The international financial system has evolved in response to the changing requirements of borrowers and lenders, most of them in the industrial countries. It has also responded to changes in the objectives, constraints, and behavior of the financial institutions operating in the system. It is therefore a dynamic system constantly adapting to the global economic and financial environment. The speed of adaptation has been faster in some parts of the system—particularly among banks in recent years—than it has in others.

This chapter, which serves as an introduction to Part III, examines the international financial system from the perspective of developing countries. It describes how the system has evolved and the factors that have driven its evolution. Against this background, it suggests some criteria for assessing whether the arrangements have provided sufficient opportunities for developing countries to manage their external borrowing and debt successfully.

Functions and use of the system

In many ways the international financial system performs on a global basis what a national financial system does domestically. It provides a payments mechanism and offers facilities for borrowing and disposing of surplus funds. It creates different types of financial assets and liabilities, which aim to satisfy the portfolio preferences of lenders, investors, and borrowers. To the extent that it is not hindered by national policies, such as controls on capital movements, it helps to allocate funds to their most efficient use around the world. It also determines the ease with which capital can be moved between countries, which has a significant influence on the choices open to governments in adjusting to shocks. The efficiency with which the international financial system performs its various functions can influence the volume of savings and investment generated in the world economy. The functioning of the system therefore has an important impact on economic activity in developing countries.

The term international financial system normally covers the institutional arrangements for ensuring that the world's surplus funds flow to countries or entities in deficit, the rules governing the international exchange rate regime, and the mechanisms for creating and distributing liquidity. In Part III of the Report, the focus is on the institutional arrangements—the institutions, instruments, and markets—for channeling finance specifically to developing countries. These arrangements involve a wide range of participating entities—international financial institutions, governments, commercial banks, and industrial companies—that provide or channel funds to developing countries. Sometimes the funds flow directly to developing countries, but other times they flow through various intermediaries and markets. Roughly 40 percent of net flows to developing countries went through intermediaries and markets in 1970, but this figure had risen to more than 60 percent by 1983.

The institutional arrangements relevant for developing countries can be divided into two parts. The official sector contains direct channels for capital flow—for example, bilateral aid—and a number of intermediaries, such as the World Bank and the other multilateral development banks. The private sector, too, has direct mechanisms—direct foreign investment, for instance—as well as intermediaries, such as commercial banks and markets for international bonds and other securities.

Because intermediaries of all kinds have become increasingly important in channeling finance to developing countries, the range of maturities, currencies, and financial instruments offered to developing countries has grown. The economies of scale achieved by financial intermediaries—in terms of information, transaction costs, research, credit assessment, and portfolio diversification—yield efficiencies that reduce costs and risks for savers and borrowers. Ultimately, improvements in
financial efficiency can mean increased flows to developing countries at lower costs.

Most global capital flows are associated with economic and financial relationships between industrial countries. Developing countries have greatly expanded their use of external capital over the last decade, but industrial countries still account for the bulk of the main types of private flows (see Figure 6.1). Between 1978 and 1983, the share of developing countries in net new international bank lending was 36 percent; in gross international bond issuance, 7 percent; and in direct foreign investment, 27 percent. Most official flows, of course, go to developing countries.

The evolving institutional arrangements

The evolution of the institutional arrangements for channeling finance to developing countries has mirrored changes in the world economy. In the postwar period, they have passed through three broad phases. The first phase lasted from the end of World War II to the late 1960s, when official flows, direct foreign investment, and trade finance were the main forms of external capital for developing countries. The financing of current account deficits was done largely through governmental arrangements and international organizations. Financial intermediaries were mainly involved in domestic business and in financing international trade for their domestic clients. The overseas operations of commercial banks in the industrial countries were limited by exchange and other controls.

The second phase covered the period from the late 1960s to 1982. It was characterized by considerable volatility in exchange rates and interest rates and by much larger current account imbalances. In this environment, the structure of the institutional arrangements changed, and several new mechanisms were introduced. Institutions operating in the international banking and bond markets proved very innovative. International banking developed rapidly, shifting from trade financing to more direct balance of payments financing. Encouraged by the reduction or abolition of controls on international flows of capital, banks participating in international lending grew in number and broadened the range of their countries of origin. As a share of net flows to developing countries, direct foreign investment fell from 19 to 12 percent between 1970 and 1982. The international bond markets—especially the Eurobond market—grew quickly, although developing countries tapped them to a limited extent. Official flows kept pace with the growth in private flows during this
The World Bank has increased its lending to developing countries substantially, especially since 1970. By the end of the World Bank's 1984 financial year cumulative IBRD lending totaled $94.2 billion and IDA credits reached $33.6 billion.

There have been some distinct changes in the sectoral distribution of World Bank lending over time (see Box figure 6.1A). During the 1950s and 1960s the main thrust of World Bank lending was for the development of basic infrastructure; lending for power and transportation was predominant. There was a reorientation of lending during the 1970s toward agricultural projects in recognition of the potential high rates of return associated with such projects. Furthermore, given that a large proportion of the poor were engaged in agriculture, this shift in emphasis also directly increased their standard of living.

The regional composition of lending has changed more slowly than the sectoral composition. In the 1980s, however, taking the IBRD and IDA together, there has been a shift toward greater lending to Asia—mainly related to the development financing needs of a new member, China. The acute developmental problems of sub-Saharan Africa have also led to an increase in lending to that region.

For similar reasons social sector lending was also raised. The sharp increase in oil prices in the 1970s led to a growth in projects aimed at increasing oil and gas capacity. Since 1980 the financing requirements of the major structural adjustments being made in developing countries have been met in part by the introduction of structural adjustment lending (see Box 4.8 in Chapter 4).

The regional composition of lending has changed more slowly than the sectoral composition. In the 1980s, however, taking the IBRD and IDA together, there has been a shift toward greater lending to Asia—mainly related to the development financing needs of a new member, China. The acute developmental problems of sub-Saharan Africa have also led to an increase in lending to that region.

As illustrated in Figure 6.2, these developments led to a major increase in the flow of capital to developing countries. Of particular significance was the shift from equity financing (mainly direct foreign investment) to debt-creating flows. That development increased the vulnerability of developing countries.

phase. Within the official sector concessional official flows (or official development assistance, ODA) expanded quickly, but the fastest growth was in the activity of the World Bank (see Box 6.1) and other multilateral institutions. These institutions became increasingly active as borrowers in the bond markets and lent the proceeds to developing countries.
The third phase began in 1982, when commercial banks started to reassess their exposure to developing countries, and budgetary pressures in several industrial countries worked against aid. A fall in OPEC’s current account surplus also led to a reduction in its aid. As Figure 6.2 shows, ODA has fallen in nominal terms since 1981. Other official flows, notably from some of the multilateral institutions, have leveled off. Direct foreign investment registered a nominal decline. A significant portion of commercial bank lending reflected concerted loans raised as part of debt rescheduling agreements. A more cautious attitude toward private lending to developing countries evolved against a background of further significant structural changes in the banking and bond markets. And the pace of innovation quickened markedly in this third phase.

The scale and growth of the flows of medium- and long-term capital, both official and private, to the various categories of developing countries can be gleaned from Figure 6.3. Disbursements of official credit to developing countries in 1970 totaled $5.2 billion, but by 1983 had grown to $31.9 billion. Disbursements of private credit grew more quickly, from $9.7 billion in 1970 to $73.8 billion in 1980, before falling in the wake of the debt difficulties to $60.2 billion in 1983. As a result, the share of private credit in total credit increased from 65 percent in 1970 to 72 percent in 1980, declining to 65 percent again in 1983.

The low-income countries have been highly dependent on official financing. In 1983 some 74 percent of disbursements to low-income Asia and 84 percent of disbursements to low-income Africa were from official sources. It is only in years of high liquidity in private markets that the low-income countries have been able to raise any appreciable amounts of private finance. The middle-income countries, especially the major exporters of manufactures and the middle-income oil exporters, have borrowed primarily from private sources since 1970. These two categories of countries received up to 80 percent of their medium- and long-term finance from private sources.

Throughout its postwar evolution, the international financial system has been responding to pressures for change in ways that have affected the institutional arrangements for capital flows to developing countries. Changes in the financial climate have often acted as a spur to innovation. In
the past ten years, for example, the most obvious pressure for innovation came from changes in financial regulations and from the high and volatile inflation experienced over that period. The latter contributed to big fluctuations in interest rates and exchange rates. Lenders and depositors sought to cover themselves against interest rate movements, with the result that lending increasingly switched from fixed rate to floating rate terms. The rapid development of technology that reduced the costs of getting information and dealing internationally also contributed to the process.

The financial system has also been influenced by the size and distribution of current account imbalances; it has responded to the portfolio preferences of investors and depositors in different parts of the world. One example was the OPEC members in the mid-1970s and early 1980s that wanted to keep their surpluses initially in highly liquid form (see Box 6.2), primarily in bank deposits. Another important factor in the 1970s was that leading banks were choosing to lend abroad to satisfy their own portfolio and profitability objectives. The result was a greater willingness of commercial banks to finance the growing current account deficits of developing countries. More recently, the large current account deficits run by the United States have had their counterpart in the surpluses of Japan and some other industrial countries. In this instance the surplus countries have

Box 6.2 The deployment of the OPEC surplus

The big increases in oil prices in 1973–74 and 1979–80 produced substantial current account surpluses for all OPEC members, "low absorbers" and "high absorbers" alike.1 Between 1973 and 1982 the net foreign assets of low-absorbing countries increased from $12 billion to $32 billion, while high absorbers swung from net liabilities of $5 billion to net assets of $23 billion. Placements by OPEC have fluctuated significantly. From a total of $57 billion in 1974 they fell to $20 billion in 1978 before rising to a peak of $100 billion in 1980. With the subsequent fall in oil prices, placements have been substantially lower.

Roughly 40 percent of the cumulative OPEC surplus went to the United States and the United Kingdom, countries with deep and efficient financial markets. Considerable sums were also placed in France, Germany, Japan, and Switzerland. There have been significant

Box table 6.2A OPEC international placements, 1974–83
(billions of dollars)

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1. Low-absorbing OPEC members comprise Kuwait, Libya, Qatar, Saudi Arabia, and United Arab Emirates. These countries possess a relatively low propensity to turn revenues into domestic expenditures.

Box 6.2

Roughly 40 percent of the cumulative OPEC surplus went to the United States and the United Kingdom, countries with deep and efficient financial markets. Considerable sums were also placed in France, Germany, Japan, and Switzerland. There have been significant

Box table 6.2A OPEC international placements, 1974–83
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<td>0.8</td>
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a. Other placements include those in OECD countries, international organizations, and developing countries. The last include net flows of concessional assistance, syndicated Eurocurrency credits, bond issues, and direct investment.

had a preference for U.S. government securities and paper issued in the international bond and note markets.

These pressures for change operate within a regulatory framework for domestic and international financing. Exchange controls, for example, were used extensively before the 1970s. Their abolition in many industrial countries during the 1970s significantly increased the ability of banks to lend abroad. Moreover, monetary controls, though aimed primarily at containing money supply growth or influencing interest rates, can have major international side effects: such controls in the United States and some other industrial countries were one reason for the growth of the offshore Eurocurrency markets (see Box 8.3 in Chapter 8). Similarly, access to the foreign bond markets has been subject to controls: the markets operate formal or informal entry requirements and queuing systems. The role of taxation in influencing the pattern of capital flows can also be illustrated with reference to the bond markets. Some governments, for instance, have imposed interest equalization taxes, blunting demand for foreign issues of bonds, or have removed withholding taxes in order to encourage capital inflows for the purchase of bonds. In general, however, the 1970s were an era of financial liberalization, and this had a decisive impact on the pace at which financial institutions internationalized their business.

Prudential controls on commercial banks have probably had some effect on international lending (see Box 8.4 in Chapter 8), although the effect is difficult to measure. Most industrial countries have recently urged banks to be more prudent in dealing with the added risks faced in international lending. Banking supervisors have encouraged banks to raise their capital ratios and strengthen their balance sheets. They have also sought to ensure that the banks have adequate means of assessing country risk. The increasingly global nature of banking has led the supervisors to cooperate to strengthen the international banking system.

Finally, political factors have combined with economic pressures to limit certain types of capital flows. The limited constituency for aid, combined with budget stringencies in several industrial countries, has reduced the amount or slowed the growth of their aid in recent years. And some developing countries have restricted inflows of equity investment to prevent their domestic resources from passing into foreign control or ownership.

Several broad trends can be discerned in the financial system, which may have implications for the future pattern of external financing for developing countries:

- A gradual increase in world wealth has led to a greater demand for financial assets and a diversification of asset holding across markets and currencies worldwide. One measure of this trend is the share of external claims of banks in their total claims, which has increased from 8.5 percent in 1973 to 18.4 percent in 1983. Deregulation in domestic banking markets and the changing portfolio objectives of the banks may slow this process or reverse it in the future. It is possible, however, that other forms of wealth holding may be internationalized; increased institutional purchase of foreign stocks and bonds might eventually lead to enhanced flows to developing countries.

- There has been movement toward lending at floating rates both in the banking markets and in bond markets. In the latter the floating rate note (35 percent of total bond issues in 1984) has recently found favor, especially with banks seeking greater marketability in their portfolios. In the banking markets floating rates seem here to stay even if inflation and interest rate volatility subside. In the bond markets the issuance of fixed rate bonds will remain subject to periodic fluctuations depending on inflation and interest rate expectations. About 43 percent of developing countries' long-term external debt was in floating rate form in 1983, compared with 16 percent in 1974.

- A trend has emerged toward greater use of bonds and other types of securities in international lending; a so-called process of securitization may be under way. Given the debt service difficulties of many developing countries and the high creditworthiness required in these markets, there is a question as to the extent to which these countries can benefit from the trend.

- Major advances in information technology and the widening of the range of business transacted by individual financial institutions have led to an integration of financial markets. The various national banking markets have been drawn together by the workings of the international interbank market (see Box 6.3) because banks are able to switch funds quickly between markets. Close links also exist between conditions in the banking markets and those in the bond markets. The advent of currency and interest rate swaps (see Box 5.5 in Chapter 5) has helped integrate financial markets, as has the growth of hybrid instruments that blend features of the banking and bond markets. The trend toward integration is important for
developing countries' debt management in that shifts in sentiment in one market rebound increasingly on fund availability in another.

- There has recently been a stagnation of official flows and direct foreign investment at a time when banks want to lend less to developing countries. This is a matter of particular concern. Greater cooperation between official and private lenders has been one response to the problem. Banks have increasingly lent in conjunction with IMF adjustment programs. The World Bank has also sought to increase the financing available to developing countries through the expansion of its cofinancing program. The official sector is in some instances playing the role of catalyst for the private sector; an example is the IFC through its encouragement of equity investment. There are also several initiatives, including a proposal for a multilateral investment guarantee agency (see Box 6.4 in Chapter 9), to increase direct foreign investment through the provision of more extensive investment insurance.

Assessing the institutional arrangements

Developing countries have to match their external financing needs to the type of capital that is available. For example, most low-income countries have only limited access to commercial finance. They are almost totally dependent on concessional flows from official sources and on official or officially guaranteed trade credits. The middle-income countries have a potentially wider range of borrowing opportunities because of their greater creditworthiness. But the existence of sovereign risk, as Box 6.4 explains, limits this range, particularly in comparison with sovereign borrowers from industrial countries. Commercial banks, because of their widely ranging business relationships with developing countries, have a comparative advantage in sovereign lending. Governments have in some instances a degree of political leverage in the provision of official finance, and so have a similar advantage. Direct investors are at a distinct disadvantage in coping with sovereign risk. This is one reason why national schemes for investment insurance and, more recently, a private insurance market have sprung up. Bond investors are also disadvantaged, and so bond finance has not been a significant form of capital for developing countries.

As Chapter 5 made clear, for a developing country to obtain external finance carrying a suitable combination of cost and risk, it may need a mixed portfolio of liabilities. The broader the mix of liabilities, the less exposed are developing countries to interruptions in the supply or increases in the cost of any one element. The desired mix may contain the following.

- Equity and debt to reduce commercial risks and ensure that interest or dividends correlate with the borrower's ability to service the external capital.

- Different currency denominations of loans to
Box 6.4  Sovereign risk and its implications for international lending

When a government borrows from abroad or guarantees a loan, the legal status of the contract is unlike that between two private companies. It is much harder to enforce, since a sovereign borrower may reject a claim against it within its own territory. The problems arising from this limited enforceability are complicated by the fact that governments have considerable discretion over policy choices that affect their own ability to fulfill a contract. Many of these policies—shifts in monetary policy, limits on exchange remittances, changes in competition policy, changes in taxes—could not be deemed a breach of contract, even though their effect might be to negate the substance of the loan.

The ability of governments to influence economic outcomes, coupled with a lender's limited scope for imposing legal sanctions, means that contracts between developing countries and the private market have little economic value unless both parties feel it is in their long-term interest to honor their obligations. This means that the (present discounted) economic value to a borrower of meeting its obligations must be equal to or greater than the present value of not meeting them. In short, the countries that are most likely to service their debts are those that would suffer most if they did not do so.

To a borrower, the cost of possible sanctions depends on the importance of its future trade and finance with the lender (and its sponsoring government). Countries that are heavily involved in international trade depend on a continual flow of finance, the use of transport facilities, smooth customs clearance, and so on. They are therefore very open to sequestration orders and to a cutoff of trade credits. Their past success has been made possible by the network of trade and finance. They are unlikely to choose to jeopardize the chances of future success by excluding themselves from that network.

The major international banks have a comparative advantage in dealing with sovereign risk because they are closely involved in a number of facets of a developing country's international business. This helps explain the growth in importance of banking intermediation during the 1970s.

Reduce exchange rate risks for the borrower.

- Fixed and floating rate finance to mitigate the borrower's interest rate risk.
- Long-maturity borrowing (for projects) and short-term borrowing (to finance trade) to smooth out debt service payments and reduce the borrower's refinancing risks.
- Concessional and nonconcessional lending to ease the debt-servicing burden, especially for low-income countries.

A key question for developing countries is whether the financing opportunities available to them can produce the appropriate liability portfolio. Any answer must distinguish between (a) policy deficiencies in lending and borrowing countries, to which the institutional arrangements respond; and (b) the problems inherent in the functioning and evolution of the institutional arrangements themselves. The financial system cannot be blamed for high and volatile interest rates, for instance; they stem from policies followed in the major industrial countries. Similarly, sluggishness in direct investment cannot be attributed to a systemic failure; it may have more to do with the policies and procedures of home and host countries. And a dearth of commercial finance for low-income countries and some middle-income countries in many instances reflects appropriate market judgments rather than a failure of the system. What creates an additional difficulty for these countries, however, is that the level of official finance, and especially ODA, is in large part a matter of donor budget priorities often unrelated to the development policies of either donor or recipients.

With these caveats in mind, institutional arrangements that provide for efficient liability management and contribute to steady growth in developing countries would have three qualities.

- **Flexibility.** This refers to the capacity to respond to changes in the economic and financial environment and, specifically, the changing funding requirements of developing countries. Financial innovation is not an arbitrary process. It has been particularly marked among private financial institutions where competitive pressures have been intense. Multilateral development institutions have also adapted to the changing needs of developing countries, particularly in the 1970s and early 1980s.
- **Stability.** This refers to the ability to maintain a steady flow of finance to developing countries, within limits determined by creditworthiness considerations. Maintaining a stable flow of financing is important in facilitating a smooth net absorption of real resources, in avoiding unduly severe balance of payments adjustment, and in sustaining the debt-servicing capacity of borrowers. Stability implies an absence of "herd instincts" among lenders and investors. Official flows and direct
investment grew steadily for much of the past decade, providing a foundation for other flows. Banks, while contributing to the system's flexibility, have nonetheless been inclined to lend excessively to a few developing countries; some have then suddenly withdrawn altogether from lending to specific countries, as happened in 1982 with the largest Latin American debtors.

- **Balance.** This refers to the range of instruments and facilities offered, so that borrowers can spread their risks and diversify the currency composition of their debt at minimum cost. A high degree of dependence on a single kind of institution or instrument makes borrowers vulnerable to abrupt changes in supply or cost. Taken as a whole, the sources of capital became more diversified in the 1970s, even though not all developing countries were eligible for all of them all the time. However, there was a concentration of risks in a small number of large banks in meeting the financing requirements of major borrowers.

Judged by these three yardsticks that contribute to efficient liability management and steady growth in developing countries, the system responded quickly and effectively to the pressures of the 1970s. However, the early 1980s exposed some serious weaknesses that were inherent in bank lending. The rapid growth of lending in the 1970s was unstable. If the growth in such lending during the 1980s is construed as a one-time stock adjustment by banks, then moderation in this growth might have happened even without the deterioration in the world economy that began in 1979. A system in which one type of lender grows increasingly exposed to relatively few borrowers may be inherently unstable. Furthermore, the banks' main form of lending, the syndicated credit, carried a medium-term maturity whose cost was linked to a short-term interest rate. The risks of rising interest rates were thus transferred to borrowers.

Another weakness was the behavior of ODA. It increased substantially in the aftermath of the first oil price increase in the early 1970s, but it stagnated in the 1980s at the very time when the banks were seeking to reduce their lending.

Any assessment of the present institutional arrangements must therefore consider how the stability of external capital flows can be increased and lending by commercial banks be restored. In particular, it must address the question of how future capital flows, including the provision of enough concessional finance to meet the needs of low-income countries, can be made available. There is a need for solutions that will avoid a recurrence of the difficulties of the early 1980s. Remedies lie in five main areas:

- The provision of longer-maturity capital.
- Commercial risk sharing through the development of secondary markets for developing-country debts.
- An increase in equity investment.
- Increased levels and better coordination of aid programs to improve their effectiveness.
- Greater availability of mechanisms for hedging interest rate and exchange rate risks.

The first four of these are explored in greater detail in the Chapters 7, 8, and 9; the last was noted in Chapter 5. None of these changes will come about quickly. But even slow progress on every front would do much to reduce the weaknesses and increase the strengths of the present institutional arrangements.