November 21, 1985 - 85/198
Revised: 11/22/85

The Chairman's Summing Up of the Discussion on
International Capital Markets - Developments and Prospects, 1985
Executive Board Meeting 85/166 - November 13, 1985

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, in 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 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 away from the need in a number of cases to reach agreement on sufficient and quick-disbursing balance of payments financing. Third, co-financing 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 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 which 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.

DOCUMENT DU FONDS MONETAIRE INTERNATIONAL A NE PAS COMMUNIQUER AU PUBLIC

Le 3 décembre 1985

Le Secrétaire

Aux membres du Conseil d'administration

Objet : Résumé par le Président de l'examen du document intitulé "Marchés internationaux des capitaux - Evolution et perspectives, 1985 - Réunion 85/166 du Conseil d'administration, 13 novembre 1985

Un administrateur a demandé que la troisième phrase de la section 3 (voir page 2) soit modifiée comme suit : "... à cause de l'ampleur de l'ajustement en cours, et encore nécessaire..." Le présent texte tient compte de cette modification.

Pièce jointe