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October 17, 1985

To: Members of the Executive Board
From: The Acting Secretary
Subject: International Capital Markets - Recent Developments, 1985

The attached paper provides background material for the paper on "International Capital Markets - Developments and Prospects, 1985" (SM/85/267, 9/27/85), which will be brought to the agenda for discussion on a date to be announced.

Mr. Watson (ext. 7350) 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, 1985

Prepared by a staff team 1/

Approved by C. David Finch

October 15, 1985

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I. Introduction

This paper provides background information to the report on "International Capital Markets--Developments and Prospects, 1985" (SM/85/267, 9/27/85). Section II discusses recent structural changes in major financial markets including changes in supervision. Developments in international banking activity are reviewed in Section III, while Section IV discusses trends in bank debt restructuring. Section V presents developments in other financial flows, including issuance of international bonds and short-term notes.

The Annexes provide additional information on a number of subjects: multiyear restructurings and enhanced surveillance; activities of the Institute of International Finance; developments in the pattern of savings and investment flows; issues of measurement and coverage in international banking statistics; and technical information on interest rate and currency swaps. Further statistical tables are contained in a supplement to this paper.

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 provided internationally on a separate and independent basis.

II. Structural Changes in the Financial Markets

In recent years, the structure of major international financial markets has been fundamentally altered by the development of new instruments, more intense competition, and significant changes in official regulations governing the banking and securities markets. While the principal instrument of medium-term international finance in the 1970s was the syndicated bank loan, alternative instruments such as floating rate notes (FRNs), interest rate and exchange rate swaps, and international issuance facilities developed rapidly during the 1980s, serving in a number of cases as substitutes for syndicated lending.

Although many of the new financial instruments initially were designed in response to tax or regulatory factors, the more enduring innovations have significantly altered the sharing of risks between borrowers and lenders, more closely integrated market conditions among the major countries, and strongly affected the roles of various financial intermediaries in channeling the flows of savings and investment between countries. The rapid pace of innovation represents a fundamental response to variability in the international economy, experience of the debt crisis, and changes in official policies relating to bank supervision and financial markets. The changes in official policies relating to financial markets, in turn, have been undertaken in

response to changes in economic conditions affecting domestic and foreign financial markets. These policy changes also reflect a desire to increase efficiency and competition in financial markets.

One factor which has contributed to the rapid pace of change has been the development of new computer and telecommunications technologies. While these technological changes would not, by themselves, have fundamentally altered the financial markets without accompanying changes in the economic environment and official regulations, new technology has increased the ability of financial institutions to manage more complex and sophisticated operations in an increasingly integrated global market.

This section examines some of the key sources of change that arise from *macroeconomic conditions and from official policies aimed at liberalizing financial markets*. It also discusses the nature of a number of new instruments in international markets. Finally, recent developments in market supervision are reviewed.

1. Factors contributing to change in financial markets

a. Inflation and increased uncertainty

The sharp acceleration of inflation during the 1970s in countries with major financial markets was a major factor leading to changes in financial instruments and regulations. The regulatory and institutional structures of major financial market countries in the 1960s and early 1970s reflected, to an important degree, a long experience of relatively low inflation rates and stable interest rates. ^{1/} Relatively low inflation contributed to interest rate stability and helped create a willingness on the part of savers to hold long-term fixed interest rate assets. In addition, there emerged a number of financial institutions holding relatively illiquid, long-term, fixed interest rate loans that were financed by issuing relatively liquid, short-term fixed interest rate liabilities.

Rising inflation generated low or negative real interest rates on many financial assets and reduced capital values of those assets. Although the acceleration in inflation was not uniform among major industrial countries, the average inflation rates in the 1970s were

^{1/} For example, the inflation (as measured by the consumer price index) in the United States averaged only slightly more than 2 percent per annum during the 1950s and 1960s; and, in the United Kingdom, inflation was typically between 3 and 4 percent during this period. In Germany, the rate of inflation rose only slightly from an average annual rate of 2 percent in the 1950s to 2.5 percent in the 1960s; whereas in Japan, inflation was usually between 4 and 5.5 percent during this period.

generally twice those observed in the 1960s. ^{1/} For holders of long-term, fixed interest rate securities during the 1960s, the higher levels of inflation and the accompanying increases in interest rates imposed large capital losses and low (and often significantly negative) real returns on their portfolio holdings. This experience created a preference on the part of investors for instruments with relatively short maturities or carrying variable interest rates. While these inflation rates were reduced during the early 1980s, average inflation rates for the 1980-84 period were still higher than in the 1960s (except in the case of Japan).

Changes in financial markets were also stimulated by the emergence of more volatile macroeconomic conditions in the international economy during the 1970s and early 1980s. In addition to high and variable inflation rates and interest rates, this period witnessed the emergence of considerable exchange rate variability, sharp swings in economic activity, and substantial movements in relative prices of commodities. Moreover, macroeconomic policies generally placed less emphasis on stabilizing exchange rates or interest rates than in the past.

Sharp changes in economic conditions increased the uncertainty regarding real yields on financial instruments. As a result of increased uncertainty, lenders became reluctant to provide long-term, fixed interest rate funds except in exchange for high real rates of return. To respond to changes in perceived risks, the issuers of securities and deposit liabilities attempted to alter the characteristics of financial instruments to enhance their liquidity and to make their future capital value more certain. As will be discussed, this process has included the emergence of floating interest rate instruments, interest rate and exchange rate swaps, and financial futures and option markets.

b. Changing patterns of payments imbalances, savings, and investment flows

The types of instruments used in international financial markets have been strongly influenced by the changing patterns of payments imbalances and the implied redistribution of savings and investment flows across countries and regions. During the 1970s, the need to finance the current account imbalances associated with the sharp movements in energy and commodity prices led to a significant expansion in international bank lending and the emergence of the syndicated bank loan as a principal vehicle of international finance.

^{1/} In the United States, inflation during the 1970s averaged nearly 8 percent per annum versus 3 percent in the 1960s. In the United Kingdom, the annual average rate of inflation in the 1970s was nearly 14 percent in comparison with an average of 4 percent in the 1960s. The German rate of inflation equaled 5 percent in the 1970s versus 2.5 percent in the 1960s. In Japan, inflation during the 1970s averaged 9 percent per annum versus less than 6 percent in the 1960s.

For those developing countries which relied heavily on credit from commercial sources (the market borrowers), foreign capital inflows measured relative to GDP increased by nearly one half between 1967-72 and 1973-82, and these inflows added the equivalent of 12 percent of domestic savings to total savings. Foreign capital inflows also represented an important component of total funds available to finance investment for those developing countries which have been heavily dependent on credits from official sources (official borrowers). During the period between 1967 and 1984, the inflows received by this group represented an average 6 percent of GDP and 51 percent of their domestic savings. In contrast, while individual industrial countries at times experienced large capital inflows or outflows during the 1960s and 1970s, the imbalances for the group as a whole varied between surpluses or deficits that were equivalent to less than 1 percent of their combined incomes or 3 percent of their domestic savings. ^{1/}

In the period following the emergence of external payments difficulties for many developing countries in the early 1980s, there were sharp changes in the pattern of payments imbalances. Reflecting both the adjustment efforts of developing countries and a reluctance of commercial lenders to increase their exposure to countries with external payments difficulties, net capital flows and current account deficits declined sharply. The current deficit of the developing countries declined from \$100 billion in 1982 to \$42 billion in 1984.

At the same time, the current account position of the industrial countries switched from a small surplus in 1982 (\$3 billion) to a sizeable deficit (\$35 billion) in 1984. Moreover, the current account imbalances of individual industrial countries increased significantly, with the U.S. current account deficit reaching \$93 billion in 1984 and the Japanese surplus amounting to \$36 billion. International capital movements thus increasingly represented flows between industrial countries, as opposed to flows between industrial and developing countries. At the same time, the issuance and purchase of securities (principally between entities in industrial countries) gradually displaced syndicated bank lending as a primary vehicle of international finance.

The decline of foreign capital flows to developing countries has sharply reduced the contribution of external savings to the financing of investment in these countries. For the market borrowers, the average ratio of foreign capital inflows to GDP in the 1983-84 period was below that experienced in the late 1960s and early 1970s. As a result, foreign capital inflows were equivalent to less than 7 percent of domestic savings during 1983 and 1984, whereas they had represented over 12 percent of the groups' domestic savings in the late 1960s. In contrast, the capital inflows that have been received by the official

^{1/} See Annex III for a discussion of the evolution of savings, investment, and foreign capital inflows over the period from 1967 to 1984.

borrowers have remained more stable and helped to sustain the level of investment for this group. Since the ratios of domestic savings to GDP in many developing countries have not increased or declined over the period between 1967 and 1984, reduced capital inflows have been accompanied by generally lower ratios of investment to income.

c. Liberalization

While many recent changes in regulations governing financial markets have been undertaken in response to the pressures created by macroeconomic developments, there have also been efforts in some countries to introduce additional competition into domestic financial systems in order to promote efficiency and to increase international access to domestic financial markets. In addition, the growing scale of Eurocurrency operations has led to competitive pressures in both domestic and international financial markets, permitted certain restrictions on domestic financial transactions to be bypassed, and allowed arbitrage of financing conditions across major financial markets.

The pressures for regulatory change affecting banking activity were often most evident when market interest rates rose relative to ceiling interest rates on bank deposit liabilities. Since interest rate ceilings on bank deposits were adjusted slowly to increases in market interest rates, there were at times significant outflows of funds from depository institutions subject to these interest rate ceilings into securities, including government paper, and deposits in nonbank institutions which were not subject to interest rate ceilings. Disintermediation was also encouraged by the need to finance large fiscal deficits in a number of countries with major financial markets. To finance these deficits, the authorities often issued debt with shorter average maturity, offered higher yields, and removed restrictions on the types of investors that could purchase short- and long-term government securities. Government debt carrying market-related yields provided attractive alternatives to holding deposits with fixed ceiling interest rates.

In most instances, changes in official policies have encompassed the relaxation of barriers separating the activities of different types of institutions, extensions of the geographical domain of existing institutions, the relaxation of interest rate ceilings, reductions in barriers to entry into the domestic financial system by both foreign and domestic institutions, the abolition or reduction of exchange controls, and elimination of quantitative credit ceilings. New regulatory policies typically have been introduced gradually in order to allow the various sectors of the financial system sufficient time to adjust to the new financial market environment as well as to changing macroeconomic conditions.

Access to major financial markets has been improved by removal of capital controls, changes in regulations governing the taxation and issuance of bonds, the continuing expansion of the Eurocurrency

markets, and changes in regulations governing access to both domestic and international markets. Table 1 provides some examples of the types of changes in regulations governing securities and banking markets that have occurred in recent years in Japan and the United States. Changes in Japanese regulations have broadened the array of instruments that can be used in securities markets and enlarged the access of both domestic and foreign borrowers to these markets, while increasing the role played by foreign financial institutions. In the United States, there has been a gradual removal of ceilings on domestic interest rates for bank deposits, a redefinition of the activities that various financial intermediaries can undertake, and a lessening of geographical restrictions on activities of banks.

Substantial changes have taken place in many other countries. In *the United Kingdom*, the authorities abolished exchange controls, removed restraints on the growth of bank liabilities (the Supplementary Special Deposit Scheme), and announced plans to liberalize the ownership of stock exchange firms with regard to both domestic and foreign institutions. In *Germany*, the authorities recently liberalized the types of securities that can be issued, allowing floating rate notes, zero-coupon bonds and swap-related issues. Foreign owned institutions are now permitted to lead manage foreign deutsche mark issues.

In addition, withholding taxes on interest payments paid on domestic bonds held by foreigners have been removed in a number of countries including the United States, Japan, and Germany. There has been a removal of restrictions on the establishment of futures and options markets for financial assets, foreign exchange, and equities. Unlisted securities markets have been encouraged in several countries, to facilitate equity raising by small- and medium-sized enterprises.

The increasingly important role of foreign banks in the domestic markets of the major industrial countries is another aspect of growing integration--and competition--of financial markets. While foreign banks have traditionally provided financial services in the host country for exporters from their home countries, these banks are now attempting to establish positions in domestic retail banking markets through the establishment of branch networks or purchases of domestic banks.

2. Development of new instruments

In parallel with the changes in official regulations, a variety of new instruments have developed in response to macroeconomic changes as well as existing and new regulations. Most of these instruments redistribute risk in the markets, and also foster greater integration, whether by blurring the demarkation lines between banking activity and the securities markets, or by allowing borrowers to access markets in new ways.

Floating rate notes (FRNs) have become an important instrument because they have been able to satisfy certain needs of both lenders and borrowers during the periods of high and variable interest rates,

Table 1. Selected Changes in Regulations Governing Financial Markets in Japan and the United States

JAPAN	
September 1982	It was announced that the rules governing the issuance of yen-denominated obligations by nonresidents would be liberalized effective January 1983. The rule of one issue per quarter for a foreign corporate borrower abolished, and private companies could compete for a place in the new issue queue on the same basis as supranational organizations and sovereign borrowers. All AAA-rated companies can issue on the market.
February 1983	Ministry of Finance lifted its ban on the sale of zero-coupon bonds in Japan but some conditions were placed on purchases of such bonds by Japanese investors.
December 1983	Financial institutions were allowed to set up subsidiaries dealing exclusively in consumer lending.
January 1984	The minimum size of CDs was reduced from ¥ 500 million to ¥ 300 million. Effective April 1, 1984 (i) the ceiling on overseas borrowing in the form of government guaranteed bonds by public corporations and state agencies was raised by one half; (ii) the required credit rating for foreign governments and official agencies who wish to borrow for the first time in the domestic yen market was lowered from AAA to AA; and (iii) the waiting period between two offerings by the same borrower was reduced from six to three months.
April 1984	Guidelines on the issue of Euro-yen bonds issued by residents were eased, allowing some 100 Japanese firms to issue convertible Euro-yen bonds and some 30 firms to issue straight Euro-yen bonds. Guidelines on overseas lending by Japanese banks discontinued.
May 1984	The Ministry of Finance decontrolled exchange swaps in connection with the issuance of foreign currency bonds by residents, and of yen bonds by nonresidents. Nonresidents were excluded from the 20 percent withholding tax on interest paid on government bond issues in foreign currency. The final communique of the Working Group on Yen/Dollar Exchange Rates and the U.S. Secretary of the Treasury was published. It included a commitment by the Japanese authorities to: (i) create a framework for a yen-denominated bankers' acceptance market; (ii) abolish as of June 1, 1984, swap limits on spot foreign exchange position of banks; (iii) authorized foreign companies to issue Euro-yen bonds under the criteria established for the use of samurai bonds. The criteria were to be relaxed further beginning in April 1985; (iv) allow foreign financial entities to lead manage Euro-yen bond issues; (v) permit the issue of short-term Euro-yen denominated certificates of deposit; and (vi) liberalized short-term Euro-yen loans to residents.
June 1984	Ministry of Finance relaxed "Gensaki" trading to include bonds denominated in foreign currencies which are listed on foreign stock exchanges. Banks were permitted to deal in secondary market issues of government and municipal bonds with maturities of up to two years. Short-term Euro-yen loans to Japanese residents were allowed.
September 1984	Three foreign banks invited to submit applications for licenses to deal in secondary market issues of government guaranteed bonds under same rules applying to Japanese banks.
December 1984	Overseas branches of Japanese banks and foreign banks were allowed to issue abroad negotiable Euro-yen certificates of deposits with maturities of up to six months; nonresident borrowers were allowed to issue unsecured Euro-yen bonds under the same rules which govern foreign yen bond issues in Japan; and (iii) six further foreign banks were authorized to sell Japanese government bonds over the counter. Yen-denominated Bankers' Acceptance Market established.
March 1985	Ministry of Finance announced: (i) from June 1985, banks and securities houses would be authorized to offer revolving loan facilities (up to ¥ 2 billion) by using public bonds as collateral; and (ii) brokering licenses would be granted to banks for trading in the bond futures market which would begin operations in October 1985.
April 1985	All banks permitted to sell new types of large denomination deposit instruments with market determined interest rates. Minimum size of CDs lowered (to ¥ 100 million) and minimum maturity shortened from three months to one month. Nonresident lenders and Japanese banks' overseas branches allowed to extend medium- and long-term Euro-yen loans, with a maturity of one year or more, to nonresidents and to overseas subsidiaries of Japanese corporations. The withholding tax on nonresidents' earnings on Euro-yen bonds issued by Japanese residents was abolished.
June 1985	It was confirmed that FRNs issued by nonresidents would be allowed on the Euro-yen market. Establishment of a yen-denominated Bankers' Acceptance Market announced. Nine foreign banks were allowed to participate in trust banking business in Japan, thus permitting them to participate in the management of corporate pension funds.
July 1985	It was also announced that foreign securities firms would be allowed membership of the Tokyo Stock Exchange before the end of the year.
October 1985	Interest rates on large time deposits were liberalized.

Table 1. Selected Changes in Regulations Governing Financial Markets in Japan and the United States (Concluded)

UNITED STATES	
March 1980	Depository Institution Deregulation and Monetary Control Act became law and: (i) authorized negotiable orders of withdrawal (NOW) accounts on a nationwide basis from December 31, 1980; (ii) extended reserve requirements to banks and other depository institutions that were not part of Federal Reserve System; (iii) allowed savings and loans to invest 20 percent of their assets in consumer loans, commercial papers, and debt securities; (iv) allowed mutual savings banks to make business loans and accept business deposits; and (v) created Depository Institutions Deregulation Committee (DIDC) and charged it with responsibility to gradually eliminate interest rate ceilings on deposit accounts.
December 1982	Following instructions given by the Garn-St. Germain Depository Institutions Act, the DIDC indicated that: (i) money market deposit accounts (MMDA) with a minimum balance of \$2,500 (subsequently changed to \$1,000 after January 1, 1985, and zero after January 1, 1986) and with no interest rate ceiling were authorized. Depositors were allowed up to six transfers per month; (ii) effective January 5, 1983, depository institutions allowed to offer the Super-NOW account that had unregulated interest rates and unlimited transfers but with minimum balance requirements; and (iii) savings and loans allowed to increase proportion of assets in the form of commercial loans.
June 1983	Depository Institutions Deregulation Committee decided to eliminate all remaining interest rate ceilings on new time deposits of over \$2,500 and longer maturity than 31 days opened after October 1, 1983. The Federal Reserve set a 5 percent capital/asset ratio requirement for larger banks.
October 1983	Depository Institutions Deregulation Committee decided that the remaining requirement of a balance of \$2,500 on deposit accounts should be phased out by January 1, 1986.
July 1984	Effective July 18, 1984, 30 percent withholding tax on interest paid to foreigners holding U.S. bonds abolished.
September 1984	The Treasury banned direct or indirect sales to nonresidents of U.S. Government backed security issues in bearer form.
November 1984	About 9,300 state-chartered banks regulated by the Federal Deposit Insurance Corporation were permitted to enter the securities business.
January 1985	The Treasury announced that a separate trading of registered interest and principal of securities (STRIPS) programs would be available first for its long-term notes and bonds and later for all old and new eligible securities in circulation.

uncertainty about the future trends in interest rate and inflation, and unstable macroeconomic conditions. In particular, FRNs fundamentally alter the sharing of the risks associated with interest rate variability between the borrower and the lender. With an FRN, the borrower bears the costs of higher interest rates or obtains the benefit of lower yields. Borrowers have been willing to bear this additional risk in order to obtain longer maturities than are typically available through the issuance of fixed interest rate bonds.

Although the first Eurocurrency FRNs were issued in the early 1970s, it was not until recently, when banks began to use FRNs for liquidity management and as a means of adding to their capital, that the volume of these instruments expanded to a significant level. During the period 1979-81, for example, Eurodollar FRNs represented 12 percent of all new international bond issues, but this proportion grew to 34 percent in 1984. Commercial banks have been both major purchasers and issuers of FRNs. Many non-U.S. banks often found Eurodollar FRNs the least expensive means of securing medium-term U.S. dollar funding for their medium-term floating interest rate U.S. dollar syndicated loans. In addition, subordinated FRNs were at times used as a source of bank capital, where this was permitted by the authorities.

Many corporate and sovereign borrowers found it less expensive to issue FRNs (or fixed interest rate bonds) than to obtain syndicated bank loans. This change in the relative cost of borrowing through bank loans and securities reflected, in part, the perception that the creditworthiness of many banks had declined in view of the difficulties that many of their borrowers were having in servicing their bank loans. As a result, the ratings of a number of leading banks were reduced relative to some of their sovereign and corporate clients. This factor, in addition to the costs of loan intermediation, helped keep the cost of syndicated loans for many creditworthy borrowers above the costs they experienced by directly issuing FRNs or other securities. In many cases, banks were able to hold FRNs without incurring the full liquidity and capital costs associated with direct loans, due to privileged regulatory treatment of securities.

FRNs typify a more general tendency to increase the marketability of banks' assets which traditionally have been held to maturity ("securitization"). Also, a large number of recent syndicated loans have incorporated contractual features permitting their transferability, usually in the form of transferable loan certificates. Of course, regulators and many banks point out that the negotiability of an asset does not ensure that saleable at close to par value. Ease and value of resale can be affected by the evolving creditworthiness of the borrower, as well as by interest and exchange rate fluctuations.

From the point of view of the borrower, syndicated loans are more flexible than the issuance of an FRN in a number respects. The borrower can draw on the funds available through a syndicated loan at any time during the loan period, can often change the interest rate basis (e.g.,

from the three- to the six-month LIBOR), can prepay the loan, and can sometimes even select the currency in which to receive the loan. With an FRN, in contrast, the borrower receives all funds at the time of issuance, the interest rate basis is typically fixed for the life of the FRN, the FRN can generally not be prepaid, and these notes are denominated in a single currency. However, lenders find FRNs much more attractive since they typically have greater liquidity than participations in a syndicated loan.

In a number of respects, the note issuance facilities (NIFs) and other backup credit facilities that have recently developed are an attempt to combine some of the characteristics of the traditional syndicated loan with those of an FRN. The NIF consists of an arrangement whereby an underwriting syndicate commits itself for several years (sometimes as long as ten years) to purchase the borrower's notes of one- to twelve-month maturity with a fixed spread (the "cap rate") above a benchmark interest rate. When the borrower activates the facility, notes are sold through bidding by tender or through negotiation to banks and other institutions that then place the notes with investors or add them to their investment portfolios. The cost to the borrower of such sales is usually below the "cap rate."

The underwriting banks are required to take up only those notes that cannot be sold below the "cap rate," although the underwriters can--and do--acquire the notes voluntarily also. About 25 percent of all NIFs are not underwritten or only partially underwritten. Approximately three quarters of the underwritten NIFs operate with a tender panel while the rest are underwritten by a single bank. The average maturity of the facility is seven to ten years, whereas the notes that are issued typically have maturities of one, three, or six months.

The development of such facilities is characteristic of the type of innovation that arises through the application in a new setting of a financing technique well established in one financial market. The short-term "committed" bank credit line or stand-by credit has been a common feature of domestic financial markets in many industrial countries. The type of international issuance facility that has recently grown so rapidly differs from domestic stand-by arrangements primarily in being explicitly medium term. It seeks to protect the underwriters by covenants analogous to those used in medium-term syndicated credits rather than through periodic renewal, as in domestic stand-bys.

These facilities have generally been arranged for highly regarded borrowers from the major industrial countries, including large banks and international institutions. They can potentially be used for a variety of purposes. While a fully drawn facility could be used in place of a syndicated loan to raise cash, very few facilities have been arranged in this manner. During 1984 and the first half of 1985, only a relatively modest proportion of the notes that could be issued under the existing facilities have actually been issued, especially in the case of facilities for corporations. NIFs arranged for corporations have thus far

been used primarily as a replacement for a bank stand-by. NIFs may, however, serve as the basis for the issuance of Eurocurrency commercial paper. NIFs are still undergoing rapid evolution. This is evident most recently in the development of multiple-option funding facilities (MOFFs) which allow the borrower either to sell Eurocurrency notes in different currencies or to obtain short-term bank advances.

The yields on the notes issued under these facilities have typically been below LIBOR but above the yields on alternative money market instruments (e.g., Eurocurrency deposits of comparable maturity). Notwithstanding this favorable interest rate differential, nonbanks' holdings of Euronotes are believed to remain very modest at this time. The principal nonbank purchasers have been corporations, insurance companies, investment trusts, and central banks.

Thus, the development of a true Eurocommercial paper market for corporate and sovereign borrowers is still at an embryonic stage. The future development of NIFs will be crucially dependent on the willingness of nonbank investors to purchase the short-term notes which are issued under these facilities. One element necessary for many nonbank corporations to invest in such paper on a large scale may be widespread rating of such paper by established credit-rating agencies.

Another new instrument, which emerged in significant volume only in the early 1980s, has been the medium-term swap. Swap transactions have been used both to arbitrage differences in borrowing costs across major financial markets and to reallocate the interest and exchange rate risks implicit in medium-term financial transactions. ^{1/} Given the extensive interest rate and exchange rate movements that have occurred in the period since 1973, institutions have sought means to better control and minimize their borrowing costs, to cover long-term commitments in foreign currencies, and to be able to fully use worldwide intracompany liquidity, both in convertible and blocked currencies. The thinness or absence of forward foreign exchange markets for cross-currency financial transactions with maturities beyond one or two years implied that medium-term transactions could not be fully hedged using traditional foreign exchange markets, although the existence of the medium-term swap market has itself now stimulated and facilitated development of the forward exchange markets at similar maturities.

Both securities houses and commercial banks have expanded their swap activities at a rapid pace. Since 1981, interest rate and exchange rate swap transactions have grown at a rapid rate, reaching an estimated \$80 billion in 1984. Over the last few years, swap markets have undergone extensive change. During the initial development of the swap markets, swaps typically had a value of between \$10 million and \$150 million, with a maturity from 3 to 10 years. By 1984, in contrast,

^{1/} Annex V explains the mechanics of an interest rate and currency swap.

maturities were generally between 1 and 12 years, with amounts ranging from \$5 million to \$500 million. Swaps are now also being utilized by corporations, banks, insurance companies, savings and loan associations, governments, and multilateral agencies. Currently, a very substantial proportion of new bond issuance in international markets is undertaken as part of a swap transaction. There are approximately three times as many interest rate swaps as currency swaps.

In swap transactions, financial intermediaries may play the role of a broker, bringing together two counterparties that undertake the actual swap, or may stand between the parties. In this latter instance, the financial intermediary assumes the credit risk of the counterparty failing to perform, which could result in unintended losses or profits, depending on intervening currency and interest rate movements. Staff discussions revealed extremely widely ranging estimates of the proportion of face value of a swap which might be considered as representing the credit risk. These estimates varied in particular in the case of medium-term interest rate and currency swaps, where the currencies concerned have varied materially in the past (e.g., interest and currency swaps involving U.S. dollars against deutsche marks or Swiss francs). The very fine margins now obtaining for some types of swaps reflect the fact that some institutions view their swap transactions as having relatively low credit risk attached to them.

As the outstanding volume of swaps had increased, a so-called "secondary market" had developed. Existing swaps are said to be "traded" when the swap is terminated, with payment of a negotiated fee by one original counterparty to the other original counterparty; is reversed through an offsetting swap with a different counterparty; or when one side of the swap is assigned by an original participant to a third party. In the second and third of these cases, the credit risk is not extinguished and may be increased since new counterparties are introduced in the chain of transactions. Swaps have thus not yet reached the status of finely tradable instruments. Moreover, it is not clear that actual trading of swaps is free from all risks. To reduce such risks, many corporations refuse to deal with counterparties whose credit rating are inferior to their own rating.

For corporate borrowers, swaps have also been a means of obtaining medium-term fixed interest rate credits. Among other factors, the financing of large fiscal imbalances in a number of major countries has to some degree stimulated corporate borrowers with less than the very best credit ratings to seek access to medium- to long-term capital market funds outside the traditional fixed rate market. Swap transactions have allowed these corporations to issue floating rate debt in markets where their name has a scarcity value, and then to enter into a swap transaction in which they agree to service the fixed interest rate debt of another entity (often a bank). The other entity agrees to service the corporation's floating rate debt. These swaps allow the corporation to obtain the equivalent of fixed interest rate debt at a

cost that is lower than could often be obtained through direct fixed interest rate bond issues. (Annex V provides an example of this type of transaction.)

Early in the development of the market, some non-U.S. dollar-based banks were able to obtain indirectly medium-term floating interest rate U.S. dollar finance at rates substantially below LIBOR, by issuing fixed interest rate, non-U.S. dollar foreign and Eurobonds, and by swapping the proceeds for U.S. dollars. As the market has developed, the initial large savings in borrowing costs that could be obtained through these swaps were eroded by competitive pressures.

A further area of innovation has been the rapid expansion of currency and interest rate options and futures. These markets permit banks and corporations to hedge their exposure to financial risks. The expansion of such activity may involve banks both as an agent for other parties and as principals--and if as principals, they may be trading on their own account, or taking positions to limit the interest and exchange rate exposure arising through other assets and liabilities. The use of financial futures by banks for their own account has increased sharply. Interest rate futures, for example, offer banks an alternative route to hedge mismatches between interest rates applicable to their assets and liabilities. This avoids an increase in interbank positions to match such exposure, thus economizing on the capital required for the banks' business.

3. Changes in the supervision of financial markets

The growth in banks' off-balance sheet business, the securitization of loan claims, and the growing integration of different financial markets and market segments have raised new and complex issues for supervisory agencies. These changes have occurred at a time when the quality of many banks' assets was still affected by the external payments problems of certain developing countries, and in some cases by debt-servicing difficulties of borrowers in the energy, agricultural, shipping, and real estate sectors of industrial countries.

These developments have posed substantial challenges to supervisors. They have also demonstrated the importance of steps taken over the past ten years to develop international coordination of bank supervision under the auspices of the Cooke Committee ^{1/} and of regional supervisory groups. With the growing integration of different types of financial markets, the need for close coordination between banking supervisors and regulators of other financial intermediaries has also been demonstrated.

^{1/} The Group of Ten Committee on Banking Regulations and Supervisory Practices, which meets under the auspices of the Bank for International Settlements.

There has been a continuing need to strike a balance between the common concern of bank managements and supervisors to strengthen individual institutions rapidly and a concern that such actions could-- by their cumulative effect in restricting flows of new funds to debtor countries--jeopardize the immediate stability of the financial system and thus prove self-defeating. Supervisors' sensitivity to this dilemma is illustrated by their acceptance of increases in banks' exposure to countries experiencing payments difficulties that have occurred under internationally concerted "new money" packages. Some current issues of relevance in this area are touched on in the discussion below of banks' reserves for loan losses.

a. Capital adequacy

Bank supervisors have continued their coordinated efforts to halt and reverse the decline in capital adequacy levels that had been evident in the late 1970s in many national groups of banks. Published capital ratios in a number of industrial countries have risen as a result of supervisory and market pressures (Table 2). The need to persist in this endeavor has been underscored by recent experience of some supervisors. This experience has indicated that adequate capital is essential to allow banks to withstand significant losses arising from their lending and other activities, and to limit the potential liabilities of public agencies in the event of the failure of an institution.

In the United States, strong impetus for the strengthening of capital asset ratios was given by the passage of the International Lending Supervision Act of 1983. Recently, the Federal agencies adopted new capital adequacy standards involving a minimum ratio of 5.5 percent for primary capital and 6 percent for total capital to banks' assets, increasing the minimum capital requirements for larger banks. At a hearing before the Senate Banking Committee in September 1985, the Chairman of the Federal Reserve Board indicated that, in his view, an increase in the ratio of total capital to assets to 9 percent for commercial banks was "attractive in concept and worthy of study." The possibility of a 9 percent total capital ratio had been raised previously by the Chairman of the Federal Deposit Insurance Corporation. Market estimates indicate that the total (as opposed to primary) capital ratio of the holding companies for the U.S. money center banks was equivalent to 8.5 percent in June 1985, up from 7.8 percent at end-1984. The comparable picture for a wider group of 35 banks gives closely similar results.

A further area of change is an increased vigilance by supervisors over the quality of banks' capital. Authorities have expressed concern about the role subordinated debt can play in bank capital. In particular, they have questioned the ability of such debt capital to absorb running losses, and to back assets except in the event of liquidation. In Germany, for example, subordinated debt has not been included in the capital base. In many other countries, such debt has been viewed as only "secondary" capital, subject to limitations on the degree to which

Table 2. Capital-Asset Ratios of Banks in Selected Industrial Countries, 1977-84 ^{1/}

(In percent)

	1977	1978	1979	1980	1981	1982	1983	1984
Canada ^{2/}	3.40	3.27	3.16	2.98	3.46 ^{3/}	3.65	4.06	4.43
France ^{4/}	...	2.29	2.62	2.40	2.20	2.07	1.96	1.94
Germany, Federal Republic of ^{5/}	3.41	3.32	3.31	3.27	3.26	3.31	3.34	3.38
Japan ^{6/}	5.28	5.12	5.13	5.28	5.25	5.03	5.22	5.15
Luxembourg ^{7/}	...	...	...	3.52	3.45	3.50	3.59	3.83
Netherlands ^{8/}	4.41	3.86	4.29	4.20	4.33	4.60	4.68	4.72
Switzerland ^{9/}								
Largest 5 banks	6.09	6.20	6.11	6.18	5.78	5.58	5.44	5.29
All banks	5.59	5.68	5.63	5.66	5.36	5.25	5.16	5.05
United Kingdom								
Largest 4 banks ^{10/}	7.14	7.53	7.18	6.85	6.39	6.28	6.59	6.20
All banks ^{11/}	5.20	5.20	5.10	5.00	4.47	4.14	4.35	4.47
United States								
Nine money center banks ^{12/}	4.95	4.73	4.51	4.52	4.62	4.93	5.41	6.22
Next 15 banks ^{12/}	5.72	5.42	5.37	5.51	5.21	5.34	5.69	6.63
All country reporting banks ^{12/13/}	5.70	5.53	5.29	5.35	5.38	5.60	5.94	6.53

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

^{1/} Given the problems of consistency across banks and over time in the accounting of bank assets and capital, aggregate figures such as the ones in this table must be interpreted with caution.

^{2/} Ratio of equity plus accumulated appropriations for losses (beginning with 1981, appropriations for contingencies) 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 (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 1984 would show a ratio of 6.98 percent. Inclusion of current-year profits in banks' capital resources would result in a weighted average of 4.03 percent for 1984. Provisions for country risks, which are excluded from capital resources, have been considerably increased in the last four years, with a tripling of the level of provisions between 1982 and 1984.

^{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 reserves to total assets (Swiss National Bank, Monthly Report).

^{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.

it can be included in prudential capital measures. Supervisory concern about the role of subordinated debt as capital has increased as many banks have become holders as well as issuers of substantial quantities of such debt. Thus, capital available to the banking system is to some degree being double-counted, and the capacity of such instruments to serve as capital may be perceived differently by issuers and holders.

Limits on the ability of banks to issue straight equity capital, particularly in cases where a bank's stock is poorly regarded by the market or where the bank is under government ownership, have thus led banks to issue instruments that fall between the traditional categories of loan and stock. These securities--with titles such as "participation certificates"--typically offer investors a somewhat higher return than bonds, but can (directly or by concession) bear part of the burden of lower profits or eventual losses.

As regards the international coordination of supervision, the consensus among bank supervisors on the need to supervise the international activities of banks on a worldwide consolidated basis has been implemented more fully. The authorities in Japan have moved to a consolidated monitoring procedure and, in Germany, legislation mandating consolidated supervision of banks has come into force. Considerable progress has also been made in agreeing on common techniques to monitor the capital adequacy of banks in different countries, based on alternative definitions of banks' capital and assets. Work on coordinated monitoring of capital ratios has been pursued by the Cooke Committee. Moreover, the European Commission (EC) has proposed to the representative organizations of the banking industry in each member state the harmonization of capital adequacy monitoring. The EC is currently engaged in trial calculations of capital ratios, or "observation ratios."

The treatment of country risk in observation ratios of the kinds used by the Cooke Committee and the EC, respectively, was discussed in a recent speech by Mr. H.J. Mueller of the Netherlands Bank. ^{1/} "Both systems apply relatively simple weighting, which essentially distinguishes between four broad categories of assets: claims on (a) governments, (b) banks, (c) private sector, and (d) contingent items. Apart from some minor differences with respect to the relative weighting of the various assets, a more fundamental problem needs, however, to be resolved: how to reflect cross-border risk in a risk/assets ratio. In the EC calculation, claims on governments and banks are split into two groups, namely, industrialized and nonindustrialized countries (based on IMF definitions) in order to reflect, through a different weighting, the element of country risk. It is to be hoped that the Basle Supervisors Committee will recommend the same kind of approach of

^{1/} Speech by Mr. H.J. Mueller, Executive Director of the Netherlands Bank, at the conference on "Banking Control and Supervision," hosted by the Arab Bankers Association, in London on May 7-8, 1985.

incorporating a country-risk factor into its capital adequacy ratio. Although the inclusion of an element of country risk may raise conceptual and political difficulties, this aspect cannot be overlooked nowadays."

b. Interaction of capital adequacy regulation and market innovation

Given the competitive and innovative nature of financial markets, official actions to increase the capital cover of bank-intermediated flows inevitably have met with responses from financial market participants to minimize the incidence of these costs. Thus, a key aspect of financial market activity in 1984-85 has been the remolding of capital market business to reduce or eliminate the costs of intermediation. Supervisory actions were not, however, the only factor influencing this trend. Another important factor was the deterioration in the credit rating of some banks that has taken place in recent years. This deterioration has been indicated by a downgrading of bank liabilities by rating agencies, and on occasion by widening differentials in short-term funding rates at times of market concern. Consequently, in the longer run, supervisory endeavors to improve the financial position of banks would help enhance banks' ability to raise funds cheaply and intermediate domestic and international credit flows effectively.

A few examples may illustrate how banks have restructured their business in response to supervisory influences on capital adequacy and related market pressures. First, there has been a very rapid growth in types of banking business that--in many countries--are not recorded on banks' balance sheets or are not captured in capital adequacy requirements. Thus, bank stand-by arrangements which back issues of negotiable securities by nonbanks have expanded substantially. Activity in financial futures markets has presented an important alternative to "on balance sheet" interbank activity for the matching of interest rate positions. Credits have been granted in the form of negotiable instruments (such as FRNs) in part because, in some supervisory schemes, listed securities receive privileged treatment in measurement of capital or liquidity adequacy.

These market developments have led to an evolution in supervisory approach to capital adequacy, perhaps especially in countries where a simple gearing ratio (capital to total assets) has traditionally been applied. The need for capital adequacy measures to capture differing degrees of risk attached to various instruments has heightened interest in the more flexible "risk assets" ratio approach to assessing capital adequacy. Under the risk assets approach, which is prevalent in European countries, different capital weightings are applied to various types of claims and reflect broadly the degree of bank risk. Both in the United States and Japan, supervisory agencies have indicated that the risk asset approach is being studied.

As indicated above in connection with cross-border risk, defining risk weightings for capital adequacy purposes and modifying them over time to reflect market developments is not a simple task. A coordinated study among supervisors in the Cooke Committee is currently under way to assess the regulatory implications of different types of off-balance sheet business, including notably their treatment for capital adequacy purposes. In the meanwhile, supervisors in the key financial market countries have strongly warned banks that supervision is in the process of being extended to off-balance sheet activities, and that these activities may be included formally in capital adequacy requirements.

In the United States, revisions to guidelines regarding capital adequacy issued in 1985 included reference to off-balance sheet banking: "The Federal Reserve will also take into account the sale of loans or other assets with recourse and the volume and nature of all off-balance sheet risk. Particularly close attention will be directed to risks associated with stand-by letters of credit and participation in joint venture activities. The Federal Reserve will review the relationship of all on- and off-balance sheet risks to capital and will require those institutions with high or inordinate levels of risk to hold additional primary capital. In addition, the Federal Reserve will continue to review the need for more explicit procedures for factoring on- and off-balance sheet risks into the assessment of capital adequacy." One market estimate of the effect of incorporating such stand-by letters of credit indicates that the primary capital ratio for 12 money center banks would decrease from 6.3 percent to 5.6 percent. 1/

In April 1985, the Bank of England instituted a comprehensive review of off-balance sheet risks for banks in the United Kingdom, although without a presumption that all types of such business would necessarily be included in prudential ratios. The first stage of this review was essentially fact finding, involving consultation with banks, banking associations, and licensed deposit-takers, as well as other interested parties, including auditors. A discussion paper is to be issued by the Bank of England in late 1985. The second stage will be a set of recommendations on the treatment of off-balance sheet risks for the purposes of assessing capital adequacy and liquidity management and control.

Pending completion of this study, and in response to the increase in banks' contingent commitments from revolving underwriting facilities and other note issuance facilities, the Bank of England has announced that such commitments must be given a 0.5 weighting in banks' capital adequacy ratios. This weighting also applies to guarantees and a number of other contingent liabilities. It is anticipated that the Japanese authorities will take action along similar lines, involving a weight of 0.3 for underwriting commitments. Similar measures are being studied or implemented in other countries also.

1/ Implications of the Federal Reserve's proposed capital guidelines, Salomon Brothers, Inc., September 12, 1985.

c. Reserves for loan losses

Closely linked with the assessment of banks' capital adequacy is the valuation of banks' assets. While current profits are a first protection against losses, banks also need adequate reserves to withstand potential losses, including those arising from cross-border exposure. Pressure on banks to establish adequate reserves is clearly manifest in market reactions as well as supervisory responses.

Provisioning practices on cross-border exposure are complex and--notwithstanding the pursuit of common supervisory objectives--the detail of practices in different countries differ to a very considerable degree. While increasing their general capital and reserves, banks in many countries have also reserved (or "provisioned") against exposure to individual debtor countries. Alternatively, in a number of countries banks have taken a "basket" approach to constitution of reserves, setting aside reserves against a portion of their exposure to a group of countries--typically those that have recently experienced payments difficulties. Variants on this latter technique are applied, for example, in Canada, France, Japan, and Switzerland. This approach reflects a view that transfer risk is inherent in all such loans, but that it is inappropriately captured by specific provisioning against individual debtors countries.

The degree of supervisors' involvement in the process of establishing reserves against transfer risks varies considerably from country to country. In some countries (for example Canada, Switzerland, and the United States), supervisors are involved in setting mandatory provisioning levels, although these are, in effect, minimum provisioning levels, and some banks build up their loan loss reserves beyond such levels. In many other countries, supervisors' involvement is primarily based on assessment of individual banks' actions, as reviewed by external auditors, when measured against prudent valuations made by other institutions. A further variation is that the scale of reserves held available to meet losses (and transfers to or from such reserves) need not be disclosed in some countries.

The degree of provisioning differs widely from country to country and from bank to bank. While minimum provisioning standards are mandatory in some countries, these countries are not necessarily those where provisioning is most sizeable. Key factors influencing provisions are the scale of a bank's exposure, the availability of current profits, and the possibility of securing tax deductibility. In general terms, banks in Continental Europe can offset provisions for unrealized losses against current taxes to a considerable degree. At the other end of the spectrum are banks in Japan and the United States where, beyond certain specified levels, banks can only reduce their tax burden when actual loan losses are experienced. Tax deductibility, however, is not within bank supervisors' direct control.

As a broad generalization, it is not uncommon for banks in continental European countries to have earmarked reserves against exposure to countries that have experienced payments difficulties, on a scale that could absorb losses equivalent to one fifth or more of their exposure to such countries. Banks in industrial countries elsewhere may generally have less reserves earmarked against such potential losses. However, such a comparison is of limited usefulness. Banks' ultimate ability to absorb losses is not mainly a function of average national provisioning percentages. It depends on the relationship between a variety of factors. These include the scale and distribution of any bank's exposure, after allowing for reserves earmarked against such exposure; the underlying earnings stream of the bank from other, unrelated activities; the concurrent loss experience on other types of lending or off-balance sheet activity; the total capital and available resources of the bank (including resources represented by assets carried below market value); and the liquidity available to the bank to withstand sudden market reactions. The diversity of such factors--within as well as between countries--is very considerable.

The difference in banks' exposure and ability to absorb losses is one element that has weakened cohesion among banks providing financial support for countries in payments difficulties. However, there is no immediate prospect of convergence in key factors influencing such ability, whether this be technical factors, such as the tax deductibility of reserves, or the longer run relationship between individual banks' available profits and the scale of their exposure. Moreover, banks' attitudes to such financing may be strongly influenced by their longer term business interests in individual countries.

A subject of particular interest at the present time is the influence of provisioning practices on banks' willingness to resume spontaneous lending to countries that have restructured their external debt. In this regard, the distinction between mandatory and non-mandatory provisioning is relevant, but the impact of either system on individual institutions can vary. For example, under either system a bank which has high provisions relative to other banks, or relative to mandatory levels, might feel comfortable with a modest increase in exposure to a country whose external position is improving. The bank might feel that the type and scale of exposure strengthened its existing claims. In addition, it might judge that adequate reserves were already established, or alternatively desire additional tax savings gained from new reserves, if its profits and tax regime permitted. At the other extreme, a bank with sizeable exposure, low provisioning, weak profitability, and limited tax advantages on further provisions would likely seek to avoid any increase in exposure--even through instruments that were serviced regularly such as, say, trade financing. Under such circumstances, mandatory minimum provisioning levels, if they existed, would be only one aspect only of its concern.

However, one identifiable concern relates to the impact at the margin of mandatory provisions on exposure to a group ("basket") of

countries. Specifically, any increase in exposure to one country in the basket results in a need to increase provisions. The dynamics of this process imply that, for example, a spontaneous increase in trade financing which has been regularly serviced, to a country whose economic prospects have improved, would result in the same provisioning requirement as a new medium-term loan to a country whose economic policies and prospects have worsened sharply. Supervisors in those countries where a basket approach is adopted are sensitive to the possibility that such arrangements have the potential to operate in a counterproductive manner, and in several cases are reviewing this problem.

As indicated above, banks and supervisors suggest that supervisory rules, like immediate tax considerations, are only one factor influencing banks' willingness to lend. In general, these regulatory factors may well be subordinate to banks' perceptions of their longer run business interests. While attention to potential regulatory obstacles is an important concern, neither banks nor regulators believe that growth in spontaneous lending can be stimulated primarily by fine-tuning of microprudential instruments.

d. Liquidity

A substantive reappraisal of liquidity management in banks' international business has been underway in recent years. Four main factors have caused this reappraisal: problems in the interbank market encountered with banks from certain developing countries; funding difficulties experienced by a number of industrial country banks, and the official response to these difficulties; a decline in the interbank business of some major banks as part of an effort to restrain their balance sheet growth relative to capital; and the rapid growth in certain instruments (notably, FRNs and stand-by credits) whose liquidity characteristics have yet to be fully tested. Banks and supervisors have begun to subject liquidity adequacy to a fundamental review of the kind undertaken for capital adequacy in the period since 1977.

Problems encountered by developing countries in the interbank market since 1982 were one of the first factors leading to reappraisal of the role of interbank placements in banks' liquidity management. A main reaction to these problems was a more critical appraisal of the purposes for which banks were tapping the interbank market. Concern developed, and has persisted, that banks should not use short-term interbank funding as a principal source of medium-term lending to their home countries. From 1982, spontaneous access to the international interbank market has been curtailed for banks from developing countries that have restructured their debt. A substantial proportion of these banks' interbank borrowings have been consolidated under "maintenance of exposure" facilities. In Brazil and Mexico, in particular, interbank facilities amounting to \$11 billion have been consolidated since 1982. Trade-related and interbank borrowing of ten other countries has also been consolidated, and the total short-term bank debt rolled over or converted into medium-term loans since 1982 stood at \$37 billion at

the end of September 1985. Over time, a natural increase in trade-related lending may allow such maintenance of exposure arrangements to be dispensed with.

Funding difficulties experienced by a number of industrial country banks have also exercised a substantial influence on liquidity management. A first conclusion drawn by market participants from recent experiences in the United States, the United Kingdom, and Canada is that monetary authorities remain highly sensitive to the dangers of contagion that could arise if an institution of significant size were to fail to meet its commitments in the wholesale money markets. Taken alone, this conclusion would certainly raise serious concerns about the "moral hazard" posed by national authorities' willingness to provide liquidity support, especially while uninsured deposits are being withdrawn.

A number of other responses to these incidents may run counter to that concern. Authorities in different countries have been impelled by funding problems or serious losses in commercial banks to tighten significantly supervisory procedures during the past ten years. In a number of instances, this has involved closer collaboration with bank auditors and increased coordination with supervisors in other countries. Banks have also been influenced directly by events in the interbank market, and have sought to strengthen and safeguard their own liquidity positions. A number of techniques have been employed to lengthen the "survival period" during which a bank could withstand strains in international wholesale markets. On the funding side, banks have raised medium-term funds through interest rate swaps, diversified wholesale funding sources, increased the proportion of "relationship" deposits, and--in the case of U.S. banks--broadened their retail deposit base.

On the asset side, banks have focused on the liquidity of various categories of assets. Interbank placements with other banks have been viewed much more critically to assess their true liquidity in times of stress. More conservative institutions indicate that they see merit also in holding some prime quality, short-term negotiable paper, including government debt, in currencies that match their wholesale liabilities. The desire for greater asset liquidity has also been one of the factors leading to the "securitization" (transformation into negotiable instruments and notes) of bank assets. Certainly, in a legal sense, or for some regulatory ratios, an increase in liquidity results from securitization. However, supervisors have indicated a concern that the effective liquidity of these instruments may be overestimated in some cases. On the other hand, banks' liquidity position may deteriorate quickly if they are required to provide funds to borrowers under stand-bys or international issuance facilities.

For some banks, including notably U.S. banks, the effort to improve liquidity has had to be weighed against a desire to restrain balance sheet growth due to market and regulatory pressures for higher capital ratios. Indeed, one of the factors leading supervisors to favor risk-asset ratios for capital adequacy purposes has been the desire to ensure

that capital adequacy requirements were not met by measures that could weaken a bank's liquidity position. The interaction of capital and liquidity supervision has attracted increased attention recently and is likely to be a key area of interest in the period ahead.

e. Functional versus institutional supervision

The lowering of barriers in financial markets has advanced to varying degrees in different countries, but there is a manifest tendency for financial institutions to develop a full spectrum of financial products. Thus, in some markets, banks now compete directly with securities houses, mortgage institutions, insurance companies, and even "nonfinancial" companies in different markets for financial products. A striking development of the past two years has been the perception of a need to align supervision practices better to more integrated financial markets.

In many industrial countries, traditional forms of regulation in the financial services industry have been based on restrictions to entry into various types of business, and limitations on product competition between different sectors of the industry. In many ways, this has facilitated the supervision of institutions, and allowed supervisors to have detailed knowledge of the management and activities of individual institutions whose business was, to a degree, homogeneous. Such compartmentalization persists to a degree in some countries, for example, the United States and Japan, where deposit-taking and securities underwriting are separated. Nonetheless, even in these countries, commercial banks and securities houses have considerably greater freedom for competition in their respective business areas outside the national territory.

In the United Kingdom there was a clear demarcation between stock exchange members and other financial institutions. The past year has seen the formation of links between banks and stock exchange members with the intention of combining the roles of issuing house, agent broker, market-maker, and investment manager in a single institution. Investment business will be subject to common standards for entry, with much emphasis on disclosure and transparency. A key task of the new securities authority will be to devise rules to control conflicts of interest. The issue of avoiding conflict of interest in an evolving financial structure has also been addressed in Canada, where a Green Paper on the future structure of parts of the financial services industry was issued early in 1985.

In a number of countries, efforts are under way to study and enhance the coordination between supervisors of different types of financial intermediaries. While this issue has arisen with regard to various aspects of supervision, it has been clearest in the areas of capital adequacy. To illustrate, both banks and securities companies carry inventories of securities and enter into medium-term currency and

interest rate swaps. To raise the capital costs associated with banks' involvement in such activities may simply displace business to other financial institutions.

In countries where integration of the financial services sector is proceeding rapidly, regulatory authorities have been studying the merits of supervising financial companies on a "functional" rather than an "institutional" basis. Under a functional approach, a given activity would be subject to the same supervisory regime regardless of the type of financial institution undertaking the activity. For example, the same prudential rules would apply to both banks and to securities houses' inventories of marketable securities (including frequent marking to market, full disclosure and regular turnover of portfolio holdings). To facilitate supervision, different market activities might be confined within identified departments of a company, or companies within a group.

In this connection, supervisory attention has come to focus also on safeguards to contain any problems of confidence within single parts of a financial company, avoiding contagion to the remainder of the company or group and to the rest of the system. Component parts of financial conglomerates can be separately capitalized, and the Bank of England's discussion document relating to primary dealers in the gilt-edged market proposed that these should be backed by dedicated capital. The Canadian Green Paper emphasizes the barriers within a financial conglomerate. These are not simple issues, however, as was noted in a speech by the Deputy Governor of the Bank of England in November 1984: "There is, however, a potential tension between the desire to isolate market-making risks, and the well-established principle that parent banks have a moral obligation to stand behind their subsidiaries to cover losses, even when they exceed their limited liability in law. The involvement of a bank in a group which contains a market-maker is therefore likely to have implications for the assessment of its own capital adequacy." 1/

The functional approach to supervision has attracted attention because it creates a regulatory "level playing field," but it does not offer a simple solution. In practice, it may prove unrealistic to supervise one segment of the business of a financial company--or even of a group of companies--without knowledge about other parts. Experience has demonstrated that, in an industry where confidence plays a crucial role, problems in one part of a financial business can spread quickly to affect the position of other units. Thus, close coordination between regulatory authorities--domestically and internationally--is likely to remain of paramount importance.

1/ Speech by Mr. C.W. McMahon, Deputy Governor, Bank of England, to the "Euromoney" conference in Sydney, Australia, on November 27, 1984.

III. International Banking Activity

1. Measurement of international banking flows

The quantity and quality of statistics on international bank lending have improved substantially in recent years. However, with the spread of liberalization and innovation in the international capital markets, the range of financing techniques available to market participants has expanded greatly. In addition, banks' financial operations have become increasingly complex in light of the international debt crisis. These factors are affecting not only the way in which markets function, but also the ability of compilers to measure and interpret the transactions that are taking place.

The description of international banking activity presented in this section is based on data from a number of sources in order to provide as comprehensive an analysis as possible of underlying patterns. Annex IV of this paper describes the coverage issues involved, with particular emphasis on differences inherent in data that are drawn from different sources or that represent banking activity on different bases, e.g., residential, consolidated, or by nationality of ownership. However, Table 3 and Chart 1 illustrate the similarity in trends in international banking activity in recent years, as shown by the Fund's International Banking Statistics (IBS) and the quarterly data published by the Bank for International Settlements (BIS) in International Banking Developments.

Annex IV also addresses current measurement problems. These problems result, essentially, from the fact that bank lending flows are derived from changes in stock data (banks' claims). Changes in these stocks are caused not only by new lending and amortization but by exchange rate movements, write-offs of debt, calling of guarantees, and classification problems (including inconsistent reporting by debtors and creditors). Moreover, banks' purchases of securities have not been fully included in the geographical analysis of banks' claims in many countries.

The description of banking activity in this section is based on data that have been corrected for these problems whenever possible, and in particular for exchange rate changes and identified inconsistencies in reporting of data by debtor and creditor sources. Revisions to take account of reporting problems were made to lending data for 12 countries, principally affecting lending to countries in the Western Hemisphere. The downward revision in cross-border lending to developing countries as a result of correcting identified reporting problems amounted to about \$10 billion in 1983 and \$1.5 billion in 1984, mainly due to changes for Brazil and Mexico.

Table 3. International Lending and Selected Economic Indicators, 1979-85

(In billions of U.S. dollars, or in percent)

	1979	1980	1981	1982	1983	1984	1985 Estimates
International lending							
through banks and bond markets							
Total ^{1/}							
IMF based	370	414	434	236	184	247	...
BIS based (net of redepositing)	148	179	195	145	130	153	...
Bond issues (net) ^{2/}	23	19	30	50	45	60	...
Bank lending ^{1/}							
IMF based	347	395	404	186	139	187	...
(growth rate)	(27)	(24)	(20)	(8)	(5)	(7)	(...)
BIS based (net of redepositing)	125	160	165	95	85	93	...
(growth rate)	(23)	(24)	(20)	(10)	(8)	(8)	(...)
International lending to developing countries ^{3/}							
Bond issues ^{4/}	3	2	4	5	3	5	...
Bank lending ^{1/}							
IMF based	59	85	87	51	38	15	...
(growth rate)	(23)	(27)	(22)	(11)	(7)	(3)	(...)
BIS based	48	55	33	33	26	8	...
(growth rate)	(23)	(22)	(17)	(9)	(7)	(2)	(...)
World economic developments							
Total of identified current account deficits ^{5/}							
Industrial countries	29	59	41	40	50	108	141
Of which:							
Seven largest	(12)	(31)	(16)	(17)	(37)	(96)	(130)
Developing countries	69	92	134	133	100	78	82
Overall current account balance of capital importing developing countries	-61	-77	-113	-104	-60	-38	-44
Reserve accumulation of capital importing developing countries ^{6/} (accumulation +)	22	19	-3	-18	9	18	4
Growth rate in value of world trade	26.3	21.5	-0.6	-6.3	-2.3	6.4	1.8
Growth rate of real GNP of industrial countries	3.5	2.0	1.7	0.4	2.5	4.5	2.8
Inflation rate of industrial countries ((GNP deflators)	7.9	9.1	8.7	7.2	4.8	4.1	3.2
Interest rates (six-month Euro-dollar deposit rate)	11.9	13.9	16.7	13.6	9.9	11.3	8.5

Sources: Bank for International Settlements; Organization for Economic Cooperation and Development; International Monetary Fund, International Financial Statistics; "World Economic Outlook - General Survey" (EBS/85/201, 8/26/85); 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 the BIS 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 coverage of the series. 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 due to expanding coverage.

^{2/} Net of redemption and of double-counting due to bank purchases of bonds.

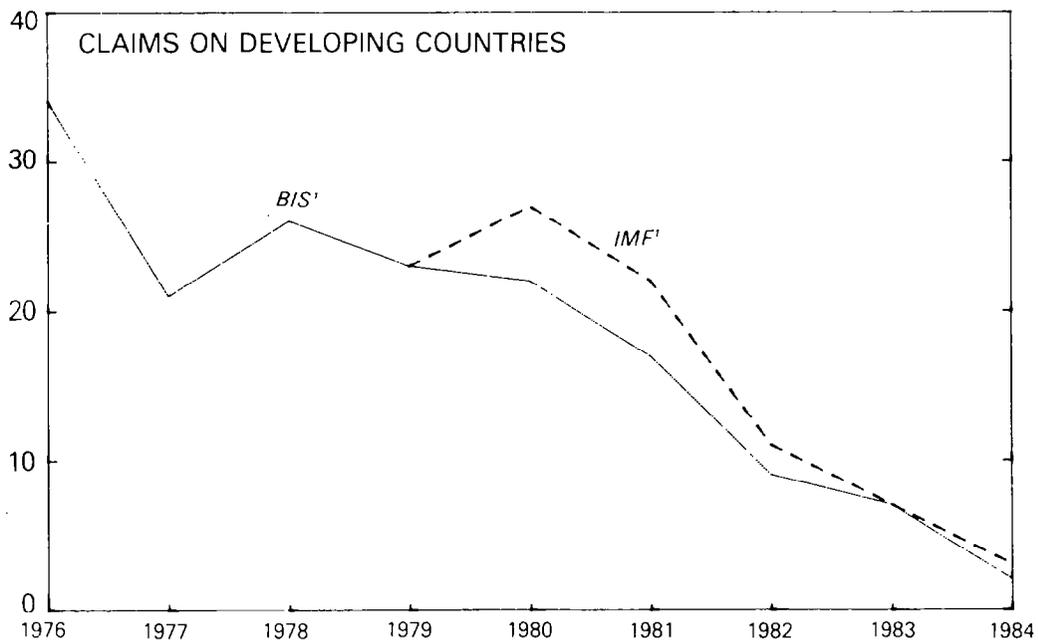
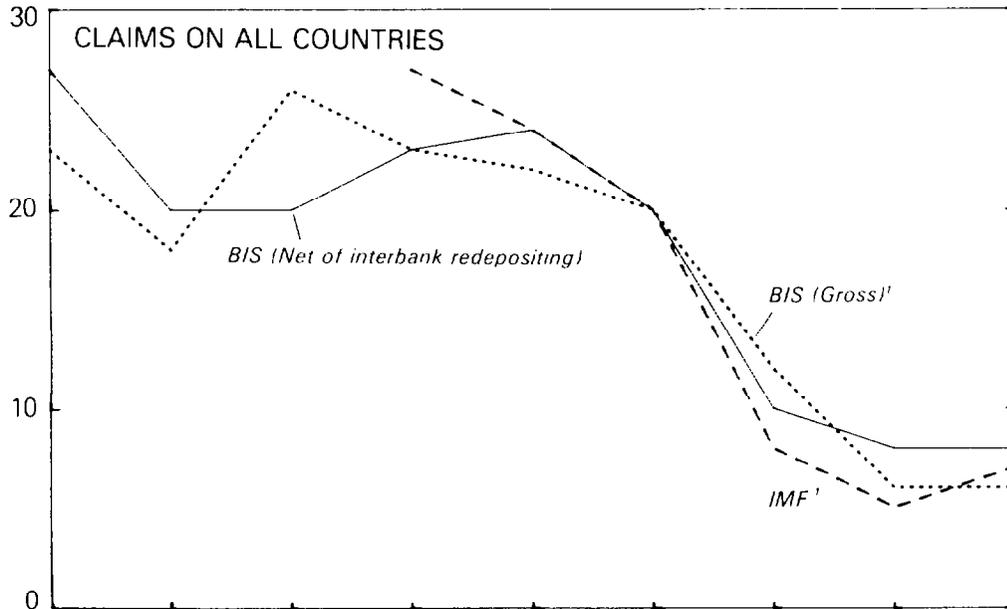
^{3/} Excludes the seven offshore centers, which are: the Bahamas, Bahrain, the Cayman Islands, Hong Kong, Netherlands Antilles, Panama, and Singapore.

^{4/} Unadjusted for redemptions and double-counting due to bank purchases of bonds.

^{5/} Goods, services, and private transfers.

^{6/} Based on balance-of-payments definitions.

CHART 1
GROWTH RATE OF
INTERNATIONAL BANK CLAIMS, 1976-84
(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.



2. Overview of bank lending and deposit-taking

Banks' overall cross-border lending 1/ increased by \$187 billion in 1984, compared with \$139 billion in 1983 (Table 3); this corresponded to a rate of growth of 7 percent, up from 5 percent in 1983. However, international bank lending activity was still considerably below that during the early part of the decade. The slight pick-up in activity in 1984 was due to cross-border interbank lending, which amounted to \$149 billion in 1984, compared with \$102 billion in 1983. 2/ This corresponded to a rate of growth in interbank lending of 8 percent in 1984, up from 6 percent in 1983. In the first quarter of 1985, overall bank lending activity amounted to \$56 billion. This was accounted for virtually entirely by an increase in cross-border interbank lending that was unusually large in terms of normal seasonal patterns.

Bank lending to industrial countries rose from \$92 billion in 1983 to \$114 billion in 1984, and rose further to \$49 billion in the first quarter of 1985 (Table 4). A high proportion of bank lending to industrial countries took the form of interbank flows. Claims on the developing countries (excluding seven offshore centers 3/) grew by only \$15 billion in 1984 (3 percent) compared with \$38 billion in 1983 (7 percent). 4/ In the first quarter of 1985, bank claims on this group of countries declined by \$1 billion, less than the decline of \$3 billion in the first quarter of 1984.

Total deposit-taking from both banks and nonbanks increased from \$161 billion in 1983 to \$191 billion in 1984. Growth of deposits of the industrial countries increased from \$88 billion in 1983 to \$131 billion in 1984, despite a sharp drop in deposit-taking from the U.S. from \$32 billion in 1983 to \$11 billion in 1984. There was a leveling off of the increase in developing countries' deposits with the international banking system. These increased by \$25 billion in 1984, compared with \$29 billion in 1983. However, a much higher proportion of this depositing reflected increases in official reserves.

1/ Cross-border lending is measured in the IBS as the increase in interbank accounts by residence of borrowing banks and of international bank credits to nonbanks by residence of borrower. Changes attributed to exchange rate measurements are excluded.

2/ Data showing the split between lending to banks and interbanks are provided in the statistical supplement to this paper.

3/ All references to developing countries exclude the major offshore banking centers (the Bahamas, Bahrain, the Cayman Islands, Hong Kong, the Netherlands Antilles, Panama, and Singapore).

4/ Deposit-taking flows are measured as differences in the outstanding assets of depositing countries, excluding changes attributed to exchange rate movements.

Table 4. Total Cross-Border Bank Lending and Deposit-Taking, 1982-First Quarter 1985 ^{1/}

(In billions of U.S. dollars)

	1982	1983	1984	1985		First Quarter	
				1st Half	2nd Half	1984	1985
Lending to ^{2/}	186	139	187	97	90	31	59
Industrial countries	123	92	114	65	50	30	29
of which:							
United States	(61)	(38)	(36)	(27)	(9)	(7)	(8)
Japan	(...)	(10)	(19)	(8)	(11)	(10)	(10)
Developing countries ^{3/}	51	39	45	4	11	-3	-1
Offshore centers ^{4/}	25	7	30	11	19	-3	8
Other transactors ^{5/}	-1	6	6	--	6	-2	-1
Unallocated (Nonbanks) ^{6/}	-12	-4	21	18	4	9	1
Memorandum items:							
Capital-importing developing countries ^{3/2/}	...	38	15	5	11	-2	-1
Major borrowers ^{8/}	...	13	9	3	6	--	-1
Non-oil developing countries ^{3/9/}	-1	31	17	6	11	-1	-1
Deposit-taking from ^{10/}	188	161	191	115	77	41	71
Industrial countries	150	88	131	78	53	37	54
of which:							
United States	(107)	(32)	(11)	(28)	(-16)	(6)	(5)
Japan	(...)	(15)	(12)	(3)	(7)	(9)	(10)
Developing countries ^{3/}	4	29	25	14	11	-3	-1
Offshore centers ^{4/}	25	25	19	13	6	-1	18
Other transactors ^{5/}	4	10	2	--	2	--	-3
Unallocated (Nonbanks) ^{6/}	6	9	14	10	4	8	4
Memorandum items:							
Capital-importing developing countries ^{3/2/}	...	38	27	15	12	2	-3
Major borrowers ^{8/}	...	12	18	7	12	3	--
Non-oil developing countries ^{3/9/}	17	32	23	13	10	--	-6
Change in net claims on ^{11/}	-2	-22	-4	-17	13	-10	-15
Industrial countries	-26	-4	-16	-13	-4	-7	-5
of which:							
United States	(-46)	(6)	(25)	(-2)	(27)	(1)	(4)
Japan	(...)	(-5)	(7)	(3)	(3)	(-)	(-)
Developing countries ^{3/}	-7	9	-10	-10	1	--	--
Offshore centers ^{4/}	--	-19	11	-1	13	-2	-10
Other transactors ^{5/}	-5	-4	4	--	4	-2	1
Unallocated (Nonbanks)	-18	-12	7	7	--	--	-2
Memorandum items:							
Capital-importing developing countries ^{3/2/}	...	--	-12	-11	-1	-3	3
Major borrowers ^{8/}	...	1	-9	-4	-5	-2	-1
Non-oil developing countries ^{3/9/}	24	-1	-6	-9	2	-2	5

Note: Components may not add due to rounding.

Sources: International Monetary Fund, *International Financial Statistics*; 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, 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 Argentina, Brazil, Indonesia, Korea, Mexico, the Philippines, and Venezuela.^{9/} Consisting of all developing countries except the eight Middle Eastern oil exporters (listed above), Algeria, Indonesia, Nigeria, and Venezuela.^{10/} 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.^{11/} Lending to, minus deposit-taking from.

3. Industrial countries as international borrowers and depositors of funds

The growth of bank lending to industrial countries rose to 7 percent in 1984 from 6 percent in 1983. Growth in interbank claims on industrial countries was somewhat faster than the total, whereas there was a slowing to 3 percent in lending to nonbanks (from 5 percent in 1983). The major destination of cross-border bank lending was the United States, with flows amounting to over \$36 billion. Lending totaled almost \$30 billion to the United Kingdom, \$19 billion to Japan, \$12 billion to Belgium-Luxembourg, and \$6 billion to France. In contrast to the other industrial countries, nonbanks in the United States took in over \$12 billion of cross-border bank lending, while the rest of the industrial countries, in aggregate, experienced a decline in claims on nonbanks of over \$3 billion. Industrial countries' recourse to bank lending increased in the first quarter of 1985 to \$49 billion (in comparison to \$30 billion in the first quarter of 1984) all of which took the form of cross-border interbank lending.

The slowdown of bank lending to nonbanks in industrial countries in 1984, and its total absence in the first quarter of 1985, may be attributable to three factors: the strong liquidity position in 1984 of nonbanks in a number of industrial countries; the preference on the part of nonbanks for bonds rather than bank finance, reflecting the lower cost of issuing various types of securities versus the cost of bank finance; and banks' preference for fee-earning--rather than asset-creating--business.

The growth in cross-border interbank lending occurred despite some factors which have been operating to slow interbank activity. These include, inter alia, the impact of higher capital asset ratio requirements on U.S. banks, and efforts to raise capital asset ratios in many of the industrial countries; the greater use that banks are making of other instruments (such as futures, options, and swaps) for managing interest and exchange rate exposures; and a more critical attitude to the liquidity of interbank deposits.

However, in other ways the liberalization of financial markets may have added to cross-border interbank activity. Bank head offices in some major financial centers may have been transferring funds to their branches and subsidiaries abroad to fund larger trading portfolios of securities associated with the liberalization of security markets in the countries where the branches or subsidiaries operate. A significant proportion of interbank lending appears to reflect the increasing integration of the Japanese market into the international financial system, including the effect of relaxation of limits on Japanese banks' funding through swaps. Also, the relatively high level of interbank lending could be related to dealings in the foreign exchange market, which has witnessed large fluctuations. Banks covering of forward exchange operations in the spot market can result in an increase in cross-border interbank positions when the banks deposit the purchased currencies in banks abroad.

In addition, the rapid growth of the ECU market has contributed to interbank lending. Borrowing denominated in ECU has risen from less than 2 percent of total international borrowing in 1983 to almost 5 percent in the first half of 1985 (Table 5). Because banks' ECU assets exceed their nonbank ECU deposits, banks have borrowed component currencies of the ECU on a large scale in the interbank market. ^{1/} Cross-border interbank activity was also required, insofar as ECU borrowing and depositing by nonbanks occurred in different countries.

Finally, interbank lending has reflected the particularly strong ability of U.S. and Swiss banks to attract deposits from nonbanks, which exceeded their loans to nonbanks. Moreover, some tiering in the interbank market may have led to an increased recycling of deposits received by highly regarded banks, in addition to flows reflecting the difficulties of a major international bank.

Developments in new long-term external bank credit commitments ^{2/} provide some indication of recent capital market conditions to different borrowers. Total commitments amounted to about \$67 billion in 1984, or about the same amount as in 1983 and about \$58 billion at an annual rate in the first half of 1985. New commitments to industrial countries rose slightly to almost \$30 billion in 1984 from \$28 billion in 1983 (Table 4). Thus, they remained considerably below the 1982 level of \$52 billion, again reflecting borrowers' reliance on the security markets to obtain external financing. New commitments to industrial countries picked up to an annual rate of about \$33 billion in the first half of 1985.

Depositing by industrial countries increased significantly from \$88 billion in 1983 to \$131 billion in 1984. Interbank deposits rose from \$62 billion in 1983 to \$119 billion in 1984, while bank deposit-taking from nonbanks in the industrial countries fell from \$26 billion in 1983 to \$12 billion in 1984. Industrial countries' depositing abroad continued on a sizeable scale in the first quarter of 1985, amounting to \$54 billion in comparison to \$37 billion in the first quarter of 1984.

^{1/} Alternatively, they have used foreign exchange transactions to generate ECU funds.

^{2/} This analysis is based on OECD data on long-term external bank credit commitments. These cover new publicized medium- and long-term banks loans--including not only syndicated loans, but also "club" deals and single banks loans--signed or completed in a certain period, which have an original maturity of more than one year. They are not directly comparable to the data on lending previously referred to in the text, both because the amounts committed are not necessarily disbursed during the period, and because they relate to gross commitments and do not take account of amortization. These data nevertheless provide a useful indication about trends in the international banking markets. The statistical supplement to this paper includes OECD data on long-term external bank commitments and other bank facilities.

Table 5. International Borrowing Operations in ECU

(In billions of ECUs)

	1983	1984	1st Half 1985
By instrument			
Bonds	2.49	3.92	4.95
Of which:			
FRNs	(--)	(0.57)	(0.71)
Syndicated loans	0.72	2.16	2.66
Other facilities	--	--	0.26
Total	<u>3.21</u>	<u>6.08</u>	<u>7.87</u>
By borrowers			
Italy	0.94	1.68	2.70
France	0.60	0.57	0.80
EEC institutions	0.62	1.00	0.47
Other EEC countries	0.23	0.48	1.24
Other borrowers	<u>0.82</u>	<u>2.35</u>	<u>2.66</u>
Total	<u>3.21</u>	<u>6.08</u>	<u>7.87</u>
Memorandum item:			
ECU as a percent of total borrowing <u>1/</u>	1.7	2.5	4.9

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

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

Industrial countries as a group made net deposits of \$16 billion in new funds in 1984 after taking a net of \$4 billion in new funds in 1983. ^{1/} Within the industrial group, the United States was a net user of international funds, with a net inflow of \$25 billion. This contrasts with its historical role as the major supplier of funds. Net financing from the international banking system amounted to more than one-quarter of the U.S. current account deficit in 1984. Interestingly, the United Kingdom and Japan were also net takers of funds of \$9 billion and \$7 billion, respectively. The Japanese net financing from the international banking system occurred while recording a current account surplus of \$36 billion, a development which reflects, among other factors, investment by Japanese residents in international bond markets. In contrast, Switzerland (including trustee accounts) was a net placer of funds of almost \$28 billion in 1984. Industrial countries were net depositors of funds in the first quarter of 1985, with a net outflow of \$5 billion. The United States continued to be a net taker of funds (totaling \$4 billion).

4. Developing countries as international borrowers and depositors of funds ^{2/}

a. Overview

Bank lending to the developing countries continued to slow in 1984, increasing by only \$15 billion compared with \$38 billion in 1983. This corresponded to a growth of bank claims of 3 percent in 1984, in comparison to 7 percent in 1983. Bank lending to nonbanks in developing countries declined from \$22 billion in 1983 to \$5 billion in 1984. The growth in bank claims on developing countries continued at about the same pace during the 12-month period ended in the first quarter of 1985.

The sharp decline in bank lending to developing countries was associated with those countries' lower current account deficits in 1984 and a reluctance on the part of international banks to lend to many developing countries--especially those experiencing payments difficulties. About 60 percent of the growth in banks' claims on developing countries in 1984 took the form of concerted lending to Latin American countries in conjunction with bank debt restructurings and Fund-supported programs. ^{3/} Disbursements under concerted lending packages totaled over \$10.3 billion in 1984, of which Brazil and Mexico accounted for almost \$9.5 billion.

^{1/} However, recent global developments in flows of net funds should be treated with caution, particularly in view of the sizeable net inflows in 1984 recorded for offshore centers and appearing as unallocated.

^{2/} All references to developing countries exclude the major offshore banking centers (the Bahamas, Bahrain, the Cayman Islands, Hong Kong, the Netherlands Antilles, Panama, and Singapore).

^{3/} Concerted lending (or "new money") refers to equi-proportional increases in exposure coordinated by a bank advisory committee.

The combined deficit of capital importing developing countries (i.e., all developing countries except the eight major oil exporters in the Middle East region) fell from \$60 billion in 1983 to \$38 billion in 1984--a deficit equivalent to about 7 percent of their exports of goods and services--the lowest figure since 1967. The financing requirement in 1984 was covered by nondebt-creating flows (grants and direct investment) and by long-term borrowing from official creditors. The improved external financial position of the developing countries allowed them to accumulate \$22 billion in reserves in 1984, following an accumulation of \$10 billion in 1983.

Bank lending to most developing countries in Asia and Europe has remained spontaneous, though in some cases more limited in volume. Some countries, again particularly in Asia and Europe, were able to take greater recourse to the securities market, notably issues of floating rate notes and, to a lesser degree, note issuance facilities. Some countries in Eastern Europe were able to regain substantial access to syndicated lending in 1984, following a period when their access to spontaneous financing was limited. However, for most developing countries, access to spontaneous medium-term bank financing was even more limited in 1984 than in the previous year.

Almost two-thirds of bank lending to developing countries in 1984 took place through the interbank market, compared to one-third during 1982-83. This higher share was related, in part, to the transfer of claims on nonbanks to the monetary authorities in the context of debt restructurings.

New bank commitments to developing countries declined to \$31 billion in 1984 from \$35 billion in 1983 and \$45 billion in 1982 (Table 6 and Chart 2). There was a continuing fall in spontaneous commitments, which was only partly offset by concerted loans. Spontaneous commitments declined from an average of \$45 billion in 1979-82 to \$21 billion in 1983 to \$15 billion in 1984. Concerted commitments, mostly to a limited number of Latin American countries, totaled \$14 billion in 1983 and \$15.7 billion ^{1/} in 1984. All regional groupings of developing countries recorded virtually unchanged, or lower bank commitments in 1984, with countries in Africa and the Middle East reporting the greatest reductions. There was a large increase in new commitments to some non-Fund member countries with centrally planned economies, notably the U.S.S.R. and the German Democratic Republic, in 1984, but new commitments remained small in absolute terms (details of commitments to all groups of countries are provided in the Statistical Supplement).

New bank credit commitments to the developing countries slowed further to \$9 billion in the first half of 1985, compared with \$18 billion in the first half of 1984. Commitments to developing

^{1/} Excluding a new short-term trade deposit facility for Argentina of \$0.5 billion.

Table 6. New Publicized Long-Term External Bank Credit Commitments to Developing Countries, 1979-First Half 1985

(In billions of U.S. dollars)

	1979 <u>1/</u>	1980 <u>1/</u>	1981	1982	1983	1984 <u>2/</u>	1984		1985
							1st Half	2nd Half <u>2/</u>	1st Half <u>3/</u>
Developing countries	50.9	38.3	48.1	44.6	34.9	31.0	18.0	13.0	9.3
Capital-importing	49.8	37.8	47.0	42.6	32.6	29.9	17.6	12.3	8.7
Africa	4.8	2.6	4.1	2.7	2.7	0.5	0.3	0.2	1.1
Spontaneous lending <u>4/</u>	(4.8)	(2.6)	(4.1)	(2.7)	(2.7)	(0.5)	(0.3)	(0.2)	(1.0)
Concerted lending <u>4/</u>	(...)	(...)	(...)	(...)	(--)	(--)	(--)	(--)	(0.1)
Asia	11.0	9.2	12.8	12.6	10.4	10.2	4.6	5.6	2.9
Spontaneous lending <u>4/</u>	(11.0)	(9.2)	(12.8)	(12.6)	(10.4)	(9.3)	(4.6)	(4.7)	(2.9)
Concerted lending <u>4/</u>	(...)	(...)	(...)	(...)	(--)	(0.9)	(--)	(0.9)	(--)
Europe	7.8	4.9	4.7	3.7	3.5	3.4	1.2	2.2	2.3
Spontaneous lending <u>4/</u>	(7.8)	(4.9)	(4.7)	(3.7)	(2.9)	(3.4)	(1.2)	(2.2)	(2.3)
Concerted lending <u>4/</u>	(...)	(...)	(...)	(...)	(0.6)	(--)	(--)	(--)	(--)
Middle East	0.2	0.7	0.2	0.6	0.7	0.4	0.1	0.3	--
Western Hemisphere	26.0	20.4	25.2	23.0	15.3	15.4	11.4	4.0	2.4
Spontaneous lending <u>4/</u>	(26.0)	(20.4)	(25.2)	(23.0)	(2.0)	(0.6)	(0.3)	(0.3)	(0.2)
Concerted lending <u>4/</u>	(...)	(...)	(...)	(...)	(13.3) <u>5/</u>	(14.8)	(11.1)	(3.7)	(2.2)

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

1/ Includes only Eurocredit commitments.

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

3/ Includes agreements in principle with Chile and Colombia.

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

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

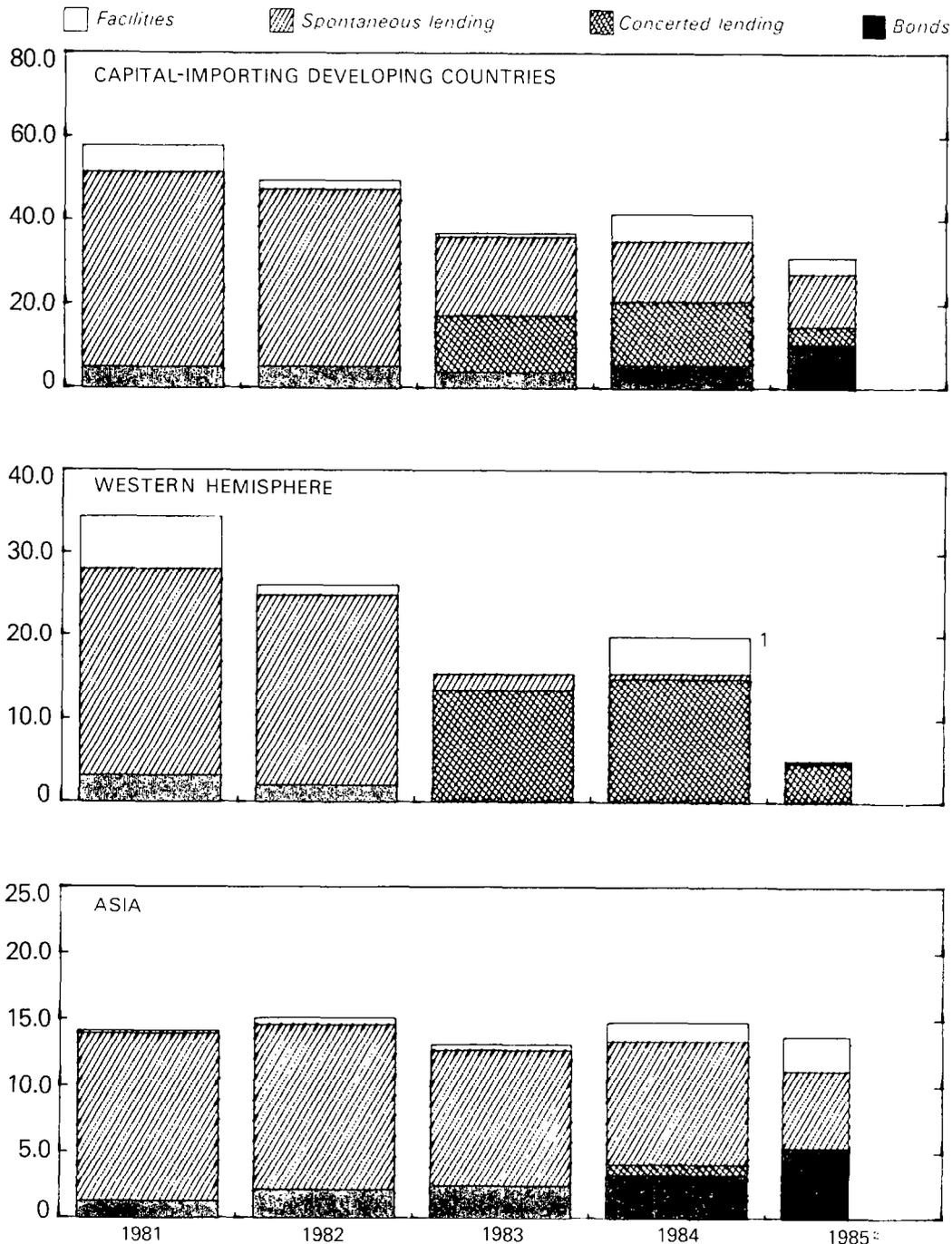




CHART 2

BOND ISSUES AND LONG-TERM COMMITMENTS OF CREDITS AND FACILITIES TO CAPITAL IMPORTING DEVELOPING COUNTRIES, 1981- FIRST HALF 1985

(In billions of U.S. dollars)



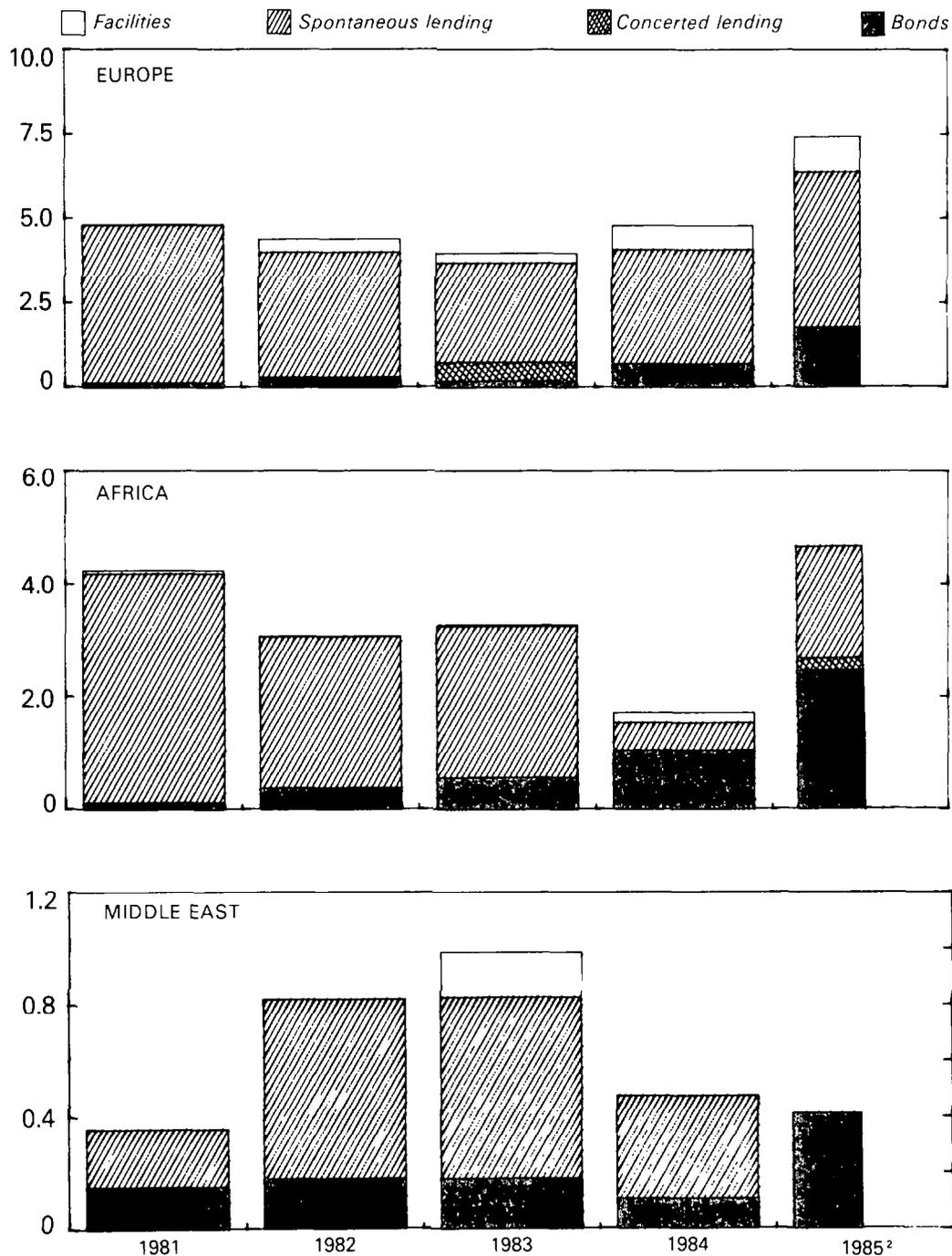
Source: Organization for Economic Cooperation and Development, *Financial Statistics Monthly*.

¹Includes a facility arranged for Mexico.

²First half annualized.



CHART 2
BOND ISSUES AND LONG-TERM COMMITMENTS OF CREDITS AND FACILITIES TO CAPITAL IMPORTING DEVELOPING COUNTRIES, 1981- FIRST HALF 1985 (Concluded)
 (In billions of U.S. dollars)



Source: Organization for Economic Cooperation and Development, *Financial Statistics Monthly*.
² First half annualized.



countries in the Western Hemisphere dropped to \$2.4 billion--virtually all was concerted lending. In contrast, bank credit commitments to developing countries in Europe rose to \$2.3 billion in comparison to \$1.2 billion in the first half of 1984. Credit commitments to countries in Africa rose in the first half of 1985, reflecting mainly a large bank commitment to South Africa. New commitments to centrally planned economies that are not Fund members continued to rise and were 25 percent higher, at an annual rate, than during 1984.

Data supplied by the BIS yields information concerning undisbursed credit commitments of countries in the BIS reporting area ^{1/} to developing countries. These unused lines of credit declined from almost \$78 billion at the end of 1981 to \$70 billion at the end of 1983 and to \$62 billion at the end of 1984. The \$8 billion decline in unused lines of credit to developing countries during 1984 was almost accounted for by a \$7.2 billion cutback to Western Hemisphere countries; in contrast, developing countries in Europe saw a slight increase in their unused credit lines. (In light of changes in coverage in this data, direct comparisons between end-year figures from 1982 to 1984 should be interpreted with caution, however.)

Deposit-taking of the international banking system from the developing countries was \$25 billion in 1984, or \$4 billion less than in 1983. Interbank deposits of developing countries rose by \$21 billion in 1984, compared to \$6 billion in 1983, reflecting an accumulation of gross official reserves by many of the countries in the group, while deposit-taking from nonbanks in developing countries declined from \$23 billion in 1983 to \$4 billion in 1984, in part as a result of decreased capital flight from developing countries. Banks' liabilities to these countries declined in the first quarter of 1985, but to a lesser extent than occurred in the first quarters of 1983 and 1984. Overall, developing countries contributed a net flow of funds to banks in the rest of the world of over \$10 billion in 1984, following net inflows to developing countries of \$47 billion and \$19 billion in 1982 and 1983, respectively.

b. Regional developments

Growth in international bank claims on the developing countries in the Western Hemisphere (excluding the offshore centers of the Bahamas, the Cayman Islands, the Netherland Antilles, and Panama) declined from about \$16 billion in 1983 (6 percent) to about \$7.5 billion (3 percent) in 1984 (Table 7). Interbank lending declined from almost \$12 billion in 1983 to about \$7 billion in 1984, while bank lending to nonbanks fell from just over \$4 billion in 1983 to less than \$0.5 billion in 1984.

^{1/} Bank for International Settlements, The Maturity Distribution of International Bank Lending. An overview of these data is provided in the Statistical Supplement.

Table 7. Total Cross-Border Bank Lending to and Deposit-Taking from Developing Countries, 1983-84 1/ 2/

(In billions of U.S. dollars)

	Lending <u>3/</u>		Deposit-Taking <u>4/</u>	
	1983	1984	1983	1984
Africa	7.3	0.4	1.8	-0.8
of which:				
Algeria	0.2	0.7	-0.5	-0.5
Ivory Coast	0.1	-0.3	--	0.1
Liberia	-0.1	1.5	0.4	0.3
Nigeria	1.3	-0.4	-0.1	0.4
South Africa	3.0	-1.5	0.6	-2.5
Asia	8.4	5.5	10.7	7.3
of which:				
China	0.8	1.0	3.6	0.3
India	0.9	0.1	0.9	0.3
Indonesia	2.8	0.3	2.1	1.6
Korea	2.2	3.5	-0.9	2.1
Malaysia	1.8	1.4	0.1	-0.2
Philippines	-1.3	0.1	-1.2	0.2
Thailand	0.5	0.9	-0.2	-0.1
Europe	3.1	2.6	2.8	4.4
of which:				
Greece	0.9	1.4	-0.1	0.4
Hungary	0.9	0.2	0.5	0.8
Portugal	0.6	-0.1	0.4	0.6
Romania	-0.6	-0.6	0.2	0.3
Turkey	0.5	1.4	0.3	0.9
Yugoslavia	0.7	0.9	0.5	1.1
Middle East	3.3	-0.9	-2.5	-3.2
of which:				
Egypt	0.4	0.6	2.1	-0.2
Israel	-0.4	-0.7	-0.5	-1.0
Kuwait	0.1	-0.5	-0.9	-0.3
United Arab Emirates	--	-1.2	-0.3	2.0
Western Hemisphere	15.8	7.5	16.0	17.1
of which:				
Argentina	2.2	-1.8	-0.4	-0.1
Brazil	5.6	7.4	4.9	7.3
Chile	0.3	1.2	0.8	0.1
Colombia	0.6	0.3	...	-0.2
Ecuador	1.0	0.6	0.6	--
Mexico	2.9	1.5	5.3	4.8
Peru	0.3	0.2	0.2	0.5
Venezuela	-1.1	-2.2	2.5	2.3
Total <u>2/</u>	37.9	15.1	28.7	24.9

Note: Components may not add due to rounding.

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

1/ In general, 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/ Excluding offshore centers.

3/ 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.

4/ 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.

In 1984, total bank lending to developing countries in the Western Hemisphere was less than disbursements under concerted lending packages because some banks reduced their claims on certain countries. In most countries where international banks agreed to provide new money as part of debt restructuring packages, overall lending was larger than the concerted loans disbursed. Banks' claims on Brazil and Chile rose by \$7.4 billion and \$1.2 billion, respectively, compared to concerted lending of \$6.5 billion and \$0.8 billion, respectively. However, international bank claims on Mexico rose by \$1.5 billion, despite concerted bank lending of almost \$3 billion. Banks also reduced their claims by almost \$2 billion on Argentina and Venezuela by \$2.2 billion. In the first quarter of 1985, banks' total claims on the developing countries in the Western Hemisphere increased by \$0.9 billion, compared with lending of \$0.3 billion in the first quarter of 1984. 1/

Countries in the Western Hemisphere were able to increase their deposits with international banks by over \$17 billion in 1984, about the same amount as in 1983. Depositing was unchanged in the first quarter of 1985. Monetary authorities largely accounted for an increase of \$12 billion of interbank deposits, mostly from Brazil and Mexico, while the increase in international deposits of nonbanks of \$5 billion was principally from Brazil, Mexico, and Venezuela. On a net basis, countries in this region supplied almost \$10 billion to international banks in 1984, with Mexico and Venezuela accounting for over 80 percent of this. However, developing countries in the Western Hemisphere were net takers of funds on a small scale in the first quarter of 1985.

International banks increased their claims on countries in Asia (excluding Hong Kong and Singapore) by \$5.5 billion in 1984 (6 percent increase in bank claims) compared with \$8.4 billion in 1983 (9.5 percent). This slowdown in bank lending may reflect the smaller net financing requirement of the region and increased borrowing on the international bond and floating rate note markets. 2/ (Asian country borrowers accounted for 60 percent of bond issues by developing countries in 1984.)

In 1984, Korea increased its liabilities to international banks by \$3.5 billion. China increased its external liabilities by \$1.0 billion. The Philippines continued to face major debt-servicing difficulties and a tentative agreement on concerted lending of \$925 million was finalized only in 1985. Total bank claims on the Philippines

1/ However, excluding bank lending to Ecuador, bank claims were unchanged with interbank claims falling by \$0.9 billion due, in part, to international banks reducing their claims on banks in Mexico by \$0.3 billion.

2/ Lending to Asian countries may be particularly affected by an underrecording of lending due to the exclusion of floating rate notes from the geographic analysis of bank claims in many countries. Bond issues by developing countries are discussed in Section V of this paper.

increased by \$0.1 billion in 1984. In the first quarter of 1985, international banks' claims on the developing countries in Asia declined by \$0.3 billion.

Asian countries deposited about \$7 billion in 1984, after having deposited \$11 billion in 1983. Indonesia increased its deposits by \$1.6 billion, while the international banks took in \$2.1 billion in deposits from Korea, of which \$1.9 billion were interbank transactions. Banks' liabilities to countries in Asia declined by \$1 billion in the first quarter of 1985 in comparison to an increase of almost \$3 billion in the same period a year earlier. Thus, Asian countries supplied \$1.8 billion of funds to the rest of the world in 1984, a slightly smaller amount than the \$2.3 billion in 1983, but became net takers of funds of \$0.7 billion in the first quarter of 1985.

International banks' claims on countries in Europe increased by \$2.6 billion in 1984 (4 percent) compared with an increase of \$3 billion in 1983 (5 percent). In 1984, banks' total claims increased by \$1.4 billion on Turkey, \$0.9 billion on Yugoslavia, \$1.4 billion on Greece, and \$0.2 billion on Hungary, but declined by \$0.6 billion on Romania.

In other regions, international banks increased their claims on countries in Africa by less than \$0.4 billion in 1984 (1 percent) compared with an increase of over \$7 billion in 1983 (11 percent). In 1984, banks' recorded claims increased by \$1.5 billion on Liberia (reflecting loans related to shipping activity), and \$0.7 billion on Algeria, but declined by \$1.5 billion on South Africa, \$0.4 billion on Nigeria, and \$0.3 billion on the Ivory Coast. International banks decreased their total claims on countries in the Middle East (excluding Bahrain) by almost \$1 billion (1 percent) compared with an increase of over \$3 billion in 1983 (3 percent).

Seven offshore banking centers, comprising the Bahamas, Bahrain, Cayman Islands, Hong Kong, the Netherlands Antilles, Panama, and Singapore are treated separately from other developing countries for the purposes of this report. Lending to offshore centers picked up significantly to \$30 billion in 1984, compared with \$7 billion in 1983. Cross-border interbank lending accounted for \$28 billion in 1984 and \$6 billion in 1983. The rebound in lending to offshore centers was more than accounted for by the increase of bank claims on Singapore, the Cayman Islands, and Hong Kong of \$16 billion, \$12 billion, and \$7 billion, respectively. In contrast, deposit-taking from offshore centers is recorded as having declined from \$26 billion in 1983 to \$19 billion in 1984. Thus, the offshore centers are shown as net-takers of funds of \$11 billion in 1984, while they were net-placers of \$19 billion in 1983. However, during the first quarter of 1985 offshore centers were net-placers of \$10 billion, and net swings of this order of magnitude for such countries may indicate incorrect or partial reporting of data.

5. Lending behavior of banks by ownership and size

As described above, the BIS has developed data detailing the international activity of banks classified by nationality of ownership, rather than by the location of banking offices (Table 8). At the end of 1983, the first date for which data exist, the reporting banks' international claims totaled \$2,136 billion. By end-1984, these claims had increased by almost \$47 billion (2.2 percent) in current dollar terms. The BIS has estimated, however, that the dollar's appreciation against other currencies in 1984 reduced the current dollar value of banks' total assets in other currencies by almost \$65 billion. In exchange rate adjusted terms, therefore, the reporting banks' international books grew by some \$110 billion. 1/ The \$65 billion valuation effect cannot be allocated across individual banking nationalities. 2/

The statistics, while not adjusted for the effect of exchange rate movements, provide insight into the relative importance of different groups of banks in lending to nonbanks, other banks, and their own related offices. The most important nationality groups are U.S. banks with a share of 28 percent of total reported assets and Japanese banks with a share of nearly 24 percent. The increase in 1984 total claims of all reporting countries of almost \$47 billion was more than accounted for by Japanese banks. This compares with a decline of some \$17 billion, or 2.6 percent, in the international claims of U.S. banks. The increase in total claims of all reporting countries reflected, in large part, an increase of interbank activity which was \$41 billion, or almost 90 percent of the total.

Broadly, more than half of the increase in international assets of banks in industrial countries during 1984, and two thirds of total interbank activity, was accounted for by an increase in claims of banks on their own related offices--an activity that was dominated by Japanese and U.S. banks. The increase in assets between unrelated banks was more than fully accounted for by Japanese banks. Japanese banks also recorded the largest change in liabilities to unrelated banks. Lending to nonbanks by Japanese banks also more than accounted for the total increase in such lending and Japanese banks were also the largest net providers of funds to nonbanks. U.S. banks reduced their claims on

1/ "The Nationality Structure of the International Banking Market and the Role of Interbank Operations," Bank for International Settlements, May 10, 1985.

2/ It may be assumed that this effect, which on average amounted to about 3 percent of total assets, had a relatively greater weight in the case of the European and, to a lesser degree, Japanese banks (as the share of assets denominated in currencies other than the dollar is probably higher than in the case of United States and Canadian banks).

Table 8. International Assets, Liabilities, and Net Position of Banks by Nationality of Ownership

(In billions of U.S. dollars)

Parent Country of Bank	Total Claims		Related Offices		Of which: To Other Banks		Nonbanks	
	Change		Change		Change		Change	
	Dec. 1984	during 1984	Dec. 1984	during 1984	Dec. 1984	during 1984	Dec. 1984	during 1984
Total	2,183.0	46.7	505.3	25.8	939.9	14.7	702.7	7.4
Of which:								
Canada	88.9	-0.4	21.0	-1.4	31.5	2.3	35.5	-1.2
France	197.1	6.8	24.2	0.2	112.1	7.7	55.6	-0.8
Germany	142.1	-1.8	11.1	0.6	72.7	2.8	56.9	-5.2
Italy	88.2	8.1	2.9	0.6	60.8	4.1	24.0	3.6
Japan	513.7	63.0	136.2	16.5	218.6	25.0	153.5	20.9
Switzerland	75.3	-1.5	11.7	-1.3	37.2	0.9	20.4	--
U.K.	161.4	-9.5	19.6	0.7	73.8	-8.0	63.3	-1.8
U.S.	614.5	-16.5	241.9	7.7	193.4	-20.0	176.1	-4.3

Parent Country of Bank	Total Liabilities		Related Offices		Of which: On Other Banks		Nonbanks	
	Change		Change		Change		Change	
	Dec. 1984	in 1984	Dec. 1984	in 1984	Dec. 1984	in 1984	Dec. 1984	in 1984
Total	2,088.4	70.4	504.5	34.1	935.5	-13.4	421.8	43.3
Of which:								
Canada	98.0	1.5	12.3	0.2	37.4	-4.5	38.6	4.5
France	189.1	5.1	29.2	1.5	123.5	1.2	21.1	1.2
Germany	128.3	-2.8	17.6	3.7	70.6	-11.7	27.5	3.6
Italy	87.6	9.5	4.2	-0.4	73.2	7.0	6.0	0.8
Japan	493.2	81.5	137.7	23.8	256.4	36.6	40.1	10.1
Switzerland	68.3	2.3	25.2	-0.2	10.7	-4.7	19.9	6.3
U.K.	164.7	-10.8	19.5	0.9	78.0	-8.3	43.7	-2.9
U.S.	559.0	-8.4	222.9	8.6	122.9	-16.9	147.0	12.8

Parent Country of Bank	Net Claims/Net Liabilities		Related Offices		Of which: Vis-à-vis Other Banks		Nonbanks	
	Change		Change		Change		Change	
	Dec. 1984	in net position	Dec. 1984	in net position	Dec. 1984	in net position	Dec. 1984	in net position
Total	94.6	-23.7	0.8	-8.3	4.4	28.1	280.9	-35.9
Of which:								
Canada	-9.1	-1.9	8.7	-1.6	-5.9	6.8	-3.1	-5.7
France	8.0	1.7	-5.0	-1.3	-11.4	6.5	34.5	-2.0
Germany	13.8	1.0	-6.5	-3.1	2.1	14.5	29.4	-8.8
Italy	0.6	-1.4	-1.3	1.0	-12.4	-2.9	18.0	2.8
Japan	20.5	-18.5	-1.5	-7.3	-37.8	-11.6	113.4	10.8
Switzerland	7.0	-3.8	-13.5	-1.1	26.5	5.6	0.5	-6.3
U.K.	-3.3	1.3	0.1	-0.2	-4.2	0.3	19.6	1.1
U.S.	55.5	-8.1	19.0	-0.9	70.5	-3.0	29.1	-17.1

Source: Bank for International Settlements, The Nationality Structure of the International Banking Market and the Role of Interbank Operations.

other banks by about 3 percent and on nonbanks by over 2 percent. The scale of Japanese banking activity is evidenced by the fact that 8 Japanese banks now rank by assets in the world's 20 largest banks. 1/

The BIS also compiles information that incorporates, where available, measures of banks' assets on a consolidated basis for countries within the reporting area vis-à-vis countries outside the reporting area. A summary of these data, together with the components for U.K. and U.S. banks, is provided in Table 9. These data extend to the activities of bank affiliates located outside the reporting area; also, the figures include not only the cross-border claims of such affiliates, but also their local lending in nonlocal currency. However, several countries, including Japan, do not yet publish information for their banks on a consolidated basis, and the reporting area for the data was expanded in 1984, making interpretation of the flow data problematic. 2/

The United States publishes data for its banks on a consolidated basis by geographical destination (Table 10). After increasing by 10 percent in 1982, the consolidated claims of U.S. banks' on developing countries increased by 4 1/2 percent in 1983 and declined by over 2 percent in 1984. In 1984 U.S. banks' claims decreased in aggregate by \$3.1 billion (10 percent) on developing countries in Asia. The decline in U.S. banks' claims was particularly large in Korea (\$1.5 billion) and the Philippines (\$0.6 billion). The only material increases in U.S. banks' claims occurred in China (\$0.2 billion) and Thailand (\$0.1 billion). With regard to developing countries in the Western Hemisphere, U.S. banks' claims increased in aggregate by \$2.2 billion (2.5 percent) in 1984. The largest increase in banks' claims was to Brazil (\$3.2 billion), while U.S. banks' claims declined to Argentina (\$0.5 billion) and Venezuela (\$0.4 billion). Further, U.S. banks' claims declined to developing countries in Europe by 3 1/2 percent and to Africa by almost 8 percent.

1/ A list of major banks is provided in the Statistical Supplement.

2/ These data are not corrected for exchange rate changes. Coverage of the BIS semiannual data was substantially broadened during the course of 1984, as additional countries began to report on a consolidated basis. It appears that changes in claims on developing countries were largely unrelated to the broadening of the statistical coverage. On that basis, and before exchange rate adjustment, the reporting banks' claims on the developing countries rose by less than 0.5 percent in 1984, after increasing by over 6 percent and 10 percent in 1982 and 1982, respectively. To give a broad indication of the effect of exchange rate changes, it is estimated that, after adjustment, the growth in claims on all developing countries in 1984 would amount to \$13 billion, or 2.8 percent (a rate of growth broadly comparable to that shown by the IBS data).

Table 9. Change in Bank Claims on Developing Countries,
1982-First Quarter 1985 ^{1/}

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

	1982		1983		1984		Q1 1984-Q1 1985	
	Billions of U.S. dollars	Growth rate (In percent)	Billions of U.S. dollars	Growth rate (In percent)	Billions of U.S. dollars	Growth rate (In percent)	Billions of U.S. dollars	Growth rate (In percent)
Developing countries								
BIS semiannual	38.7	10.1	26.0	6.2	2.0	0.4	...	...
U.S. claims data	12.7	9.9	6.4	4.5	-3.3	-2.2	-5.8	-3.9
U.K. claims data	6.1	10.9	2.5	4.0	-0.7	-1.2	...	...
Capital-importing developing countries								
BIS semiannual	37.6	10.4	21.7	5.4	4.7	1.1	...	...
U.S. claims data	12.7	10.3	5.9	4.3	-2.6	-1.8	-5.0	-3.5
U.K. claims data	5.9	11.5	2.1	3.6	--	--	...	...
Africa								
BIS semiannual	5.6	12.8	3.2	6.5	-1.0	-1.9	...	...
U.S. claims data	1.4	15.9	1.0	9.7	-0.9	-7.9	-1.3	-11.1
U.K. claims data	2.8	33.6	0.5	4.7	-0.1	-1.2	...	...
Asia								
BIS semiannual	10.6	17.5	8.7	12.2	3.7	4.6	...	...
U.S. claims data	3.5	13.2	1.6	5.2	-3.1	-10.0	-2.2	-7.1
U.K. claims data	1.4	16.5	0.4	3.6	-0.3	-3.0	...	...
Indonesia								
BIS semiannual	2.7	37.5	1.5	15.2	1.1	9.3	...	...
U.S. claims data	0.6	24.2	0.6	19.9	-0.2	-5.0	-0.3	-6.9
U.K. claims data	0.5	63.6	0.3	26.0	--	2.1	...	...
Korea								
BIS semiannual	3.3	16.6	1.9	8.2	0.2	0.8	...	...
U.S. claims data	2.1	24.1	0.5	4.1	-1.5	-13.3	-0.7	-6.4
U.K. claims data	0.3	10.8	-0.2	-7.4	-0.1	-2.5	...	...
Philippines								
BIS semiannual	2.4	23.5	0.6	4.8	-1.4	-10.1	...	...
U.S. claims data	0.4	6.9	0.3	5.5	-0.6	-10.0	-0.5	-8.3
U.K. claims data	0.2	11.7	0.1	4.2	-0.2	-9.6	...	...
Europe								
BIS semiannual	-0.3	-0.7	1.6	3.5	-0.5	-1.0	...	...
U.S. claims data	-0.8	-7.0	0.9	9.5	-0.4	-3.6	-1.1	-10.6
U.K. claims data	-0.2	-2.7	0.2	3.2	-0.2	-2.5	...	...
Middle East								
BIS semiannual	3.3	20.3	0.6	3.1	-0.2	-1.5	...	...
U.S. claims data	0.2	7.1	0.3	8.9	-0.3	-8.4	-0.4	-10.7
U.K. claims data	0.3	23.4	-0.1	-3.5	-0.2	-11.6	...	...
Western Hemisphere								
BIS semiannual	18.4	9.4	7.6	3.6	2.7	1.2	...	...
U.S. claims data	8.3	11.2	2.1	2.6	2.2	2.5	--	-0.1
U.K. claims data	1.6	6.0	1.1	3.8	0.8	2.9	...	...
Argentina								
BIS semiannual	0.9	3.6	0.2	0.8	-1.7	-6.3	...	...
U.S. claims data	-0.2	-2.0	0.3	3.3	-0.5	-6.3	-0.5	-5.5
U.K. claims data	-0.3	-7.8	0.1	2.8	-0.1	-1.3	...	...
Brazil								
BIS semiannual	8.0	15.2	1.7	2.8	4.9	8.1	...	...
U.S. claims data	3.6	21.5	0.2	1.1	3.2	15.6	2.0	9.2
U.K. claims data	1.2	18.2	0.7	8.5	0.7	8.5	...	...
Mexico								
BIS semiannual	5.8	10.2	5.5	8.7	1.4	2.0	...	...
U.S. claims data	2.9	13.4	2.0	8.0	0.2	0.7	-0.1	-0.3
U.K. claims data	0.2	3.1	0.3	3.8	0.1	1.1	...	...
Venezuela								
BIS semiannual	1.3	5.0	-0.3	-1.1	-1.3	-4.7	...	...
U.S. claims data	1.1	10.5	-0.3	-2.8	-0.4	-4.0	-0.6	-5.3
U.K. claims data	-0.1	-4.3	-0.2	-5.4	-0.1	-4.2	...	...

Note: Components may not add due to rounding.

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/} This data is not adjusted for the impact of exchange rate movements, and is based on consolidated reports of banks.

Table 10 also shows the U.S. banks' claims by geographical destination according to the size of the bank. The middle-size U.S. banks recorded some expansion in lending to developing countries, increasing their claims by 1 percent in 1984, but the nine money center banks (banks ranked 1 to 9) decreased their claims by 1.4 percent in 1984. The regional banks (banks ranked below 24) have been withdrawing from international lending, increasing their claims on developing countries by only 1 1/4 percent in 1983 and decreasing their claims by 10 percent in 1984. These trends were broadly maintained in the 12 months ending March 1985, although during this period the middle-size banks also show a reduction in claims on developing countries.

Estimates prepared by staff of the Board of Governors of the Federal Reserve System indicate that U.S. banks' lending to non-OPEC developing countries may have been understated by \$3 1/2 billion (approximately 3 1/2 percent) during 1983-84. This is roughly equivalent to the absolute decline in claims on developing countries recorded in 1984 alone; thus, the falling trend in U.S. claims is slowed but not reversed by such corrections.

The only other country within the BIS reporting area that publishes consolidated data by geographical destination on a basis that permits analysis of flows on a Fund country classification is the United Kingdom (Table 9). There was also an overall decline in claims of U.K. banks' claims on developing countries in 1984 (of \$0.7 billion, or 1.2 percent), although claims rose by 2.9 percent on developing countries in the Western Hemisphere (\$0.8 billion). The decline against countries in Asia and Europe may, in part, reflect underrecording due to banks' holdings of floating rate notes issued by developing countries' borrowers, as well as the fact that exchange rate adjustments cannot be made to take account of the non-U.S. dollar lending of U.K. banks.

6. Developments in banks' exposure relative to capital

For the United States, available data permit a detailed analysis of developments in banks' balance sheets (Chart 3). Between 1977 and 1981 there was a deterioration in U.S. banks' capital ratios from 5.7 percent to 5.4 percent. During this period, claims on developing countries grew, on average, by about 5 percent per year more rapidly than nominal GDP, and increased as a proportion of total claims from 9.2 percent to 10.7 percent. Bank capital grew at about the same rate as nominal GDP.

Between 1982 and 1984, banks' capital to total claims rose from 5.6 percent to 6.5 percent. This improvement in U.S. banks' capital ratios reflected both a rapid growth in capital and also a marked slowdown in the growth of total assets. Increases in capital were substantial in 1982-84, especially in light of the slowdown in inflation. Total assets grew relatively slowly during this period. U.S. banks' external claims on developing countries declined as a proportion of their total claims to 10 percent in 1984, but this was still somewhat

Table 10. Change in Claims of U.S. Banks on Developing Countries, 1982-First Quarter 1985 ^{1/}

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

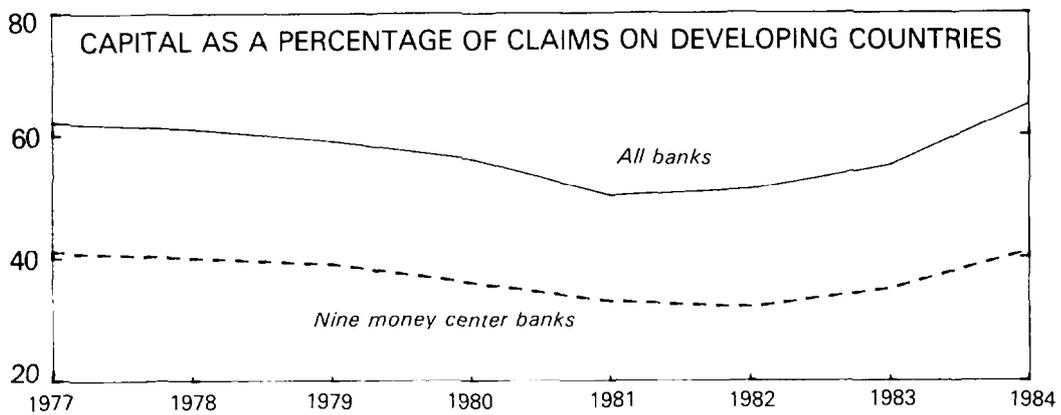
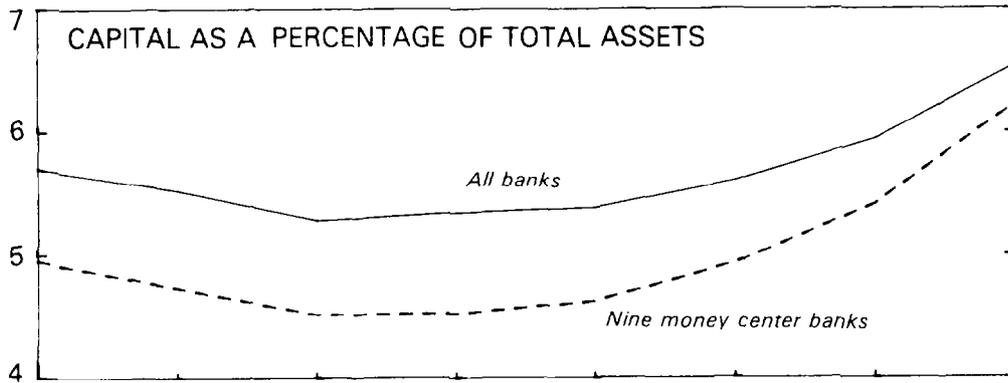
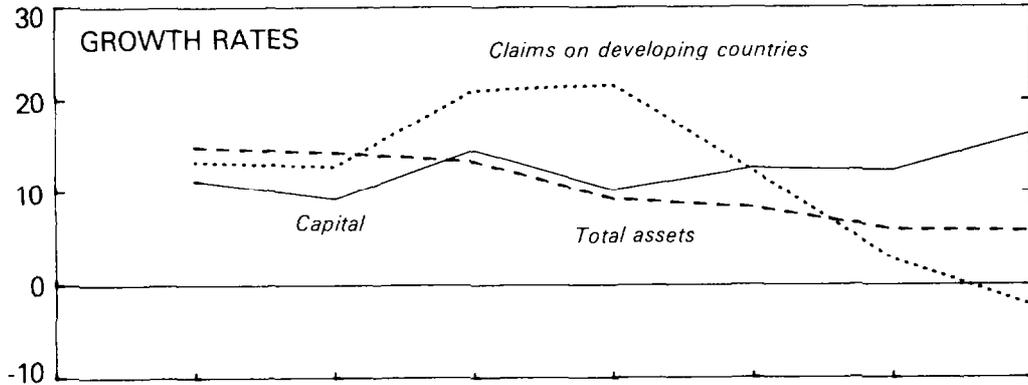
	1982		1983		1984		12 months to March 1985	
	Billions of U.S. dollars	Percent						
Developing countries								
Total	12.7	9.9	6.4	4.5	-3.3	-2.2	-5.8	-3.9
Nine banks	8.1	9.7	4.4	4.8	-1.4	-1.4	-3.1	-3.2
Fifteen banks	3.6	15.7	1.7	6.4	0.4	1.3	-0.8	-2.6
Others	1.1	4.6	0.3	1.3	-2.3	-9.7	-1.9	-8.2
Capital importing developing countries								
Total	12.7	10.3	5.9	4.3	-2.6	-1.8	-5.0	-3.5
Nine banks	8.3	10.6	3.8	4.3	-0.8	-0.9	-2.5	-2.7
Fifteen banks	3.5	15.7	1.8	7.1	0.4	1.6	-0.6	-2.7
Others	0.9	4.2	0.3	1.4	-2.2	-9.4	-1.9	-8.1
Africa								
Total	1.3	15.9	1.0	9.7	-0.9	-7.9	-1.3	-11.1
Nine banks	0.7	9.8	0.8	9.9	-1.0	-11.3	-0.9	-10.7
Fifteen banks	0.5	54.9	0.3	17.4	0.3	14.5	-0.1	-7.1
Others	0.2	21.8	--	-0.8	-0.8	-16.7	-0.3	-21.7
Asia								
Total	3.5	13.2	1.6	5.2	-3.1	-10.0	-2.2	-7.1
Nine banks	2.5	13.6	0.5	2.2	-2.1	-9.8	-1.7	-8.2
Fifteen banks	0.4	7.7	0.5	8.6	--	0.1	--	0.2
Others	0.6	20.9	0.6	17.0	-1.1	-25.6	-0.5	-13.2
Indonesia								
Total	0.6	26.2	0.6	19.9	-0.2	-5.0	-0.3	-6.9
Nine banks	0.5	26.9	0.5	21.0	-0.3	-8.8	-0.3	-10.4
Fifteen banks	--	10.9	--	7.5	0.1	30.1	0.1	13.7
Others	--	12.2	--	12.6	--	-14.8	--	8.1
Korea								
Total	2.1	24.1	0.5	4.1	-1.5	-13.3	-0.7	-6.4
Nine banks	1.5	26.4	-0.5	-6.8	-1.0	-15.5	-0.3	-4.5
Fifteen banks	0.4	18.9	0.5	20.5	--	0.4	-0.1	-3.1
Others	0.3	22.0	0.5	28.5	-0.5	-24.0	-0.3	-16.9
Philippines								
Total	0.4	6.9	0.3	5.5	-0.6	-10.0	-0.5	-8.3
Nine banks	0.2	6.3	0.1	1.3	-0.2	-4.4	-0.4	-10.1
Fifteen banks	--	1.7	--	2.7	-0.1	-4.6	--	-0.2
Others	0.1	22.8	0.2	36.3	-0.4	-42.7	-0.1	-12.5
Europe								
Total	-0.8	-7.5	0.9	9.5	-0.4	-3.6	-1.1	-10.6
Nine banks	-0.3	-4.6	0.6	13.8	-0.4	-4.9	-1.0	-12.9
Fifteen banks	-0.1	-7.3	0.1	5.7	0.1	6.1	--	0.6
Others	-0.3	-20.4	--	-3.5	-0.1	-7.6	-0.1	-11.4
Middle East								
Total	0.2	7.1	0.3	8.9	-0.3	-8.4	-0.4	-15.7
Nine banks	0.1	4.2	0.2	9.1	-0.2	-6.9	-0.1	-4.2
Fifteen banks	0.1	20.3	0.1	19.1	--	-0.2	-0.1	-22.8
Others	0.1	8.1	--	2.2	-0.2	-18.7	-0.2	-21.7
Western Hemisphere								
Total	8.3	11.2	2.1	2.6	2.2	2.5	--	-0.1
Nine banks	5.4	12.1	1.5	3.0	2.8	5.4	1.2	2.3
Fifteen banks	2.6	18.6	0.9	5.4	0.1	0.5	-0.4	-2.1
Others	0.4	2.2	-0.3	-1.6	-0.7	-4.3	-0.9	-5.4
Argentina								
Total	-0.2	-2.0	0.3	3.3	-0.5	-6.2	-0.5	-5.5
Nine banks	-0.1	-1.7	0.2	4.5	-0.3	-4.6	-0.1	-2.4
Fifteen banks	0.1	6.0	0.2	8.4	-0.1	-6.1	-0.2	-7.8
Others	-0.2	-12.7	-0.1	-8.4	-0.2	-13.6	-0.2	-15.9
Brazil								
Total	3.6	21.5	0.2	1.1	3.2	15.6	2.0	9.2
Nine banks	2.7	25.0	--	--	2.5	18.8	1.7	12.0
Fifteen banks	0.9	30.7	0.4	10.3	0.4	10.0	0.2	5.3
Others	0.1	1.5	-0.2	-5.8	0.3	9.4	0.1	2.4
Mexico								
Total	2.9	13.4	2.0	8.0	0.2	0.7	-0.1	-0.3
Nine banks	1.3	11.1	1.3	9.8	0.6	4.0	0.4	2.7
Fifteen banks	0.8	18.7	0.2	4.0	--	-0.2	-0.1	-1.6
Others	0.8	14.1	0.5	7.7	-0.4	-5.3	-0.4	-5.6
Venezuela								
Total	1.1	10.5	-0.3	-2.8	-0.4	-4.0	-0.6	-5.3
Nine banks	0.8	11.3	-0.2	-2.2	-0.2	-2.6	-0.3	-3.9
Fifteen banks	0.3	18.8	--	1.3	-0.1	-5.3	-0.2	-8.7
Others	--	-1.4	-0.2	-10.6	-0.1	-8.9	-0.1	-7.5

Note: Components may not add due to rounding.

Source: Federal Financial Institutions Examination Council, Country Exposure Lending Survey.^{1/} This data is based on consolidated reports of banks.

CHART 3
 SELECTED BALANCE SHEET DATA FOR
 U.S. BANKS, 1977-84

(In percent)



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



higher than in 1977. It is noteworthy that banks reduced their lending to developing countries at a considerably more rapid pace than the reduction in their total lending in 1983, and claims on these countries were reduced in 1984.

It is not feasible to prepare a general analysis of banking developments in other industrial countries with the same degree of detail or internal consistency as for the United States, because comprehensive information is not generally available on banks' consolidated exposure to developing countries or the corresponding bank capital. Moreover, national accounting regulations differ markedly, as do prudential guidelines on capital and on the valuation of assets; exposure of non-U.S. banks is overstated to the extent that undisclosed provisions have been made.

While developments among countries have varied very markedly, the capital ratios of industrial country banks generally deteriorated during the late 1970s (Table 2). Subsequently, for many of these countries, there was a rise in capital/asset ratios. For the industrial countries as a group, the bank capital ratio appears to have returned in 1984 to the 1977 level, although this was not the case in all countries. The strengthening of the aggregate capital ratio during this period reflected a significant increase in capital. In countries other than the United States, bank capital is largely denominated in local currency, while foreign assets tend to be denominated in U.S. dollars, and the sizeable appreciation of the U.S. dollar in recent years retarded efforts to increase aggregate capital ratios. Similarly, the depreciation of the U.S. dollar in the first half of 1985 will have aided these countries' banks in strengthening their capital ratios while allowing room for further increases in banks' claims.

While the true exposure of industrial country banks to developing countries cannot be estimated, some general trends can be seen (Chart 4). As a percentage of banks' total assets, banks' international claims have risen significantly since the mid-1970s. More than 30 percent of banks' assets are now accounted for by external claims. Some 23 percent of international claims are claims on developing countries, although the proportion has been falling, especially for developing countries other than the seven major borrowers. The recent decline in claims on developing countries as a proportion of international claims is only partly accounted for by developments in U.S. banks' claims. Moreover, the exposure of European banks in particular has probably been reduced further by provisioning. Even before allowance for provisioning, it appears that claims on developing countries probably do not now account for a greater proportion of banks' international claims than in the mid-1970s. ^{1/} However, within this aggregate, the share accounted for by major borrowers has risen to a modest extent.

^{1/} After allowing for breaks in statistical series, reflecting wider coverage.

While projections of future exposure must be viewed with caution, the projections of bank lending to developing countries contained in the World Economic Outlook (WEO) medium-term scenarios are consistent with a reduction in the ratio of claims on these countries to the aggregate capital of banks in industrial countries, a process which is already under way. Lending by private creditors was projected to rise by about 2 percent in 1986 and more rapidly in 1987-90. The ratio of banks' exposure to capital could thus return to the level prevailing before the increase in lending to developing countries during the late 1970s and early 1980s, provided that bank capital continues to increase somewhat more rapidly than nominal GDP and that exchange rate developments are as projected. For non-U.S. banks, developments in the U.S. dollar exchange rate will have an important impact on the speed at which their exposure relative to capital is reduced, although this will be offset to the extent that currency redenomination of U.S. dollar-denominated claims takes place.

7. Terms of bank lending

The BIS semiannual series show that the maturity of outstanding bank debt of most of the countries outside the BIS reporting area lengthened considerably in 1984, after a gradual lengthening in the previous years, as evidenced by the reduced share of short-term debt in total debt outstanding (Table 11). ^{1/} This development marks a significant departure from the tendency toward a general increase in short-term indebtedness that prevailed through mid-1982. In some instances, the declining proportion of short-term debt reflects the impact of bank debt restructuring arrangements, whereby sizeable proportions of short-term debt have been converted into long-term debt. In the case of Mexico, the share of short-term debt declined from a peak of almost 49 percent at the end of 1981 to 24.1 percent at the end of 1984, while in Brazil, the share of short-term debt declined from almost 35 percent at the end of 1981 to 25 percent at the end of 1984.

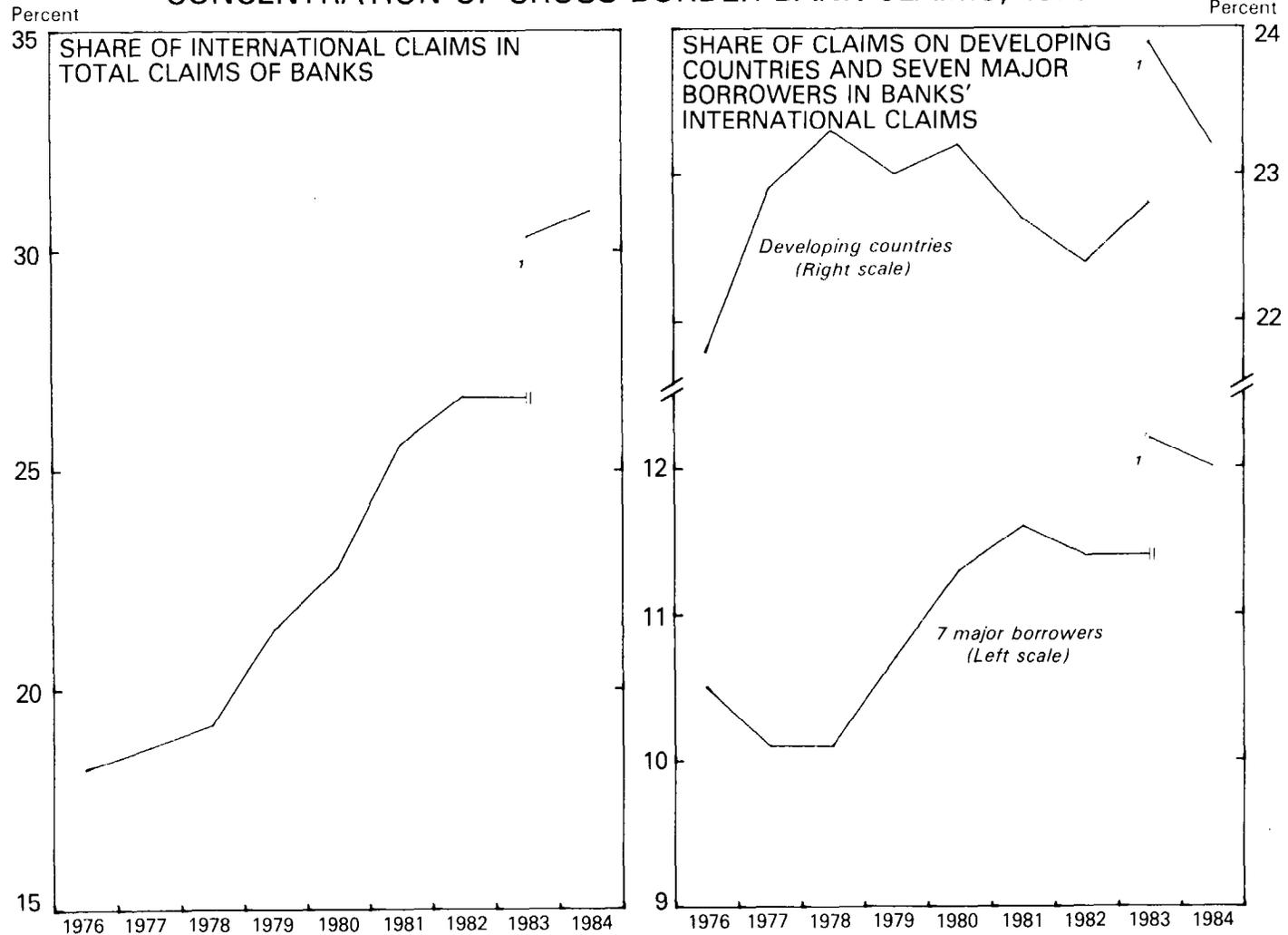
This trend also reflected a deliberate effort by some borrower countries, which continued to have access to spontaneous bank credits, to improve their external position by lengthening the maturity of their debt. This is evidenced by Korea, where the share of short-term debt declined from over 62 percent at the end of 1980 to under 50 percent at the end of 1984. In still other instances, this trend may have resulted from a withdrawal of short-term loans and deposits by creditor banks.

The OECD data covering the maturity of new long-term bank credit commitments indicate that the average final maturity of new long-term bank credit commitments has lengthened slightly (Chart 5). The lengthening of maturities affected mostly concerted lending and, more generally lending to developing countries.

^{1/} There are changes in the coverage of the BIS, so that direct comparisons between years for 1983 and 1984 should be interpreted with caution.

CHART 4

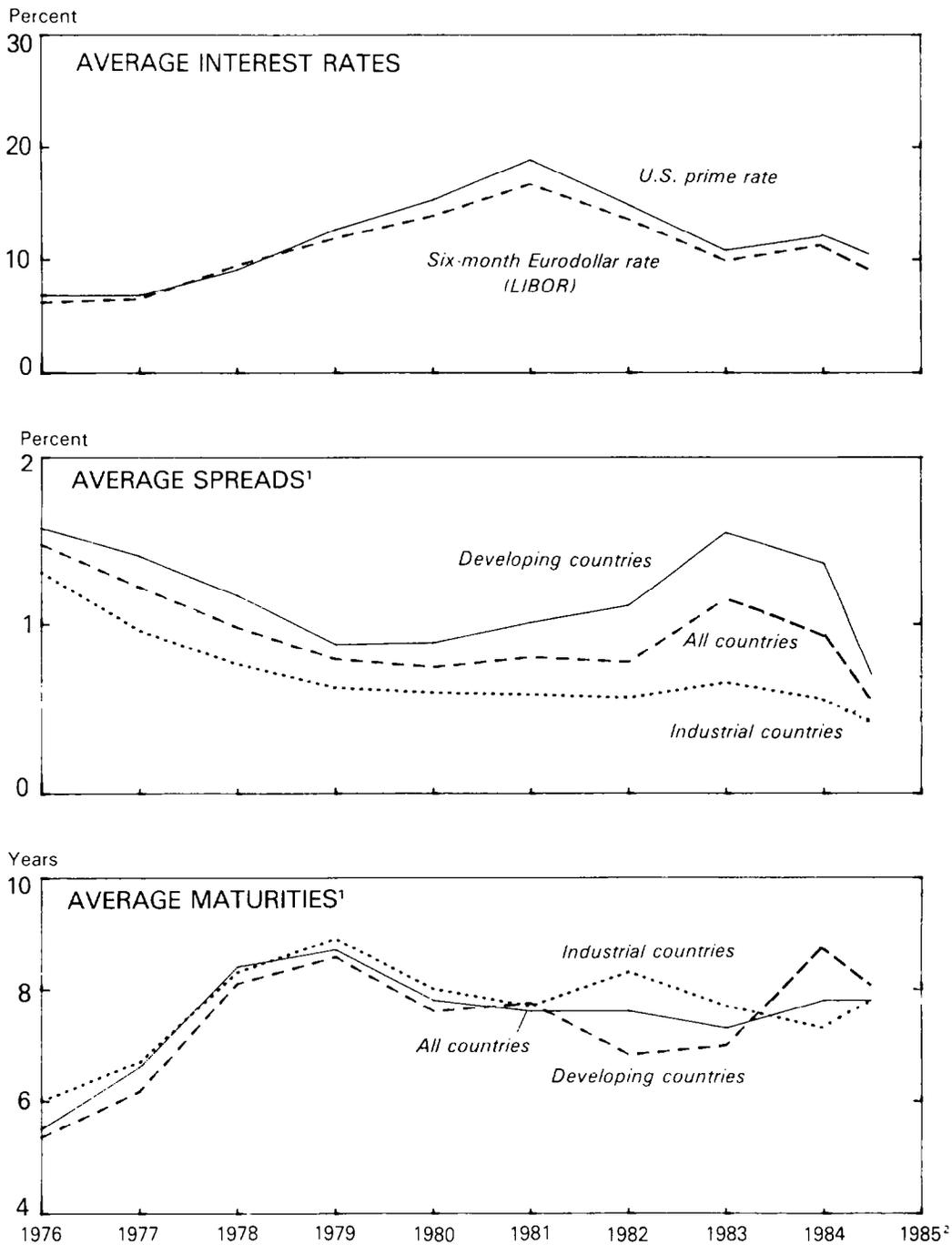
CONCENTRATION OF CROSS-BORDER BANK CLAIMS, 1976-84



Source: Bank for International Settlements, International Banking Developments; International Monetary Fund, International Financial Statistics; and Fund staff estimates.
 1/ There is a break in the series due to a change in the coverage of BIS reporting area.



CHART 5
**TERMS ON INTERNATIONAL BANK
 LENDING COMMITMENTS, 1976-FIRST HALF OF 1985**



Sources: Organization for Economic Cooperation and Development, *Financial Statistics Monthly*; Federal Reserve Bulletin for Prime Rate and IMF, *International Financial Statistics*.
¹New, publicized long-term international bank credit commitments.
²First half only.

1

2



Table 11. Short-Term Claims 1/ in Percent of
Outstanding Bank Claims, 1979-84

(In percent)

	<u>Dec.</u> 1979	<u>Dec.</u> 1980	<u>Dec.</u> 1981	<u>Dec.</u> 1982	<u>Dec.</u> 1983	<u>Dec.</u> 1984 <u>2/</u>
All countries	44.0	45.5	47.1	46.7	44.3	41.3
Industrial countries (other than Group of Ten and Switzerland, Austria, Denmark, and Ireland)	41.4	43.0	44.0	43.7	42.9	44.7
Developing countries	44.9	47.0	48.1	48.0	45.1	40.9
Capital-importing	43.4	45.4	46.3	46.2	42.8	40.6
Africa	28.9	28.9	35.8	39.4	40.9	43.2
Asia	52.4	55.2	53.9	51.6	48.6	55.2
Of which:						
Indonesia	39.7	41.3	41.7	38.4	39.0	41.9
Korea	55.8	62.3	57.8	59.9	56.4	49.8
Philippines	52.7	58.1	56.9	59.5	52.9	53.2
Europe	37.6	36.2	34.4	32.4	33.3	33.3
Middle East	75.2	76.5	77.9	77.6	67.2	65.9
Western Hemisphere	43.0	46.1	46.5	46.0	41.7	34.6
Of which:						
Argentina	51.5	52.3	46.8	54.1	52.6	55.0
Brazil	29.3	35.5	34.7	34.9	27.9	25.0
Mexico	34.6	44.2	48.7	47.5	42.4	24.1
Venezuela	61.1	58.9	61.5	57.5	59.1	65.4
Centrally planned economies <u>3/</u>	41.0	38.4	43.1	39.2	38.1	38.5

Source: Bank for International Settlements, The Maturity Distribution of International Bank Lending.

1/ Remaining maturity of one year or less.

2/ Coverage of the series changes at end-1983 and end-1984.

3/ Excluding Fund member countries.

Reference rates ^{1/} in 1984 were, on average, about 1-1 1/4 percentage points higher than in 1983 but declined significantly in the first half of 1985. As regards weighted average spreads over reference rates on new publicized medium-term bank credit commitments, such lending margins declined to 0.93 percent in 1984, compared with 1.15 percent in 1983. Average spreads remained above the levels experienced in 1979-82, but below those of 1974-78. Developments in 1984, however, reflected limited access for developing countries and increased competition for loans to highly regarded borrowers. As discussed in Section IV of this paper, margins for countries gaining external finance through concerted lending have also declined. The differential in the average spread between OECD and developing country borrowers, which had risen dramatically to 170 basis points in 1983, declined to 89 basis points in 1984. Furthermore, this average differential declined to 22 basis points in the second half of 1984 and the first half of 1985, when the spread to developing countries was cut significantly.

The general decline in margins for borrowers with access to international markets, and the decline in the average differential between industrial and developing countries, reflects the fairly high liquidity of the financial markets and competitive pressures resulting from the increasing share of financing achieved through issuance of bonds or short-term notes. It is noteworthy that a market has developed in which banks are willing to extend long-term international credit on a spontaneous basis mainly to those countries that also have access to the securities market where margins were very low during this period.

Concerning the currency distribution of syndicated loans, there was a continuation of the trend toward lessening the predominance of the U.S. dollar in 1984. The share of U.S. dollar in total borrowing declined below 75 percent in 1984, compared with 92 percent in 1981. This decline was broadly matched by the growing importance of the ECU, pound sterling, and yen, which increased their combined share from 2 percent in 1981 to almost 19 percent in 1984; the yen accounted for 60 percent of the increase. This reflects the internationalization of the yen and the liberalization of the Japanese financial markets, as well as the large proportion of cross-border bank lending accounted for by Japanese banks.

The pound sterling continued to increase its share of the market in 1984, although the bulk of borrowing operations was confined to U.K. enterprises. The use of the ECU expanded more rapidly than any other monetary unit with the exception of the yen, with loan completions exceeding the equivalent of \$1.6 billion compared to \$0.6 billion in 1983. Italian and Spanish entities remained the most frequent national borrowers to use ECUs on the loan market, but the U.S.S.R. and Hungary also accessed funds in ECU in 1984.

^{1/} Primarily comprising LIBOR, U.S. prime rate, and interest rate on certificate of deposit.

IV. Recent Trends in Bank Debt Restructuring

1. General

This section reviews developments in bank debt restructuring during the last year. Such developments were also discussed in two recent staff papers--"Developing Countries' External Indebtedness to Commercial Banks," (SM/85/61, 2/20/85) and "The Role of the Fund in Assisting Members with Commercial Banks and Official Creditors," (EBS/85/173, 7/23/85). Key elements in those earlier papers and in the Board discussions, in particular as they relate to multiyear restructurings (MYRAs) and enhanced surveillance, are summarized in Annex I.

Successful restructuring of countries' bank debt has continued to demand intensive coordination among banks, governments, the Fund, and other multilateral agencies on the financial requirements associated with the adjustment programs, and continuous liaison by the coordinating banks with all creditor banks to secure agreement on the restructuring packages. Almost all restructurings have been linked to a Fund-supported adjustment program.

While the basic approach to solving debt servicing problems has been maintained from the outset of the debt problem, more recently, creditors have been willing to enter into longer term arrangements with a number of countries. To this end, debtor countries and banks have negotiated MYRAs. However, for some countries engaged in debt restructuring negotiations, the process has been complex and slow, especially where agreement on new financing has been sought. In some cases, final agreements have yet to be signed, despite prolonged negotiations.

The coverage of bank debt restructurings has reflected a number of factors. One major consideration has been a concern to achieve equitable burden-sharing among banks, which has involved securing agreement from all of a country's creditor banks. Another important consideration has been to minimize the potential danger to restructuring countries' prospects of regaining access to international capital markets. Therefore, interest payments on bank debt have been excluded from reschedulings in almost all cases, although banks have been willing in some cases to reduce the interest rate on existing loans; formal restructuring of trade credits and interbank deposits has been avoided whenever feasible; and bonds and floating rate notes owned by nonbanks virtually always have been excluded from rescheduling, in part because their holders have not normally been known.

A further concern has been burden-sharing among bank and official creditors; therefore, agreements with bank creditors at times were made contingent on comparable debt relief from official creditors. Official creditors, for their part, made further debt relief conditional upon debtor countries seeking debt restructuring by banks on comparable terms. Each instance of official rescheduling during the past two years

has been preceded or followed by parallel discussions on bank debt restructuring, except in one case where there was no medium-term debt to banks. Banks, on the other hand, have restructured debt for some countries that did not seek a multilateral rescheduling from official creditors.

In addition to restructuring debt owed or guaranteed by the debtor government, a number of debtor countries encouraged the restructuring of nonguaranteed private debt in order to regularize the private sector's relations with creditors, and to secure additional balance of payments relief. In several of such cases, governments introduced preferential exchange rate schemes, and sometimes special domestic credit arrangements to induce the private sector to reschedule its debts. Also, interest payments on rescheduled debts were sometimes given priority under an exchange allocation system. In some cases, banks have pressed countries' authorities to assume or mitigate the commercial risk of their loans to the private sector.

2. Amounts and terms

In 1984, restructuring agreements were reached (at least in principle) by 18 countries, compared to 14 countries in 1983 and an average of 6 countries per year during 1980-82. During the first three quarters of 1985, an additional seven countries signed restructuring agreements. The amounts of debt restructured in agreements signed or agreed in principle, excluding short-term debt rolled over, are estimated to have been \$99 billion in 1984, about three times the amount in 1983, and \$9 billion during the first three quarters of 1985. ^{1/} The amount rescheduled in 1984 was equivalent to almost 18 percent of the stock of bank debt of developing countries compared to 6 percent in 1983.

Under arrangements concluded in the context of all bank debt restructurings, an estimated \$36 billion of short-term debt was rolled over or converted into medium-term debt in 1984, almost 30 percent more than in 1983. These arrangements affected trade-related, interbank, and money market facilities in 12 countries. For the first three quarters of 1985, the amount covered increased only slightly as banks raised facilities in only two countries, Costa Rica and Panama. (Details on amounts of debt restructured, rollover arrangements, and concerted lending are contained in the Statistical Supplement.)

Between September 1984 and June 1985, banks signed or reached agreement in principle on MYRAs with Mexico, Venezuela, Ecuador, the Dominican Republic, and Jamaica. These agreements cover \$75 billion of principal repayments due between 1983 and 1990. Preliminary agreement was also reached on a MYRA with Yugoslavia. For the countries involved,

^{1/} Excluding three MYRAs agreed in principle, the amount of bank debt restructured in 1984 would have been somewhat below the 1983 figure.

the MYRAs provided considerably longer consolidation periods and maturities of up to 14 years, as compared to 10 years in typical recent debt restructurings. Spreads in some cases were fixed at 7/8 to 1 1/8 percent over LIBOR, significantly below the spreads in other recent debt restructurings, and rescheduling fees were waived.

Recent agreements with other countries that had previously undertaken debt restructurings and are implementing economic adjustment programs show a narrowing of spreads, and a lengthening of grace periods and maturities, compared with earlier agreements. This trend has been clearest in the case of MYRAs, but a number of other recent agreements show spreads of 1 3/4 percent or less over LIBOR, considerably lower than was generally the case in the first year after widespread payments difficulties emerged in late 1982 (Table 12). In the case of Chile, for example, the interest rate in the 1983 rescheduling arrangement was 2-2 1/8 percent over LIBOR, while the 1985 arrangement includes a spread of 1 3/8 percent over LIBOR. In addition, creditor banks have been willing in certain cases to alter the schedule for interest payments (e.g., semiannual instead of quarterly payments).

Maturities of restructurings, other than MYRAs, have recently ranged up to 10 or 12 years, compared with typical maturities in 1982-83 of up to 8 years. Taking Chile as an example again, the maturity in the 1983 debt rescheduling was 8 years, while the recently signed 1985 arrangement calls for a 12-year maturity. Grace periods, too, have been lengthened, from typically 3 years in 1982-83 up to 5 years more recently. While these terms are still less favorable than the average terms recorded for all new publicized long-term international bank credit commitments to developing countries, the differences have narrowed.

Where no improvement in economic performance has been apparent, or where the country has been unable to fulfill the terms of an existing restructuring agreement, banks on occasion entered into deferment agreements that have been periodically renewed. For some countries that were experiencing extremely protracted payments difficulties, banks have also been prepared to stretch out repayment terms over a relatively long period, and in a very few cases have rescheduled or formally deferred a portion of interest payments (notably in Nicaragua and Sudan). However, in such cases, there has been no provision of new medium-term financing by banks, and banks have considered that there was little prospect of an early return by the countries to normal access to capital markets.

3. New financing agreements

In 1984, five member countries engaged in debt restructuring and adjustment programs reached agreements with banks on new financing agreements. Three of these were firm concerted lending commitments, totaling \$11.1 billion, while two other countries reached agreements in principle on concerted lending loans for a total amount of \$5.1 billion. This compares with concerted lending commitments involving eight

Table 12. Terms of Selected Bank Debt Restructurings and Bank Financial Packages, 1983-Sept. 1985

Country	Year of Agreement	Type of Debt Restructured	Grace Period (In years)	Maturity	Interest Rate (In percent spread over LIBOR-U.S. Prime)
Argentina	1983	New financing	3	4/6	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 2/8
	1983	New financing	2 1/2	8	2 1/8-1 7/8 ^{1/}
	1984	Restructuring 1984	5	9	2-1 3/4
	1984	New financing	5	9	2-1 3/4
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	6/6 to 7/6	2 1/4-2 1/8
	1985	Restructuring	3	10	1 5/8-1 5/8 ^{5/}
Dominican Republic	1983	Restructuring	1	5	2 1/4-2 1/8
	1985	MYRA ^{6/}	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	MYRA ^{6/}	3	12	1 3/8
	1984	New financing	2	10	1 5/8
Jamaica	1984	Restructuring	2	5	2 1/2
	1985	MYRA ^{6/}	3 ^{7/}	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	MYRA ^{6/}	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	MYRA ^{6/}	--	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	MYRA ^{6/} ^{8/}	5	11	1 1/8

Note: Year of agreement refers in some cases to agreements which have yet to be signed. Sources: Restructuring agreements; press reports; and Fund staff calculations.

^{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 maxima--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 maxima for public sector borrowers without official guarantee, private sector borrowers with Development Bank guarantee and for commercial and investment banks under Resolution b3; 2 1/2 percent/2 1/4 percent as generally acceptable maxima 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 maxima for spreads over LIBOR to be generally acceptable (spreads over U.S. prime rate in parentheses): public sector borrowers with official guarantee as well as Petrobras and CVRD--2 1/8 percent (1 7/8 percent); public sector borrowers without the Republic's guarantee, private sector borrowers with Development Bank guarantee, and Resolution b3 loans to commercial and investment banks--2.25 percent (2.0 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 fiat facility fee on amounts disbursed, payable at the time of disbursement.

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

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

^{6/} Multiyear debt restructuring agreement.

^{7/} 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.

^{8/} Preliminary agreement.

countries in 1983 for \$13.9 billion. During the first three quarters of 1985, concerted lending commitments for six countries amounted to \$2.3 billion. While concerted lending to countries in the Western Hemisphere accounted for more than 90 percent of total new bank commitments to this area in 1983-84, new bank commitments to Asian countries other than the Philippines continued to be on an entirely spontaneous basis.

All concerted bank lending during 1984-85 took place with the encouragement of the Fund and, except for Colombia, was linked to purchases under a Fund program. Nonobservance of performance criteria under a Fund program usually delayed disbursements under new money packages until such time as the country had its drawing rights under the Fund arrangement restored. Colombia is a special case, insofar as banks tied their financial package to the Executive Board's endorsement of Colombia's adjustment program, although no use of Fund resources was involved.

Banks have expressed interest in greater involvement of the World Bank in new financing arrangements. The increased involvement of the World Bank is viewed as reducing the risk by associating commercial bank lending with sound projects and sector policies. In specific cases, direct financial protection of a portion of bank claims has also been sought through cofinancing operations involving a portion of concerted lending.

The World Bank's cofinancing program for private banks aims to foster capital flows to developing countries, and to improve the terms of commercial lending, by providing lenders with greater assurance through their association with investments supported by the World Bank. The B-loan program was introduced in early 1983. Unlike the earlier cofinancing program, which involved separate, parallel loans to the country, this program enables the Bank to participate in the cofinancing loans syndicated by the commercial banks in three possible ways. First, the World Bank can take a direct participation in the later maturities of a loan. Second, it can provide guarantees of later maturities of a loan. Third, it can take a contingent obligation in respect of a fixed repayment installment loan to compensate co-lenders for any rise in a floating market interest rate above an initially scheduled level. Since introduction of the program in 1983, cofinancings through B-loans have involved some \$1.7 billion in commercial bank credits, based on some \$360 million of World Bank involvement, inclusive of the Chile and Uruguay operations currently in progress. Most of these operations took place on a spontaneous basis--i.e., outside the framework of concerted arrangements to close the ex ante financing gap of countries engaged in negotiating a debt restructuring. (Details of recent World Bank cofinancing arrangements are provided in the Statistical Supplement to this paper.)

As regards cofinancing as a part of new money packages, Chile reached an agreement in principle with commercial banks in July 1985 on

a new loan of \$785 million and a World Bank cofinancing of \$300 million, also to be funded by commercial banks. Of the \$300 million cofinancing, up to \$150 million will be guaranteed by the World Bank. The World Bank commitment was made contingent upon the commercial banks' participation in the new money package, while the disbursement of the new loan from the commercial banks is tied to Chile's purchases from the Fund and drawings under the World Bank's Structural Adjustment Loan in 1985/86. Uruguay also has requested a World Bank guarantee to cover part of a \$45 million syndicated loan from commercial banks which is needed to close Uruguay's 1986 financing gap. Commercial banks have made conclusion of a MYRA for Uruguay contingent upon the closing of the 1986 financing gap.

In the case of Colombia, the \$1 billion financing package, committed in principle in June 1985, does not involve a cofinancing. However, the fourth disbursement of the bank package is tied to a communication from the World Bank confirming that Colombia will have access to the second tranche of the Trade Policy Loan during 1985. All disbursements require a communication from the Fund to the Colombian authorities indicating that Colombia was in compliance with its quantitative economic program.

4. Other current developments

During 1984-85, a number of key developments have occurred in bank debt restructurings and new money packages. One key development, the development of MYRAs and of enhanced surveillance has been discussed by the Executive Board on earlier occasions in 1985. A summary of these developments, together with an outline of the MYRAs for Yugoslavia, the Dominican Republic, and Jamaica, is provided in Annex I to this paper. The MYRA with Yugoslavia is to include provisions for enhanced surveillance, and these were outlined in "Yugoslavia - Enhanced Surveillance - Note Prepared by the Staff for the Background Information of Executive Directors" (EBS/85/171, 7/19/85).

This subsection discusses developments in three other areas: currency redenominations, on-lending, and loan swaps and sales.

a. Currency redenomination

Under several recent restructuring agreements with several countries (including Argentina, Mexico, the Philippines, and Venezuela) banks have been permitted, at their option, to redenominate existing loans into their domestic currencies or the ECU. The period for such conversions has varied, extending in one case to four years. Between 50 and 100 percent of the shares of existing loans not denominated in banks' home currency have been eligible for redenominations, with an additional effective ceiling in the case of Venezuela that limits conversions to about one seventh of the total debt restructured.

Such redenomination may reduce funding risks for nondollar-based banks and would reduce the effect of future exchange rate movements on the banks' exposure relative to domestic currency capital, albeit at a U.S. dollar exchange rate which some banks view as unfavorable. For the debtor country, the benefits from currency diversification are difficult to predict, because possible savings on interest payments could be in part offset by the opportunity cost of benefiting from any further depreciation of the U.S. dollar.

Information on the amounts actually redenominated or likely to be redenominated is limited. Banks do not need to elect to redenominate their loans before the restructuring agreement is signed, or for a specified period thereafter. The agreement between Argentina and the banks foresees that almost a quarter of the debt restructured is eligible for redenomination, but there are no indications yet to what extent banks intend to exercise their option. In the case of Mexico, about half of the restructured debt is covered by the currency denomination option; of this amount, a maximum of 50 percent is eligible for redenomination. It is expected that only a modest proportion of Mexico's total debt will eventually be converted.

In the case of the Philippines, the currency composition of the first tranche of new bank money indicates a continuing strong preference for the U.S. dollar, with a share of 70 percent, but also a considerable interest in yen denomination (18 percent) and ECU (5 1/2 percent). 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.

b. On-lending and re-lending

A second development in some recent financial packages has been a preference on the part of banks to extend fresh funds in the form of (or convertible into) trade- or project-related loans to the private sector or to parastatals, instead of purely financial credits to the central government ("on-lending"). Arrangements have also been made to allow some existing debt to be converted into this form ("re-lending"). This enables banks to maintain business relationships in the developing country and to support the export activities of their customers. A number of recent restructurings or new money packages (including those with Argentina, Brazil, Chile, Venezuela, and the Philippines) all include specific provisions for on-lending or re-lending.

In the case of Argentina, for example, the \$3.7 billion medium-term loan agreement signed in principle in 1984 foresees that one third of each lender's disbursement to the central bank will be available for on-lending to borrowers from Argentina's public sector. Specifically, 28 percent will be available for on-lending either to public sector borrowers with a government guarantee or to private sector borrowers without a government guarantee, while a further 5 percent, subject to

certain conditions, will be available to private sector borrowers without being guaranteed. Moreover, an additional \$0.5 billion of new funds made available to Argentina were in the form of a short-term trade deposit facility.

In the case of Brazil, the 1983 and 1984 restructuring agreements and the interim arrangement for 1985 specify that lenders may relend to private and public sector borrowers those amounts falling due during the life of the restructuring agreements; in addition, new money provided under the 1983 and 1984 concerted lending arrangements can be on-lent on similar terms. Chile's \$785 million new money facility signed in 1985 allows re-lending of up to \$80 million to the private sector and to certain designated public sector entities, and the 1985 rescheduling provides for the partial on-lending to the private sector of certain rescheduled maturities of the private sector deposited with the Central Bank up to a ceiling of \$120 million.

The \$925 million credit signed by the Philippines and banks in May 1985 includes a re-lending option which specifies that banks that wish to on-lend have to apply for central bank approval which has to take a decision on such applications within 30 days. The Venezuelan MYRA, signed in principle in 1984, contains provisions for a re-lending facility if amortization payments are made over and above the agreed repayment schedule; in such cases, banks have the right to lend to those borrowers and/or sectors that will be designated semiannually by the government or for which individual approval is granted.

c. Loan swaps and sales

Banks in various countries have engaged in swaps (or outright sales) of loan claims, to even out the distribution of their portfolios, to regroup their claims on countries with which they expect to have continuing business interests or to reduce their overall exposure. There have been isolated instances of banks undertaking swaps on a large scale. Generally, however, individual swaps and sales are believed to be of very small amounts (substantially less than \$5 million).

The U.S. Institute of Certified Public Accountants has provided guidance on the valuation of asset swaps. This guidance indicates that such swaps are to be viewed as the sale of two loans. When such sales are made, the fair market value of the loans must be established, and any loss that arises for each selling bank must be recognized in its income statement. There is a presumption that sales of developing country debt instruments in the context of asset swaps would involve a recognition of loss, although this does not necessarily carry implications for valuation of a bank's other loan claims. Nonetheless, banks do express concern that swapping assets on any significant scale, or selling sizeable claims on developing country borrowers, could at some stage result in regulatory insistence that their holdings of such claims be marked to a lower value. These concerns are strongest among banks which have not earmarked significant reserves against claims on the countries concerned.

A few banks have specialized in arranging loan swaps. These banks apparently find customers mainly among small- and medium-sized banks. In some cases, the "market-making" bank purchases small participations outright, at a discount, and sells them to concerns with an ongoing investment program in the debtor country. According to reports, discounts range from 10 to (at the extreme) 90 percent, reflecting the economic situation of the debtor country, banks' existing specific provisions, and--to a lesser degree--the size of the claim.

V. International Bond and Note Markets and Other Flows

One of the most important recent changes in the structure of international financial markets has been the displacement of the syndicated bank loan as a principal instrument of international finance by a wide range of bonds and other marketable securities. Between 1981 and 1984, international bonds, 1/ net of redemptions and double-counting due to bank purchases of bonds issues, rose from \$30 billion to \$60 billion and, as a result, the proportion of the sum of net international bank loans and net bond issuance accounted for by net bond issuance rose from 15 percent to 39 percent (Table 13).

This expansion of bond market activity stands in sharp contrast to the stagnant level of activity in the late 1970s and represents a response to lower inflation and improvements in other macroeconomic conditions, high real returns on bond holdings, the development of new types of financial instruments, and reductions in regulatory restrictions on bond issuance in certain major markets. This section first considers the general factors leading to the sharp growth of bond issuance during the past five years and then reviews specific developments in international bond markets during 1984 and the first half of 1985.

1. Bond market trends

The record level of bond issuance in the period 1981-84 represents a sharp recovery from an almost decade-long decline in bond market activity, especially during the late 1970s. 2/ Although the nominal

1/ International bonds consist of foreign and Eurocurrency bonds. Foreign bonds are issued by a borrower who is of a nationality different from the country in which the bonds are issued. Such issues are underwritten and sold by a group of banks of the market country and are denominated in that country's currency. In contrast, Eurocurrency bonds are those underwritten and sold in various national markets simultaneously usually through international syndicates of banks.

2/ The earlier stages of this recovery were discussed extensively in Appendix II, IMF, "International Capital Markets: Developments and Prospects, 1983," Occasional Paper No. 23 (Washington: July 1983) and Appendix IV, IMF, International Capital Markets: Developments and Prospects, 1984, "Occasional Paper No. 31 (Washington: August 1984).

Table 13. Measures of Real Size of Bond Market, 1976-84

	1976	1977	1978	1979	1980	1981	1982	1983	1984
	<u>(In billions of U.S. dollars)</u>								
Bond issues (net) <u>1/</u>	30	31	30	32	28	36	58	59	84
	<u>(In billions of U.S. dollars at 1975 prices)</u>								
Deflated by U.S. GNP deflator	30	28	25	25	20	23	35	34	47
	<u>(In percent)</u>								
Bond issues as ratio to world imports in U.S. dollars	3.2	2.9	2.4	2.2	1.5	1.9	3.2	3.4	4.1
As ratio to international bank lending (net) <u>2/</u>	42.3	45.6	33.3	26.4	17.5	25.2	60.4	105.4	107.1

Sources: International Monetary Fund; Orion Royal Bank, Ltd. (London); and Bank for International Settlements.

1/ New international bond issues less redemptions and repurchases, but including bank purchases of bonds.

2/ International bank lending equals external lending by banks in the BIS reporting area, net of interbank redepositing.





level of net bond issuance remained at approximately \$30 billion in the period 1976-80, Table 13 shows that the real value of these net issues fell to \$20 billion in 1980 (a 31 percent decline from the real value in 1976). Moreover, net bond issues declined from the equivalent of 3.2 percent of world imports in 1976 to only 1.5 percent in 1980. At the same time, a growing level of international syndicated bank credits reduced the ratio of international net bond issuance to international bank lending from 42 percent in 1976 to only 18 percent in 1980.

High inflation, increased exchange rate and interest rate variability, and the substantial capital losses experienced on fixed interest rate securities as interest rates rose combined to reduce the attractiveness of long-term, fixed interest rate bonds as an instrument of international finance (Table 14). Borrowers found they could attract purchasers to the bond markets only by offering high real yields and by changing the maturities and risk-sharing characteristics of the instruments used in bond markets. In a number of major financial markets, real yields rose sharply during 1979-80 and remained at historically high levels throughout the early 1980s. In addition, bond maturities were shortened with the average maturity of Eurodollar bonds declining from a range of 12-15 years in the early 1970s to 7-10 years in the late 1970s. (Information on maturities is provided in the Statistical Supplement.)

The recovery of bond market activity began in late 1981 as short-term interest rates started to decline from post-World War II peaks in many industrial countries. As discussed in Section II, this recovery has encompassed record volumes of new issues, an extended period of high real returns on bonds, and a gradual lengthening of bond maturities. Declining interest rates and the slowing of inflation in a number of industrial countries created a situation where investors were able to obtain high real rates of return. Borrowers were willing to pay these high real rates in order to reduce their reliance of short-term debt and because of their ability to issue callable debt which helped ensure that they would not be locked into permanently high real borrowing costs, if future interest rates should decline.

The extent of the recovery in bond issuance activity during 1981-84 is indicated in Table 13. Net bond issues have risen from \$28 billion in 1980 to \$84 billion in 1984 (an average annual rate of growth of 32 percent), and the real value of net bond issues has risen from \$20 billion (in terms of 1975 prices) in 1980 to \$47 billion in 1984. The recovery of bond market activity in the early 1980s has now more than offset the bond market decline of the late 1970s. This recovery has been based on an environment characterized by relatively low inflation in countries with major financial markets, declining nominal interest rates, high real bond yields, but considerable interest rate and exchange rate variability.

Table 14. Real Return on Bond Holdings, 1976-83 ^{1/}

(In percent per annum)

Purchased in December of:	1976	1977	1978	1979	1980	1981	1982	1983	1984
<u>U.S. Investor Holding a U.S. Dollar Eurobond</u>									
Sold in Dec. of:									
1977	0.48								
1978	-2.00	-5.18							
1979	-4.65	-8.23	-13.42						
1980	-4.97	-7.22	-9.91	-8.55					
1981	-3.41	-5.38	-6.72	-5.00	-3.09				
1982	-1.05	-2.13	-2.28	1.22	6.27	17.27			
1983	0.40	-0.20	0.28	3.95	8.56	16.05	14.00		
1984	1.34	0.93	1.57	5.01	9.29	14.86	12.67	10.51	
<u>U.S. Investor Holding a Deutsche Mark Eurobond</u>									
Sold in Dec. of:									
1977	27.12								
1978	20.38	10.80							
1979	11.94	2.68	-5.95						
1980	1.59	-5.80	-13.65	-23.61					
1981	-1.42	-7.54	-11.82	-16.10	-11.30				
1982	-0.99	-5.69	-9.28	-10.23	-4.41	3.71			
1983	-1.80	-5.46	-8.07	-9.24	-5.44	-2.29	-7.72		
1984	-2.42	-5.35	-7.36	-8.14	-5.37	-3.28	-6.06	-4.05	
<u>German Investor Holding a Deutsche Mark Eurobond</u>									
Sold in Dec. of:									
1977	18.40								
1978	11.00	3.10							
1979	5.51	-1.47	-6.89						
1980	2.66	-2.59	-6.38	-7.40					
1981	2.57	-2.23	-3.19	-2.01	3.59				
1982	3.60	-0.15	-1.56	1.46	6.65	10.33			
1983	4.26	1.20	0.44	2.27	6.48	8.32	6.03		
1984	4.72	2.11	1.68	3.63	7.25	8.94	8.09	10.41	
<u>German Investor Holding a U.S. dollar Eurobond</u>									
Sold in Dec. of:									
1977	-6.42								
1978	-8.40	-11.77							
1979	-8.72	-11.52	-14.29						
1980	-4.17	-4.17	-1.89	10.85					
1981	0.15	0.59	3.97	13.71	13.18				
1982	3.52	4.79	8.88	18.71	19.92	24.76			
1983	7.52	9.59	14.74	25.09	26.47	30.74	30.98		
1984	11.15	13.64	19.28	29.81	31.33	34.46	32.87	27.17	

Sources: Orion Royal Bank, Ltd., The Orion Royal Guide to the International Capital Markets (Euromoney Publications Limited, London, 1982); the Organization for Economic Cooperation and Development; and the International Monetary Fund, International Financial Statistics.

^{1/} In calculating the real rates of return in this table, the following assumptions were made: (1) The bond is assumed to be purchased in December of the year at the top of the table. (2) All interest on the bond is paid on December 31 of each year and the initial coupon rate of interest is taken as equal to the prevailing market interest rate. (3) Principal is repaid only at maturity. (4) Bonds are sold in December of the year given at the side of the table at a price which ensures that the bond yields a return to maturity equal to the prevailing (December) interest rate. (5) All coupon interest received is assumed to be continuously reinvested in three-month Eurocurrency deposits (at the prevailing Eurocurrency deposit rate) in the same currency as the interest rate payments and bonds are denominated. (6) In calculating the real return on bonds not denominated in the domestic currency, the accumulated interest income and bond sale proceeds are converted at the prevailing exchange rate, and any exchange gain or loss is included in the calculation of the real return. (7) The real return is calculated using the consumer price index in the investors' home countries. (8) The bonds are those issued by private corporations.

Issuance activity on international bond markets during 1984 and the first half of 1985 suggest a continuation of the recovery in bond market activity. The remainder of this section examines the nature of these developments.

2. Developments in 1984 and 1985

a. Overview

After relatively slow growth in 1983, international bond issues rose to record levels in 1984 and the first half of 1985. While \$77 billion of international bonds were issued in 1983, a total of \$110 billion were sold in 1984. If the annualized rate of bond issuance during the first half of 1985 is sustained through the rest of the year, then \$158 billion of bonds will be issued in 1985. Much of this recent increase in bond issuance was accounted for by larger Eurobond sales, which increased from \$50 billion in 1983 to \$82 billion in 1984. During the first half of 1985, Eurobond issuance amounted to \$66 billion. In contrast, foreign bond sales grew only slightly, from \$27 billion in 1983 to \$28 billion in 1984.

In part, this increase in bond issuance activity was stimulated by declining interest rates (especially in the second half of 1984 and early 1985), relatively stable inflation rates, the removal of withholding tax on bond holdings by foreigners in a number of countries, and a continued recovery in economic activity which helped stimulate corporate borrowing in the countries with major financial markets. Most of these bond issues were made by borrowers from industrial countries or international organizations, and only a quite limited number of developing countries have had access to these markets (Table 15). The U.S. dollar has continued to be most widely utilized currency of denomination for bond issues.

b. Interest rate developments

Charts 6 and 7 show recent movements in interest rates. While there were extensive movements of short- and long-term interest rates during 1984, a number of countries began and ended the year with rates that were not very different. During the first half of 1985, however, interest rates fell in many major industrial countries. In the United States, for example, short-term interest rates rose from 9.5 percent in December 1983 to 11.6 percent in August 1984, but then declined to 8.4 percent at the end of the year. During the same period, U.S. long-term interest rates declined only marginally. Following some firming of short- and long-term U.S. interest rates in February and March of 1985, interest rates continued to fall during the remainder of the first half of 1985 (to 7.5 percent for the short-term rate and 10.6 percent for the long-term rate) and into the third quarter of the year.

Table 15. Developments in International Bond Markets, 1980-First Half of 1985

	1980	1981	1982	1983	1984	First Half 1/ 1985
<u>(In billions of U.S. dollars)</u>						
Bond market lending (net of redemptions) <u>2/</u>	28	36	58	59	84	119
Of which: purchases by banks	(9)	(2)	(6)	(11)	(24)	(42)
By category of borrower						
Industrial countries	20	31	50	47	70	98
Developing countries	2	3	3	2	4	7
Other (including international organizations)	6	7	9	11	10	14
<u>(In percent)</u>						
By currency of denomination						
U.S. dollar	43	63	64	57	64	67
Deutsche mark	22	5	7	9	6	6
Swiss franc	20	16	15	18	12	8
Japanese yen	5	6	5	5	6	6
Other	10	10	9	11	12	13
Share purchased by banks	32	6	10	19	29	35
<u>(In percent per year)</u>						
Interest rate developments						
Eurodollar deposits <u>3/</u>	14.6	16.8	13.2	9.7	10.8	8.6
Dollar Eurobonds <u>4/</u>	12.6	14.4	15.0	12.6	12.7	11.7
Deutsche mark international bonds <u>4/</u>	8.9	10.1	8.9	7.9	7.9	7.6

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

- 1/ On an annualized basis.
2/ This series is net of redemptions but is not adjusted for double-counting due to bank purchases of bonds.
3/ Three-month deposits.
4/ Bonds with remaining maturity of 7-15 years.

CHART 6

DOMESTIC MONEY MARKET RATES,
JANUARY 1983 TO JUNE 1985

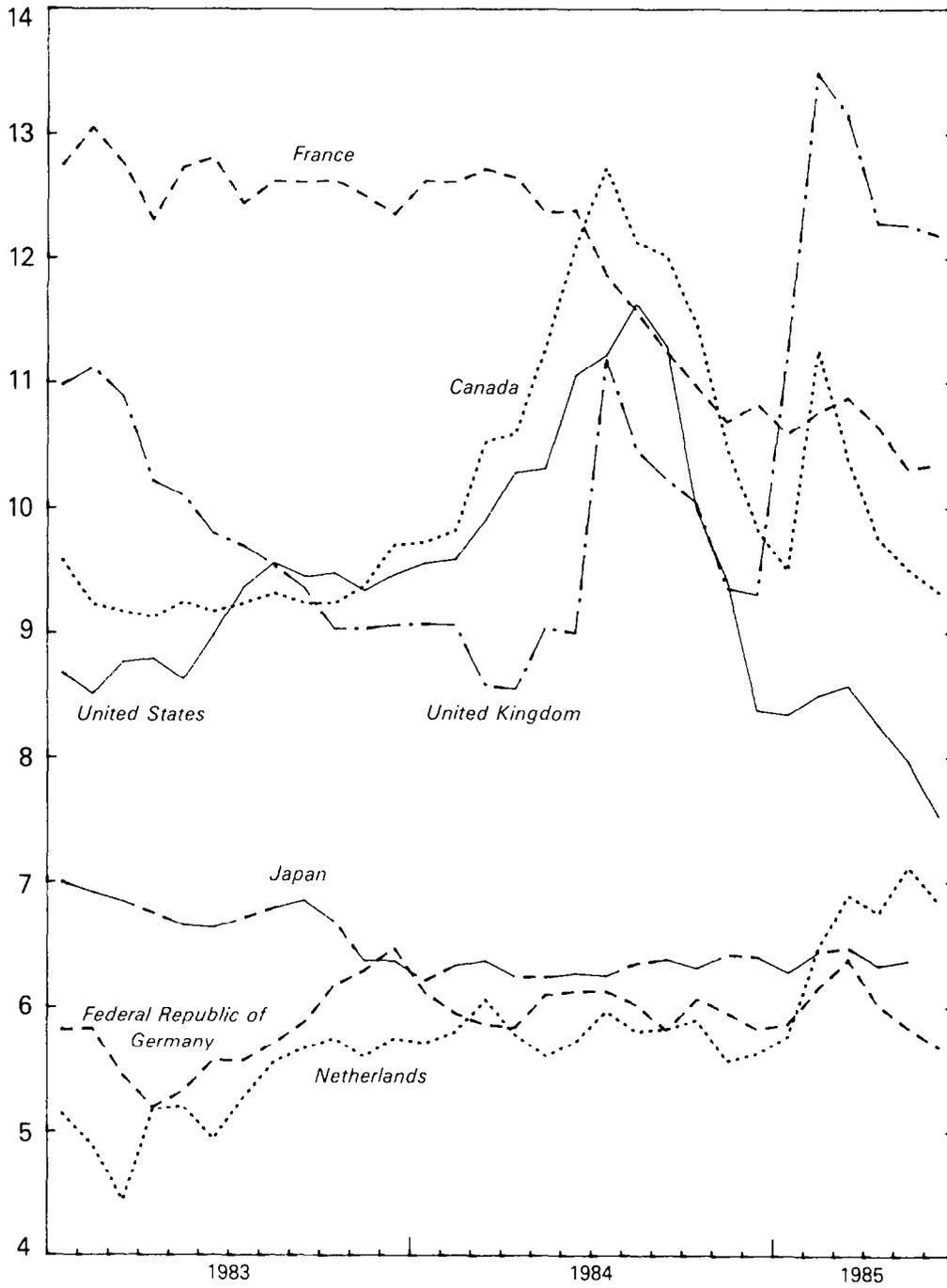
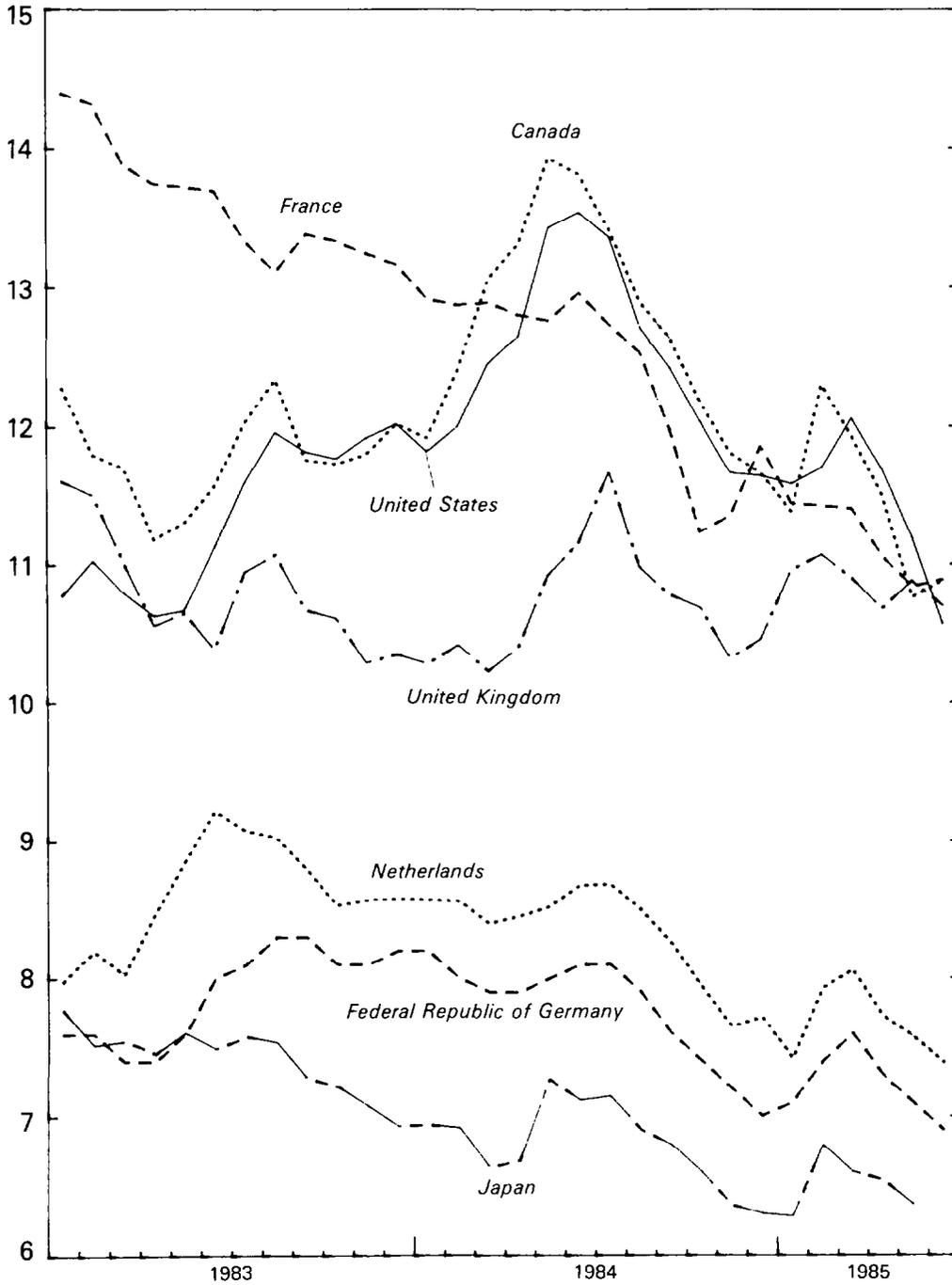




CHART 7
DOMESTIC LONG TERM INTEREST RATES,
JANUARY 1983 TO JUNE 1985





In contrast, German short-term interest rates fell from 6.5 percent in December 1983 to 5.8 percent in December 1984, and German long-term rates declined from 8.2 percent to 7.0 percent in the same period. During the first half of 1985, German short-term interest rates declined by approximately 50 basis points, whereas long-term rates rose from 7.0 to 7.9 percent. Since interest rates in Canada and the United States have tended to decline more rapidly than in the European countries and Japan, there was a narrowing of interest rate spreads between U.S. and Canadian interest rates and those in other major markets throughout the last half of 1984 and first half of 1985.

Since inflation has been declining or remaining stable in most major industrial countries, interest rate movements in 1984 did not bring about a sharp reduction in real interest rates in the major industrial countries (Table 16). The level of real interest rates in the major industrial countries in the 1980s generally has been higher than at any other time in the 1960s or in the 1970s. Moreover, the dispersion of real yields across the major industrial countries has been lower than in many earlier periods (especially in 1980-81).

This persistence of high real interest rates has been attributed to such factors as expectations of higher inflation in the future, the existence of risk premiums required to compensate asset holders for uncertainty about future inflation rates, the impact of large current and prospective budget deficits on the balance between the supply and demand for loanable funds, the impact of financial deregulation, and the stance of monetary policy. During the first half of 1985, the continuing decline in interest rates helped lower real interest in most major industrial countries and reduced the spread of real yields between the United States and other major financial markets.

c. International bond issuance

Although the total issuance of foreign and Eurobonds grew at an annual rate of 26 percent during the period 1980-83, these issues expanded by 42 percent in 1984. Moreover, if the rate of issuance evident in the first half of 1985 should be sustained in the rest of the year, then the international bond issues could total nearly \$158 billion in 1985, a 44 percent increase over 1984 (Table 17). This expansion has primarily reflected growth in the issuance of Eurobonds rather than foreign bonds. While foreign bonds grew from \$27.1 billion in 1983 to only \$27.8 billion in 1984, Eurobonds increased by 63 percent (from \$50.1 billion in 1983 to \$81.8 billion in 1984).

The volume of international bonds issued by industrial country entities grew from \$50.7 billion in 1983 to \$91.4 billion in 1984, with their issuance of Eurobonds expanding sharply and foreign bond issues declining. U.S. residents borrowed \$25 billion on the international bond markets in 1984, which was three times higher than in 1983. Most of this borrowing (\$19.5 billion) involved the issuance of Eurobonds, but the subsidiaries of U.S. corporations raised substantial funds on

Table 16. Nominal and Real Interest Rates, 1979-84

(In percent)

	1979	1980	1981	1982	1983	1984
United States						
Three-month Eurodollar deposit rate	12.1	14.1	16.8	13.2	9.6	10.8
GNP deflator	8.6	9.2	9.4	6.0	3.8	3.8
Real interest rate	3.2	4.6	6.8	6.8	5.6	6.7
Germany, Federal Republic of						
Three-month money market rate	6.7	9.5	12.1	8.9	5.8	6.0
GNP deflator	4.0	4.5	4.2	4.7	3.2	1.9
Real interest rate	2.6	4.8	7.6	4.0	2.5	4.0
Japan						
Three-month gensaki rate	5.9	10.7	7.4	6.8	6.5	6.3
GNP deflator	2.6	2.8	2.7	1.7	0.7	0.7
Real interest rate	3.2	7.7	4.6	5.0	5.8	5.6

Sources: International Monetary Fund, International Financial Statistics; Deutsche Bundesbank, Monthly Report; and Bank of Japan, Economic Statistics Monthly.

Table 17. Gross International Bond Issues and Placements, 1979-June 1985 1/

(In millions of U.S. dollars)

	1979	1980	1981	1982	1983	1984	Jan.- June 1985
Foreign bonds							
Industrial countries	13,421	11,339	14,129	16,854	18,693	18,299	7,745
Developing countries	1,431	746	1,212	726	893	1,618	840
Centrally planned economies <u>2/</u>	43	--	--	--	--	--	--
International organizations	5,259	5,714	5,030	7,461	7,269	7,580	4,430
Other	154	125	143	158	195	304	53
Total foreign bonds	20,308	17,924	20,514	25,199	27,050	27,801	13,068
Eurobonds							
Industrial countries	14,212	17,206	25,210	42,816	41,015	73,145	56,989
Developing countries	1,885	1,403	3,215	3,970	2,382	3,646	4,095
Centrally planned economies <u>2/</u>	30	--	55	--	--	--	--
International organizations	2,220	1,710	2,486	3,280	6,074	4,218	4,598
Other	344	75	358	263	627	708	356
Total Eurobonds	18,691	20,394	31,324	50,329	50,098	81,717	66,038
International bonds							
Industrial countries	27,633	28,545	39,339	59,670	59,708	91,444	64,734
Developing countries	3,316	2,149	4,427	4,696	3,275	5,264	4,935
Centrally planned economies <u>2/</u>	73	--	55	--	--	--	--
International organizations	7,479	7,424	7,516	10,741	13,343	11,798	9,028
Other	498	200	501	421	822	1,112	409
Total international bonds	38,999	38,318	51,838	75,528	77,148	109,618	79,106

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.

the bond markets in the Federal Republic of Germany, Switzerland, and the United Kingdom. The second largest group of borrowers were Japanese corporations and banks which raised \$17 billion and \$3.8 billion, respectively, on international bond markets. French entities obtained \$8.5 billion from these markets, with French banks accounting for \$4.3 billion of these issues. Moreover, Swedish borrowers raised \$6.4 billion, with the government borrowing accounting for \$4.6 billion of the total increase. This rapid growth of bond issuance raised the share of industrial country in total international bond issues from 77 percent in 1983 to 83 percent in 1984 and 82 percent in the first half of 1985.

Although the bond issues of developing countries rose from 4 to 5 percent of international bond issues between 1983 and 1984, the issuance of such bonds was highly concentrated. Korea, Malaysia, and South Africa issued about \$1 billion each, and together they represent more than 60 percent of the developing country issues. Moreover, some bond issues by developing countries appear to have substituted for medium-term bank credits, since few of these bonds were placed outside the banking system. In the first half of 1985, bond issues by developing countries represented 6 percent of total issues.

The bond issues of international organizations declined from \$13.3 billion in 1983 to \$11.8 billion in 1984. While the issuance of international bonds by the World Bank expanded from \$4.3 billion in 1983 to \$5.2 billion in 1984, other regional institutions significantly reduced their issuance. For example, the EEC issued only \$300 million of international bonds in 1984 compared with \$3 billion in 1983. As a result of the decline in their issuance activity, international organizations accounted for only 11 percent of total international bonds in 1984 and in the first half of 1985, as opposed to 17 percent in 1983.

In 1984, international bond issues net of redemptions amounted to \$84 billion or 42 percent above net issues in 1983. These net flows went mainly to the industrial countries and international organizations. The net flows to developing countries have remained relatively unchanged during the past five years.

d. Currency composition and market share

Since the U.S. dollar serves as the primary currency of denomination in the Eurobond markets, the sharp surge in Eurobond issues relative to those in foreign bond markets had a pronounced effect on the currency composition of international bonds in 1984 and in early 1985. Although the share of international bonds denominated in the U.S. dollar had declined to 57 percent in 1983 (Table 18), the share rose to 64 percent in 1984, which matched the previous peak share established in 1982. This higher share reflected the fact that Eurobonds denominated in U.S. dollars have increased by 67 percent between 1983 and 1984, and that they represented 80 percent of all Eurobonds issued in 1984. In the first half of 1985, moreover, the share of U.S. dollar-denominated bonds

Table 18. International Bond Issues and Placements by Currency of Denomination, 1979-June 1985

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

	1979		1980		1981		1982		1983		1984		Jan.-June 1985	
	Amount	Share of total	Amount	Share of total	Amount	Share of total	Amount	Share of total	Amount	Share of total	Amount	Share of total	Amount	Share of total
U.S. dollar	14,724	37.8	16,358	42.7	32,617	63.0	48,253	63.9	43,940	57.0	69,628	63.5	52,992	67.0
Eurobonds	10,360		13,649		25,761		42,228		39,205		65,334		50,837	
Foreign bonds	4,364		2,709		6,856		6,025		4,735		4,294		2,155	
Deutsche mark	8,571	22.0	8,408	21.9	2,592	5.0	5,362	7.1	6,660	8.6	6,743	6.2	4,477	5.7
Eurobonds	5,881		3,457		1,396		3,253		4,042		4,324		3,675	
Foreign bonds	2,690		4,951		1,196		2,109		2,618		2,419		802	
Swiss francs	9,718	24.9	7,470	19.5	8,118	15.7	11,325	15.0	13,500	17.5	13,120	12.0	5,986	7.6
Eurobonds	--		--		--		--		--		--		--	
Foreign bonds	9,718		7,470		8,118		11,325		13,500		13,120		5,986	
Japanese yen	2,855	7.3	1,844	4.9	3,132	6.0	3,915	5.2	4,084	5.3	6,063	5.5	4,856	6.1
Eurobonds	184		301		410		598		233		1,190		1,866	
Foreign bonds	2,671		1,543		2,722		3,317		3,851		4,873		2,990	
Netherlands guilder	470	1.2	874	2.3	929	1.8	1,474	2.0	1,681	2.2	1,846	1.7	769	1.0
Eurobonds	308		549		490		618		748		986		387	
Foreign bonds	162		325		439		854		933		860		382	
Pound sterling	291	0.7	1,152	3.0	1,446	2.8	1,975	2.6	3,012	3.9	5,614	5.1	2,623	3.3
Eurobonds	291		974		535		846		2,153		3,965		2,466	
Foreign bonds	--		177		911		1,129		859		1,649		157	
French franc	571	1.5	1,142	3.0	602	1.2	221	0.3	188	0.2	21	--	646	0.8
Eurobonds	374		882		513		--		--		--		343	
Foreign bonds	197		260		89		221		188		21		303	
Other currencies	1,799	4.6	1,070	2.7	2,373	4.6	3,005	4.0	4,083	5.3	6,583	6.0	6,777	8.5
Eurobonds	1,294		582		2,219		2,786		3,717		6,018		6,464	
Foreign bonds	505		488		184		219		366		565		293	
Total	38,999	100.0	38,318	100.0	51,838	100.0	75,528	100.0	77,148	100.0	109,618	100.0	79,106	100.0
Eurobonds	18,691		20,394		31,324		50,329		50,098		81,817		66,038	
Foreign bonds	20,308		17,924		20,514		25,199		27,050		27,801		13,068	

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

rose to 67 percent of all international bonds. In contrast, the shares of international bonds denominated in deutsche marks, Swiss francs, and Netherlands guilders all declined in 1984 and the first half of 1985.

e. Types of bonds

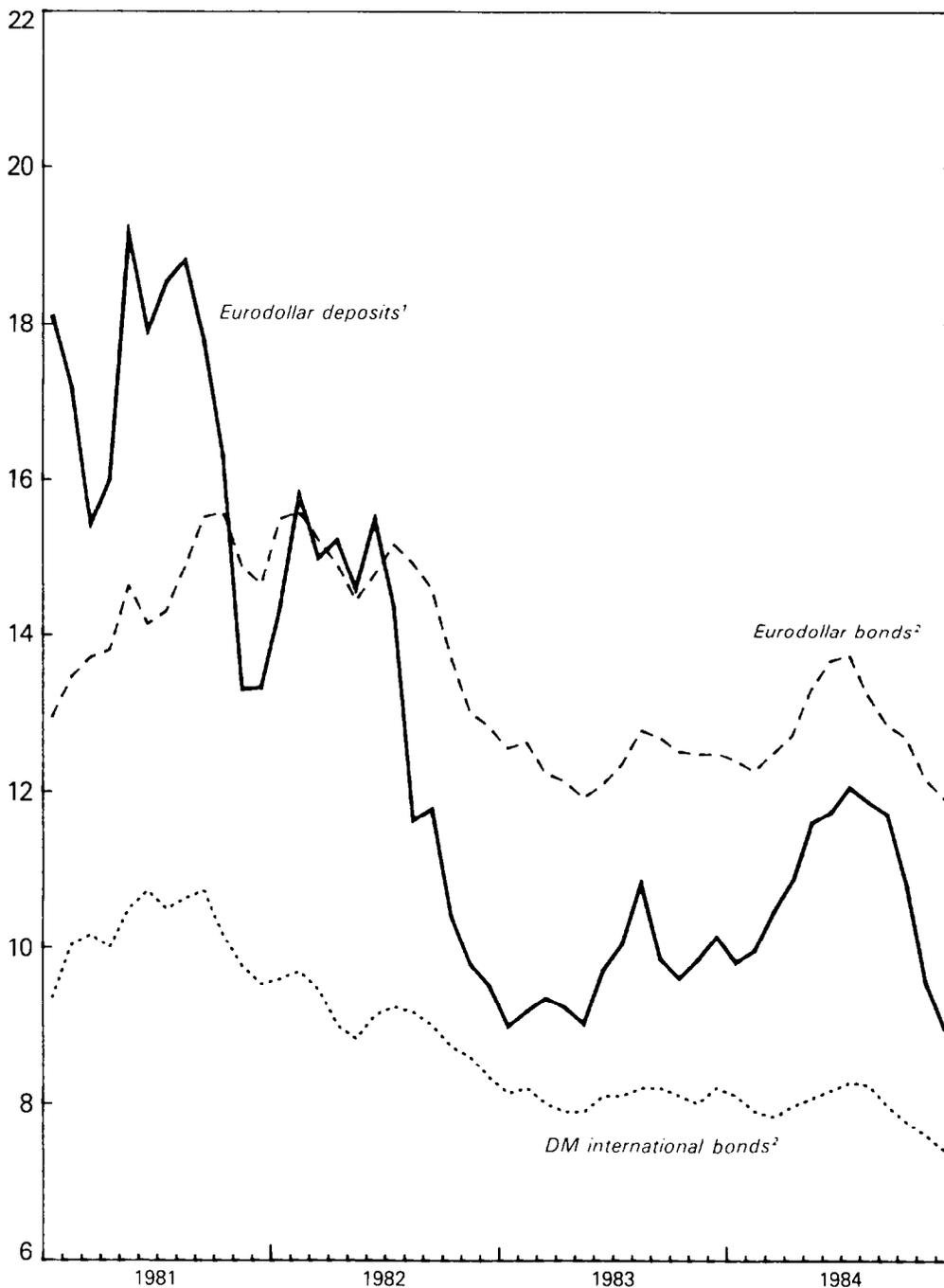
The implications of recent bond market developments for the types of instruments used in international bond markets is illustrated in Chart 8. While straight debt issues represented 66 percent of all international bond issues in 1982, this proportion declined to 52 percent in 1984. In contrast, the share of floating rate notes (FRNs) have expanded from 20 percent to 34 percent in the same period. At the same time, use of convertible international bonds rose from 3 percent to 10 percent of total bond issues.

In addition to a growing volume of FRNs, the average size of individual issues and average maturity have increased noticeably in recent years; and the secondary market for FRNs has gained both in terms of volume and participants. As discussed in Section II, FRNs have served as an attractive alternative to fixed rate bonds during periods when volatile interest rate movements discouraged lenders from committing their funds long term at fixed interest rates. Moreover, holders of FRNs have generally earned high returns in the period since the late 1970s. For example, investors in Eurodollar FRNs earned an annual average rate of return of 13.6 percent during 1979-84, which compares favorably with 12.8 percent on three-month Eurodollar deposits or 10.9 percent on three-month U.S. Treasury bills.

Commercial banks also became major purchasers of FRNs, especially those issued by the best credit risk, in order to improve the quality of their balance sheets. They have been willing to accept a lower spread on FRNs than on loans in order to obtain what they regard as a more liquid and safer security and to maintain business ties with prime borrowers. In addition, U.S. savings and loan associations acquired FRNs as an offset to their money market deposits, and Japanese banks, until recently, may have purchased Eurodollar FRNs because these securities fell outside certain domestic regulatory guidelines applied to medium-term loans.

Sovereign borrowers and commercial banks have been the major issuers of FRNs. As concerns about the quality of banks' portfolios raised their funding costs in the 1980s, those sovereign borrowers regarded as good credit risk often found it possible to obtain funds from international bond markets at a lower cost and with longer maturity than could be obtained by borrowing from banks. Bank issuance of FRNs has reflected attempts to secure longer term funding, especially with regard to U.S. dollar funding from non-U.S. banks. In addition, where allowed by the supervisory authorities (e.g., in the United Kingdom and the United States), banks have also made extensive use of subordinated debentures as a means of raising capital funds.

CHART 8a
INTEREST RATE DEVELOPMENTS, 1981-84



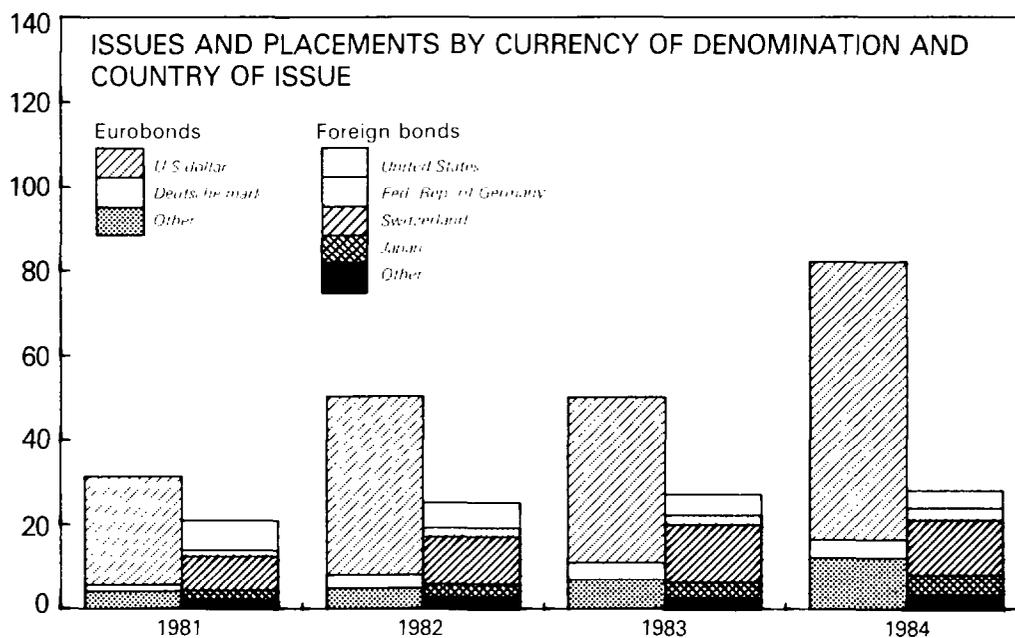
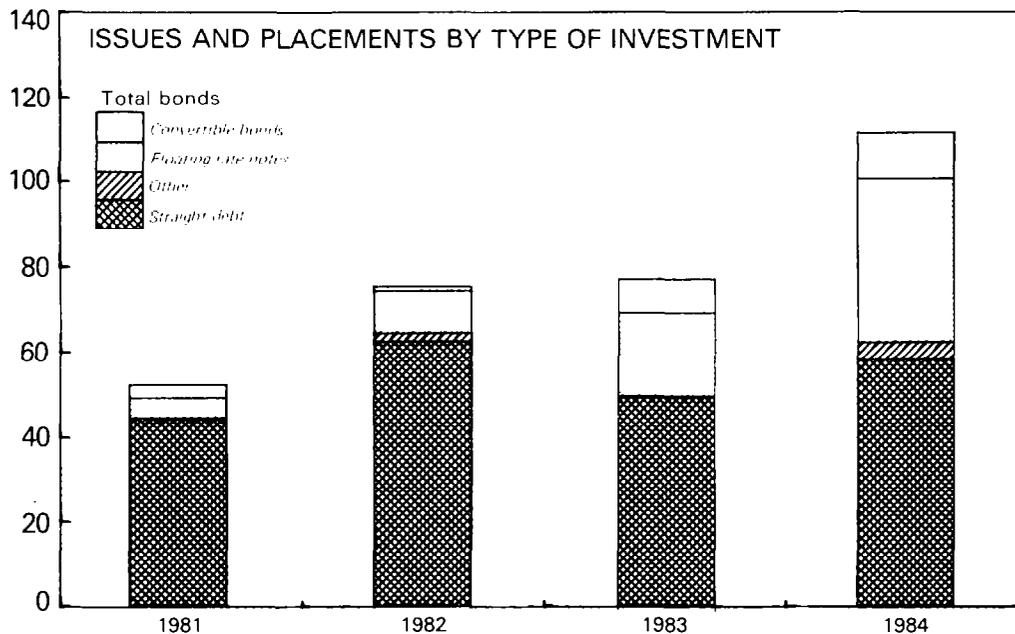
Source: Organization for Economic Cooperation and Development, Financial Statistics Yearbook; and International Monetary Fund, International Financial Statistics.

¹ Three-month deposits.

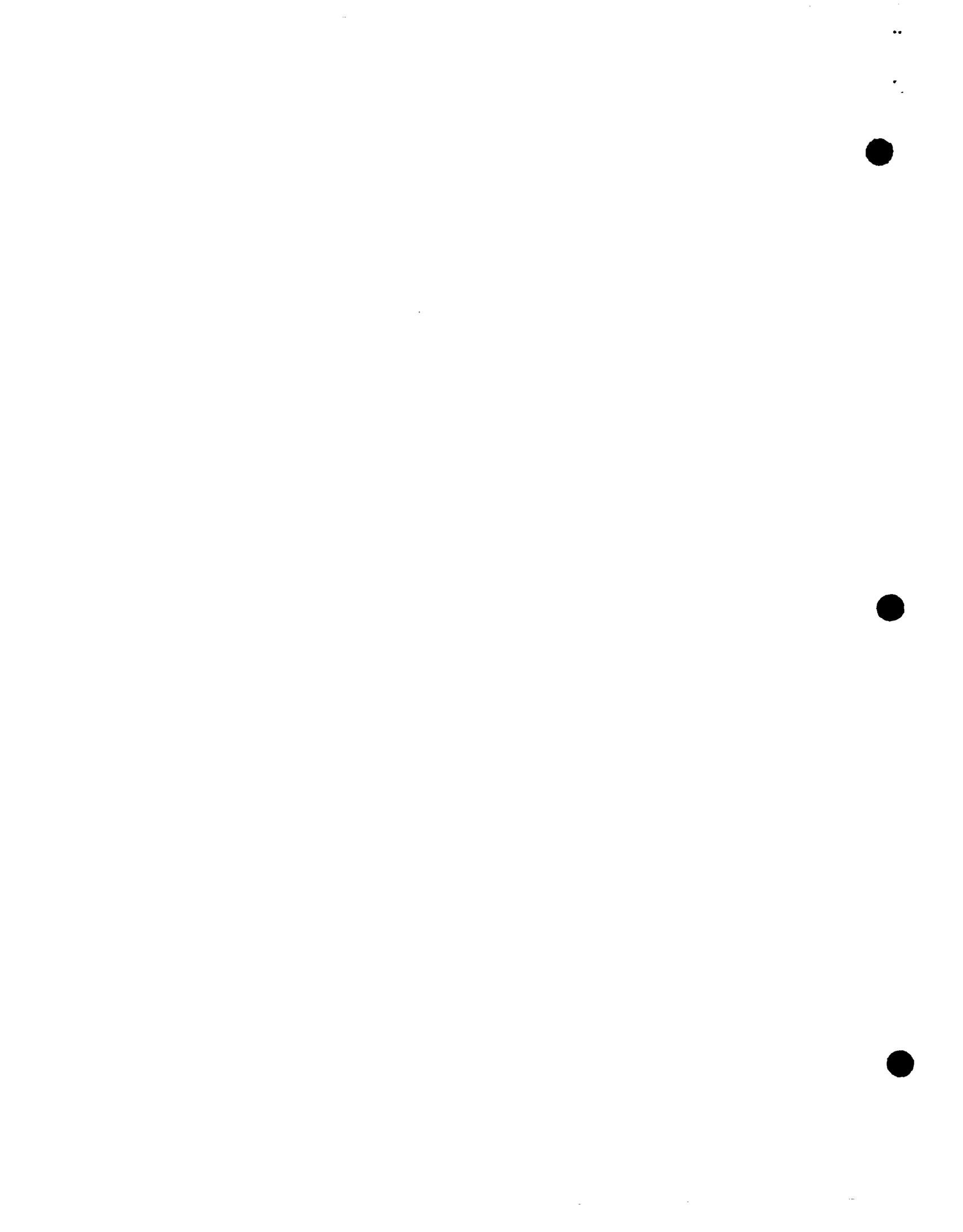
² Bonds with a remaining maturity of 7 to 10 years.



CHART 8b DEVELOPMENTS IN INTERNATIONAL BOND MARKETS, 1981-84



Source: International Monetary Fund, *Cooperation in Development*, Finance Statistics Monthly and International Statistics Yearly, International Financial Statistics.



Bond market activity has also been affected by the growing use of swaps. In 1984, interest rate and exchange rates swaps have been estimated to have reached \$65 billion and \$12-\$15 billion, respectively, amounting to a total volume three times greater than in 1983. Such transactions are a part of a continuing arbitrage of financial market conditions in different national and international financial markets, and they reflect the differing ability of borrowers to access the various markets.

f. Foreign bond markets

Although the Eurodollar bond market has expanded at a rapid rate in recent years, sales of foreign bonds denominated in U.S. dollars (yankee bonds) continued the decline first evident in 1981. In part, this reflected the efforts of international organizations, such as the World Bank, to lower their borrowing costs by relying less heavily on U.S. capital markets. Canadian entities, in particular public agencies, also reduced their issuance of U.S. dollar bonds from \$2.5 billion in 1983 to \$700 million in 1984. As a result, the share of yankee bonds in total foreign bonds fell from 18 percent in 1983 to between 15 and 16 percent in 1984 and the first half of 1985.

While the value of Swiss franc foreign bonds rose in 1984, an approximately 19 percent depreciation of the Swiss franc relative to the U.S. dollar resulted in a small decline in the U.S. dollar value of these issues (from \$13.5 billion in 1983 to \$13.1 billion in 1984). Swiss franc issues, nonetheless, continue to represent the largest share of total foreign bonds (15 percent in 1984). As in 1983, Japanese firms were the most important issuers in this market accounting for 44 percent of all issues. The activities of Japanese corporations were particularly evident in the convertible bond market where their issues of Swiss franc convertibles increased to nearly \$3.8 billion in 1984 from \$3.5 billion in 1983. Swiss franc issues by U.S. banks and corporations declined slightly from \$1.3 in 1983 to \$1.2 in 1984. Moreover, Swiss franc bond issues have often been associated with currency or interest rate swaps, especially as they relate to the Japanese yen. In the first half of 1985, the Swiss franc value of foreign bond issues was about 15 percent below that for the corresponding period in 1984.

Foreign bonds denominated in deutsche marks declined slightly from \$2.6 billion in 1983 to \$2.4 billion in 1984. Despite a rise in the deutsche mark value of foreign bonds (from DM 6.6 billion in 1983 to DM 7 billion in 1984), the U.S. dollar value of these issues declined in 1984 as the deutsche mark depreciated relative to the U.S. dollar. International organizations accounted for a significant share of foreign bonds issued in Germany. Japanese corporations were also particularly active in the private placement market for convertibles and warrant attached bonds. Issue activity was especially heavy in the latter part of 1984 when secondary market yields on foreign deutsche mark bonds fell from 8.2 percent in July to 7.2 percent in January 1985. During late January and early February 1985, however, yields began to rise sharply

when the deutsche mark came under pressure in the foreign exchange market. The capital markets subcommittee, therefore, closed the foreign deutsche mark market to new borrowing for three weeks to early March.

In May 1985, the authorities announced a number of changes in regulations pertaining to the issuance of foreign bonds in Germany. Since May 1, foreign bonds can take the form of floating rate notes and zero-coupon issues. In addition, such bonds can be used as part of a swap transaction. Moreover, the capital markets subcommittee had its last regular meeting on April 12. Lead managers now inform the Bundesbank at the beginning of the month of the size and form of the new issues which they plan to bring to the market. Foreign deutsche mark-denominated bond issues may now be lead-managed by foreign banks incorporated in Germany.

Total issue volume in the deutsche mark market during the first half of 1985 nearly doubled the volume during the first half of 1984. Two FRNs were sold in early May, including a DM 1.5 billion issue by Sweden. In addition, there was a DM 500 million FRN for Ireland and a swap-related FRN of DM 250 million by a French bank. Two zero-coupon bond issues with a nominal value of DM 1.1 billion were also marketed. Moreover, Malaysia sold a DM 100 million bond issue with a coupon of 7 1/2 percent on a ten-year maturity; and The Bank of China raised DM 150 million through a bond issue with a coupon of 7 percent and a seven-year maturity.

Foreign bond issues in the Japanese yen rose from \$3.9 billion in 1983 to \$4.9 billion in 1984 (a 27 percent increase); in the period since 1980, the volume of these issues has more than tripled. Borrowers from all major industrial countries, some East European countries, international organizations, and developing countries obtained funds by issuing either public (samurai) bonds or by private placements.

While industrial country borrowers tend to almost totally dominate in most other markets, international institutions accounted for approximately 25 percent of bond issues in the Japanese market during 1984 and early 1985, and developing countries represented approximately 12 percent of issues. China was the largest developing country borrower in that period but substantial amounts were also raised by Malaysia and Korea. Among the industrial country borrowers, U.S. corporations accounted for over half of the bond issuance in the first half of 1985.

Low and stable interest rates on Japanese markets have helped attract borrowers, while the yen's relative stability against the U.S. dollar helped to make these bonds attractive for investors. During 1984 and 1985, the Japanese authorities also undertook a series of measures designed to further liberalize the foreign bond market; the required credit rating for foreign governments and official agencies borrowing on the Japanese market for the first time was lowered from AAA to AA. Recently, ECU and U.S. dollar-denominated issues by foreign borrowers have also taken place on the Japanese market.

Activity in other foreign bond markets in 1984 was generally little changed from that in 1983, although foreign bond issues denominated in the pound sterling rose from \$0.9 billion in 1983 to \$1.6 billion in 1984.

Although the Swiss market has continued to account for the largest portion of total foreign bond issues, its share declined from 50 percent in 1983 to 47 percent in 1984, and 46 percent in the first half of 1985. The rapid increase in issuance activity in the Japanese foreign bond markets gave that market the second largest share (18 percent in 1984 and 23 percent in the first half of 1985). Activity in the foreign bond markets in the United States had the third largest share (15 percent in 1984 and 16 percent in the first half of 1985). Foreign bonds issued in Germany represented 9 percent of total foreign bonds in 1984 and 6 percent in the first half of 1985.

g. Eurobond markets

During the past five years, Eurobond issues have expanded at an average annual rate of 34 percent, and the growth was even more rapid in 1984, at 63 percent. In the first half of 1985, Eurobond issues expanded at a rate which would imply a 61 percent growth for the year 1985. The issuance of Eurobonds denominated in all currencies expanded, but bonds denominated in the U.S. dollar continue to account for 80 percent of all Eurobond issues and approximately two thirds of all international bond issues.

For the second successive year, the volume of U.S. dollar Eurobonds issued in 1984--floating rate notes, straight bonds, and convertible bonds--exceeded the total issues of U.S. domestic corporate bonds (by over \$10 billion). Throughout this period, the level of activity in the Eurodollar markets was naturally strongly affected by interest rate and exchange rate developments. As Eurobond yields rose from 12 percent in January and February 1984 to nearly 14 percent in July, issue volume fell from an annual rate of \$65 billion to \$50 billion. When U.S. money market rates began to decline in the early fall and the U.S. dollar showed strength on foreign exchange markets, however, there was a sharp increase in issuance activity (to an annual rate of \$90 billion in the August-December period). This increase in Eurodollar bond market activity was also stimulated by the repeal by the United States of its 30 percent withholding tax on interest payments to foreign holders of U.S. bonds and legal changes which made it possible for U.S. corporations to issue directly debt obligations on the Eurodollar market in bearer form.

One important aspect of the rapid expansion in Eurodollar issues has been the growing importance of floating rate notes (FRNs) relative to straight debt issues. Although straight debt issues expanded from \$17.2 billion in 1983 to \$25.4 in 1984, their share of Eurodollar bond issues fell from 44 percent in 1983 to 39 percent in 1984. In contrast, FRNs accounted for 50 percent of all Eurodollar bond issues in 1984; their issuance increased from \$17.9 billion in 1983 to \$32.8 billion.

The deutsche mark represented the second most heavily utilized currency of denomination in the Eurobond markets. Issues of Euro-deutsche mark bonds rose from \$4 billion in 1983 to \$4.3 billion in 1984. However, the share of Euro-deutsche mark bonds in total Eurobonds fell to 5.3 percent, the lowest share since 1981. The share of deutsche mark-denominated bonds in the first half of 1985 amounted to 5.6 percent of total Eurobonds. As noted earlier, however, the liberalization of German bond markets that occurred in May 1985 has had a significant impact on the recent volume of international bonds denominated in deutsche marks.

The third most heavily utilized currency of denomination in 1984 in the Eurobond markets was the pound sterling, which was used for 4.8 percent of Eurobond issues. Euro-sterling bond issues increased from \$2.2 billion in 1983 to \$4.0 billion in 1984. Nearly a quarter of these issues were made by borrowers from the United Kingdom, although entities from the United States, France, and Canada were also active. Despite the issuance of \$2.4 billion Euro-sterling bonds in the first half of 1985, the share of sterling issues in total Eurobond issues fell to 4 percent.

Although Eurobonds denominated in European currency units (ECUs) were first issued in 1981, ECU Eurobond issues reached \$2.9 billion in 1984 and constituted 3.6 percent of all Eurobond issues. In the first half of 1985, moreover, there were \$3.2 billion of ECU issues, which made the ECU the third most heavily utilized currency of denomination. The ECU bond has been used by a variety of borrowers, including EEC official institutions, sovereign borrowers in the European monetary system (such as France, Italy, and Ireland), international organizations (such as the World Bank), and European, Japanese, and (to a more limited extent) U.S. banks. Banks have often increased their issuance of ECU bonds to fund their growing holdings of ECU-denominated assets. Investors have been attracted to the ECU in part by a relatively high nominal yield and the fact that the ECU underlying basket of currencies does not include the U.S. dollar. In addition, some European investors have been affected by the more favorable treatment that ECU-denominated bonds have received under exchange regulations and capital controls in some European countries.

The liberalization of the Euro-yen bond market in 1984-85 was discussed in Section II of this paper, and included notably easing of the guidelines on eligible resident and nonresident issuers, permission to make swap-related issues, and abolition of the withholding tax for nonresident purchasers of Japanese corporate issues.

Although Euro-yen bond issues rose from only \$0.2 billion in 1983 to \$1.2 billion in 1984, and to \$1.9 billion in the first half of 1985, there was a sharp distinction between the issuance activity in this market before and after the financial market liberalization which took place in late 1984. The pace of Euro-yen issues has accelerated sharply in the wake of these liberalization measures. In December 1984,

\$464 million of Eurobonds were issued out of a total of \$1.2 billion for the year as a whole. January and February of 1985 saw an additional \$1.1 billion of issues, which nearly matched the total issues for the year 1984.

h. Maturities

There has been considerable diversity of maturities across the international bond markets on the basis of currency of denomination in the period since 1981. In the U.S. dollar market, there has been a general decline in the proportions of short-term (0-5 years) and medium-term (6-10 years) maturities and an increase in the proportion of long-term (over 10 years) bonds. This partly reflects the growing importance of FRN issues, whose maturities are currently much longer than those typically available through the fixed interest rate markets. In contrast, in the markets for borrowings in Japanese yen, pound sterling, and Netherlands guilder, there has been a shift from longer-term bonds to medium-term issues. (Details on bond market maturities are provided in the Statistical Supplement.)

i. Developing country access

Most developing countries currently have very limited access to international bond markets. Although bond issues by developing countries rose from \$3.3 billion in 1983 to \$5.3 billion in 1984, the share of developing country bonds in total bonds fell from 9 percent in 1981 to 5 percent in 1984 (Table 19). Only those developing countries regarded as the best credit risks have been able to access these markets. The four largest developing country issuers typically accounted for 67-80 percent of all developing country issues in each of the years between 1982 and 1984. In the first half of 1985, six developing countries (Algeria, China, Greece, Korea, Malaysia, and Thailand) accounted for approximately 70 percent of all developing country issues.

These limitations on entry into international bond markets have persisted despite the continued servicing of principal and interest on outstanding bonds by almost all developing countries. This servicing record has, nonetheless, had a strong impact on the differentials between yields on developed and developing country bonds in the secondary markets for bonds denominated in deutsche mark (Chart 9). Although the differentials between the yields on developed and developing country bonds had reached levels from 6 to 10 percentage points in the period following the emergence of the external payment difficulties for many developing they declined to less than 2 percentage points by the beginning of 1985. A similar pattern of yield differentials have also been found for U.S. dollar-denominated bonds. 1/

1/ See D. Folkerts-Landau, "The Changing Role of International Bank Lending in Development Finance," IMF Staff papers, March 1985.

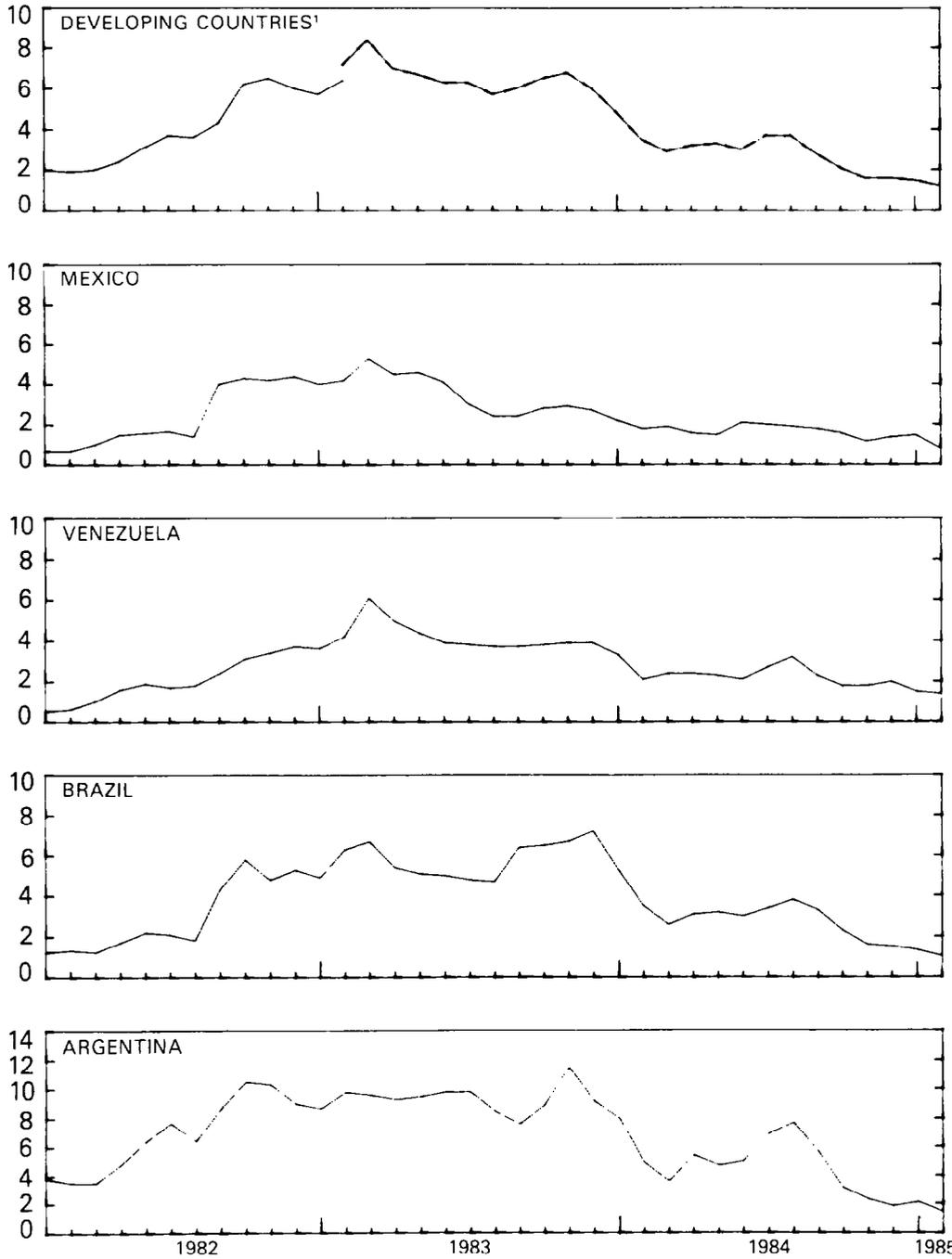
Table 19. Developing Country Gross Issues and Placements in International Markets, 1979-June 1985 ^{1/}

(In millions of U.S. dollars)

	1979	1980	1981	1982	1983	1984	Jan.- June 1985
Algeria	182.8	--	--	--	--	--	500.0
Argentina	416.6	163.9	195.3	--	--	--	--
Bahrain	--	--	30.0	--	--	100.0	150.0
Bermuda	--	--	--	60.0	--	--	--
Brazil	735.6	316.2	60.8	100.9	--	--	--
Chile	83.5	82.2	30.0	--	--	--	--
China	--	--	--	44.5	20.5	81.7	246.5
Colombia	--	55.0	20.0	35.0	15.0	--	--
Costa Rica	--	109.3	--	--	--	--	--
Egypt	--	--	--	65.0	40.0	--	50.0
Gabon	--	--	--	33.2	--	--	--
Greece	--	--	30.0	50.0	41.6	200.8	464.1
Haiti	8.0	--	--	--	--	--	--
Hong Kong	--	--	123.8	71.7	62.8	185.6	--
Hungary	--	50.0	20.0	--	--	40.5	195.5
India	--	30.0	281.7	185.0	60.0	297.6	180.0
Indonesia	62.7	45.8	96.5	363.1	365.7	50.0	--
Israel	200.0	130.0	117.0	110.0	135.0	--	--
Ivory Coast	--	14.3	--	--	--	--	--
Korea	43.6	47.8	322.8	141.7	546.8	1,056.0	758.6
Kuwait	--	--	25.0	110.0	--	50.0	--
Malaysia	152.4	--	--	816.8	884.6	1,141.2	893.1
Mexico	363.0	353.5	2,344.1	1,602.5	--	--	--
Morocco	21.8	23.2	--	--	--	--	--
Panama	110.7	25.0	--	--	21.0	--	20.0
Papua New Guinea	--	--	--	--	--	20.6	--
Peru	--	--	25.0	--	--	--	--
Philippines	176.2	66.8	68.5	30.0	--	--	--
Portugal	--	30.0	20.0	183.3	76.2	389.4	177.0
Saudi Arabia	14.7	--	--	--	--	200.0	--
Singapore	25.0	--	55.6	125.0	70.0	--	--
South Africa	243.6	36.5	92.0	314.1	532.5	1,013.9	691.6
Sri Lanka	--	--	--	11.3	--	--	--
Thailand	176.2	45.9	98.7	62.5	253.5	283.3	540.6
Trinidad and Tobago	--	--	--	--	50.0	107.4	28.6
Tunisia	--	--	--	--	60.0	--	20.3
United Arab Emirates	--	--	--	--	--	25.0	--
Venezuela	173.6	131.5	290.8	35.0	--	--	--
Yugoslavia	96.3	37.2	--	--	--	--	--
Other	29.7	354.9	79.4	145.6	39.8	21.0	19.1
Total	3,316.0	2,149.0	4,427.0	4,696.0	3,275.0	5,264.0	4,935.0

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

CHART 9
YIELD DIFFERENTIALS ON DEUTSCHE MARK-
DENOMINATED PUBLIC BONDS ISSUED BY NON-RESIDENTS



Source: Deutsche Bundesbank
Economic and Financial Data of the Federal Republic of Germany



3. International issuance facilities

The rapid increase in the volume of international issuance facilities is one of the key changes that have taken place recently in international markets. Long-term international bank facility commitments (excluding those that were merger-related) amounted to almost \$29 billion in 1984, in comparison to less than \$10 billion in 1983 and and \$5 1/2 billion in 1982. In the first half of 1985, these commitments proceeded at an annual rate of \$40 billion (Table 20). The central feature of these arrangements is the rapid development of an international market in short-term securities. Back-up facilities for Euronotes and commercial paper rose from less than \$4 billion in 1983 to \$12 billion in 1984 and \$22 billion in the first half of 1985 (at an annual rate).

The market for such facilities is in a phase of rapid evolution. Increasingly complex financial packages are being created, as reflected in the increase in the volume of "multiple component facilities" from \$7.7 billion in 1984 to \$11.3 billion, at an annual rate, in the first half of 1985. These facilities allowed the issuance of Euronotes or use of short-term bank advances by competitive bidding, against a range of funding bases and currencies. In contrast, the volume of other facilities of a more traditional nature, e.g., bankers' acceptances, has not increased substantially during the period.

As indicated in Table 21, most borrowers utilizing these facilities have come from within the OECD area. Highly regarded U.S. corporations used such facilities to back up commercial paper programs or the issuance of Euronotes. In addition, there was a strong demand for such facilities by corporations which has not previously borrowed extensively in international markets. Official borrowers using these facilities have included Indonesia, Oman, Portugal, and Sweden. The users of international facilities have thus been highly regarded governments and governmental agencies, corporations, bank holding companies and banks. Although financial institutions were the principal users of note issuance facilities (to obtain stand-by funds) during 1983, nonbank corporations and governments were the most active participants in these markets during 1984 and the first eight months of 1985. During 1984, corporations and governments each accounted for roughly 40 percent of announced NIFs, while during January to August 1985 corporations became the most active users of these facilities, arranging nearly 70 percent of new facilities.

Borrowers using such facilities have paid relatively low fees and have generally obtained funds at a lower cost than that associated with either syndicated loans or FRNs. The size of the potential differential in borrowing costs can be illustrated by the spread between the yields on U.S. commercial paper and LIBOR (Chart 10). Despite relatively low fees, many banks have been active participants in the underwriting of NIFs. As in the case of FRNs, a high proportion of the short-term

Table 20. International Facility by Type of Use, 1982-85

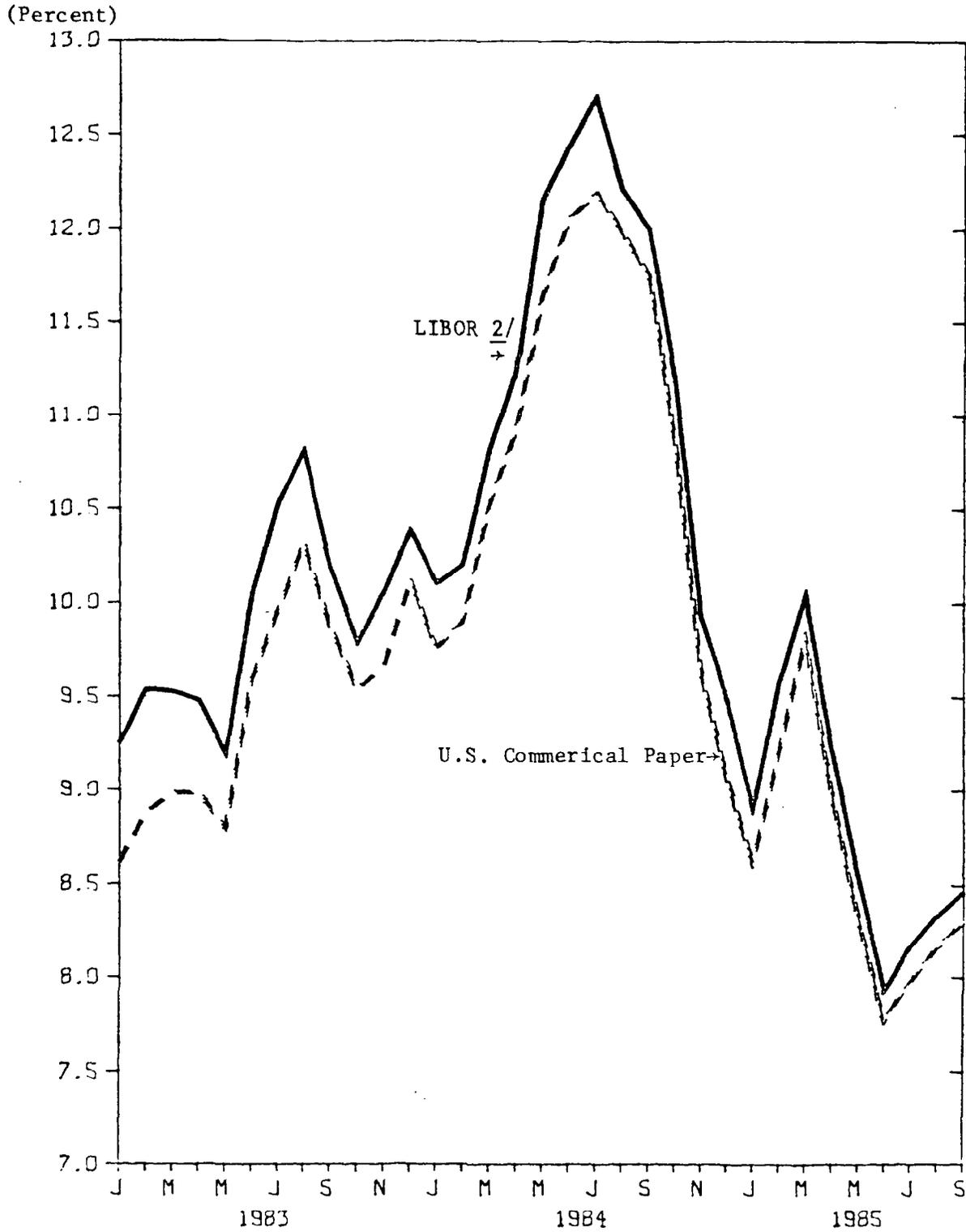
(In billions of U.S. dollars)

	1982	1983	1984	1985 <u>1/</u>
Euronotes	2.2	0.8	8.8	15.8
Commercial paper	0.2	3.1	3.5	5.9
Certificates of deposit	0.7	2.8	1.1	1.8
Bankers' acceptance	2.0	1.8	5.8	2.4
Multiple component facilities	--	--	7.7	11.3
Other instruments	0.3	1.0	1.9	2.7
Merger-related stand-bys	<u>--</u>	<u>4.0</u>	<u>26.5</u>	<u>--</u>
Total	5.5	13.5	55.3	39.8

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

1/ January-June at annual rates.

Chart 10. Eurodollar and U.S. Commercial Paper Interest Rates, January 1983-September 1985 1/



Sources: Board of Governors of the Federal Reserve, Statistical Release H.15 (for Commercial Paper); Bank of America (for LIBOR).

1/ Six-month maturities.

2/ London Interbank offered rate.



Table 21. International Facility by Borrower, 1982-85 1/

(In billions of U.S. dollars)

	1982	1983	1984	1985 <u>2/</u>
OECD area	3.3	8.6	22.0	36.8
Eastern Europe	0.1	0.1	0.3	--
OPEC	0.5	0.3	0.5	1.2
Other LDCs	1.3	0.4	5.7	1.8
Other	<u>0.2</u>	<u>0.1</u>	<u>0.3</u>	--
Total	5.5	9.5	28.8	39.8

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

1/ Excluding merger-related stand-bys.

2/ January-June at annual rates.

notes is held by bank portfolios. Nonetheless, leading arrangers of these facilities report an increasing market for notes outside the banking system. Holders reportedly include insurance companies, investment trusts, corporations, and central banks.

While the market for back-up facilities is in a phase of rapid growth, the utilization of these facilities is believed to have been below that of other forms of financial commitments. For many borrowers, back-up facilities may not actually involve any drawdown of funds. Data is not available concerning the issuance of notes under these facilities, but it is estimated that private sector borrowers have, by mid-1985, made issues amounting to 10-20 percent of facilities. In contrast, sovereign borrowers have tended to use these facilities as a substitute for syndicated loans, and have issued notes equivalent to a substantial proportion of their facilities.

4. Foreign direct investment, official flows,
and the financing of external payments

As a result of the sharp slowdown in the growth of international bank lending to developing countries and this group's limited access to international bond markets, foreign direct investment and official flows have come to play an increasing role in financing of current account deficits and reserve accumulation of developing countries. For example, the financing requirements of the two major groups of capital-importing countries, the market borrowers and the official borrowers, are given in Table 22.

For the market borrowers, the sum of their current account deficits and reserve accumulations in the period from 1973 to 1984 reached a peak of \$70 billion in 1981 but has declined to \$26 billion in 1984 despite extensive reserve accumulation. While other net external borrowing accounted for 113 percent of the financing requirement of 1981, this type of borrowing accounted for only 31 and 35 percent of the borrowing requirements in 1983 and 1984, respectively. In contrast, direct foreign investment flows represented only 14 percent of the borrowing requirement in 1980 but have subsequently increased to 30 percent in 1984. Nonetheless, such investment flows have fallen in absolute amount from \$11 billion in 1981 to less than \$8 billion in 1984.

The position of the official borrowers has been significantly different from that of the market borrowers. Other net external borrowings accounted for the largest proportion of the sum of current account deficits and reserve accumulations in 1977 when it represented 28 percent. However, there has been a net repayment of these borrowings in 1981 and 1982. Foreign direct investment flows have also represented only a small proportion of the financing requirement for this group of countries. In contrast, official transfers and lending have represented at least 84 percent of their financing requirement since 1979.

Table 22. Capital Importing Developing Countries: Financing of Current Account Deficit and Reserve Accumulation, 1977-84

(In billions of U.S. dollars)

	1977	1978	1979	1980	1981	1982	1983	1984
<u>Market borrowers</u>								
(1) Current account deficit	19.5	32.8	30.3	36.5	72.7	74.7	29.4	7.2
(2) Reserve accumulation	6.1	10.6	18.2	17.4	-2.7	-25.1	4.0	18.5
Financing: sum of (1) and (2)	25.6	43.4	48.5	53.9	70.0	49.6	33.4	25.7
(3) Direct investment	4.5	6.4	7.8	7.4	11.3	10.6	7.4	7.7
(4) Official transfers	0.8	1.0	1.2	1.3	1.8	1.9	2.2	2.1
(5) Long-term borrowing from official creditors, net	5.4	6.5	5.1	7.5	8.4	8.0	14.4	12.3
(6) Other net external borrowing	22.2	36.1	41.6	56.9	79.2	50.1	10.3	9.0
(7) Other sources <u>1/</u>	-7.3	-6.6	-7.2	-19.2	-30.7	-21.0	-0.9	-5.4
<u>Official borrowers</u>								
(1) Current account deficit	8.4	11.0	12.1	16.0	19.0	17.6	15.7	16.3
(2) Reserve accumulation	1.9	0.7	0.8	0.5	-0.2	-1.0	0.8	-0.9
Financing: sum of (1) and (2)	10.3	11.7	12.9	16.5	18.8	16.6	16.5	15.4
(3) Direct investment	0.7	0.6	0.6	0.2	0.9	0.5	0.4	0.4
(4) Official transfers	4.2	3.9	6.1	7.0	7.4	7.2	6.5	6.2
(5) Long-term borrowing from official creditors, net	2.8	3.8	6.3	8.5	9.7	9.0	7.4	7.3
(6) Other net external borrowing	2.9	2.5	0.9	0.5	-1.4	-2.1	1.7	1.9
(7) Other sources <u>1/</u>	-0.3	0.9	-1.0	0.3	2.2	2.0	0.5	0.6

Source: International Monetary Fund, World Economic Outlook.

1/ Includes errors and omissions.

While the WEO projects a recovery of foreign direct investment in 1985-86 (from \$10 billion in 1984 to \$12 billion in 1986 for all capital importing countries), official lending and transfers to this group are anticipated to fall from \$40 billion in 1984 to \$38 billion by 1986. This will encompass an increase in official transfers from \$14 billion in 1984 to \$17 billion in 1986 but a decline in official lending from \$26 billion to \$22 billion in the same period.

Multiyear Restructurings and Enhanced Surveillance

1. Multiyear restructuring agreements

The most significant new development in bank debt restructurings in 1984-85 was the adoption by bank creditors of a medium-term perspective for debt restructuring through the negotiation of multiyear restructuring arrangements (MYRAs) with certain countries. In all cases, MYRAs have been seen to provide a clearer planning horizon for bank creditors, as well as the government.

In several cases, MYRAs were intended to facilitate an early return by debtor countries to more normal access to capital markets, that is, to move away from a concerted approach to new lending and to re-establish independent decision making by market participants. In such cases, banks sought economic monitoring procedures for the period when countries would no longer be using Fund resources. In this context, the concept of enhanced surveillance by the Fund was developed (enhanced surveillance is discussed further below).

MYRAs have also been agreed or discussed with countries that would not meet the criteria for enhanced surveillance, mainly because they have not established an adequate record of adjustment. In certain such cases, member countries and bank creditors have agreed on a multiyear restructuring to avoid the burdens and uncertainties imposed by multiple annual restructurings.

In order to maintain a close link between debt relief and the implementation of adjustment policies, bank creditors have in some cases made only subperiods within the consolidation period of a MYRA eligible for unconditional restructuring. The restructuring for later years in the consolidation period depends on certain conditions being met with regard to economic performance and monitoring arrangements. This approach, known as a serial MYRA, facilitates a periodic review of economic policies and prospects.

Mexico was the first case for which a MYRA was agreed in principle (in September 1984). Maturities of \$48.7 billion falling due in 1985-90 (of which \$3.2 billion are dollar-denominated debts to foreign branches of Mexican banks falling due in 1985-90) were rescheduled, and the repayment period was lengthened from 8 years to 14 years, ending in 1998. Margins were set at 7/8 percent over LIBOR for 1985/86, 1 1/8 percent over LIBOR for 1987-91, and 1 1/4 percent for 1992-98. Under the arrangements requested by the Mexican authorities, the Fund will conduct semiannual Article IV consultations under the enhanced surveillance procedure. These staff reports will be made available by Mexico to creditor banks. Enhanced surveillance will continue through 1990 or 1994 (depending upon the date of final repayment of Mexico's 1983 new money package).

During the period of the arrangements, creditor banks party to the restructuring agreement can call an event of default if they determine that the implementation of Mexico's financial program is materially incompatible with the country's sound and sustained economic growth and with a viable external payments position consistent with a continuing ability to service external debt. An event of default could also occur if the consultation and reporting procedures were not carried out as described, or if the average level of certain foreign liabilities falls below a specified figure.

In addition, three years of the Mexican consolidation period (1985-87) have been "carved out" for a block rescheduling; there is specific provision for the possibility that creditor banks may discontinue the restructuring beyond that point if they decide that Mexico's policies are inadequate. ^{1/} In the event that Mexico's economic situation or prospects deteriorate, such that it would be unable to meet its financing requirements through normal market channels, it has covenanted to seek financing from other sources, which may include a request to use Fund resources.

In the case of Venezuela, the period of final repayment for maturities of \$21.2 billion due in 1983-88 was set at 12 1/2 years from the date of agreement in principle (September 1984), and the margin was set at 1 1/8 percent over LIBOR. The arrangements for monitoring Venezuela's economy closely parallel those adopted in the case of Mexico. However, Venezuela's initial adjustment effort was undertaken without a request to use Fund resources. Consequently, enhanced surveillance by the Fund commenced with the Executive Board's first review of Venezuela's policies during the midyear Article IV consultation on May 30, 1985. It is to extend through the amortization period of the debt restructuring (i.e., 1997).

The Venezuelan MYRA reschedules a complete block of maturities falling due during 1983-88. Thus, there is no specific provision for a date on which banks may vote to discontinue the restructuring. At any time, however, two thirds of the banks (weighted by exposure) could call an event of default if "in their reasonable judgment, the results of Venezuela's economic program are or will be materially incompatible with

^{1/} The rescheduling agreement provides that a majority of banks having more than 55 percent of the original commitments under the 1983 new money package is required to arrest the rescheduling, but that banks having 33 percent of the commitments may trigger a vote on this issue. On the one hand, the provision for a minimum initiating group of votes protects the debtor country from disruptive actions by individual creditor banks. At the same time, the reference to 33 percent of the commitments has been interpreted as an indication that the bank advisory committee (which held approximately one third of the votes) might continue to exercise some form of monitoring role.

a viable external payments position consistent with continuing debt service." In addition, should operating reserves of the Central Bank fall below \$2 billion, an event of default would occur.

For Ecuador, maturities were rescheduled of \$4.3 million due in 1985-89. For maturities not previously rescheduled final repayment was set for 1996, with a grace period of three years and an interest rate of 1 3/8 percent over LIBOR or floating domestic rate. Final repayment for previously rescheduled maturities was set for 1995, with a grace period of two years and an interest rate of 1 5/8 percent over LIBOR. The commercial banks' arrangements with Ecuador for monitoring its economy also are similar to those concluded with Mexico, although Ecuador is required to be under stand-by arrangements through both 1985 and 1986.

Enhanced surveillance of Ecuador would begin in 1987, and run for ten years to the final amortization payment of the restructured debt. After 1986, the restructuring is "serial," insofar as there is explicit provision for a majority of banks to arrest the restructuring in any year, if Ecuador's financial program is judged inadequate by the banks, or if its external situation or prospects deteriorate. This provision is in addition to the events of default, which could end the restructuring at any time if, based on the comments and conclusions expressed in the annual and mid-year consultation reports, the majority of lenders determine either that the implementation of Ecuador's economic and financial program is or would be materially incompatible with a viable external payments position consistent with a continuing ability to service external debt, or that there has been a deterioration in the economic position of Ecuador. An event of default could also occur if the consultation and reporting procedures were not implemented in the manner described.

With Jamaica an agreement in principle on a MYRA was reached in June 1985. Amortization payments of \$195 million falling due between April 1985 and March 1987 will be rescheduled with a grace period of 3 years, final repayment after 10 years, and a margin of 1 7/8 percent over LIBOR. The rescheduling covers all principal payments due during the Fund stand-by arrangement under consideration. Included among the conditions governing the restructuring are that "the IMF stand-by or other such arrangement covering the fiscal year shall have received IMF Board approval" and that "all disbursements scheduled to have been made at such date under the current IMF program shall have been drawn in full." Jamaica and the commercial banks also agreed to consolidate the maturities of April 1987 to March 1989 into a single loan, thereby setting up an administrative mechanism for a subsequent rescheduling.

For the Dominican Republic, maturities of \$707 million falling due in 1985-89 will be rescheduled. In the agreement in principle signed in May 1985, final repayment was set for 1997, with a grace period of three years and with an interest rate of 1 3/8 percent over LIBOR. The arrangements for monitoring the Dominican Republic's economy initially include the "1985 IMF stand-by agreement being in effect and all

drawings that could have been made under the said agreement having been made," and in subsequent years, an understanding that monitoring arrangements acceptable to banks would be in place. In addition, "failure to have arranged a medium- or long-term World Bank export-oriented sector loan or other similar World Bank financial assistance acceptable" to banks prior to 1988 could constitute an event of default.

In the case of Yugoslavia, the preliminary agreement with bank creditors covers restructuring of maturities of \$3.6 billion falling due in 1985-88, with repayment in equal installments over the seven years 1990-96, which implies a grace period of 3-5 years and a spread of 1 1/8 percent. The draft agreement is based in part on an understanding that the Fund would be asked to agree to undertake Article IV consultations from the expiration of the present stand-by arrangement in May 1986 until 1991. In addition to the monitoring of economic performance under enhanced surveillance, the authorities have agreed an objective indicator mechanism that would trigger discussions between themselves and their creditors. This is totally separate from and additional to the Article IV-type surveillance. Thus, it is understood that the triggers could go off although policies were on track and, conversely, that policies could be off track although none of the triggers had gone off. The major purpose of the trigger 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 the banks. The arrangements contemplated for Yugoslavia were discussed further in a note to the Executive Board on enhanced surveillance for Yugoslavia (EBS/85/171, 7/19/85).

Arrangements between debtor countries and creditors in the early cases of MYRAs thus provide for several different forms of monitoring by creditors. In general, creditors can arrest the restructuring process when they conclude that the implementation of a debtor's financial and economic program is insufficient. Clauses in the agreement indicate what would happen in the event that the country's economic situation deteriorates, or other events of concern to the banks. A key feature of each agreement is the provision governing whether, or to what degree, the restructuring is a "block" or a "serial" restructuring--that is, how strong a presumption is created that rescheduling of maturities falling due in the later years of the consolidation period will depend on satisfactory economic performance and policies.

Monitoring procedures, where enhanced surveillance rather than a Fund-supported program is in place, range from judgmental assessments of the sustainability of the debtor country's policies to the monitoring of certain variables in relation to agreed "trigger" values for these variables. In principle, the design of trigger mechanisms and the establishment of monitoring procedures is a matter of agreement between the debtor country and its creditors. The Fund staff will not negotiate, design or assess trigger mechanisms, so as not to dilute banks' responsibility in the monitoring process. But the Fund staff could provide technical assistance. The function of triggers would be to

initiate discussions between creditor banks and the debtor countries. However, triggers should not be seen as simple on/off switches for determining the appropriateness of continued restructuring or new lending. Creditors will need to be full and active participants in the process of monitoring and assessing the policies of debtor countries and the progress achieved in their implementation, and take full responsibility for their lending decisions.

2. Enhanced surveillance

The procedure of enhanced surveillance was developed to assist in the process of restoring normal market relations between bank creditors and debtor countries in connection with negotiation of a MYRA. In these circumstances, enhanced surveillance was seen as a way for the Fund to help in the process of normalization of market relations. The key objectives were to improve the 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.

Under enhanced surveillance, the annual Article IV consultation report will review and appraise the adequacy of a quantified financial program prepared by the country's authorities, commenting specifically on the internal consistency of its objectives and targets, and addressing their compatibility with sustained growth and the attainment of a viable external payments position. Interim consultations will address the progress achieved in implementing the financial program and evaluate the country's economic performance on the same basis as annual consultations. Both annual and mid-year reports will be transmitted to creditor banks by the member country. While the Fund staff will make an assessment of the country's program and review actual developments, the creditor banks will need to weigh that information, together with other available information, before arriving at a judgment about the economic performance of the country and before making their financing decisions.

The terminology and certain techniques of enhanced surveillance are closely akin to those of surveillance. The activities of the Fund under enhanced surveillance, however, extend beyond the normal implementation of its responsibilities under Article IV. Three separate elements together comprise enhanced surveillance: a quantified financial program prepared by the country's authorities, presenting a comprehensive description of the major macroeconomic objectives and the policies to be followed in their achievement; supplemental staff visits to the country concerned and supplemental staff reports and discussions of these reports by the Executive Board; and the release of staff reports by the member to banks.

Some of these elements of enhanced surveillance represent a further strengthening of improvements already introduced in the implementation of the Fund's traditional surveillance function. The release of staff reports to private creditors, however, is clearly exceptional. For this reason, enhanced surveillance has been conceived as an exceptional and temporary adaptation of Fund procedures and practices, in response to equally exceptional circumstances. Enhanced surveillance is not intended to become a substitute for stand-by and extended arrangements.

Experience gained in early cases of enhanced surveillance has allowed the identification of broad criteria to apply in deciding whether the Fund should accept requests for enhanced surveillance. A first criterion is that the initiative to request enhanced surveillance must rest with the member, which must be convinced that enhanced surveillance procedures are suited to its circumstances. A second criterion is that the member has already achieved a good record of adjustment. A third criterion is that it should support a MYRA that is needed to normalize a member's market relations and to facilitate a return to spontaneous financing. A fourth criterion is that the member must be in a position to present an adequate quantified policy program in the framework of consultations with the Fund staff, which are part of the procedure of enhanced surveillance. With respect to the length of the Fund's involvement, it has been concluded that, in the future, the Fund should try to limit the procedure to about the consolidation period of a MYRA or, at most, a little beyond the consolidation period.

It has also been decided that countries would be authorized to release these staff reports to their creditor banks not earlier than two weeks after their issuance. The reports to be released to creditor banks would reflect only the staff's views and would not contain any reference to the discussions and views of the Executive Board.

The procedures followed in the process of enhanced surveillance would thus involve, first, a request by a member for enhanced surveillance; and second, management assessment of the case in accordance with the policies agreed by the Executive Board, and determination whether to submit the request for the endorsement of the Board. In cases where the criteria raise delicate problems of interpretation, management would continue to consult informally with Executive Directors at the earliest opportunity.

In view of the need to assess changing circumstances and the possible effects of the procedures for enhanced surveillance on the Fund and its policies, the Executive Board will engage in a periodic review of the policy of enhanced surveillance, with an initial review to be held in about the fall of 1986.

The Institute of International Finance, Inc.

The Fund staff has had a number of discussions with the Institute of International Finance (IIF) concerning its activities over the past year. The membership of the IIF has increased to 196. While most members are commercial banks, a number of official export credit agencies have joined as associate members in the past year as have some multinational corporations. The IIF's member banks account for some 80 percent of global lending to developing countries.

A primary objective of the Institute is to improve the timeliness and quality of information on sovereign borrowers available to banks and other international lenders. During the past year, the IIF has expanded the database that it provides on-line to members. The database now includes approximately 150 series for more than 30 countries, and is being progressively expanded to cover a total of 40-50 developing countries which have significant outstanding borrowings from commercial banks. Information is provided on fiscal policy, domestic economic performance, and the external sector, including estimates of liabilities to main creditor groups.

The IIF has also prepared full reports on 33 countries. Staff have visited more than 20 countries, including Mexico, Argentina, Venezuela, Chile, Colombia, Ecuador, Peru, Korea, Indonesia, the Philippines, Malaysia, Egypt, Morocco, the Ivory Coast, Turkey, and Hungary. Informal visits have been paid to Greece and Nigeria. Missions are planned in the near future to Brazil and Poland as well as second visits to a number of other countries. Missions normally include both IIF staff and representatives of commercial banks.

In addition to its work on specific countries the IIF has undertaken a number of general, policy-oriented initiatives. The institutional focus of this work is the IIF's Working Party on the Future of International Lending, which comprises 50 participants. In 1984, the Working Party created four specialized committees. Committee No. 1 conducted an analysis of the restructuring process. Committee No. 2 considered legal and regulatory matters. Committee No. 3 dealt with technical issues, in particular the currency composition of lending. Committee No. 4 was responsible for institutional matters, and examined new initiatives in international lending by private banks and the public sector, as well as obstacles to development of long-term solutions to financing LDC development. The conclusions of the four committees' reports were made public in September 1984. Main conclusions included an endorsement of techniques designed to foster an early return to voluntary lending, multiyear reschedulings, provision of currency options, and exclusion of trade financing from reschedulings.

In the second half of 1984, the Working Party set up two study groups, both of which involve regulators, multilateral agencies officials, lawyers, and accountants as well as banks. The primary objective of the first study group, the Task Force on the Regulatory,

Accounting, and Tax Treatment of Cross-border Lending is to conduct a fact-finding study to clarify the implications of different national policies, procedures, and practices in the main creditor countries for cross-border lending. A main objective is to indicate potential actions to overcome some distortions and impediments to international bank lending resulting from such differences. Initially, the North American and European members of the Task Force met separately in Washington and London. A further meeting which will bring together accountants, bankers, and regulators from Europe, Japan, and North America has been scheduled for November 1985 in Washington. The second study group, the Study Group on Insurance and Guarantees, is addressing possible mechanisms to insure bank loans or portfolios and spread international risk. It has met several times in Washington and London.

In addition to the Working Party, the Institute has set up an Economic Advisory Committee, composed of the chief international economists of some 20 member banks, to advise the Institute on all aspects of its country economic work, as well as to provide a forum to discuss matters which go beyond the analysis of individual debtor countries, such as alternative scenarios for the world economy and their implications for the resolution of the debt problem. As part of the general services which the Institute provides for its members, the Institute regularly publishes two surveys: A "Survey of Debt Restructurings by Banks" and a "Survey of Official Reschedulings and Balance of Payments Support."

Prior to the Spring 1985 meetings of the IMF Interim Committee and the IBRD/IMF Development Committee, which focused on the debt problem, the IIF's Board met to approve a letter to the Chairman of the Interim Committee in which the Managing Director, Mr. de Lattre, highlighted some issues essential for a sound development of the banks' role in providing finance to developing countries. The letter was accompanied by a memorandum on factors affecting the future of international lending.

Domestic Savings, Foreign Savings, and Investment

This annex examines the relative sizes of domestic and foreign savings and their contributions to the financing of domestic investment during the period from 1967 to 1984. This comparison is undertaken for the groups of industrial countries and the capital-importing developing countries. In addition, the capital-importing developing countries are divided into the market borrowers, including the major borrowers, and official borrowers. Since consistent data on domestic savings, foreign savings, fiscal imbalances, and investment are not available for all countries over the period 1967-84, this analysis is based on a sample composed of 18 industrial countries and 50 developing countries. 1/

There are a number of insights concerning the international pattern of savings and investment flows which are evident in developments during 1967-84. First, while individual industrial countries have at times experienced large capital inflows or outflows, the capital account imbalances for the group as a whole have varied between surpluses or deficits equivalent to less than 1 percent of their combined incomes or 3 percent of domestic savings. However, during 1983-84, some industrial countries experienced relatively large current account deficits (e.g., the U.S. deficit equaled \$93 billion in 1984) and surpluses (e.g. Japan has a surplus of \$36 billion in 1984) which made these countries significant users of foreign savings or suppliers of domestic savings to the rest of the world.

Second, although the major developing country groups received foreign capital inflows throughout the period, the size of these inflows relative to domestic savings or GDP varied sharply over time and across groups. For the market borrowers and major borrowers, the average ratio of foreign capital inflows to GDP increased by nearly one half between 1967-72 and 1973-82, but then declined in 1984-84 to an average value below that of the late 1960s and early 1970s. As a result, foreign savings were equivalent to 8 percent of the groups' domestic savings in the late 1960s, over 12 percent in the late 1970s, and less than

1/ The note at the end of this annex describes the countries that are included from each country group. Additional discussions of the relationships between capital flows, domestic savings, and investment can be found in International Monetary Fund, World Economic Outlook, April 1985, (WEO), p. 63-67 and World Bank, World Development Report, 1985, p. 43-70. The country classifications employed in this annex are defined in the WEO. The market borrowers consist of those countries that obtained at least two thirds of their external borrowings between 1978 and 1982 from commercial creditors. The major borrowers are a subgroup of the market borrowers and are composed of the seven countries with the largest outstanding external indebtedness. Finally, official borrowers comprise those countries, excluding China and India, that obtained two thirds or more of their external borrowings between 1978 and 1982 from official creditors.

7 percent in 1983-84. In contrast, foreign savings represented an important component of total funds available to finance investment for official borrowers throughout the period since 1967. The ratio of capital inflows to GDP averaged over 6 percent during this period and these inflows equaled on average of nearly 51 percent of domestic savings.

Third, while the ratios of domestic saving to income have shown considerable variability during 1967-84 period, the industrial countries, market borrowers, and major borrowers showed little net change in their savings ratios over the entire period. In contrast, the ratio of domestic savings to GDP for official borrowers declined significantly.

Fourth, a significant part of the variation in domestic savings ratios has been associated with changes in the fiscal positions of central governments. For the market borrowers and major borrowers, this was in part evident in both the decline in domestic savings ratios as fiscal deficits grew during 1980-82 and the recovery of savings in 1983-84 as fiscal deficits declined.

Finally, the behavior of the ratios of investment to income have varied sharply across country groups. The investment ratios for the market borrowers and major borrowers first rose significantly between 1967 and 1975 but then by 1983 and 1984 declined to levels not very different from those prevailing in the late 1960s. In contrast, the investment ratios for the industrial countries and the official borrowers have been somewhat more stable.

1. Domestic and foreign savings

Since the late 1960s, foreign capital flows have often played an important role in financing investment and fiscal imbalances in both developed and developing countries. Naturally, the roles of foreign and domestic savings can be compared only if the two concepts are defined on a comparable basis. Since the usual measures of domestic savings--gross national or gross domestic savings--are broadly defined, net foreign savings (which could involve dissavings) must also be measured in a similar manner. A broad measure of a country's use of foreign savings is given by its current account deficit, which represents the real transfer of resources that is financed by the rest of the world's net accumulation of the country's liabilities. 1/ 2/

1/ The financing of such a deficit could involve a reduction in the country's assets as well as an increase in foreign liabilities. This measure of the use of foreign savings does not rule out the possibility that these funds may be used to acquire external assets in some future period. As will be discussed, the measure of the current account balance used in this paper is that on goods, services, and private transfers. An alternative definition would be to also include official transfers.

2/ Although the current account balance (continued on next page)

While total domestic savings is typically measured as gross domestic product (GDP) less the sum of private and public sector consumption, its behavior can often be most usefully examined in terms of the differences between private and public sector savings. There is, however, no consistent data on overall fiscal deficits for all countries over the period from 1967 to 1984. Even where fiscal data is available for this period, they generally represent the position of only the central government and do not incorporate the imbalances of local or provincial governments, or state enterprises. The scope of this problem varies from country to country and is often especially significant for countries with large state enterprise systems. Nevertheless, a rough division between domestic savings of the private and public sectors can be obtained by defining public sector use of total savings to equal the fiscal imbalance of the central governments.

a. Domestic savings

Although foreign savings often reached significant levels for many countries during the period between 1967 and 1984, domestic savings was the most important and stable source of financing for domestic investment for all country groups. Industrial countries had the most stable ratios of domestic savings to GDP during 1967-84; their ratio remained within the range of 20 to 24 percent during that period (Chart 1). ^{1/} This group's savings ratio declined from 24 percent in 1973 to 20 percent in 1982, before recovering somewhat during 1983 and 1984. As a result, the savings ratio for the industrial countries in 1984 was only about 1 percentage point below that prevailing in the late 1960s.

^{2/} (concluded) broader indicator of a country's use of foreign savings, it is not traditionally measured on the same national income basis as gross domestic savings or gross domestic investment. Studies of the relationships between savings, investment, and current account balances have therefore used a variety of methods to ensure consistency between the three concepts. One approach has been to treat gross savings as a residual obtained by adding gross domestic fixed investments, changes in inventories, and the current account balances (see A. Penati and M. Dooley, "Current Account Imbalances and Capital Formation in Industrial Countries, 1949-81," IMF Staff Papers, March 1984, p. 1-24). Alternatively, the current account balances have been calculated as a residual (see J. Sachs, "The Current Account and Macroeconomic Adjustment in the 1970s," Brookings Papers on Economic Activity, 1, 1981, p. 201-68). Gross domestic investment could also potentially be the residual component. In this annex, however, the actual data for all three concepts are represented in the charts.

^{1/} For a description of the countries included in each group, see the note at the end of this annex. The group savings ratio equals the savings ratio for individual countries weighted by the average U.S. dollar value of their respective GDPs over the preceding three years.

Savings ratios of capital-importing developing countries experienced more diverse behavior. The average ratio of domestic savings to GDP for the market borrowers and the major borrowers rose sharply during the 1970s and then declined significantly in the early 1980s. For the market borrowers, the domestic savings ratio rose from 22 percent in 1967 to approximately 26 percent during 1976-80 but then fell back to roughly 24 percent in 1983 and 1984. The major borrowers had a domestic savings ratio of 22 percent in the late 1960s that rose to approximately 25 percent by 1977 but declined to 23 percent in 1984. It is too early to tell whether these recent declines in the domestic savings ratios of the market borrowers and the major borrowers represent a new trend or merely a temporary downturn from the past upward trend.

These variations in domestic savings rates for the groups of market borrowers and major borrowers have at times been strongly influenced by changes in central government fiscal imbalances and thereby the level of public sector savings. As indicated in Chart 2, the fiscal deficits of the central governments of the market borrowers and major borrowers increased sharply relative to GDP between 1980 and 1982 reaching roughly 5 percent of GDP in 1982. During 1983 and 1984, however, net dis-saving by the central government declined to 3 percent of GDP for the market borrowers and 2 percent for the major borrowers.

The domestic savings ratio of the official borrowers deteriorated sharply between 1967 and 1984. Their domestic savings ratio was 16 percent of GDP in 1967, and it reached a peak of 19 percent in 1969. However, since 1969, the domestic savings ratio has declined nearly continuously, reaching a level between 9 and 10 percent in 1981. Since 1981, there has been little movement in the ratio. The deterioration in the domestic savings performance of these countries reflected both relatively large fiscal imbalances and adverse domestic and external developments which reduced private savings. Although the size of these fiscal deficits relative to GDP declined in the late 1970s, they still averaged nearly 5 1/2 percent of GDP in 1984. This lower level of domestic savings was to a considerable degree offset by larger foreign capital inflows (principally from official sources).

b. Foreign savings

The capital flows recorded by industrial countries have been considerably larger in volume than capital flows of developing countries. Nevertheless, the importance of foreign savings--as indicated by their size relative to GDP--generally has been much greater for developing countries than for industrial countries. In Chart 3, the ratio of the current account balance ^{1/} (with sign reversed) to GDP is used to measure the relative scale of foreign capital inflows. A positive value

^{1/} The current account balance is that on goods, services, and private transfers.

CHART 1
GROSS DOMESTIC SAVINGS, 1967-84

(As percentage of GDP)

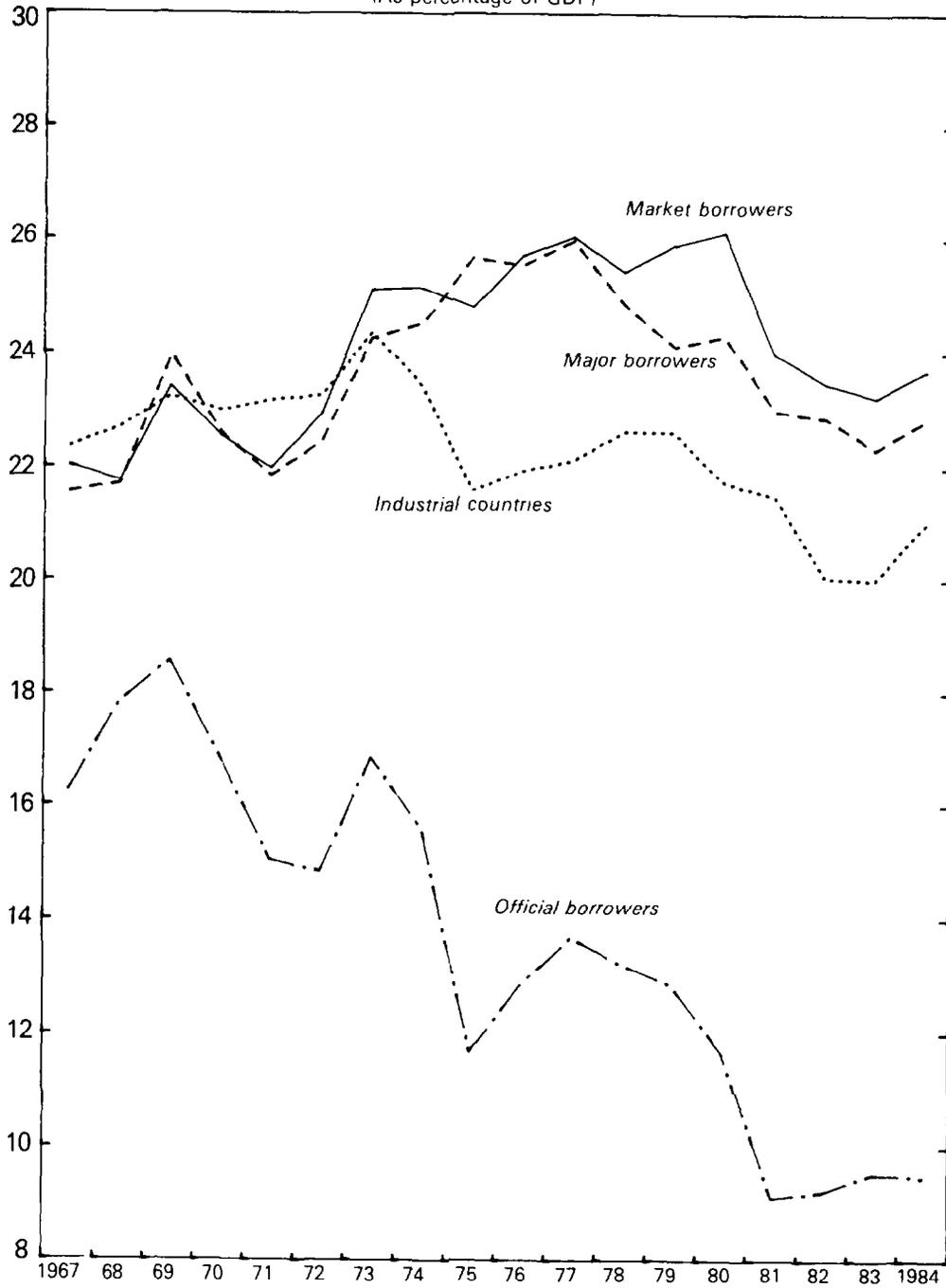
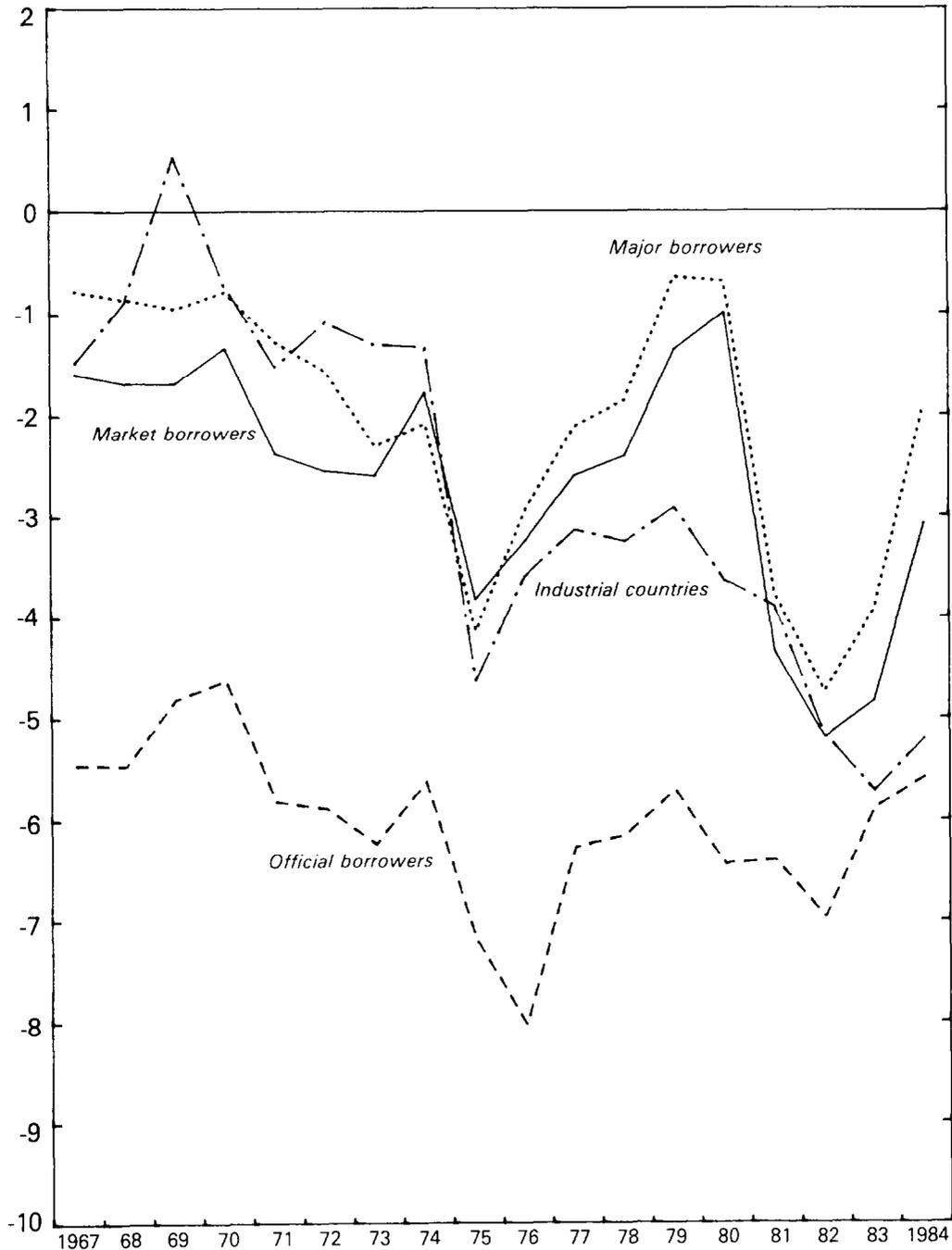




CHART 2 FISCAL IMBALANCES, 1967-84¹

(As percentage of GDP)

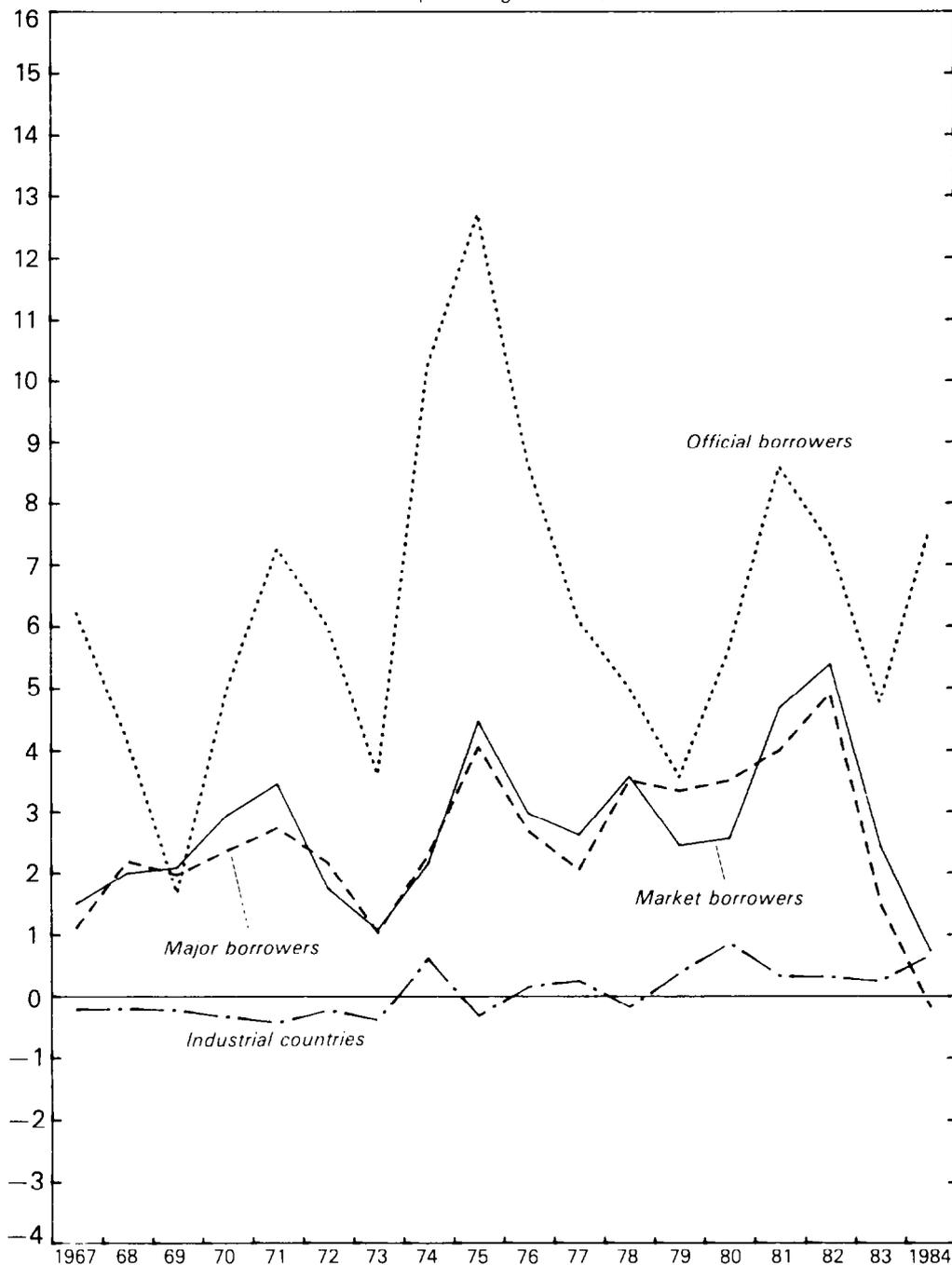


¹A deficit is indicated by a negative value



CHART 3
FOREIGN CAPITAL FLOWS, 1967-84¹

(As percentage of GDP)



¹ Foreign capital inflows are measured by the size of the current account deficit (with sign reversed). A larger positive value in this Chart implies a larger current account deficit and a larger capital inflow. The current account balance is that on goods, services, and private transfers.



of this ratio represents a net inflow of foreign savings; whereas a negative value represents a placement of domestic savings in foreign markets.

While the current account imbalances of the industrial countries have been at times quite large, the ratio of these imbalances to their income has generally been small. These flows (typically an outflow) represented less than 3 percent of this group's domestic savings and less than 1 percent of their combined incomes. Nonetheless, the combined current account imbalance of \$35 billion in 1984 has been exceeded only by that in 1980 (\$39 billion) in the period since 1973, and a distinction must be made between the positions of individual countries and the group as a whole. Some industrial countries have at times run relatively large current account deficits or surpluses (e.g., the U.S. deficit equaled \$93 billion in 1984; Japan had a surplus of \$36 billion in 1984) and were therefore significant users of foreign savings or suppliers of domestic savings to the rest of the world.

For developing countries, foreign savings have often represented a significant addition to domestic savings. The importance of these foreign inflows can be measured relative to both GDP and gross domestic savings. Net foreign capital inflows to the capital-importing developing countries amounted on average to nearly 3 percent of their GDP and 14 percent of domestic savings during the period 1967-84. Even in 1983 and 1984 when current account deficits declined sharply, foreign savings was equivalent to 11 percent of gross domestic savings. However, there was a considerable divergence between the experiences of different developing country groups. In the period 1967-82, the market borrowers had an average current account deficit of 3 percent of their combined GDPs. Viewed somewhat differently, foreign savings averaged nearly 13 percent of gross domestic savings during 1967-81 and amounted to nearly 23 percent in 1982. However, this capital inflow had fallen to less than 1 percent of GDP in 1984, and these flows added only the equivalent of 3 percent to available domestic savings.

The major borrowers' reliance on foreign savings averaged 3 percent of their GDP during 1967-81, but reached 5 percent of their combined GDPs in 1982. Reflecting the adjustment efforts of these countries and the limited availability of external capital, this group recorded a balanced current account position in 1984.

The official borrowers experienced relatively large foreign capital inflows throughout the period since 1967. In the late 1960s, foreign capital inflows represented approximately 4 percent of GDP. These inflows rose to 13 percent of GDP in 1975 and remained at nearly 7 percent of GDP during 1982 to 1984. Given the deterioration in this group's domestic savings ratio (Chart 1), official lending and transfers have played a vital role in maintaining investment. While foreign inflows had equaled 24 percent of domestic savings of the official borrowers in the late 1960s, this proportion reached 58 percent in the late 1970s and 71 percent in the 1980s.

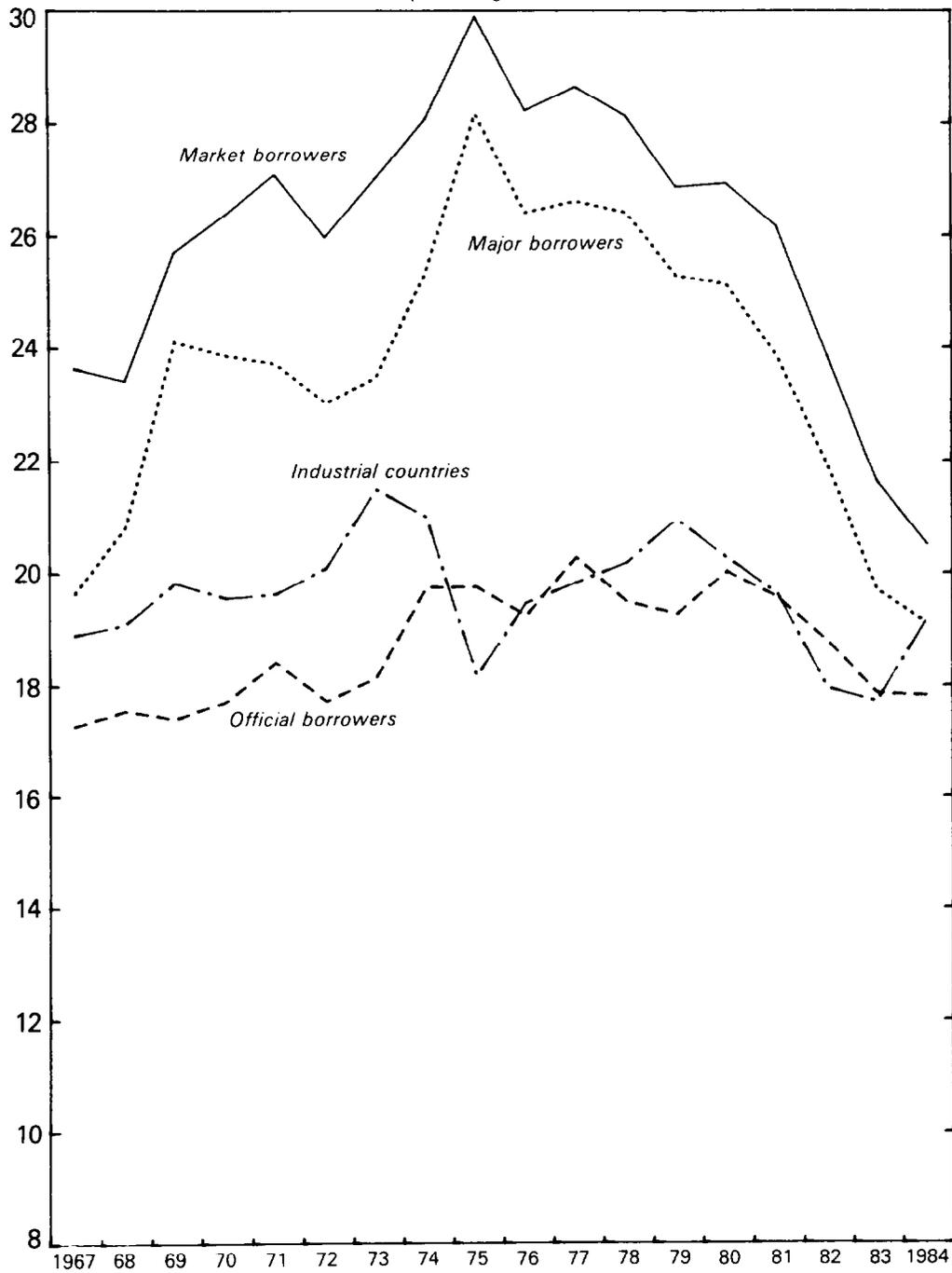
2. Investment

While the ratios of gross capital formation to GDP that prevailed in 1983 and 1984 were not very different from those evident in the late 1960s (Chart 4), there has been considerable diversity of experience both between the groups of industrial and developing countries and within the groups of developing countries during the 1970s and early 1980s. The evolution of the industrial countries' domestic savings and investment ratios has been quite similar, since the average net supply of savings to the rest of the world by industrial countries represented only a small proportion of their domestic savings or income. In contrast, the large reliance on foreign savings by developing countries during 1973-82 often allowed consumption and investment to expand simultaneously. When this occurred during certain periods in the 1970s, investment ratios rose more rapidly than savings ratios.

The behavior of the ratios of gross capital formation to GDP for different groups of developing countries in the period since 1967 are given in Chart 4. For the market borrowers and major borrowers, domestic investment ratio rose erratically from the late 1960s until the mid-1970s. This rise in the investment ratios was supported by an increase in both domestic savings ratios (Chart 1) and foreign savings ratios (Chart 3). During the late 1970s, in contrast, the investment ratios for these country groups began to decline, while domestic savings ratios stabilized or declined slightly. Associated with these developments was a fall in foreign capital inflows. Moreover, the decline in the investment ratio accelerated in the early 1980s as there were reductions in the flows of domestic savings and net foreign capital inflows relative to GDP. For the market borrowers, the investment ratio fell from 26 percent in 1981 to 21 percent in 1984; and, for the major borrowers, the ratio declined from 24 to 19 percent during the same period. As already discussed, this fall in the ratios of investment to GDP for the developing countries was cushioned to a degree by a recovery of domestic savings in 1984 which reflected reduced central government fiscal imbalances.

CHART 4
GROSS CAPITAL FORMATION, 1967-84

(As percentage of GDP)





Note to Annex III

The countries included in the major country groups of the World Economic Outlook are listed below, and those countries for which there is savings, investment, capital flows, and fiscal imbalance data for the period between 1967 and 1984 are denoted by an asterisk.

Industrial countries

Australia*	France*	Japan*	Sweden*
Austria*	Germany,*	Luxembourg	Switzerland*
Belgium*	Fed. Rep. of	Netherlands*	United Kingdom*
Canada*	Iceland	New Zealand*	United States*
Denmark*	Ireland*	Norway	
Finland*	Italy	Spain*	

Market Borrowers

Algeria*	Cyprus	Mexico*	South Africa*
Antigua and Barbuda	Ecuador	Nigeria*	Suriname
Argentina*	Gabon	Panama*	Trinidad and Tobago
Bahamas	Greece*	Papua New Guinea	Uruguay*
Bolivia*	Hong Kong	Paraguay	Venezuela*
Brazil*	Hungary*	Peru*	Yugoslavia*
Chile	Indonesia*	Philippines*	
Colombia*	Ivory Coast*	Portugal*	
Congo	Malaysia*	Singapore*	

Major Borrowers

Argentina*	Indonesia*	Mexico*	Venezuela*
Brazil*	Korea*	Philippines*	

Official Borrowers

Afghanistan	El Salvador*	Liberia	Sierra Leone
Bahrain	Equatorial Guinea	Madagascar	Somalia
Bangladesh	Guinea	Malawi	St. Lucia
Bhutan	Fiji*	Maldives	St. Vincent
Burkina Faso	Gambia, The	Mali	Sudan
Burma	Ghana	Malta*	Swaziland
Burundi*	Grenada	Mauritania	Syrian Arab Rep.
Cape Verde	Guatemala*	Nepal	Tanzania
Central African Rep.	Guinea-Bissau	Netherlands Antilles	Togo
Chad	Guyana	Nicaragua*	Uganda
Comoros	Honduras*	Pakistan*	Viet Nam
Djibouti	Jamaica*	Rwanda	Western Samoa
Dominica	Jordan	Sao Tome and Principe	Yemen Arab Rep.
Dominican Rep.	Lao People's Dem. Rep.	Senegal	Yemen, People's Dem. Rep. of
		Seychelles	Zaire*
			Zambia*

Measurement of International Banking Flows

The quantity and quality of statistics on international banking have improved substantially in recent years. In particular, the Fund introduced six new tables on international banking statistics (IBS) in the January 1984 issue of International Financial Statistics (IFS), the coverage of which was further expanded in early 1985. The IBS series are a source of comprehensive data on a country's gross liabilities to, and claims on, nonresident banks and on its banks' liabilities to, and claims on, nonresident nonbanks.

These series are also used in deriving measures of banking flows on which the discussion of international banking activity in this paper is largely based. However, flow data derived from stock data need to be interpreted cautiously since changes in banks' external positions do not necessarily measure transactions and since the quality of the stock data heavily depend on the accuracy, completeness, and currentness of information supplied by national authorities. Hence, this annex briefly reviews the coverage of the IBS series and other sources of international banking statistics used in this paper and discusses statistical issues affecting the measurement of international banking flows.

a. Coverage

IBS data are drawn in part from data on banks' external positions included in the regular money and banking returns of Fund members for publication in IFS and in part from confidential reports giving geographic analyses of the external accounts of deposit banks in a number of international banking centers. Information provided in the money and banking returns of Fund members is used to derive the series on cross-border interbank liabilities and claims, 1/ cross-border interbank credits to nonbanks by residence of lending bank, and cross-border bank deposits of nonbanks by residence of borrowing bank.

Detailed reports on the geographic distribution of the external assets and liabilities of deposit banks in 32 international banking centers are made available to the Fund. These reports, although individually highly confidential, are aggregated across reporting centers to produce the tables on cross-border bank credit to nonbanks by residence of borrower and cross-border bank deposits of nonbanks by residence of lender, except for the world totals, which are equal to the "all country" totals in the tables on cross-border bank credit to nonbanks by residence of lending bank and cross-border bank deposits of

1/ Exceptionally, interbank accounts of nonmembers of the Fund are derived from the geographic analysis of banks' external accounts supplied by reporting international banking centers.

nonbanks by residence of borrowing bank, respectively. ^{1/} International banking centers whose detailed geographic reports are currently used consist of nearly all industrial countries as well as the major offshore banking centers and some developing countries that play a major role in international banking.

The IBS series also provides an extensive data base for a comprehensive analysis of international bank lending and deposit-taking flows by country of residence. As these data are on a residency basis from the point of view of both the reporting and reported country, they are conceptually close to the balance of payments data on both monetary and nonmonetary capital movements. Data on bank lending and deposit-taking flows are derived from stock data detailed above. Separate estimates are generated for cross-border lending flows to banks, deposit-taking from banks, lending flows to nonbanks, and deposit-taking from nonbanks. Lending flows to banks are measured by changes in stock figures on the cross-border interbank accounts by residence of borrowing bank, and those to nonbanks by changes in the stock figures on international bank credits to nonbanks by residence of borrower. Deposit-taking flows from banks are measured by the changes in stock figures on the cross-border interbank accounts by residence of lending bank and those from nonbanks by the changes in stock figures on international bank deposits by nonbanks by residence of deposit. The changes in stock figures for individual countries are adjusted for changes attributable to exchange rate movements.

The other major source of international banking statistics is the Bank for International Settlements (BIS), which has long published quarterly data on the geographic distribution of the external accounts of banks in BIS reporting countries. The BIS recently enlarged its reporting area to take in the geographic distribution of the external accounts of banks in 25 countries, including nearly all the industrial countries and offshore banking centers. In addition to stock and flow figures, the BIS derives a measure of "net international bank credit" by excluding estimates of redepositing among reporting banks. The main

^{1/} Conceptually, at the world level, totals should be the same in each pair of tables since they represent opposite ends of the same transactions. However, banks in only 32 international banking centers report their positions with nonbanks in individual countries, compared with more than 100 countries reporting their positions with nonbanks as a whole in their monetary statistics. Differences between the world totals and the sum of the country (and area) components, in the tables derived mainly from the detailed geographic analysis, are shown under allocated items, which are expected to be reduced over time as the reports of an increasing number of international banking centers are made available to the Fund and the quality of these reports improves; the area residuals reflect the extent to which reporting banks identify positions by area but not by individual country, as well as all reporting banks' positions with countries not specifically listed.

explanations for differences between the Fund and BIS series are that, for data on the interbank market, the Fund uses information on the external positions of the banking systems of over 140 Fund members, whereas the BIS uses data derived from the geographic analysis mentioned above; that, for the data where it relies on the detailed geographic reports, the Fund has more international banking centers in its reporting system than the BIS; and that the Fund estimates the positions, with reported countries' nonbanks, of banks in centers not providing a bank/nonbank breakdown as a classification of the geographic distribution.

In addition, the BIS publishes semiannual data entitled "The Maturity Distribution of International Bank Credits." These series have been compiled on a consolidated basis since the end of 1984. ^{1/} Hence, for banks with head offices in the reporting area, coverage extends to the activities of their affiliates located outside the reporting area, and the data include not only the cross-border claims for such affiliates, but also their local lending in non-local currency. The main value of this report is to provide information on the maturity distribution of the reporting banks' external positions and on undisbursed commitments to individual countries. Also, these data permit comparison of banks' consolidated claims published by some countries to total claims by the reporting group, although changes in the coverage of the data make comparison over time difficult.

Recently, the BIS published data on banks' nationality of ownership. The new reports encompass the international activities of bank offices in 14 countries plus the cross-border operations of the branches of U.S. banks in some offshore banking centers. These data allow an analysis of changes in the positions of banks in each of these countries with their own related offices abroad, with other banks, and with nonbanks, but do not provide a geographic analysis. The data are not adjusted for exchange rate changes.

b. Measurement issues

This section discusses measurement issues arising first from the derivation of international banking flows from the IBS series, and second from the accuracy of the reports the Fund receives.

(1) Exchange rate adjustment

Figures on international bank lending to, and deposit-taking from, banks and nonbanks in individual countries are calculated by taking changes in the IBS series adjusted for variations in exchange rates. The adjustment of the stock figures is necessary because, in an

^{1/} Bank claims captured in these reports are smaller than those in the BIS quarterly reports because a smaller number of countries provides information for the semiannual reports. The reports do not provide information on liabilities or positions with banks and nonbanks.

environment of floating exchange rates, some of the changes in the external positions of banks result from the variations in exchange rates used to convert external positions denominated in several currencies into U.S. dollars. The adjustment process is based on the overall currency composition of the external positions of banks in 18 major international banking centers in relation to banks and nonbanks in individual countries. ^{1/} This currency distribution is assumed to represent the currency distribution of the external positions of banks and nonbanks in the reported countries with all nonresident banks. The flow data are calculated as follows: external positions, reported to the Fund in U.S. dollars, are converted back into their original currencies using the currency distribution and exchange rates prevailing on the dates to which the reports refer; then, the changes in these positions are calculated and converted back into U.S. dollars using period average exchange rates; finally, the flow figures are obtained by aggregating changes (expressed in U.S. dollar terms) across currencies of denomination. ^{2/}

Flow figures derived from stock data must be interpreted carefully. The assumptions made in estimating flows from stocks (particularly with regard to the currency composition of stocks) are approximations. In addition, banks' external positions can vary due to reclassification of some items, rather than on account of transactions between debtor and creditor. For instance, creditor banks may reduce their reported external claims when they make provisions or write-offs on international loans. The same can be said when banks sell their claims to nonbank investors or transfer some of their claims to guaranteeing agencies for value. Also, renegotiation and rescheduling of external debt can give rise to variations in banks' external positions, which are difficult to interpret, when combined with other transactions.

(2) Accuracy of reports

A second set of measurement issues is related to the accuracy of the reports the Fund utilizes in compiling the IBS series. The accuracy of the reports is especially important because the IBS series are compiled using two main sources of data. Hence, inaccurate reports can result in overestimation or underestimation when two series are combined. Also, the comprehensiveness of the reports has become an increasingly important issue because the greatly expanded range of financing techniques available markets is unevenly captured in existing statistical collection system.

^{1/} The Fund receives these figures from the BIS.

^{2/} The BIS uses the end-of-period exchange rates to adjust the stock data, in effect assuming that changes in deposit banks' positions occur at the end of each period. In contrast, the Balance of Payments Manual assumes that such changes are evenly distributed over the period.

To analyze international bank lending to individual countries, the IBS series on interbank accounts by residence of borrower is combined with the series on international bank credit to nonbanks by residence of borrower. The first series is derived from the interbank positions reported in the monetary statistics that countries report to the Fund while the second series is calculated from the reports of major banking centers on the positions of their banks with banks and nonbanks in individual countries. Obviously, any misclassification between banks and nonbanks either in the monetary statistics or in the reports of major banking centers can result in either overestimation or underestimation.

Misclassification may occur either because the data are improperly reported or because the staff makes its own estimates when a bank/non-bank breakdown is not available in either the monetary statistics or the reports of some international banking centers. In the past few years, some misclassifications have resulted following negotiated debt reorganization that have involved the assumption by the country's banking system (generally the central bank) of the external debt of nonbanks. In that case, the monetary statistics will generally report an increase in the external liabilities of the banking system to international banks; but this will not always be matched by a reduction in the claims on nonbanks reported by international banking centers.

Overestimation of bank lending may also occur due to the practice of recording payments arrears as part of the external liabilities of the monetary authorities. If these arrears are related to the external debt of nonbanks, it is likely they will be accounted twice in the IBS series since international banks will also report them in their claims on nonbanks, to the extent that they consider the nonbanks to remain the legal obligers. To help remove double counting, interbank positions reported by major international banking centers with individual countries are compared interbank positions reported in the monetary statistics of these individual countries.

The comprehensiveness of international banking statistics is also affected by the increasing use of securities to meet international financial needs, as discussed earlier in this paper. The proliferation of these financing techniques has caused statistical problems. First, the recording of banks' investment portfolios and banks' issuances of securities differs among banking centers. In general, holdings and issuances of external securities by banks are properly recorded in the monetary statistics (with a few major exceptions) and, hence, in the four IBS tables derived from these data. However, securities are not systematically reported in the geographic analysis of the external positions of banks in 32 international banking centers. To the extent that such instruments represent positions with nonbanks, and that they are reported in the monetary statistics, they will be reported as unallocated items in the two IBS tables derived from the reports of major banking centers. Second, the underwriting of instruments recorded

off the banks' balance sheet, such as NIFs, is not reported in the external positions of banks and, hence, IBS do not record the amount of international financing supported by banks' medium-term commitments.

Data used in the international capital markets staff report and background paper incorporate adjustments made to the IBS series to correct for some of the above-mentioned measurement issues. The general methodology to adjust the IBS series was to check area department estimates closely against the IBS and BIS data for all developing countries where there were significant differences between the IBS and BIS data in terms of either stocks or flows in 1983 and/or 1984; area departments in some instances consulted with national authorities in an effort to assist in this exercise. Revisions to estimated lending flows to 12 developing countries resulted in a downward adjustment of total cross-border lending to these countries of approximately \$10 billion in 1983 and \$1 1/2 billion in 1984.

Technical Note on Interest Rate and Currency Swaps

1. Interest rate swap

The typical interest rate swap is designed to arbitrage the different abilities of two borrowers (counterparties) to access the fixed and floating interest rate markets. One counterparty generally has access to floating interest rate bank debt at relatively attractive rates but wants instead to secure fixed interest rate funds. The other counterparty has good access to the fixed interest rate markets but would prefer to have floating interest rate debt.

For example, let the counterparty issuing fixed interest rate debt be an AAA-rated corporation; while the counterparty supplying floating interest rate debt will be an A-rated corporation (Figure 1). Assume that the AAA corporation could issue a fixed interest rate bond carrying a 12 percent yield, whereas the A corporation would have to pay 14 percent (an interest rate differential of 2 percent). In contrast, the AAA corporation could borrow in the floating interest rate market at LIBOR plus 1/4 percent, whereas the A corporation could obtain a loan at LIBOR plus 1/2 percent (an interest rate differential of minus 1/4 percent). The combined interest rate differential ($2 \text{ minus } 1/4 = 1 \text{ } 3/4$ percent) represents the potential arbitrage gain that the corporations could share through a swap of obligations. The A corporation would be interested in undertaking a swap if it can obtain fixed interest rate funding at less than 14 percent, whereas the AAA corporation would engage in the swap only if it obtains floating interest rate funds at less than LIBOR plus 1/4 percent.

Exactly how the differential is shared between the two corporations is determined by negotiations. One possibility would be for the swap to be arranged so that the A corporation obtains fixed interest rate funds at 13 1/4 percent, whereas the AAA corporation would obtain floating rate funding at LIBOR minus 3/4 percent. The cumulative benefit for both counterparts equal the initial 1 3/4 percent interest rate differential. To achieve this situation, the A corporation would agree to service not only the 12 percent cost of the AAA corporation's fixed interest rate debt but also to pay 1 1/4 percent towards the cost of servicing the LIBOR plus 1/2 percent floating interest rate debt that it had raised.

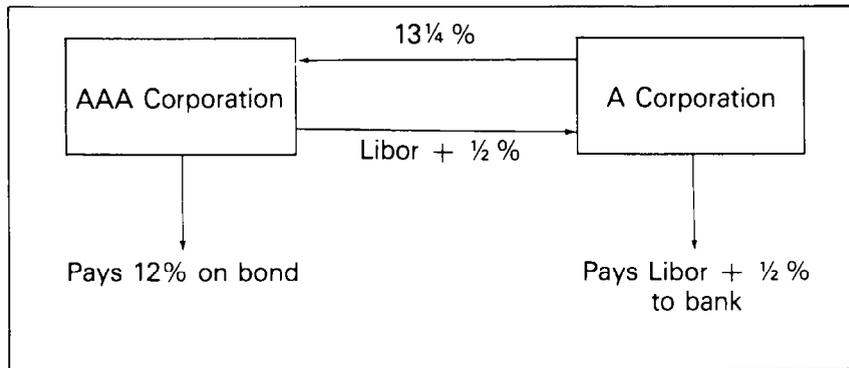
2. Currency swaps

A typical currency swap is illustrated in Figure 2. In this situation, Company 1 has an outstanding deutsche mark bond which it is willing to swap into an equivalent U.S. dollar liability. Assume Company 2 plans to issue new fixed interest rate U.S. dollar bonds (a market in which it has access to credit at relatively good terms) and to swap the proceeds into deutsche marks (a market where it does not have very good access to credit at a relatively attractive cost). Initially,

FIGURE 1

INTEREST RATE SWAP

	AAA Corporation	A Corporation	Interest Rate Differential
Floating Interest Rate	Libor + ¼ %	Libor + ½ %	¼ %
Fixed Interest Rate	12%	14%	2%
			1¾ %



	AAA Corporation	A Corporation
Fixed rate outflow	12%	13¼ %
Fixed rate inflow	(13¼ %)	—
Floating rate outflow	Libor + ½ %	Libor + ½ %
Floating rate inflow	—	(Libor + ½ %)
Net cost	Libor - ¾ %	13¼ %
Alternative cost	Libor + ¼ %	14%
Saving	1%	¾ %

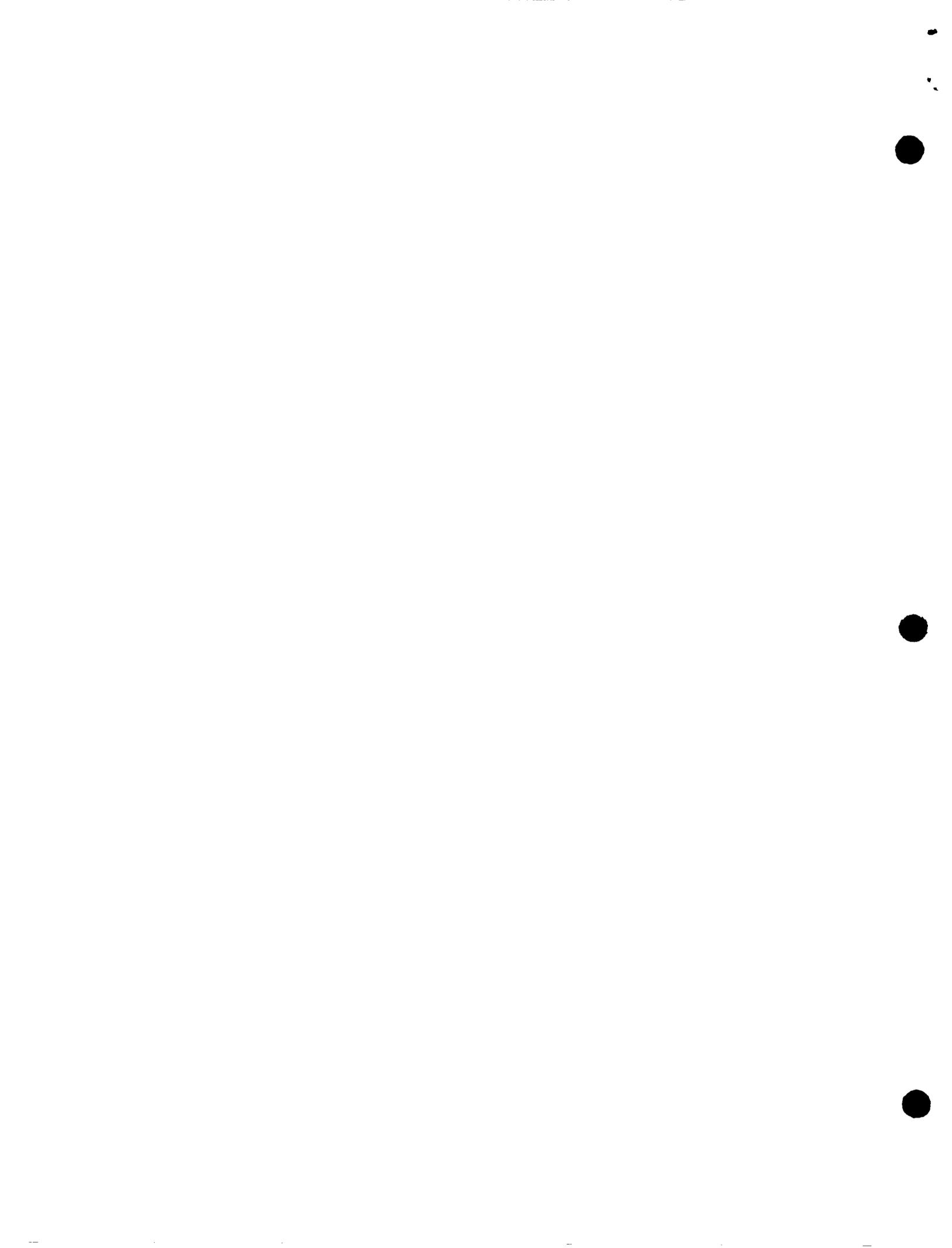
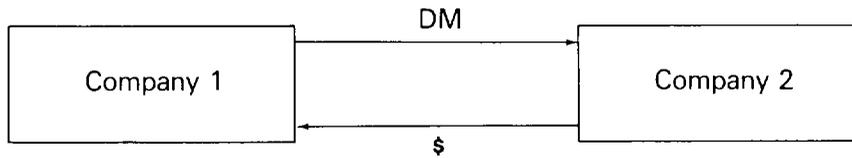
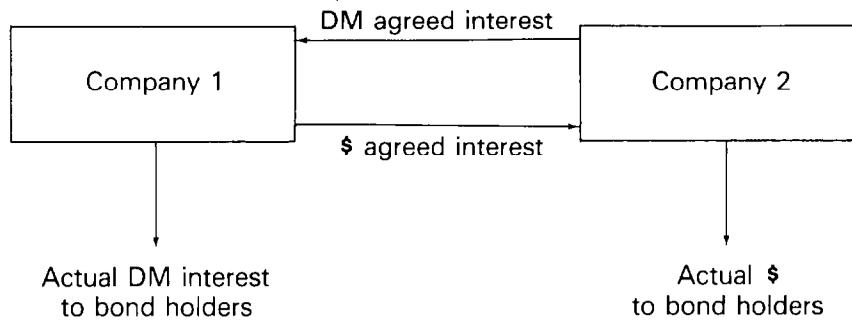


FIGURE 2
CURRENCY SWAP

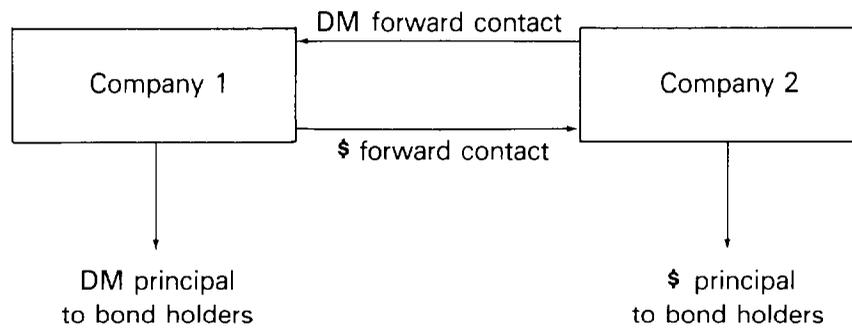
Initial transaction

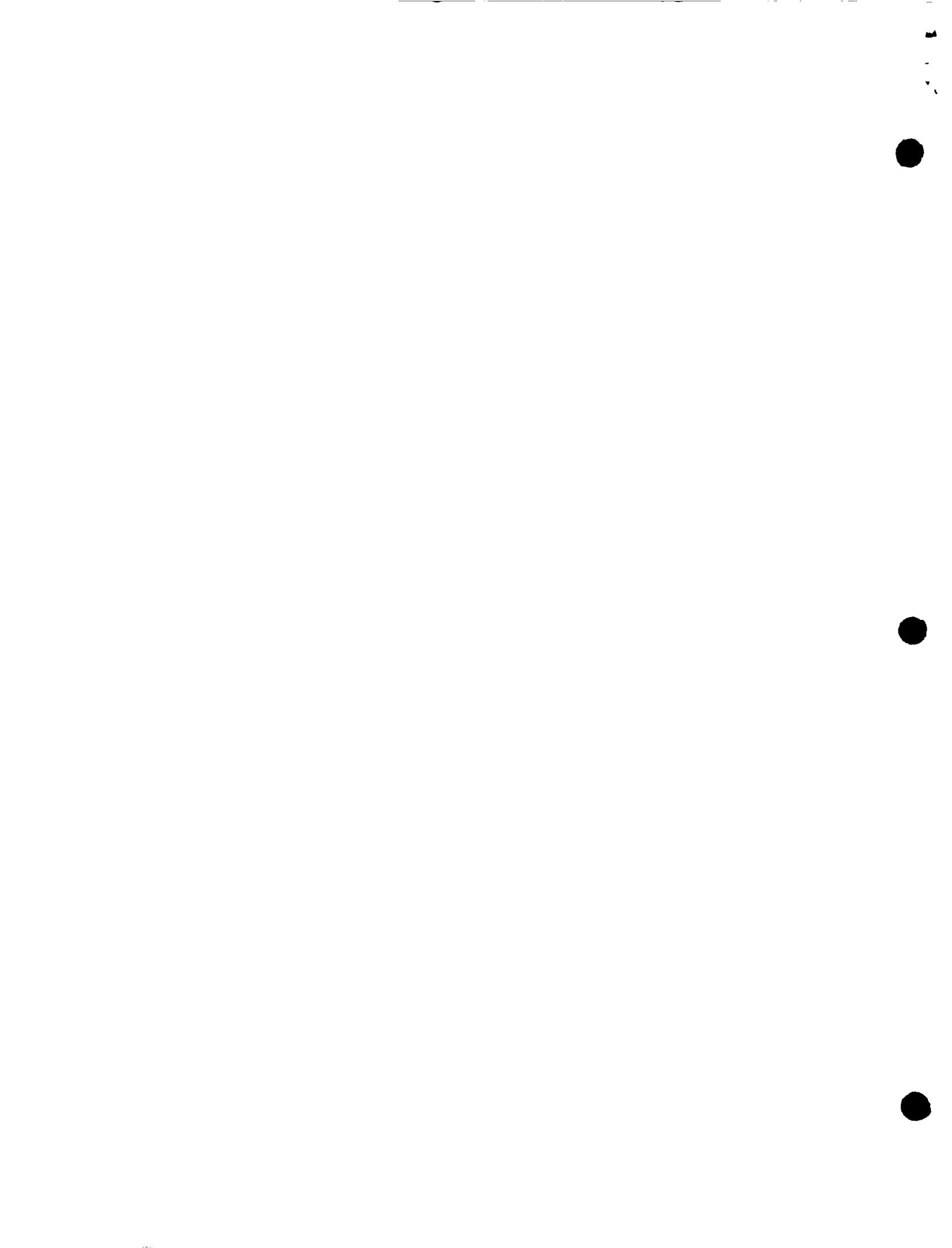


Agreed annual interest payment



Transaction at final maturity





Company 1 would sell deutsche marks to Company 2 in exchange for U.S. dollars. Over the life of the swap arrangement, the two companies would then agree to provide the amounts of U.S. dollars or deutsche marks needed to service the other party's servicing payments. At the end of the swap period, the two companies would reverse the initial transaction at a pre-arranged exchange rate.