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INTERNATIONAL MONETARY FUND

# Minutes of Executive Board Meeting 85/166

3:00 p.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 | T. Alhaimus |
| H. Fujino | M. Sugita |
| G. Grosche | B. Goos |
| | Jaafar A. |
| A. Kafka | J. Hospedales, Temporary |
| T. P. Lankester | M. Foot |
| H. Lundstrom | H. Fugmann |
| 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

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Also Present

IBRD: D. Bock, Director, Financial Policy and Analysis Department. European Department: A. G. G. Bennett. Exchange and Trade Relations Department: C. D. Finch, Director; W. A. Beveridge, Deputy Director; R. B. Johnston, E. R. J. Kalter, S. Kanesa-Thasan, M. R. Kelly, G. R. Kincaid, K. P. Regling, C. M. Watson, External Relations Department: R. M. Stough. IMF Institute: O. B. Makalou. 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: A. P. Bhagwat. Treasurer's Department: Y. Kawakami, O. Roncesvalles. Western Hemisphere Department: E. Wiesner, Director. Bureau of Statistics: W. Dannemann, Director; C. Briançon, H. Flinch, J. B. McLenaghan. Personal Assistant to the Managing Director: R. M. G. Brown. Advisors to Executive Directors: P. E. Archibong, L. P. Ebrill, S. M. Hassan, G. Nguyen, G. W. K. Pickering, M. Z. M. Qureshi, E. M. Taha, D. C. Templeman, A. Vasudevan, M. A. Weitz. Assistants to Executive Directors: I. Angeloni, A. Bertuch-Samuels, J. de la Herrán, J. J. Dreizzen, G. Ercel, S. Geadah, V. Govindarajan, L. Hubloue, H. Kobayashi, M. Lundsager, R. Msadek, J. K. Orleans-Lindsay, J. Reddy, J. E. Rodríguez, M. Sarenac, A. A. Scholten, S. Simonsen, B. Tamami, H. van der Burg, B. D. White.

1. INTERNATIONAL CAPITAL MARKETS - DEVELOPMENTS AND PROSPECTS, 1985

The Executive Directors continued from the previous meeting (EBM/85/165, 11/13/85) their consideration of 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 paper on international banking activity in the first half of 1985 (SM/85/294, 11/4/85; and Cor. 1, 11/8/85).

Mr. Jaafar remarked that one of the main conclusions to be drawn from the staff papers was that there had been a sharp reduction in the flow of capital between industrial and developing countries in 1984-85. Given the present world economic conditions, the downward trend in the flow of capital to developing countries was likely to continue in 1986 and beyond, thereby requiring many developing countries to make severe adjustments that could result in the curtailment of their imports and economic growth. The main policy question at hand was how the international banking community, the multilateral financial institutions, and the international community at large should respond to the current adverse trends in international capital markets.

Secretary Baker's initiative was a positive response to the complex and difficult debt-related issues, Mr. Jaafar considered. The recognition by the U.S. Government that commercial banks had been less forthcoming than hitherto in increasing their exposure in support of members' adjustment programs was welcomed by his authorities, although they felt that Secretary Baker's proposal would not adequately meet the different kinds of problems facing the developing countries as a group. For example, nearly all those countries, including those in Asia that had maintained sound economic policies, had suffered from the reduced flow of capital. By concentrating on a few heavily indebted countries, Secretary Baker's initiative ignored the capital needs of other developing countries--especially low-income countries--that faced substantial debt problems that would inevitably worsen if timely remedial action were not taken. Accordingly, a more general approach to promoting international capital flows was warranted. In that context, the statements by Mr. Erb and Mr. Dallara that the list of countries provided by Secretary Baker was meant to serve only as an illustration of the potential beneficiaries under the U.S. initiative were reassuring.

He was pleased that the U.S. proposal included the goal of enhancing the role of multilateral institutions--especially the Fund and the World Bank--in promoting the transfer of resources to developing countries, Mr. Jaafar said. However, there was a danger that in concentrating their efforts on the heavily indebted countries the Fund and the World Bank would be effectively rationing resources to other countries whose balance of payments and development financing requirements as a ratio to GNP could be as large as that of the heavily indebted members. It was important for the Fund and the World Bank not to lose sight of the need to assist all developing countries, including members whose problems did not pose a systemic threat.

The shift in emphasis to growth-oriented policies--which he fully supported--under the U.S. initiative called for a re-evaluation of the design of Fund-supported programs with a view to considering possible improvements in it, Mr. Jaafar said. The focus of such programs should continue to be on the promotion of sound financial policies, and any modification of program design should be aimed at encouraging supply-side structural measures. In his address at the 1985 Annual Meeting, Secretary Baker had given priority to the introduction of tax reform measures and flexible pricing policies. At the present stage more attention must be given to introducing supply-side measures and to determining which aspects of such measures fell within the scope of short-term and medium-term programs supported by the Fund and which should be supported by the World Bank. The Fund should examine the financial implications of possible modifications in the design of Fund-supported programs to promote the basic growth-oriented strategy.

The scope and effectiveness of the Fund's role as a catalyst of resources should be reconsidered in the light of the debt situation, including the commercial banks' apparent reluctance to increase their exposure in debtor countries despite the Fund's involvement in negotiating credible adjustment programs for some of those, Mr. Jaafar remarked. The increased role of the World Bank under Secretary Baker's initiative was welcome, but the World Bank, in close coordination with the Fund, should re-examine its various lending programs. Each institution should be careful to avoid duplicating the efforts of the other group, and together they should consider how they could promote collaboration. However, the idea of joint missions could not be endorsed without qualification: the logistical and other practical factors involved had to be carefully examined, and possible modalities and procedures should be further discussed on another occasion. The call for an enhanced financing role for the World Bank should be followed closely by acceptance of that institution's long-standing request to enlarge its resource base. Secretary Baker's highly qualified statement in support of such an increase was not sufficiently strong.

He supported Secretary Baker's request to have commercial banks increase their exposure in debtor countries, Mr. Jaafar commented. It was difficult to say whether the proposed commercial bank financing of $20 billion over three years would be adequate; the prospects for a stronger world recovery were not bright, and world trade in primary commodities had been disappointing. He doubted whether the amount was sufficient to finance growth-oriented programs and to encourage direct investment. The proposal to benefit a list of the 15 largest debtor countries should be further clarified; assistance to those countries should not be given at the expense of assistance for other debtor developing countries that had successfully implemented adjustment programs either on their own or with the Fund's support.

In devising a new debt strategy, members should work closely with the Fund and the Bank, the commercial banks, and official creditors, which were not mentioned in Secretary Baker's debt initiative, Mr. Jaafar commented. The suggestion to transfer risks associated with debt to either the multilateral development banks or governments should be elaborated in some detail. He wondered what implications that suggestion would have for the objective of promoting spontaneous bank lending without official guarantees. For the time being, the option of transferring debt risks to multilateral development banks or governments was unacceptable.

The participation of commercial banks in solving the debt problem should be rationalized, Mr. Jaafar considered: the larger banks and governments could take up the share of smaller banks. That approach would greatly facilitate new net financing and debt restructuring.

Progress by the United States in reducing its fiscal imbalance would make a fundamental contribution to solving the debt problem, Mr. Jaafar considered. In addition, the implementation of sound policies by the major countries--including opening their markets to developing countries' exports--would create a more favorable economic environment and help the countries to adjust and to grow out of the present difficult debt situation.

Mr. Mawakani commented that the staff papers clearly showed that in 1984 and early 1985--as in 1982 and 1983--total capital flows to the developing countries had continued to slow even though total bank lending and new international bond issues had increased in response to the financing needs of industrial countries. The flow of capital to sub-Saharan Africa had come to a halt. Those developments were cause for considerable concern to the developing countries in general--and to the countries in his constituency in particular--as they seemed to suggest that the international capital markets were not a reliable source of international liquidity creation and distribution.

Over the previous several years, many developing countries had acted, at great social and political cost, to intensify their adjustment efforts--some of them with the assistance of the Fund and the World Bank--to improve their external payments position, and to restore sustainable economic growth, Mr. Mawakani continued. The countries making those efforts had expected to receive financial flows from official and private sources and to be able to restore quickly normal relations with the international capital markets. However, those expectations had been been slow to materialize. The commercial banks wished to minimize their exposure in many developing countries, including countries that had recently restructured their debt or had not required debt restructuring. While the banks' attitude seemed understandable, given the need to strengthen their capital base, the recent hardening of their attitude, as reflected especially in their reluctance to provide new lending in support of strong adjustment policies, was worrying. The adverse effects of that trend on the efforts of countries that were making appropriate adjustment and other economic policy reforms could not be overemphasized. It was discouraging that the painful and costly adjustment measures introduced by developing countries to establish a sounder basis for economic growth had failed to attract the necessary financial support.

Strong adjustment policies also should be maintained by developed countries, especially the large industrial countries, whose economies had a significant effect on the world economy, Mr. Mawakani considered. The inadequate policies of the major industrial countries had caused a deceleration in the rate of growth of world trade and a reduction in the export volume of developing countries, which had been hurt by the weakening of primary commodity prices. In the circumstances, developing countries were likely to make only slow progress toward achieving sustainable balance of payments positions and the trade surpluses that would enable them to offset the declining capital inflows and to build up their foreign exchange reserves.

He was pleased that recognition was being given to the contribution to the stability of the international financial system that could be made by a resumption of economic growth in developing countries together with progress toward overcoming their external financial problems, Mr. Mawakani said. The international economic environment should improve following the realization by developed countries that an enhanced flow of capital was essential for developing countries' efforts to achieve growth and financial stability. The initiative and leadership shown by the U.S. authorities in the efforts to alleviate the debt problem facing developing countries were commendable. The U.S. proposal on a "Program for Sustained Growth" was welcome, and Mr. Dallara's elaboration on that proposal was encouraging. More work must be done on the mechanics of the proposal in order to ensure that it could be effective.

The U.S. initiative called for, inter alia, increased lending by the private banks in support of comprehensive economic adjustment programs, Mr. Mawakani noted. Accordingly, the commercial banks could make an important contribution to the U.S. initiative by softening their attitude toward participating in new money packaging and debt restructuring efforts. A reversal of the sharp decline in net new commercial bank lending to debtor countries would help to protect the banks' interests in those countries. He welcomed Mr. Erb's comments at the previous meeting on the encouraging signs of the commercial banks' willingness to play their part in the new debt strategy and the Chairman's efforts--reflected in his recent address in Montreal urging commercial banks to be more forthcoming because of their special position in the international financial system--to solve the debt problem. Governments had shown interest in the new debt strategy by encouraging more direct investment and official transfers, and the establishment of a Multilateral Investment Guarantee Agency would minimize the risks of foreign investment. Finally, he agreed with the staff's assessment of the major issues concerning international capital markets.

Mr. Abdallah remarked that the number and pace of changes and innovations in international capital markets were bewildering even to the regulatory authorities in the major capital market centers. He would concentrate his comments on developments that were of particular interest to capital-importing developing countries.

Capital markets still felt the effects of the 1982 debt crisis; that was particularly evident in the lack of normal debtor-creditor relations and in the banks' continued efforts to improve their balance sheet positions. The adjustment of international capital markets was clearly taking longer than had been expected; that fact was reflected in the sharp decline in overall bank lending to developing countries in 1984 following the significant drop in 1983, and by the continued fall in spontaneous lending in particular.

Despite the small increase in total cross-border commercial bank lending in 1984, the rate of growth of lending to developing countries had fallen to 3 percent in 1984, compared with 7 percent in 1983, Mr. Abdallah went on. That outcome was the result of the growing financing needs of industrial countries and of the reluctance of commercial banks to lend to many developing countries. There had been an important shift in the pattern of net bank financing flows in 1984: developing countries had become net suppliers of funds to the international capital markets, contributing $10 billion, while the United States had become the largest net borrower by financing more than one fourth of its current account deficit with funds obtained through the international banking system.

Other important features of financial flows in 1984 were the particular forms that bank lending had taken and the distribution of capital flows among regions, Mr. Abdallah commented. There had been only $15 billion in spontaneous bank lending in 1984--a 30 percent decline over the already low level of 1983; spontaneous bank financing for most developing countries had been even more limited in 1984 than in 1983. Conditional flows in the form of concerted lending had represented about 60 percent of the growth in bank claims on developing countries in 1984. Another feature of bank lending to developing countries in 1984 was the growing tendency to transfer claims on the private sector to the monetary authorities of those countries through debt rescheduling, thereby increasing the public sector debt burden of the debtor countries.

There had been significant regional disparities in bank lending to developing countries in 1984, Mr. Abdallah noted. While most countries in Asia and Europe had enjoyed reasonable access to spontaneous bank lending and the Western Hemisphere countries had received most of the concerted flows, African countries had experienced the largest reduction in bank lending. The increase in total cross-border bank lending to Africa in 1984 was only $0.4 billion--about 1 percent--compared with $7.3 billion--11 percent--in 1983. There had also been a sharp drop in new long-term bank credit commitments to African countries in 1984 to only $0.5 billion, compared with an annual average of $3.2 billion in the preceding three years. That trend was alarming, particularly when seen in the context of the severe domestic resource constraint in African countries, the very low income level, and the growing social and political costs of adjustment.

As to the debt situation, the multiyear restructuring arrangements accepted by commercial banks were welcome; they should facilitate the return of normal financing conditions in capital markets, Mr. Abdallah said. However, thus far only a few large debtor countries had benefited from multiyear restructuring. Standardization of multiyear debt rescheduling to enable all debtor countries to benefit from it was a necessary step in the normalization of relations between debtors and creditors. Enhanced surveillance should not become either a normal feature of Fund operations or a prior condition for multiyear debt rescheduling.

Lending procedures had become more complex rather than simpler, Mr. Abdallah commented. There was a growing tendency to link disbursements of concerted lending to purchases under a Fund-supported program. In addition, there was an increasing preference by banks to limit new lending to cofinancing with the World Bank and to make releases of the banks' own funds follow, rather than precede or coincide with, disbursements by the World Bank. Those new devices merely delayed and hindered flows of needed resources to developing countries. In addition, there was pressure by commercial banks for permission to lend domestic currency counterparts of blocked funds to the banks' private customers; such arrangements might cause complications. Furthermore, banks were pressing debtor country governments to guarantee existing bank loans; such guarantees would necessarily increase the debtors' official debt burden.

Low-income countries, especially those that faced protracted debt problems and had no immediate prospects of regaining creditworthiness, needed more imaginative arrangements involving official lenders, even though their debt was mainly to private sources, Mr. Abdallah said. While he broadly supported Secretary Baker's debt initiative, its effective implementation would depend entirely upon commercial banks. Given the banks' initial reactions to the initiative, there was no reason to feel fully confident that the minimum capital flows specified under the U.S. initiative would be made available to all the eligible countries in a timely fashion. Some incentives would have to be given to the private creditors either by the regulatory authorities or by tax administrators. Merely exhorting private creditors to provide needed credit would not be sufficient. In Kenya the authorities had issued directives under which a certain percentage of commercial bank deposits were to be lent in the agricultural sector at the rate applied to other loans. Even though the banks had been required to provide the authorities with data on their lending activities and regular meetings had been held between the authorities and bank executives, the target for agricultural loans had not been reached. Given that experience, he wondered whether there was any reason to believe that commercial banks would meet the lending targets under Secretary Baker's initiative.

Commercial bank financing to developing countries had been falling, and the banks seemed to be generally reluctant to resume spontaneous lending even to members that had restructured their external debt and were implementing adjustment programs, Mr. Abdallah said. The reduced capital inflows were undermining debtor countries' adjustment efforts, were adversely affecting their growth prospects, and were limiting their ability to repay their debts. Unfortunately, many commercial banks were more preoccupied with their effort to cut their potential losses than with the need to provide effective support for international adjustment. He agreed with the staff that the banks' search for protection in the form of legal security, preferential payments arrangements, and guarantees from such institutions as the World Bank could divert attention away from the fundamental need for the banks to make their own credit evaluations.

The staff's assessment of future capital flows to developing countries was not encouraging: net financial flows to developing countries were likely to continue at a low level in 1986, Mr. Abdallah said. If the adjustment efforts of developing countries were to be successful, there would have to be a major change in the banks' lending behavior and in the recent pattern of overall financial flows between industrial and developing countries.

The additional resources that debtor countries urgently needed to be able to grow out of their debt problem were unlikely to come from commercial banks or capital markets, Mr. Abdallah remarked. Decisive official action was required to reach agreement on a General Capital Increase for the World Bank; most members agreed that such an increase was urgently required. In addition, the Fund should be strengthened so that it could play a larger role in supporting the new strategy of adjustment with growth. That objective could best be achieved by advancing the next General Review of Quotas, which should be completed before the end of 1986. Those actions would send important signals to the international banking system regarding the contribution that that system could make to members' adjustment and growth efforts.

The various innovations being introduced in banking operations could affect the soundness of the global financial system, Mr. Abdallah said. The staff had noted that banking operations were becoming less transparent; there was an increasing tendency to convert many loans into marketable instruments that were sold to investors, some of which were unable to judge the risks inherent in such investments. There was also a growing trend toward so-called securitization, with commercial banks holding each other's floating rate note issues. Some banks regarded those notes as money market instruments, while the issuers of the notes saw them as subordinate capital and did not accept any obligation to guarantee that they could be promptly liquidated.

Compartmentalization was disappearing in many capital markets as operations involving securities were being merged or associated with commercial banking operations, while bond trading was being integrated with brokerage and other formally separate activities, Mr. Abdallah noted. Recent developments and innovations in capital markets had important implications for the international financial system and would have to be kept under careful scrutiny by members. The core of the international financial system remained sound, but some of the new practices in capital markets might have some adverse effects on the system. The staff should continue to follow closely developments in capital markets to ensure that they would not impair the soundness of the international financial system, of which the Fund was the guardian.

Mr. Rye considered that the main underlying issue in the present debate was the debt problem, and particularly how to ensure that the progress in dealing with that problem since 1982 would be continued in the coming period. The present discussion was especially timely, as the world economic environment might not be as supportive of balance of payments adjustment and economic growth in developing countries in the coming year or so as it had been in the recent past. In addition, the staff had suggested that the commercial banking community's level of commitment to the present debt strategy was declining.

It would be a mistake to conclude that the present debt strategy had failed, Mr. Rye continued. The considerable progress that had been made was reflected in the substantial reductions in the current account deficits of many capital-importing developing countries since 1982. Moreover, financing and refinancing arrangements had been available for countries that had been making strong adjustment efforts so that those countries had received enough nondebt-creating flows and disbursements from official sources to be able to accumulate some reserves. In sum, as a result of the efforts of debtors, creditors, and multilateral institutions, the debt problem had been contained. However, the problem had not been solved, and there was some risk that the progress could be reversed if the current forward momentum were lost. For that reason, the members of his constituency felt that Secretary Baker's initiative was useful; it highlighted the need for a renewed momentum in dealing with members' debt problems.

Secretary Baker's initiative had a number of attractive features, Mr. Rye remarked. First, it was based explicitly on the need for growth-oriented adjustment. Second, Secretary Baker's strategy was an evolutionary one, not a revolutionary one. It was based on the principles that had guided the response to the debt crisis since 1982, namely, the need for adjustment by debtors, the need for continued involvement in the international financial institutions, including the Fund--which was to play a central role--and the need for further commercial bank lending. Third, Secretary Baker's strategy would preserve the case-by-case approach to handling debt problems. If greater emphasis were to be given to structural adjustment and growth-oriented policies, then the unique institutional, trading, and infrastructural characteristics of each country would have to be taken into account, perhaps even more than in the past.

In the future, commercial banks and regulatory authorities should place greater emphasis on the case-by-case approach, Mr. Rye continued. The apparent tendency for commercial banks not to discriminate as carefully as they might among countries according to the effectiveness of the members' adjustment efforts was not in the best interest of either the banks or the debtor countries. The staff's conclusion on page 17 of SM/85/267 that banks had occasionally paid inadequate attention to the implementation of appropriate adjustment policies was worrying, although some elaboration of that matter might have been helpful. The staff's reference to discussions having been started on possible multiyear rescheduling arrangements for some countries that had not yet established an adequate record of adjustment also raised questions, and further elaboration by the staff would be useful.

That some banks had been unwilling to lend to members that were implementing adjustment programs was of concern, Mr. Rye said. If banks were to persist in attempting to reduce their exposure in those countries, the techniques that had been developed for assembling new financing packages and for managing debt--for example, multiyear rescheduling arrangements--would be much less useful in contributing to the stabilization efforts of developing countries.

The apparent reduction in the cohesion of banks responding to new requests for restructuring and concerted lending was also worrying, Mr. Rye remarked. The solutions to problems in that area were not obvious, but it was clear that sustained adjustment efforts by debtors were an essential prerequisite for further progress. Debtor countries must continue to make needed macroeconomic adjustments; structural adjustments, although essential in many countries, could not be a substitute for appropriate macroeconomic policies. In many countries, including some in his constituency, the implementation of appropriate structural adjustment policies presented at least as many political and other difficulties as the implementation of appropriate macroeconomic policies. He wondered whether, under Secretary Baker's debt initiative, members that had already begun to implement a program with a substantial structural element would automatically qualify for additional assistance under the new debt initiative or would be expected to make an even larger adjustment effort.

The commercial banks would have to continue to demonstrate responsibility and flexibility in assisting countries that were successfully implementing adjustment measures, Mr. Rye commented. The apparent tendency of some banks to increase their reliance upon such modalities as legal security, preferential payments arrangements, and government guarantees must be reversed. That approach by the banks--which was equivalent to the beggar-my-neighbor approach in the exchange rate field--would increase the difficulties for all parties concerned, including the banks themselves.

At the same time it was important to remember that the banks had experienced a weakening in their competitive position, especially vis-à-vis securities dealers, who to an increasing extent were arranging lending for more creditworthy borrowers and were offering more attractive terms than the banks could offer, Mr. Rye continued. That conclusion was particularly applicable to those banks that had lent heavily to debtor developing countries. He wondered whether the commercial banks had the capacity to increase their lending to developing countries, as called for under Secretary Baker's initiative, and what terms the banks would have to ask for if the additional lending were to be feasible for them. Was it reasonable to expect the recent trend toward higher margins to be reversed? In the end, the banks would have to answer those questions for themselves.

There was considerable uncertainty about the so-called modalities of lending under Secretary Baker's initiative, Mr. Rye remarked. It would be useful to know what departures from the present modalities were being contemplated. In particular, were changes in the framework for World Bank-Fund cooperation or more enhanced surveillance being envisaged? He wondered whether it would be necessary for the Fund to involve itself further in promoting medium-term structural adjustment and, if so, what that involvement would entail in terms of the Fund's operations. Would the Fund continue to have the final word on the adequacy of economic and financial programs for individual members? Until more specific proposals with respect to Secretary Baker's initiative were made available, it was premature to state for certain which modalities would be appropriate. More thought should be given to the respective roles of the Fund and the World Bank under Secretary Baker's strategy. It was important to bear in mind that, as the Governor for Australia had said during the 1985 Annual Meetings, the distinct and unique character of the Fund was as valuable now as at any time in the past.

As to the commercial banks, Mr. Rye went on, the modalities for debt relief and for constructing financing packages might need to be re-examined. It was perhaps too early to begin exploring the precise changes that might be appropriate, but it was important to underline that the chances of any revised modalities being successful would be small if the Fund were unable to convince commercial banks that strong and durable adjustment programs were actually in place in debtor countries.

Mr. Goos commented that the present report correctly focused on recent trends regarding liberalization and innovations in capital markets and on the debt situation, all of which required the international community's close attention. He generally agreed with the staff's analysis and conclusions.

The pressures on the banking system for liberalization and innovation had apparently tended to be much less pronounced in countries with a record of low inflation and little administrative interference in the financial system, Mr. Goos noted. Those countries also had a history of early interest rate liberalization and had had universal banking systems that had been able to adjust flexibly to changing conditions. The implication of that conclusion was that incentives for financial innovations could be lessened by providing for a noninflationary and institutionally less rigid domestic financial environment. The accelerating pace of change in financial markets seemed to reflect to a significant degree shortcomings in members' underlying economic policies. Care must be taken so that the regulatory authorities' efforts to contain the potential damage from financial innovations would not deal merely with the symptoms, rather than the actual causes, of shortcomings in members' underlying economic policies.

Regarding the nature and the effects of the current innovations, he agreed with the staff that the innovations could be seen as a repackaging and a redistribution of financial risks that had resulted in an increase in the integration of domestic and international capital markets, Mr. Goos continued. The process of innovation had microeconomic and macroeconomic dimensions. The staff's assessment of the microeconomic dimension--especially the immediate impact on individual balance sheets--might be somewhat overoptimistic. Innovations had significant benefits for financial intermediaries--especially the opportunity to reduce certain risks, improve the intermediaries' liquidity position, and strengthen the intermediaries' profitability--but the staff had perhaps confined the potential drawbacks of the redistribution of financial risks too narrowly to the inability of market participants to evaluate accurately and manage those risks. However, there were indications that the increasing use of new financing techniques could create additional risks not only for individual commercial banks but also for the whole banking system.

More adequate coverage in the staff report was given to the potential repercussions of the increasing use of off-balance-sheet transactions and "securitization," Mr. Goos said. The current trend in the repackaging and redistribution of risks could lead to the concentration of risks in certain segments of the capital markets; that trend could have an unfavorable impact on other segments of the market and perhaps on the entire financial system. Moreover, the legal validity of the complex structure of underlying contracts still had not been tested. And the increasing use of issuance facilities, like the process of "securitization," tended to cause increased disintermediation that weakened the quality of banks' assets. The staff had correctly noted that the intensifying competition among banks might result in inadequate credit risk assessment, excessively narrow interest rate margins, and the overoptimistic perception of the degree of liquidity of newly issued money market paper. German banks felt that the present interest rate margins were extremely narrow and were insufficient to cover the credit risk associated with even the most creditworthy customers.

Given the uncertainties that he had mentioned, he agreed with the staff that the spread of innovations might require a re-examination of the existing regulations on capital adequacy, Mr. Goos continued. A number of members also should consider the possibility of extending their supervision to investment houses and financing companies. However, the staff had noted that there were clearly limitations on such an extension; supervision beyond the traditional institutional approach might prove to be unfeasible.

Liberalization and innovation clearly increased the efficiency of overall resource allocation and the integration of domestic and international financial markets, Mr. Goos remarked. Those trends posed new challenges for monetary authorities, especially in terms of their ability to understand and monitor new developments and the impact of those developments on strategic monetary variables. Moreover, the issue at stake was not limited to the task of finding a new, reliable basis for monetary management. The new financial instruments had tended to create considerable additional demand for capital. That trend implied that the real asset base was becoming increasingly leveraged and that the real base of members' economies was becoming increasingly vulnerable to disturbances in the financial sector. At the same time, the tasks of understanding monetary innovations had been greatly complicated in recent years by the reduced transparency of the financial markets owing to the lack of inadequate data. That unsatisfactory situation clearly called for continued efforts both nationally and internationally level to prevent serious strains on the economic and financial system.

He generally agreed with the staff's assessment of the developments in the capital markets that had a direct bearing on developing countries in general, and on the debt problem in particular, Mr. Goos said. The signs of fatigue within the commercial banking community with respect to lending to developing countries, particularly the highly indebted ones, was a cause for concern. It posed an immediate threat to the continued effective use of the current international debt strategy, which depended critically upon the cooperation of all the parties involved. In assessing the reasons for the banks' apparent fatigue, the staff had said that much of the blame rested with the banks themselves, and that they appeared to be reluctant to lend even to developing countries that were maintaining appropriate adjustment policies.

While such behavior could be explained partly by the banks' attempts to reduce their exposure in developing countries in response to regulatory requirements, the staff's assessment suggested that the banks were voluntarily forgoing opportunities for profitable and low-risk lending, Mr. Goos went on. Instead, the banks were showing growing interest in forms of legal security, preferential payment arrangements, and guarantees on new lending to developing countries. That trend suggested that the banks might have a different view than the staff on the appropriateness of the adjustment policies of the relevant countries and therefore on the prospects for future timely debt servicing. Inasmuch as prospects for such debt servicing were also affected by global economic conditions; the banks' perceptions of those conditions might also differ from those of the staff. Placing too much emphasis on other explanations of the banks' behavior toward developing countries suggested that the banks were behaving irrationally; it assumed, in particular, that the banks were unaware of the fact that reducing their exposure in certain countries could seriously impair the quality of their existing assets. Consistent with that conclusion Secretary Baker had called upon the banking community to increase its contribution to the debt strategy as well as upon the principal debtors to adopt comprehensive macroeconomic and structural policies. A strengthening of adjustment by the major debtor countries would have a positive effect on the banks' assessment of their creditworthiness and would therefore help to mobilize the necessary financial flows--including a return of flight capital--that would enable the debtor countries to continue to adjust in an orderly manner and to improve their growth prospects.

He warmly supported the objectives pursued by Secretary Baker in building upon the existing debt strategy, Mr. Goos said. Secretary Baker's initiative provided a constructive framework within which the various parties concerned could continue to cooperate on a case-by-case basis to deal with the international debt problem. The lending target of $20 billion and the list of 15 countries should only be illustrative in nature. The implied average net increase in lending of less than 3 percent a year seemed to be low. The 15 countries mentioned by Secretary Baker should not have an explicit claim on the financing that was to be made available under the U.S. initiative. The precise amount of financing to be available would have to be established on a case-by-case basis; the access of individual countries to the resources available under the U.S. initiative would have to be decided on the basis of the merits of each case.

Official calls upon the commercial banks to provide additional financing should not be taken as a signal that the banks would be released from the responsibility for making their own decisions on lending to individual countries, Mr. Goos remarked. His authorities were determined not to influence the lending decisions of the German banks with respect to either the countries to receive additional loans or the specific amounts in each case. The authorities would not engage in any form of arm-twisting and would not change their regulatory requirements.

The operational details of the U.S. initiative, including the specific role of the Fund and the multilateral development banks, still had to be worked out, Mr. Goos noted. The Fund would probably have to maintain its central role. The detailed arrangements would have to be the subject of a separate discussion, perhaps in the context of the coming review of upper credit tranche arrangements.

Mr. Salehkhou said that his overall impression from the staff papers was that the situation in international capital markets had been further strained in 1984, and that the prospects for the remainder of 1985 and for 1986 remained uncertain. Global economic conditions seemed likely to be a significant constraint on international lending to developing countries in the coming period. Financial markets had failed to respond in a rational manner to the imbalances in members and to recycle effectively to developing countries the current account surpluses that were concentrated in some industrial countries. In sum, the hopes that had been expressed during the previous review of capital markets had not materialized. Cross-border bank lending to developing countries had declined sharply in 1984 in favor of lending to industrial countries. That unfavorable trend had continued in the first half of 1985, when the increase in international bank claims on developing countries had been limited to $1 billion, about one fourth the amount recorded in the same period in 1984; indeed, on a net basis, developing countries had supplied $8 billion in 1984 and $2 billion in the first half of 1985 to the international banking system. That unsustainable trend, together with the stagnation in official development assistance, the reduction in Fund and World Bank commitments in the current financial year, the lack of a new allocation of SDRs, and the decline in nominal and actual access limits for Fund resources, was most unfavorable for developing countries.

International financial flows to developing countries continued to be insignificant despite the implementation of serious, and in many cases costly and painful, austerity measures in debtor countries, Mr. Salehkhou continued. The resumption of spontaneous lending in the coming period seemed unlikely. The concern about the inability of a few major borrowers to service their debts had continued to limit the availability of credit to most developing countries. The implementation of Fund-supported programs obviously had failed to foster the resumption of spontaneous lending. As a result, developing countries had had to rely on other sources to meet their balance of payments needs.

The external current account deficits of industrial countries had more than doubled in 1984, Mr. Salehkhou continued. The increasing budget and external deficits of some of those countries had reversed their traditional role as capital exporting countries. Their deficits had been financed largely by flows from other industrial countries, thereby limiting the capital available for developing countries. Those trends clearly underscored the need for corrective domestic policies and concerted international cooperation by the major industrial countries. The recent agreements on interest and exchange rates were welcome, but the obstacles to sufficient flows of financial resources to developing countries must be eliminated.

Real international interest rates were higher by historical standards and were clearly unsustainable, Mr. Salehkhou considered. To alleviate the burden on debtors caused by the high interest rates, major industrial countries should provide a framework within which to achieve lasting reductions in interest rates.

Exchange rate fluctuations had adversely affected investment and trade, particularly in developing countries, Mr. Salehkhou said. Comprehensive and concerted efforts to correct fiscal and monetary policies of industrial countries were clearly needed, rather than continued reliance on direct or indirect intervention in the exchange market.

The growing protection in industrial countries had obviously undermined international trade and developing countries' adjustment efforts, Mr. Salehkhou remarked. The weakening of export markets and the continued decline of primary commodity prices had increased developing countries' dependence on external financing. Non-oil commodity prices had been deteriorating steadily: average dollar prices in the third quarter of 1985 were 12.5 percent less than the comparable prices in the same quarter of 1984. As a result, total exports of developing countries in the first half of 1985 were 9 percent less than in the same period of 1984. In the absence of effective Fund surveillance over the major industrial countries, the ability of developing countries to service their debts would remain in doubt.

The Fund should encourage borrowing members to undertake needed policy reforms, but it should also use its influence to obtain more realistic and equitable terms on existing and new debt, Mr. Salehkhou considered. The Fund should be in a position to require industrial countries to ease the pressure in credit markets, thereby reducing the risks and uncertainties associated with international lending. The reluctance of commercial banks to resume lending was due partly to the uncertainties concerning developing countries' policies and the external economic environment.

Africa and the Middle East particularly had suffered from the present international financial environment; they had experienced the largest percentage reductions in new long-term international bank credit commitments in 1984, and there had been almost no bank commitments to the Middle East in the first half of 1985, Mr. Salehkhou observed. In that period, nearly all new bank commitments to developing countries had been in the form of concerted, rather than spontaneous, lending, even for countries with successful adjustment records. The Fund should effectively use its influence to encourage international banks to resume voluntary lending. The recent improvements in bank credit conditions, such as the decline in Eurodollar interbank rates, U.S. dollar prime rates, and interest rate spreads, were welcome. However, lending in international bond markets was increasingly becoming a substitute for syndicated loans.

The introduction of multiyear rescheduling arrangements might have reduced the immediate debt service burden of a few major debtors, Mr. Salehkhou remarked. However, there had been some difficulty in implementing multiyear rescheduling arrangements, and a further staff comment on the status of and prospects for such arrangements would be helpful.

Some developing countries were highly regarded borrowers, but the banks were still concerned about their exposure in many other developing countries, particularly those that had restructured their debt, usually in cooperation with the Fund, Mr. Salehkhou commented. That trend indicated that the so-called catalytic role of the Fund had not yielded the expected higher level of lending.

The U.S. debt initiative was a further indication of the limits of the so-called case-by-case approach, Mr. Salehkhou said. The new initiative was another piecemeal approach that seemed to deal mainly with the problems facing a selected number of heavily indebted countries. Thus far, the proposed amount of new commercial bank lending--$20 billion over three years--had received a lukewarm reception by commercial banks and was in any event clearly insufficient. He wondered whether the $20 billion in lending to the members benefiting from the U.S. initiative would be offset by a reduction in lending to other countries.

The short-term prospects regarding international capital markets clearly were not favorable for developing countries, Mr. Salehkhou remarked. There was a clear need for immediate action by the Fund, the World Bank, and other international financial organizations to open up needed financing avenues for developing countries. Such efforts should aim at alleviating the debt burden of those countries while helping them to continue their adjustment efforts and to regain sustained economic growth. An appropriate contribution by the Fund would obviously involve a reversal of the recent trends in access to, and conditionality on, Fund resources. Such a reversal would clearly entail the provision of adequate resources for the Fund and the World Bank.

The consensus during the 1985 Annual Meetings on the need for growth-oriented Fund-supported programs was encouraging, Mr. Salehkhou said. The Fund and the World Bank should, each within its own field of competence, help members to formulate and implement such programs, so that the members could effectively tackle their debt problems and maintain public support for the adjustment process.

Mr. Nebbia remarked that the staff papers provided a comprehensive description and balanced assessment of the far-reaching developments since mid-1982 in the international financial markets. One of the major disappointing developments was the reduction in bank claims on developing countries from $80 billion in 1981 to $15 billion in 1984 and 1985. Claims of U.S. banks on developing countries had declined by $3 billion in 1984, or by about 2 percent. Those trends underscored the reluctance of commercial banks to lend to many developing countries, including those countries that had maintained strong adjustment efforts since the 1982 crisis.

The net transfer of real resources from developing countries to industrial countries was a potential serious danger, Mr. Nebbia continued. The World Bank had recently reported that net resource flows associated with long-term lending had declined from $33 billion in 1978 to a negative $7 billion in 1984. Net transfers to major borrowers had been $18 billion in 1978 but had been increasingly negative since 1982, reaching a negative $15 billion in 1984. That trend had clearly undermined the recovery in debtor developing countries; he doubted whether the current adjustment efforts in those countries could be sustained in the absence of unchanged external conditions.

On several occasions he had stressed that the current trends in financing flows were a cause for serious concern, Mr. Nebbia said. Concerted lending remained necessary, and the efforts by management and staff to encourage such lending were welcome, but other parties to the international debt situation were not performing as well. Continued sizable net payments, including interest payments, by debtor nations to creditor nations in coming years would be paradoxical; after all, adjustment programs could not be sustained in the absence of adequate and timely financing. In explaining their increasing reluctance to lend to developing countries, the banks had stated that they already had relatively substantial exposure in those countries, their supervisory authorities had been applying existing guidelines and regulations with more vigor, and the ratio of their capital to their assets was unfavorable. At the same time, the governments of some industrial countries had said that they were worried about the banks' apparent reluctance to contribute their fair share to the overall financing efforts.

The use of multiyear rescheduling arrangements was a positive development, but they had been limited to a small number of members, had not restored normal creditor-debtor relationships, and had not resulted in the increased access of developing countries to spontaneous lending, Mr. Nebbia commented. Indeed, there had been a negative trend in spontaneous lending in most developing country regions, and there had been almost no such lending to Western Hemisphere developing countries. Commercial banks had been reluctant to resume spontaneous lending despite the vigorous adjustment policies of developing countries and the improvement in their current account position, which should have restored their creditworthiness and reduced the systemic risks that those countries had posed.

There had been several other positive developments, Mr. Nebbia noted. Maturities of rescheduled debt and for new money had been lengthening, and there had been an increase in the ratio of rescheduled debt to the stock of overall external debt. There had also been some success in maintaining or increasing short-term trade-related credit lines for some countries.

The U.S. debt initiative was basically a welcome step toward eliminating the debt problems that faced the most heavily indebted countries, Mr. Nebbia remarked. The U.S. initiative was still in an early stage of development, and his comments on it were preliminary. It was based on three tiers of responsibility: the debtor countries must seek adjustment with growth by the implementation of structural policies and a reduction in the rate of inflation; lending by multilateral development banks must be more effective; and private banks must provide increased new net lending in support of borrowers' comprehensive adjustment programs.

He agreed that debtor countries must adopt appropriate policies, Mr. Nebbia continued. The amount of commercial bank lending was not the main issue with respect to the U.S. initiative. In fact, the main issue was the most prompt and effective way of setting the U.S. initiative in motion, even if long-standing principles and traditions had to be departed from in the process. He fully understood the wish of the U.S. authorities to see market forces in the form of private commercial banks play the main role in the debt strategy, but the banking system clearly needed some encouragement to play that role, and one of the main questions at hand was how best to provide the encouragement. Borrowers could provide some encouragement by implementing serious adjustment programs and consolidating and strengthening their means of repaying debt; a significant number of countries had been doing so over the previous three-year period. More tangible and immediate encouragement must be given by the governments and monetary agencies of the major countries in which the commercial banks were located. Those countries could also influence the banks through the countries' leading positions in the multilateral lending institutions. If the U.S. initiative to promote adjustment with growth were to be successful, commercial banks and multilateral lending institutions would have to be given tangible guidance. At the same time, certain countries must provide clear evidence of their political will to act.

A new adjustment strategy would have to be devised for debtor countries; the achievement of stable growth must be at the heart of that strategy, Mr. Nebbia considered. The desired rate of growth and related objectives would have to be carefully assessed for individual countries so that the financing need for each country could be determined. The staff should prepare a paper on the role of the Fund in formulating the set of macroeconomic and structural policies needed to encourage growth and balance of payments adjustment in individual developing countries. The U.S. debt initiative was consistent with the developing countries' position that the solution to the debt problem required the cooperation of debtor and industrial countries, commercial banks, and international financial institutions. Symmetrical adjustment was of paramount importance. The imbalances in the U.S. economy had been a significant destabilizing factor in the international financial markets. However, the protectionist measures of Japan and most of the European countries had been equally damaging and would continue to be especially harmful if the desired shift to a strategy of adjustment with growth were actually made. In addition, protection against agricultural exports had been as harmful as protection against industrial products. Cooperative efforts at tackling the various problems that he had described were needed if members were to find durable solutions to the debt problems.

Mr. Sengupta said that Mr. Abdallah had usefully described the developing countries' views on recent developments in, and prospects for, capital markets. The staff papers clearly indicated that the increase in net lending in 1984 through international capital markets was accounted for mainly by loans to industrial countries; new lending to developing countries had declined further in comparison with 1983. The increase in overall net lending in 1984 had been in response partly to the growing current account deficits of industrial countries, especially the United States. At the same time, however, the capital-importing developing countries had maintained their strong adjustment efforts, and their external current account deficit had declined sharply, from $60 billion in 1983 to $38 billion in 1984. Moreover, the current account deficit of capital-importing developing countries had not been financed by international capital markets; nondebt creating flows to those countries plus net disbursements from official sources had amounted to some $51 billion in 1984-85.

The staff papers clearly described the structural changes in capital markets and the financial innovations in the form of new investment mechanisms to meet the challenges of the evolving international economic situation, as well as the liberalization of financial markets and the improvements in communications among markets, Mr. Sengupta continued. He agreed with the staff that efforts to improve coordination between supervisory and monetary authorities in the major countries was crucial to maintaining stability in financial markets. The emerging changes in those markets had given rise to a wide variety of questions in a variety of fields such as the definitions of monetary aggregates, the likely problems caused by the divergence of adjustment in the financial markets and in the goods and labor markets, and the international impact of the policies of major countries through the increased integration of financial markets. The staff had noted that the Fund should pay increased attention, through its surveillance over the major countries, to the need for greater harmonization of economic policies and performance, to improve resource allocation, and to foster orderly conditions in financial markets. He wondered precisely how the Fund would achieve those goals. Could it do so by using the existing surveillance mechanisms of Article IV consultations and world economic outlook discussions, or were major changes in those mechanisms needed so that the policies of a number of countries could be examined simultaneously and coordinated?

The staff papers clearly gave the impression that the commercial banks had not been sufficiently forthcoming in lending to developing countries, even countries that had made substantial adjustment efforts, Mr. Sengupta remarked. The Fund had assisted several developing countries with Fund-supported programs in their efforts to reschedule their external debt. Many countries had attempted to attract private lending by introducing severe adjustment measures at great political and social costs. It was disappointing to note that the staff had been forced to conclude that there had been some weakening in the banks' cohesion in responding to new requests for restructuring and concerted lending.

The attitude of the commercial banks toward debtor developing countries was clearly described in the staff papers, Mr. Sengupta went on. The banks' reluctance to resume spontaneous lending was due partly to the uncertainties about the policies of the debtor developing countries and about the external economic environment. The staff had further concluded that many smaller banks in particular might not wish to continue general purpose lending to many developing countries, even countries pursuing adjustment programs. The staff's conclusions suggested that the commercial banks had not been responding positively even to developing countries that were making substantial adjustment efforts. It was for that reason that the Group of Twenty-Four had concluded, in its recent report on the international monetary system, that the implementation of adjustment policies by developing countries did not necessarily improve their creditworthiness. Commercial banks seemed to be using various mechanisms to try to reduce their exposure in developing countries. That conclusion was evident in the banks' apparent withdrawal from restructuring exercises and accounted for what the staff had called the diminishing cohesion among the banks. The banks that were still active in developing countries were insisting upon the involvement of the World Bank and official creditors, in addition to the Fund's involvement and the provision of guarantees of bank loans.

In the circumstances, it was not clear to him whether the commercial banks would be willing to increase their exposure by as much as the $20 billion advocated by Secretary Baker to those countries that had been on the point of defaulting on external debts and in respect of which regulatory authorities had been insisting on the introduction of adequate provisions to cover loan losses, Mr. Sengupta said. The U.S. Government obviously preferred to see that commercial decisions be left to the play of free market forces. It seemed odd that the U.S. debt initiative was based on the assumption that the commercial banks would wish to make additional loans to debtor developing countries; in fact, the banks clearly felt that additional lending to debtor developing countries was not in the banks' own commercial interest. The U.S. Government could be expected to pressure banks to make additional loans to debtor developing countries, but there was no certainty that the banks would make the loans. It seemed reasonable to assume that the banks would seek assurances and safeguards as a condition for increasing their participation in the debt strategy. In that context, cofinancing and guarantee arrangements with the World Bank could become relevant. Any such safeguards should appropriately be provided by industrial country governments in a direct and transparent manner.

Nevertheless, the U.S. debt initiative was timely and welcome, Mr. Sengupta went on. Although the scheme had not yet been described in detail, it obviously had several positive features. As a result of the initiative, there was for the first time in recent years adequate emphasis on the need for growth-oriented policies as a part of the international debt strategy. The U.S. initiative also emphasized the need for adequate levels of financing--together with adjustment--in debtor countries, and it implicitly recognized that the governments of lending countries had a role to play in solving the debt problem. Moreover, the initiative was in effect an admission that commercial banks, which responded to market incentives, should not be expected to respond to systemic challenges; what might be good for the banking system as a whole might not be seen as a positive development by individual banks. There should be an in-depth examination of the U.S. initiative at an early date.

However, a number of details would have to be worked out before Executive Directors could have a full understanding and meaningful discussion of the U.S. debt initiative, Mr. Sengupta continued. It was not clear to him that the commercial banks would respond positively to the call for them to increase their exposure to 15 developing countries by $20 billion. The staff had noted that commercial banks were keen on involving the World Bank and cofinancing in the debt strategy, and that the banks appeared to be less reluctant to support trade and project financing in debtor developing countries. However, the U.S. initiatives seemed to give a relatively large weight to structural adjustment lending by the World Bank; such loans were typically disbursed relatively quickly and would enable borrowing countries to meet their immediate balance of payments financing need. Nor was it clear to him that commercial banks would increase their lending to debtor developing countries in the absence of guarantees from the World Bank. Such guarantees were equivalent to World Bank lending, given the operating rules of the institution.

Secretary Baker's initiative would also require the regional multilateral development banks to increase their lending to debtor developing countries by 50 percent over a three-year period, Mr. Sengupta noted. Of the total new lending commitments of about $20 billion by development banks, the World Bank's share would probably be $13-14 billion. Those commitments should be in addition to, and not a substitute for, the World Bank's financing under its established lending programs. He wondered what the implication of the World Bank's lending under Secretary Baker's initiative would be for the future size of the World Bank's general capital. Presumably, the World Bank's lending under Secretary Baker's initiative could weaken the institution's credit rating, thereby making it more difficult and more costly for the World Bank to borrow in the markets. He also wondered whether the World Bank had considered the possible effects of lending under Secretary Baker's initiative on the cost of World Bank financing for borrowers from the World Bank.

The World Bank's main tasks were to promote development and to alleviate poverty, Mr. Sengupta continued. Accordingly, the World Bank's participation under the U.S. initiative should be development oriented. The World Bank should not be required to encourage macroeconomic adjustment measures in borrowing countries, something that was strictly within the purview of the Fund. The World Bank should be in a position to make adequate financing available to all members, and to that end donor countries should agree immediately on a substantial increase in the World Bank's general capital and in the resources of IDA under the Eighth Replenishment.

The Fund was to play a central role in Secretary Baker's strategy, but it was not clear to him how the Fund could do so in the absence of adequate financing for the institution, Mr. Sengupta said. It was important to remember that the international community had been given a respite from the crisis in 1982 mainly because of the timely intervention of the Fund. He wondered whether the Fund was to continue to organize multiyear rescheduling arrangements, or whether that work would be shifted to the World Bank. Did the World Bank have the financial means and the expertise to take on that responsibility? If the Fund were to play its role in promoting international adjustment, there was an urgent need to increase quotas substantially and to improve the Fund's policy framework so that the Fund could provide financing under Fund-supported programs adequate to ensure growth and adjustment. Presumably the theory and design of the Fund's policy framework would be discussed by the Executive Board in the coming period. He wondered whether the staff agreed with Secretary Baker that the Fund's policy framework should stress the need to increase the reliance by members on the private sector while decreasing their reliance on the government sector.

He was worried by Mr. Lankester's comments that the U.K. authorities were reluctant to apply any kind of pressure on the commercial banks to provide new loans under the U.S. debt initiative and by the statement of Mr. Goos that the German authorities would not engage in any kind of arm-twisting of the commercial banks, Mr. Sengupta commented. The commercial banks should be encouraged to see that it was in their own interest to make the additional loans called for under Secretary Baker's initiative.

While Secretary Baker's request for commercial banks to increase their lending to debtor developing countries was welcome, the proposed amount would not solve the debt problem or eliminate the risk of default, Mr. Sengupta said. Nevertheless, the U.S. initiative was a positive step, and other industrial countries should be urged to play their part in persuading commercial banks to act in their own best interests by increasing lending to the debtor developing countries. The proposed increased role of the multilateral development banks was welcome, provided that the banks were given sufficient resources to play that role while maintaining their development assistance under their existing lending programs.

Mr. Lundstrom commented that much of the innovation, diversification, integration, and liberalization in the international capital markets had been desirable. However, they had apparently failed to produce a rational pattern of financial flows; indeed, the current pattern was unfavorable.

He strongly supported the U.S. debt initiative, Mr. Lundstrom continued. It marked the end of a period of complacency. However, it was still merely an outline of some ideas and principles, and the present discussion on it had raised more questions than it had provided answers.

One of the basic principles underlying Secretary Baker's debt initiative was that new commercial bank lending and increased lending by multilateral development banks should be linked to the implementation by recipient countries of appropriate economic policies, including structural and development policies as well as traditional macroeconomic policies, Mr. Lundstrom said. In addition, those policies should be aimed at achieving economic growth as well as balance of payments adjustment, and it was for that reason that Secretary Baker's initiative also called for closer collaboration between the Fund and the World Bank. That collaboration, possibly on a case-by-case basis, would be acceptable provided that it did not place in jeopardy the continuation of the particular respective functions and identities of the Fund and the World Bank.

The U.S. initiative alone would not solve the debt problem, Mr. Lundstrom considered. The fundamental importance of concessional capital flows--particularly to countries that had no access to international financial markets--could not be overemphasized. The capacity of multilateral financial institutions, including IDA, to increase their disbursements to developing debtor countries depended crucially upon the attitude of the United States toward the funding of those institutions. Direct investment would also have an important role to play. An even more important role would be played by the economic policies--financial, monetary, and trade--of the industrial countries, especially the major countries. He agreed with Mr. Polak that as the world's largest importer of capital the United States must reduce its budget and external current account deficits. He also agreed with Mr. Zecchini that the Executive Board should hold another discussion on the U.S. debt initiative when the details and implications of the U.S. proposal were clearer than at present.

Mr. Polak said that the comments by Mr. Lankester, Mr. Abdallah, and Mr. Goos suggested that Secretary Baker's initiative had two elements that would be difficult to combine. The first was to give debtor developing countries confidence that, if they adopted appropriate policies, they would receive substantial additional commercial bank financing. The second was that the commercial bank lending was to be genuinely voluntary; there were to be no guarantees, no relaxation of prudential rules, and no arm-twisting by governments. The first objective could be met by introducing something like the so-called superbank, which would receive deposits from individual commercial banks up to $20 billion on which the Fund could draw to provide financing for individual members that were maintaining adequate policies, but that solution was not envisaged. As to the second goal, he wondered whether the aim could be anything more than an agreement in principle among the commercial banks to resume their participation in concerted lending, perhaps with the marginal improvement of an understanding in advance of the distribution among the banks concerned of the required lending. Neither of the two goals--which represented extremes--was likely to be met, and he wondered whether there could be a workable balance between the two. One conceivable solution was for the Fund to act as an intermediary between a debtor country and the banks until an agreement was reached on a package of policies and an amount of credit. He wondered whether that solution could be applied to all the countries that were to benefit from the U.S. initiative.

Mr. Dallara said that he welcomed the broad support of Executive Directors for Secretary Baker's initiative to strengthen the international debt strategy. He took Executive Directors' comments at the present meeting, together with other statements of support such as the recent statement by the G-10 central bank governors meeting in Switzerland, as an indication of an emerging consensus that the U.S. initiative should be moved forward and eventually implemented. The support for the initiative was based not only on the proposed financing under the U.S. strategy, but also on the emphasis on the need for comprehensive economic programs that included macroeconomic and structural measures designed to promote sustained economic growth in developing countries. The staff's analysis clearly showed that financing under the U.S. initiative should not be provided in the absence of comprehensive programs in debtor developing countries. He also welcomed the support by Executive Directors for the proposal to have the Fund play a central role in the overall efforts to strengthen the debt strategy, partly by increasing the Fund's emphasis on structural measures and partly by continuing the Fund's critical role in encouraging the maintenance of sound macroeconomic policies and in monitoring members' policy measures. Mr. Jaafar's description of the Fund's role was particularly appropriate. He himself looked forward to working with management, staff, and other Executive Directors to develop more detailed understandings and procedures in support of the needed evolution in the Fund's role.

A member's efforts to play a leading role in resolving international financial issues was likely to fail if the member presumed that it had gained a perfect understanding of the issues concerned, Mr. Dallara continued. Secretary Baker continued to feel that the details of his initiative would have to be worked out over time, in an evolutionary fashion, with the broadest possible participation of commercial banks, the debtor countries, other creditor countries, and international institutions, including the Fund. The present discussion would make a useful contribution to the development of some aspects of the U.S. debt strategy, such as the respective roles of the Fund and the World Bank, which had been mentioned by a number of speakers. All the parties involved in the debt strategy should recognize that it was in their self-interest to play their respective roles, and each should feel that it had a hand in the evolution of the initiative.

His authorities believed that Secretary Baker's initiative was a continuation and a strengthening of the case-by-case approach, Mr. Dallara said. That conclusion raised complex issues, one of which had been underscored by Mr. Rye, namely, whether members that were currently implementing economic programs that contained significant structural components would need to adopt new programs to qualify for assistance under Secretary Baker's strategy. To some extent Mr. Rye had provided the answer to that question in stressing that, in many respects, the current circumstances underscored the usefulness of the case-by-case approach; in his own view, the answer to the question Mr. Rye had posed would have to be determined on a case-by-case basis, bearing in mind the fact that, while many members had undertaken efforts to deal with structural problems, most of them would have to make an extra effort.

The proposed list of 15 countries was the result of a rather basic analysis of the October 1985 World Economic Outlook report, Mr. Dallara said. His authorities had focused on the developing countries that were reported by the staff to have negotiated rescheduling arrangements.

Rescheduling was not the only criterion that had been used in compiling the list, but it was one of the criteria that had been met by all the countries on the list except Colombia, which had not yet reached the stage at which it received purely voluntary lending from commercial banks. Panama had rescheduled its debt but had not been included in Secretary Baker's list because of the banks' relatively small exposure--excluding offshore banking activities--in that country. The proposed list was not exclusive. Inclusion in the list was not a derogatory sign for any particular member, just as inclusion on the list did not guarantee that a member could fully meet its financing need.

In their contacts with the commercial banks his authorities had underscored two additional points, Mr. Dallara said. First, they hoped that the banking community would continue to provide additional financing as needed in support of the economic programs of countries that had already been able to obtain commercial bank borrowing on an essentially voluntary basis, presuming of course that the members concerned would maintain sound policies. Second, there was a clear need for the international financial community--including the banking system--to provide additional financing to other developing countries that were prepared to adopt and implement comprehensive economic programs. He hoped that that second point would provide some assurance to members that were not included in Secretary Baker's list; there was no intention to make it more difficult for members excluded from the list to obtain needed financing from commercial banks. The determination of individual financing needs would be made largely under the leadership of the Fund working in close collaboration with the World Bank on a case-by-case basis, as had been the practice in the past.

Further attention must be paid to the plight of the low-income debtor developing countries, Mr. Dallara continued. Secretary Baker's initiative was not meant to focus on the problems of those countries. However, he agreed with speakers who had stressed that, even though debt problems facing the low-income countries did not have a systemic effect on the international financial system, those problems urgently required the attention of the international community. It was for that reason that Secretary Baker had proposed the separate, but clearly related, initiative to take a broad approach to the use of Trust Fund reflows. He hoped that Secretary Baker's proposal concerning Trust Fund reflows would receive further attention by and the support of Executive Directors in the near future so that that important initiative for the future economic well-being of low-income developing countries could be further developed.

The $20 billion mentioned by Secretary Baker was not meant to be a hard and fast estimate of the assistance that would be required under his initiative, Mr. Dallara commented. Financing needs would undoubtedly change over time; even the likely direction of the change was somewhat unclear at present. His authorities had made their best effort to estimate financing needs on the basis of certain key assumptions, the most important of which were that sound macroeconomic and structural policies would be introduced by the countries concerned, and that those policies would make a contribution to reversing capital flight and would gradually encourage additional foreign direct investment in those countries. He tended to agree with Executive Directors who felt that $20 billion might eventually prove to be too low. It was therefore especially important that the broad support that was evident in the Executive Board should be made public so that the commercial banks would recognize it.

He had been surprised by the comments to the effect that the proposed U.S. debt initiative marked the end of a period of complacency, Mr. Dallara said. After all, the Executive Board, the Managing Director, many individual countries, and many debtor countries had made enormous efforts over the previous several years to deal with the debt problem. His authorities believed that substantial cooperative efforts had been made over the previous several years and that those efforts should be reinforced in the coming period.

Mr. Nimatallah said that he agreed that the announcement of the U.S. debt initiative did not mark the end of an era of complacency. All the parties concerned had been working hard to make the debt problem more manageable.

Mr. Polak commented that, as he understood it, with the exception of Colombia and Panama, the list of members mentioned by Secretary Baker was composed of market borrowers that had rescheduled their external debt. He wondered whether he was also correct in assuming that the members on the list had been chosen without regard to the extent to which they had made progress toward restoring normal relations with commercial banks.

Mr. Dallara remarked that his authorities recognized that there were differences among the 15 countries with respect to the degree of their current access to capital markets and the progress they had made toward restoring normal, voluntary borrowing in the capital markets.

The Director of the Exchange and Trade Relations Department said that the staff would circulate its next report on developments in capital markets before, rather than after, the 1986 Annual Meetings. The staff would continue to make every effort to improve the statistics in its report. There was clearly considerable scope for improving the statistics, and the staff looked forward to receiving cooperation from the relevant members in its efforts to make the improvement.

The staff considered that commercial bank relations with the smaller low-income countries were important, the Director said. Those members would require significant trade financing, and a good record of debt repayment would be an important factor in reopening avenues of financing for those countries. The staff intended to monitor those developments closely in the coming period.

A question had been raised about the extent of the commercial banks' reluctance to make new money available to debtor countries, the Director remarked. All creditors--commercial banks, export credit agencies, and other institutions--tended to react to a borrower's record of repayment. However, creditors' reactions to a borrower's record tended to take place with a lag; accordingly, creditors often continued to provide credit even after a borrower's repayment record had been deteriorating for some time. Similarly, once a borrower had begun taking steps that clearly suggested that it was improving its record of appropriate use and repayment of credit, creditors tended to delay in resuming lending. The staff hoped that the delay in the resumption of lending to members that had introduced and maintained appropriate policies could be reduced; in that connection, the assessments of commercial bank supervisors were in some cases significant. There was need for coherence among commercial banks in responding to the financing needs of debtor countries. There was a need for broad participation in efforts to support the needed recovery in the economies of those members; the interests of banks in general in such participation could differ from the interests of an individual bank, which might wish to reduce its exposure, to particular borrowing countries.

Economic growth had always been an essential part of Fund-supported programs, the Director said. Without an effort by a member to achieve positive economic growth the Fund would have no assurance that the member would use Fund credit in a constructive manner. At the same time, it was important to recognize that economic growth in individual members was significantly affected by world economic conditions. The substantial recovery of export growth in 1984 had not been possible in 1985, when the demand for exports had diminished and protectionist measures--including protection against agricultural exports--had limited the scope for economic growth in developing countries. Moreover, an effort to accelerate economic growth often involved difficult political decisions for the countries concerned. For example, in some countries, economic growth could be achieved only if the authorities were able to make the politically difficult decisions to reduce real wages, cut subsidies, and solve long-standing problems in state enterprises. The Fund always encouraged members to use capital transfers as efficiently as possible and, to that end, often recommended privatization. Secretary Baker's debt initiative encouraged members to maintain conditions that would encourage economic growth throughout the world economy; under that initiative, there was to be a concerted effort on all fronts--including efforts by the World Bank and the regional development banks--to create conditions conducive to economic growth. In that connection, improvements in the operations of state enterprises were critical, and the World Bank would be expected to support initiatives taken in that area by individual members.

The staff assumed that, under Secretary Baker's strategy, capital would be transferred to members that were making progress in introducing needed adjustment measures and in restoring normal relations with the their creditors, the Director of Exchange and Trade Relations Department remarked. The total amount of concerted loans commitments in 1984--$16.2 billion--was less than the amount of new bank lending under

Secretary Baker's proposal. The $20 billion that Secretary Baker had suggested was not a large figure in the context of the commercial banks' current exposure and the financing needs of the countries concerned.

The staff representative from the Exchange and Trade Relations Department said that it was not easy to compare $20 billion in additional bank lending, or an increase of 2 1/2-3 percent a year in commercial banks' exposure, with the projections in the most recent World Economic Outlook exercise. The 15 countries on Secretary Baker's list did not correspond precisely with any of the categories in the World Economic Outlook papers, and the World Economic Outlook private lending estimates were based on the concept of overall private lending rather than on commercial bank lending in particular. The pace of private lending to the capital importing developing countries was expected to accelerate in 1986-88 and was expected to average about 4 percent a year for all the capital importing developing countries. However, the present rate of growth of exposure to the market borrowers was less than 2 1/2-3 percent a year, and the rate of growth of exposure to the market borrowers that had experienced payment strains of one kind or another was estimated to be very low. Hence, a rough generalization was that the $20 billion under the U.S. initiative would be in addition to the lending that had been estimated at the time of the latest World Economic Outlook exercise. The staff would look at the matter more carefully during the forthcoming World Economic Outlook exercise and in preparing the next paper on the debt situation.

The staff did not expect commercial banks to fail to respond to a member's efforts to sustain adjustment over an extended period, the staff representative said. The banks had obviously been prepared to normalize payments relations with some countries--for example, Turkey--that had maintained their adjustment efforts over a significant period. There were even countries among the group of 15 members that Secretary Baker had mentioned that were making considerable progress in restoring normal relations with commercial banks. Mr. Polak had mentioned that Yugoslavia did not wish to be seen as requiring concerted lending in coming years. Commercial banks sometimes responded to a member's adjustment efforts with serious lags, but typically they did respond in due course.

Project lending was likely to be one of the important forms of financing in coming years, and commercial banks would probably wish to increase their expertise in that area, the staff representative remarked. Some of the major banks already had considerable expertise, but commercial banks and export credit agencies could be expected to take advantage of the World Bank's expertise in project evaluation, partly through cofinancing arrangements.

Only a small number of developing countries had genuine access to the bond market, the staff representative commented. In early 1985 approximately three fourths of the bond issues by developing countries had been accounted for by just six countries, namely, Algeria, China, Greece, Korea, Malaysia, and Thailand. Other countries had issued floating rate notes, but in some cases those notes were not regarded as genuine bond market instruments. Commercial banks apparently looked carefully at individual bond issues to determine whether they were truly transferable and liquid in the secondary market.

There were different types of multiyear rescheduling arrangements, the staff representative commented. At the one extreme, the agreement with Venezuela involved a rescheduling covering a block of maturities falling due in 1983-88. At the other extreme, the arrangement for the Dominican Republic was, in effect, a series of annual agreements: the Dominican Republic was to implement a Fund-supported program in the first year of the arrangement, and at the end of each year of the arrangement the commercial banks concerned and the Dominican Republic authorities were to meet to consider the form of monitoring that would be appropriate in the eyes of both parties during the coming year. A rapid return to capital market access was necessarily expected under an arrangement like the one for the Dominican Republic.

The Deputy Managing Director said that it was too soon to say which countries would be the first to be included in the effort to strengthen the debt strategy. In the coming months the staff would conduct a series of discussions with members, the outcome of which would determine which countries were meeting the adjustment objectives that could be supported with assistance from the Fund, the World Bank, and commercial banks. The commercial banks expected to continue their work with individual countries through the bank advisory committees rather than through a kind of committee of the whole of commercial banks; that approach would be consistent with the case-by-case approach under the debt strategy. Discussions by a member with commercial banks about the country's situation should remain the responsibility of the country concerned. As in the past, the Fund would respond to and assist the country in dealing with the commercial banks. It was at a country's initiative that the Fund became involved in either briefing commercial banks or explaining at greater length to the banks the amount of external financing required by the country, including the potential commercial bank component.

The Fund and the World Bank already had considerable experience in collaborating to assist a member in dealing with its commercial bank creditors, and the institutions could build on that experience in the coming period, the Deputy Managing Director remarked. The managements of both institutions had stressed to the staff the importance of close collaboration in working with individual countries, including countries that were not on Secretary Baker's list of 15 members. In addition, the Inter-American Development Bank would occasionally be involved in the economic policy adjustments being undertaken by countries that were working with their commercial bank creditors. The three institutions would be involved to varying degrees--depending on a country's particular circumstances--in helping the member to develop an external financing package and to deal with its commercial bank as well as official creditors. The detailed aspects of the cooperation could be worked out over the coming months.

Mr. Nimatallah said that he agreed with previous speakers who had said that bank regulators should be encouraged to exercise some flexibility in dealing with banks that were being asked to make additional loans to debtor developing countries.

The Chairman made the following summing up:

1. In their comments on developments in the structure of financial markets, a number of Directors noted the current wave of innovation and liberalization and remarked that deregulation has led to a lowering of barriers within and between national financial markets. Directors felt that these developments and the associated diversification of instruments had the potential to redistribute financial risks more broadly, thereby enhancing the efficiency of markets, increasing the supply of funds, improving the allocation of funds, and reducing the cost of funds. Indeed, several Directors noted that lower spreads were a recent manifestation of the competition that was taking place in more sophisticated markets. However, Directors also noted that these developments had limitations and perhaps drawbacks: the use of some of these innovations had, in effect, been confined to the most highly regarded borrowers; and many developing countries that were pursuing credible adjustment policies had had very limited access to the most dynamic and sophisticated segment of international capital markets. It could therefore be said that in a sense these innovations had neither led to a better and broader spread of sovereign risks nor yielded an in-depth strengthening of the markets. In addition, reservations were expressed about the rapid expansion of banks' off-balance sheet activities. Some Directors stressed the macroeconomic implications of these innovations, particularly the need for sound monetary and fiscal policies in countries with major capital markets if the innovations were to produce any lasting strengthening of the markets.

2. I come now to the debt strategy. Directors remarked that there were a number of favorable developments in some areas over the previous year, including an improvement in the terms of new money packages and rescheduling agreements as well as the negotiation of several multiyear restructuring agreements. Nevertheless, Directors expressed concern about a number of disturbing trends that had emerged over the past year. I would summarize them in the following way. There had been a slowing in bank lending to developing countries in 1984-85; net lending had recently fallen to negligible amounts, even for some countries that were pursuing appropriate adjustment policies. Spontaneous lending had remained a limited proportion of the developing countries' financing, and concerted packages had been difficult to assemble owing to the lessening of cohesion among banks. Several Directors thought that the deceleration in the growth of world trade and the fall in commodity prices had added

to the debt service burden of certain heavily indebted countries to the extent that, under the present economic and financial conditions, they could not adequately manage the financing of their external debt.

Therefore, Directors welcomed Secretary Baker's initiative in his speech at the Annual Meetings in Seoul. Indeed, this initiative received very broad support today. Directors thought that the initiative had sent an important signal to the international community and was a timely step toward renewing the momentum in dealing with the debt problem and toward providing a constructive framework within which to act, although the details must still be fleshed out.

Various aspects of Secretary Baker's initiative were stressed. First, the growth-oriented strategy of adjustment was welcomed. Executive Directors clearly attach importance to macroeconomic policies that would foster domestic savings, restore confidence in fiscal and monetary policies, and establish the foundation for a resumption of investment and growth. In this respect, Fund-supported programs must include an adequate combination of demand and supply-side measures tailored on a case-by-case basis to the situation of individual countries.

Second, Directors stressed the increased role of multilateral development and financial institutions under Secretary Baker's proposal. The central role of the Fund in providing policy advice and balance of payments financing support, and in helping to catalyze external resources was emphasized by all Directors today. A number of Directors emphasized that the Fund should focus increasingly on supply-side aspects of programs, and that point will be covered in the forthcoming paper on conditionality.

This led Directors to stress the importance attached to continued and enhanced collaboration between the Fund and the World Bank. Under Secretary Baker's proposal, each institution, acting in its particular fields of competence--and while avoiding the pitfalls of cross conditionality--would help countries to formulate the comprehensive economic policies needed to stimulate growth and attract greater external financing. Directors welcomed the increased role to be played by the World Bank and regional development banks in support of countries' efforts to implement structural reforms. The willingness of industrial countries to increase the capital of these institutions in order to allow them to step up their lending will be a test of the cooperation required under Secretary Baker's proposal.

3. Another aspect of that proposal is increased commercial bank lending. While several Directors stressed that the banks would have to make their lending decisions on their own, and that national authorities should not "force" those decisions,

there was unanimous agreement on a number of points concerning the role of commercial banks. First, a sharp increase in commercial bank lending is needed because of the magnitude of the adjustment that is under way and that is still required because of the common interests of banks and the countries to which they have lent. When it is geared to adjustment measures leading to growth in borrowing countries the increase in commercial bank exposure will increase the quality of the assets of the banks themselves; increased lending is therefore in the banks' own best interest. Second, the present tendency toward trade and project financing by commercial banks should not divert attention from the need in a number of cases to reach agreement on sufficient and quick-disbursing balance of payments financing. Third, cofinancing operations with the World Bank and other development institutions should be encouraged and were already in the direction of project or even sectoral financing. However, guarantees to banks by governments or the World Bank would not be acceptable, because they would transfer risks from the private banking system to the public sector and would be inconsistent with the element of additionality that was the essence of Secretary Baker's proposal. It was noted that the major role of the Fund, the World Bank, and the regional development banks should reinforce banks' confidence and lead to increases in banks' exposure.

Secretary Baker's list of 15 countries raised a number of questions, and Directors were clearly interested in Mr. Dallara's indication that the list was not exclusive. The list focused on middle-income developing countries that had negotiated reschedulings without regard to the degree to which any of these countries have progressed toward the regularization of their relations with commercial banks. Directors also stressed the list should not lead to a reduction in spontaneous financing to countries that were not on the list; indeed, continuation of that financing was essential. Nor should the list cause us to forget that other countries need concerted financing. Also, the list should not minimize the importance of bank lending and other resource flows to low-income countries; the Trust Fund proposal was a partial solution to that problem.

In commenting on the role of commercial banks Directors underscored their feeling that the $20 billion mentioned by Secretary Baker was the minimum required and that the suggested increase in banks' exposures of less than 3 percent was moderate. Moreover, as a number of Directors said, that increase would likely be negative in real terms. The commercial bank financing should be tailored, on a case-by-case basis, to the policies, prospects, and financial requirements of individual member countries. No entitlements or predetermined ceilings were created by the list of 15 countries and the suggested percentage increase in banks' exposure. Although some Directors felt that the participation of a large number of small banks might complicate the assembling of financing packages, others considered that broad participation was essential. Some diversification of the instruments offered to banks, particularly to the smaller banks, might eventually be necessary.

4. In commenting further on trends in and prospects for handling debt problems, Directors stressed the role of industrial countries' governments, which should use all available means to promote the new steps in the debt strategy. In their assessments of regulatory activities in industrial countries Directors stressed that, while it was right to strengthen the capital position of the banks, it was also important to apply banking regulations in a flexible way that would take into account the quality of adjustment policies in individual countries. It was also important for industrial countries to apply their export credit cover policies in a way that would support the overall debt strategy. Avoiding and rolling back protectionist measures was seen as a major ingredient of that strategy, since exports remained the essential means by which developing countries could service their debts. Also, several Directors stressed that excessive absorption of international savings through the financing of the U.S. fiscal deficit was not consistent with a strategy of channeling additional funds to developing countries at more reasonable interest rates.

5. A first major conclusion of this important discussion is that we need coordinated efforts by all the parties involved--governments, multilateral agencies, and commercial banks--to implement the debt strategy. This will require the authorities concerned to express their strong, unambiguous support for the strategy. This support is essential to facilitating the adhesion of the banking community to the debt strategy.

Second, the discussion has underscored the need to flesh out the concrete aspects of Secretary Baker's initiative and to deal with issues of implementation pragmatically and on a case-by-case basis. More detailed consideration should be given to the questions of the breadth of banks' participation, the decision-making process, the modalities of assessment of individual countries' financing needs, and the responsibility for applying follow-up mechanisms. Finding answers to these questions will require us to adopt important decisions. In my view, given the experience that the Fund has acquired in these matters, the Fund will be able to play a central role in facilitating the follow-up to an implementation of the strategy in close cooperation with the World Bank.

We have already taken internal measures to follow, on a country-by-country basis, how the $20 billion plus $9 billion debt strategy will work out in practice. However, it is not possible to answer the question put by some Executive Directors today--which country is going to come up first--because the Fund works constantly with its member countries in a continuous economic dialogue. This will therefore depend on the normal timetable of our work, and it may indeed be that no country "comes up first," since we are currently in active consultation under Article IV with a number of countries.

We will have to form an idea of individual needs and the policies of individual countries and we will of course ask the World Bank and the IDB about their financing plans, not only about their lending to each country but also about the prospects for stepping up their lending as part of Secretary Baker's initiative. Growth will not be a residual as was suggested by one Board member, but should be emphasized as part of the strategy, although it might well entail the pursuit by debtor countries of tight fiscal and monetary policies. We will maintain contacts with all providers of finance to carry out this follow-up and this catalytic role. The implementation of the strategy is still being worked on. Although they have not formulated their final answer, the initial reactions of the banks have been positive, but of course a large number of issues remain to be addressed in detail.

We will keep the Board informed of developments. We will seek to be as helpful as possible in addressing the numerous practical problems that will have to be resolved, and we will report back to the Board as soon as there are significant developments of which it should be aware.

Finally, I should like to stress that today's meeting has been most helpful--and indeed historically important--since the members have given a clear demonstration of their willingness to support the debt initiative.

## 2. UNAUTHORIZED DISCLOSURE OF INFORMATION

The Chairman observed that the recent unauthorized disclosure of a document concerning the Fund's relations with Colombia had created considerable embarrassment for the Fund and had complicated its work with the Colombian authorities. The authorities had reacted in a reasonable and responsible way. They had publicly protested the unauthorized disclosure of information, and he himself had apologized to them. However, the next staff mission to Colombia had been postponed. Although he expected normal relations with Colombia to be re-established fairly soon, management would make every effort to discover the source of the unauthorized disclosure of information and, to that end, external assistance would be required. Management had decided to ask Professor Dugan--the former ombudsman--to conduct an investigation. Professor Dugan was respected by staff and management and could be counted upon to conduct a firm and objective inquiry; moreover, he had considerable knowledge of the Fund as well as experience in handling similar investigations. Professor Dugan would, in turn, probably require assistance outside the Fund in the course of his investigation, and management would make every effort to see that his needs were met.

He had explained to the Chairman of the Staff Association Committee the steps that management intended to take to conduct a full investigation of the unauthorized disclosure of information, the Chairman added. He had stressed that it was important to demonstrate to the Colombian authorities and to the entire membership of the Fund that the Fund continued to give the highest priority to maintaining the trust that had traditionally characterized the Fund's relations with members. He had also stressed the need for the staff to appreciate that it should cooperate fully in Professor Dugan's investigation.

Mr. Kafka considered that management's initiative was necessary and useful, and all Executive Directors undoubtedly hoped that it would be successful. As the Chairman had emphasized, the Fund must be able to maintain the confidence of governments that were expected to provide the institution with confidential information. Any expenditure that management might incur in conducting the investigation would be appropriate.

Mr. Zecchini said that he wondered whether the investigation would be designed merely to discover who was responsible for the unauthorized disclosure of information, or whether it would also review the procedures that might be needed to prevent future unauthorized disclosures.

The Chairman replied that Professor Dugan's main objective would be to discover the source of the unauthorized disclosure. In so doing Professor Dugan would naturally review the procedures involved, and the investigation might well teach general lessons about the procedures that could be used in the future.

Mr. Salehkhou commented that management should keep the Executive Board informed of the external assistance that Professor Duggan would require in conducting his investigation.

Mr. Nimatallah remarked that, in addition to discovering the source of the unauthorized disclosure of information and the possible means of avoiding future unauthorized disclosures, the Fund should learn from the investigation by Professor Dugan how to conduct its own inquiries so that it would not have to rely on outside help in the future.

The Chairman said that he hoped the Fund would learn from the investigation and that any further recourse to such investigations would prove to be unnecessary.

The Executive Directors concluded their discussion of the unauthorized disclosure of information.

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LEO VAN HOUTVEN
Secretary