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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 84/49

3:00 p.m., March 30, 1984

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

Executive Directors	Alternate Executive Directors
A. Alfidja	
J. de Groote	
	X. Blandin
A. Donoso	
R. D. Erb	
	M. Z. M. Qureshi, Temporary
T. Hirao	T. Yamashita
J. E. Ismael	Jaafar A.
	L. Leonard
	J. R. N. Almeida, Temporary
G. Laske	
G. Lovato	C. P. Caranicas
R. N. Malhotra	A. S. Jayawardena
Y. A. Nimatallah	
J. J. Polak	T. de Vries
A. R. G. Prowse	
	A. A. Agah, Temporary
	E. I. M. Mtei
	E. Portas, Temporary
J. Tvedt	
	T. A. Clark
	Wang E.

L. Van Houtven, Secretary
R. S. Franklin, Assistant

Also Present

C. F. Schwartz, Consultant. Asian Department: G. R. Kincaid. European Department: P. B. de Fontenay, A. Fidjestol. Exchange and Trade Relations Department: M. Allen, E. H. Brau, G. G. Johnson. External Relations Department: H. O. Hartmann, N. K. Humphreys. Fiscal Affairs Department: V. Tanzi, Director; R. A. Feldman, P. S. Heller. Legal Department: G. P. Nicoletopoulos, Director. Middle Eastern Department: 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. Secretary's Department: A. P. Bhagwat. Western Hemisphere Department: Y. Horiguchi. Bureau of Statistics: J. V. Carter. Personal Assistant to the Managing Director: S. P. Collins. Advisors to Executive Directors: E. A. Ajayi, S. El-Khouri, K. A. Hansen, S. M. Hassan, L. Ionescu, H.-S. Lee, Y. Okubo, D. C. Templeman. Assistants to Executive Directors: I. Angeloni, R. L. Bernardo, Chen J., L. E. J. M. Coene, G. Ercel, I. Fridriksson, V. Govindarajan, D. Hammann, H. Kobayashi, M. J. Kooymans, G. W. K. Pickering, M. Rasyid, D. J. Robinson, A. A. Scholten, Shao Z., S. Sornyanyontr, N. Toé, Wang C. Y.

1. WORLD ECONOMIC OUTLOOK - GENERAL SURVEY

The Executive Directors continued from the previous meeting (EBM/84/48, 3/30/84) their consideration of 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 the OECD Secretariat, on the statistical discrepancy in global current account balances (EBS/84/49, 3/9/84).

Mr. Clark remarked that, while the staff forecasts suggested an assessment of the global economy similar to that made by his own authorities, the assumptions on which they were based raised certain questions. There was a case for adopting conventional assumptions with regard to such elements as interest rates and exchange rates; however, on the present occasion at least, he wondered whether those conventional assumptions taken together and extended over the entire period of the forecast did not offend against consistency. For example, it seemed reasonable to assume that, if present interest rates were maintained, there might before long be some significant movements in exchange rates. Like Mr. Leonard, he wondered whether an analysis of the sensitivity of the most important results to the most uncertain assumptions might not be helpful.

Despite the concerns he had mentioned, he could in general accept the forecasts, which indicated that the outlook for the world economy was more encouraging than it had been one year previously, Mr. Clark continued. For industrial countries, growth prospects were better, and inflation was expected to fall to its lowest level in many years. Given appropriate policies, the chances of sustained growth seemed reasonably bright. On the other side of the coin, a number of serious problems remained: the debt situation was still fragile, with improvement dependent on sustaining growth, lowering interest rates, and restoring or maintaining the confidence of lenders; unemployment continued to present grave difficulties, as did large domestic imbalances in a number of countries; and pressures for protectionism were increasing.

His authorities welcomed the World Economic Outlook discussion as an opportunity to assess the mutual compatibility of members' policies, especially since the question of policy compatibility was related to the design of Fund programs, Mr. Clark commented. If several members of a group of countries with substantial trading links were being encouraged to adopt policies of export-led growth in combination with import restraint, problems were likely to arise. It was of course possible that such interactions would occur infrequently or on a relatively small scale, especially when--as was the case with Latin American countries--internal trade accounted for only about one fifth of the region's total trade. Still, the danger could be greater in other regional currency or trading groups. He was not suggesting that the policy linkages diminished the case for adjustment; rather, they reinforced the need for coordinated programs. In that regard, a staff paper examining the situation in, say, West Africa or sub-Saharan Africa as a whole might be useful.

Commenting on the topics for discussion suggested by the staff, Mr. Clark endorsed the view that policies of continued or reinforced monetary and fiscal restraint combined with structural measures were essential. He also agreed with the staff's proposition that monetary restraint had often been secured more successfully than fiscal restraint over the past few years, and high fiscal deficits in some countries had made life difficult for the monetary authorities, a matter on which he would have welcomed further discussion in the paper, perhaps in Appendix I of the World Economic Outlook. The main concern at present was the compatibility of current policies with continuing world recovery and, in that respect, attention must inevitably focus on the United States because of its importance in the world economy. The United States was currently showing remarkable strength in terms of GDP growth and reduced unemployment, which was a tribute to the continuing flexibility of the economy. However, the actual and prospective budget deficits of the country had contributed to the high level of real interest rates, which threatened the durability of the recovery in the United States and in the world at large. Even at their present level, interest rates imposed a severe burden on debtor countries, and he therefore welcomed the efforts being made by the U.S. authorities to contain the budget deficits.

Another issue to be addressed was the matter of setting fiscal targets in the medium to longer term, Mr. Clark continued. For most countries, both industrial and developing, fiscal developments in recent years had limited the objective of policy to reducing fiscal deficits; and, for many that would remain the case. But the underlying objective remained the attainment of balanced and inflation-free growth, and in due course that might involve looking at targets for, say, the stock of public sector debt in relation to GDP or the total of private sector assets or borrowing in terms of private savings. It would be interesting if the staff could begin to examine more closely such measures of a country's fiscal stance.

He strongly supported the staff's view that the removal of structural rigidities, particularly in the labor market, was an essential counterpart to appropriate fiscal and monetary policies, Mr. Clark commented. Eliminating those rigidities would not only accelerate the recovery globally but would reduce the vulnerability of each individual economy to external shocks. Given the worrisome level of unemployment, action was needed to improve the functioning of the labor markets. In recent Article IV consultation discussions, for example, Directors had noted the problems that had arisen in many countries with high minimum wage levels, indexation of wages to past inflation rates, skill mismatching, restrictive labor practices, and the deleterious effects of the tax and social security systems on the incentive to work. Physical mobility of labor from area to area was also a problem in some countries.

Beyond the factors relating to the labor market as a whole, there appeared to be some crucial issues relating to relativities within the labor market, in particular those concerning the relationship between the cost of different kinds of labor and the cost of substitute capital, Mr. Clark said. Within the labor force, relativities no doubt tended to reflect historical relationships between wage rates for different jobs; and adjustment of those relativities might be slow. However, the price of some kinds of capital had fallen sharply with the introduction of new technology, and it might at present be profitable to substitute capital for some categories of labor at real wage rates far below present levels. If so, that posed questions in relation to the short-term reabsorption of the unemployed into the labor force and also in relation to social security arrangements and to income distribution more generally. It would be interesting if, at some stage, the staff could review the literature on capital-labor substitution, both in aggregate and at the level of particular categories of labor.

With respect to exchange rates, Mr. Clark noted that it was clear from what he had already said that his authorities saw some scope for adjustment of exchange rates from their present levels. On the question of debt, he observed that, despite the substantial reductions in the deficit of the non-oil developing countries in 1983--and the further small reduction projected for 1984--the overall debt position remained difficult. The forecast in the staff paper suggested that, in aggregate, the situation should be manageable. However, the staff had rightly cautioned against translating that general conclusion into one applying to individual countries. The position of certain countries could be far more difficult and, even in aggregate, the useful sensitivity analysis presented in Chapter 4 of the World Economic Outlook made it clear that much depended on sustained growth in industrial countries and on the level of interest rates. It was disturbing to note that real interest rates were projected to remain at about 5-6 percent, while real growth rates for the developing countries in aggregate would be less than 5 percent.

An equally important factor in the debt question was the assumption of a 7 percent a year increase in the net exposure of commercial banks, Mr. Clark continued. He was not clear how that 7 percent figure had been derived; and he noted that a similar assumption in the previous year's World Economic Outlook papers had proved to be optimistic in the event. A sensitivity analysis on that assumption would have been helpful: a naive calculation suggested that, given a ratio of debt to imports of 100-150 percent--with one third to one half being debt to financial institutions--a 1 percent slower growth in exposure would imply about 3/4 of 1 percent lower imports. If that was true, it underlined the significance of the assumption. Moreover, it indicated that a commitment to continued adjustment in developing countries was doubly important, not only to provide a base from which growth could resume but also to help maintain the confidence of creditors and ensure the continued supply of finance. Therefore, he strongly endorsed the staff's view that efforts to improve the structural functioning of developing economies must continue; in particular, it would be important to control public finances, bring domestic savings and absorption into better balance so as to reduce the risk of further debt problems in future, and improve the functioning of the price and incentive systems, all as a way of providing the right framework for development and diversification of production and exports.

The alternative scenarios presented by the staff were interesting, Mr. Clark remarked. He took particular note of one that combined a renewed downturn in the industrial countries with the hump of debt repayments in 1986-88. The staff's projections showed clearly how serious the implications of such a conjunction could be. Hence, he welcomed the continuing efforts to improve the monitoring of the debt situation so as to spot possible problems early, as well as to improve international banking statistics.

His authorities fully endorsed the staff's views on protectionism and supported the initiative by the Secretary-General of the OECD for a two-phase rollback of measures, Mr. Clark said. Part of the difficulty in dealing with protectionism was clearly that the short-term attraction of protection and the adjustments that free trade required were obvious and quantifiable, while the longer-term benefits of free trade--although just as real--were more difficult to quantify and would of course be longer in coming. He therefore welcomed the staff's efforts to analyze the effects of freer trade on GDP growth in developing countries as well as the effects on their current accounts and on their debt and debt service ratios. A more refined analysis that looked explicitly at trade flows affected by protection--and that considered what effects changes in protection might have--would have been interesting. Rough calculations by his authorities for nine major debtor countries suggested that the effect in aggregate might still be modest--about 5 percent of debt service payments in 1982--if a 25 percent increase in export earnings on protected products was assumed. In general, however, analysis that emphasized the longer-term costs of protection was to be encouraged, and he hoped that it would be possible to provide such analysis in future World Economic Outlook papers. In conclusion, while the latest economic outlook was more encouraging than in the past, there was no great margin for slippage. It seemed to his authorities of vital importance that the momentum of the recovery should be consolidated and that the temptation to try to move too fast too soon should be avoided.

Mr. Tvedt welcomed the pickup in world economic activity that had begun in 1983. Thus far, the recovery had been led mainly by the United States; however, domestic demand had rebounded relatively strongly in Canada, the United Kingdom, and Germany as well. Progress in most other industrial countries remained weak; especially disappointing had been the decline in the growth of domestic demand in Japan to below 2 percent in 1983, despite the virtual stability of prices, substantial unutilized resources, and a surplus on the external current account. On the positive side, inflation had continued to fall in the industrial countries as a group, reaching its lowest level in 15 years.

Despite the turnaround in the world economy, Mr. Tvedt continued, there remained numerous reasons for concern about what the future might hold. The uneven growth rates in the industrial countries were not expected to converge to any appreciable extent until perhaps 1985. And the divergence had, inter alia, contributed to relatively high interest rates in the United States, which in turn had led to a strengthening of the U.S. dollar and the tendency for higher global interest rates. A combination of a strong dollar and substantially more buoyant economic growth in the United States than in the other industrial countries had resulted in major balance of payments disequilibria with a growing deficit on current account. Until only recently, the U.S. deficit had had positive effects on the world recovery; however, it was clear that the deficit had reached an unsustainable level that could in fact jeopardize economic growth in the medium term.

As the recovery continued and private sector credit demand increased, it would be imperative to reduce the structural fiscal deficits, particularly in the United States, where the deficit had a strong influence on inflationary expectations, Mr. Tvedt commented. When the U.S. economy reached a high level of capacity utilization, inflationary pressures were likely to gain momentum; and, without a tightening of fiscal policy, interest rate increases would occur that could be highly detrimental to the future of the recovery.

Except in the United States and Canada--where it had declined noticeably--unemployment remained at high levels in the industrial countries, and its growing structural nature was of particular concern, Mr. Tvedt remarked. Moreover, given the growth rates envisaged for the next few years, unemployment was unlikely to fall appreciably anytime soon. High unemployment levels could undoubtedly be held accountable for the increasing tendency of countries to resort to protectionist measures to achieve short-term objectives. In the view of his authorities, there was considerable danger that continuing high unemployment would make it more difficult for countries to withstand protectionist pressures; repeated declarations by individual countries of adherence to the principles of free trade had not proved sufficient, and a fresh multilateral approach to the problem might be necessary.

In general, Mr. Tvedt observed, considerable rigidities continued to persist in the labor, commodity, and financial markets of various countries. The policy strategy adopted in the late 1970s to combat stagflationary tendencies had been effective in bringing down inflation, although the detrimental effects of the approach on the level of activity had probably been greater than expected, in part because insufficient attention had been paid to the needed correction of the wide-ranging structural problems so prevalent in many countries.

The tight situation of many heavily indebted developing countries had been at least partly alleviated of late, and debt problems generally seemed to have been reduced to more manageable proportions, with prospects for an easing of the debt situation in the medium term, despite the hump in repayments in the second half of the decade, Mr. Tvedt noted. Still, the situation in many countries continued to be precarious as a result of drastic import compression and continued high debt service burdens. The central scenario drawn up by the staff for the developing countries for the period through 1990 was based on several comparatively optimistic assumptions. If some of those should not be realized, the developing countries could well encounter major financing difficulties once again. In particular, his authorities questioned whether it would be possible to realize an annual growth rate of 7 percent in net credits from the international banking system. Also, the reduction in imports in the past few years had occurred at a rate that could not be repeated. An important feature of the projections was the sensitivity of the developing countries to changes in the growth rates of industrial countries. In passing, he noted that, since the previous World Economic Outlook discussion, the growth rates projected for non-oil developing countries for 1984 had been revised downward, while the inflation forecast had been increased significantly and the expected increase in non-oil primary product prices had been reduced. Those changes should increase Executive Directors' awareness of the fragility of the present recovery.

A more technical problem--albeit one with potential policy implications--was the statistical discrepancy in the global current account balances, Mr. Tvedt commented. The problem did not lend itself to easy solutions, but the asymmetry had grown to such proportions that it could not be ignored in the assessment of international financial developments and exchange rate movements. The increased attention being devoted to the problem was therefore fully deserved.

The conclusion emerging from his recapitulation of some of the problems confronting the global economy was that, even though the world was witnessing its second year of recovery, the future remained highly uncertain, Mr. Tvedt said. Should growth in the industrial countries turn out to be below the projections of the staff, the consequences were likely to be serious. Difficulties of the developing countries would quickly become more acute as their debt servicing capacity was reduced; and in the industrial countries, various structural rigidities would probably intensify, and protectionist pressures would become difficult to withstand. It was therefore important to nurture the recovery. It was worth noting in that regard that the expansionary fiscal policy in the United States had been a prime mover of the upswing in 1983. Fiscal policy had also been rather expansionary in Canada and the United Kingdom, two other countries with relatively strong growth in 1983. On the other hand, tight policies across the board in Japan undoubtedly explained the slow growth of domestic demand in that country, and a similar argument could be made with regard to some European countries.

The U.S. fiscal deficit had had positive effects in the initial stages of the recovery, but it had lately become excessive and needed to be reduced, Mr. Tvedt went on. Determined fiscal action in the United States would contribute importantly to the stability of exchange rates and to more normal levels of interest rates; however, his authorities felt that some other industrial countries could usefully stimulate their economies without any inflationary consequences. That advice applied in particular to Japan and Germany, both of which had comfortable external positions and seemed to have inflation firmly under control. The fiscal impulses had been negative in Germany and Japan since 1980 and 1981, respectively, and would remain so at least through 1985 according to present projections. Moreover, some evidence suggested that the German government deficit in 1983 had been essentially cyclical in nature, with the structural balance actually having moved into surplus. Given that the risk of postponing further reductions in the budget deficit in those countries was substantially smaller than the risk of aborting the upswing, a cautious shift in fiscal policy toward greater expansion should be considered. Those countries should perhaps look at alternative policy mixes--such as a parallel increase in fiscal receipts and public investment expenditure--that would provide stimuli to the economy through the balanced budget multiplier without widening the budget deficits. Unless Japan and Western Europe achieved a considerably higher rate of growth than at present, many of the world's current problems--including unemployment--would remain indefinitely.

He agreed with the staff that monetary discipline would of course continue to be of importance over the next few years, Mr. Tvedt added. Nonetheless, the flexible approach to monetary policy demonstrated by some industrial countries in 1982 and 1983 should serve as an example that pragmatism in policy implementation could positively affect growth without having any measurable adverse impact on inflation or inflationary expectations.

In conclusion, Mr. Tvedt said, his authorities felt that, given the present policies in many industrial countries, the recovery might not have the necessary momentum to bring about even the relatively modest growth rates projected by the staff for the remainder of the decade. And the projected rates must be viewed as the minimum required to prevent a backlash of recession; consequently, the recovery must be underpinned by careful expansion in selected countries.

Mr. Wang considered that the world economy in 1983 had taken a turn for the better. Total output and world trade had increased by roughly 2 percent, and the threatening debt crisis of 1982 had somehow been avoided. According to staff projections, moreover, world output in 1984 would increase by a further 3.7 percent and world trade by 5.5 percent. The rate of inflation in the major industrial countries was expected to remain at approximately its current level, while the rate in the developing countries would increase only slightly.

Despite those encouraging developments and projections, there remained a number of problems engendering concern, Mr. Wang continued. The recovery in the industrial countries was not balanced, either in geographical coverage or in the various economic sectors within individual countries. Furthermore, the longer-run prospects for economic growth were clouded by the persistence of many structural imbalances. The economies of the developing countries had continued to deteriorate in 1983. Despite some projected pickup in activity in 1984, only the export sectors were likely to see significant improvement; domestic demand would continue to be suppressed. Given the interdependence of individual economies, the imbalances he had mentioned would exact a heavy toll on the rate of world expansion.

Commenting on some of the factors that had given rise to the imbalances, Mr. Wang noted, first, the prevailing high interest rates, which influenced the fiscal and monetary policy mix adopted by the U.S. authorities. The high interest rates had attracted large capital inflows, which had turned the United States--traditionally a major capital exporter--into a major importer of world capital. That change had adversely affected the recovery in Western Europe and other industrial countries, placing severe constraints upon the policy choices of governments. The high interest rates had also greatly aggravated the debt service burden of the developing debtor countries. Moreover, with the large budget deficits of some countries absorbing resources that should go toward financing private investment, it was questionable how long the economic upturn could be maintained. As the recovery began to spread, the competition for scarce resources by the public and private sectors would be further aggravated and might drive up the already high interest rates, thus jeopardizing economic growth.

Trade protection normally followed closely on the heels of a recession but lingered after a recovery, Mr. Wang remarked. In the current cycle, the interplay of a number of factors could act to make protectionism persist even longer, particularly if no conscious effort was made to reduce it. The modest and unsynchronized recovery would likely strengthen trade imbalances, and the abnormal exchange rates would have a similar effect. Protectionist pressures would then strengthen in the countries with unfavorable trade balances; and, as protective measures were adopted, trading partners would retaliate. Another factor that would ensure the persistence of protectionism was the high rate of unemployment, which was projected well into 1984 and 1985. There was already evidence that protectionism had an ominous impact on trade, particularly for the developing countries. Trade restrictions on the exports of the developing countries would certainly impair their effort to improve their balance of payments positions. Moreover, the adjustment measures they had been adopting and the lack of financial resources brought about by heavy debt service burdens would present a long-term constraint on the ability of the developing countries to import. Hence, there was some question about the extent to which world trade would serve as an impetus for world growth. In general, there was a clear need for a joint effort immediately to roll back trade protection, beginning with the major industrial countries.

With regard to external debt, Mr. Wang observed that the monumental rescheduling operations accomplished during the past year had only postponed the resolution of the problem. The question was whether it had been postponed to a better or worse time; and the present uncertainties surrounding certain rescheduling programs served to highlight the importance of that question. The staff had projected a large amortization balance due in 1986-88, with the hump around 1987. If the hump coincided with a general and strong business expansion in the industrial countries and with a general rollback of trade protection and a greater demand for debtor countries' exports, then the debt servicing problem might not again become acute. However, if the outcome were quite different, it would be important to think about what policy measures might be necessary to avert another and perhaps more serious debt crisis. If not properly handled, the debt problem would not only jeopardize future growth and cause social and political complexities in the debtor countries, it would also damage creditor countries and endanger the entire international financial system.

His comment on interest rates, trade, and debt had been put forward in order to impress upon his colleagues the grave need for policy coordination in those areas and the particular responsibility of the major industrial countries to pursue economic policies that would have a positive effect on the world economy as a whole, Mr. Wang said. On a related matter, he considered that the Fund had played an important role in assisting its member countries in carrying out adjustment and debt rescheduling. However, there was scope for the institution to be even more active; for example, it could work toward putting together concerted financing arrangements in collaboration with governments and with official and private financial institutions on terms and conditions that were more favorable to the debtor countries. At the same time, an effort should be made to achieve an immediate and substantial allocation of SDRs for the fourth basic period. In designing Fund-supported programs, priority should be given to the achievement of external viability and growth in the program countries while still paying sufficient attention to their social and political conditions. Furthermore, the Fund should exercise more effective surveillance over the economic policies of the major industrial countries so as to establish greater order and symmetry in international relations and to ensure the expansion of world trade and growth.

Mr. Alfidja noted that, in recent years, the need to revamp the financial and economic policies of Fund members had received widespread recognition. The scope and strength of the adjustment under way in many developing countries had been examined extensively during the November 1983 review of Fund-assisted financial and structural adjustment programs and conditionality-related issues. It had become clear that the combined current account deficit of the non-oil developing countries had decreased by nearly 50 percent over a two-year period to about $56 billion in 1983. Despite that improvement and the progress made in the fiscal area, some of the new policy initiatives had had adverse effects on future economic growth, employment, and inflation. As indicated by the staff, the adjustment in the external sector had often taken the form of large cutbacks in imports of spare parts and raw materials, the very items needed to maintain and run the machines used to produce commodities for export or import substitution. Also, the implementation of development projects had often been delayed or suspended while the grace period of the related loans was elapsing and the cost of project completion was continuing to rise. Government employment policies had had to be completely recast to meet tight budgetary constraints; and training, health, and other facilities were short of equipment, only partly used, or closed down. In spite of those unfavorable repercussions, the developing countries should not relax their effort to redress the imbalances that had besieged their economies. The favorable impact of foreign technical and financial assistance on the prospects for economic growth in a sustainable financial and economic environment was likely to be more substantial if the domestic policies were appropriate to begin with.

The effects of maladjustment arising from the implementation of inadequate domestic policies in some developing countries had been compounded by the impact of inappropriate financial and economic policies undertaken in some of the industrial countries, Mr. Alfidja continued. For example, according to the staff, the U.S. budget deficit could hover around $200 billion annually during the next several years unless corrective measures were taken. The impact of such an imbalance on inflationary expectations, interest rates, the exchange rate, inflows of foreign savings into the United States, and the resulting smaller amount of resources available for other countries had been amply described in the present and previous staff papers on the World Economic Outlook. Of course, the problem of fiscal imbalance was not limited to the United States; several other major countries had experienced large imbalances between government receipts and spending during the past few years, with little prospect of a rapid and substantial improvement. He hoped that the governments of those and other countries would muster the political courage necessary to adopt the required adjustment measures.

Commenting on trade matters, Mr. Alfidja indicated his support for increased access to markets, particularly those of the developed countries. As noted by others, the developing countries could not obtain the foreign exchange necessary to pay debt obligations unless they could sell their commodities abroad; hence, the removal of impediments to trade was crucial. On the price side, the subject of better terms of trade did not appear to have wide coverage in the current survey of the World Economic Outlook. A brief description of the past evolution of some commodity prices had been provided on page 12 of the paper; elsewhere, only a few ambiguous references had been made to the subject. In his view, the problem was a serious one: with only a few exceptions, the terms of trade of non-oil developing countries had deteriorated since 1974, an unfavorable development that was at the root of weak external sector positions. That view was supported by several studies, including one conducted at the Fund (DM/83/84, 12/23/83). In the circumstances, the issue of a generally persistent fall in relative prices of exports originating from developing countries should be highlighted in the World Economic Outlook papers.

On the external debt situation, the staff had indicated that, while interest payments could be lower during the next few years, amortization payments were likely to cluster in magnitude around 1987, Mr. Alfidja said. He was uncertain about the reasons for assuming that interest payments could be substantially lower in future, and he was all the more skeptical because the interest was on loans that had not been retired but only rescheduled. According to the staff, "the debt burden of developing countries should be on a downward trend from now on, and their domestic economic growth could pick up to a more acceptable pace." The staff's view was based on the assumption that developing countries would pursue appropriate economic and financial adjustment policies and that foreign creditors would continue to provide sufficient financing. While the commitment by debtor countries to undertake adjustment had not been questioned thus far, the availability of appropriate financing had proved difficult to secure in many instances. In sum, the problems experienced by several developing countries in meeting their debt service obligations during the past three years had not been resolved but only postponed through rescheduling. Imaginative and durable solutions to those problems, perhaps outside the existing framework of the Paris Club, needed to be found. The contribution of the Fund and the World Bank in taking concerted action toward that end would be most helpful.

Mr. Donoso remarked that the world economy at present was showing clear signs of recovery and progress on the inflation front. However, growth in 1983 had been concentrated in relatively few countries and had been extremely slow in the developing countries. Success in controlling inflation had also been clearer in the industrial countries. Moreover, unemployment remained high and was even increasing in many parts of the world. Cognizant of the tenuous and patchy nature of the recovery thus far, the staff had presented an interesting analysis of the elements on which the sustainability of the recovery depended.

He agreed with the staff that continued adherence to policies directed toward maintaining financial stability in major industrial countries was achievable, Mr. Donoso said. The adoption of expansionary policies at present might well lead to short-term gains for industrial and developing countries alike; however, unless such policies were very carefully administered, they would run the risk of undermining all that had been achieved thus far in providing a solid basis for continuing growth. Expansionary policies could lead to a situation in which the industrial world was once again forced to take drastic austerity measures of the sort that had cost the world economy dearly in the recent past. The problem of unemployment in the industrial countries would continue to exist--even with more expansionary policies--and he agreed with the staff that a more reasonable approach to the unemployment problem was greater flexibility in the institutional arrangements applied in the determination of wages.

In looking for ways to ensure that growth in the industrial countries had a rapid and positive effect on the developing countries, Mr. Donoso considered that improvement in the fiscal sector of the United States would make the most important contribution to the economic and financial well-being of the developing countries. The movements of capital toward the United States, induced by its extraordinarily high fiscal deficit, had placed the value of the U.S. dollar vis-à-vis other major currencies at an unsustainable level. With the appreciation of the dollar, prices of commodities and, in general, of exports of the less developed countries had fallen in dollar terms. The combination of high interest rates and the appreciation of the U.S. dollar brought about by the fiscal deficit had imposed on developing countries during the past three years annual real rates of interest of about 15-20 percent. An important part of the explanation of the debt problem lay in that combination of high dollar rates of interest and the appreciation of the dollar, which had suddenly increased the burden of external debt as a proportion of GDP at a dramatic pace for countries that had contracted debts in dollars. Part of the debt problem could be called artificial, if the U.S. deficit was considered unsustainable. A reduction in the U.S. deficit would reduce interest rates and, through the depreciation of the dollar, would induce an equivalent increase in the real price of exports of developing countries. The staff had estimated that a 1 percent depreciation of the U.S. dollar would increase those real prices by 1 percent. Hence, the sooner the fiscal deficit was reduced in the United States, the easier it would be to manage the debt problem. The resumption of growth in a number of countries involved in the problem, as well as the stability of the financial system itself, depended very much on fiscal policy in the United States.

Commenting on the specific analyses and projections related to the debt problem, Mr. Donoso said that he was somewhat uncomfortable with certain aspects of the approach followed by the staff. For example, he would have preferred a more direct discussion of the solvency issue. The staff had stated that there were no perfect indicators--a point with which he could agree--and yet had gone on to pursue the entire analysis in terms of ratios of debt or debt service payments to exports. A better indicator of solvency was the debt/GDP ratio. If a country had an external debt the size of its GDP, the debt/GDP ratio would be equal to one. Assuming a real rate of interest of about 4.5 percent, to keep its external debt constant in real terms a country would have to generate a trade surplus (exports of goods and nonfinancial services minus imports of goods and nonfinancial services) in an amount corresponding to 4.5 percent of its external debt and 4.5 percent of its GDP. The effect would be a "loss" of resources that would otherwise have been available for investment equivalent to 4.5 percent of GDP in the context of efficient policies. The higher the debt/GDP ratio, the higher would be the cost of investment and, therefore, the higher the cost in terms of growth for the country to maintain its debt constant in real terms.

If the ability to reduce the real value of external debt was what determined the solvency of a country, the cost in terms of lower rates of growth was a good indicator of that ability, Mr. Donoso went on. His purpose in introducing such an example was not to indicate a preference for a particular technical approach. Any empirical estimate would put the cost in terms of lower annual rates of growth of a reduction in investment of 4.5 percent of GDP at something like 1-1.5 percent. The staff was projecting an annual rate of growth for the major borrowing countries over the next six years of about 2 percent below historical rates for those countries; hence, the staff would probably agree with him that a reduction of 1-1.5 percent in the annual rate of growth for a country with a debt/GDP ratio equivalent to one--as a way of reducing its external debt--was sustainable. If so, under the assumption of a real rate of interest of 4.5 percent for the next few years, almost every country would seem to be solvent because debt/GDP ratios of one were almost nonexistent. The justification for the interest rate spreads would almost disappear, and it followed from the analysis that it was higher interest rates--or higher spreads--that would aggravate the situation.

The staff had assumed interest spreads of 2 percent and perhaps provided some justification for the assumption by stating that "it should be borne in mind that the position of certain countries is particularly vulnerable and that a relatively satisfactory outcome for the group of countries considered in this scenario may mark critical situations in individual cases," Mr. Donoso continued. He was certain there was no intention to exacerbate the fears of the different parties involved in the problem or to make recommendations with respect to spreads. However, the staff paper might be conveying such a message. His own feeling was that there was a basis for presenting a more optimistic view. In the staff papers, there was some notion that the value of the U.S. dollar was not sustainable. If that element was incorporated in the analysis of the debt, the resulting improvement in export prices would amount to a real interest rate lower than the 4.5 percent projected, so that the situation in terms of solvency would look even more assured.

In order to reduce their external debts in real terms, indebted countries could live for a period with the type of reduction in their rates of growth that one might associate with the estimates for the real interest rates and the general world economic environment presented by the staff, particularly if some of the other favorable factors that he had mentioned were to occur, Mr. Donoso commented. However, that development would only be possible with the acceptance of the following factors: first, that indebted countries were solvent; second, that conditions associated with new borrowing would not be the sort that transformed a liquidity problem into a solvency problem through, for example, the high spreads previously discussed; third, that it was important to establish a new mechanism of financing to make the availability of resources more predictable; and finally, that adjustment of indebted countries should be maintained at the required level. In his view, the last three notions depended critically on the acceptance of the first; hence, the effort to clarify the solvency problem was crucial. In that respect, the paper produced by the staff was not reassuring; indeed, it focused on the financial problems posed by the structure of debts and on the relations between service payments and exports. The paper was pessimistic on the solvency issue--which made the availability of financing more difficult to attain--and excessively optimistic with respect to the availability of resources, which might be a dangerous approach. It was important to encourage the creditors of indebted countries to look for sound financial measures to deal with the problem rather than trying to avoid it. The notion that, by getting out, those countries might cut their losses should be replaced by the notion that, by trying to get out or by applying unreasonable conditions, they might produce the losses that would otherwise not appear.

He could agree with the staff's assessment of the problem of trade restrictions, Mr. Donoso stated. However, the effort to reverse existing restrictions should not draw attention away from the basic problems, which created an environment in which protectionism could flourish. In his view, the reduction of the fiscal deficits in some industrial countries was the most effective way to attack protectionism. Still, he could endorse all the staff's recommendations for more direct measures to accomplish the goal.

Mr. Mtei welcomed the confirmation in the staff report of the continued world economic recovery in 1983. It appeared that the pessimism of recent years had been replaced by optimism: expansion in world output and trade, successes on the inflation front in the industrial countries, and the relatively improved current account position of developing countries were all pleasing signs. However, a number of difficult problems continued to plague both the developing and the developed countries. The large fiscal deficits in many industrial countries threatened the recovery through misallocation of resources and crowding out of private investment. High real interest rates, besides discouraging domestic investment, tended to increase debt servicing costs of already burdened debtor countries and to undermine their adjustment efforts. Moreover, the historically high 8.3 percent rate of unemployment in industrial countries, the distortions in cost-price relationships, and the erratic movements in foreign exchange markets caused by a lack of convergence of national economic policies of the major industrial countries continued to fuel protectionist pressures and thus constituted a major threat to widespread recovery.

In the developing world, Mr. Mtei continued, high debt servicing costs and external financing difficulties remained the major stumbling blocks to recovery. The very low real GDP growth rate of 1.5 percent in the non-oil developing countries in 1983 had coincided with a second consecutive year of declining per capita output. In the oil exporting countries, real GDP had declined for the fourth year in a row--by 1.1 percent in 1983--a clear indication that the developing countries had not yet begun to feel the impact of the recovery. The situation in the African countries was even more disturbing, their output having declined by 1.5 percent in 1983. While that was disappointing and alarming in itself, it did not show nearly the extent of the strains that the African countries had experienced. Persistent and widespread drought conditions were only the backdrop against which other troubles should be seen. A difficult external payments position, resulting from adverse international developments, had contributed to the intensification of the problems of the African countries. The persistent worsening of their terms of trade and a rise in real interest rates had siphoned off an increasing proportion of their domestic output, and severe shortages in foreign exchange had left them with no choice but continued reductions of imports, which had adverse implications for growth and essential services. In that regard, the apparent decline in the current account deficit of the African countries was more a reflection of import compression than of any improvement in the underlying external payments position.

Despite the problems he had mentioned, Mr. Mtei continued, the staff projections for 1984 and 1985 seemed to encourage some optimism. The real GDP growth rate in African countries was expected to average 2.7 percent and 3.4 percent in 1984 and 1985, respectively. Of course, the crucial underlying assumption--the firming of external demand for exports--hinged on trade and economic policies in the industrial countries which, in turn, would determine the durability of the ongoing recovery and the pace at which that recovery began to be felt in Africa and the rest of the developing world. Other limiting factors included the lack of external financing on appropriate terms, heavy debt service burdens, and some shortcomings in the domestic economic and financial policies of the developing countries.

Commenting on the question of economic management in the industrial countries--one of the topics suggested by the staff for discussion--Mr. Mtei considered that the industrial countries had succeeded on the inflation front and that they now needed to adopt an appropriate policy mix to reinforce the recovery and provide the needed impetus for its sustainability. While he recognized the need for maintaining financial stability, he was not clear whether a continued restrictive demand management policy--with the sole objective of fighting inflation--was appropriate at the present stage, particularly in those countries with considerable excess capacity and where the problem of inflation was minimal at most. In his view, monetary policy should be assigned a more active role to provide the necessary stimulus for the recovery; at the same time, a narrowing of fiscal deficits, coupled with reform in the structure of public finances, should provide the main vehicle for reducing interest rates and releasing resources to stimulate private sector investment and encourage employment.

Although the need for structural adjustment in the developed countries had long been recognized, it had never, in his view, been taken seriously by the policymakers in those countries, Mr. Mtei said. The persistent high level of unemployment, loss of competitiveness, and intensification of protectionist measures were symptomatic of deeply rooted structural rigidities. It was time to come to grips with those problems and to be realistic about the need to take appropriate measures aimed at correcting structural weaknesses in all economies.

Another area of concern in the economic policies of the industrial countries related to the exchange rate, Mr. Mtei remarked. The volatility of exchange rates was an inherent feature of the present system, but the continued divergence of economic and financial policies among the major industrial countries had aggravated the situation. In particular, the persistent appreciation of the U.S. dollar, fed by high real interest rates and large fiscal deficits, had created problems for many countries. As mentioned by the staff, the impact of national policies was transmitted through prices, interest rates, and capital flows. It went without saying that the present pattern of exchange rates--given its impact on debt servicing costs and the uncertainties generated with respect to trade, foreign exchange earnings, and development planning--was harmful to the adjustment effort of the developing countries.

On the issue of external debt, Mr. Mtei observed that substantial improvement had been made in the debt position of most developing countries in 1983. However, much of the progress had been the result of large-scale debt rescheduling. While rescheduling arrangements had allowed some time for the implementation of adjustment policies, their effect was to postpone the effort to deal with the problem, which would have to be met eventually, and probably at a higher cost. Even with rescheduling, more than one fifth of the total export earnings of the non-oil developing countries had been devoted to servicing their debts in 1983. The staff had rightly called on creditors and debtors to expect the hump of debt repayment as early as 1986. He agreed that debtor countries should persevere with the adjustment effort and the prudent conduct of debt management; however, without a more realistic approach to debt restructuring over a long period of time and at a cost that could reasonably be carried by the economies of the debtor countries, and without full cooperation of the creditors themselves, smooth debt servicing by developing countries would remain problematic; and the consequences for the international financial system could be adverse.

With regard to adjustment, Mr. Mtei noted the staff's view that the improvement made thus far in the current account position of non-oil developing countries had mainly been the result of a reduction in imports, with all its implications for future growth and debt servicing capacity. The high costs involved in terms of employment, output, and consumption, and the hardship emanating from restrictive demand policies, could not be tolerated over an extended period without endangering sociopolitical stability. He was not questioning the need for adjustment--which he recognized to be of paramount importance in present circumstances--but only the strategy of adjustment and its impact on growth and the fabric of society. Of course, there could be no adjustment without costs; but the deflationary impact of continued extreme austerity measures made such costs unduly high and raised doubts that the approach would necessarily lead to a resumption of growth and an improvement in welfare. There seemed to be some tendency to assume that once "equilibrium" in the external position was achieved, sustained growth would automatically follow. That was not necessarily the case. The equilibrium level of output might be too low to sustain minimum basic needs, let alone provide for growth. In general, the adjustment process could have been more successful, and would have involved less hardship, had its strategy taken due account of the nondomestic factors responsible for the difficulties facing developing countries and of the need for growth.

He fully shared the staff's concern with regard to the wave of protectionist measures in industrial countries, Mr. Mtei said. His chair had on several occasions emphasized that protectionism was not only harmful to economic efficiency and resource allocation in industrial countries, it also prevented developing countries from reaping the benefits of their adjustment efforts and limited their chances of gaining from the global economic recovery. It could not be overemphasized that, without access to markets for their exports, it would be difficult for developing countries to earn sufficient foreign exchange to finance needed imports and to meet their debt servicing obligations. Hence, protectionist measures in the industrial countries, while they might have very short-term benefits, could in the long run jeopardize the very economies they were designed to protect.

On another matter, Mr. Mtei expressed disappointment at the lack of detail in the staff report on prospects for official development assistance (ODA). Such assistance in sufficient amounts--from both multilateral and bilateral sources--played a major role in the adjustment process, particularly for low-income countries that had no access to private capital markets. The relatively unsatisfactory level of ODA in recent years had made the task of adjustment for many low-income countries especially difficult.

Like others, he believed that the Fund's role, and the assistance it provided, were important elements in the adjustment process, Mr. Mtei said. That role should be expanded and made more flexible by, first, taking into account the high economic and social costs imposed on adjusting economies. Second, the Fund should strengthen its surveillance over the policies of those members that did not need to make use of the Fund's resources. Finally, in an environment where the reserves/import ratio had deteriorated greatly in recent years and where global liquidity had been strained, a positive role for the Fund in facilitating adjustment and growth must involve a substantial allocation of SDRs in the immediate future.

Mr. Portas considered the recent turnaround in economic activity, the reduction in inflation in the industrial countries, and the progress in the correction of external imbalances in the developing countries to be favorable developments. However, as the staff and earlier speakers had noted, both the developed and the developing countries continued to be confronted with serious problems requiring resolution at the national and international level. It was thus entirely appropriate for the staff to analyze the policy responses to such problems, especially in the major industrial economies, and their impact on the developing countries.

One of the conclusions that could be drawn from the staff analysis was that sustaining recovery in the industrial countries would require the adoption of a more balanced policy mix and more adequate rates of growth in the developing countries, both of which were in turn necessary conditions for a satisfactory solution to the financial imbalances facing the world economy, Mr. Portas continued. In general, he agreed with the staff that prevailing conditions in the industrial countries did not permit a significant relaxation of the anti-inflationary stance of monetary and fiscal policies. The fears of a revival of inflationary pressures suggested the need for a cautious approach of the sort reflected in the slow pace of economic growth projected by the staff for the industrial countries. Still, current conditions indicated that there was room for a more balanced mix of monetary and fiscal policies in the major industrial countries that had attained lower inflation rates. He agreed with the staff and others that large fiscal deficits--particularly in the United States--and the prospects for even larger deficits in future were already affecting inflationary expectations and giving rise to high real interest rates, which impaired economic growth in the United States and made the adjustment efforts of other countries more difficult.

One important negative consequence of high real interest rates in the United States was the high value of the U.S. dollar vis-à-vis other major currencies, Mr. Portas commented. The appreciation of the U.S. dollar could not, of course, be regarded by itself as a negative development from an international standpoint, since it had encouraged demand for imports from the rest of the world. However, it was clear that the maintenance of a high value for the U.S. dollar at the expense of keeping real interest rates at historically high levels was not appropriate. High interest rates were the major obstacle to investment growth and to the sustainability of a more balanced economic recovery so necessary to reduce unemployment and protectionist tendencies in the United States and in other industrial countries.

The scenarios presented by the staff showed that, despite some progress, the developing countries would face serious constraints in their efforts to resume economic development, Mr. Portas observed. The modest rates of economic growth projected for the next few years were indicative of the substantial adjustment effort--because of the projected limitations on external financing--that those countries needed to make. He agreed with previous speakers that a sustained recovery, lower interest rates, reduced protectionism, and adequate availability of external financing were crucial to successful adjustment in the developing countries. Those countries of course had the primary responsibility of continuing with determination the adjustment of their economies, a task that could nonetheless be facilitated by a favorable external environment. In that respect, it was particularly important that the developing countries should face a liberal trade environment. Also, for the main borrowers, access to markets was crucial for the solution of the debt problem.

A sustainable solution to the external problems of developing countries clearly required the resumption of growth, Mr. Portas considered. The hardships brought about by external developments during the past few years had been more intense than what had been reflected in GDP statistics, particularly in the areas of unemployment and per capita income losses. Hence, adequate adjustment would require growth and appropriate flows of external financing. Given the uncertainties surrounding the prospects of financing from commercial banks, he agreed with Mr. Kafka and Mr. Ismael that further consideration at the national and international level should be given to increasing other types of financial flows. The Fund, in particular, should continue playing a significant role by providing adequate assistance under its facilities and, as had been emphasized in recent discussions, by agreeing on a meaningful SDR allocation.

Mr. Prowse said that there was little in the staff papers with which he disagreed, although he was somewhat disappointed at the lack of emphasis given to the issue of protectionism. Perhaps the oversight could be corrected in the published version of the General Survey and in the Managing Director's introductory remarks to the Interim Committee on the World Economic Outlook.

On another presentational matter, Mr. Prowse remarked that it was disconcerting to see an inconsistent use of terminology in the topics for discussion in Part IV of the paper. The first topic was titled "Economic management in the industrial countries" and included three items under the subheadings "Demand management," "Structural policies," and "Exchange rates." The second topic--"Debt and adjustment"--covered the subheadings "The manageability of the debt situation in the medium term," "Adjustment policies," and "Protectionism." He had assumed that adjustment policies were the same as structural policies or demand management policies. In his view, it would be preferable to make the terminology consistent, if for no other reason than to avoid the implication that adjustment was something only for developing or indebted countries. Similarly, the discussion of protectionism under the main heading "debt and adjustment" seemed to ignore the fact that protectionism was a severe problem for those major industrial countries whose economies were becoming obsolete and inflexible in the face of changing external circumstances. There was nothing wrong in relating protectionism specifically to debt, so long as it was remembered that protectionism had a wider impact.

While the projections for 1984 might be cause for some optimism, those for 1985 painted a picture that was not as bright as it should be, Mr. Prowse commented. They showed a moderation of growth in the industrial countries, little change on the inflation front, and little improvement in unemployment; the overall picture for the developing countries was even gloomier. It was not yet time to change the medium-term policy prescription but, as 1985 approached, it might be necessary to consider an adaptation in the message. The projections gave evidence of a less than satisfactory outcome for the medium-term strategy; current problems would still exist in 1985, with patchy growth, unchanged unemployment, large fiscal deficits, high real interest rates, and problems of current account financing.

Commenting on the suggested topics for discussion, Mr. Prowse said, first, that he endorsed the staff's view that demand management policies must continue to be directed toward restoring and maintaining financial stability. Unfortunately, over the years, the quality of advice had not been matched by the quality of implementation. The monetary aggregates in most major industrial countries had been allowed to grow at or near the target levels and, more recently, there had been serious failures of fiscal policies in several countries. The general government budget deficits of the major industrial countries had averaged 2.2 percent of GNP in the four years up to 1982; in the past two years, taken together, those deficits had averaged 4 percent of GNP, and certain of them were notably higher. For example, the staff had estimated that, in 1983, the U.S. federal government deficit had risen to 5.75 percent of GNP, implying an addition of stimulus equivalent to 1.5 percent of GNP. While the deficit was expected to decline somewhat in 1984, the improvement would apparently be entirely cyclical and would be offset by a later expansionary impulse from the general government deficit. On the desirable rate of reduction of the U.S. deficit and the effects that reduction would likely have, he tended to endorse Mr. Hirao's analysis.

He had been pleased to note Mr. Laske's emphasis on the importance of reviving business investment and, hence, on the importance of profitability, Mr. Prowse continued. A revival of business investment was central to the ongoing strength of the recovery. As a final point on the projections, he was disappointed at the lack of information in the summary paper on the performance of the newly industrialized countries. Those countries had been quite successful in the face of external difficulties and were a good example of how external borrowing could be fruitfully used.

With regard to the demand management and structural policy prescription in the staff papers, Mr. Prowse considered the menu to be a realistic one that did not discriminate against any particular segment of the economy. All the policies mentioned warranted serious study, and a number of them should be implemented immediately where appropriate.

Turning to the problem of debt, Mr. Prowse said that he had found interesting the discussion on pages 37 and 38 of the staff paper on what might constitute a viable or manageable external debt. However, the discussion did not go as far as he would have liked in that it did not define any benchmarks. On other occasions, he had asked whether, for example, the staff thought a particular debt service ratio was acceptable or could be regarded as satisfactory; and it was important that such questions be answered. In his view, debt ratios above 15 or 20 percent of exports were in the danger zone, where any adverse external developments could cause problems. In that regard, he wondered whether rescheduling of debt that left countries with very high debt service ratios could be considered a satisfactory approach to the problem.

The section of the staff paper on the consequences of changing some of the assumptions for the outlook on the debt picture were revealing, Mr. Prowse considered. The staff had calculated that the result of a reduction in the growth rate of industrial countries by 1 percent a year below what was assumed in the scenario would tend to "increase the projected deficit of the non-oil developing countries to about $80 billion in 1987 (against about $60 billion in the central scenario) and to about $150 billion in 1990." It was also rightly noted that such current account deficits could not be financed if the scenario assumptions with regard to bank exposure were to hold. In 1984 the amount of amortization projected was about $34 billion, which would rise to $85 billion in 1987. He could not be sanguine about those amounts. And it did not help to resolve the matter to say that no one expected the debt to be repaid, although it was reassuring to some extent to realize that, through the Paris Club, creditors would no doubt roll debt over whenever a country was prepared to adopt a Fund-supported program. However, he was not reassured that such an approach would leave countries with a debt service ratio that was tolerable. Long-term growth was dependent not only on growth in the markets for exported products, but also on necessary debt rescheduling as seen from a longer-term perspective. It would be tragic if costs were imposed in rescheduling that themselves exacerbated the problem. Creditors might need to consider whether rescheduling one year at a time was sufficient or whether rescheduling should take place over longer periods.

In sum, Mr. Prowse said, despite the brighter prospects for the world economy, there was no room for complacency. What had been achieved thus far amounted to successful damage control; what was required in future was that the ship be put back into full operation.

Mr. Malhotra observed that the world economy had showed some signs of recovery in 1983, following a prolonged recession. The growth of world output, which had been stagnant or declining since 1979, had recovered to a modest rate of 2 percent in 1983. The industrial countries as a group had registered a growth rate of 2.25 percent, although satisfactory growth had been concentrated mainly in North America and, to a certain extent, in the United Kingdom. Many industrial countries were experiencing a weak recovery, and a number of problems remained. While there had been notable success in bringing inflation down to about 5 percent, interest rates continued to be high, and there were recent indications that they might rise still further. Unemployment, too, remained at high levels.

The developing countries continued to face severely constrained economic and financial conditions, Mr. Malhotra commented. Those countries as a group had recorded a growth rate of only 0.9 percent in 1983; moreover, the volume of exports, which had declined by 7 percent in 1982, had recovered by only 1 percent in 1983. While the economic declines of recent years had generally been stopped or reversed, the progress did not give him cause for much satisfaction. The terms of trade of the non-oil developing countries had improved by about 1 percent in 1983, but the accumulated loss in their terms of trade over the past several years was about 18 percent. Similarly, while one might take hope in the decline, for the second successive year, in the combined current account deficit of the non-oil developing countries, the reduction was not necessarily a healthy one, since most of it had been due to a severe compression of imports, which translated into underutilization of existing capacities and disruption of development projects in many countries.

The harsh adjustment forced on developing countries was taking place against the background of high debt service obligations and a severe squeeze on liquidity, Mr. Malhotra noted. The staff was projecting that the developing countries would experience considerable export-led growth over the next few years. However, the transmission of the gains of recovery in the industrial countries to the developing countries had so far been weak and slow. Hence, one should look at the assumptions of transmission of the effects of recovery with a degree of caution. For one thing, the recovery in the industrial world itself was patchy. In that respect, he agreed with Mr. de Groote that, while it was appropriate for the Fund to be consistent in its prescriptions, it needed to look more closely at the factors contributing to the recovery in the United States and elsewhere. During the most recent Article IV consultation with the United States, he had asked the staff to attempt to quantify the contribution of the fiscal deficit and the accommodating policy of the Federal Reserve to the U.S. recovery, which had begun to manifest itself toward the end of 1982 and had gained strength during 1983. There was no doubt in his mind that those factors had been responsible to a great extent for bringing about a turnaround in the U.S. economy.

He agreed with those who felt that the staff's observations on economies like those of Japan and Germany were overcautious, Mr. Malhotra said. Unless those very large economies played their part, the industrial recovery would not become a global one, and the expected beneficial effects on the developing countries might not occur. In the circumstances, the Fund should analyze in greater depth the factors that had brought about a turnaround in the U.S. economy and in those of Canada and the United Kingdom in order to develop a better prescription for other industrial countries. He agreed with the staff that there was little or no room for maneuver in the French and Italian economies; however, there were varying degrees of scope for maneuver in other industrial economies.

Discussion of adjustment focused perhaps too much on developing countries, Mr. Malhotra observed; it should not be forgotten that real adjustment in the industrial world had been inadequate. A manifestation of that inadequacy was the increase in protectionism in the industrial countries and the adverse implications that it had for weaker nations of the world. He agreed with Mr. Polak that, in discussing structural improvements, the staff tended to concentrate too much on wages. Such emphasis might be appropriate for European countries and certain other economies where unions were far too strong but might have to be different for other countries. Perhaps it was time to pay greater attention to what governments or industries themselves could do to bring about structural change, especially in developed countries. The task was not an easy one. Protected industries felt no pressure to change, and it was easier for governments to suggest different macroeconomic policies than to take hard decisions about which industries needed to be phased out and which could be saved or improved. To help countries make the move toward structural change, the Fund should be more specific in its advice.

He could endorse completely the staff views on exchange rates, Mr. Malhotra said. On fiscal matters, there appeared to be a growing feeling among economists generally that the fiscal deficit of the United States was far too high, that it was likely to persist for some time, and that it had evident implications for other countries. There was some debate within the U.S. Administration about the relationship between the deficit, high interest rates, and the strong dollar. His own feelings on the matter were similar to those of the staff. The U.S. authorities had taken the view that U.S. interest and exchange rates must continue to be determined by the market. However, the high rates, which could not be divorced from the fiscal deficit, were hurting others, and it was important for the Fund, as part of its surveillance function, to persist with its sound advice, particularly to large countries with strong economies that had worldwide impact.

On the matter of debt and adjustment, Mr. Malhotra considered that the crisis management effort thus far had been successful. However, serious problems would continue to arise, and a still more practical approach to the debt problem was called for. Mr. Donoso had made a useful point in asking the staff to look at the solvency prospects of countries; even more important was the need for both creditors and debtors to look toward a major restructuring of debt over the longer term instead of rescheduling debts every year or two. Ultimately, of course, such an approach would increase the interest burden; however, as conditions improved, many countries might be able to repay ahead of schedule. On a related matter, he observed that the debt problems of the Western Hemisphere, because they were highly publicized, occasionally led people to overlook the debt situation in other regions, particularly Africa, where, despite the good work of the Paris Club, a major new initiative was needed.

There appeared to be less emphasis than in past papers on the flow of resources into developing countries and much more on the need for adjustment and its speed, Mr. Malhotra remarked. It had been suggested that, without Fund programs or financing, the adjustment required of countries would be much harsher. While the point might be valid, it should not be used to justify harsh programs. The questions remained of what was an appropriate speed of adjustment and of whether the Fund should not be using more of its resources to help member countries in difficulty. He could endorse the remarks made by Mr. de Groote in that regard. The Fund should look closely at the role it would play in future, particularly given the debt projections through 1989. He had heard some talk of phasing out or phasing down the enlarged access policy; but such an approach was questionable in view of the debt projections for the future. The same critical comment could be made with respect to the recent decisions to reduce the ceilings on access to the Fund's resources. It should be remembered that, more often than not, the Fund did not provide resources equivalent only to a fraction of quotas.

The overall flow of resources to developing countries was inadequate, Mr. Malhotra considered. IDA would have fewer resources than in the past, and overall World Bank lending was down. It would have been helpful if the staff had devoted more space in its papers to a discussion of overall resource flows to clarify the problem as it affected the developing countries in particular. Since commercial banks had drastically reduced their exposure in many countries, it was all the more important for international organizations like the Fund and World Bank to provide larger amounts of resources and to play a more meaningful role in the resolution of the debt problem. Finally, like everyone else, he was opposed to protectionism. It was however evident that, while countries had pronounced themselves against protectionist measures, they had done little to dismantle them.

Mr. Agah recalled that, during the World Economic Outlook discussion of January 31, 1983, his chair had taken note of the idea that the working assumptions of the exercise might be changed--as circumstances altered their essential elements--to introduce greater realism into the scenarios. In many existing and emerging economic situations, the volume and dimensions of the problems were so unprecedented that conventional wisdom and customary methods might not be suitable for dealing with them effectively. It was imperative that an effort be made to approach those problems from different angles. Admittedly, it was not easy to come up with original ideas and new methods for dealing with the current multidimensional economic and financial problems; however, that was no justification for failing to make the effort. The first step in dealing with the problems was to determine their root cause and to adopt an approach that attempted to deal with them in their totality rather than piecemeal. The staff had showed its cognizance of the interrelationship of such problems by observing, for example, that it was not the pattern of exchange rates alone that was cause for concern; rather, consideration had to be given to other policy divergences that underlay the exchange rate problem. The staff's analysis of the dollar's strength and of the absorption of global savings presented another aspect of a multicontextual analysis of exchange rate policies. Yet another pragmatic approach was to place greater emphasis on other crucial variables, such as the real sector, employment, and income.

On another matter, Mr. Agah considered the World Economic Outlook exercise to be a surveillance instrument as well as an adjustment tool for the Fund. In order to extend the geographical and temporal usefulness and efficiency of the exercise and to reinforce its role, the staff should follow up and assess--within a suitable agreed interval--the extent to which the proposals made in the World Economic Outlook exercise had been implemented.

The overall extended outlook for the world economy, as previewed by many forecasting institutes, did not seem bright or promising, Mr. Agah remarked. The menacing shadow of international debt, imbalances in international trade, one-sided pricing of essential commodities, persistently fluctuating exchange rates, and unstable and often increasing interest rates left little hope that the world would soon be relieved of the threat of a devasting economic and financial crisis. Although certain aspects of the current situation and prospects were positive, many crucial problems remained. The unemployment situation, the fiscal deficit--and its inevitable impact on interest rates--and the debt service crisis would not soon disappear. Moreover, debt, debt servicing, and adjustment problems continued to prevent many developing countries from improving their economic situation or prospects. In the circumstances, he agreed with the staff that it was crucial to resist any politically motivated pressures that might hamper a better global allocation of resources and a continued rapid improvement in the balance between indebtedness and export earnings in the developing countries. In that regard, he placed greater emphasis on the self-adjustment policies of individual countries than on the mobilization of new resources. Adjustment tended to increase the scope for real economic development, while reliance on the mobilization of external financing tended to keep debtor countries continually exposed to undesirable external influences.

In the area of debt management, Mr. Agah agreed with the staff that appropriate borrowing policies should be adopted "so that borrowing for low-priority projects can be quickly halted." Commenting on credit management, he considered that special care should be taken by creditors to direct credit more toward economically and financially viable projects and away from unpredictable projects. Despite his agreement with the staff's analysis and suggestions on the use of Fund resources, he felt that, since the financial resources of the Fund were limited in amount and revolving in character, it would better serve the overall objectives of the Fund and world economy if greater emphasis were placed on making the Fund's resources available to all borrowers on a more impartial and equitable basis. The potential for positive developments in a number of countries, whether or not they had any favorable impact on the world economy, should be exploited as a way of creating opportunities for a more balanced recovery. Unfortunately, contradictory practices in the economic policies of certain countries prevented such exploitation; persistent structural problems, high interest rates, fluctuating and unpredictable exchange rates among major currencies, the problems of external debt in many developing countries, and a generally unfavorable economic climate were all obstacles to an improved world economic and financial situation.

In looking at the problems of some developing countries, some Directors had placed excessive emphasis on the price of oil, although that price had been on a downward trend for a number of years, Mr. Agah continued. Far from considering the adverse effects of a continuous fall in the real price of oil on the economy of the oil producers, those critics seemed still to be concentrating on the doubtful connection between the rise in the price of oil some five years previously and the present, sometimes self-made, problems of certain countries. Many studies showed that, in 1980, when oil prices had been at their highest point, for every dollar equivalent paid for gasoline by consumers at the pump in Western Europe, 52 cents had been government tax, 17 cents had represented the costs and profits of the oil companies, and only 31 cents--less than one third--had gone to OPEC members, including production costs. With that in mind, he wondered whether it was still fair to attribute the rapid price rise of industrial products in Western Europe only to the increased price of oil by a group of oil exporting countries or, by the same token, to presuppose that the decrease in the oil price in recent months was only the result of dramatic technological improvements or changes in oil consumption and nothing more. In the circumstances, a follow-up mechanism for frankly assessing the level and degree of accomplishment based on proposals and predictions in the World Economic Outlook would be a useful exercise and would clarify some of the unjustified assumptions and perceptions.

Commenting on the topics for discussion suggested by the staff, Mr. Agah observed that, in any evaluation of the issues analyzed in the World Economic Outlook papers, policy interdependence among variables should be taken into consideration. For example, there was a close relationship between tighter demand management policy and more intensive trade restrictions or protectionism.

On structural policies, Mr. Agah noted that, while it was important to pay attention to economic and financial problems such as unemployment, payments imbalances, and fiscal deficits, it was equally important to be cognizant of deeply imbedded rigidities in all countries, developed and developing, in order to guard against unrealistic projections. Furthermore, a realistic assessment of exchange rate policies necessarily required taking a broader view of the entire global pattern of exchange rate developments and analyzing both the interregional and intraregional consequences. Put more simply, the strengths and weaknesses of currencies could not be studied in isolation. As for developing countries' exchange rates, the trend had been to take those developments for granted and to subjugate any interest by those countries in pursuing an independent exchange rate policy to the policies of the "key" currencies. If the conviction was that floating rates had acquired, as a by-product, widespread instability--which in turn had hampered world trade and increased the debt burden--then there was a clear mandate under the Articles of Agreement for promoting SDRs as an international medium of exchange.

He wondered why the crucial role of the Fund had not been illustrated under the discussion topic of "Debt management," Mr. Agah continued. The debt outlook projected by the staff seemed sanguine, particularly from a medium-term perspective, but much depended on the realization of various hoped-for assumptions underlying the forecasts. More objective assumptions based on available data and trends might suggest a less optimistic scenario. The Fund should seize the occasion to intervene more in the capital markets and, in accordance with its charter and heavy global responsibility, the Fund should strike a balance between national interests and global interests.

Commenting on adjustment policies, Mr. Agah remarked that the desire to distinguish between the aggregate current account positions of developing countries and the structural functioning of their economies was predicated on the idea that, at first, Fund-supported adjustment programs should aim at bringing about a balance in the current account before addressing the serious structural and growth problems. However, it might be better to attack on both fronts simultaneously, since experience showed that the two elements were intricately interwoven.

Protectionism should not be viewed in isolation, Mr. Agah considered. Protectionism was a response to a complicated economic environment and, as such, should be seen in conjunction with growth and demand management strategy on the one hand and exchange rate policies on the other. Solutions based on adequate market accessibility were directed only at the cause of the problem; other crucial factors, such as the stance of exchange rate and demand management policies--which cast light on trade policies--should be changed to ensure that they were consistent with the objective of free trade. As pointed out recently by the Managing Director, open trade was not just a matter of goodwill for the industrial countries; it was very much in their own self-interest.

Recent adjustment efforts in the non-oil developing countries had had to rely heavily on a contraction of imports, mostly through administrative measures, Mr. Agah observed. In many cases, the result had been some improvement in the balance of payments position but a delay in actual domestic and external adjustment. Adjustment in those countries had entailed high costs in terms of growth and unemployment, which was all the more unsustainable as domestic adjustment had generally been concentrating on more restrictive policies and had placed much of the burden on spending cuts, particularly of capital and social expenditures. Hence, while adjustment in the non-oil developing countries was clearly geared toward a restoration of external confidence, there seemed to be little provision for broadening internal support for the stabilization effort. Moreover, the dimensions of adjustment policies were to a great extent export oriented, and most developing countries were encouraged to adopt them as the only viable solution to current difficulties. The effects of export-promoting policies on the output of nontraded commodities and other sectors of the economy in developing countries merited further study. Some side effects of export-oriented adjustment policies obviously included increased vulnerability of the countries concerned to external developments and to expanding protectionism.

Mr. Hirao, supplementing his earlier remarks with a brief summary of recent developments in the Japanese economy, noted that, for fiscal year 1984/85, the Government was forecasting 4.1 percent growth, which would be brought about through expansion in domestic demand. Recent data showed an upturn in private domestic demand, with growth at an annual rate of 4 percent in the third quarter of 1983 and 6 percent in the fourth quarter. Hence, the picture of the Japanese economy in recent months had brightened. Private investment had begun to show strong signs of recovery due to a rise in capacity utilization and improvement in corporate profits; and that recovery appeared to be continuing in the current quarter, which seemed to indicate that the economic recovery, which had begun in the first half of 1983, had gained strength and momentum.

The Executive Directors agreeed to continue their discussion of the World Economic Outlook on Monday, April 2.

DECISION TAKEN SINCE PREVIOUS BOARD MEETING

The following decision was adopted by the Executive Board without meeting in the period between EBM/84/48 (3/30/84) and EBM/84/49 (3/30/84).

2. EAST AFRICAN CENTRAL BANKING COURSE - FUND PARTICIPATION

The Executive Board approves Fund participation in the East African Central Banking Course to be held in Tanzania, as set forth in EBD/84/98 (3/26/84).

Adopted March 30, 1984

APPROVED: September 7, 1984

LEO VAN HOUTVEN
Secretary