trade and investment.

Some details of the U.S. initiative are set out below. The proposals are at a preliminary stage and should be seen primarily as illustrating the need for financing to countries implementing appropriate economic policies. Thus, the U.S. initiative seeks to address directly the concern about the prospects for capital market flows identified in the staff report on "International Capital Markets - Developments and Prospects, 1985" (SM/85/267). Specifically, the staff report emphasizes that a central task in the period ahead relates to the need to stimulate adequate financing flows. Moreover, the staff report points out that banks, by demonstrating responsibility and flexibility where adjustment efforts are underway, can protect the quality of their existing claims on developing countries as well as contribute to further progress in reducing systemic risk and restoring sustainable growth.

## II. New Financing Flows

### 1. The role of the multilateral institutions

The proposal supports the role that has been played by the Fund in encouraging policy changes and catalyzing capital flows to debtor countries, and envisages a continued important role for the Fund in both respects. In this connection, it was noted that the development by the Fund of new techniques, such as "enhanced surveillance," could be useful in certain cases in generating additional financing to support further progress in borrowing countries.

The adoption by debtor countries of economic reforms would also be supported by an increase in structural and sectoral loans from the World Bank and other multilateral development banks. The U.S. has suggested that annual disbursements from the World Bank and Inter American Development Bank to principal debtor countries could increase by about 50 percent from the current level of nearly US$6 billion in support of structural policy changes in debtor countries. If the principal debtors implement growth-oriented reforms, commercial banks provide adequate increases in net new lending, and increased demand for quality World Bank lending demonstrates the need for increased capital resources, the United States would be prepared to look seriously at the timing and scope of a general capital increase for the World Bank. The United States also proposed that the Inter American Development Bank should strengthen its lending policies to give more effective support to growth-oriented structural reform and on this basis to introduce a program of targeted nonproject lending.

The World Bank role in stimulating private lending to developing countries would be enhanced under the U.S. proposal, with strong support for an expansion in the Bank's cofinancing operations. In addition, the proposal anticipates that the operations of both the recently negotiated Multilateral Investment Guarantee Agency (MIGA) and of the International Finance Corporation will assist in attracting nondebt capital flows to member countries.

2. Commercial bank lending

The U.S. initiative is aimed at overcoming an increasing reluctance among banks to participate in new money packages and debt restructuring, and at reversing the sharp decline in net new bank lending to debtor countries. It envisages a public commitment from the banking community to provide net new lending of US$20 billion to a group of 15 heavily indebted, middle-income developing countries over the period 1986-88, provided that sound economic policies are put into place. U.S. officials have indicated that this would represent an increase on the order of 2 1/2-3 percent a year in total commercial bank claims on the group of countries. In addition to the provision of new loans to the group of 15 countries, banks would be asked to continue to provide net new loans to countries now receiving adequate bank financing on a voluntary basis, provided that these countries maintain sound policies, and to consider lending to other developing countries experiencing debt servicing problems that require relatively small amounts of commercial bank financing under agreed adjustment programs.

The U.S. Treasury has indicated that a variety of techniques for generating the new bank lending could be considered. At this stage, the Secretary of the Treasury has invited suggestions from the banking community about possible arrangements to ensure that an adequate flow of new financing is obtained.

3. Other private financing

The U.S. plan stresses that other sources of external finance, including foreign equity investment, private sector borrowing, and repatriation of domestic capital must also be encouraged. This should be facilitated by the implementation of sound economic policies to stimulate growth and investment, and would also be encouraged by the expansion of the role of multilateral institutions described above. In particular, policy measures must succeed in reversing capital flight if foreign financing is to increase. The U.S. Treasury Secretary also laid emphasis on the importance of enhancing foreign direct investment. He noted that it is not debt-creating, that it may have a compounding effect on growth, as well as bringing new technology and innovation into recipient countries, and that this may help to keep capital at home.