NOT FOR PUBLIC USE

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 84/48

10:00 a.m., March 30, 1984

J. de Larosière, Chairman
W. B. Dale, Deputy Managing Director

Executive Directors	Alternate Executive Directors
A. Alfidja	
J. de Groote	
B. de Maulde	X. Blandin
A. Donoso	
R. D. Erb	M. K. Bush
M. Finaish	T. Alhaimus
T. Hirao	T. Yamashita
J. E. Ismael	Jaafar A.
	L. Leonard
A. Kafka	
G. Laske	G. Grosche
G. Lovato	C. P. Caranicas
R. N. Malhotra	A. S. Jayawardena
Y. A. Nimatallah	J. E. Suraisry
J. J. Polak	T. de Vries
A. R. G. Prowse	K. G. Morrell
	A. A. Agah, Temporary
	E. I. M. Mtei
	E. Portas, Temporary
J. Tvedt	A. Lindå
	T. A. Clark
	Wang E.

L. Van Houtven, Secretary
J. C. Corr, Assistant

Also Present

C. F. Schwartz, Consultant. African Department: O. B. Makalou, Deputy Director; A. C. Woodward. Asian Department: G. R. Kincaid, L. Mendras, B. J. Smith. Central Banking Department: L. Koenig, Deputy Director. European Department: L. A. Whittome, Counsellor and Director; P. B. de Fontenay, A. Fidjestol. Exchange and Trade Relations Department: W. A. Beveridge, Deputy Director; S. Mookerjee, Deputy Director; M. Allen, S. J. Anjaria, E. H. Brau, G. G. Johnson, S. Kanesa-Thasan. External Relations Department: H. O. Hartmann, N. K. Humphreys. Fiscal Affairs Department: V. Tanzi, Director; P. S. Heller. IMF Institute: U Tun Wai, Deputy Director. Legal Department: G. P. Nicoletopoulos, Director. Middle Eastern Department: J. G. Borpujari, S. von Post. Research Department: W. C. Hood, Economic Counsellor and Director; A. D. Crockett, Deputy Director; R. R. Rhomberg, Deputy Director; J. Artus, C. P. Blackwell, J. E. Blalock, M. Bond, J. M. Boughton, M. C. Deppler, M. P. Dooley, R. A. Franks, S. J. A. Gorne, O. E. G. Johnson, M. D. Knight, A. Lanyi, A. K. McGuirk. Secretary's Department: A. P. Bhagwat. Treasurer's Department: W. O. Habermeier, Counsellor and Treasurer. Bureau of Statistics: C. A. Patel. Personal Assistant to the Managing Director: S. P. Collins. Advisors to Executive Directors: E. A. Ajayi, H. A. Arias, S. El-Khouri, K. A. Hansen, S. M. Hassan, L. Ionescu, H.-S. Lee, G. E. L. Nguyen, Y. Okubo, M. Z. M. Qureshi, D. C. Templeman. Assistants to Executive Directors: H. Alaoui-Abdallaoui, J. R. N. Almeida, I. Angeloni, Chen J., L. E. J. M. Coene, I. Fridriksson, G. Gomel, V. Govindarajan, D. Hammann, H. Kobayashi, M. J. Kooymans, E. Landis, G. W. K. Pickering, M. Rasyid, D. J. Robinson, A. A. Scholten, S. Sornyanyontr, N. Toé.

1. WORLD ECONOMIC OUTLOOK - GENERAL SURVEY

The Executive Directors considered a staff paper providing a general survey of the world economic outlook (EBS/84/33, 3/2/84; and Cor. 1, 3/26/84). They also had before them a paper, prepared by the Fund staff and OECD Secretariat, on the statistical discrepancy in global current account balances (EBS/84/49, 3/9/84).

Mr. Erb commented that the staff was correct when it stated at the outset of its discussion of the main policy issues:

> The key elements of the policy strategy adopted by industrial countries in the late 1970s are well known. In the main, these countries decided that the stagflation process that had afflicted them for a number of years had to be broken, if adequate growth was to be achieved on an enduring basis. This in turn required the restoration of a stable financial environment and a reduction of the rigidities that hindered the working of markets for goods, labor, and financial assets.

It might be added that most industrial countries had approached that set of policy objectives within a medium-term framework.

The staff began with a discussion of "demand management," Mr. Erb continued, an inadequate term because it had been used in the past to describe a particular kind of policymaking approach that was quite different from the strategy and timing orientation adopted by industrial countries in the late 1970s. It was preferable to distinguish between monetary policy and fiscal policy in considering the subject matter of that section of the paper. On the monetary side, the staff was correct in its comment on inflation when it stated:

> This is all the more important in that the disinflation process cannot be regarded as complete, except perhaps in Japan. In the past, the monetary authorities have often fueled inflation, both by providing too much money in the initial phases of recovery, and by maintaining a policy of accommodation well into the recovery. By demonstrating that they will not repeat these mistakes, monetary authorities will help keep inflationary expectations under control, and thus enhance the prospects for noninflationary growth.

That policy advice was consistent with the approach that most monetary authorities had been taking--setting monetary growth objectives that were consistent with bringing down inflation over time. In that regard, "monetary restraint" was another term to be avoided as it carried connotations of an activitst countercyclical approach to monetary policy that did not adequately reflect the approach of monetary policies in most of the major industrial countries in recent years. It was inappropriate to say, as the staff suggested at one point in the paper, that "the present level of [interest] rates reflects a continued stance of restraint in monetary policy."

In the present period of recovery, Mr. Erb remarked, monetary policy should not err on the side of too much expansion, a view held by his authorities both within the Federal Reserve Bank and within the Executive Branch. That judgment had recently been reinforced by statements by the Chairman of the Council of Economic Advisers and, in the previous few days, by the Secretary of the Treasury, who had commented on monetary policy and the importance of decelerating monetary growth to continue the progress on the inflation front.

The staff had placed great emphasis on the strategy that governments adopted to reduce fiscal deficits, Mr. Erb observed. As his authorities viewed it, the issue was broader. Fiscal policy had three dimensions: the relative size of government expenditure and expenditure growth; the level and structure of taxes; and fiscal deficits. Among the members of the Fund, there had been differences of emphasis on each of those aspects. His authorities had placed priority on shaping a process of debate and political decision making that would restrain the rate of growth of government expenditures and the relative share of expenditures in the economy, and that would change the structure of taxes in a way that would not have detrimental effects on savings and investment. In the course of that adjustment process, less priority had been given, at least initially, to the objective of reducing fiscal deficits per se. However, that objective remained important, both within the Executive Branch and within the U.S. Congress.

Developments on the fiscal front should be examined more deeply in the context of Article IV consultations, Mr. Erb suggested. In the United States, considerable progress had been made in the previous three years in reducing the rate of growth of expenditures. As the staff noted, the pace of public spending on goods and services had tended to be slow between 1982 and 1983 in a number of countries, "especially in the United States, where public sector consumption in real terms declined by 2 1/4 percent during 1983." It was too early to tell what effect the changes in the structure of taxes were having on savings and investment, but there were indications that they were having a favorable impact on investment.

The view was clearly held within the U.S. Government that it was in the country's own interest to bring down the fiscal deficit over time, Mr. Erb added. While observers might differ in the degree of optimism that they held in that regard, it was encouraging that steps were being taken to reduce the deficit, on both the expenditure and revenue sides, during an election year. That development showed that the political process in the United States was not ignoring the deficit question.

With regard to structural policies, it was important to deal with labor market rigidities and real wage rigidities, Mr. Erb stated. In a large number of countries, they created disincentives for investment and problems in specific industries, exacerbating protectionist measures. In its conclusions on exchange rate policy, the staff had placed too much emphasis on the U.S. policy mix. In the earlier part of the discussion

on policy issues, it had pointed out that an array of factors lay behind the strength of the dollar, and that adjustment was taking place in the right direction with regard to the dollar rate in light of the impact that the strong dollar had had on the U.S. trade balance.

The importance of anticipating the debt hump in 1986-88 was emphasized by the staff, Mr. Erb went on. His authorities believed that if world economic conditions continued to proceed toward recovery, and if adjustment continued within the countries that had large external debts, overcoming the debt hump problem would not be a major point of stress to the system. If it became clear that countries had restored economic growth and a more sustainable level of external borrowing, much of the debt coming due in that period would be easily restructured over a longer period. He agreed with the staff's recommendations on adjustment policy; the policy guidance appropriate for developing countries was also appropriate for industrial countries. The discussion of protectionism should include not only direct measures impeding the flow of goods, but also the use of subsidies and other special incentives designed to promote exports artificially. The discussion should also be broadened to include developing countries as well as industrial countries. Many of the protectionist measures within the United States had arisen partly in response to subsidies and special incentives that specific industries perceived to exist in other countries, both industrial and developing.

His authorities believed that the staff had placed too much emphasis on the linkage between interest rate developments and developments in the exchange rate of the dollar, Mr. Erb stated, and not enough emphasis on other factors influencing the behavior of exchange rates. The relationship between interest rates and exchange rates was difficult to assess. When only nominal interest rates were taken into account, it was clear that the dollar had appreciated substantially against all major currencies in the previous three years despite the fact that interest rate differentials had moved against the dollar. Since mid-January 1984 the dollar had depreciated against other major currencies while interest rate differentials had moved in favor of the United States. It was much more difficult to calculate real interest rates; many different techniques existed. While it was hard to find a close relationship between the behavior of real interest rates and exchange rate developments in the shorter run, the strength of the dollar during the past three or four years, in contrast to the weak dollar in 1977 and 1978, reflected the shift in policy toward price stability, which had been permitted to work through positive, rather than negative, real interest rates.

High real interest rates might not be as large an obstacle to recovery as many observers had believed, Mr. Erb considered. Other factors determining investment decisions needed to be taken into account, as the staff had pointed out, including prices, depreciation, expected rates of return on investment, and the degree of regulation. It was sometimes suggested that the strong dollar in conjunction with high real interest rates and a large trade deficit would cause unbalanced growth in the United States. However, to date there was no evidence to support that conclusion. While

a problem might arise within the next year or two, so far the interest-sensitive components of the economy had performed better in the United States during the present recovery than during the five previous periods of expansion. During the course of the present recovery, business capital growth had constituted about 22 percent of total growth, whereas in previous recovery periods it had been 7.6 percent. The pickup in housing had been about the same as in previous recoveries, and spending on consumer durables had improved slightly.

A large increase in the U.S. trade deficit and current account deficit had taken place, Mr. Erb observed, a shift related partly to developments in the exchange rate and partly to developments in the world economy. Analysis undertaken within the U.S. Government suggested that, among the factors accounting for the expected shift of about $72 billion in the U.S. trade balance between 1981 and 1984, cyclical factors accounted for about $15-20 billion. The impact of the international debt problems on the U.S. economy was estimated to be about $25-30 billion. For example, the debt problem had had a special impact on important trading partners of the United States, such as Mexico, which alone accounted for a sharp reduction in U.S. exports. U.S. Government analysts estimated that the impact of the dollar appreciation on the trade deficit ranged between $25 billion and $100 billion, depending on the technique used. As economic growth in other countries picked up, the impact of the trade balance would in the normal way bring about a downward exchange rate adjustment, some of which had already taken place in 1984. His authorities would not be surprised if the dollar declined further, but they did not expect a sharp fall. The principal factor that could produce a sharp decline in the value of the dollar over the coming few years would be an acceleration in the rate of inflation and the perception that money growth within the United States was too rapid.

Too much emphasis had been placed by the staff on the impact of the U.S. current account deficit on the distribution of world savings, Mr. Erb suggested, and not enough on the demand-pull aspects or the growth-creating effects of the U.S. current account deficit. In 1983, and again in 1984, the growth of U.S. imports had had a beneficial effect on economic growth in other countries. As a number of Directors had pointed out at EBM/84/45 and EBM/84/46 (3/26/84), the problems in the rest of the world were large amounts of excess capacity, unemployment, and the need to generate growth. In that sense, the change in the U.S. trade balance between 1981 and 1983 had been a source of potential growth for a number of countries. The turn-around had involved a net increase in the trade deficit with other industrial countries of about $21 billion, a shift of about $12 billion in the balance with Mexico, and an increase of about $10 billion in the balance with other non-OPEC developing countries. However, his authorities agreed that, as adjustments took place in the exchange rate and as the U.S. fiscal deficit declined, there would be a natural reduction in the U.S. current account deficit.

Mr. Kafka said that, with regard to industrial countries, the overemphasis on monetary policies relative to fiscal policies had been discussed at length on previous occasions. It should be noted that

because interest payments were tax deductible expenses for corporations and, in some countries--particularly the United States--even for individual taxpayers, the domestic effects of the high level of interest rates in creditor countries were perhaps less damaging to those countries than the external effects on debtor countries. Protectionism was also becoming an increasingly difficult problem for the debtor countries, even vis-à-vis countries that did not have the excuse of an overvalued currency--although the latter was not a valid excuse for protectionism.

The staff assumed that the growth of industrial countries in the medium term would be somewhat more than 3 percent a year, Mr. Kafka continued. Even if that assumption did not prove to be overoptimistic, a major problem would face the world in 1987, when the developing countries' debt service ratio would increase sharply because of a further rise in the amortization ratio of the major borrowing countries. The burden of that increase would be offset partly by a fall of 2-3 percentage points in nominal interest rates. Nevertheless, it was too sanguine to assume that, as early as 1987, the creditworthiness of many debtors would have been re-established to the extent that they would find no difficulty in rolling over by normal voluntary means the heavy amortization payments coming due that year. It would be advisable to prepare additional arrangements guaranteeing that a new debt crisis did not erupt because of the increase in amortization payments. Such action would require the cooperation of commercial banks, governments--including regulatory authorities--and the Fund. One problem would be how to ensure or to replace the continued cooperation of the smaller commercial banks. Another would be how to find the best way to help debtors to conduct any necessary negotiations, whether the present method of annual negotiations or a different method. The importance of those matters had increased because it was not possible to be confident that nominal interest rates would actually fall, as the staff had forecast.

The prevention of a new debt crisis was by no means the only problem facing the developing countries and the international community, Mr. Kafka stated. The staff assumed that 3 percent a year real GDP growth in the industrial countries would be capable of sustaining a growth rate of about 4.5 percent for the developing countries. The absolute difference in those rates might be small, but the relative difference of 50 percent was very large. Even the relatively favorable growth projection of 4.5 percent for developing countries still left much to be desired in terms of per capita growth and recovery of per capita income levels, which had suffered gravely during the past three years of crisis, when per capita GDP for developing countries as a group, and for the major borrowers in particular, had fallen substantially.

Long before 1987 the question of how to find a different approach to the problems of debt and adjustment would be posed, Mr. Kafka added. Under present conditions, the combination of high interest rates and sharply reduced net borrowing created a heavy burden for developing countries whose savings ratios had not risen appropriately. Such a development, allied to low growth rates, could become extraordinarily

burdensome in terms of per capita absorption. Although the present pattern of adjustment was largely unavoidable, it should be improved as far as possible. The social fabric in the debtor countries should not be allowed to be excessively strained. Relief had to be sought in various directions, including changes in the demand policies of the industrial countries, progress against protectionism that directly affected debtor countries' ability to pay, and the development of existing, as well as the establishment of new, financial mechanisms. It was doubtful whether over the medium term commercial banks could provide amounts of development finance close to those that they had provided in the 1970s. Greater reliance would certainly have to be placed on direct investment as well as on increased use of the international bond and stock markets. However, even those approaches might be insufficient. The role of official multilateral banks and other lenders would have to be enhanced.

Mr. Hirao observed that there had been a consensus among the industrial countries on the objective of economic policies in the 1980s--the attainment of noninflationary sustained growth. That consensus had been clearly shown in the declarations of the summit meetings of the industrial countries and had been underlined in recent communiqués of the Interim Committee. The common goal had been set not only in the interest of the industrial countries, but also for the benefit of all member countries.

The central scenario presented in EBS/84/33 assumed an average annual growth rate of 3 1/4 percent for the industrial countries during the period 1985-90, Mr. Hirao continued. Whether or not the assumed growth rate could be attained depended crucially upon how much progress could be made in structural adjustment and other important policy areas in coming years. The staff indicated that if the rate of growth in industrial countries was reduced by 1 percentage point, the projected deficit of the non-oil developing countries would increase to about $150 billion in 1990, compared with about $90 billion in the central scenario, and that financing such a current account deficit would be extremely difficult. In light of those scenarios, sustained economic growth in the industrial countries would be the key element in the stability of the global economy in the coming decade.

In order to achieve noninflationary sustained growth, Mr. Hirao remarked, improving productivity and strengthening the productive base of each member's economy would be essential. Those aims would in turn require that investment was sustained at a reasonably high level. It was widely recognized that an important factor behind the recent stagflation had been the stagnation in investment in plant and equipment. Real wages had remained unchanged in the face of the rise in the real cost of energy in the last half of the 1970s. The result of the large disequilibrium in the prices of those two most important inputs had been a severe squeeze of business profits, which had been responsible for the depressed level of capital formation. The staff rightly addressed the issue, pointing out that the rigidities in labor markets were obstacles to a fair distribution of income between capital and labor. There were a number of ways in which policy could help to make wage movements more sensitive to

changes in the marginal product of labor. It was encouraging that there had been some progress in that area in recent years in the United States, the United Kingdom, Germany, and some other industrial countries.

An inverse correlation had clearly been observed during the previous 20 years between the growth rate of investments and the size of government outlays in relation to GDP, Mr. Hirao noted. During that period, government expenditures relative to GDP had increased steadily in the industrial countries, while the trend of growth in investment had declined as a result of various factors. Expansionary fiscal policy had deliberately been employed as a countercyclical measure in the latter half of the 1970s, when investment activities had stagnated and economic growth had declined; the implication was that the weakness in private sector demand had necessarily prompted the higher government expenditures. However, there had no doubt been causal relationships working in the opposite direction; in other words, the growing size of government had adversely affected business activities in the private sector for a number of reasons.

First, the excessive growth in government activities had simply provided less room for private sector activities, Mr. Hirao suggested. Second, the increase in social security expenditures had resulted in a reduction of profitability through the higher burden on enterprises, thereby reducing investment incentives. Third, the increase in the tax burden on enterprises had exerted negative effects on business investment by reducing expected rates of return. Fourth, the incentive to work had tended to decline as more favorable social security benefits were received. Fifth, government intervention and regulation had become more complex and widespread, which, together with the proliferation of subsidies to ailing industries, had greatly hampered productive efficiency.

The growth in the size of government expenditures had generally been accompanied by increases in budget deficits, Mr. Hirao went on, largely because there had emerged a growing public reluctance to live with higher tax burdens as the overall level of the tax burden had approached what was regarded as an acceptable maximum. The core of the structural fiscal deficit comprised social security payments and debt service expenditures. In the present political climate, it would be difficult to restrain social security payments, despite their negative impact on efficiency and the productive base of the economy. In a situation in which fiscal imbalances had existed for a long time, additional bond issues would be necessary, even if expenditures were to be severely restrained, merely to meet the snowballing debt service obligations. As a result, the size of debt service expenditures would be pushed up, further aggravating the structural component of fiscal deficits. There was little doubt that the growing fiscal deficits, or the expectation of large fiscal deficits, were a major factor behind the high level of interest rates in the major industrial countries. In order to achieve a resumption in investment activities and sustained economic growth, it would be essential to reduce the structural fiscal deficits and to bring down the high level of interest rates.

If noninflationary sustained economic growth was the global policy objective, Mr. Hirao commented, such structural adjustments would be the key elements of policy strategy. In particular, it would be essential to contain the growth of the size of government and to reduce structural fiscal deficits. Without visible signs that fiscal deficits were being reduced, no economy could achieve sustained growth.

The ratio of government financing to available domestic savings rose rapidly as the result of a rapid rise in the ratio of fiscal deficits to GNP, Mr. Hirao added. An increasing share of global savings, which ought primarily to be directed toward financing capital formation in industrial countries and development investment in developing countries, was being absorbed by governments to finance their outlays. As the staff noted, that situation raised questions about the efficiency with which global savings were being allocated. He fully agreed with the staff view that "continued adherence to the strategy of restoring and maintaining financial stability in the major industrial countries will provide the best framework for sustainable economic growth in the medium term. It is true that the reduction of fiscal deficits required by this process involves a withdrawal of stimulus...however...such an influence would be offset in due course by the effects of lower interest rates and improved confidence on the investment climate."

The important issue of policy coordination had received renewed attention in light of Mr. Erb's remarks during the Executive Board's recent discussion of surveillance (EBM/84/40, 3/12/84), Mr. Hirao stated. He agreed with Mr. Erb's views. The prospects for achieving greater exchange rate stability rested on achieving a relatively high degree of convergence in underlying economic conditions. It was not always clear what was meant by the phrase "convergence of economic policies." It was more important to achieve greater convergence of underlying economic conditions and for governments to follow over time the policies that would achieve that convergence. Emphasis should be placed on convergence in the medium term, rather than the short run. Finally, policy coordination should be geared toward the pursuit of noninflationary sustained growth over the medium term; a commitment to that coordinated policy would play a major role in stabilizing the foreign exchange markets.

Mr. Finaish observed that over the past year or so a significant improvement had taken place in the world economic situation. A recovery was under way in the industrial countries from the severest recession since the 1930s, and at the same time further progress had been made in reducing inflation. The external deficits of developing countries had declined to more manageable levels, and the debt servicing problems faced by a number of them had eased somewhat from the serious levels reached in late 1982 and early 1983. While those developments were encouraging, many problems remained. The recovery in the industrial world continued to lack a sufficiently broad geographical base, and unemployment had continued to mount in some countries beyond the high levels reached earlier. Even in countries where the recovery had been stronger, a number of questions continued to cloud the prospects for sustainability over the medium term. There had been no recovery thus far in the pace of growth in

developing countries from the recent exceptionally low rates, and the debt problem would remain a source of difficulty for some time to come even in the best of circumstances.

A key policy challenge at present was to sustain and to extend the recovery that was currently taking place in industrial countries, Mr. Finaish continued. The main elements of the policy required for that task remained the restoration and maintenance of financial stability and the reduction of structural distortions and rigidities that hindered needed flexibility in the functioning of those economies. The restrained demand management policies pursued in recent years had already made possible a considerable reduction in inflation in many industrial countries. Those countries that had been more successful in bringing down inflation and in subduing inflationary expectations had greater room at present for flexibility in the conduct of their financial policies. Advantage of the situation could be taken in cases in which it was perceived that a lack of growth in effective demand could inhibit the recovery and the reabsorption of some of the large amount of unemployed resources. Countries in which inflationary pressures remained relatively strong were, of course, not yet in that position.

In the implementation of their policies, Mr. Finaish remarked, industrial countries had in general been more successful in achieving monetary restraint than in reaching some of the other policy goals, such as reducing fiscal deficits and improving structural flexibility. The resulting imbalance in the mix of policies, which placed much of the burden of the fight against inflation on monetary policy, had entailed a heavier cost in terms of lost output and increased unemployment than the process of disinflation would otherwise have required. The same weaknesses in policy now posed a threat to the sustainability of recovery and the longer-term growth prospects. More determined efforts would, therefore, need to be directed at attaining a better balance in the policy mix and at effecting the necessary structural changes. A reduction of fiscal deficits in the United States was particularly significant in that regard; those large deficits could not only undermine the longer-term growth prospects of the U.S. economy--and, indirectly, elsewhere as well--but they also had immediate and direct adverse implications for the current debt problem.

While there was a clear need for a reduction of fiscal deficits in many industrial countries, particularly the United States, Mr. Finaish added, some other industrial countries had been more successful in that regard. Indeed, in several countries, fiscal policy had been quite contractionary--overly contractionary in a few instances according to some observers--in view of the severity of the recession and the progress made against inflation. In some of those countries, where further reductions in fiscal deficits were being sought primarily out of longer-term structural considerations rather than for immediate stabilization purposes, the pace of further fiscal adjustment could be determined so as to avoid the possibility of the implied withdrawal of stimulus causing a weakening of the recovery through inadequate growth in demand. Thus, given the differences

in fiscal situations among industrial countries, the need at present was for compatible, and not necessarily uniform or convergent, budgetary policies. He invited the staff to comment on that question.

While the staff's estimates of the fiscal impulse in major industrial countries, expressed as estimated changes in the "cyclically neutral" or "structural" budget deficits, were useful, Mr. Finaish considered, it would have been instructive also to have had estimates of the level of that measure of fiscal balance, to the extent that it could be meaningfully calculated. The discussion of fiscal policy in the industrial countries in EBS/84/33 had generally focused on the size of deficits, with much less attention paid to the composition of public expenditures. The latter aspect, however, was also important because it was a key factor in determining the overall productivity of public expenditures. The composition of government spending in major industrial countries as presented in the Appendix to EBS/84/33 was useful, but the classification of expenditures should have been supplemented by a breakdown between current and capital expenditures. It would be interesting to know whether some adjustment for the effect of cyclical developments on public finances could also usefully be made in analyzing the fiscal positions of developing countries. A comparison of Table A-8 in EBS/84/33 and Table 3-3 in the version of the World Economic Outlook prepared for publication indicated that, over the period 1979-83, the ratio of the central government deficit to GDP rose less in the non-oil developing countries, in weighted average terms, than in the major industrial countries; it had also been lower in absolute terms in the former group of countries at the end of that period.

Turning to the question of debt and adjustment in developing countries, Mr. Finaish observed that over the past several years a large number of developing countries had been implementing adjustment programs, in many cases with Fund support, to cope with the difficult external situation confronting them. Since 1982 a number of major borrowing countries facing a marked intensification of their debt servicing difficulties and a sharp cutback in financing had also initiated adjustment programs. As a result, the combined external deficit of developing countries had been halved from the peak level reached in 1981. The debt servicing burden had also eased somewhat, as a result of both the improvement in the balance of payments positions and the debt restructuring arrangements involving some major borrowers. However, while the external financial position of developing countries had improved, success had been slow in attaining the other important objective of adjustment, namely, resumption of adequate growth. The average growth rate of developing countries had been falling continuously for five years, and since 1981 there had been widespread declines in per capita income. The combination of falling external deficits and declining or stagnating growth reflected the fact that the decline in deficits had so far been realized mainly through a sharp compression of imports.

In the medium term, external adjustment would be sustainable only if it was combined with a restoration of adequate growth rates, Mr. Finaish suggested. Payments deficits and the consequent need for financing could

always be reduced through a sufficient degree of deflation, but the test of successful and sustainable adjustment was an improvement in the external position without undue adverse consequences for growth. For some countries, a significant slowdown in growth had perhaps been inevitable in the short run in view of the difficult debt position and the sharp reduction in available financing. However, the longer-run capacity of those countries to service their debts would depend importantly on an early resumption of growth. While a cutback in imports released funds for debt servicing in the short run, a prolongation of that process could undermine the future debt servicing capacity by damaging growth prospects.

The medium-term picture presented in the staff's base scenario pointed to a resumption of growth in developing countries in 1984, and to a strengthening in later years, Mr. Finaish noted. At the same time, the improvement in the combined external position of developing countries was projected to be sustained, and the debt burden was forecast to be on a downward trend. While the picture was encouraging, its realization would depend heavily on four basic factors: pursuit of adjustment policies; improvement in the external environment; provision of adequate financing; and enhanced access to export markets.

It should be clear that developing countries, especially those facing debt servicing difficulties, would have to continue their adjustment efforts, Mr. Finaish said. At the same time, in the design of adjustment programs, greater attention needed to be given to addressing adequately the structural factors underlying balance of payments problems so as to strike a balance between external and internal adjustment.

To make the remaining adjustment take place in an environment of rising exports and renewed growth, rather than of continued compression of imports, would be difficult without an improvement in the external situation facing developing countries, meaning a sustained recovery in the industrial world, Mr. Finaish commented. The analysis of the components of the balance of payments of developing countries and the broad orders of magnitude suggested by the sensitivity analysis presented in Chapters 3 and 4 of the draft publication served to show that external factors, such as the depressed demand for exports, terms of trade deterioration, and high interest rates, accounted for a large proportion of the external financial difficulties faced by those countries in recent years.

Adequate financing would have to be provided to make adjustment proceed in an orderly fashion and at an appropriate pace, Mr. Finaish stated. While creditors had to maintain an adequate, stable flow of funds, it had to be recognized that their willingness to continue to lend would depend importantly on debtors' success in making the necessary adjustments and in meeting their debt service obligations. In that regard, the projected hump in amortization payments later in the 1980s called for particular caution and advance planning on the part of both debtors and creditors, including the Fund. There was also a need for recovery in the share of official financing, including development assistance to lower-income countries, in the total financial flows to developing

countries, not least because of the tendency for private commercial banks to concentrate on a few countries and not to take adequately into account the individual circumstances of different countries in the event of a decline in creditor confidence. An allocation of SDRs would also be helpful in view of the much weakened reserve position of many countries. While excessive recourse to financing might have been made by some large borrowers, a factor that tended to delay needed adjustments, that experience could not be generalized. There was a much larger number of developing countries, especially smaller and lower income countries with little or no access to international capital markets, where the supply of financing had been far more constrained. Furthermore, a preoccupation with the stability of the global financial system as a whole in the provision of new financing created the danger that the smaller countries would receive still less financing, as attention became focused on big borrowers.

Because it was only through export growth that a durable and growth-oriented solution to the payments and debt problems could come about, Mr. Finaish went on, the high and rising protectionist barriers in industrial countries constituted a grave obstacle to adjustment by developing countries, in addition to compounding domestic structural distortions. There was a stark contradiction between the advice given to developing countries to take adjustment measures to increase their exports, and the erection of barriers against them. Clearly, a rolling back of those barriers deserved a high place on any agenda for promoting effective and durable international adjustment. It would have been useful to include an appendix on developments in trade policy in the World Economic Outlook, as had occurred in the past. For that purpose, a summary of the staff paper, "Linkages between Trade and the Promotion of Development" (EB/CW/DC/84/1, Rev. 1, 3/7/84), could have been used.

In the section of EBS/84/33 dealing with the role of the Fund, Mr. Finaish remarked, the staff raised and summarily commented upon some important questions, including the relationship between adjustment and financing, the pace and manner of adjustment, and whether adjustment programs of the kind advocated by the Fund imparted a deflationary bias to the world economy when simultaneously pursued by a large number of countries. The staff correctly noted that those questions were complex, and not amenable to adequate treatment in a limited space. However, since the staff had chosen to raise them, it would have been better if they had been allotted greater space than a couple of short, terse paragraphs. For example, one consideration that had an important bearing on those questions, which could have been brought out more clearly and related to recent experience, was the origin or proximate cause of payments disequilibria; in other words, the extent to which those disequilibria had resulted from endogenous or exogenous factors, whether those factors could be considered reversible in the short to medium term, and the extent to which the nature of payments disequilibria had differed in those respects within the group of developing countries. The diagnosis and prescription outlined by the staff in the brief section on the role of the Fund implicitly assummed that the payments deficits to be tackled had been caused entirely, and universally, either by endogenous factors and/or by exogenous factors that ought to be considered irreversible.

The subject of flows of official development assistance (ODA) to developing countries found little or no mention in the discussion, Mr. Finaish commented, despite its relevance to the questions of adjustment and financing. In a publication such as the World Economic Outlook there should be some discussion of the trends in ODA and their significance; a separate table on ODA flows for major donors would also be useful.

With regard to the subcategory of developing countries called "major borrowers," Mr. Finaish remarked, 25 countries might be too large a group. A smaller number might provide a clearer focus on the major borrowing countries. In the World Economic Outlook published in August 1983, in which the subcategory of "major borrowers" had been introduced for the first time, the number of countries included had been 20, and the categorization had been based on indebtedness to private creditors only, whereas the present categorization was based on total indebtedness. It would be useful if the staff could explain the basis for the categorization, including both the size of the category and the selection criterion. Furthermore, insofar as the objective of having a separate category for major borrowers was to provide a focus on countries with a heavier debt burden, a ratio rather than a scale measure would be preferable.

Mr. Laske said that the recession of 1980-82 was clearly over. Led by an intensification of economic activity in the industrial countries, the world economy had turned the corner to recovery. Although not yet fully secured, because it was based mainly on rising consumer demand, the recovery opened up the prospect of a broader-based improvement in growth and, later, in employment. The continuation of the recovery should also help the developing countries to overcome their present debt servicing difficulties and to regain the momentum for real growth. The indispensable prerequisite for a sustained recovery would be the pursuit of economic policies in both the industrial and developing countries that enhanced the flexibility of those economies and that thereby allowed the potential for growth to unfold. For the industrial countries it would mean a set of policies that aimed for or maintained financial stability while reducing structural obstacles to growth. For the developing countries, especially those countries with heavy external indebtedness, it would mean the continuing pursuit of strong external adjustment policies.

He agreed with the staff's assessment of the characteristics of the present recovery in the industrial countries, Mr. Laske continued. In particular, the critical importance of productive investment for the sustainability of that recovery should be stressed. To date, the major impetus to the revival of economic activity had come from increased consumer demand, and to some extent from the reconstitution of stocks in the business sector. That pattern had been observable in earlier recovery periods, but to make a recovery sustainable, an increase in consumer demand had to be supplemented by a pickup in productive investment. In that crucial area, certain doubts arose as to whether the recovery that had been under way for almost a year had achieved the stage of self-sustainability. The staff's evaluation of the prospects for an early revival of business investment exhibited a degree of skepticism, a view

that did not appear to be ill-founded. The reasons given for that cautious view--high real interest rates, excess capacity, high levels of real wages--were well understood and well documented.

On the basis of its analysis, the staff had derived relatively cautious growth projections for 1984 and for 1985, Mr. Laske noted. On a fourth quarter to fourth quarter basis, the staff expected real growth in the industrial countries to slow from 4 percent in 1983 to 3 1/4 percent in 1984. His authorities considered that outlook a little pessimistic. They based their more sanguine view on, inter alia, the expectation that the inventory cycle might not yet have reached its recovery peak. They also pointed out that the slowdown in wage developments, to which the staff referred, had improved macroeconomic conditions for recovery. Furthermore, they had pointed out that the course of fiscal and monetary policy, especially in the United Kingdom and in Germany, was beginning to show beneficial effects on growth prospects.

The staff had alluded to the high degree of rigidity of prices and wages in Europe, compared with the United States, Mr. Laske observed, regarding it as a major obstacle to a significant pickup in economic activity. Without downplaying the importance of those factors, attention should be paid to the considerable slowdown in the growth of unit labor costs in Europe, indicating the responsiveness of wages to changes in labor markets. The authorities in Germany and in many other European countries had long recognized the importance of the rigidities in the labor and goods markets, as well as of other institutional barriers. An important part of their policies was addressed to those obstacles and to increasing the flexibility of their economies.

There could be little disagreement that the most promising way to establish the macroeconomic conditions favorable to business investment was through firm fiscal and monetary policies, Mr. Laske stated. Through tight monetary policy, the inflation rates in most of the industrial countries could be significantly reduced; those countries that had not yet achieved enough in that regard appeared to be determined to stick to their policies. Unfortunately, those firm monetary policies had produced high interest rates, both in nominal and in real terms, at the present relatively early stage of the cyclical upswing, even allowing for the fact that they had declined by about 1 percentage point since mid-1983. Interest rate developments over the past 12 to 18 months pointed to a degree of incongruity between fiscal and monetary policies in countries in which the burden of stabilizing the economy had relied almost exclusively on monetary restraint.

In that context, Mr. Laske went on, he agreed with the staff's analysis of the domestic and external effects of the stance of fiscal policy in the United States. He was particularly worried about the possibility that the financing needs of the U.S. Government might crowd out the growing credit demands of the private sector, thereby keeping interest rates at a level too high for additional private investment to be profitable and ultimately threatening the recovery process. The rising

interest rate trend of recent weeks might be a portent of things to come. It was also a matter of concern that at present, and most likely for several months to come, no action would be taken by the authorities to bring the structural deficit under firm control. He was afraid that the persistence of high interest rates in the industrial countries might complicate the management of the serious debt situation facing many developing countries.

Another regrettable consequence of the incompatibility between fiscal and monetary policies in the United States was the rising protectionist pressure that could obviously have a contagious effect on other industrial and developing countries, Mr. Laske suggested. Authorities in all countries should be aware that the developing countries needed an open trading system and adequate access to the markets of the industrial countries if they were to overcome their present predicaments. The strong current account position of Japan argued for a further opening up of that country's economy to imports. He realized that Japan's strong trade performance was to some extent a reflection of the import surge into the United States as the result of that country's recovery and that Japan had made progress in the liberalization of its import regime, as he had mentioned on the occasion of the Article IV consultation with Japan (EBM/84/32 and EBM/84/33, 2/29/84).

The dollar had been relatively strong throughout the recovery period, Mr. Laske remarked. Some observers might say that it had been excessively strong. More recently, European currencies and the yen had gained in relation to the dollar, but it was not clear that those latest developments had changed the picture significantly. The staff traced the dollar's strength to the successful reduction of inflation and to the attractiveness of the United States for financial investment. The interest rate differential in favor of the dollar had tended to remain relatively stable since the first quarter of 1983; it might not, therefore, have added to the general attractiveness of the dollar as an investment vehicle. Another factor, not explicitly mentioned by the staff, might have been a sharp retrenchment of foreign lending by American banks in 1983, a tendency that would help to explain why the dollar had been in short supply. On various occasions market observers had commented that the dollar might suddenly collapse when the market re-evaluated the fundamentals, meaning the budgetary situation and the rapidly rising current account deficit. The latter development was leading to a pattern of current account positions that was not sustainable for an extended period.

Another worrisome factor was the substantial absorption of global savings by the United States, Mr. Laske considered, as a consequence of both the fiscal deficit and the deficit on the current account. The current account deficit induced protectionist tendencies in the goods markets, while the pull exerted by U.S. money and capital markets on foreign savings suggested that restrictions on international capital transactions should be reintroduced or strengthened. However, the sustainability of the recovery and the manageability of the debt situation were heavily dependent on the free flow of goods and capital. It was of the

utmost importance for the world economy that fiscal and monetary policies in the United States were made more consistent with each other and that they were brought into better balance. Such action would imply not only greater internal policy consistency but would also enhance international policy consistency, because other industrial countries were more advanced in correcting their underlying fiscal imbalances, thereby gaining more room for flexibility. However, that flexibility would remain circumscribed so long as exchange markets reflected the present policy mix in the United States.

The approach developed by the staff with regard to the combination of adjustment and financing of developing countries' external imbalances was fully endorsed by his authorities, Mr. Laske stated. The desired amount of official and private debt rescheduling, as well as the provision of fresh money, would be forthcoming only when the highly indebted countries continued to make determined adjustment efforts. Procrastination in formulating and implementing such policies, as could be seen currently in the case of important countries, would not convince present and potential creditors that their loans were extended wisely and safely. The base scenario presented by the staff justified a degree of optimism that the developing countries would be able to manage if sensible policies were followed. He hoped that it would not be considered overoptimism to say that the worst of the debt crisis appeared to be over, largely due to the achievements thus far in the adjustment efforts of countries such as Mexico and Brazil and equally to the putting together of substantial refinancing packages, an effort in which the Fund had played a major role.

Although the projections in the base scenario relied on assumptions that were reasonable for the most part, Mr. Laske continued, slight deviations could make the positions of individual countries untenable. In particular, the expectation of a decline in real rates of interest by as much as 3 percentage points could be considered overly optimistic. The projections also indicated that the developing countries would be faced with a hump in their debt repayment obligations about 1987. It was questionable whether that hump could be negotiated without additional debt rescheduling operations, which in turn would require a satisfactory adjustment performance of the countries concerned. Spontaneity in the provision of additional capital flows should not be taken for granted. The staff's projections had been made on the expectation that policy formulation and implementation in the indebted countries were regaining credibility, as reflected in the projected reduction in the size of the negative errors and omissions items. It would be highly desirable if the outflows of private capital induced by confidence considerations were to recede, given that large amounts of the international assistance provided over the past two years had refinanced substantial capital flight. It would be even more welcome if those flows could be reversed.

Commenting on the German economy and the policies pursued by his authorities, Mr. Laske said that he generally agreed with the staff's analysis. However, with regard to calculations on the extent of fiscal stimulus, the staff's analysis might have been too narrowly based. By

taking into account only the Central Government, the staff could draw inaccurate or misleading conclusions. The federal structure of Germany accorded a heavy weight in fiscal developments to the state and local governments. While the staff believed that the policies pursued by the Central Government between 1980 and 1982 had led to a withdrawal of fiscal stimulus, the Council of Economic Advisers, basing its analysis on all three levels of government, held to a different view. Perhaps the structure of government in Germany should be taken into account in future World Economic Outlook exercises.

Mr. Polak remarked that he agreed with the staff that in the present circumstances members should follow a medium-term financial strategy aimed at restoring and maintaining financial stability and at correcting structural weaknesses in their budgetary and, where applicable, monetary situations. Such a policy could now be carried out in a framework of rising world demand; therefore, there should be no delay in cutting fiscal deficits for fear of what the staff referred to as "withdrawal of stimulus"; that conclusion applied to all industrial countries, including the United States.

It was not correct to attribute the expansion that had taken place in the United States to fiscal stimulus partly offset by tight monetary policy, Mr. Polak continued, so that a reduction in the deficit should be part of "a change in the policy mix." A more accurate diagnosis of the current situation in the United States was that the country had a monetary policy that permitted a satisfactory rate of growth. Too large a proportion of that permissible and potential growth was being taken up by the fiscal deficit or, to put it another way, by the sum of government expenditures and consumption expenditures, while investment and the trade balance were being crowded out. A smaller fiscal deficit with the same monetary policy would not produce slower growth but a more balanced growth at lower interest rates and with high investment and a better trade balance. While Mr. Erb had suggested that there was no evidence at present that investment was being crowded out, Alan Greenspan, a former Chairman of the Council of Economic Advisers, believed that crowding out had been under way since the beginning of the present recovery as a result of the high interest rates; he had cited as evidence the abnormal concentration of business investment on capital goods with a short life rather than on long-term capital equipment.

A related issue, to which Mr. Finaish had referred, was the connection between structural adjustment as carried out under Fund programs and the impact of those programs on global demand, Mr. Polak stated. The staff had commented that: "it is sometimes suggested that these policies impart a deflationary bias to the world economy, and may not be wholly effective if all countries attempt to pursue them at the same time." In reply to that allegation, the staff had stated that countries had no alternative. While that view was correct, additional points deserved consideration, as the staff admitted. One of the lessons of Fund experience in working with countries carrying out adjustment programs was that when serious adjustment was required, the total cost of that adjustment, in terms of lost output,

was maximized through unduly gradual application. Furthermore, it did not make sense for the Fund to calibrate the conditionality it applied to individual countries in response to fluctuations in the level of world activity. The notion that Fund conditionality should vary over time depending on world economic conditions, as measured by indices of current and prospective activity, so that it could contribute in some way to a global anticyclical policy, as proposed, for example, by John Williamson of the Institute for International Economics, was not only impracticable, but also wrong in principle. It should also be noted that at present the world economy was recovering reasonably well in spite of the severe adjustment programs that many countries were applying.

Turning to the question of structural policies in the industrial countries, Mr. Polak agreed with the staff that the current high unemployment rate had much to do with structural rigidities. A good deal of the absorption of present unemployment would have to come not from traditional employment policies but through changes in incentives for employers to hire more workers and for workers to seek work more actively. However, the staff should be careful not to write in a way that could be interpreted as antilabor; some observations on page 27 of EBS/84/33 gave such an impression.

There was not much to add to earlier Executive Board discussions on exchange rates, Mr. Polak considered. The staff attributed the current strength of the dollar to the attractiveness of the U.S. capital market; such a statement was hardly more than a tautology, given the large deficit on the current account. It should be borne in mind that a given measure of attractiveness, for example, an interest rate differential, could not keep the exchange rate high for ever. The flow of capital to the United States as a result of the complex attractiveness of the U.S. capital market was essentially a stock adjustment; at some point, the owners of capital would conclude that they had an adequate proportion of their capital invested in the United States, at which time the inflow of capital would slow, becoming smaller than the current account deficit. The exchange rate would then fall, but that would not necessarily reflect a change in the attractiveness of the United States for capital. The point was an additional strong reason to expect a decline in the dollar exchange rate at some time, unless U.S. interest rates kept rising relative to interest rates elsewhere in the world.

On the question of debt and adjustment, Mr. Polak went on, the staff's projections in EBS/84/33 were more realistic than those in previous papers. About a year earlier, he had had difficulty with the staff assumption that, given reasonable adjustment in the world economy, the current account deficit of the non-oil developing countries could return to about $100 billion a year by about 1986. In the present paper, the staff estimated the deficit to be about $60 billion, partly as a result of lower inflation, but mostly because the staff believed that the ratio of the current account deficit of the non-oil developing countries to their exports of goods and services could be held at about 10 percent, instead of the 14 percent estimated a year earlier, an important change. In spite of its more realistic

appraisal, the staff might be too optimistic about the debt situation, quite apart from the possibility of the difficulties for individual countries that inevitably occurred from time to time. In that regard, he agreed with the comments made by Mr. Kafka and Mr. Laske.

There were two difficulties with the staff's approach to the debt situation, Mr. Polak remarked, even if its basic assumptions about the various "environmental factors" could be regarded with confidence. The first difficulty was the hump in gross repayments starting in 1987, and the second was the absence of any allowance for disappointments in the period from the present until about 1990. The staff assumed that the hump in financing in gross repayments could be taken care of almost entirely through spontaneous financing, a view supported by Mr. Erb, and that rescheduling would be necessary in only a few cases. The assumption was based on the notion that the banks, witnessing effective adjustment in debtor countries, would be willing to maintain credits to those countries in their portfolios, and that they would, therefore, be spontaneously willing to refinance them. The issue was open to doubt; banks might be willing to maintain credits to the indebted countries in what they considered appropriate proportions, but only if other banks were willing to do the same. Therefore, the banks might prefer to continue to rely on the rescheduling mechanism, especially for the very large amounts that would come due in 1987 and beyond. In those circumstances, the assumption of additional spontaneous credit became questionable; it was more likely that countries would have to rely on rescheduling and on coordinated bank action for a number of years to come. That problem, which was still a few years away, should be approached well in advance, through agreement on organized reschedulings for countries carrying out Fund-approved policies or whose policies deserved general commendation.

It was almost certain that there would be disappointments in the process of recovery and restoration of creditworthiness, Mr. Polak added. Even if the assumptions about growth and other indicators were realized, disappointments could arise from policy failures. For example, in the industrial countries there might be, even if only for one year, a sharp jump in interest rates, or there could be an ordinary cyclical downturn affecting the terms of trade of the developing countries. It would be advisable to ensure against such risks. In that regard, three approaches, which were not mutually exclusive, deserved early consideration. The first approach would be for the developing countries to adopt a more cautious attitude than envisaged in the staff's basic scenario; it would involve less use of new debt, higher reserve accumulation, in which SDR allocations should play a role, and slower growth or, if that was considered undesirable, faster real exchange rate depreciation. That approach would represent an effort by the developing countries to insulate themselves against possible disappointments. A second approach could involve the attempt to build into debt rescheduling arrangements provision for cyclical adjustment of debt service, perhaps as a function of export fluctuations, along the lines previously suggested by Mr. de Groote. The third approach would involve an important contingent role for the Fund, not as a financial intermediary, but as a standby to take care of unexpected adverse circumstances. That

point had been made by Mr. Senior on the occasion of the Executive Board's discussion of the extended arrangement for Mexico (EBM/84/34 and EMB/84/35, 3/2/84). Finally, he agreed entirely with the staff's comments on protectionism.

Mr. Lovato said that the world economy was emerging from the deepest recession of the postwar era in a condition of profound disarray, with deep disparities in countries' rates of growth, worrisome imbalances in the structure of international payments, and generally unequal economic prospects in the medium term. On the other hand, the strength of the recovery in some major industrial countries and its continuation despite unfavorable conditions gave rise to legitimate hopes that it could be sustained and spread to those areas that continued to lag behind. More important, many industrial and developing countries had taken important policy steps toward sounder public financial policies and greater economic efficiency, whether through spontaneous political choice or through necessity dictated by current constraints. Many of those steps had been warranted even before the 1979-80 oil crisis; they could confidently be expected to provide the conditions for more solid economic growth.

Against that background, policymakers had to face a major challenge at the national and international levels, Mr. Lovato continued, namely, to take the opportunity offered by the current momentum and by the improved underlying conditions to tackle the serious imbalances inherited from the recent recession. Two major areas in which equilibrium was far from being achieved were productive capacity utilization and the debt problem. In both areas, the figures provided by the staff in EBS/84/33 were worrisome. The base scenario forecast indicated that productive expansion in the next few years was expected to proceed at about the same trend rate as capacity growth, so that factor markets were likely to be slack through the end of the decade. On debt, the staff indicated that, even if the heavy schedule of debt servicing obligations facing the developing countries was dealt with successfully, the real stock of debt was likely to continue to increase in the medium run at a substantial rate; it was expected to decrease slowly only in relation to exports. A failure to deal with those problems could jeopardize the prospects for stable recovery. The two issues had related policy implications, because equilibrium on both fronts required the maintenance of a high rate of economic activity in the industrial world.

The debt problem was particularly important for financial stability and for the role of the Fund, Mr. Lovato stated. A crucial issue was sustainability. Although the question of whether a given debt situation was sustainable ultimately depended on market evaluation and was, therefore, subject to the instability of expectations, the growth of real debt and of the debt ratio provided rough yardsticks for making an assessment in that regard. The two measures were quite different; a steady level of real debt implied a relationship between the trade and noninterest services accounts and real interest rates for any given initial stock of debt, while a steady debt ratio also took into account the growth of real exports and was less of a constraint in periods of recovery.

Under the first, stricter criterion, sustainability of developing country external debt appeared to be incompatible with global equilibrium in the trade accounts of industrial countries and with the maintenance of positive real interest rates in the financial markets, Mr. Lovato suggested. The tradeoff was sharper the worse the initial debt situation; it had deteriorated to a substantial extent in recent years. Under the second, weaker, criterion, sustainability was compatible with the two conditions that he had mentioned, provided that real exports grew at a sufficiently high rate. However, a situation that was barely sustainable in the second instance offered little room for maneuver and it made the country, or group of countries, in question much more vulnerable to a shortfall in exports, whether that shortfall arose out of local circumstances or out of a world recession.

A sound medium-term policy for dealing with the debt problem required a combination of two elements, Mr. Lovato considered, a vigorous trade performance by the indebted developing countries, and lower real interest rates. Because the scope for reducing those countries' imports was limited in the long term, it was essential that favorable conditions should be created for sizable export flows from the developing countries in the years ahead; those conditions implied a sustained high rate of economic activity, a holding back from protectionist measures by industrial countries, and easier world financial conditions. An interesting aspect of the problem that emerged from the staff's projections was the strong sensitivity of debt repayments to industrial countries' growth and protectionism, a point that underscored the importance of the economic environment and of the trade policies of those countries to the attainment of viable solutions to the debt problem. At the same time, it was essential for developing countries to continue to pursue sound adjustment policies, both to preserve the confidence of international lenders and to prevent short-run capital flight. The importance of that point was so obvious that it need not be discussed at length.

In sum, the problem of developing country debt would continue to be a matter of concern over the medium term, Mr. Lovato went on. Some of the comments made by the staff in EBS/84/33 appeared to be more optimistic than the data on which they were based. A solution to the problem would continue to require the pursuit of strict financial policies by all borrowing countries in conjunction with a flexible and farsighted attitude on the part of the industrial countries.

Commenting on the nature of the recovery and policy issues in the developed world, Mr. Lovato remarked that a noteworthy aspect of the current upswing was the coexistence in major industrial countries of a strong pickup in purchases of consumer durables and investment with persisting high real interest rates. A possible explanation for that phenomenon was the spontaneous upturn that tended to take place after a period of stagnation, when depreciation had substantially decreased the size of the existing stock of capital and consumer durables. The upturn fed on itself and accelerated, giving rise to a recovery. A further explanation involved the relationship between household spending and

nominal interest rates, which was determined by wealth or liquidity considerations. Whatever the role of those factors in triggering the recovery, the level of real interest rates remained fundamental to its sustainability. An appropriate policy mix in major industrial countries was essential to sustain a high rate of economic activity.

With regard to the Italian economy, Mr. Lovato said, it was well known that his authorities were engaged in a major policy effort to correct some of the economy's long-standing weaknesses, particularly labor costs and public finances. One part of the package, specifically aimed at reducing the extent of wage indexation, was currently making its way through the difficult process of parliamentary approval; he hoped that it would contribute to the sizable reduction in the growth of labor costs forecast for 1984. Other factors expected to play a part in that reduction were the virtual absence of contract renewals at the enterprise level during the year, and the elimination of special social security charges, which had aggravated labor costs in 1983. In conjunction with the widespread slack in the labor market, those factors were expected to reduce the increases in labor costs far below the estimates in EBS/84/33, with obvious implications for the inflation outlook. The staff was already reviewing the data; nevertheless, it should be stressed that it was important to monitor closely the situation of individual countries during the preparation of World Economic Outlook reports, particularly when the prospects were evolving rapidly. Especially if confidentiality could not be ensured, the use of figures that were not wholly up-to-date could jeopardize the credibility of policies and have a subtle effect on the formation of expectations.

Mr. Nimatallah said that he agreed with the staff that recovery in the world economy was gaining momentum. The projections for output, world trade, commodity prices, and inflation in 1984 and 1985 were encouraging. They would materialize only if Fund members followed appropriate policies to sustain the recovery. The policies of the major industrial countries were of particular importance in that regard. A sustained recovery in the industrial countries would depend critically on five main policies.

First, recovery would depend on the ability of those countries to maintain stable financial conditions, Mr. Nimatallah continued. Past experience showed that excessive money creation led to a vicious circle of inflation and recession. It was, therefore, important that the industrial countries consolidated the gains that they had made in the fight against inflation.

Second, a sustained recovery would also depend on the ability of the industrial countries to improve the present mix of monetary and fiscal policies, Mr. Nimatallah considered. In general, industrial countries should aim at reducing their fiscal deficits so as to ease the burden on monetary policy and to allow real interest rates to decline gradually. While such an approach would be desirable to stimulate business investment, caution would have to be exercised so as not to overheat some of the

economies concerned. A gradual, steady reduction in the deficits would allow the recovery to be based on a more appropriate balance between private and public sector activity, thereby making it more sustainable.

The large budget deficits in the industrial countries had also contributed to the emergence of a pattern of exchange rates that was unsustainable over the medium term, Mr. Nimatallah added. The dollar, however, had recently eased against some of the major currencies. While that development was positive, it was important to ensure that the transition to a new pattern of exchange rates was also gradual and smooth. The transition could be helped by a gradual reduction in the U.S. budget deficit as well as by action by some other industrial countries to reduce inflationary pressures in their economies. He welcomed the recently expressed intention of the U.S. authorities to seek a gradual reduction in the budget deficit, as well as the extensive efforts in several European countries to control inflation.

Third, it was important that wage increases should be related to productivity gains, not to inflation, Mr. Nimatallah remarked. There had been encouraging signs during the past year of more moderate wage settlements in a number of industrial countries. He hoped that that trend would continue. Fourth, the sustainability of the recovery in the industrial countries would also depend on structural adjustment based on the principle of comparative advantage. The industrial countries should allow resources to be reallocated more efficiently to new, more competitive industries. Labor retraining programs, among other things, would be needed to ease the transition to a more efficient industrial structure in those countries. Fifth, concerted efforts were needed to dismantle trade barriers in the industrial countries. Those barriers were delaying the necessary structural adjustment and they were affecting the prospects for sustained expansion in world trade from which all countries would benefit.

None of those policies was easy to follow, Mr. Nimatallah went on, but all were essential if the recovery was to be well balanced and firmly based. Together, they offered the best chance of a reduction in unemployment in the industrial countries over the medium term, of a smooth return to a more sustainable pattern of exchange rates, and of an orderly solution to the debt problem. In a real sense, there was no viable alternative to such policies.

Commenting on debt and adjustment in the developing countries, Mr. Nimatallah observed that, although much had been done since mid-1982 to relieve the situation, the debt problem was by no means over. Many countries remained heavily indebted, and a great deal of debt would have to be repaid between 1986 and 1988. Precautions should be taken early enough to ensure the smooth completion of those transactions.

With the efforts of the Fund, Mr. Nimatallah stated, the international financial system had proved its resilience and had remained intact. He agreed with the staff that under certain conditions the debt problem could

continue to be manageable. It should be stressed that one of those conditions was to ensure that the indebted countries avoided slipping into a state of no growth while they adjusted.

Both the debtor and creditor countries should help to create the right conditions for solving the debt problem, Mr. Nimatallah suggested. If the industrial countries followed the policies that he had just outlined, the indebted countries would be able to increase their exports, finance their necessary imports, and service their debts. As for the debtor countries, they had no alternative but to continue with their adjustment efforts. The initial adjustment process had resulted in a substantial reduction in current account deficits, but it had been accompanied, unfortunately, by a reduction in imports and, therefore, in growth. The focus should be on growth-oriented adjustment, a need recognized by the staff. He had stated on a number of occasions that, unless the developing countries grew, they would not be able to repay their debt effectively.

In conjunction with the adjustment efforts, Mr. Nimatallah went on, sufficient financing had to be made available. The Fund should continue to play its catalytic role in arranging financing packages in support of adjustment. As part of that role, the Fund should also provide its members with unconditional resources through SDR allocations. Such action would be helpful in providing the system with much-needed liquidity.

The emphasis in EBS/84/33 on the problems of debt and financing of the oil exporting developing countries was welcome, Mr. Nimatallah commented. Those countries, like the other developing countries, had been hard hit by the recession in the world economy. The demand for oil had declined substantially over the previous few years, causing a decline in export volumes. Together with a decline in prices, the result was a substantial reduction in export earnings. Consequently, despite adjustment efforts, the combined current account position of the oil exporting developing countries had been in deficit since 1982. Moreover, several of those countries, both members and nonmembers of the Organization of Petroleum Exporting Countries (OPEC), had their share of debt problems; they were facing financial difficulties and they might need the help of the Fund. He was confident that the Fund would be understanding in that regard.

With respect to the world oil situation, Mr. Nimatallah said, the staff's assumptions and predictions regarding the price of oil and the volume of oil exports appeared reasonable, barring any shocks that might disrupt oil supplies. Most of the OPEC countries were producing below their capacity levels. It would be some time before the increase in world demand for oil was reflected in an increase in the nominal price of oil. As for export volumes, the staff's projections assumed no accumulation of commercial inventories during 1984 and 1985. That assumption depended, of course, on judgments about the cost of accumulating inventories. If uncertainties appeared and the price of oil was expected to rise, the staff's projections could turn out to be conservative.

Mr. de Maulde remarked that the optimistic tone of EBS/84/33 was welcome. Confidence was an important ingredient of economic policy, and the Fund played a useful role by expressing its faith in the recovery. There were a number of valid reasons for believing that the deep recession of the early 1980s was being left behind. The resumption of economic growth in industrial countries had been associated with a sharp decline in the rate of inflation, and the developing countries' adjustment efforts had brought about a turnaround in their current account deficit, which had been reduced by one half between 1981 and 1983. The main thrust of EBS/84/33 was the staff's effort to demonstrate that an improvement of the present recovery could be expected.

The main concern regarding the sustainability of growth in industrial countries was that the current situation in those countries remained unbalanced in various ways, Mr. de Maulde continued. For example, the United States was growing rapidly but it also had a large and worsening external deficit, clearly a menace to that growth. At the opposite extreme, Japan was experiencing a low rate of growth by its own standards, associated with a large and increasing external surplus. The other major industrial countries fell between those two examples, with the exception of those countries, such as France, that were continuing the adjustment of their external balances. The harmonization of policies that had been advocated at the Williamsburg summit in 1983 still had a long way to go. There were also substantial imbalances within the various national economies of the industrial countries, as evidenced by the unemployment rates that the staff forecast to remain at the current unacceptable levels for a long time, indicating that the adjustment of the real sector was also far from complete. Additional causes for concern included the level of real interest rates, with its consequences for investment and indebtedness; the inadequacy of the current pattern of exchange rates; and the increase in protectionism, which cast doubts on the future increases in the volume of world trade. Taken together, those imbalances were disturbing because they formed a distinct pattern of a recovery that could become self-destructing.

Commenting on the sustainability of the adjustment process in developing countries, Mr. de Maulde suggested that there were again ample causes for concern: the impact of interest and exchange rate developments on the debt burden, where the latest interest rate developments were especially disquieting; the brutal reversal of capital flows between industrial and developing countries, creating huge unsatisfied financing needs; and the unsustainable character of the sharp restrictions on imports, including the most essential imports, that developing countries had had to resort to as an emergency measure. Such restrictions could not be maintained without the gravest consequences for the domestic productive bases of those countries and for the export sectors of other countries. In view of those considerations, his conclusion for developing countries was similar to that drawn for the industrial countries: like the recovery in the developed world, the adjustment in the developing countries could become self-destructing.

In order for the staff's optimistic scenario to be credible, Mr. de Maulde considered, it would have to be supported by far-reaching policy actions. There was no basic disagreement in the Executive Board about the kind of actions required with regard to individual countries' domestic policies. The points raised by the staff for discussion indicated the right answers. All Directors could agree that members should be prudent in managing their fiscal policies; that they should be ambitious in correcting structural rigidities; that they should be unrelenting in the fight against inflation; and that the major countries, particularly the United States, had special responsibilities in those areas.

However, the current picture also clearly called for new initiatives in the field of international economic cooperation, Mr. de Maulde added. The desired convergence in national policies would not materialize if progress was not made toward a more rational management of exchange rates and if positive actions were not taken to solve the debt problem, including initiatives in international reserves and liquidity as well as trade and financing. In that regard, he strongly supported the remarks made by Mr. Polak.

Mr. de Groote said that he did not fully share the staff's negative attitude with regard to the possible effects of more active demand management policies in industrial countries. Indeed, the staff's recommendation that maintaining financial neutrality in the major industrial countries would provide the best framework for sustainable economic growth in the medium term would not be sufficient to spread the benefits of the U.S. recovery worldwide. The staff had correctly formulated different recommendations for all major industrial countries, depending on their economic situation. However, in its recommendations for those countries that had recorded satisfactory adjustments, the staff had not taken sufficiently into account the lessons learned from recent experience in the United States and the United Kingdom, where fiscal stimulus, coupled with a temporary relaxation of monetary restraint, had provided a vigorous recovery in economic activity which, particularly in the United States, had had strong employment-generating effects without being accompanied by price increases. The staff appeared to attribute the recovery of economic activity in both countries to the deceleration of inflation; several times it stressed that demand had increased most in those countries in which inflation had recently decelerated most. That explanation for the recovery was too simplistic. If it were correct, a recovery in economic activity in Japan and Germany would already have been seen for some time; however, those two countries continued to suffer from insufficient domestic demand.

The simultaneous occurrence of the deceleration of inflation and of recovery in some countries was not fortuitous, Mr. de Groote continued. The deceleration of inflation had allowed those countries to undertake more active policies to stimulate the recovery, without endangering the gains on the inflation front. The data in Table A-8 clearly indicated the strong expansionary fiscal impulse in 1983 in the United States, the United Kingdom, and, to a lesser extent, in Canada; it was not by accident that those countries had recorded a strong recovery in economic activity

in 1983. In the same table, the data indicated the contractionary fiscal impulse in Japan, Germany, and other European countries, which had been reflected in low output growth rates in all those countries.

The staff recommendation for exclusive reliance on structural measures, rather than demand measures geared to the position of the business cycle, was based on the argument that as far as Europe was concerned, unemployment was of a classical type and was therefore due entirely to excessive wage costs that had priced labor out of the market, Mr. de Groote commented. That approach constituted too extreme a view of the European unemployment problem. There was broad agreement that a large part of present unemployment was Keynesian in nature, as it was due to insufficient domestic demand. The absence of sufficiently strong domestic demand in Europe, which was related to policies of wage moderation and restrictive fiscal policies, would probably further delay the expected revival of activity. Again, the experience in the United States and in the United Kingdom had shown that the recovery had been primarily consumer-led, fueled by real income increases mainly as a result of tax reductions. Only after the consumer-led recovery was in full swing and, accordingly, capacity utilization had increased, had it been possible to observe a recovery in investment activity.

Policymakers were, therefore, faced with a choice, Mr. de Groote considered. They could follow the staff's advice to concentrate on structural reforms, but in that case it was highly probable that the projections of a continuous recovery in 1985 and 1986 would turn out to be unrealistic, and that the recovery in the United States would not spread to the rest of the world. Alternatively, they could accept that those countries that had brought inflation under control, where the fiscal deficit did not risk crowding out private investment, and that had already made progress in their structural adjustment should moderately stimulate their economies, thereby reinforcing the expansionary effect of the U.S. recovery. Such action would have two clear benefits. First, it would allow the acceleration of the required structural changes; a revival in economic activity would facilitate further reductions in real wages and the removal of restrictions to labor mobility, thereby improving the scope for a more durable recovery in investment activity. Second, it would mitigate the calls for labor-sharing formulas that could make the removal of labor-market rigidities even more difficult. The structural transformation could only be facilitated by more buoyant economic activity.

Commenting specifically on the main countries where such action could take place--Germany and Japan--Mr. de Groote suggested that the magnitude of the fiscal deficit in those countries would not prevent a recovery from taking place. It was hard to accept the notion that a budget deficit equivalent to 1.5 percent of GDP, as was the case in Germany, was excessive under present circumstances. The staff's reluctance to advise more active policies rested on its view that in most European countries the absorption of resources by government was excessive, an opinion that he fully shared. However, the solution lay in the combination of temporary monetary relaxation with tax reductions to stimulate domestic demand.

In suggesting a more active fiscal policy in those countries that had adjusted sufficiently, Mr. de Groote went on, he was not advising an increase in public expenditure, but rather a reduction, in order to provide incentives to the private sector through a reduction of the tax burden. A more active fiscal policy of that type would require some relaxation in monetary policy for only a short time. Experience in the United States and in the United Kingdom had shown that such action could be taken, when adjustment had been sufficient, without a revival of inflation. In the short term, therefore, measures were needed that were in line with the medium-term requirement of a reduction of the share of government expenditures in GDP to more acceptable levels. The appropriate level in each country was a matter of judgment because there was no optimal level of government intervention in an economy. The room created by those expenditure reductions should, however, be translated into a reduction in fiscal revenues aimed mainly at benefiting the enterprise sector. In that way, domestic demand would be maintained at least at its prevailing level, or perhaps increased slightly, while a further transfer of income was effected from wage earners to enterprises and from the public sector to private enterprises.

From the overall standpoint of the adjustment process, the staff's recommendation for financial neutrality was not compatible with the smooth functioning of the international economy, Mr. de Groote considered. If the countries that had successfully adjusted their economies counteracted, through fiscal contractions in their domestic markets, the positive effects, both direct and indirect, arising from the U.S. recovery, they would nullify the multiplier effects of that recovery on other countries. Such a policy approach would run directly counter to the objective of ensuring a worldwide recovery.

For the United States, which had followed policies quite divergent from those recommended by the Fund, and which was, therefore, in a different and more advanced phase of the business cycle, Mr. de Groote observed, the recommendations would have to be different. The fiscal deficit that had contributed positively to the recovery now had to be reduced gradually to make room for the financing of new investment. He fully supported the staff's view that the foreseeable persistence of the deficit over a number of years was responsible for the very high interest rates at the present phase of the business cycle, and that those interest rates, in turn, were mainly responsible for the high value of the U.S. dollar. The present pattern of exchange rates was clearly unsustainable, and required, therefore, policy changes to bring about a gradual adjustment of the rates to more sustainable levels. In the absence of policy measures, the unrealistic exchange rates would elicit calls for protection that would put an additional brake on the spreading of the recovery.

If no policy actions were taken to allow gradually for a lower level for the dollar, Mr. de Groote argued, the current account deficit would reach such proportions that in a short time it would turn the United States from a creditor country to a debtor country. The present positive inflows from interest income would disappear, even turn negative, thereby

deepening further the current account deficit. Such a development would then require the United States to run a trade surplus in order to compensate for a negative services balance, implying a much lower value for the dollar than at present. Once public opinion perceived the likelihood of that situation, there could be substantial portfolio shifts away from dollar assets into other currencies.

In order to avoid such destabilizing swings in the exchange rate, the authorities should act gradually to bring the value of the dollar to levels more compatible with a sustainable U.S. balance of payments position, Mr. de Groote suggested. Such action, if gradual, would not be detrimental to the rest of the world, because the loss in competitiveness that other countries would experience would be compensated by gains in inflation moderation and by the ensuing revenue effects, as well as by a greater room for maneuver to lower interest rates. It was obvious that such a development could not be brought about through intervention in the exchange market; it should be the result of a change in policies, particularly a reduction in the public sector deficit, which would, in turn, bring down interest rates. His remarks should not be interpreted to imply that the reduction in the public sector deficit in the United States was required only for external considerations related to the value of the dollar and the reduction of the current account deficit. A gradual lowering of the deficit was also essential for the sustainability of the present recovery, and to avoid a crowding out of private investment. That point had already been stressed by several Executive Directors.

Turning to the question of debt and adjustment, Mr. de Groote remarked that the staff had clearly emphasized that an improvement in the situation rested on extremely tight assumptions regarding adjustment and financing. There was no reason for complacency, because the conditions for success were restrictive, implying a protracted adjustment effort for most countries for the rest of the decade. It was unlikely, indeed, that the staff's positive scenario would materialize; he doubted that the recovery in Europe and in the United States would be sufficiently sustained during the period 1986-88 to allow debtor countries to acquire sufficient export earnings to service their external debt. Because it was not realistic to assume that economic activity would follow a smooth path during that period, or that the underlying assumptions would materialize, it was important that Executive Directors should begin to think of possible ways to deal satisfactorily with a disappointing outcome.

One way, which he had mentioned on previous occasions and which had been referred to by Mr. Polak, Mr. de Groote said, could be to have debt repayments by developing countries geared more directly to the level of their export earnings. The Fund need not officially propose or monitor such a scheme in all cases; nevertheless, it was clear that a number of countries that were extremely dependent on a few basic commodities for their export earnings would greatly benefit from such a scheme, which would have to be agreed in a pragmatic way between creditors and the debtor countries. The scheme would be particularly useful when economic developments turned out more positively than expected, as it would prevent

the additional resources from being diverted to new projects instead of being used to accelerate the adjustment. Through such schemes the banking community would contribute more efficiently to the financial restoration of the debtor countries than was the case at present.

In order to take account of the likely movements in economic activity and financing conditions, Mr. de Groote went on, it would be crucial to modulate the Fund's intervention in such a way that it would not exacerbate the problems affecting deficit countries when economic recovery turned out to be less sustainable than anticipated or when capital flows were lower than expected. He was not suggesting that the Fund should intervene systematically in an anticyclical way, as assumed by Mr. Williamson of the Institute for International Economics, but the special circumstances of 1987, when a debt hump was expected, might well require the Fund to be more forthcoming at that time, as a lower level of activity or reduced capital flows would translate into higher financing needs of the developing countries.

Despite a somewhat higher growth projection for industrial countries in 1984 in EBS/84/33 than had been projected in the previous year's World Economic Outlook survey, Mr. de Groote noted, the projection for output growth in developing countries in 1984 had been revised slightly downward, from 3.5 percent to 3 percent on a weighted average basis. At the same time, the anticipated use of Fund credit in 1984 was expected to be about 30 percent lower than foreseen in 1983. The question arose whether the Fund was being too restrictive in the interpretation of its role and whether it was not sufficiently counteracting the effects of the liquidity shortage in the world economy. Indeed, the downward revision of the estimate of the current account deficit of non-oil developing countries in 1984 from $67.4 billion in the 1983 forecasting exercise to $50 billion in the current projections clearly illustrated that the Fund had over-estimated expected capital flows, and that developing countries had been forced to cut further their imports and to reduce their future growth prospects.

There had also been a fall in the demand for the Fund's resources, Mr. de Groote added, as illustrated in the staff paper on the Fund's liquidity position and financing needs (EBS/84/44, 3/7/84) to be discussed by the Executive Board at EBM/84/50 and EBM/84/51 (4/2/84). The situation required the Fund to reassess its policies; in that spirit he had supported the suggestion by the Chairman on the occasion of the Executive Board's discussion of the extended arrangement for Mexico (EBM/84/34 and EBM/84/35, 3/2/84) to increase the access to Fund resources of countries that had shown willingness and success in undertaking a strong adjustment policy. If the Fund restricted its financing too much, it would begin to lose the leverage required to induce countries to undertake the necessary adjustment. For the same reason, the Fund would not be able to exert its catalytic influence as much as expected. Indeed, it might be hard to convince banks to continue to increase their exposure to borrowing countries for the remainder of the decade if the Fund was perceived as pulling out, as might be construed from some arrangements that had recently been discussed in the Executive Board.

The adjustments implemented in 1983 and 1984 had generally been more substantial than had been perceived by the media, Mr. de Groote stated, but at the cost of an important reduction in growth. There were, therefore, many good reasons to review the Fund's policies in order to try to achieve adjustments through an expansion of activity, as some countries had managed to do. The Chairman had correctly stressed that point in his remarks to a conference in Belgium (IMF Survey, 2/6/84). As Mr. Nimatallah had pointed out in the Executive Board's discussion of a possible SDR allocation (EBM/84/45 and EBM/84/46, 3/26/84), the adjustments sought by the Fund should not bring countries back to equilibrium at a lower level of income. In order to achieve positive results in that regard, it might be necessary to set somewhat less rigorous credit ceilings in Fund programs and to provide more ample financing so as to permit countries to undertake, after the initial and unavoidable reduction of income, more growth-oriented adjustment. A necessary condition for growth-oriented adjustment was a more appropriate burden sharing between industrial and developing countries, and between the financial markets and the Fund. Thus far, the adjustment burden had fallen disproportionately on deficit countries, a fact that the Executive Board should start recognizing.

The Fund had a crucial role to play in ensuring a more balanced approach to solving the present difficulties, Mr. de Groote commented. That role implied making judicious recommendations for a broader worldwide recovery in industrial countries, ensuring adequate adjustment in developing countries, and providing directly and indirectly the required financing to ensure the smooth functioning of the process, a process that was predicated upon the maintenance of free trade. In the monitoring of the adjustment process it was, therefore, appropriate for the Fund to place more emphasis on trade issues. However, it should not forget that the principal tendencies toward greater protectionism originated in unbalanced exchange rate levels. Thus, the Fund could appropriately focus its attention on obtaining a more equilibrated exchange rate structure among the major industrial countries.

Mr. Ismael stated that the first issue to be considered was whether the current strong recovery in the U.S. economy was sustainable and whether it could become more widespread among other industrial countries as well as among the developing countries. The U.S. monetary authorities were rightly concerned about the possibility of a resurgence of inflation, and they had maintained a monetary policy that would ensure that inflation would remain under control. At the same time, as the economic recovery gained momentum, there was evidence of increased demand for credit from the private sector. In addition, there was a large fiscal deficit that was being financed by market borrowing. One result of the large fiscal deficit combined with the resurgence of private sector demand for credit had been a sharp increase in interest rates. In the previous week, the rates on U.S. Government treasury bills and other securities had risen to the highest level since 1982; it was expected that those rates would rise further in the coming months in the absence of measures to reduce the fiscal deficit. Failure to take measures to reduce the deficit would not only have serious international repercussions, it would also remove any

room for flexibility in the use of fiscal policy. High interest rates in the United States made it difficult for other industrial countries to adopt more expansionary monetary policies because of the ramifications of such policies on exchange rates. Lower interest rates in the United States were therefore vital not only to ensure a more broad-based world economic recovery, but also to ease the debt service burden of developing countries.

Another matter of serious concern was the record U.S. trade deficit, Mr. Ismael continued. While it was a welcome development insofar as it contributed to the revival of global trade, a contribution that reflected mainly the strength of the dollar and of the U.S. economy, he was, nonetheless, concerned about the implication of the deficit for the confidence that the international community could have in the value of the dollar in the period ahead. Persistent record deficits, if unchecked, could precipitate an unwarranted sharp decline in the dollar's value, which could prove disruptive to the global economy. The objective should continue to be to work toward a more gradual decline of the value of the dollar.

A further matter of concern was the intensification of protectionist measures in industrial countries, Mr. Ismael suggested. The available evidence suggested not only that the level of effective protection had increased in recent years, but also that the range of products subject to protection had increased dramatically. Those measures were hurting the developing countries, and in some cases they were seriously affecting the ability of debtor countries to service their debt. The temptation to protect domestic industries arose from the concern for the growing unemployment rates in industrial countries. It was important, therefore, to examine the cause of the growth of unemployment in those countries to see whether protectionism offered a long-term solution. The main cause of high unemployment in industrial countries was the structural rigidities, particularly in the labor market, that made it difficult for a large number of industries to compete with imported items. Adjustment in those noncompetitive industries was postponed, sometimes for a long period, through protectionism, leading to an inefficient allocation of resources. It was important for industrial countries to restructure their industries and to remove all rigidities from the working of labor and product markets, so that efficiency could be maximized and resources shifted from inefficient to efficient industries. The adoption of such policies would maximize the advantages associated with world trade, and it would ensure that the impact of recovery in the industrial countries was spread more widely to the developing countries.

In 1983 the non-oil developing countries had experienced a low rate of economic growth of approximately 1.5 percent, compared with the historical growth rate of about 5.5 percent, Mr. Ismael remarked. That low growth rate, together with the marked deterioration in the terms of trade, implied a rate of income growth in developing countries far below their population growth rate. In 1983 the current account position of those countries had shown a marked improvement, with the deficit declining to $56 billion from $109 billion in 1981. That improvement had come about at

a time when exports of developing countries had declined from $259 billion to $251 billion and when those countries had also suffered a deterioration in their terms of trade of about 7.5 percent. Much of the improvement in the current account had arisen from a severe compression of imports from $333 billion in 1981 to $292 billion in 1983. The statistics illustrated an important point, namely, that the adjustment process in the non-oil developing countries was being implemented effectively, and that imports had been so severely compressed that further compression might not be possible without major sacrifices, in terms not only of economic growth but also of social and political stability in many countries. The adjustment process in the developing countries should not be pushed too far; adequate resources should continue to flow to those countries in order to sustain a reasonable rate of economic growth.

It was a matter of concern, Mr. Ismael observed, that there had been a sharp reduction in the volume of capital flows to developing countries and that the flows' behavior had been erratic. In 1981, for example, private creditors had provided more than $70 billion to the non-oil developing countries, but only $20 billion in 1983. Erratic supplies of private capital could be an important source of instability; indeed, they were partly responsible for the present debt problems. The efforts of the Fund in ensuring the flow of private sources to developing countries deserved recognition. Without such efforts, there might have been a sharper decline in private lending.

The issue facing the world community was how to ensure that the indebted countries would continue to receive adequate resources that would enable them to maintain a reasonable growth rate while remaining able to service their external obligations, Mr. Ismael considered. One solution might be for official development agencies to increase their long-term lending to developing countries in order to offset the decline in private capital flows. However, the major institutions were not adequately funded to carry out that task. Another development that might help in present circumstances would be for the net flow of nondebt-creating resources to increase. It was disappointing that the flow of such resources had declined from $27 billion in 1981 to $21 billion in 1983. Furthermore, the major industrial countries were opposed to an allocation of SDRs, a measure that could assist the developing countries in the present difficult times. Major initiatives were needed to complement the adjustment efforts of developing countries to bring about an increased flow of resources to them. There might also have to be a major rescheduling exercise involving the substitution of short-term private credit by long-term official credit on reasonable terms. At the same time, the industrial countries would have to maintain open trading policies, and the developing countries, for their part, would have to maintain sound domestic and external policies.

In sum, the present recovery in the major industrial countries could be short-lived unless a better mix of monetary and fiscal policies was adopted by them, Mr. Ismael stated. In some countries structural reforms were needed to bring the fiscal imbalances under control and to remove rigidities in the labor market. For the world recovery to be sustained,

and for its impact to be widespread, an open trading system would have to be maintained, and the protectionist measures taken to date would have to be rolled back. Finally, the flow of resources to developing countries would have to be increased. The terms on which those resources were supplied would have to be made more favorable, both in relation to the cost of money as well as through extension of the maturities. A major initiative on the part of the international community, particularly the large industrial countries, would be required. Without such an initiative, the prospects for many of the debtor countries would remain dim.

Mr. Leonard commented that it had been a pleasure to read EBS/84/33. The details were handled with sureness and their implications were convincingly analyzed and presented. It was particularly valuable that the report presented data going beyond 1984, giving the reader a sense of likely developments in the global economy through 1985 and even in later years.

The staff foresaw an improvement in the world economic outlook, Mr. Leonard continued. Although the recovery in the industrial countries was mild by historical standards, it would, nevertheless, prove beneficial, particularly insofar as it reflected a long-term trend. He strongly agreed with the staff that one of the most important developments in 1983 had been the continuing decline in inflation. Provided that the gains to date were not eroded and that further efforts were made, particularly in those countries that had not yet obtained full control over inflationary pressures, the progress achieved to date was an indispensable condition of sustainable growth in the future. However, there was little prospect of an early return to the growth rates of the 1960s and 1970s. Policy expectations in the areas of employment and fiscal expenditures would have to be modified accordingly. In considering the origins of the present recovery it would have been useful to have had the staff's views on the part played by the U.S. budget deficit, which in some respects could be seen as having the characteristics of Keynesian demand management.

The main aim for the industrial countries ought to be to ensure that, within the context of continued control over inflationary pressures, the economic recovery broadened and endured, Mr. Leonard suggested. In that connection continued restraint in monetary policy was an obvious necessity. In addition, soundly balanced recovery entailed significant reductions in the "structural" component of the U.S. deficit. He agreed with the staff that, outside of North America, continued demand restraint was needed in the countries in which inflationary expectations and structural rigidities continued to present problems. In Japan and Germany, however, there appeared to be room for flexibility in fiscal policies to assist in bolstering economic growth. Superficially, the exercise of such flexibility might appear to be out of line with the policy strategy for inflation-free growth adopted by the industrial countries, but on closer examination it could be defended in light of developments since the inception of that strategy. It would make good sense only in the context of complementary U.S. action to contain its current budget deficit.

It would not be too worrisome if the pace of recovery in the United States slowed toward the end of the forecasting period, Mr. Leonard considered. Such a development need not be undesirable if it were to reflect the maturing of the U.S. economic recovery. Furthermore, it could help to prevent the re-emergence of inflationary pressures and rising interest rates at a later stage.

Turning to the policy stance in Canada, Mr. Leonard observed that the staff had expressed concern about the fiscal deficit and had suggested that measures to reduce it, at present planned for introduction in 1985, should be brought forward. His Canadian authorities appreciated, but they did not share, the staff's concern, for the reasons outlined on the occasion of the Executive Board discussion of the latest Article IV consultation with Canada (EBM/84/10, 1/20/84). While his Canadian authorities did not differ fundamentally from the staff on the general prospects for the economy, they foresaw a somewhat different pattern of growth in 1984 than was forecast in EBS/84/33. Differences in the Canadian projections stemmed from more recent data on the performance of the economy than had been available to the staff at the time of the preparation of its report; the information had now been communicated to the staff. The projections suggested that the rate of growth of business fixed investment might not be as strong as forecast by the staff, and that export performance had not deteriorated. Indeed, the continued strengthening of exports was expected.

For major industrial countries outside Canada, Mr. Leonard went on, his chair's expectations for 1984 were close to, although perhaps slightly more optimistic than, those of the staff. He strongly supported the staff's view that high priority should be accorded to promoting structural adjustment. The rigidities that had built up over the previous decade had played a significant role in constraining economic growth and maintaining high unemployment. Problems of structural adjustment extended to labor market rigidity, excessive levels of real wages, and undesirable intervention to support declining industries. Some success in tackling labor market rigidities had been achieved in a number of countries, but, in the area of protectionism and government support for declining industries, ground had been lost. In view of the negative effect of rigidities in economic development and of the often lengthy period needed for adjustments in that area to bear fruit, the earlier that adjustment action was taken the better. Clearly, the difficulties involved required a high degree of political commitment if progress was to be made, and such commitment might not always be forthcoming.

Commenting on the implications arising from current exchange rate developments, Mr. Leonard said that he sympathized with the staff's assessment that the sustainabililty of the present pattern of exchange rates was questionable. In attempting to address that situation, it was important that attention should be focused on the underlying causes of current exchange rate patterns and on the harmonization of policies, rather than merely on seeking to establish exchange rate levels artificially through market intervention.

The course of events in the developing countries gave cause for guarded optimism, Mr. Leonard remarked. However, the continued low rate of economic growth and the constricting indebtedness of many of those countries warranted concern. With regard to the manageability of that indebtedness in the medium term, the staff's projections were plausible, but the projected downward trend in the debt burden, in combination with rising growth and larger current account deficits in nominal terms, was viable only if various assumptions were simultaneously realized. Those assumptions included a continued flow of financing and the successful implementation of adjustment measures. Failure in those areas would compromise the projections. A key period would be 1986-88 when the hump in debt payments occurred. Amortization schedules over that period would have to be watched closely, and preparatory action to deal with the hump along the lines proposed by Mr. Polak was warranted. If the momentum of progress in dealing with developing country problems that had been gained over the past year failed to endure in the period ahead, the smooth development of sustainable external balances in the medium term would be highly questionable.

In that regard, he agreed with the staff that adjustment efforts by the developing countries had to place a high priority on structural reforms, so that the improved payments position could be sustained in an environment of resumed growth, Mr. Leonard stated. To date, adjustment efforts had relied mainly on import reductions. Over the longer term, however, adjustment would have to be consonant with an environment of expanding trade. While sustained growth in the industrial countries would play a key role in ensuring that expansion, appropriate adjustments, particularly in prices, exchange rates, and interest rates, were needed to ensure that the developing countries would be able to take full advantage of the improving environment. With regard to protectionism, his chair believed that it was important that recent moves toward increasing trade restrictions should be reversed. His authorities' views had been fully expressed at the Committee of the Whole's discussion of the linkages between trade and the promotion of development (CW/DC/84/1, 3/9/84).

The summary of the World Economic Outlook that was to be provided to the participants in the forthcoming Interim Committee meeting would attract much press interest, Mr. Leonard suggested. Perhaps it could, therefore, be made generally available in an unclassified form. There had already been reports in the press outlining the Fund's main projections; it would be appropriate for the sake of accurate reporting, if an authoritative document on the outlook was made available to the press. In making its statistical projections, the staff assumed that November 1983 exchange rates would prevail throughout the projection period. Given that there had been substantial shifts in exchange rates since then, the staff might indicate, at least in general terms, what impact the shifts could have on its forecasts. In addition, interest rates in effect at the end of 1983 were assumed to remain throughout the forecasting period. While he could accept that approach as a working assumption, it might be useful, in view of the current high level of concern over the implications of possible future interest rate developments, for the staff to provide some analysis

of alternative interest rate trends. Finally, the World Economic Outlook survey had been prepared on the basis of data made available before February 24, 1984. The published report should mention that cutoff date.

The Executive Directors agreed to resume their discussion in the afternoon.

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/84/47 (3/28/84) and EBM/84/48 (3/30/84).

2. APPROVAL OF MINUTES

a. The minutes of Executive Board Meeting 83/160 are approved. (EBD/84/94, 3/22/84)

Approved March 28, 1984

b. The minutes of Executive Board Meetings 83/161 and 83/162 are approved. (EBD/84/96, 3/23/84)

Approved March 29, 1984

3. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/84/61 (3/27/84) and EBAP/84/63 (3/28/84) is approved.

APPROVED: September 7, 1984

LEO VAN HOUTVEN
Secretary