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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 85/165

10:00 a.m., November 13, 1985

J. de Larosière, Chairman
R. D. Erb, Deputy Managing Director

Executive Directors	Alternate Executive Directors
	Mawakani Samba
C. H. Dallara	
J. de Groote	
	S. de Forges
M. Finaish	
H. Fujino	M. Sugita
G. Grosche	B. Goos
	Jaafar A.
A. Kafka	
T. P. Lankester	M. Foot
H. Lundstrom	
M. Massé	
	A. Abdallah
F. L. Nebbia	B. Jensen
Y. A. Nimatallah	J. E. Suraisry
	G. Ortiz
J. J. Polak	J. de Beaufort Wijnholds
C. R. Rye	
G. Salehkhou	O. Kabbaj
A. K. Sengupta	A. S. Jayawardena
S. Zecchini	N. Coumbis
	Jiang H.

L. Van Houtven, Secretary
K. S. Friedman, Assistant

<u>Also Present</u>

IBRD: D. Bock, Director, Financial Policy and Analysis Department. African Department: R. J. Bhatia, Deputy Director. European Department: A. G. G. Bennett, P. Dhonte. Exchange and Trade Relations Department: C. D. Finch, Director; E. H. Brau, B. de Schaetzen, R. B. Johnston, G. R. Kincaid, E. R. J. Kalter, K. P. Regling, C. M. Watson. External Relations Department: R. M. Stough. Legal Department: F. P. Gianviti, Director Designate; W. E. Holder. Research Department: A. D. Crockett, Deputy Director; R. R. Rhomberg, Deputy Director; M. C. Deppler, A. Lanyi, D. J. Mathieson, M. C. Williamson. Secretary's Department: J. W. Lang, Jr., Deputy Secretary; A. P. Bhagwat. Treasurer's Department: Y. Kawakami, O. Roncesvalles. Western Hemisphere Department: E. Wiesner, Director. Bureau of Statistics: W. Dannemann, Director; J. B. McLenaghan, C. Briançon. H. Flinch. Personal Assistant to the Managing Director: R. M. G. Brown. Advisors to Executive Directors: L. P. Ebrill, S. Ganjarerndee, S. M. Hassan, J. Hospedales, G. Nguyen, G. W. K. Pickering, M. Z. M. Qureshi, A. Steinberg, E. M. Taha, D. C. Templeman, A. Vasudevan, M. A. Weitz. Assistants to Executive Directors: A. Bertuch-Samuels, M. B. Chatah, J. de la Herrán, G. Ercel, S. Geadah, V. Govindarajan, L. Hubloue, Z. b. Ismail, J. M. Jones, M. Lundsager, J. K. Orleans-Lindsay, M. Rasyid, J. Reddy, J. E. Rodríguez, M. Sarenac, S. Simonsen, A. J. Tregilgas, H. van der Burg, E. L. Walker, B. D. White, Yang W.

1. INTERNATIONAL CAPITAL MARKETS - DEVELOPMENTS AND PROSPECTS, 1985

The Executive Directors considered staff papers entitled International Capital Markets - Developments and Prospects, 1985 (SM/85/267, 9/27/85; Cor. 1, 10/2/85; Cor. 2, 10/10/85; and Sup. 1, 11/1/85) and International Capital Markets - Recent Developments, 1985 (SM/85/280, 10/17/85; and Sup. 1, 10/18/85). They also had before them as background information a staff paper on international banking activity in the first half of 1985 (SM/85/294, 11/4/85; and Cor. 1, 11/8/85).

Mr. Erb said that he had attended a meeting of the Committee of Advisory Banks in New York on November 8, 1985 to hold a preliminary discussion of the debt initiative proposed by U.S. Treasury Secretary Baker. That committee consisted of representatives of the major banks that had either a chairmanship position or vice-chairmanship position on the various committees of commercial banks involved in individual countries. The representatives at the meeting of the World Bank and the Inter-American Development Bank and he himself had told the Committee that Secretary Baker's initiative was a positive one that recognized that in a number of debtor countries the adjustments designed to restore normal market relationships had not yet been completed; that process was taking longer than had been expected, and a number of countries facing serious debt problems would continue to need to benefit from concerted action.

During the meeting he had stressed that a positive aspect of Secretary Baker's initiative was its involvement of all the parties concerned, the Deputy Managing Director continued. Under the initiative, member countries, commercial banks, and official agencies were to cooperate for their mutual self-interest. He had also stressed that the U.S. strategy would be applied on a case-by-case basis in an evolutionary manner, building on the experience and cooperation over the previous three years; it was not a revolutionary strategy, but one designed to strengthen the approach that had been in use for several years.

He had mentioned that the list of 15 countries eligible for commercial bank loans under Secretary Baker's initiative was in the view of the Fund staff and management illustrative in nature, the Deputy Managing Director said. In addition, the $20 billion in commercial bank lending mentioned by Secretary Baker was meant to be an indication of the potential scale of financial commitments that might be involved. The list of 15 countries was not an exhaustive one; it did not include some countries that faced serious debt problems and would require concerted assistance by commercial banks and official institutions. The countries that were not on the list could be dealt with in the framework of Secretary Baker's debt strategy. Moreover, some of the countries on the list were approaching the stage at which they would probably be in a position to restore normal creditor relations with commercial banks and might not need concerted lending. The list of 15 countries and the figure of $20 billion provided an indication of the members that might need assistance and the order of magnitude of possible assistance but did not imply either an entitlement to or a limit on the assistance. The amount of assistance that would be needed in individual cases would be determined on the basis of the analysis of individual countries' economic policies, economic prospects, and external debt position; the amount would not be based on any particular arbitrary target for an increase in the banks' exposure in a country.

He had also indicated that considerable progress had been made in recent years in strengthening the collaboration between the Fund and the World Bank in the areas of economic analysis and policy advice, the Deputy Managing Director commented. Past examples of cooperation--such as the financing packages for Chile and Colombia--could be built upon in the future.

The commercial bank representatives at the meeting in New York had expressed great interest in the extent to which new commercial bank lending under the Baker initiative would be subject to some form of World Bank guarantee, the Deputy Managing Director remarked. He had said that it was his understanding that the new commercial bank lending would be made entirely at the banks' own risk; the banks could not expect to be given direct or indirect guarantees by the World Bank for the amounts implicit in the $20 billion figure. The banks would need to assess their financing commitments in light of both their own interests and the economic prospects of the countries to which they would be lending.

The commercial banks involved were in the process of considering their possible commitment under Secretary Baker's strategy, the Deputy Managing Director commented. The Committee of Advisory Banks represented a narrow--although important--group of commercial banks. There was still some question of how to broaden the discussion on the U.S. initiative among all the commercial banks involved in order to attain a broad-based commitment by the banks. Discussions on the initiative would probably take place in a variety of forums, but the Committee of Advisory Banks would probably play an important role in the commercial banks' efforts to reach a consensus on their general commitment to the U.S. strategy.

Mr. Dallara said that he welcomed the compilation of data on and the analysis of developments concerning international capital markets. Members should continue their efforts to facilitate the Fund's work in collecting and publishing timely data. Having the best possible information available was critical in the current international financial environment.

In considering Secretary Baker's debt initiative, Executive Directors should bear in mind the significant progress that had been made in dealing with the international debt problem over the previous several years, Mr. Dallara went on. The present occasion was not the one on which to examine that progress in detail, but it was useful to note that positive developments in capital markets had occurred, including rescheduling in general and multiyear rescheduling in particular, involving large amounts and more favorable interest rate spreads. At the same time, certain difficulties had clearly emerged, especially the shortfall in the commercial bank lending that was needed for the successful implementation of the debt strategy. Secretary Baker had stressed that the shortfall was one of the reasons why the debt strategy required strengthening. There was also a need for developing countries to implement comprehensive, growth-oriented economic programs.

In his address to the 1985 Annual Meetings Secretary Baker had stressed that the strategy to achieve sustained economic growth would involve three key elements, Mr. Dallara continued. First and foremost, the principal debtor countries must adopt comprehensive macroeconomic and structural policies supported by the international financial institutions and designed to promote growth and balance of payments adjustment while reducing the rate of inflation. Second, the Fund would continue to play a central role and the multilateral development banks would play an increased and more effective role in structural adjustment lending, all with a view to supporting the adoption by principal debtor countries of market-oriented policies designed to promote economic growth. Third, commercial banks should increase their lending in support of comprehensive economic adjustment programs. The staff had noted the recent reluctance of commercial banks to increase their exposure in developing countries partly because of the banks' concern about the adequacy of economic adjustment efforts of some capital-importing developing countries. In Seoul, Secretary Baker had stressed the important role to be played in the debt strategy by the mobilization of additional commercial bank financing. A reinforced effort by debtor countries to make needed macroeconomic adjustments and structural and institutional reforms was a necessary condition for an increase in lending to those countries by commercial banks and official institutions.

Commenting on recent developments in, and the prospects for, capital markets, Mr. Dallara said that individual commercial banks understandably might wish to reduce their exposure--or at least to slow the rate of increase of their exposure--in developing countries, particularly where there had been slippages in adjustment efforts. Those banks understandably might wish to take steps that would in their view strengthen their financial position. However, such efforts by the banking system as a whole--as had recently been evident--adversely affected the banking community at large by weakening borrowers' ability to adopt the policies that could improve their creditworthiness and increase the quality of commercial bank portfolios. Additional lending by the banking community in support of comprehensive adjustment programs in developing countries was consistent with the banks' basic objective of strengthening their financial position and improving the quality of their assets. Additional commercial bank lending in support of adjustment programs that could improve the quality of the banks' existing assets was clearly in the best interest of the banks themselves.

The figure of $20 billion and the list of 15 members were not meant to be exclusive, Mr. Dallara commented. It had been made clear during the 1985 Annual Meetings that the U.S. authorities believed that countries that were receiving adequate financing from commercial banks on a voluntary basis should continue to receive such assistance, provided that those countries maintained sound policies. Moreover, the commercial banks would need to lend to other developing countries with debt service and balance of payments difficulties. The continued support of the banking community would play a crucial role in encouraging those countries to adopt the kind of broad adjustment program needed to solve the problems facing their economies.

His authorities had been in contact with the banking community in order to move Secretary Baker's debt initiative forward, Mr. Dallara continued. In those discussions his authorities had made it clear that they favored the broadest possible participation by U.S. banks, but that it would be up to the entire banking community--including non-U.S. banks--to devise the exact procedures that they deemed most appropriate and effective for making and following through on the banks' financing commitment to Secretary Baker's initiative. Non-U.S. banks obviously would have to be closely involved in the initiative; after all, those banks held nearly two thirds of the outstanding credit of the group of countries that were associated with the $20 billion in commercial bank lending indicated by Secretary Baker. His authorities considered that the banking community's initial reaction to Secretary Baker's initiative was generally positive, although questions had naturally arisen and some time would invariably be required for detailed procedures to be formulated and final commitments to be made. Steady and immediate progress in moving Secretary Baker's initiative forward should be made. Progress on all the various aspects of the initiative must be made at the same time. If debtor countries were to implement the needed wide-ranging policies, the commercial banking community must indicate its willingness to support those policies.

His authorities saw the need for and the possibility of an increased role for the multilateral development banks--particularly the World Bank--in tandem with additional lending by commercial banks, under Secretary Baker's initiative, Mr. Dallara commented. The development banks could increase their financial support and provide more policy advice than hitherto, especially in the areas of structural and institutional reform. The increased financial assistance could take the form of cofinancing with commercial banks as well as nonproject financing related to structural reform. The Fund would have a central role to play in catalyzing the additional financing that would be needed and especially by continuing to provide sound policy advice and its own financial support to encourage further economic policy action as needed in debtor countries. Accordingly, the Fund would not only support sound macroeconomic policies in members, it, like the World Bank and other institutions, would also place additional emphasis on needed structural reforms.

The staff's discussion on the linkage between financial liberalization and innovation, and the appropriate role of national banking supervisory authorities was interesting, Mr. Dallara said. The U.S. Government had been in the forefront of efforts to achieve greater liberalization and internationalization of the global financial system. He recognized that such efforts could complicate the lives of supervisory authorities in many countries, including those in the United States, but the benefits of liberalization and innovation clearly outweighed the costs. The staff had correctly stressed the importance of flexibility in banking supervision of international lending, taking into account the need to preserve the overall soundness of the international financial system. At the same time, bank supervisors obviously had an important responsibility for protecting the soundness of national banking systems, and a careful balance must be struck between the objective of promoting flexibility in international lending and the need to maintain the soundness of national banking systems. Regulators had already shown some flexibility in their efforts to strike the proper balance between those goals, and a continuation of that pragmatic supervisory approach was needed if the desired revival in commercial bank lending in support of economic programs were to take place.

Implementing Secretary Baker's debt initiative would require the participation of all the parties concerned, including creditor countries, debtor countries, international institutions, and the entire international financial community, Mr. Dallara concluded. He looked forward to moving ahead with that effort to strengthen the international debt strategy.

Mr. Polak remarked that the time spent by Executive Directors in assessing individual economies and the World Economic Outlook was usually concentrated on the balance of payments and especially on the goods and services component of that balance. It was therefore particularly helpful to have the staff survey each year the capital side of the international payments picture, especially as it had become increasingly clear in recent years that capital flows were not merely passive financing items of the flows of goods and services; indeed, capital flows played a major role in determining the size and direction of the flows of goods and services. The staff paper before the Executive Board cast light on the ever-changing structure of financial flows. In addition, it provided highly instructive information on the financial institutions and on the financial markets that produced the capital flows--and occasionally did not produce the flows--on which the hopes for the international financial system had been based.

The staff's discussion of liberalization and innovation in international financial markets contained some important insights as well as some carefully worded warnings, Mr. Polak noted. The commercial banks had displayed great ingenuity in devising innovative operational techniques that could contribute to the deepening of markets and to providing useful additional hedging possibilities. However, the staff had correctly noted that most of the innovations were essentially instruments designed to redistribute risk. It was not always clear to the staff whether the process of risk assessment by the parties concerned had been sufficiently developed, and supervisory authorities had recently issued statements urging caution with respect to innovations. The staff also was correctly concerned about the growing role of off-balance sheet transactions, and a movement toward better reporting of such transactions seemed to be under way. There was also some risk of overestimating the liquidity of some of the new instruments, including floating interest rate notes, which had become a major element in international capital markets. Supervisory and monetary authorities obviously would have to remain vigilant in order to respond in a timely fashion to any possible adverse effects of rapid innovation and liberalization. The authorities should not attempt to halt those developments, but they should try to ensure that the developments took place in a sound environment. In that connection, the staff had appropriately called for further Fund surveillance.

Despite the experience of the previous several years and the efforts that had been made to improve risk appraisal procedures, commercial banks were still far from being omniscient allocators of credit among countries, Mr. Polak remarked. Contrary to the hopes expressed by some, the international banking industry and its competitor, the international bond market, had not provided the international financial system with a credit mechanism that met all legitimate credit needs and avoided overlending. The staff had concluded on page 17 that "in some cases, banks' willingness to lend to countries reflects their assessment of economic policies being pursued, but this is not the case in all instances.... Banks undertaking substantial loans on very fine terms to certain countries, have on occasion signaled inadequate attention to the implementation of appropriate adjustment policies. At the same time, in some cases, banks have been indicating an unwillingness to lend to countries pursuing adjustment programs."

The staff paper provided the essential background material for considering the bold proposal put forward by Secretary Baker during the 1985 Annual Meetings, Mr. Polak commented. There was indeed increasing evidence that the free play of international financial markets, together with the Fund's surveillance activities, would not be sufficient to bring about adjustment and growth in developing countries. Members were indebted to Secretary Baker for having reversed the prevailing tendency toward complacency and for having put forward a program of action. The United States had also encouraged the important recent initiative concerning the exchange rates of the major currencies.

The details of many features of Secretary Baker's proposal had yet to be provided; his authorities, while welcoming the initiative, had not yet had an opportunity to take a definite position on it, and his observations on the matter were preliminary, Mr. Polak said. The present discussion should help to flesh out Secretary Baker's proposal into an operational plan.

To focus the banks' attention and to make it possible to translate the global figure of $20 billion for three years into a percentage increase in exposure a year, the U.S. Treasury had made available a list of 15 heavily indebted middle-income developing countries on which the banks were asked to concentrate, Mr. Polak remarked. As Mr. Dallara had stressed, the list was not meant to reflect any neglect of other developing countries that deserved additional international credit. While the provision of such a list was perhaps inevitable, it was a cause of considerable concern to his Yugoslav authorities. The list raised serious issues, as it omitted some smaller countries where conditions were similar to those in the heavily indebted middle-income developing countries.

While the list did not include some countries that had managed to overcome substantially their debt problems and should be able to rely upon spontaneous bank credit--for example, Romania--it included at least one country, Yugoslavia, of which the same could be said after the recent conclusion of its multiyear rescheduling arrangement with its commercial bank creditors, Mr. Polak went on. The fact that Yugoslavia had been included in the list had raised new questions about that country in banking circles in Europe. There was an urgent need to clarify the status of the list of 15 countries and to underline the wide differences among those countries in their progress toward regularizing their relations with commercial banks.

If Secretary Baker's proposal were to become operational, there would have to be a decision on the locus for the decision-making process involved, Mr. Polak commented. The multilateral development banks would undoubtedly establish their own lending criteria and make their own decisions, in close collaboration with the Fund. In his view, the essence of Secretary Baker's plan was that the commercial banks would not set the conditions that would apply to their new credits under the plan. The objective of the plan was to give debtor countries the assurance that they would receive additional credit, provided that they would make what Secretary Baker had called growth-oriented policy commitments as their part of the cooperative effort. The banks were not in a position to define those conditions in general terms, negotiate them in individual cases, or decide when the conditions were or were not being met; moreover, as experience had shown, the banks were excessively prone to concentrate on the large countries, permitting the smaller ones to fend for themselves. The Fund clearly should perform those functions in the context of its country programs or its enhanced surveillance, although the implementation of Secretary Baker's plan might well involve a smaller role for enhanced surveillance than had seemed likely several months previously. The staff should begin to consider how the Fund could undertake such functions. The decision-making responsibility under Secretary Baker's plan would have to be discharged by the Fund in close collaboration with the World Bank; under Secretary Baker's initiative, financing by multilateral development banks and commercial banks was to be highly coordinated. It was, however, important to bear in mind that the Fund had more experience than the World Bank in the area of macroeconomic conditionality.

It was too soon to say much about the conditionality under the plan proposed by Secretary Baker, Mr. Polak continued. However, it was already clear that the fully justified concern about the conditions required for long-term economic growth should not detract attention from the urgent need to tackle the macroeconomic imbalances in many debtor countries. The main cause of the present difficulties in those countries was the slippages--including poor growth performance--under Fund-supported programs. The staff could usefully comment on the Fund's prospective relations with Argentina after the end of the current stand-by arrangement, and especially about any plans for an early application of Secretary Baker's plan to Argentina.

Secretary Baker's initiative included voluntary participation by commercial banks, Mr. Polak noted. He hoped that techniques could be developed to encourage smaller U.S. banks to participate on a voluntary basis. However, the issue of participation was broader: it was important to stress the need for voluntary participation by all banks--large and small, North American, European, and Japanese. Each participating bank should accept the fact that a modest increase in its exposure--within the framework of Secretary Baker's plan--in debtor countries was in the bank's own interest. A purely formal agreement for participation by all the banks concerned would be of dubious value; there must be a genuine feeling among the banks that their voluntary participation would help the banks themselves. Otherwise, banks that did wish to avoid increasing their exposure would undoubtedly find ways of doing so. Moreover, it should be clearly understood that each bank would participate at its own risk and that the banks would not request any relaxation of prudential rules if loans proved to be unsuccessful; a bank was to have no recourse if its loans turned sour.

The U.S. budget deficit was a significant factor in the debt problem, Mr. Polak said. Unless the excessive absorption of the world's savings by the United States were halted, the problem of providing enough capital to the developing countries would remain intractable; the problems in the exchange rate area also would persist. Domestic economic initiatives were required if Secretary Baker's initiatives in the exchange rate and debt areas were to contribute to the objective, defined in Article IV, of promoting the development of the orderly underlying conditions that were necessary for financial and economic stability.

Mr. Ortiz remarked that, while there had been a number of recent developments in international capital markets, he would concentrate his remarks on the debt situation in general, and on his authorities' preliminary views on Secretary Baker's initiative in particular. His authorities welcomed Secretary Baker's general approach to achieving sustained growth. Creditor countries, particularly those in the Western Hemisphere, had repeatedly stressed that a viable long-term solution to the debt problem must be based on a strategy designed to promote economic growth in debtor countries. In addition, the strategy must include all the parties involved--debtor and creditor countries, the international organizations, and the banking community. His authorities agreed with the three main elements of Secretary Baker's proposal: the continuation of the macroeconomic adjustment process in debtor countries with emphasis on the adoption of structural policies aimed at improving the overall efficiency of debtors' economies thereby establishing the basis for sustained economic growth; a continued central role for the Fund and increased lending by multilateral development banks; and increased lending by the private banks in support of comprehensive adjustment programs.

The strength of the adjustment undertaken by debtor countries--reflected in the nearly 60 percent decline in the aggregate current account deficit of developing countries over the previous three years--was widely acknowledged, Mr. Ortiz commented. The favorable world economic environment in 1984--especially the expansion of world economic activity and trade and the reduction of interest rates--had been significant factors in that adjustment. However, those favorable trends had been at least partially offset by negative shocks in the form of a steep decline in the real prices of most primary commodities and a continued deterioration in the terms of trade of debtor countries. Hence, recent developments were worrying: despite the adjustment efforts--made at enormous costs in terms of declining living standards--by many debtor countries, the structural characteristics of the debt problem had improved only marginally on average and the problem facing many countries had actually worsened. The structural characteristics included the debt/GDP ratio and debt/export ratio, which were indicators of a country's real ability to service its debt. In addition, many adjusting countries still had substantial domestic financial imbalances and rigidities in their economies despite the corrective measures that they had introduced and the dramatic turnaround in their balance of payments.

Given the developments that he had described, the question naturally arose whether the debt strategy followed thus far had not been fundamentally flawed, Mr. Ortiz said. Alternatively, it seemed natural to wonder whether that strategy was basically correct but the assumptions about the external environment had been overoptimistic, the cost of adjustment had been underestimated, and/or the results expected from the corrective measures had been overestimated. His authorities believed that the second alternative interpretation was accurate. Three significant actual external developments had not been foreseen three years previously--namely, the decline of prices of primary commodities, the intensification of protectionism, and the reluctance of the banking community to increase its financing flows to developing countries. On the domestic side, the decline in economic activity and living standards in debtor countries had generally been much greater than had been expected. In addition, debtor countries had had great difficulty in reducing the rate of inflation despite the implementation of severe fiscal and monetary measures. The resilience of high rates of inflation was partly a reflection of the adjustment process itself, as fiscal adjustment usually involved the elimination of subsidies and increases in the prices of goods and services provided by public enterprises. Those measures usually not only had a short-run direct inflationary impact, but also accented relative price movements, inhibited the working of the price mechanism, and had at best ambiguous effects on inflationary expectations.

Part of the difficulty in gauging the effectiveness of adjustment programs in coping with members' debt problems was that attention was usually focused on the external portion of the debt, Mr. Ortiz remarked. Most developing countries that had borrowed on commercial terms had accumulated large external debts but had also built up substantial internal debts to finance past public sector deficits. Fiscal adjustment in many debtor countries was complicated by the fact that at least some of the measures aimed at reducing balance of payments imbalances, and consequently the pace of accumulation of external debt, had a significant effect on the overall servicing of debt, at least in the short run. For instance, a currency depreciation increased the cost of servicing the foreign debt in terms of domestic currency, and corrective domestic price measures normally increased the cost of servicing the internal debt, further straining the government budget. Another significant example of the complications was interest rate policy. Fund-supported programs normally stressed the need to maintain positive real interest rates on domestic assets to encourage domestic savings and to discourage capital flight. However, if the premium that a government had to pay on its internal obligations was excessively high and the size of the internal debt was large, a paradoxical situation might result: compression of nonfinancial government expenditures would not result in a reduction in the public sector borrowing requirement, since the increases in interest payments would more than offset the expenditure cuts. Hence, in many cases, governments apparently, in effect, had to run faster merely to stay in the same place.

His authorities were convinced that the emphasis on structural adjustment under Secretary Baker's debt initiative was well placed, Mr. Ortiz commented. Many of the policies that Secretary Baker had mentioned in his address during the 1985 Annual Meetings had already been implemented or were being implemented in several adjusting countries. However, it was important to remember that the short-term conflict between the application of corrective pricing measures and the attainment of macroeconomic stability involved additional adjustment costs and limited the speed at which structural change could be made. Accordingly, Secretary Baker's new strategy must be seen in a medium- to long-term perspective.

Experience over the previous several years had shown how difficult it was to implement adjustment programs in highly indebted countries, even when the authorities concerned were making serious efforts and the needed political commitments were in place, Mr. Ortiz said. Those efforts and the associated costs had considerably reduced authorities' room in which to maneuver. The public in general had become much more aware of the vulnerability of the fiscal and financial stance of governments making adjustments and had reacted promptly to weaknesses that were thought to have originated from external or domestic sources. The public's increased sensitivity had often been reflected in exchange rate and interest rate instability.

For any debt strategy to be successful, the public in debtor countries must be convinced of the desirability of the relevant measures and of the feasibility of the overall strategy, Mr. Ortiz remarked. Accordingly, the public must believe that if consistent macroeconomic policies were maintained and appropriate structural measures were introduced, the government would be able to service both its internal and external debt and would be able to move the economy back onto a healthy growth path. In other words, the public must be able to see the light at the end of the tunnel and understand that, although current sacrifices implied by austerity measures might well be painful, there was good reason to hope for eventual improvement in the country's economic and financial situation. The restoration of confidence required realistic and flexible scenarios for financial flows that gave governments some room in which to maneuver and minimized the risk of deviations from the intended policy path owing to an excessively tight and fragile financial position.

The main feature of Secretary Baker's debt strategy was an increase in lending by commercial banks of some $20 billion over the coming three years to a group of approximately 15 middle-income developing countries and of approximately $9 billion in additional net resources from multilateral institutions, Mr. Ortiz noted. The first question that naturally arose in considering the volume of the resources under Secretary Baker's initiative was its adequacy, and that matter should be examined in the context of overall flows between debtor and creditor countries. If interest rates remained at their current levels, the additional resources that would be available to debtor countries under Secretary Baker's strategy would represent approximately 25-30 percent of the total interest payments that countries benefiting from the arrangement were expected to have to make. That conclusion implied that the sizable transfer of resources from developing to industrial countries that had been observed since 1982 would continue. That pattern of resource transfers was anathema to the Fund and had significant economic implications; unlike the period before 1982, debtor countries would have to generate substantial trade surpluses in order to service their debts. In other words, the increase in commercial banks' exposure of 2 1/2-3 percent under Secretary Baker's initiative would imply a significant reduction in such exposure in real terms, especially if the flows were expressed in U.S. dollars.

Accordingly, Mr. Ortiz continued, the main question at hand was whether economic growth could be generated and sustained in debtor countries while their external debt was being amortized in real terms, thereby implying a real transfer of resources from debtor to industrial countries through either the current or capital account. If economic growth and real debt amortization were to occur simultaneously, the efficiency of resource utilization must be enhanced--partly through the introduction of appropriate structural policies--and arrangements for filling resource gaps must be realistic so that the public in debtor countries would believe in the feasibility of the debt strategy. Otherwise, adding new debt to the existing debt would not improve the climate of expectations and would not restore the confidence and sustain the social cohesion needed to implement the required adjustment measures. Realistic financial scenarios must be based on flexible management of the resources that were to be made available under Secretary Baker's initiative. He felt encouraged by the remarks of the Deputy Managing Director and Mr. Dallara on the flexibility with respect to the eligibility of countries under Secretary Baker's initiative and the allocation of the resources involved among the countries concerned.

Considerable flexibility and ingenuity would be required to ensure the broadest possible participation of commercial banks in Secretary Baker's initiative, Mr. Ortiz continued. The authorities in some of the countries in his constituency considered that, as a matter of principle, smaller banks should participate; otherwise, medium-sized banks would claim that they were not sufficiently large to participate. Other members of his constituency considered that it would be pragmatic to exclude smaller banks that had traditionally been reluctant to participate in lending to debtor countries; experience suggested that the effort involved in confirming the participation of such banks in lending efforts had been greater than the financial benefits of their participation. Accordingly, the exclusion of smaller banks could help the banking community to reach a prompt agreement on its participation under Secretary Baker's strategy. In general, his authorities believed that the preference of banks of different sizes and geographical locations with respect to their participation should be accommodated by offering a variety of optional means of participation, including interest capitalization and partial debt cancellation. That approach would be consistent with two of the main objectives of Secretary Baker's proposal, namely, to ensure the broadest possible participation of the institutions involved in the debt problem and to ensure the availability of additional resources.

The mechanics of access to the resources that would be available under Secretary Baker's initiative were of great interest to his authorities, Mr. Ortiz continued. He wondered whether the current thinking on Secretary Baker's initiative was centered on the creation of a "super fund" financed by contributions from all the commercial banks concerned and to which the World Bank and/or the Fund would automatically have access in the process of putting together financing packages. Conceivably a request for access to funds, available under Secretary Baker's strategy, could be at the initiative of debtor countries working separately with international organizations and commercial banks.

Another aspect of the access issue was the determination of the financing needs of individual countries, Mr. Ortiz went on. If the objective of the U.S. initiative was to formulate adjustment programs in the context of economic growth, a country's growth target would have to be set first, and its financing need would then have to be determined on the basis of realistic assumptions concerning export growth, investment, savings, and other variables which, in turn, were affected by the member's various policy measures. That exercise differed from the traditional process of designing Fund-supported programs, which usually began with a consideration of the amount of resources needed to ensure a sustainable balance of payments and in which economic growth was a residual factor.

Another crucial aspect of Secretary Baker's strategy was the conditionality that would be attached to the resources provided under the strategy, Mr. Ortiz commented. The conditions would not only determine how receptive debtor countries would be to the proposal, but would also influence the relationships between the Fund and the World Bank and between those two institutions and commercial banks. It had been suggested that enhanced surveillance might be a useful means of providing for continuing Fund involvement under the U.S. strategy and that the World Bank should increase its structural and sectoral adjustment lending. In that connection, a question that naturally came to mind was whether the Fund and the World Bank would be simultaneously involved in program formulation and monitoring in individual countries and therefore whether cross conditionality was likely to occur. The Executive Board had repeatedly expressed its reservations about the Fund's involvement in credit evaluation exercises on behalf of commercial banks. His authorities had serious reservations about any extension of guarantees by the World Bank to commercial banks for their lending under Secretary Baker's initiative; such guarantees would fundamentally alter the relationship between the World Bank and members, thereby posing the danger of turning the World Bank into merely another commercial bank. Debtor countries should be consulted at an early stage about the various aspects of the implementation of Secretary Baker's proposal.

It had been repeatedly stressed that a member that could not keep its own internal savings from leaving the country could hardly be expected to attract foreign savings, Mr. Ortiz remarked. The clear implication of such statements was that capital flight occurred because governments were unable to maintain confidence through the consistent application of sound policies. While that conclusion might be warranted in some cases, capital flight and exchange rate instability might occur even if the governments concerned were obviously committed to achieving adjustment and sound policies were being implemented.

When a debt problem was viewed comprehensively as encompassing both internal and external debt, and when the financial position of a debtor's public sector was both tight and vulnerable, the emergence of a perceived financing gap in that sector immediately caused the public to fear that the government would have no choice but to resort to taxing financial assets through inflation, a currency devaluation, or some other means, Mr. Ortiz commented. Hence, the public's natural reaction was to shift away from such assets. Ironically, if the public believed that the government was determined to honor its external financial obligations, it might fear that the government would be less likely to service fully its internal debt. It was widely felt in some countries that the overall public sector debt had already reached an intolerable level, and the doubts about the solvency of public sectors and their ability to meet their commitments might well have provoked capital flight. That conclusion might well be applicable to some industrial countries.

Mr. Lankester said that he supported the staff's continued efforts to improve its reporting of statistics on international capital markets. The published version of the staff paper would help to inform and underpin future public discussion on capital market developments.

The staff paper highlighted the reduction in commercial bank lending over the previous three years, Mr. Lankester noted. Secretary Baker's proposal was partly designed to reverse that trend and was greatly welcome, as it offered a sensible way forward for the principal debtor countries. Secretary Baker's proposed general principles for channeling Trust Fund reflows to the very poorest countries were also welcome.

He strongly supported all Secretary Baker's objectives with respect to the major debtors, Mr. Lankester continued. There was a clear need for continued adjustment but with a greater emphasis than hitherto on growth. Accordingly, more attention must be paid to the structural element of adjustment, including, the need for market-oriented solutions and a more efficient use of resources. In addition, more emphasis should be placed on the efficient use of public expenditure in the countries concerned.

In return for implementing stronger policies, and to foster faster growth and improved creditworthiness in the debtor countries, the flow of external resources to those countries should be increased, Mr. Lankester said. The Fund should continue to play a central role in helping members to formulate adjustment programs and to catalyze additional resources. The Fund's net financial contribution over the coming several years would necessarily be relatively small. He fully endorsed Secretary Baker's call for the multilateral development banks--especially the World Bank--to play a stronger role, both by providing additional money and by helping members to enhance the structural content of their programs.

A crucial question was how to promote greater collaboration between the Fund and the World Bank, Mr. Lankester commented. The further the World Bank moved away from its traditional role of project financing and toward supporting structural and even economywide measures, the more important that collaboration would become. The two institutions must act and advise consistently. There would inevitably be differences of view between the Fund and the World Bank from time to time, and progress had been made over the previous several years in ensuring that members did not receive contradictory advice. Further efforts in that area were needed.

The modalities of collaboration between the Fund and the World Bank should be further explored, Mr. Lankester went on. One proposal that seemed to merit further examination was to have the Fund and the World

Bank staffs prepare a joint analysis of a country's policies and the resource availability for that country. Another idea was to have the two institutions agree on the specific policy areas in which each would take the lead: exchange rate and fiscal and monetary policy should clearly fall to the Fund, while sectoral policies should basically be covered by the World Bank. The assignment of some policy areas--such as trade liberalization and parastatal pricing and efficiency--were less easy to make. One possibility was for the two institutions to agree that one or the other should take the lead in particular policy areas in individual countries. Successful collaboration would depend upon the quality and attitudes of the people involved. The Executive Board should not attempt to impose over-rigid formulas, but a case could perhaps be made for tightening up somewhat the procedures for collaboration.

The third part of Secretary Baker's initiative was $20 billion in new lending by commercial banks, Mr. Lankester noted. There was no need to be precise about that figure at the present stage; reversing the recent downward trend in bank lending to the debtor countries was clearly needed. Secretary Baker had performed a great service for the international community by pointing out the unsustainability of the positions of both debtor countries and the banks themselves should the banks continue to withdraw. Secretary Baker had set in train a process whereby the banks could collectively and individually assess the steps that would be in their best interest. He hoped that the banks would accept the framework that Mr. Baker had proposed, so that they would play their part along with the renewed efforts by debtors and additional financing by multilateral development banks; in that connection, there were already signs of progress. However, in the final analysis, the decision whether or not to make new loans would have to be up to the commercial banks; there must be no arm twisting by governments. The U.K. Government was not prepared to alter the regulatory environment in the United Kingdom; it would continue to encourage banks to strengthen their capital positions and, where appropriate, to introduce adequate loan-loss provisions. Both those steps were consistent with the idea that banks should increase their exposure wherever the banks themselves felt that that was justified.

Additional bank lending under Secretary Baker's initiative should be genuinely on the banks' own books; the problems of the debtors could not and should not be solved by transferring risks from the banks to governments or the international financial institutions, Mr. Lankester stated. The World Bank and Fund staff had correctly discouraged the commercial banks in their various requests for comfort, including a major expansion of World Bank guarantees. He had been interested to note that Mr. Ortiz had taken the same position. That was not to say, however, that there was no scope for further linking World Bank finance to commercial bank finance as had happened recently in Costa Rica, Chile, and Uruguay. The comfort that commercial banks could legitimately ask for was that the borrower would pay them back. That assurance was in turn based on the improved economic performance of the borrower. In supporting a borrowing country's program the World Bank and the Fund might thereby be able to give the banks greater confidence to lend; in the final analysis, however, the banks would have to make their own assessment. That conclusion underscored the need to continue the case-by-case approach, making the actual amount of new external financing for each country dependent upon the country's requirements and the creditors' perception of the member's policies and performance.

The various innovations--particularly in the securities market--described by the staff had both encouraging and worrying aspects, Mr. Lankester commented. The innovations were meant to increase the liquidity and marketability of particular forms of lending, thereby enabling the original lenders to make more funds available and/or to offer a lower interest rate than might otherwise be possible because they could hope to sell the assets if necessary. In addition, the innovations might make it possible to involve more potential sources of funds in a variety of financing package forms, each of which might have a special appeal to a particular class of lender. The benefit of bringing in new--often nonbank--private sources of finance in an international context would be considerable.

However, the innovations also involved some risks, Mr. Lankester continued. While those risks might be less apparent than the risks inherent in traditional lending, they had increasingly occupied the attention of bank supervisors in a number of countries in recent years. Novel packaging might help to produce more and/or cheaper new money, but the packaging did not in itself generally reduce the overall risk; it might redistribute that risk between different participants. Many of the innovations to date had involved only prime borrowers and had taken place in a period when the creditworthiness of those borrowers had not been in question. If and when conditions became more difficult, some of the supposed benefits of those innovations--such as their marketability--might be found to be illusory. Those considerations called for some caution in welcoming innovations of the kinds described by the staff. On balance, however, the innovations were welcome.

The staff had correctly recognized the two purposes of multiyear rescheduling arrangements, Mr. Lankester commented. They were part of the transition to normal creditor relations for countries that had undertaken appropriate adjustment measures. They also reduced debt management costs and uncertainties about members' debt situations for both borrowers and lenders.

He agreed with the staff that enhanced surveillance was a useful tool for clearing the path to restoring normal creditor relationships and might well be an appropriate concomitant of a multiyear rescheduling arrangement, Mr. Lankester said. However, it was important to stress that enhanced surveillance was not a means for banks to avoid making their own credit assessments. His authorities believed that, in general, enhanced surveillance should be limited to the consolidation phase of a multiyear rescheduling arrangement.

Mr. de Forges commented that the situation in international capital markets had not changed fundamentally since the previous discussion, in July 1984. Indeed, recent developments had confirmed the trends that had been foreseen during that discussion. However, there had been some change in psychological and political attitudes, and capital flows had become an increasing cause for concern in recent months.

If the staff paper was to be published, the discussion on enhanced surveillance should be reviewed and shortened, Mr. de Forges considered. In addition, there were technical and some minor points that he wished to raise with the staff on a bilateral basis.

The present trend in net transfers from developing countries to commercial banks followed naturally from the peak lending in the late 1970s, Mr. de Forges said. However, the present trend was too violent to be sustainable and, if continued much longer, would impose excessive adjustment requirements on borrowers. As Secretary Baker had said, those countries must solve their debt problem by accelerating their rate of economic growth. In the coming period, a smooth evolution of the financial problem would result either by accident, by default, or by reasonable action on the part of the whole banking community.

The current disintermediation by banks, together with the increase in bond financing, was similar to the pattern evident in the nineteenth and early twentieth centuries when all international financing was in the form of bond financing, Mr. de Forges remarked. The recent trend was the result of the drying up of oil surpluses for recycling and of the major banks' wish to restore an appropriate equilibrium in the risks on their domestic and international assets. The latest trend called for new concerted efforts by national authorities to agree on a better definition of the rules of the game, particularly as an increasing number of currencies were involved in international financial operations.

Recent developments in commercial bank lending terms were in the right direction, Mr. de Forges commented. Similarly, the banks' wish to concentrate their new credits on commercial operations and productive projects--rather than on loans to governments with the attendant undetermined sovereign risks--was appropriate. Nevertheless, the banks should be ready to refinance at least a part of their credits to governments in order to avoid severe contractions of their outstanding credit, which had negative effects on borrowers.

Secretary Baker's proposals required considerable further examination, Mr. de Forges remarked. His authorities had not yet taken a final position on the U.S. initiative, and his comments on it at the present meeting were personal in nature.

The direction of Secretary Baker's proposal was clearly positive and welcome, Mr. de Forges went on. It was evidence of the U.S. Government's increasing involvement in the debt strategy and gave a new momentum to what was necessarily a slow and cumbersome process. The proposals also reflected the view, shared by the French and U.S. Governments, on several needs, including economic growth to solve the debt problem, a larger role for the World Bank, and adequate financial flows to support development.

At the same time, the case-by-case approach remained indispensable, Mr. de Forges went on. The list of 15 countries mentioned by Secretary Baker should be seen as an illustration of the "most indebted countries." In addition, the Fund retained a central role, and any statements or proposals that might undermine the Fund's difficult negotiations with several major borrowers should be avoided. Indeed, the Fund's role should be reinforced. There would then be a clear and firm basis on which to establish the needed coordination between the Fund and the World Bank. The responsibility for handling the debt problem should be shared among the parties concerned; therefore, the commercial banks' request for multilateral guarantees on their new loans was unacceptable. Capitalization of interest would also be unacceptable; it would undermine the basic principle that debt service payments were a prerequisite for rescheduling and new funding agreements. Similarly, establishing new machinery to handle debt problems probably would merely complicate and delay procedures designed to solve those problems.

Secretary Baker's initiative showed that innovation and momentum could arise out of existing ideas when they were applied with the energy, pragmatism, and consistency that Secretary Baker had shown in his address to the 1985 Annual Meetings and in subsequent statements, Mr. de Forges remarked. If the initiative were to be successful, the major countries must make a greater effort to maintain a favorable economic environment, there must be active coordination between the Fund and the World Bank, and financial resources must be used to support sound development efforts in the debtor countries concerned. His authorities and the commercial banks in France were willing to take part in a further examination of Secretary Baker's debt initiative.

Mr. Massé commented that there had been a number of significant changes in international capital markets since the Executive Board's previous examination of those markets. The staff papers dealt with a number of complex issues, most of which were not easy to resolve and would probably remain a cause for concern. Over the coming several months the Executive Board should monitor developments in the capital markets, particularly flows to countries facing debt problems.

The distribution of the large and growing external current account deficits was a cause for concern, Mr. Massé continued. The maldistribution reflected mainly the expansion in the financing needs of industrial countries. The U.S. current account deficit, estimated at about $120 billion in 1985, accounted for more than half of the total identified current account deficits. As long as the U.S. deficits continued and the United States remained a relatively safe destination for banking funds to flow to, the chances for a sizable increase in bank lending to and private sector investment in developing countries would likely remain unfavorable.

That conclusion underscored the need for the United States to correct the fiscal imbalance that had given rise to its external current account deficit.

There had been some positive developments in bank lending to developing countries over the previous 18 months, Mr. Massé commented. The medium-term perspective reflected in the growing number of multiyear rescheduling arrangements and the adaptation of certain banking practices--for example, the evolving and crucial role of bank advisory committees--had generally been helpful.

However, there had also been some disturbing trends in recent bank lending, Mr. Massé continued. Bank lending to developing countries had fallen in the first half of 1985, and the share of concerted lending in total lending had been increasing. Those developments were a reflection of the precarious nature of the present phase of the debt problem. A number of developing countries were unlikely to regain spontaneous private lending for several years.

The unfavorable trends in recent bank lending were reflected in the erosion of the cohesion among commercial banks, Mr. Massé commented. The various bank advisory committees had had increasing difficulty in obtaining banks' support for developing countries' adjustment efforts. In some recent cases, there had been lengthy and disruptive delays in finalizing agreements. Those difficulties were linked to the growing recognition that the solution to the debt problem would be more protracted than had originally been assumed, and that a return to voluntary lending--even for countries that had made considerable adjustment efforts--would be more difficult than had been expected. New efforts by all the parties concerned were needed to support the adjustment and growth process in debtor countries.

There had been a welcome strengthening of the position of commercial banks, Mr. Massé remarked. The banks' capital/asset ratio position had generally improved, greater provision had been made to cover loan losses, and the banks' exposure in developing countries relative to the banks' capital had been reduced. A weak banking system in the major industrial countries was in no one's best interest. The main challenge at the present stage was to persuade the banks and their regulators that an increase in the banks' exposure in debtor countries that were maintaining adjustment efforts might well be the best way of protecting the banks' existing assets.

The staff had usefully described the recent innovations and the rapid changes in capital markets that had reduced the barriers between those markets, Mr. Massé commented. The changes raised a number of significant issues concerning market supervision and the conduct of monetary policy that should be examined, but the increased efficiency resulting from freeing financial markets suggested that it was helpful to continue to encourage the liberalization and to make appropriate changes in other areas as necessary.

It was generally recognized that the international debt problem had entered a new phase, and that members needed to shift their attention to the medium-term development aspects of the adjustment process and the long-term nature of the debt service burden of many countries, Mr. Massé remarked. The management of debt problems was made difficult by the need to service large accumulated debts, the considerable demands of the process of economic adjustment, and the uncertainty about the sustainability of economic recovery in industrial countries. Recent developments in commercial bank lending to debtor countries was a cause for considerable concern. Secretary Baker's initiative represented an essential step toward strengthening the international debt strategy and was particularly important in the debt situation at the current juncture.

The recognition by Secretary Baker of the key role of sound policies in the principal debtor countries was of fundamental importance, Mr. Massé went on. There was nothing about Secretary Baker's initiative that should serve to delay the adoption by debtor countries of policies designed to adjust their balance of payments and to promote economic growth. It was regrettable that only about half the 15 debtor countries mentioned by Secretary Baker could be considered as having sound policies in place.

The U.S. initiative had had the important effect of focusing attention on the short-term bias in the adjustment efforts of many debtor countries over the previous three years, Mr. Massé commented. The past approach to handling debt problems had been useful in many respects, but debtors' adjustment efforts and the nature of the financing that had supported them had not reflected a sufficient emphasis on medium-term development issues. The U.S. initiative appropriately aimed at redressing that failing.

The various elements of the U.S. initiative were linked together, and the importance of the initiative's integrated nature should not be overlooked, Mr. Massé stated. As to the proposed increased lending by private banks in support of comprehensive adjustment programs, there were a number of modalities that the banks themselves would have to work out, including the choice of the banks that would participate, the criteria to be applied in sharing the lending among banks, and the amounts that should be lent to an agreed list of countries. Those matters, together with any needed arrangements for coordination or new entities, must be dealt with by the banks themselves.

He agreed with the U.S. authorities that the Fund should continue to play a central role in the debt strategy, Mr. Massé said. However, there was some uncertainty about the ability of the World Bank and the regional development banks--especially the Inter-American Development Bank--to respond to the U.S. challenge. It might not be financially prudent for the World Bank to step up its lending in the absence of a firm understanding on a new general capital increase. In addition, there was legitimate concern about the ability of the regional banks to increase the efficiency and volume of their lending.

Consideration of the U.S. debt initiative should not deflect attention away from the responsibilities of the major industrial countries, Mr. Massé commented. Those countries had to deal with persistent substantial external imbalances and must achieve a better convergence of their economic policies. The world recovery needed to be sustained and strengthened; to that end, the fight against protectionism would continue to be important.

Mr. Finaish remarked that the staff paper provided a detailed survey of recent developments and prospects in the international capital markets. He would focus his comments on an aspect that was particularly significant in solving the debt problem, namely, the reported increase in the difficulty of arranging flows of bank financing to debtor countries that were adequate, in conjunction with other financing, to support the ongoing adjustment process in those countries. The return to normal market access or voluntary bank lending by countries that had experienced debt servicing problems had for some time been thought to be a difficult and gradual process. Recent developments in the capital markets suggested that the process could be even more difficult and slower. Even coordinated or concerted financing packages were reportedly becoming more difficult to arrange. Those tendencies, if unchecked, would undermine an important element of the strategy for an orderly solution to the debt problem, namely, the provision of adequate financing to support needed adjustments in debtor countries. In the circumstances, the staff had correctly stressed that "a central task in the period ahead will concern the need to catalyze adequate financial flows."

The reported increase in the commercial banks' reluctance to supply new money in some cases had been related to lapses in the successful implementation of requisite adjustment policies by the countries concerned, Mr. Finaish said. The appropriate response in those cases in order to restore needed commercial bank flows was, of course, to strengthen the implementation of adjustment measures. In addition to the adoption and maintenance of appropriate macroeconomic policies, adjustment strategies in the debtor countries should adequately stress structural, supply-side measures to restore sustained economic growth that would be consistent with a strengthened external financial position. Adjustment measures should be formulated with a view to restoring economic growth not only to make sustained adjustment politically feasible but also because the enhancement of debtor countries' capacity to service their debt in the longer run--and therefore a durable solution to their debt problems--would depend fundamentally upon the growth of their output and exports. The prospects for restoring normal capital market access would be better if successful adjustment were combined with improved growth prospects for the countries concerned.

However, successful growth-oriented adjustment in debtor countries might be obstructed if the requisite financial support were lacking, Mr. Finaish continued. Recent capital market trends indicated that the risk of that development had increased. The weakening of commercial banks' willingness to supply new funds reflected not only the banks' concern about the firmness and success of adjustment policies in certain debtor countries but also an increase in the banks' general reluctance to increase their exposure in countries that had experienced debt servicing problems. Smaller banks in particular had become increasingly reluctant to continue lending to debtor developing countries. In addition, by reducing the prospects for debtor countries' economic growth and export prices the slowdown in the world economy had contributed to the change in the banks' lending behavior.

The circumstances that he had described underscored the continued important role to be played by official creditor institutions in helping to catalyze adequate bank flows, Mr. Finaish said. The formulation of financing and restructuring packages, on a case-by-case basis, including where appropriate multiyear rescheduling arrangements would remain crucial; in that connection, the Fund would continue to play a central role.

The increased reluctance by the banks in general to provide new loans to debtor countries might require certain additional measures to assure an adequate flow of such lending, Mr. Finaish went on. Several ideas that had been put forward deserved further exploration, and some discussion in the staff paper on practical options would have been helpful. For example, further thought should be given to the possibility of expanding cofinancing between commercial banks and the multilateral development banks, particularly the World Bank. Mention also had been made of making judicious use of guarantees of commercial bank loans by official bilateral agencies and the World Bank; views on that proposal differed markedly, and a careful analysis of the various implications of the proposal was needed.

The main task for bank supervisory authorities should be to continue to seek a balance between the objective of strengthening banks' balance sheets and the need to maintain an adequate flow of funds to debtor countries that were introducing adjustment measures, Mr. Finaish said. In the recent past commercial banks had demonstrated considerable innovation in devising new types of financial instruments. However, recently developed instruments, such as floating rate notes and issuance facilities, had been of use mainly to countries that had continued to enjoy access to voluntary bank lending. Banks should be encouraged to use the same innovative skills in developing financing instruments that were better matched to the circumstances of countries that had faced, and would for some time continue to face debt servicing difficulties. Reimbursable interest-averaging caps and variable maturity loans had been the subject of particularly active discussion.

In examining options for supporting adequate commercial bank flows to debtor countries making needed adjustments, care should be taken to ensure that the official financing was seen as a catalyst, rather than a substitute, for bank lending, Mr. Finaish considered. It was also important to bear in mind that the mechanisms used to sustain adequate bank flows in the coming period should bear a minimal risk of interfering with the eventual return to normal, voluntary lending. Since, as the staff had noted, commercial banks were expected to be more forthcoming in the period ahead in providing trade and project-related lending on a voluntary basis, the need for supportive mechanisms and new lending techniques was likely to be felt more in the area of general purpose balance of payments lending.

His remarks on the U.S. debt initiative were preliminary, Mr. Finaish said. Given the recently heightened concern about the weakening prospects for sustained growth in the debtor countries and the further shrinking of available commercial bank funds to those countries, the main elements of the recently announced U.S. initiative were in the right direction. Those elements included emphasizing growth-oriented adjustment, enhancing the role of multilateral development banks--particularly the World Bank--in supporting such adjustment, and inducing commercial banks to maintain adequate flows of new lending. The question had been raised whether the U.S. initiative went far enough in the intended direction. In any event, there were a number of unanswered questions about the actual operations of the U.S. debt strategy which would have to be elaborated and fleshed out.

The commercial bank lending aspect of Secretary Baker's proposal raised several questions, for example, whether the proposed amount of $20 billion over the coming three years for the 15 countries identified by the Secretary was adequate, Mr. Finaish commented. That amount was said to represent an annual increase in commercial bank claims on the countries concerned of 2 1/2-3 percent. It was difficult to judge whether that amount would be sufficient to help the countries concerned to support growth-oriented adjustment while making continued progress toward reducing their debt burden; to make such a judgment Executive Directors needed a proper analysis of the financing needs of the countries concerned that would take into account the kind of adjustment policies to be implemented, the projected external environment, and the prospects for financial flows from other sources. An analysis of the adequacy of financial flows in support of growth-oriented adjustment in debtor countries could usefully be part of the next World Economic Outlook exercise or could be undertaken in the next staff paper on the debt situation and prospects. The staff could usefully comment on how the rate of bank lending under the U.S. initiative compared with the rate envisaged in the staff's medium-term scenario analysis in connection with the latest World Economic Outlook exercise.

A major motivation of the U.S. initiative was said to be the increased reluctance by commercial banks to make new loans to debtor countries, Mr. Finaish remarked. However, the U.S. proposal said little about how the banks in general were to be induced to provide the amount of new money being requested from them, and how smaller banks in particular were to be encouraged to continue lending to the countries concerned. Was moral suasion by the respective monetary and financial authorities in the framework of existing arrangements expected to be sufficient? If not, what kind of supplementary techniques or additional supportive official action might be considered?

While supporting an enhanced role for the multilateral development banks and the World Bank, the U.S. plan was unclear about the assurances that those institutions would be given adequate resources to perform the necessary tasks, Mr. Finaish commented. Moreover, the U.S. plan as presented thus far failed to include as an integral element the responsibility of the industrial countries to maintain policies conducive to growth and stability. In that connection, Mr. Polak's reference to the need for a substantial and sustained reduction of the U.S. fiscal deficit was especially pertinent. Questions had also been raised about limiting new initiatives on the debt strategy to a specific group of larger, middle-income debtor countries. There were also questions about the structure of the decision-making process for the plan's implementation and about the relative roles in that process for all the parties concerned.

In considering how adjustment could be made more growth oriented, it would be useful to examine how collaboration between the Fund and the World Bank was actually harnessed for that purpose and how the design of Fund-supported adjustment programs was adapted to promote adjustment with growth, Mr. Finaish said. The recent suggestion to have the staff prepare a paper on growth-oriented adjustment strategies was useful.

The main elements of the U.S. debt initiative were in the right direction, Mr. Finaish concluded. However, there were still several questions about the initiative's adequacy, comprehensiveness, and the practical mechanisms to implement it that required further consideration and elaboration.

Mr. de Groote said that there were two themes of the staff's analysis: the explosion of new financial markets together with the rapid integration of the world financial market; and the reversal in 1984 of the historical patterns of capital flows, with the developing countries becoming net suppliers of funds to the international banking system and the United States becoming a net borrower.

The Executive Board's annual discussion of international capital markets was typically held after the conclusion of the Annual Meetings and five or six months before the spring meeting of the Interim Committee, Mr. de Groote noted. However, it had become increasingly clear that international financial flows played an essential role in the prospects for the world economy, and that the interaction between the financial markets and real economic variables had become a major policy issue. Accordingly, future discussions of international capital markets should be held at a time of year that would enable the Managing Director to present the conclusions of those discussions to the next meeting of the Interim Committee.

There had been an explosion of new financial instruments over the previous several years, Mr. de Groote commented. The speed and creativity of the private capital markets in responding to the disturbances of the early 1980s were impressive. When those disturbances had first become evident there had been a genuine danger of a far-reaching disintegration of the international financial system. However, instead of collapsing, the international banking system had responded promptly to the emerging process of financial deregulation. The banking community's dynamic response to the difficulties had led to increased, rather than decreased, integration of the international capital markets in terms of both financial instruments and geographic centers. The development of the global financial market was welcome, as it could be expected to lead to greater competition, more efficient allocation of financial resources, and a greater diversification of financial products.

However, there was some question whether the recent changes in international capital markets had strengthened financial institutions and the process of financial intermediation, Mr. de Groote continued. The Fund's interest in the complex tasks confronting bank supervisory authorities was more than merely academic in nature: the international debt crisis was due partly to poor risk management by the banks and to the gradual weakening of the banks' funding base; the stability of international economic and financial conditions obviously depended upon the soundness of the international banking system.

Two developments in international banking were a cause for particular concern, Mr. de Groote went on. The banks' increasing reliance on floating rate notes to strengthen their capital base should be closely watched. The fact that the issuing banks considered the notes to be part of their capital while the purchasing banks tended to consider the notes as money market instruments was a cause for concern. In addition, the fact that most notes issued by banks were purchased by other banks meant that the instrument of floating rate notes did nothing to strengthen the capital base of the banking system as a whole.

The second cause for concern was the rapid expansion of the banks' off-balance sheet activities by the provision of backup facilities to issue notes in the international credit markets, Mr. de Groote said. Although the instruments created in that process might improve the marketability of claims and increase the disbursion of risk, the banks must always be aware that their commitments under backup facilities represented a continuing threat to their balance sheets that needed to be covered by adequate risk provisions.

To monitor adequately the recent developments in the international banking system bank supervisory authorities must make a considerable effort to increase the statistical coverage and transparency of the financial markets, Mr. de Groote continued. In addition, coordinated action on an international scale was called for. The Fund could play an important supportive role in both areas.

As a result of the steep drop in new bank lending commitments from $51 billion in 1982 to $15 billion in 1984, the developing countries as a group had become a net supplier of funds to the international banking system while the United States had become a net borrower in the international capital markets, Mr. de Groote noted. It was particularly worrying that the international banking statistics for the first half of 1985 and the staff's discussions with international bankers suggested that new lending to many developing countries would remain very limited in coming years. That trend, together with the lower than expected rate of economic growth of the industrial countries, suggested that the main medium-term scenario of the latest World Economic Outlook exercise was excessively optimistic.

The large degree of freedom within the international capital markets called for reinforcement of economic policy coordination among the major industrial countries to prevent capital movements from creating distortions in the world economy, Mr. de Groote went on. That conclusion was supported by the evidence that the trade imbalances and protectionist pressures created by the large capital shifts that had occurred in response to the diverging budget policies in the United States and other industrial countries. The contribution that Secretary Baker's debt initiative could make to improving the international allocation of financial resources was minimal in comparison with the advantages--in the form of an additional supply of savings and a reduced interest rate burden--of a reduction in borrowing by the U.S. public sector.

The fact that new commercial bank lending to the developing countries had continued to decline despite those countries' adjustment efforts suggested that the banks would not decide spontaneously to resume lending on an adequate scale even if the adjustment of the countries concerned became sufficient and durable, Mr. de Groote remarked. The lending pattern of the previous two years seemed to reflect an attempt by the banks to limit new money to the debtor countries to the minimum that was financially tolerable, rather than a broader assessment of how much new money the countries concerned might require to improve their debt service capacity by accelerating their economic growth and increasing their exports. Even the Fund was having increasing difficulty in playing the role of a catalyst of resources by orchestrating concerted lending. The situation was complicated by the fact that the various commercial banks' longer-term business interests in international lending were divergent: some banks felt compelled to continue lending in order to protect their outstanding assets; others had decided to shift the focus of their business to other activities. At the same time, the media had not helped matters by continuing to portray the reflow of funds from the developing countries to the banks as a step along the path that the world should continue to follow.

Secretary Baker's initiative was a timely and welcome attempt to break the present stalemate in the debt strategy by reversing the recent regressive pattern of lending to developing countries and by shaping a new model of cooperation among the parties concerned, Mr. de Groote considered. The core of Secretary Baker's proposal seemed to be the recognition at the political level that the time was ripe to change the pattern of the adjustments imposed on debtor countries over the previous three years. There seemed to be a general awareness of the impossibility of establishing a sustainable adjustment process within the short-term perspective reflected in the pattern of annual debt renegotiations among the debtor countries, their creditors, and the Fund. The great merit of the U.S. proposal was its emphasis on the need to develop--in close cooperation with the World Bank--a longer-term growth-oriented adjustment strategy and to provide the volume of financial assistance required to achieve that kind of adjustment. He looked forward to the further elaboration of the U.S. initiative. The U.S. authorities had recognized the validity of a number of points that most Executive Directors had repeatedly stressed in the recent past, such as the need to make additional growth-oriented lending dependent upon the adoption by the borrowers themselves of realistic development programs, and the anomaly of the present balance of payments structure of the developing countries.

While the U.S. initiative was welcome, it seemed to contain some pitfalls that must be borne in mind, Mr. de Groote continued. First, it should be clearly understood by the commercial banks that the new lending envisaged in the U.S. plan was additional to, and should in no way replace, the money that would normally be expected to be provided by the banks to the countries that had recently regained or were about to regain access to spontaneous market borrowing. The circulation by the U.S. authorities of its list of countries involved serious dangers. The commercial banks must understand that the countries not mentioned on the list which had performed well under Fund-supported programs would have to maintain the access to financial markets that their improved situation warranted. In addition, the banking community should accept the fact that some countries mentioned on the list, such as Yugoslavia, had sufficiently improved their situation to warrant their regaining access to spontaneous market borrowing. A statement of clarification on those matters by the U.S. authorities was urgently needed to dispel misunderstandings that might preclude market access for the countries that were most qualified to receive it.

The $20 billion in new lending envisaged under the U.S. initiative to the 15 designated countries was clearly the minimum amount required, Mr. de Groote said. There was some question whether that amount would be sufficient to cover the financing requirements of the countries on the list. It was regrettable that even such a minimum amount must be the subject of political negotiation and bargaining between the commercial banks and monetary authorities.

The focusing of attention by Secretary Baker on a limited number of middle-income developing countries might well make it all the more difficult to attract new financial resources to the many low-income developing countries that were continually dependent upon official financial assistance to maintain their adjustment efforts, Mr. de Groote went on. There seemed to be a hidden assumption behind Secretary Baker's plan that the poorest countries should rely almost exclusively on official aid to support their adjustment efforts, an idea that he rejected.

Additional lending for development would not be successful, and was bound to entail undue risks for banks, if the lending was directed toward countries that had not undertaken short-term balance of payments adjustment programs, Mr. de Groote said. The U.S. initiative should not be a pretext for minimizing the importance of Fund-supported stabilization programs.

Under Secretary Baker's initiative the commercial banks would have to become accustomed to linking their lending to the implementation of projects that were conducive to economic growth and the expansion of exports, Mr. de Groote commented. That objective would not be easy to reach. There had been no mention in the press since the announcement of Secretary Baker's proposal about the need for commercial banks to enter into a new field by learning how to assess the validity of lending to support specific development-oriented projects. He wondered whether the banks could do so without relying upon the World Bank's assessment of each country's priority projects. He also wondered whether the banks could be expected to make a fundamental change in their pattern of behavior by becoming involved in the process of making judgments on development projects, or whether they would delegate the decision to finance one project or another to the recipient country.

The tasks of dealing with the debt problem were particularly complex, and many issues would have to be clarified in the coming months, Mr. de Groote remarked. The Fund might have to reshape its adjustment programs to make room for growth-oriented policies and World Bank initiatives, and the financing requirements of that new strategy would have to be considered. It must be clearly understood at the outset that the growth-oriented, export-based strategy's initial stage would require additional financing and increased indebtedness.

Thought must also be given to means of attracting sufficient new financing for the low-income developing countries that were not covered by the U.S. initiative, Mr. de Groote continued. Another issue to examine was how the Fund could contribute to the establishment of new financial relations between private creditors and developing countries that would meet the prudential concerns of the creditors and the development needs of the countries concerned. The possible effect of Secretary Baker's initiative on direct investment in developing countries would have to be considered as well. Direct investment was the key to supply-oriented strategies because it involved a judgment by the business community on the profitability of the investment. The restoration of confidence that might result from the resumption of commercial bank lending to the developing countries could have the beneficial side effect of strengthening the flows of direct capital investment.

Mr. Zecchini considered that the main factors that strongly influenced trends in capital markets were financial innovation, the liberalization of capital markets--with the consequent reduction of market segmentation--the "securitization" in the credit markets, and the discrimination by commercial banks in their lending to countries. Those factors had been evident since the beginning of the 1980s, but in the recent past they had become increasingly important influences on the behavior of creditor banks, investors, debtor countries, multilateral institutions, and supervisory agencies.

In recent months there had been a remarkable tendency toward financial innovation, partly through spontaneous initiatives by market participants and partly through the introduction of gradual liberalization by the supervising authorities in the main financial centers, Mr. Zecchini remarked. The trend toward innovation had enhanced market efficiency by giving lenders and borrowers a greater variety of instruments for diversification and risk sharing than would otherwise have been available.

Innovation had blurred the dividing lines among the various market segments and had caused a significant shift in the focus of banking activities, Mr. Zecchini noted. New financial instruments and facilities had established new links between short- and medium- to long-term sections of the credit markets, between credit and equity markets--particularly through new corporate takeover techniques--and between different national credit and currency markets, mainly through interest rate swaps and currency swaps. The best evidence of those new linkages was the so-called securitization. The rapid growth of off-balance sheet activities had induced many banks to pay more attention to forms of financial intermediation other than direct lending. That trend had been in the interest of those creditor banks that could avoid the costly expansion of their equity base, and of the "prime" debtor countries that had been able to finance their resource needs at a lower cost.

The strong tendency toward increased allocational and operational efficiency in capital markets had not necessarily improved either the stability of the markets themselves or the international debt situation, Mr. Zecchini commented. The evaluation of the creditworthiness of debtors had not evolved at the same pace as financial innovations and market liberalization. As the staff had noted on page 17 of SM/85/267, some countries that had maintained appropriate policies had had difficulty in tapping the capital markets, and there was no certainty that the transfer of risks implied by swap transactions reflected an adequate perception by the market of the solvency risks involved in such transactions. The regulatory authorities had appropriately reacted to those developments by enforcing existing regulations more strictly, and by strengthening supervisory procedures and adopting new rules to improve capital ratios. However, those developments had not helped the large majority of debtor developing countries to gain access to credit markets; those countries were not in a position to take advantage of financial innovations or securitization. As a result, the demand for bank credit by countries tended to be concentrated in the developing world just at the time when the banking community was increasingly reluctant to lend to those countries.

The factors that he had mentioned had played a part in the split in capital market lending that might become a lasting feature of those markets, Mr. Zecchini continued: on the one hand, a group of industrial countries and some prime borrowers among developing countries enjoyed easy access to international credit in a variety of new forms; on the other hand, many developing countries had experienced a dramatic decline in external borrowing. The most recent data on international banking--covering the second quarter of 1985--suggested that that pattern showed no sign of being reversed in the coming period. The marked reduction in spontaneous lending to debtor developing countries, owing partly to their external current account deficits, had been offset only to a small extent by the successful conclusion of a number of concerted financing packages under the auspices of the Fund.

Different considerations were applicable to the group of prime borrowers and to the group of capital importing developing countries, Mr. Zecchini said. With respect to the former, he agreed with the staff that the process of financial innovation and liberalization and the tendency toward a strengthening of the capital structure of the banking system were favorable developments, Mr. Zecchini said. Those developments should help to enhance the efficiency and the stability of capital markets and ultimately promote a better allocation of resources and a more favorable distribution of credit risk. The main cause for concern at the present stage was the lack of an adequate and steady flow of financing to developing countries. Improvements in that area could probably be expected from only a limited number of technical forms and sources, including direct investment, trade credit flows, banking flows, official credit, and credit from international agencies.

Recent developments in direct investment and trade credit seemed favorable, Mr. Zecchini considered. The establishment of a new multilateral investment guarantee agency and the apparent willingness of a number of industrial countries to restore access to export credits for developing countries were steps in the right direction. Renewed export credits were of particular interest to his Italian authorities, and any initiatives by the Fund or other parties to improve the information about, and access to, that form of credit to developing countries would be helpful.

Commercial bank credit and multilateral assistance remained the key forms of intervention on behalf of developing debtor countries, Mr. Zecchini went on. Given the banks' reluctance to make new lending available, the Fund and other multilateral institutions had played a crucial role in maintaining limited access to bank credit for debtor countries. Their role in catalyzing bank resources, promoting adjustment policies, and providing part of the necessary financing would continue to be crucial in coming years. However, recent experience suggested that their involvement alone did not result in adequate resource availability for debtor countries. New initiatives were needed, such as the one proposed by Secretary Baker at the 1985 Annual Meetings.

Although many of the operational details of Secretary Baker's proposal had not yet been spelled out and analyzed, the proposal was an important step in the right direction and should be strongly encouraged, Mr. Zecchini continued. The U.S. initiative was a clear sign that a phase of the debt crisis had ended; the new phase called for new strategies. The approach that had been followed thus far had successfully dealt with the most serious aspects of the debt problem and had established a foundation for external adjustment by heavily indebted countries. However, the time had come for that strategy to give way to a new approach designed to encourage balanced growth in debtor countries. To that end, the goal of catalyzing additional commercial bank resources for debtor countries was fully appropriate. The additional lending should be made available only to countries that were willing to maintain sound economic policies. That requirement was crucial, as it would guarantee that the new funds could play an instrumental role in supporting appropriate policies. Care should be taken to avoid removing or weakening the incentives that borrowing countries had to adjust their economic systems and to increase productivity and efficiency.

The financial side of Secretary Baker's initiative, as well as the conditions attached to the proposed new financing, underscored an important aspect of the U.S. initiative, namely, its comprehensiveness, Mr. Zecchini remarked. The initiative called for renewed and coordinated action by all the parties involved, including the creditors, the debtors, and the multilateral institutions. At the same time, the initiative addressed the multiple aspects of the debt problem, including the financing requirement, the use of new funds, the need to introduce and monitor appropriate economic policy adjustments, and the need for a multiyear approach to handling members' debt problems.

At first glance, it might seem that the commercial banks could be expected to make a larger financing effort than Secretary Baker had proposed, Mr. Zecchini commented. Indeed, the proposed $20 billion in new lending over three years, representing an increase of somewhat more than 2.5 percent a year in the claims of commercial banks on the 15 developing countries concerned, amounted to a decline in real terms in the banks' exposure in those countries. However, given the banks' current reluctance to increase their exposure in debtor countries and the unfavorable prospects for those countries in the eyes of many observers, including the Fund, the amount of financing proposed by Secretary Baker seemed significant. The proposed amount of commercial bank lending could prove to be crucial if it, together with the other aspects of the U.S. initiative, were to trigger the resumption of spontaneous bank lending on a larger scale in coming years.

The cost of financing was a crucial aspect of the issue of the volume of capital flows to developing countries, Mr. Zecchini continued. He doubted whether a long-lasting solution to the debt problems facing many developing countries could be found if real interest rates remained relatively high. The case-by-case approach to debt problems would continue to be the best way to handle them: while some countries might be able to afford the increased real burden that new financing packages might imply over time, others had reached the point at which new lending at market rates would only briefly delay their becoming insolvent.

The U.S. debt initiative had a number of interesting implications for the role of multilateral institutions in general, and for their conditionality and operating procedures in particular, including those of the World Bank, Mr. Zecchini said. The staff should prepare a paper--for the Executive Board's examination in coming months--on the operational implications of the U.S. initiative for the multilateral institutions and the banking community. In brief, the paper would be a study of the feasibility of introducing Secretary Baker's plan.

Mr. Nimatallah remarked that Executive Directors seemed to agree that debtor developing countries must maintain sound adjustment policies that would place their economies on a sustainable growth path, and that the banking system must perceive that it was to its advantage to respond positively to countries that adopted and maintained such appropriate policies. Although there had been a welcome increase in aggregate bank lending in 1984, it concealed a decline in lending to developing countries. That decline was also evident in the latest available data, which covered the first half of 1985. In explaining their reluctance to lend, the banks had said that they had suffered a deterioration in the quality of their assets and a decline in their income due to their excessive exposure in debtor developing countries. Apparently the banks were giving priority to strengthening their balance sheets. At the same time, supervisory authorities had to try to impose more stringent quantitative as well as qualitative requirements, including higher capital asset ratios and larger reserves for doubtful loans. The banks themselves had tightened their own prudential controls; as a result, new loans had been restricted to customers that were perceived to be of lower risk than other customers.

The staff had mentioned a number of significant developments in commercial bank flows, especially the restructuring of debt with certain countries through multiyear agreements with narrower interest spreads, Mr. Nimatallah continued. According to the OECD, there had been a lengthening of the average period of debt owed by the major debtor developing countries. Those developments were healthy ones and should benefit both the debtor countries and the banks. They were good steps toward solving the debt problem.

Among other important recent developments in the capital markets, the growing share of bonds in banks' portfolios was particularly noteworthy, Mr. Nimatallah said. Banks had resorted increasingly to indirect lending by purchasing bonds to improve their asset positions. They had also resorted to issuing their own bonds to strengthen their capital base. Those developments obviously helped the banks, but he doubted whether they would help developing countries, many of which would find it difficult to raise funds by issuing bonds.

There had recently been considerable liberalization and technical innovation in capital markets, Mr. Nimatallah observed. The liberalization--which implied fewer controls and an increase in incentives through lower taxes--improved competition and presumably increased the efficiency of the capital markets. Similarly, innovations in commercial banks' ways of doing business could help to increase the efficiency of individual banks and therefore might improve profitability. For example, commercial banks could use flexible rate issues to borrow in the medium term and to reduce the mismatch between their lending and borrowing. That practice could be favorable, as it might help to spread the risks associated with interest rate variability between banks and borrowers. Commercial banks could also use flexible rate issues to increase the marketability of their assets that had previously been held to maturity; that practice might also be a favorable development, as it could help to redistribute risk among banks.

However, those activities, as well as swaps, were worrying supervisors in the various financial centers, Mr. Nimatallah went on. There were obviously hidden dangers in the recent trends of liberalization and technical innovation. The innovations could occur more rapidly than the rate of improvement in the ability of bank supervisors to keep track of banking affairs. The recent growth in off-balance-sheet activities was not only testing supervisory skills, but also raised questions about how much off-balance-sheet activities were impairing the prudential control of banks. As to the availability of direct lending to developing countries, the question naturally arose whether certain countries' adjustment efforts alone could attract new financing from banks in the present international banking environment. In other words, developments that might be perceived as being desirable for the banking system as a whole may not be perceived as being desirable for individual banks, especially smaller ones.

Secretary Baker's debt initiative should be assessed against the background of rapid changes in capital markets and the continuation of the debt problem, Mr. Nimatallah remarked. The U.S. initiative obviously was aimed at reducing the banks' reluctance to participate in new money packages and debt restructuring. Under that initiative, 15 heavily indebted developing countries would receive net lending of $20 billion over a three-year period in exchange for implementing sound economic policies. Many issues concerning the acquisition and distribution of the new resources remained to be resolved, but the initiative was welcome and should be encouraged, as it constituted another important step along the road to solving the debt problem. He hoped that the initiative could be extended to all debtor developing countries that were implementing comprehensive adjustment policies.

The success of the U.S. initiative would depend upon the response of the banks, Mr. Nimatallah went on. The banks should realize that the initiative was a sign of the growing awareness that the solution to the debt problems facing members was a shared responsibility: all the parties concerned must play a role. The commercial banks should appreciate that under the U.S. initiative they would be working in conjunction with the Fund and the World Bank. The Fund should continue to play its role as a catalyst of resources, and collaboration between the Fund and the World Bank should be enhanced. Banks would also have to appreciate that, as the staff had noted on page 2 of SM/85/267, Supplement 1, "by demonstrating responsibility and flexibility where adjustment efforts are underway, [banks] can protect the quality of their existing claims on developing countries as well as contribute to further progress in reducing systemic risk and restoring sustainable growth."

Recent trends and developments in international capital markets had also been influenced by the behavior of macroeconomic policies in industrial countries, particularly exchange rate and interest rate policies, Mr. Nimatallah said. It had recently become clear that coordinated efforts to stabilize exchange rates and to lower real interest rates had helped markedly in the servicing of external debt. Therefore, the adoption of appropriate policies in industrial countries and the international coordination of such policies were particularly important for the smooth functioning of capital markets and for improving the management of the debt problem.

International trade should not be hindered by any barriers, Mr. Nimatallah stated. The exports of debtor countries should be encouraged, and protectionist pressures against them should be resisted. The roles of the Fund and the World Bank, together with the implementation of appropriate policies in, and resistence to protectionist pressures by, industrial countries should give the assurance that commercial banks would require to resume their concerted lending to countries maintaining appropriate, comprehensive macroeconomic and structural policies.

Mr. Kafka said that, if the usual safeguards were taken, the publication of the staff papers would be acceptable. The prospects outlined in those papers were not reassuring. The scope for spontaneous lending by commercial banks was likely to remain severely limited, even for countries that had been able in recent years to avoid restructuring their external debt and had undertaken successful adjustment programs. Supervisory authorities and the accounting profession could make the outlook even more discouraging if they engaged in excessively hasty or insufficiently sophisticated pursuit of entirely legitimate prudential objectives. That those problems were being discussed by the parties directly concerned was encouraging.

Another troubling aspect of the debt problem had to do with the conditions of rescheduling, Mr. Kafka said. The scope for multiyear rescheduling arrangements that would benefit both debtors and commercial banks might well be greater than was perceived at present, and the possibility of providing more relief than hitherto for interest rates spreads had not been exhausted.

In the future, efforts should be made to encourage official flows, direct and perhaps other equity investment, as well as to develop the capacity of international capital markets to absorb security issues of developing countries, Mr. Kafka considered. The attitude of the respective supervisory authorities could play a decisive role in those areas, and the Fund could encourage the authorities of capital exporting countries to adopt a positive attitude toward the increased absorption of security issues by developing countries, just as the World Bank was making a valuable contribution to making developing countries more receptive to foreign equity investment.

Secretary Baker's initiative, like the recent G-5 initiative concerning exchange rates, was significant because it represented the end of a period of complacency, Mr. Kafka said. After the first shock of the debt crisis had passed, and the various parties concerned had rallied to respond to it, there had been a propensity to preach that as long as debtor countries adopted adjustment policies, the handling of debt problems could safely be left to the capital markets and to the good sense of the major trading countries, which could be counted upon to avoid protectionism even if they could not avoid slow or stagnant economic growth. Since economic growth was the only feasible solution to the debt problem, and since its resumption would not occur automatically, the United States was to be commended for having been the first among the major industrial countries to propose an initiative that involved the major creditor governments in the process of restarting growth in a sustainable fashion in debtor countries that were prepared to persevere on the path to adjustment with economic growth. Under the U.S. initiative, the adjustments taken by debtor countries would be crucial. However, he was concerned about another crucial aspect of the initiative, namely, the need for creditor country governments to be as forthcoming as possible in responding to the need for the capital increases required by the multilateral development banks and the provision of export credit guarantees. The response of the commercial banks was also a cause for concern, even though the proposed increase in their nominal exposure was sufficiently modest to imply a steady further decline in their real exposure and an even stronger fall in the banks' exposure relative to the banks' equity; the proposed amount of commercial bank financing might not be sufficient to meet the goals of Secretary Baker's proposal.

The U.S. initiative presented a clear challenge to the Fund as well, Mr. Kafka commented. Some of the aspects of that challenge had been mentioned by previous speakers, particularly Mr. Polak, and Mr. de Groote had stressed that the Fund should consider the possible need for new resources and should give fresh thought to the design of Fund-supported programs.

Mr. Fujino said that the staff's analysis of recent trends in bank lending had shed light on the problems emerging in the international capital markets. While bank lending to industrial countries had risen by $22 billion in 1984, the growth of bank claims on developing countries had remained at $15 billion, the same amount as in 1983. Moreover, of the 3 percent increase in bank lending to developing countries in 1984, concerted lending accounted for nearly 60 percent. The increase in the banks' claims on Latin American countries in 1984 was less than the disbursements under concerted lending packages. Apparently the concerted efforts of the banks involved in financing packages had been undermined by the decision of other banks to reduce their exposure in Latin American countries. That development could damage the cohesion of the commercial banking community.

Medium- and long-term lending by Japanese banks--including lending by overseas branches but excluding lending by affiliates--had in 1984 increased by 22 percent over the previous year, Mr. Fujino commented. Loans by Japanese banks to all developing countries had risen by 20 percent in 1984, a relatively high figure. Loans by Japanese banks to developing countries in the Western Hemisphere had increased by 20 percent by the participation of those banks in concerted lending agreements, and lending to Asian developing countries had grown by 26 percent. In all restructuring and concerted lending agreements in which Japanese banks were involved in 1984, no Japanese banks had withdrawn from any agreement. That trend might have been partly responsible for the relatively slow improvement in the capital/asset ratios of Japanese banks.

He agreed with the staff that multiyear rescheduling arrangements for countries with a good record of significant domestic and external adjustment was the key advancement in recent months toward solving the debt problem, Mr. Fujino said. However, such arrangements should be used on a case-by-case and limited basis. In principle, enhanced surveillance by the Fund was to be used in connection with the implementation of multiyear rescheduling arrangements. The staff had suggested that a serial multiyear rescheduling arrangement could be used for countries that could not meet the criteria for enhanced surveillance. For the countries concerned a serial multiyear rescheduling arrangement could be a useful way of helping to reduce the burden and uncertainty caused by annual debt restructuring if the banks concerned could agree. The staff had correctly cautioned that periodic reviews of economic policies and prospects under the serial multiyear rescheduling arrangements must be conducted by the banks concerned on their own responsibility.

The weakening of the cohesion among commercial banks in responding to requests for restructuring and concerted lending was a cause for serious concern, Mr. Fujino remarked. The bank advisory committees should try to alleviate the uneasiness or suspicion felt by the commercial banks regarding the behavior of some banks by quickly providing sufficient information and by closely monitoring the exposure of the participating banks to the countries concerned. The expansion of cofinancing with the World Bank to the extent feasible was desirable, but it was important to ensure that the official resources involved were used to catalyze additional bank financing rather than to substitute for such lending.

Arrangements to cap or reschedule interest payments should be avoided as much as possible, Mr. Fujino considered. The use of such arrangements would distort normal relations between debtors and creditors, thereby undermining the basic structure of the international financial system.

The fact that some banks were reducing their exposure in countries with new bank debt restructuring agreements by not complying with the request to maintain existing short-term exposure in those countries was a cause for great concern, Mr. Fujino said. As private enterprises the banks naturally wished to avoid any unfavorable developments in their balance sheets. However, the recent behavior of some banks could seriously weaken the cohesion within the international banking community, an outcome that would clearly be undesirable; closer monitoring by bank advisory committees could be instrumental in eliminating that problem. It was important to create an atmosphere in which the commercial banks would voluntarily participate in concerted lending. To that end, equitable burden sharing among commercial banks was indispensable. At the same time, debtor countries must persevere in their adjustment efforts and demonstrate their creditworthiness.

The Fund and the World Bank would continue to play the key role in handling debt problems, Mr. Fujino remarked. However, the Fund's assessment of members' macroeconomic policies and increased World Bank involvement in members' structural policies should not be seen as substitutes for commercial banks' own assessments. It might well be true that in future the emphasis of commercial bank lending would shift to short-term trade and project financing, but caution was required to prevent the shift from being excessive and too rapid. The growth of such lending should be brought broadly into line with the flow of funds from other sources.

There were traditional differences in the supervisory regulations of national authorities, and harmonizing them would be difficult, Mr. Fujino noted. Those differences did not constitute an obstacle to handling debt problems, but strict and inflexible application of existing supervisory regulations might hinder the successful handling of debt problems. A flexible approach should be used whenever necessary within the general framework of the continued application of prudential principles; Mr. Dallara's comments on that issue had been helpful.

The rapidly changing international capital markets and practices in those markets posed a substantial challenge for members and the Fund, and the staff had raised a number of important points for the Executive Board's consideration, Mr. Fujino remarked. Future developments in financial markets and institutions would have to be watched more closely than hitherto. In addition, the macroeconomic implications of those changes must be the subject of further extensive study.

Secretary Baker's debt initiative was a welcome move in the right direction, Mr. Fujino said. It appropriately gave first priority to the need for adjustment in debtor countries, and it had usefully added to the momentum of the negotiations on supplementing the resources of the multilateral development agencies. The U.S. initiative could not be successful without the voluntary participation of the commercial banks. The banks themselves would have to decide precisely how they might participate. At present, it was clear that the participation of the broadest possible range of creditor banks would be essential.

As to the Fund's role in the U.S. proposal, the institution had played a central role in providing advice and financial support with respect to the adjustment efforts of debtor countries and it would continue to play a central role in the future, Mr. Fujino remarked. The commercial banks would continue to request the Fund's involvement as a means of ensuring that debtor countries that received increased bank lending would maintain appropriate policies. The Fund was well equipped to meet that challenge. The proposed increase in emphasis on the growth and structural aspects of adjustment policies was appropriate, and the Fund's collaboration with the World Bank--which had more expertise in those areas--should be strengthened along the lines that had been favored thus far. However, it would be imprudent to depart significantly from the traditional conditionality. In any event, the success of the growth-oriented strategy would also depend upon the willingness of debtor countries to accept adjustment programs formulated with the assistance of both the Fund and the World Bank. His authorities were prepared to support the expansion of the lending programs--including structural adjustment lending--by the World Bank and other multilateral development banks; detailed discussions of the actual modalities of the lending and the sources of the funding for the loans would have to be held.

The Executive Directors agreed to continue their discussion on international capital markets in the afternoon.

DECISION TAKEN SINCE PREVIOUS BOARD MEETING

The following decision was adopted by the Executive Board without meeting in the period between EBM/85/164 (11/12/85) and EBM/85/165 (11/13/85).

2. EXECUTIVE BOARD TRAVEL

Travel by an Executive Director as set forth in EBAP/85/272 (11/8/85) is approved.

APPROVED: July 2, 1986

LEO VAN HOUTVEN
Secretary