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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 84/137

10:00 a.m., September 7, 1984

J. de Larosière, Chairman
R. D. Erb, Deputy Managing Director

Executive Directors	Alternate Executive Directors
	J. K. Orleans-Lindsay, Temporary
J. de Groote	H. G. Schneider
B. de Maulde	X. Blandin
	M. Teijeiro
	M. K. Bush
M. Finaish	T. Alhaimus
H. Fujino	T. Yamashita
G. Grosche	B. Goos
J. E. Ismael	
R. K. Joyce	L. Leonard
A. Kafka	
G. Lovato	I. Angeloni, Temporary
R. N. Malhotra	A. S. Jayawardena
Y. A. Nimatallah	J. E. Suraisry
	T. de Vries
	K. G. Morrell
G. Salehkhou	O. Kabbaj
F. Sangare	
M. A. Senior	
	A. K. Juusela, Temporary
	T. A. Clark
Zhang Z.	

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

Also Present:
C. F. Schwartz, Consultant. Administration Department: H. Wiesner. Asian Department: U. Baumgartner. European Department: P. de Fontenay, Deputy Director; S. Kashiwagi, P. J. F. Nyberg. Exchange and Trade Relations Department: C. D. Finch, Director; S. Mookerjee, Deputy Director; E. H. Brau, S. Kanesa-Thasan, N. Kirmani, C. Puckahtikom, C. M. Watson. External Relations Department: C. S. Gardner, Deputy Director; H. P. G. Handy, H. P. Puentes. Fiscal Affairs Department: A. H. Mansur. Legal Department: G. P. Nicoletopoulos, Director. Middle Eastern Department: S. von Post. Research Department: W. C. Hood, Economic Counsellor and Director; A. Crockett, Deputy Director; R. R. Rhomberg, Deputy Director; J. Artus, C. P. Blackwell, J. E. Blalock, M. E. Bond, M. C. Deppler, O. E. G. Johnson, M. D. Knight, A. Lanyi, C.-Y. Lin, P. R. Masson, M. C. Williamson. Secretary's Department: A. P. Bhagwat. Treasurer's Department: W. O. Hambermeier, Counsellor and Treasurer. Western Hemisphere Department: S. T. Beza, Associate Director. Bureau of Statistics: J. B. McLenaghan. Personal Assistant to Managing Director: S. P. Collins. Advisors to Executive Directors: A. A. Agah, E. A. Ajayi, H. A. Arias, S. El-Khouri, S. M. Hassan, H.-S. Lee, I. R. Panday, M. Z. M. Qureshi, D. C. Templeman, A. Vasudevan. Assistants to Executive Directors: J. R. N. Almeida, J. Bulloch, Chen J., G. Gomel, V. Govindarajan, D. Hammann, J. M. Jones, H. Kobayashi, K. Murakami, E. Olsen, G. W. K. Pickering, E. Portas, M. Rasyid, J. Reddy, D. J. Robinson, A. A. Scholten, S. Sornyanyontr, A. J. Tregilgas, Wang C. Y., M. A. Weitz, A. Yasseri.

1. INTERIM COMMITTEE - PROPOSED AGENDA FOR THE TWENTY-THIRD MEETING

The Executive Directors considered a provisional agenda for the Twenty-Third Meeting of the Interim Committee (EBD/84/232, 8/31/84).

Mr. Fujino recalled that two days earlier the Executive Board had had a preliminary discussion of access limits for 1985 (EBM/84/135 and EBM/84/136, 9/5/84), at the end of which the Chairman had made some personal concluding remarks. He wondered how the preliminary nature of the Board's conclusions would be conveyed to the Interim Committee.

The Chairman commented that, in general, Executive Directors had not presented their positions in a sufficiently precise way to enable him to make a detailed report to the Interim Committee at present. He would indicate to the Committee members that the Board had had a preliminary discussion on access limits, that no conclusions had been reached, and that there were differing views on the subject that might, with guidance from the Interim Committee, lead to the development of a consensus at a later stage.

Mr. Nimatallah inquired at what point on the agenda the subject of access limits would be raised.

The Secretary replied that because the meeting was intended to last only one day, Committee members would be asked to take up all the substantive items in one intervention.

Mr. Finaish asked what documentation would be provided to the members of the Committee on the question of access limits.

The Chairman replied that the Committee members would be provided with the staff papers on the subject and with copies of his personal concluding remarks. He expected that Executive Directors also would brief their ministers.

Mr. Malhotra remarked that if the discussion in the Interim Committee was very general it might not result in much progress toward a consensus.

The Chairman said that he was confident that the Committee members would make their views on the access limits clear, thereby providing guidance for the discussions in the Executive Board. It was possible that the Committee members could come to a consensus on the matter.

Mr. Malhotra commented that he believed that there had been broad agreement on some areas during the Board's discussion of the access limits. For example, there had been general agreement that the enlarged access policy should continue and that the access limits under the special facilities should remain unchanged. It might help the members of the Interim Committee to make further progress if the positive aspects of the Executive Board's discussion were stressed.

The Chairman said that while Executive Directors had expressed broad agreement on certain aspects of the question, there were nuances among the differing viewpoints; so it might be difficult to draw definitive conclusions.

Mr. de Vries observed that if the members of the Committee could come to a consensus on the question, they would express their position in the communiqué. Alternatively, if their differences of view remained, the communiqué could also reflect that situation.

Ms. Bush said that while she agreed with Mr. Malhotra that there had been a consensus in the Executive Board that the enlarged access policy should continue in some form, she did not believe that there had been a consensus that access to the special facilities should remain at the same level.

Mr. Clark said that he agreed with the point made by Ms. Bush.

Mr. Malhotra said that while he accepted that there had not been unanimity on the question of access to the special facilities, a large number of Directors, representing a substantial majority of the Board, had supported the position that the level of access limits under those facilities should remain unchanged.

The Chairman stated that he would reflect the discussion in the Executive Board in a general way, without detailing the whole range of positions expressed by Executive Directors.

Mr. Morrell inquired whether it would be appropriate to indicate to the Committee that the discussion of access limits was expected to be preliminary.

The Chairman replied that he would prefer not to define precisely the range of the Committee's discussion.

Mr. Grosche said that he agreed with the Chairman.

Mr. de Groote stated that with regard to the date of the subsequent meeting of the Committee, his authorities believed that it might diminish the importance of the meetings if they were to be held consistently at predetermined intervals.

Mr. Malhotra observed that his authorities did not agree with the position taken by Mr. de Groote.

The Executive Board then took the following decision:

> The Executive Board approves the proposed agenda for the twenty-third meeting of the Interim Committee as set out in EBD/84/232 (8/31/84) for transmittal to the members of the Committee.

Adopted September 7, 1984

2. WORLD ECONOMIC OUTLOOK - GENERAL SURVEY

The Executive Directors considered a staff paper giving a general survey on the world economic outlook, together with a proposal to release an updated survey for publication after the Annual Meeting (EBS/84/177, 8/16/84; and Sup. 1, 8/20/84).

Mr. Joyce noted that the staff had indicated that there were grounds for continued optimism. The strength of recovery in the United States was having a beneficial impact on the rest of the world. In particular, the exports of developing countries had been growing vigorously and many of those countries appeared to have passed from the import compression phase of adjustment to that of export expansion. That development should enable many of them to deal with their debt difficulties while achieving more satisfactory domestic economic growth. There were, however, two main areas of concern: first, the recovery in the global economy was benefiting some countries more than others; second, the staff's projections, with which he broadly agreed, were clouded by a number of uncertainties.

Comment on the situation of industrial countries, Mr. Joyce noted, first, that the U.S. economy was expanding substantially faster than likely increases in productivity, and the projected moderation in growth in the United States was therefore neither surprising nor undesirable. However, the projected growth rates for 1985 were based on the "soft landing" scenario under which the rate of expansion in the United States could be moderated smoothly to a more sustainable level, i.e., without either increasing inflationary pressures or causing a recession. Even if such a balance could be achieved, the U.S. authorities would continue to face the major challenge of significantly reducing the size of the fiscal deficit, which his authorities agreed was a major factor keeping interest rates high, constraining the recovery abroad, and threatening to distort the present recovery in the United States. The measures that the U.S. authorities had taken in 1984 to reduce the deficit were welcome, but further efforts were required.

He also shared the staff's views with regard to the other industrial countries, Mr. Joyce remarked. Countries with low inflationary expectations should conduct monetary policy in as stable a manner as possible, avoiding an excessive tightening of financial conditions in response to higher U.S. interest rates and the strong U.S. dollar. He supported the fiscal efforts under way to reduce structural deficits and to limit government spending over the medium term. Where possible, however, policy should be implemented flexibly so as to enhance the return on capital investments and remove structural constraints to growth. Even in some countries with sound economies, government spending relative to GNP was large by historical standards, and further increases in aggregate fiscal expenditures ran the risk of squeezing the private sector. Structural and labor market rigidities were important causes of high unemployment in

Europe, as indicated by the fact that investment was tending to concentrate on labor-saving methods of production. Therefore, efforts to reduce unemployment should emphasize structural adjustment and increased labor market flexibility.

The staff had observed that the decline in the 1985 fiscal deficit in Canada would not be significantly greater than might normally be expected during a cyclical upswing, Mr. Joyce went on. However, assuming no changes in current policies, the contractionary impact of Canadian fiscal policy in 1985 would be the strongest of any major industrial country. The new Government, which would take office shortly, would undoubtedly wish to review the general stance of fiscal and monetary policy and might decide to modify existing policies. His Irish authorities believed that there might be scope for a less rigid approach to fiscal policy in certain countries where the structural budget deficit was low and where satisfactory positions had been achieved in respect of inflation and the balance of payments. While they welcomed the staff's recognition of the possible scope in some countries for flexibility in the implementation of budgetary policies, they believed that the staff might have stressed the desirability of utilizing any such scope in the interest of growth and employment or, at least, of keeping the possibility of doing so under review.

Commenting on the developing countries, Mr. Joyce noted that the medium-term outlook continued to suggest that their debt problems could be managed within an environment that permitted growth in per capita income. Nonetheless, developing countries continued to have a narrow margin for maneuver, nothwithstanding the major progress in their overall economic position. As many Directors had noted on the occasion of the discussion of the world economic outlook in the spring of 1984 (EBM/84/48 and EBM/84/49, 3/30/84, and EBM/84/50, 4/2/84), their situation remained highly vulnerable to changes in the international economic environment, and a balance had to be struck between the need for adequate financing and for maintaining control over debt servicing costs. Efforts to deal with the debt situation had to be addressed in a medium-term framework. Recent developments in Mexico's relations with the commercial banks were an encouraging sign in that regard. Creditors would have to continue to demonstrate flexibility in rescheduling existing debt and in providing new financing. Due to the tight financial situation, however, it would be imprudent for developing countries to risk eroding the recent gains by pursuing overly expansionary demand management policies. In addition to the need for restraint in the growth of imports, the marketability of developing countries' exports would have to be maintained through more flexible pricing, interest rate, and exchange rate policies.

Developing countries also should broaden their use of different types of financial flows, Mr. Joyce suggested. The provision of adequate development assistance would play such a role, but because economic constraints would probably limit flows, developing countries also should consider encouraging direct investment through regulatory and tax changes. While he understood the concerns of many of those countries about the perceived social and political implications of such investments, a balance had to be struck in order to promote the availability of beneficial foreign direct investment.

Two uncertainties affected the situation of the developing countries, Mr. Joyce stated. First, a number of countries facing severe external and internal imbalances had not yet adopted comprehensive adjustment measures; until they did so, their positions would remain difficult. Second, overall inflation performance was somewhat worrisome. The forecast increase in average inflation in the non-oil developing countries in 1984 reflected primarily the acceleration of the rate of inflation in five high-inflation countries. Excluding those countries, the average rate of inflation had decelerated somewhat; but even so, it remained a rather high 17 percent. Moreover, no deceleration was expected in the median rate of inflation for non-oil developing countries.

An acceptable medium-term solution to the debt problem would depend on the extent to which industrial countries maintained open markets for the exports of developing countries, Mr. Joyce commented. Efforts to resist protectionist pressures in industrial countries were, however, complicated by political pressures arising from continued high unemployment and the response to some trade measures taken by developing countries, which had been judged by certain industrial countries to be excessive. An important element in helping to ease protectionist pressures would be the pursuit of policies to remove structural rigidities in the labor markets of industrial countries. However, the Fund and the GATT had a role to play in discouraging countries from implementing trade policies that could engender retaliatory measures. More generally, greater multilateral cooperation was needed to ensure that even if major reductions in trade barriers might not be possible in the near term, further increases in those barriers should be avoided. In sum, the encouraging portrait of the world economic situation drawn by the staff was welcome, notwithstanding the numerous uncertainties. The maintenance of sound policies would enable the global economy to face the coming years with a reasonable degree of optimism.

The summary of EBS/84/177 provided to the members of the Interim Committee might also be made available to the press, Mr. Joyce suggested. Such an approach would assist Committee members in making public comments on the state of the global economy, ensuring the completeness of the survey's portrayal, and would avoid difficulties and misunderstandings that arose from piecemeal leaks. On the question whether an abridged version of the survey should be made public, he sympathized with the need to avoid duplicating unduly the analysis and conclusions set out in the Annual Report. However, in addition to Chapter II, any published version should include Chapter IV, which dealt with the medium-term outlook and the sustainability of the prospective debt situation.

Ms. Bush remarked that she agreed with the staff's assessment of world economic prospects, including the expected strengthening and widening of the global recovery on the basis of almost 5 percent growth in industrial countries as well as accelerated growth in non-oil developing countries in 1984. Although a few developing countries were experiencing severe inflation, it remained fairly low in industrial countries and in most developing countries. A widening of the U.S. current account deficit, with correspondingly higher surpluses or smaller deficits in most other countries, could be expected. The financial problems of some developing countries were improving, but the situation remained a matter for concern and warranted special attention.

Her authorities expected somewhat stronger growth in the United States in 1985 than projected by the staff, Ms. Bush continued, in conjunction with higher external surpluses or lower deficits in other industrial countries. She disagreed with the staff on points made with regard to the U.S. fiscal policy, interest rates, and exchange rates. She noted that she had made detailed comments on U.S. policy in her statement on the 1984 Article IV consultation with the United States (EBM/84/120 and EBM/84/121, 8/3/84).

Difficult questions arose concerning not only the nature and source of deficits but also the correct way to measure them and their presumed impact on the economy as a result of hypotheses concerning the way in which private sector economic agents responded to them, Ms. Bush said. Despite their difficulties with some of the staff's criticisms, her authorities recognized the need for the reduction of federal budget deficits. They had already made a down payment in that respect and were planning intensive expenditure reduction efforts in 1985. They were convinced that attempting to reduce deficits by tax rate increases would more likely lead to higher outlays, thereby frustrating those efforts as a whole.

Her authorities also believed that the key to high interest rates was inflationary expectations, which could only be brought down through continued firm anti-inflationary monetary policy, Ms. Bush said. They were skeptical of the presumed linkages between U.S. interest rates, however they might be generated, and the dollar and interest rates in other countries. For example, monetary growth in other industrial countries generally had not been below targets set with the objective of controlling inflation, which suggested that interest rates in those countries would not be notably different if U.S. interest rates had been lower. In addition, the rapid growth of business fixed capital formation in the largest industrial countries suggested that interest rates were not so high that they were preventing the growth of investment.

The continued strength of the dollar, however, remained somewhat puzzling, Ms. Bush considered. Interest rate differentials had no doubt played a role, but other factors included the strength of the U.S. economy, and the successful revival of fixed investment. The relative flexibility with which the economy had been adapted to new situations stood in contrast to the European experience. In any event, a leveling off, or slowdown, in the dollar's rise could be expected as growth strengthened abroad and confidence in other economies increased. As on previous occasions, her authorities objected to some references by the staff to the need for economic convergence among major industrial countries insofar as such comments could be interpreted to mean a close similarity or identity of policy mixes, economic priorities, or even economic performance, especially over relatively short periods.

It was particularly encouraging to note the further improvement in the situation in developing countries, Ms. Bush remarked, although the difficulties that continued to lie ahead should not be underestimated. The staff had usefully gone beyond the aggregate picture to examine the divergent experiences of specific groups of countries. Clearly, there were many differences in the success of current adjustment efforts and in the care with which long-term domestic growth and investment plans had been formulated and carried out. Although the definition of non-oil developing countries used by her authorities was somewhat different from that used by the staff, her authorities also projected an improved situation. The outlook for 1984 and 1985 implied increased growth in per capita terms, improved current account positions, and increases in reserve levels. Her authorities expected growth to be about 3.5 percent in 1984 and about 4 percent in 1985 for the non-oil developing countries as a whole. After a decline in the aggregate current account deficit of those countries of $30 billion in 1983, a further modest decline was expected in 1984, perhaps followed by a slight upturn in 1985 as economic growth and imports increased.

The overall debt situation was expected to stabilize in 1984 and 1985, Ms. Bush observed. For the largest developing countries, her authorities expected a relatively steady debt service ratio in 1984 and 1985, taking into account the effect of the recent agreement reached between Mexico and the commercial banks. Although her authorities were fully aware of the added balance of payments costs of high rates, they expected a decline in world interest rates, and they noted that the medium-term debt scenario prepared by the staff--which assumed higher interest rates than the base case--nevertheless indicated a sstisfactory resolution of the debt problem provided correct policies were followed. It was also worth noting the cooperative spirit shown by official and private creditors, as evidenced by the reduction in debt service payments of the non-oil developing countries by about $24 billion in 1983, with further debt relief expected in 1984. Continued close cooperation would be necessary over the medium term. Her authorities' analysis of the position of the non-oil developing countries confirmed that the adjustment pattern noted by the staff--namely, initial adjustment focused on imports, followed by export growth resulting from economic recovery in the industrial countries--would permit increases in imports by developing countries in 1984 and 1985. Thus far, however, the bulk of adjustment had occurred on the external side. If sustained growth was to be achieved, there would have to be internal economic adjustment to raise domestic savings, lower inflation, and increase the efficient allocation of resources.

She agreed with the staff on the importance of continued efforts to restrain and to reduce protectionist pressures in industrial countries and in developing countries alike, Ms. Bush stated. Finally, with regard to publication, a shortened version of the World Economic Outlook might be published, but she had reservations about publishing Chapter IV, which dealt with the debt situation, primarily because it might be misinterpreted by the world at large.

Mr. de Groote commented that it was surprising that the staff considered that U.S. monetary policy in 1983 had been restrictive when it clearly had not. The U.S. recovery had been made possible by a combination of expansionary fiscal policy and accommodating monetary policy. The latest data indicated that M-1 had increased in a 12-month period by 9.5 percent, M-2 by 11 percent, M-3 by 10 percent, and total debt by 11 percent, while prices had increased by about 4 percent. If the relation between the monetary aggregates and prices could be taken as a measure of the expansiveness of monetary policy, U.S. policy in the period in question could hardly be called restrictive. Otherwise, the terminology applied to other industrial countries would have to be changed.

The staff's argument on page 37 of EBS/84/177 against a more expansionary policy outside the United States was also surprising, Mr. de Groote continued. The staff believed that a significantly more expansionary fiscal policy could create difficulties even in countries that had succeeded in the fight against inflation and in re-establishing their external positions, because a change in policy would raise questions about the constancy of official strategy and could result in "crowding out" at the international level in view of the high public sector borrowing requirements in different countries. While he could accept the staff's line of reasoning, he could not agree that the countries in question should necessarily refrain from expansionary action. If they did so, they could prevent the recovery from spreading beyond the United States to the rest of the industrial world.

There would also be a fundamental contradiction in urging the developing countries to repay their debts through current account surpluses while seeking to maintain such surpluses in industrial countries, Mr. de Groote considered. He hoped that the staff's comments would not be interpreted as a recommendation, particularly because such an interpretation might suggest that other industrial countries would necessarily have to accept the consequences of U.S. policies for employment and that, in a sense, the United States could be permitted to export its unemployment to other countries. The obvious conclusion of the staff's analysis was that there was a strong argument for a reduction of the U.S. fiscal deficit. He hoped that care would be taken to convey that point if the text was published.

Mr. Kafka observed that there were two major policy areas to be discussed: first, the sustainability of recovery in industrial countries and, second, the debt problem and the problems associated with it. The issue of international collaboration was implicit in those two policy areas. He agreed generally with the staff on the sustainability of recovery in the industrial countries. The overwhelming need--from the point of view of the United States and of the world in general--was for a change in U.S. fiscal policies that would make possible a general decline in real interest rates. Whether developed or developing, countries other than the United States would have much to gain from introducing into their economies the same elements of flexibility that had so well served the United States in the recent recovery. However, he was more pessimistic than the staff. A faltering recovery among industrial countries would damage the progress of the developing countries, although the opposite observation was not true to the same extent. Furthermore, he attributed more importance than did the staff to recent declines in commodity prices, both in dollar and in SDR terms, as signs that the period of inflation in industrial countries might be giving way to a new growth recession rather than a "soft landing." Thus, the recommendation--to continue to give priority to the fight against inflation in all countries and by all means--might be obsolete. In that regard, he agreed with the remarks of Mr. de Groote.

The debt problem had not been dealt with in a way that could be expected to re-establish long-term confidence and, thus, the resumption of voluntary private lending to developing countries, Mr. Kafka continued. Obviously, a resumption of such lending on a scale such as the one preceding the debt crisis would not be realistic for a long time to come and would have to be replaced, in large part, by other forms of private and official finance. However, voluntary private lending would continue to be necessary to permit developing countries to resume a reasonable rate of growth. The present loss of capital of developing countries as a result of a negative resource gap amounted to as much as 3 percent of GDP a year for major borrowers and for the developing countries of the Western Hemisphere, implying an annual reduction in growth of about 1 percent, or 35 percent in a generation, other things being equal. Before 1980, those groups of countries had had a positive resource gap of 3 percent a year on average.

There had been some inclination by banks and by official creditors to help those debtor countries that had successfully taken energetic adjustment measures, Mr. Kafka remarked. The so-called case-by-case approach involving softer treatment for the "deserving poor" was useful insofar as it stimulated essential adjustment efforts. However, thus far, the "softer treatment" continued to be harsh; moreover, relief was also needed for those countries that had found it difficult to adjust their economies rapidly, including, in particular, their balance of payments.

The attitude of the commercial banks, who were the principal lenders, perhaps reflected primarily the views of the smaller banks, Mr. Kafka suggested, although there was also reluctance by the larger banks to raise their exposures even by the generally modest proportion that would make it possible to dispense with the cooperation of the more hesitant smaller institutions. But even the attitude of the large banks offered, not surprisingly, far too little that could be expected to smooth the transition to voluntary lending. While they were prepared to contemplate and to press others to accept multiyear reschedulings of amortization payments, such reschedulings continued to imply a heavy debt service burden because they did not extend the repayments over a sufficiently long period--although they extended them considerably. For some of the major debtors, leaving aside the question of "new money," the problems of trade and interbank credits remained unsolved.

Recent negotiations suggested that there had been substantial concessions regarding reference rates and commissions, Mr. Kafka added, but the spreads, although reduced, continued to be high if the view was taken that countries renegotiating their debts were undoubtedly more reliable debtors at present than before they had begun the negotiations. None of those factors, however, solved the basic problem of excessively high interest rates, which depended primarily on macroeconomic policies in the industrial countries, particularly in the United States. Certainly, interest capitalization was not a genuine solution.

Apart from the attitude of the banks, Mr. Kafka went on, the attitude of controllers could prejudice attempts at debt relief, particularly for those countries that had not yet emerged from the circle of the simply poor to that of the deserving poor. In view of the reduced likelihood of an immediate worldwide financial crisis, controllers had been tightening rules with regard to the treatment of interest accrued but not paid, loan loss reserves, and capital ratios. Such actions could interfere with future lending activities. While appropriate supervision of the financial institutions was essential, every effort should be made to ensure that it did not fall disproportionately on transnational loans, which were small in relation to national lending by commercial banks.

The World Bank had made an imaginative contribution to the debt crisis, Mr. Kafka said. There were also advantages to private direct and private portfolio investment in debtor countries in appropriate circumstances. However, it would be naive to believe that such investment could come close to substituting for the role that lending played in the promotion of development. The governments of creditor countries had been helpful in providing relief for official loans through the Paris Club. Furthermore, the United States had offered increased finance or guarantees of supplier credits. He hoped that other industrial countries would follow that example and that the United States would continue its financial assistance.

The reduced financing role of the Fund, not only in relation to the peak year of 1983 but also relative to preceding years, was a matter of concern, Mr. Kafka considered, despite the admirable role that the Fund had played in the debt crisis. In many cases, Fund financial assistance, which had been decisive, continued to be needed to stimulate private and other official assistance. It was worth repeating that the complete change in conditionality imposed recently on drawings under the compensatory financing facility had deprived the Fund of the only quick disbursing or bridging credit facility available to it. The Bank for International

Settlements (BIS) and some of its members, as well as the United States, had advanced short-term bridging loans to debtor countries in need of rapid assistance. But those sources were drying up, so that the world was currently deprived of any official source of bridging credit. Commercial bank bridging credits were also increasingly difficult to obtain. As an academic observer had commented, the only bridging credits available were arrears--a sad reflection of the international financial system's willingness to face up to its problems.

The entire debt problem would not be as serious as it had become if it were not for two factors in addition to high interest rates, Mr. Kafka suggested. First, world growth to 1990 was expected to be relatively slow. Interest payments, which absorbed the painful proportion of, for example, 5 percent of GNP of a debtor country, could be tolerable in a rapidly growing world economy in which one year's growth might compensate for the interest burden; however, the same was not true in the present state of the world economy. Second, there was a problem of increasing protectionism in the industrial countries that was closing off markets for both new and traditional industrial and primary exports of the developing countries. Although the latter were also guilty of protectionism, the industrial countries could not be relieved of their responsibility, which was greater because of their greater weight in the world economy.

The extreme fragility of the developing countries' situation was brought out clearly in the staff's medium-term scenarios, Mr. Kafka remarked. Even on the assumptions in the base scenario, which were by no means pessimistic, the growth of the non-oil developing countries to 1990 would be low in per capita terms--scarcely more than 2 percent--probably not enough to avoid a dangerous rise in unemployment and underemployment. Even modest growth in productivity would imply that the demand for labor would fall well below the growth of activity needed to absorb new entrants into the labor force. It was particularly worrisome that the staff's analysis suggested that corrective policies by the developing countries would have to be strong, for example, in order to offset the effects on their debt servicing capacity of growth rates in industrial countries lower than in the base scenario. The result would be a further sacrifice of developing countries' already insufficient growth rates. The situation underlined the extreme dependence of the debtor countries on decisions into which they had no input. In that regard, a more encompassing sensitivity analysis of the relationship between developing countries' debt ratios and growth rates and changes in the external environment than had been presented in Table 41 would be welcome.

It could not be overstressed that it was not sufficient that the developing countries should be enabled to pay their debts, Mr. Kafka stated. In order to avoid a catastrophe, they would have to be enabled to resume growth at a rate that would make possible the absorption of entrants into the labor market and to return within a sufficiently short time to past levels of per capita absorption. In sum, the economic outlook was not exhilarating. The debt problem was likely to hang over the developing countries and, therefore, over the world economy for a long time. Finally, although the World Economic Outlook paper was excellent, he would prefer not to publish it for the time being; it should be published in the spring, when it would not duplicate any other publication, in whole or in part.

Mr. Finaish commented that the staff had correctly noted that the margin of uncertainty attached to economic projections at the present conjuncture was particularly large; such projections ought, therefore, to be used with caution. The dissimilarity between the present situation and earlier periods of cyclical recovery, a factor cited by the staff as complicating the forecasts, derived in large part from the particular configuration of industrial countries' policies. On a specific point, while the rates of growth of output and trade had been revised upward for industrial and non-oil developing countries, they had been revised downward for the oil exporting countries. It would be helpful if the staff could explain the reasons for the downward revision and if it could elucidate its statement on page 13 of EBS/84/177 to the effect that the process of adjustment of public sector spending in those countries, prompted by the fall in oil revenues, seemed largely complete. It would also have been useful if, in the tables containing medium-term projections for developing countries, separate projections had been shown for the various subgroups other than "major borrowers," as had been done in previous projections.

The circumstances in which industrial countries had been pursuing their medium-term economic strategy of restoring financial stability and creating conditions for sustained growth had undergone substantial change over the past two years, Mr. Finaish continued. Inflation had been brought down considerably, and the recession had given way to a recovery. However, progress, particularly in respect of the resumption of growth, had been uneven across countries. Within their overall medium-term economic strategy, the current policy imperatives and the recent economic performance of industrial countries reflected those disparities.

In the United States, where the recovery had been much faster than anticipated earlier, Mr. Finaish went on, the present task was to achieve a gradual transition of the surge in economic activity to a sustainable pace as the economy approached capacity constraints. The key issue of concern remained the stance of U.S. fiscal policy. The high interest rates to which the large U.S. fiscal deficit had contributed had thus far not arrested the growth of business fixed investment; an interesting question arose, on which the staff might comment--namely, what special factors could explain the much faster growth of investment than in similar stages of previous business cycles in spite of the historically high interest rates and at what point would those high rates begin to impinge more significantly on investment expenditures. The concern with regard to the persistence of high interest rates derived not only from their eventual adverse effects on U.S. domestic capital formation, and hence on the sustainability of recovery, but also from the implications for other countries, especially debtor developing countries. Although the positive impulse imparted by U.S. fiscal policy to the pace of recovery had contributed to a faster growth of exports for its trading partners, thereby offsetting in the short run part of the impact of the high interest rates, the view was widely shared that from a medium-term growth perspective the interest of both the U.S. economy and of the global economy called for an early, substantial strengthening of the U.S. fiscal position.

In the European industrial countries, the major task remained the achievement of a recovery strong enough to cause a reduction of high, in some cases still rising, levels of unemployment, Mr. Finaish suggested. While the reduction of inflation achieved through improved financial policies, including a much more restrained fiscal stance than in North America, and the strengthening of export demand had made possible a resumption of growth, the pace of recovery thus far had been weak. In addition to the continuation of appropriate financial policies, structural adjustments appeared to be needed in those economies to improve incentives for increasing employment and investment in new capacity so as to exploit more fully the growth possibilities.

Commenting on debt and adjustment in developing countries, Mr. Finaish observed that the recent improvement in the outlook for developing countries was encouraging. After five years of declining growth rates, a pickup in growth was expected in 1984. A further reduction in those countries' aggregate current account deficit was also forecast. Unlike in previous years, the reduction was not contingent upon a further compression of imports; instead, it reflected an acceleration of exports that also allowed for a turnaround in imports. Those developments reflected both the pursuit of firm adjustment policies and the quickening of the pace of recovery in industrial countries. It should be clear, however, that the improvement in the economic situation of developing countries was only a beginning, and the improving trend would have to be sustained and strengthened over the next several years for them to emerge fully from the effects of the deep and prolonged recession.

Furthermore, the improvement in the general outlook for developing countries concealed large differences among the group, Mr. Finaish noted, which needed to be taken into account in a fuller assessment of the situation. The projected improvement in the economic situation of the smaller lower-income countries, especially in Africa, was comparatively limited. Those countries had also suffered more heavily during the recession, enduring sizable declines in per capita income from already very low levels. The expected pickup in output and exports in those countries was much weaker, and their payments deficits remained large, showing only slight improvement. The financing of their deficits remained difficult, partly because most of the new lending--both official and private--had been absorbed by the financing packages that had had to be arranged for the larger borrowing countries. As a result, their reserve positions, which were the weakest, were continuing to weaken. It was also true that the debt burden relative to exports and GDP in many of those countries was no less than in many of the more publicized larger debtor countries. The situation in the smaller lower-income countries, therefore, deserved greater attention than had been accorded it recently. While the problems faced by them might not pose a threat to the international financial system as a whole because of their smaller size, for the countries themselves the problems could be as serious as those in the larger debtor countries, perhaps even more serious.

The external situation of the larger debtor countries had shown an improvement, Mr. Finaish observed. The decline in their current account deficits had appreciably reduced their requirements for new bank financing while permitting some buildup of reserves. A resumption of growth was also forecast for 1984. While the position was encouraging, it was clear that the financing situation of those countries would remain difficult for some time to come. Their borrowing from private creditors, although reduced, remained substantial, and much of the lending that was taking place continued to be nonspontaneous. Moreover, the improvement achieved thus far seemed threatened by the recent tendency of interest rates to rise again.

The staff's medium-term scenario indicated that a gradual reduction of the debt burden could be achieved that was compatible with the resumption of per capita income growth, Mr. Finaish went on. The assumptions underlying that scenario had to be fully recognized, however, particularly the decline in interest rates, sustained recovery in industrial countries, maintenance of firm adjustment policies by the debtors, and continued provision by the lending institutions of the required amounts of financing and refinancing. Given the uncertainties surrounding those assumptions, adequate advance thinking and planning were needed to deal with any contingencies that might arise, including what new initiatives might then be necessary. Even at present, there appeared to be a case for considering long-term multiyear debt reschedulings for those debtor countries that had put in place credible adjustment programs.

The staff noted that while stronger exports would make possible some import growth, Mr. Finaish remarked, it would be prudent for developing countries to devote at least a part of the increase in export proceeds to improving their external financial position. To the extent that an allocation of SDRs could contribute to restoring the much weakened reserve positions of those countries, the constraint on the use of the increased export earnings to relieve the impact of the severe import compression of the past two years would be eased. It could also be emphasized--as noted during the recent discussion by the Executive Board of the Fund's policy on access to its resources and as convincingly argued by the Chairman in his personal concluding remarks (EBM/84/134 and EBM/84/135, 9/5/84)--the continuing difficulties and uncertainties facing a large number of developing countries and the reduced availability of spontaneous financing from private creditors did not warrant a reduction in members' access to Fund resources.

Commenting on the oil-exporting developing countries, Mr. Finaish said that the policy questions that many of them had had to deal with in the past few years had not been very different from those facing non-oil developing countries. The global recession, in conjunction with other factors such as oil inventory policies and changes in oil production outside the group, had resulted in reduced oil revenues, a fact that had necessitated a general policy of adjustment and restraint, the effects of which on domestic economic activity were clearly reflected in the output and growth figures. For a number of countries in the group, particularly those that were also major debtors, the adjustment had involved a compression of imports, a common pattern for developing countries in the recent period. While an improvement was forecast for the period ahead, it remained sensitive to assumptions regarding developments in the international oil market. The recent relative stability in that market might explain the somewhat reduced discussion at present of developments in the oil market and of the oil policies of both consumer and producer countries. The continuation of stability, which policies in oil-exporting countries had sought to preserve, was clearly in the interest of consumers and producers.

He fully agreed with the need for greater international collaboration in the areas noted by the staff, Mr. Finaish stated. He stressed the importance of arresting and rolling back protectionist pressures in industrial countries, pressures which continued unabated despite the progress of the recovery. As had repeatedly been pointed out, protectionist barriers against developing countries seriously blunted the effectiveness of their adjustment policies and contradicted the efforts being made to resolve the debt problem. In a recent staff paper, "Effects of Increased Market Access on Selected Developing Countries' Export Earnings: An Illustrative Exercise" (DM/84/54, 8/24/84), further instructive evidence had been provided of the substantial increase in developing countries' exports that could result from an easing of trade barriers against them. The Fund's coverage of trade policy matters in the case of major countries could be improved by indicating, wherever possible, the magnitude of the impact on other countries of the protectionist measures.

Mr. Fujino remarked that it was encouraging that the world economy, led by a strong recovery in North America, continued to show signs of picking up further. The brisk pace of recovery in world trade was also welcome. At the same time, inflation continued to be under control in many countries. Furthermore, the recent strength in business fixed investment in the United States, the United Kingdom, Germany, and Japan was particularly important. If sustained, it could provide a solid basis for economic growth over the medium term. Behind those recent favorable developments had been the prudent monetary policy stances in many countries aimed at bringing down inflation.

Notwithstanding those achievements, Mr. Fujino continued, the unemployment rate, except in the United States, had not declined significantly. He agreed with the staff that it was important to reduce rigidities in labor markets. Moreover, unemployment remained high even in some of the countries where business fixed investment had begun to show strength, perhaps because the recovery in such investment was in its early stages or, as was sometimes argued, because the effects of that investment in generating new jobs had become smaller in recent times. He invited the staff to comment on the issue.

The greatest challenge before policymakers was to bring about a "soft landing" so that sustained world economic growth could be maintained, Mr. Fujino considered. The staff was absolutely right to bring the issue to Directors' attention. It was most difficult to envisage that the present high rate of economic expansion could be maintained over a long period; in that regard, the data in Table II.1 of EBS/84/177, concerning physical capital and labor utilization indicators in major industrial countries, was revealing. He agreed with the staff that serious bottlenecks could arise in certain sectors well before aggregate measures of capacity utilization reached critical levels. In such circumstances, the present economic recovery could be brought to an abrupt halt, jeopardizing the favorable outcome of the staff's base scenario. To avoid such a premature and precipitous downturn in world economic activities, it would be important to bring the present rate of economic growth down to a "soft landing" on the potential growth path.

The persistence of high rates of interest and the high value of the U.S. dollar were of particular concern in that connection, Mr. Fujino said. Of course, there were many factors behind the present high level of interest rates and the strength of the dollar, such as the rapid pace of economic expansion in the United States and the relative attractiveness of investment there. He agreed with the staff, however, that among those factors the present and prospective fiscal deficits were particularly important. As he had remarked during the 1984 Article IV consultation with the United States, it would be ideal if fiscal deficits could be reduced solely through expenditure cuts. However, as a practical matter, measures aimed at strengthening revenues would also be necessary. Decisive action directed at reducing fiscal deficits would greatly contribute to alleviating fears of a possible crowding out of private credit demands and would thereby contribute toward bringing down interest rates. He welcomed the confirmation by Ms. Bush that the U.S. authorities were firmly committed to reducing their fiscal deficit further.

It would also be important to reduce institutional rigidities, Mr. Fujino added. The staff correctly focused on wage setting procedures in some countries. At the same time, structural rigidities in the fiscal area should be addressed so that fiscal policy could once again be used flexibly in economic management when necessary. That basic approach underlay his authorities' continued striving to reduce fiscal deficits in Japan with a view to eliminating deficit financing bonds by FY 1990.

Commenting on debt issues, Mr. Fujino remarked that it was encouraging that under the staff's base scenario debt problems could eventually be brought under control, mainly as a result of the expansion in world trade. All members, developed and developing countries alike, were expected to do their best if the scenario was to be realized. It would be important that developed countries maintained sustained economic growth over the medium and long term. Bringing down interest rates was also urgent. The debtor countries would have to continue their adjustment efforts. In conjunction with the recovery in exports, it would be necessary to resume economic growth, which would reverse the declining trend in per capita income of the past two to three years. However, care would also have to be exercised that the first signs of export recovery did not lead to overexpansionary policies, which could only result in the repetition of the recent failures.

In that context, there should not be a too easy and uniform application of the multiyear rescheduling approach, Mr. Fujino considered. It was perfectly appropriate that that approach should be adopted in the case of countries that had achieved significant results through their steadfast implementation of adjustment measures and were committed to adhering to adjustment efforts in the future. In those circumstances, multiyear rescheduling would enhance the member's adjustment efforts by providing reasonably firm medium-term prospects for the external environment. However, whether such conditions for enhancing adjustment efforts were fully met had to be carefully assessed on a case-by-case basis.

Taking up questions of detail, Mr. Fujino said that his authorities did not regard the real economic growth achieved in Japan during the past three years, which had ranged between 3 percent and 4 percent a year, to use the staff's words, as "disappointing," even with the modification "to some degree." His authorities would wish to have Japan placed beside Canada in the final complete paragraph on page 32 of EBS/84/177 in that regard. Similarly, they would wish to see amended the phrase on page 36 "along with sluggishness of domestic consumption and investment in Japan...." Finally, with regard to the publication of the present paper with suitable editing, he favored the approach agreed in the Executive Board at the time of the consideration of the work program (EBM/84/77, 5/14/84)--namely, to limit the publication to updated tables and notes essential to an understanding of those tables so as to avoid possible duplication of the Annual Report. Semiannual full-fledged publication of World Economic Outlook papers would lead to increased pressure on the already heavily burdened staff and on the Fund's budget.

Mr. Nimatallah said that the staff's analysis portrayed an encouraging picture for the world economy during 1984: the growth of output and the control of inflation in the industrial countries were expected to be the best experienced in many years; output growth in developing countries was expected to exceed population growth for the first time in five years; and the combined current account deficit of the developing countries was expected to show a further substantial decline. The situation had been made possible by the combined--and courageous--adjustment efforts of industrial and developing countries, and facilitated by a welcome expansion in world trade. The success of industrial countries in controlling inflation had helped bring about a healthier economic recovery, which in turn had stimulated their demand for imports, thereby reinforcing the Fund-supported adjustment efforts of the developing countries.

It was important that all members continue to pursue policies to make the recovery more widespread and sustainable, Mr. Nimatallah continued. That objective would require emphasis in a number of policy areas. First, gradual and sustained reductions in fiscal deficits of member countries would help to improve the mix between monetary and fiscal policies, reduce external and domestic debt, lower interest rates, improve exchange rate relationships, and free resources from the less to the more productive sectors. Second, wage increases should be linked to productivity gains, not to inflation. Albeit in different degrees, progress had been made during the past two years toward more moderate wage settlements in many industrial and developing countries. That trend should continue. Third, continued pursuit of structural adjustment would be necessary; in particular, rigidities in the markets for the factors of production should be reduced, which would improve the allocation of resources and increase economic efficiency. It should be recognized that structural adjustment was a long, difficult process that should be pursued for many years. Fourth, there should be continued determination to keep inflation under control. Such determination would be all the more important as some countries might approach bottlenecks or full capacity utilization.

Concerted efforts to dismantle trade barriers would also be necessary, Mr. Nimatallah stressed. It had been hoped that the recovery in the world economy would lead to a rollback of trade barriers. Unfortunately, the reverse was happening, and barriers were increasing. The trend was most disquieting and represented one of the main obstacles to spreading and strengthening the recovery from which all countries should benefit. International trade was at the heart of the process linking recovery among member countries. It was extremely important for all members to abandon narrow national considerations of protectionism in favor of free trade so as to lead to future world prosperity. Furthermore, progress in trade should not be hindered by lack of financing. It would be most unfortunate if trade expansion was choked off for that reason. The area of international trade was where cooperation among countries was needed the most.

Commenting on the debt problem, Mr. Nimatallah noted that the staff's medium-term scenarios indicated a broadly unchanged overall picture since March 1984. Like many other Directors, he believed that the debt problem was manageable. All the concerned parties were cooperating. It would, of course, take time for the problem to abate and would require continued cooperation and pursuit of appropriate policies by all parties working together and with the Fund. In light of a growing genuine need for financing, it was worrisome at present that adequate new lending by banks might not be forthcoming. International cooperation was needed in that area also. National and international efforts should be pursued to improve the legal and operational setting for the banks in their relations with countries and international organizations. The Fund should continue its effective role in helping its members, including its indirect role as a catalyst.

Mr. Goos stated that his authorities were in broad agreement with the staff's assessment of the world economic outlook and with its policy recommendations, particularly with respect to monetary and fiscal policy. He shared the staff's view that the main industrial countries--and other countries--should stick consistently to their stabilization efforts and to their endeavors to improve the efficiency of domestic markets. That judgment did not ignore the improvement of overall economic activity in the course of 1984; indeed, the first paragraph of EBS/84/177 appeared to reflect a success story. However, his authorities, like the staff, believed that the underlying objective of steady and balanced economic growth was not yet secured. Rather, the world economic picture and fiscal and monetary developments were characterized by a broad array of favorable and unfavorable aspects.

On the favorable side, Mr. Goos continued, the most encouraging aspects, other than the reduction of inflation rates and the higher than expected growth in industrial countries, included the spreading of that growth to the developing world and the easing of the latter's external financial situation. It was particularly reassuring that "developing countries have clearly passed from the import compression phase of adjustment to the export expansion phase." The staff projected that the shift could produce an overall external deficit that would be the lowest in at least 20 years as a proportion of exports of goods and services. It was obvious that those projections could only be realized if protectionist sentiments in many countries were, at the least, resisted.

The Fund should be given considerable credit for the improvement in the overall performance of developing countries, Mr. Goos suggested, inasmuch as it had greatly contributed to better prospects by supporting stabilization programs in many countries. The corollary--namely, the kind of policies that developing countries should pursue in the period ahead--was obvious. While general statements raised difficult issues, given the considerable diversity of situations in the developing world, it would be wrong if developing countries weakened their adjustment efforts and their fight against inflation in the face of improved export receipts. The beneficial effects of sustained anti-inflationary policies were clearly demonstrated by the staff's finding that it was precisely the high-inflation countries that had experienced a sizable loss of output at the beginning of the 1980s, whereas other developing countries had had positive growth.

Among the less favorable aspects of the present outlook were the continued unsatisfactory growth performance in Europe and the difficult juncture at which the U.S. economy found itself, Mr. Goos went on. There was no doubt that faster economic growth would be most welcome in Europe, particularly in light of high unemployment. However, he agreed with the staff that significantly more expansionary fiscal policies would involve great risks. Such a course would not only undermine the credibility of official strategies and place additional pressure on international interest rates, as the staff mentioned; it would also seriously restrict the present and future room for maneuver of fiscal policy. The current restrictive fiscal policy stance had its roots to a large extent in the misconception of the 1970s--that regardless of its underlying causes, a lack of growth could be overcome by deficit spending. As all Directors were aware, that misconception had brought many countries to a position of high inflation, excessive public deficits, and indebtedness. His authorities fully agreed with the staff that, for the moment, strengthening private sector initiative by various measures offered the best possibility for achieving steady, sustainable growth.

He also agreed with the staff on the economic situation in the United States and its actual and potential repercussions on the world economy, Mr. Goos stated. There was no doubt that the extraordinarily high fiscal deficit and strong private credit demand were the driving forces behind high interest rates and the exchange rate of the dollar. The distorting effects on international capital costs and on exchange rate relationships were clearly pointed out by staff, as were the beneficial effects of the U.S. policy stance in terms of a strong stimulus to other countries' exports and growth. He was not overly concerned about the present divergences of economic developments among industrial countries, as the negative and positive effects apparently offset each other to a considerable extent. However, the crucial point was that the imbalances in the U.S. economy had, in all likelihood, reached dimensions that were not sustainable. The imminent threat of disruptive adjustment, with potentially high costs for both the United States and the rest of the world, clearly called for corrective action. That task should be assigned to fiscal policy; an easing of monetary policy would be bound to jeopardize progress that had been achieved thus far in reducing inflation rates. As in previous World Economic Outlook papers, his authorities were surprised by the rather low degree of attention that was being paid to the enormous surplus in Japan's current account and its impact on the global outlook. He invited the staff to provide further information on the issue.

During the next five years, bank credits were assumed to grow by 5 percent a year, which appeared plausible, Mr. Goos remarked, and his authorities were confident that commercial banks would be able to refinance the "hump" of loans maturing in 1987. Cooperation among banks in that regard should be strengthened and facilitated by the fact that the share of official creditors in filling the balance of payments gap of developing countries since 1983 had been larger than that of private banks. He wondered whether the staff had used the same figure for the growth in bank lending in EBS/84/177 as in the spring World Economic Outlook paper (EBS/84/33, 3/2/84) or whether it had been reduced downward to 5 percent. International collaboration could help to overcome the remaining problems; he had already mentioned the overriding need to resist protectionist pressures. In addition, his authorities continued to attach great importance to the role of the Fund in the surveillance of economic and monetary policies; in view of the uncertainties remaining in the present world economic outlook, they would welcome a refinement and intensification of that role.

He had no queries concerning the assessment of monetary and fiscal policy in Germany, Mr. Goos said. However, it was questionable whether the slight upward revision of the growth rate for 1984 was appropriate if account was taken of the prolonged strikes in the metal and printing industries. The projected increase in the current account surplus in 1985 was also surprising. According to the staff, the surplus was created through a drop in import demand between 1984 and 1985, despite almost identical real rates of economic growth. He invited the staff to comment on the implied reduction in import elasticity. Finally, with regard to the publication of the World Economic Outlook, he stressed his authorities' view that the Fund should pursue a restrictive policy. Therefore, consistent with the understanding reached in May 1984, he would prefer that only a shortened version of the report should be published.

Mr. de Vries commented that the staff presented a most favorable outlook for the world economy: inflation was coming down, budget positions were improving, adjustments were taking place in the developing countries, and the debt problem was becoming somewhat more manageable. In general, the encouraging developments reflected the appropriateness of the Fund's advice. It was also worth reflecting that Keynesian analysis remained relevant. The U.S. recovery had clearly been the result of a government deficit; such a demand management policy produced the expected Keynesian effect, provided that confidence was maintained. Thus far, confidence had been maintained in the United States and the deficit had had the traditional stimulating effect. However, that observation did not necessarily hold true in all places at all times. In the past, for example, deficits had sometimes not worked when they had brought about a lack of confidence, a point that might be valid in many European countries at present. In those countries, large deficits and the fact that governments were sometimes absorbing between 50 percent and 70 percent of the gross national product resulted in fear on the part of the private sector that government finances were getting out of control. Consequently, confidence was lacking, debt burdens rose rapidly, and the results suggested by Keynesian analysis did not come through.

A similar danger might present itself in the United States, Mr. de Vries continued. Although confidence had been maintained thus far, if the fiscal deficit continued without the prospect of effective action, confidence would wane and the authorities might lose control over economic developments, as to some extent had occurred, in Europe. It would be useful if the Interim Committee could indicate to the U.S. authorities that its members understood how the fiscal deficits had come about and recognized the favorable results that they had produced thus far. The Committee should also recognize that there was little prospect of immediate action at the present political juncture, but it should point out to the U.S. authorities that the absence of action in 1985 would have negative effects on the U.S. economy and on the value of the dollar, even if it was difficult to predict the precise point when such developments might occur. Ms. Bush had stated that her authorities were fully aware of the deficit and that they intended to take action, with almost exclusive emphasis on expenditure reductions. That single approach was generally appealing, but it might not work in the particular circumstances faced by the U.S. authorities at present. The U.S. deficit amounted to approximately $3,500 per family of four, such a large figure that all avenues would have to be explored, if the U.S. budget position was to be corrected beginning in 1985 and continuing over the medium term. Of course, the appropriate balance between revenue raising and other measures was the responsibility of the U.S. authorities themselves.

He agreed with Mr. de Groote that U.S. monetary policy could not be considered to have been restrictive recently, Mr. de Vries said. It could most appropriately be described as "accommodating." The present economic situation in the world was characterized by high real interest rates and it was not clear how long such rates could persist. Real interest rates would be reduced either through inflation, which would be inappropriate, or through action to reduce budget deficits--in all countries. Indeed, although inflation had declined, it could not properly be described as low at present, and it was only low in comparison to rates of inflation a few years earlier. Despite the important measures that had been taken and the major sacrifices that had been made to bring down inflation, it was reasonable to be concerned that inflation might begin to grow more rapidly. The beneficial effects on sustainable growth of reduced inflation were clear; therefore, medium-term demand management policy should remain relatively cautious.

It was true that, as Ms. Bush had suggested, the behavior of exchange rates was sometimes difficult to explain, Mr. de Vries went on, particularly if viewed from a traditional perspective that focused primarily on current transactions. However, at present, exchange rates reflected in large part the relative prices of financial assets and expectations about the movements in those prices. Thus, exchange rates had become less predictable; the only certain thing was that they would continue to move in both directions, depending on relative interest rates, the relative stance of monetary policy in different countries, and, of course, on the markets' perceptions of future movements. In a sense, the foreign exchange markets had taken on some of the characteristics of the stock market. The staff suggested that a further rise in the value of the dollar could lead to inflationary pressures in European countries; however, that judgment was questionable. First, during the recent rapid rise in the dollar exchange rate, European exchange rates had continued to decline. Second, European countries had reduced the degree of indexation in their economies. Third, as Mr. Kafka had pointed out, commodity prices denominated in dollars had fallen and, finally, dollar-denominated trade by Europe had declined relative to intra-European trade and trade with the developing countries.

The European economies were characterized by rigidities, Mr. de Vries commented, including rigidities in the labor market and on the part of private entrepreneurs. The situation was most worrisome. Indeed, it could be said that the problems faced by the European countries were more serious than those faced by the U.S. authorities because the major problem faced by the latter--the large fiscal deficit--was amenable to well known solutions. The task of enhancing flexibility and restoring economic vitality was much more difficult.

The developing countries were engaged in heroic adjustment efforts, Mr. de Vries observed, which were beginning to have a successful outcome. However, it would be essential to persist in those efforts; the developed countries should not hinder them through protectionist measures, the consequences of which were well known. Furthermore, neither the Fund nor the commercial banks could deal fully with the transfer of surplus savings in industrial countries to the developing countries in need of them. It was a problem that deserved far more attention than it was currently receiving. Of course, the developing countries themselves should seek to boost domestic savings and to make direct foreign investment more attractive. On the Fund's role in the world economy, he agreed with the staff's comments.

In sum, Mr. de Vries stated, there had been considerable improvements in the world economy, but, while present developments were favorable, the situation was not sustainable. A number of elements would have to be dealt with if failure was to be avoided, including the budget deficit in the United States, the deficits and the level of government expenditures in other industrial countries, the movements in exchange rates, the rigidities in the European economies, and the high real interest rates. He hoped that all those problems would not be resolved in an uncontrolled manner.

Mr. Angeloni commented that the staff presented a picture of a world economy that was quickly emerging from depression but that was still plagued by deep imbalances, which included the rates of economic activity, the structure of international payments, the stances of economic policy, and the financial positions of many developing countries. The conclusion that had emerged from the previous discussion of the world economic outlook (EBM/84/48 and EBM/84/49, 3/30/84, and EBM/84/50, 4/2/84) remained valid, namely, that economic policymakers worldwide would have to take the opportunity of the current momentum to tackle those imbalances and to create the conditions for sounder, more sustainable growth.

With regard to the debt problem, Mr. Angeloni continued, the staff's analysis suggested that it appeared to be manageable in the coming years, provided appropriate policies were pursued. The staff also suggested that the most recent trends were definitely in the right direction, indicating that the main difficulties for the heavily indebted countries were for the most part over. The latter point had been expressed particularly clearly on page 16 of EBS/84/177 where the two aspects of adjustment--import compression and export expansion--were described as "distinct phases." A correct perspective on the two points made by the staff would take into account the fact that the debt problem was not so much a broad geographical problem as a problem of individual countries. Focusing attention on data for broad nonhomogenous country groups could lead to misleadingly optimistic assessments. The staff had been clear in that regard and the use of the new classification of "major borrowers" was useful, although occasionally it became more difficult to compare the data with the data in the previous World Economic Outlook paper (EBS/84/33, 3/2/84). However, even that more selective classification concealed a good deal of diversity with regard to the size of debt and the structure of the countries' foreign trade, so too much attention should not be focused on it.

Table IV.1 was helpful in evaluating the manageability of the debt problem in the next few years, particularly with regard to the noninterest portion of the current account, Mr. Angeloni considered, which indicated approximately the intensity of the adjustment effort necessary to reconcile a given evolution of net indebtedness with the burden of interest payments. The ratio of noninterest current payments to exports for the seven major borrowers, which had been approximately zero in 1982, had risen to 16.6 percent in 1983, a year of severely compressed imports, and was expected to be 16.7 percent in 1984 and to rise to 18.1 percent in 1985, declining only modestly to 15.3 percent in 1987. For some countries in the group, the figure would clearly be higher; in the case of Brazil, for example, the ratio would be about 22 percent in 1985. In light of that data, it was difficult to endorse the view that the two phases of adjustment were, in fact, temporally distinct and that the beginning of export expansion marked the end of import compression. On the contrary, the projections implied that the countries involved would be required to adapt in the medium term to a historically different relationship among imports, exports, and growth, a structural change that was dramatically documented in the lower right part of Chart 9. Whether the outlook could be considered manageable was difficult to say, particularly given the political and social aspects of the problem. It was certain that neither the outlook nor the most recent data justified excessive optimism and that the pursuit of supportive financial and trade policies in the industrial world, together with the adjustment efforts of the developing countries, was as important at present as it had been six months ago.

The effect of growth in industrial countries on the debt outlook was a related issue, Mr. Angeloni stated. It was difficult to estimate the overall effect, because to do so would require estimates of trade elasticities, the elasticities of the prices of the main commodity exports, and interest rate responses in the financial markets. The staff pointed out that changes in the environmental assumptions in the past six months had significantly improved the current account projections for major borrowers in 1984 and 1985; it would be interesting to know if those results were valid for the individual countries in the group and to have an indication of the order of magnitude of the elasticities involved.

If, for the sake of illustration, Mr. Angeloni went on, the value of export elasticity in developing countries with respect to OECD growth was about 2, and the global response of OECD growth to U.S. growth was approximately 0.6, and if, furthermore, a 1 percent increase in U.S. growth was estimated to raise the interest rate level by about 0.8--in line with the money demand estimates in the most recent report on economic developments in the United States (SM/84/178, 7/20/84)--an increase in U.S. growth, under given monetary and fiscal policies, would worsen the current account of countries in which the ratio of floating interest rate debt to exports was greater than 1.5, which was a ratio lower than in at least some of the major borrowers. Furthermore, that simple calculation did not consider the possible effect of a dollar appreciation on the real price of commodities exported by developing countries, which could make the situation even worse for those countries that exported primary commodities and imported manufactured goods. In sum, the substantial momentum of growth in the industrial countries, though certainly an important stimulus for the world recovery, might not necessarily be sufficient to induce, without adequate supporting policies, a significant improvement in the financial situation of some of the largest debtors.

Commenting on the prospects for recovery in the industrial world, Mr. Angeloni said that he generally agreed with the staff's analysis. The size of the existing payments imbalances and the divergence in policies increased the degree of uncertainty in the projections. The extent to which the current recovery was related to the depth of the previous recession and the probability of a "soft landing" to historical growth rates were difficult to evaluate at present. One important aspect that appeared to have been little investigated thus far was the effect of the tax system on the cost of capital in the major industrial countries in the present phase of the cycle. Interest deductibility provisions, depreciation rules, and the like, could well have a substantial role in supporting capital formation in the United States, while different fiscal structures implied that a rise in world interest rates might have dissimilar effects in different countries. It would be useful if the matter could be examined more deeply, so as to provide a basis for comparison among the industrial countries.

He saw no strong reason to oppose the idea of publishing the World Economic Outlook in the fall as well as in the spring, Mr. Angeloni remarked, although there were two practical problems. First, it was difficult to define the minimum text necessary for an understanding of the tables, particularly because the tables contained projections that, if not supported by comments, might generate ambiguous and incorrect interpretations among outside readers. Second, if the comments were extensive, the paper would overlap with the Annual Report. Of the two risks, he preferred the latter and believed, therefore, that if the tables were to be published they should be supported by an adequate descriptive text. Mr. Kafka's suggestion that the World Economic Outlook paper should not be published at all avoided both risks, which might be the best option at present.

Mr. de Maulde said that at the time of the previous discussion of the World Economic Outlook his assessment of the prospects had been less accurate than that of the staff. He had expressed strong doubt about the sustainability of growth in the industrial countries and of the adjustment process in developing countries and he had, therefore, been more pessimistic than the staff. The paper before Directors indicated that he had been wrong in the short term. Output in the industrial countries was expected to increase by almost 5 percent in 1984, an upward revision of more than 1 percent since the previous projection. The developing countries were also expected to perform better than anticipated earlier, particularly as a result of an unexpected strengthening of their exports. In the spring, he had not believed that there would be such a huge increase in the current account deficit of the United States, which was expected to reach $84 billion in 1984 and $109 billion in 1985. He had also underestimated the impact of the persistently large fiscal deficit in the United States and in Canada. In that regard, he agreed with Mr. de Vries's remark that the present situation reflected a classical Keynesian process. However, it was possible that, having been wrong in the short run, his assessment might prove more correct in the longer run. He continued to believe that the recovery was extremely fragile and that it was unsustainable in the medium term unless urgent, decisive actions were taken.

With regard to the situation in industrial countries, Mr. de Maulde continued, the recovery was clearly weak outside the United States and Canada. The problem stemmed from the fact that growth in North America was unbalanced. The excess demand generated by the combination of high consumer expenditure, strong business investment, and a huge fiscal deficit had led to a very large external gap, currently financed by the rest of the world through unprecedently high interest rates. The combination had two opposing consequences for the rest of the world. While it helped activity in those sectors producing goods and services that could be exported to the United States, it exerted a strong dampening influence on the other sectors of national economies, particularly through the impact of interest rates. Overall, recovery was being prevented from spreading broadly to the other industrial countries, which put at risk and increased the cost of the adjustment process in the developing countries.

However, he fully agreed with the staff that those industrial countries that had not yet completed their adjustment efforts should continue in that direction, Mr. de Maulde remarked, particularly given that some countries were in a position to adopt more stimulative fiscal policies. More generally, he agreed that the European countries should also continue to address their structural problems in order to put themselves in a better position to benefit fully from the growth opportunities that would, he hoped, emerge when the international level of interest rates had decreased significantly. He shared Mr. Goos's comments on the way in which the staff had dealt with the imbalance in the Japanese current account, which was moving in the opposite direction from the external position of the United States.

The analysis of the problem of debt and adjustment in the developing countries was similar to that made by the staff in the previous World Economic Outlook paper, Mr. de Maulde observed. The more realistic revision of the environmental assumptions used in the medium-term scenario for developing countries was welcome. Nevertheless, the scenario remained somewhat optimistic because it rested on a combination of assumptions of sustained growth in the industrial world, a sharp decrease in interest rates, and the pursuit of strong adjustment efforts by the developing countries themselves. For 1985, the assumption that the impact of higher interest rates would be offset by increased export earnings was bold in view of the signs of a slowing down in the U.S. and European economies and of the fact that interest rates were already above the levels used in the staff's projections. For the future, two uncertainties were important. First, would developing countries be in a position to implement the necessary structural reforms and to undertake indispensable investment? Second, would the financial flows to those countries be sufficient to enable them to meet their debt servicing requirements, their import needs, and their investment goals?

Five main policy conclusions emerged from the staff's analysis, Mr. de Maulde suggested. First, the structural imbalances that had emerged in the U.S. fiscal deficit in the past two years had to be corrected urgently and in an orderly manner so as to achieve a reasonable, sustainable pattern of interest rates and exchange rates. Second, the more deeply rooted structural rigidities of the industrial economies would have to be corrected. Third, the progress achieved in reducing inflation should be consolidated, particularly through the pursuit of sound monetary policies. Fourth, the debt problem would have to be dealt with effectively on many fronts, not simply through adjustment programs linked to debt reschedulings; in that regard, he agreed with most of the comments made by Mr. Kafka. Fifth, international cooperation should be reinforced through an appropriate combination of measures to resist protectionism, more effective surveillance by the Fund, sufficient financing by the Fund, and the resumption of SDR allocations. Finally, he could support the publication of the World Economic Outlook as proposed in EBS/84/177, Supplement 1.

Mr. Ismael commented that there had certainly been significant progress in the world economy toward growth and price stability since 1982. In particular, inflation had remained at a relatively low level since 1983 and was expected to continue in that direction in 1985. However, a similar conclusion could not be reached with regard to the prospects for growth in global output. The strategy for recovery, which all Directors supported, albeit with a lesser degree of enthusiasm on the part of many of the Directors from the developing countries, had called for a policy stance by the major countries that would enable growth to be sustained over a longer period without being choked off or hindered by inflation. The staff supported the continuation of such a policy in the present economic circumstances. He agreed with that position in the interest of removing the structural deficits of many major industrial countries, but he was concerned that support for such a policy on a global basis might be counterproductive and might abort the possibility of attaining the objective of sustained growth as it could lead to a lack of the underlying conditions for domestic recovery.

The staff, and other observers, had noted that the present recovery had been led mainly by the strength of recovery in the United States, Mr. Ismael continued, which had brought about strong overseas demand. In both Europe and Japan, the growth in exports far exceeded the growth in domestic demand. However, domestic-led recovery in those countries remained in doubt, particularly in Europe. If the U.S. recovery had already peaked, or if deflationary measures were to be taken in the United States, developments that could be welcomed on other grounds, what would be the consequences for the rest of the world if U.S. growth declined significantly? The implications of such developments were clear from the staff's projections in Table 1 of EBS/84/177. Europe continued to face high unemployment, and, if domestic demand in Europe did not pick up in the near future, the world economy could enter another recession shortly. The situation called for more aggressive domestic policies, perhaps a more expansionary fiscal policy, on the part of the European countries, if the recovery was to become more broadly based. He invited the staff to comment on the issue.

He shared the staff's apprehension about the uncertainty of the current projections, Mr. Ismael stated. High real interest rates were clearly an obstacle to adjustment in the highly indebted countries. Because those rates appeared to originate in the United States, they had brought about an unprecedentedly high exchange rate for the dollar. The prolonged continuation of the present situation could precipitate a sharp reversal in the dollar rate with unwanted consequences for many countries. There was little need to elaborate on the growing tendency toward protectionist policies and on their consequences. On many previous occasions, Directors had called for a roll-back in protectionism, but the results had yet to be seen. The Fund's ineffectiveness as an institution in addressing that important issue was disappointing. It would be useful if the Fund could cooperate more closely with the GATT.

The improvement in the external position of the indebted countries was welcome, Mr. Ismael went on, but as the Chairman had pointed out at the conclusion of the Executive Board's discussion on access limits (EBM/84/134 and EBM/84/135, 9/5/84), there were dangers ahead if the pattern of improvement was not broadly based. Some important countries continued to experience serious imbalances. While the global debt situation was improving and was under control, the uncertainty surrounding the sustainability of global economic growth made the whole situation precarious. The role of the Fund should be strengthened so that it could play a more effective part in the adjustment process. Recent developments with respect to the lengthening of debt maturities under rescheduling exercises deserved support; the innovation was justified and timely. However, his authorities believed that the benefits of the lengthening of such maturities should be made available to other indebted countries that had successfully undertaken adjustment programs, whether with Fund support or alone.

Mr. Sangare remarked that the staff demonstrated clearly that economic recovery was established in the industrial countries and that the effects had started to reach out to the developing world. The expected increase in output in the latter area of 3.7 percent in 1984 and 4.4 percent in 1985 seemed to confirm that assessment. He had read EBS/84/177 in conjunction with the recent paper by the World Bank entitled "Toward Sustained Development: A Joint Action Program for Sub-Saharan Africa," which was one of the background papers for the forthcoming meeting of the Development Committee. In EBS/84/177, GDP growth in Africa, excluding South Africa, was shown to have fallen from 3 percent in 1980 to 1.7 percent in 1981, 1.3 percent in 1982, and 0.8 percent in 1983, and was expected to accelerate to 3.2 percent in 1984 and 3.6 percent in 1985. The realization of the staff's projections would be a welcome relief. However, the picture for sub-Saharan Africa seemed different. According to the data in the World Bank report, the combined output of those countries, after growing by an average of 3.6 percent a year until 1980, had fallen every year since then. Thus, the global picture outlined in EBS/84/177 should be viewed with caution, otherwise the wrong impression could be created that African countries had joined the bandwagon of recovery. In that regard, the World Bank report appeared to highlight much more clearly the problems of sub-Saharan Africa, which had been largely bypassed by the recent recovery. Per capita output in that part of Africa had continued its downward trend in 1983, when it had been about 11 percent below the 1980 level.

The views of his authorities, based on the observation of domestic and external facts, were generally closer to the conclusions of the World Bank study to the extent that the optimistic conclusions about the world economy that seemed to emerge from the data presented by the Fund staff tended to mask the precarious state of the economies of most African countries, Mr. Sangare stated. Thus, while the signs of progress in the global economy should be welcomed, it should also be acknowledged that there were many countries that had not been able to arrest the almost secular deterioration of their economies. Even in those non-oil developing countries that had managed to increase output in 1983, per capita absorption was on average probably about 3-4 percent below its 1980 level. The situation implied that during that period economic growth had been accompanied not by a rise but by a decline in the standard of living, mainly because much of the increase in output had had to be used to meet the heavy debt service burden. The staff correctly pointed out that it had been a more difficult problem for many low income countries, particularly those in which the recent declines in living standards were from an already low level and were following several years of virtually no growth in per capita incomes. Many African countries consistently fell in that category.

One of the basic conclusions of the staff was that "the developing countries have clearly passed from the import compression phase of adjustment to the export expansion phase," Mr. Sangare said, which suggested that developing countries could now rely more on exports to finance their imports, something that was likely to make the adjustment process less burdensome. Again, his authorities viewed that generalization as too broad because it did not fit with their own experience. For all practical purposes, it seemed unlikely that Africa, which was almost totally dependent on primary commodities for exports, would be able to increase imports through improved export earnings in the short run. There was considerable concern that commodity prices might not turn out to be as favorable as expected earlier. There was also the question of the decline in the world market shares for most export crops produced by Africa, such as oil seeds, tea, bananas, cotton, and coffee. The problem of increased protectionism had also directly affected Africa. Among the goods affected by that protectionism were sugar and livestock; the situation was compounding an already difficult external environment. The base scenario in EBS/84/177 assumed that industrial countries would not introduce additional tariffs or trade restrictions. The realism of that assumption was questionable, in light of what was known from various reports and from what the staff itself concluded--namely, that "there is little evidence of even a standstill of protectionist measures."

His authorities were aware of the important role of domestic policies in creating conditions that would improve the external sector of their economies, Mr. Sangare went on, particularly policies aimed at increasing production and at exploiting their comparative advantage to the fullest. It was essential to note, however, the necessity for increases in net capital inflows to sub-Saharan Africa, as only such flows could strengthen the capacity to achieve the goal of economic growth. Unfortunately, the World Bank study of sub-Saharan Africa suggested that the prospect was not encouraging. The World Bank estimated that for the period 1985-87 net capital inflows to the region would drop to an average of $5 billion, from $8 billion in the period 1980-82. The situation was grim and required special action on the part of the international community, particularly in providing meaningful additional assistance to countries that were implementing programs aimed not only at financial stabilization but also at long-term structural change with a view to promoting growth and development. Policies that gave developing countries easy access to markets in industrial countries were a necessary complement to measures taken in developing countries to encourage domestic production of export commodities.

Commenting on external debt, Mr. Sangare agreed generally with the remarks made by most other Directors. With regard to the situation in Africa, the debt burden of sub-Saharan Africa was expected to rise from $9.9 billion in 1984 to an average of $11.6 billion in 1985-87. If arrears were taken into account, the picture was even more grim. Servicing obligations in 1984 would increase by about 30 percent if all arrears were to be repaid in that year. Debt renegotiations had been helpful. However, because they had not been carried out in a longer-term framework, the relief gained had in most cases been shortlived. Therefore, his authorities supported the idea of multiyear reschedulings that would give debtor nations more room in which to plan for the future.

As for adjustment in developing countries, Mr. Sangare observed, most countries--certainly those in his constituency--saw the merit of pursuing policies aimed at ensuring financial discipline, at bringing demand more in line with available resources, and at promoting the development of their productive sectors. Indeed, many countries had adopted measures in that direction. However, because such actions had been at the cost of reduced living standards, it would be impractical to assume that they could continue indefinitely without the authorities coming under pressure from the people or without straining the social fabric of those countries. At the present juncture, his authorities believed that the next phase of the adjustment process would have to give due attention to economic growth and long-term structural change. Unless sufficient goodwill and determination was shown by all parties--developing and developed countries--to reverse the adverse tendencies that were affecting, in particular, trade and financial aid cooperation policies, the staff's projections regarding the growth rates for sub-Saharan Africa were unlikely to be realized.

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

APPROVED: June 25, 1985

LEO VAN HOUTVEN
Secretary