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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 84/138

3:00 p.m., September 7, 1984

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

Executive Directors	Alternate Executive Directors
	J. K. Orleans-Lindsay, Temporary
	L. E. J. M. Coene, Temporary
	X. Blandin
	M. Teijeiro
	M. K. Bush
	D. C. Templeman, Temporary
M. Finaish	
H. Fujino	T. Yamashita
	B. Goos
J. E. Ismael	
R. K. Joyce	L. Leonard
A. Kafka	H. A. Arias, Temporary
G. Lovato	
R. N. Malhotra	A. S. Jayawardena
Y. A. Nimatallah	
	A. A. Scholten, Temporary
	K. G. Morrell
G. Salehkhou	
F. Sangare	
	E. Portas, Temporary
	E. Olsen, Temporary
	T. A. Clark
Zhang Z.	

L. Van Houtven, Secretary
B. J. Owen, Assistant

Also Present

C. F. Schwartz, Consultant. Administration Department: H. Wiesner. Asian Department: U. Baumgartner. European Department: P. B. de Fontenay, Deputy Director; S. Kashiwagi, P. J. F. Nyberg. Exchange and Trade Relations Department: N. Kirmani, C. Puckahtikom, C. M. Watson. External Relations Department: C. S. Gardner, Deputy Director; H. P. G. Handy, I. S. McDonald. 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. D. Crockett, Deputy Director, R. R. Rhomberg, Deputy Director; J. Artus, C. P. Blackwell, J. E. Blalock, M. E. Bond, M. C. Deppler, M. D. Knight, A. Lanyi, P. R. Masson, M. C. Williamson. Secretary's Department: A. P. Bhagwat. Western Hemisphere Department: S. T. Beza, Associate Director. Personal Assistant to Managing Director: S. P. Collins. Advisors to Executive Directors: A. A. Agah, E. A. Ajayi, S. El-Khouri, K. A. Hansen, S. M. Hassan, M. Z. M. Qureshi, A. Vasudevan. Assistants to Executive Directors: H. Alaoui-Abdallaoui, I. Angeloni, Chen J., C. Flamant, G. Gomel, D. Hammann, A. K. Juusela, H. Kobayashi, G. W. K. Pickering, M. Rasyid, J. Reddy, D. J. Robinson, S. Sornyanyontr, A. J. Tregilgas, Wang C. Y., M. A. Weitz, A. Yasseri.

1. WORLD ECONOMIC OUTLOOK - GENERAL SURVEY

The Executive Directors resumed from the previous meeting (EBM/84/137, 9/7/84) their consideration of a staff paper giving a general survey of 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; Sup. 1, 8/20/84).

Mr. Zhang considered that the useful diagnoses and conclusions reached by the Executive Board earlier in the year (EBM/84/48 and EBM/84/49, 3/30/84, and EBM/84/50, 4/2/84) were still apt. The staff's earlier projections also remained a reasonable reflection of the balance of probability despite some changes in world macroeconomic variables. The medium-term scenarios in the latest general survey showed the balance of payments and debt positions of developing countries as developing in a broadly similar way to that described in the earlier survey.

Nevertheless, it had to be borne in mind, Mr. Zhang observed, that while some progress had been made recently in negotiating debt rescheduling for some countries, no proposals were yet in sight that attempted to offer either a fundamental solution of the international debt problem or a generally applicable formula for rescheduling. In addition, there were still many uncertainties in the world economy overall: the economic recovery in many industrial countries was still weak; the forces of protectionism kept on rising; and the prospects for increased international capital flows were not very encouraging. Unless fundamental changes took place, growth in developing countries would continue to be constrained, even for those countries that had adjusted rather successfully; the key priorities in their domestic policies were conditional upon developments in the world economy at large. There was not much cause for optimism in that respect at the present juncture.

The need to sustain the momentum of worldwide recovery without re-igniting inflation was pointed to in the staff report, which then proceeded to recommend that industrial countries should maintain their stated policy intentions, Mr. Zhang noted. In other words, the United States should reduce its fiscal deficit, and countries in Europe and Japan should maintain a restrictive fiscal stance on a cyclically adjusted basis alongside broadly unchanged, restrained monetary policies. Was that recommendation appropriate? He would agree that a tightening of the U.S. fiscal position was vital, both for domestic considerations--with the economy approaching constraints on capacity--and for lessening the international repercussions of the divergent U.S. policy mix. But since it could indeed be argued that the strength of the U.S. expansion was underpinning the growth of exports and output in the rest of the world, there was a real danger that a move to curb the U.S. fiscal deficit sharply and abruptly would tend to weaken prospective growth outside the United States.

A two-sided convergence of fiscal policies was therefore called for, Mr. Zhang considered, with the United States tightening and countries outside North America carefully relaxing their fiscal stance. Such a cross-country convergence would lessen the damaging disparity between fiscal and monetary policy stances in the United States, while nonalignment of fiscal and monetary policies in Europe created a certain tension. The consequence might be that high interest rates would continue, at least for some time, but that might be a necessary concomitant of restoring world economic activity and employment while avoiding an inflationary acceleration of monetary expansion. The staff had argued that more expansionary policies in Europe would be risky: first, because they would raise doubts about the durability of the official strategy of medium-term financial stability--thus weakening one of the factors in the nascent recovery of demand--and second, because such a shift would have adverse effects on international interest rates. The staff view seemed to a significant extent to reflect that of several European governments. But to suggest, as the staff had emphasized on page 37 of EBS/84/177, that other industrial countries should forgo the adoption of more expansionary fiscal policies in order to avoid adding to the pressure on interest rates surely amounted to suggesting that they should be prepared to suffer continuing pressures on savings and exchange rates in order to keep down interest rates in their own countries and worldwide. A more important question was how much longer such restrictive policies could be maintained without a serious longer-term impact on employment, income, output and exports in those countries.

The vital importance of reducing the U.S. deficit in the fairly near future was a matter of universal agreement, Mr. Zhang commented. But the staff had not looked ahead to the situation that would arise should that objective not be realized, nor had it suggested what the international community could then do. Thus, unless the severe conflicts in the policy mix of the industrial countries were resolved, true international cooperation would not be possible.

With some hesitation, Mr. Zhang mentioned his belief that the recent problems of European economies could not be explained in terms of a single factor, such as structural weaknesses, and, in particular, rigidities in labor markets, which the staff had cited as a major factor preventing those countries from freely exploiting opportunities for growth. The specific character of such wage rigidities and of the measures that might overcome the structural weaknesses had not been carefully covered in the staff paper. He was inclined to think that wage flexibility was a function of various problems, such as the close link between labor's power to organize and to maintain wages in the face of unemployment and production conditions, as well as business practices in advanced economies, which were characterized by imperfect competition, monopolistic control of technology, price maintenance, and even organized political lobbies. He looked forward to hearing the staff views on that issue.

Finally, Mr. Zhang expressed his agreement with the staff proposal for publishing the updated survey.

Mr. Morrell said that his authorities generally shared the staff's view of the world economic outlook for the period ahead. However, despite the expectation that output in industrial countries would grow by some 5 percent in 1984, the continued disparity in their performance, with robust growth in the United States, moderate expansion in Canada and Japan, and a far more tentative recovery in Europe, was a key issue. Moreover, the quickening pace of recovery had not thus far been accompanied by any significant change in inflationary prospects in industrial countries generally; their rate of inflation was expected to stabilize at about 4.5 percent in 1985. Economic recovery in the industrial world was beginning to exert a significant impact on developing countries, whose GDP was expected to increase by about 3.75 percent in 1985, a faster growth of output than of population for the first time in five years. It was an encouraging but not outstanding development because of the low base from which the increase had to be measured, output having failed to keep up with the rate of population growth for some years previously. The fragility of the economic recovery was a matter of concern to some of his authorities, who had pointed out that its benefits were not yet tangible in many developing countries.

The immediate problem for the United States, Mr. Morrell agreed with the staff, was how to achieve a deceleration of growth without actually arresting or reversing it. For Europe, the main problem was to strengthen private investment and bring down high unemployment. He could endorse the staff's continued belief that the overall policy strategy pursued for several years, which tended to provide a stable medium-term framework for private decision-making, should be maintained in all industrial countries. The economic problems facing the United States were in large part associated with a departure from that medium-term strategy, and Europe would not find the solution to its own problems by taking a leaf out of the book of U.S. fiscal experience.

The harmonization of U.S. and European policies should not lead to stimulatory demand management in Europe, Mr. Morrell stated, but rather to a determined effort by the United States to reduce its structural deficit, preferably by reductions in expenditure but if necessary by increases in revenue. If policies of fiscal stimulation were followed in Europe, there would be a considerable risk of rekindling inflationary pressures in circumstances in which, with the possible exception of Germany, the objective of containing inflation had been incompletely fulfilled. In the United States it was clear that uncertainty existed about how long growth could be sustained by the present policy stance and that the chances of a soft landing for the economy would appear to be decreasing the longer the present fiscal policy was allowed to persist. As Mr. de Vries had observed, confidence would be an important factor in the success of present U.S. policies. Real GNP growth was not expected to continue at its current pace beyond 1984, so that the rate of economic expansion in the United States should ease in 1985 as stockbuilding ran its course, the economy moved nearer to capacity, and high interest rates took their toll of consumption and investment.

Although many industrial countries had large fiscal deficits, Mr. Morrell continued, concern inevitably focused on the fiscal stance in the United States. Financial markets the world over remained sensitive to economic conditions and policies in the United States; particular concerns were harbored about the possible clash of private and public sector credit demands and possible moves to alter monetary policy. The authorities were cognizant of the problem, as their recent tentative steps toward dealing with the budget deficit indicated, but the modest size of the downpayment made to date--especially as it related to the period immediately ahead--would lend little, if any, assurance to financial markets in the next year or so. Under present policies, the U.S. fiscal deficit would not shrink significantly as recovery proceeded. Accordingly, the stock of public debt would continue to swell, with potentially serious consequences in terms of future budgetary tension and strains on financial markets.

For most of the European economies--in spite of an ongoing need to achieve macroeconomic balance by reducing inflation and budget deficits and by ensuring enough profitability to sustain recovery in business investment--furthering the recovery was as much a matter of improving the underlying structure of economies that appeared to have lost the dynamism and flexibility to generate strong growth as of redressing macroeconomic imbalances, Mr. Morrell observed. In the end, no amount of manipulation of the instruments of macroeconomic control could transform a noncompetitive, inflexible and sluggish economy; the dynamics of growth sprang from the ability to adjust to changing circumstances, and regulation and protection could impair that ability. The short-term benefits from increased protection and other forms of assistance should not be allowed to distract attention from the more substantial adverse effects over the longer term. In the absence of competitive forces, industries might have little incentive to pursue gains in productivity; similarly, neither human nor capital resources would have much incentive to move into newer areas of industry. Yet it was precisely the development of new industries and the restructuring of established ones that was critical to the longer-term health of any economy. Ultimately, structural change could not be avoided; either an industry made the necessary changes and became competitive or it eventually shrank into insignificance. Attempts to resist the inevitable risked stultifying the beneficial effects that could and did flow from structural adjustment.

For those reasons, Mr. Morrell added, the staff was correct to point out that the situation in Europe "...leaves a severe challenge for policymakers, perhaps more complex than the earlier task of restoring better price stability." Measures would have to be found to improve the prospects for output and employment without creating concerns in the minds of consumers and investors that a return to stop-and-go policies was in the offing. Because the recovery in output and employment in major European economies had been inhibited by a relative lack of flexibility and adaptation in product and labor markets, it was vital that those countries should focus attention on the functioning of their goods and labor markets in order to strengthen performance and improve the prospects. The policies to be considered should encompass the following measures: first, efforts to bring down the real costs to enterprises of employing labor in order to stimulate more labor-intensive activities and investment, including the establishment of less rigid wage structures--thus making labor markets more competitive and reducing nonwage labor costs, in particular employers' social security contributions--second, tax policies that emphasize a moderate overall level of taxation on investment income; third, the avoidance of distortions and the stabilization of taxes rather than ad hoc investment incentive programs; and fourth, systematic and concerted actions to reverse the tendency to depart from market-oriented trade policies, actions which could make a major contribution to sustained growth, trade expansion, and financial stability.

In the present environment, Mr. Morrell agreed with the staff that although the stronger export performance by developing countries would make possible some acceleration in import growth, it would be prudent for them not to let up on adjustment measures designed to improve the functioning of their domestic economies, and to devote at least part of any short-term surge in export proceeds to improving their external financial position. He had been disappointed at the failure of the staff to apply the concepts sketched in Section 2 of Part IV on the sustainability of the prospective debt situation. If anything, the questions formulated--and unanswered--in that section were crucial to policy design in debtor countries. The unfortunate omission left the paper open to the criticism that it failed to justify its own optimistic conclusions about the economic outlook for debtor countries, let alone provide a thorough basis for its policy prescriptions. As Ms. Bush had suggested, it might be wise not to publish that particular section.

The role of Fund surveillance was important in highlighting the interdependence prevailing in the world economy at present, Mr. Morrell noted, and in drawing out the implications of that interdependence, including the need to resist, and roll back, protectionist pressures, especially the barriers increasingly set up against the exports of newly industrialized countries to the industrial countries; the need for increased flows of overseas development assistance; the desirability of encouraging a greater volume of private direct investment in developing countries; and the importance of providing a medium-term framework for refinancing debt. Probably the most crucial implication of interdependence, however, was the great responsibility that lay with major industrial countries to ensure the smooth and sustainable global economic expansion necessary to ease the international debt problem.

The inevitable adjustment that some large industrial countries would have to make raised fears that the necessary correction of the present abnormal pattern of exchange rates and current account balances, if not handled carefully and if delayed unnecessarily, might be too precipitous and disruptive, posing threats to international stability, at least in the short term, Mr. Morrell considered. For instance, the momentum behind the growth in the U.S. economy was likely to falter during the remaining months of 1984 and into 1985 as a result of rising interest rates and distortions in exchange rates. The precise impact of any sharp slowdown in U.S. growth in 1985 on developments elsewhere in the world was uncertain, but it could well be adverse, particularly in the short run. Eventually, such a slowdown would trigger a downward adjustment in U.S. interest rates, with an associated large depreciation of the U.S. dollar. Clearly, as stated on page 35 of EBS/84/177, divergences in national economic conditions among major industrial countries "...are generating conflicts of interest and create serious problems both for these countries themselves and for the rest of the world."

For those reasons, Mr. Morrell stated, it was important to recognize the contribution that industrial countries could make to easing the external debt situation of developing countries, particularly by taking steps to improve the global economic environment. The policies of creditor countries would be a main factor in improving market access for exports of debtor countries and in ensuring an adequate net flow of official and private capital to debtor countries to support the adjustment process. But the fundamental role of industrial countries was to pursue policies that encouraged a sustained economic recovery, thereby ensuring steady growth in the demand for exports of developing countries, and to avoid undue competition for savings between government and the private sector, thereby achieving some moderation of present high interest rates.

He took a cautious approach to the publication of the staff paper on the World Economic Outlook after the Annual Meetings, Mr. Morrell stated. He did not fully share the view that to avoid any risk, nothing should be published, but he considered that it might be best to publish only tables with an explanation, rather than a complete survey, so soon after the publication of the Annual Report.

Mr. Clark commented that the world economic situation, while it had improved, was not greatly different in its essentials from the one considered earlier in the year. Nevertheless, there had been some noteworthy developments in the past six months. For instance, it was clear that real GDP growth in the industrial countries in 1984 would be appreciably higher than expected, largely due to the remarkable pace of the U.S. recovery. Another related development was the stronger than projected rise in the exports of non-oil developing countries. In addition, interest rates had reached and stayed at higher levels than estimated, a disturbing trend. While the prospects for growth were perhaps better than they had been for some time, the substantial remaining imbalances in both domestic economies and in the international economy threatened the sustainability of that growth. Those uncertainties had important implications for the debt problem, which remained difficult; indeed, his authorities were rather more cautious than the staff about the prospects for external financing, particularly with respect to the debt hump from 1986 to 1988. Clearly, for the longer term, major structural problems and unemployment--the latter more especially in Europe--remained serious and widespread and were contributing to continued pressures for protection in developed and developing countries alike.

So far, the recovery had followed a fairly normal cyclical path, the most distinctive feature being perhaps the strength of business investment, particularly in the United States, Mr. Clark remarked. As the staff had noted, because of the divergences in fiscal policies among countries and the differences between growth rates of GDP and domestic demand, the recovery had been accompanied by the emergence of major and growing imbalances. As an illustration, he would note that the United States was absorbing external resources at a rate roughly equal to the gross national product of Belgium; the cause was largely the U.S. fiscal deficit, and its reduction was as ever a first priority. In that respect, he endorsed Mr. de Vries' remarks about the risks of future instability, especially in exchange rates.

Past and prospective non-oil commodity prices, in real terms, were weaker than might have been expected, given the path of output, Mr. Clark considered. He would be grateful for the staff's comments on the possible reasons.

Prudent monetary and fiscal policies, set in a medium-term framework and bolstered by measures to improve the functioning of markets, were the appropriate way in which to achieve sustainable growth, Mr. Clark stated. Accordingly, any relaxation of fiscal or monetary policies would be inappropriate at present. Although inflation rates had been brought down significantly in many countries, they were often still too high and significantly above the levels of the 1960s.

As he had said on the occasion of the previous discussion of the World Economic Outlook, Mr. Clark recalled, and as Mr. Morrell had just noted, the functioning of labor markets would have to be improved if unemployment was to be brought down. In some cases, real wages were too high to encourage reabsorption of the unemployed into jobs. In that connection, it would be helpful if the impact of government policy on total employment costs and on the cost of capital could be alleviated. In addition, relative real wages within the labor force might sometimes be a main cause of persistent unemployment. Relative pay was heavily influenced by traditional ideas of the importance of different sectors of the economy and might no longer correspond to the relative cost of the capital that had become available as a substitute for different categories of labor. He suggested that the Research Department or the Fiscal Affairs Department might take up some of those issues.

The large differences between the debt positions and adjustment needs of developing countries made it difficult to draw general conclusions about the priorities for policy, Mr. Clark remarked. But again, he agreed with the staff that the focus of adjustment should be shifted to export expansion. To be successful, such a policy would depend greatly on growth in the industrialized countries, but it would also depend on the adoption by the developing countries themselves of policies to enhance their supply capacity. He had taken note of the policies described by the staff for achieving that objective on page 47 of EBS/84/177. The policy implications for the developing countries of recent improvements in their trade accounts and the simultaneous rise in interest rates were not clear, as the staff had noted, and much would depend on individual circumstances. Many countries, particularly those with low reserves, might find it prudent to use at least a portion of the extra resources available to strengthen their external financial position. But for other countries, whose imports had been severely reduced and whose current account position was under control, it might be appropriate, and indeed necessary, to renew imports to underpin renewed growth.

He fully supported the staff's views on the need to continue to resist protectionist pressures and to reduce trade barriers, Mr. Clark continued. It was particularly important to allow non-oil developing countries full access to developed countries' markets. It was also of importance to promote private direct investment, which could usefully supplement other financial flows.

His authorities set great store by Fund surveillance in Article IV consultations and the adjustment programs it supported, Mr. Clark added. It was essential to analyze fully and understand the international consequences of the policy actions of major industrial countries. His authorities therefore welcomed the discussion in the World Economic Outlook Survey of the policy choices facing the industrial countries and of their interaction; they hoped that the exercise would be extended to future surveys, especially for industrial countries other than the United States.

On the publication of the Survey, Mr. Clark stated a preference for publishing a relatively short paper. Therefore, he preferred the staff proposal to publish an edited version of Chapter II.

Mr. Teijeiro observed that the improvement in the world economy, led by the behavior of the U.S. economy, was contributing to growth in many less developed countries that had moved from the import compression phase of adjustment to the export expansion phase. Nevertheless, as many Directors had pointed out, several questions remained about the fundamental nature and prospects of the recovery. The high U.S. fiscal deficit was helping to increase real interest rates to unprecedented levels. For many highly indebted countries, the direct impact of rising interest rates and the indirect impact of the fall in commodity prices was greater than that of the growth in the world economy.

It would be misleading to interpret current developments based on the average performance of groups of countries, Mr. Teijeiro continued, and he therefore welcomed the deeper analysis in the staff paper and the more refined classification of countries. It was now possible to observe that income per capita in the western hemisphere countries was 15 percent lower in 1983 than in 1980. It could not be denied that the effects of the current recovery were uneven; the position of countries that were highly indebted and that at the same time were major exporters of commodities had continued to deteriorate. In addition, the starting point of the recovery for many countries was from a level of hardship that would have been unbearable for much longer.

In his concluding remarks on the discussion of access limits and the Fund's financial position (EBM/84/135, 9/5/84), Mr. Teijeiro recalled, the Managing Director had referred to the apprehensions of many countries over social and political tensions. Even for those countries that were more favored by the current recovery, it was not much help to allot a major part of the increase in their export receipts to settle a growing interest rate bill instead of allowing imports and domestic expenditures to increase. The staff was projecting higher interest payments and lower commodity prices, confirming the continued growth in the transfer of resources from developing countries. Projections to the end of the decade would not be significantly altered just because of a revision in the starting point for adjustment, reflecting a larger adjustment by indebted countries than had previously been estimated.

The sense of realism shown by commercial banks in recent negotiations, in respect both of the spread and length of maturities of new borrowings, could be extended to other negotiations, Mr. Teijeiro considered. However, at present, there was no good substitute for a reduction in market interest rates.

The intensive efforts to be made in 1985 to bring the U.S. federal deficit down through cuts in expenditure were ideal, Mr. Teijeiro remarked, although he was concerned that if a significant reduction in expenditure was not feasible, the target for sharply reducing the deficit might be abandoned.

The staff projections of debt servicing costs were based on a major decline of interest rates through the end of the decade, Mr. Teijeiro remarked. But the projections were sensitive to growth rates in the industrial world, and if the U.S. fiscal deficit was not reduced, the outlook for the future would be completely different. In addition, the effect on exchange rates would lead to a continued worsening of the trend toward protectionism.

In conclusion, Mr. Teijeiro stated, the issues were the same as those singled out for discussion by the Board on previous occasions. It was true that there had been significant developments in terms of growth and the maintenance of low inflation in industrial countries, thereby helping to improve the situation of many countries and also preventing the debt problem from worsening. But the unresolved problem of high interest rates in the dollar area and protectionism in general were making it impossible to discern a permanent solution to the debt problem.

Mr. Portas said that he particularly welcomed the staff's analysis of the implications for policy of the difficult international setting facing both industrial and developing countries. The staff had clearly pointed to the risks behind the recent improvement in the current world economic situation and the prospects that endangered, even more than before, the attainment of a sustainable and more evenly distributed economic recovery. To attain that objective, a more balanced policy mix in the industrial countries that allowed for the resumption of adequate growth in developing countries was urgently required. An adjustment in the current stance of policies, particularly those of the United States, was indeed necessary, given the unfavorable impact of high interest rates on the U.S. economy itself as well as on the economies of other industrial and developing countries.

Looked at in isolation, the extent to which high interest rates would become a serious obstacle to a sustained U.S. recovery might be a matter of dispute, Mr. Portas remarked. However, the recent behavior of a set of indicators, interpolated into the international economic setting, pointed to the most serious risks. The growing borrowing requirements of the public sector in the face of the large growth of demand for credit by the private sector, low levels of productivity, already high levels of capacity utilization, and the magnitude of current and prospective current account deficits were all signs of an increasingly unsustainable situation. Therefore, he agreed with other Directors and the staff that a major strengthening of the U.S. fiscal position was essential to sustaining the economic recovery.

The revised estimates of economic growth in developing countries were not a cause for optimism, Mr. Portas considered. The low rate of growth projected and the uncertainties in the underlying assumptions indicated the serious constraints that developing countries were facing and would continue to face in their efforts to resume more adequate economic growth and development. For developing countries in general, the resumption of growth was one of the highest priorities, following the significant decline in per capita income experienced during the past two years. Although perseverance in the fight against high rates of inflation would continue to be required of the largest borrowers, the resumption of growth was crucial to the attainment of sustainable external debt positions in the medium term. The achievement of those economic policy objectives was however constrained by the uncertainty surrounding the future growth of imports. The unfavorable impact of current and expected interest rates was distorting still further the already highly unstable relationship between imports and growth. Thus, it was a matter of urgency for interest rates to decline in order to facilitate the attainment of a more sustainable financial position consistent with higher levels of imports and economic growth.

Decisive efforts to roll back protectionist measures in the industrial countries were essential, Mr. Portas considered. The recent increase, and in fact the institutionalization, of protectionist actions was very worrisome. It was worth noting from the staff paper that although the exports of developing countries had been growing in the current period, those countries had made no gains in their share of industrial markets, despite strong exchange rate action. It was crucial that protectionism be eliminated before permanent damage was done to the international trading system.

Finally, Mr. Portas endorsed the staff recommendations on pages 48 and 49 of EBS/84/177. He reiterated that ample scope existed for furthering international cooperation; the Fund could make a major contribution by providing appropriate access to its facilities and through the resumption of SDR allocations.

Mr. Malhotra observed that the further strengthening of economic activity in the industrial world, unaccompanied so far by the reappearance of inflationary trends and the easing of the debt problem at the margin, were good developments. At the same time, as the staff had rightly noted in the Survey that there was cause for concern on many counts: high real interest rates, the continuing precarious financial position of heavily indebted countries--and he would include among them countries in Africa and certain parts of Asia--divergences in fiscal policy, and different growth performances among industrial countries. Against that background, his impression was that the tone of the updated Survey was far too optimistic, as a quick sweep of the globe would show, and to publish it might give the wrong signals. The main engine for the recovery had been the growth performance of the U.S. economy, which the staff indicated would start declining. The recovery in Europe had been modest, with low rates of growth and high and possibly rising unemployment. The per capita incomes of large populations in Africa and South America were declining.

Referring to the topics suggested for discussion, Mr. Malhotra agreed with the staff about the limitations of projections in such an uncertain world situation. The latest projections were more optimistic than those presented six months previously, but the actual outcome could be different.

The continued pursuit by the industrial countries of the overall policy strategy of the past several years had been recommended by the staff, Mr. Malhotra commented, the objective being to provide a stable medium-term policy framework. Like Mr. de Vries and Mr. de Maulde, he believed that to ignore the major contribution of Keynesian policies to the recovery in some important economies could suggest that those policies were outdated, which he did not think they were. At the same time, it was essential for the United States--for the good of its own economy as well as for that of the world economy--to bring down its fiscal deficit appreciably, given the recovery in domestic private activity. Mr. Zhang had rightly pointed out that too steep a decline in the U.S. deficit might not be in the best interests of the world economy; there seemed to be little chance of that happening, and what was needed was substantially more than the small downpayment made toward reducing the deficit earlier in the year.

He agreed with the staff, as he had during the discussion of the 1984 Article IV consultation with the United States, Mr. Malhotra continued, that the large budgetary deficits were related intimately with the level of interest rates, especially as activity in the private business sector had picked up. While there were other reasons for the strength of the dollar, high interest rates were a major factor and posed a serious problem. Admittedly, to the extent that the large U.S. trade deficit had a counterpart in the exports of the rest of the world to the United States, it had been beneficial; and the U.S. recovery had undoubtedly helped to break the spell of pessimism concerning the world economy. But he broadly supported the staff's view that major changes were called for in the present mix of U.S. economic policies.

With respect to the European economies, where high rates of unemployment persisted and where recovery was far from satisfactory, he tended to agree with Mr. de Groote that the staff should have recommended a degree of stimulation, Mr. Malhotra went on. Growth in Europe would be all the more necessary if rates of growth in the U.S. economy--which was at present raising the average growth rate of the industrial countries--began to decline. Much was said about rigidities, and the one rigidity in particular that loomed large in the staff paper concerned the wage structure. He recognized the impact of rigidities in the structure of wages but wanted it to be assessed in quantitative terms. To what extent was the lack of profitability due to wage rigidities, and what was the contribution of other factors that he suspected did not lag far behind in significance? A study along those lines would be helpful.

On debt and adjustment in developing countries, he endorsed most of the points made by Mr. Kafka, and agreed with him and others that high interest rates were the key to the resolution of the debt servicing problem, Mr. Malhotra continued. The restructuring of Mexico's debt was a model that should be extended to other countries; the prolongation of the period for repayment as well as the reduction in fees and spreads were good features. But all restructurings increased the burden in the sense that the debt accumulated and, if interest rates remained high, so did the cost of servicing debt. The major objective should be to bring interest rates down. The staff view, based on its assumptions and projections, was that the higher interest rate burden would be counterbalanced by increases in exports. He wished to point out that while export receipts represented the gross inflow of foreign exchange, the increased burden of interest rates represented the net outflow. If as a result of lower interest rates, the net outflow were to be reduced and exports were to increase by a like amount, economic activity would be favorably influenced. True, high real interest rates had not so far dampened business fixed investment, which was reported to be quite strong in the United States and picking up in some European countries. A major reason for that might be, as suggested by Mr. Goos, generous tax exemptions relating to the cost of interest. There was, however, no international mechanism for ameliorating the interest rate burden on debt servicing.

There was a natural tendency to concentrate on the high debt of certain countries, including those in Latin America, Mr. Malhotra remarked. Mr. Sangare had effectively drawn attention to the debt situation of the African countries, especially those in the sub-Saharan region; as shown in the staff paper, the debt service ratio of those countries had been rising fast, even though a large part of the debt was official. In that connection, he was of the view that such official debt, which had a high grant element of 80-84 percent, could be written off or converted into grants, in accordance with Resolution No. 165 of the United Nations Conference on Trade and Development. It hardly seemed necessary to subject sub-Saharan African countries to the annual exercises of the Paris Club, especially as, by accepting his suggestion, creditors would not have to make too great a sacrifice. Could some international initiative not be taken in that area?

In giving serious consideration to relieving the strains experienced by sub-Saharan African countries, Mr. Malhotra added, it would also be necessary to provide longer-term rescheduling of commercial debt. Living conditions in those and in certain other similarly placed countries were much worse than in some of the heavily indebted countries. It was all very well to point to growth rates of, say, 2.5-3.5 percent in Africa, but when the low base from which those rates were measured, and the rate of population growth were taken into account, it was doubtful that rates of growth of that order of magnitude meant much. The World Bank had concluded that per capita income in sub-Saharan Africa was probably lower now than it had been in the 1960s. A more action-oriented program was required to deal with the serious difficulties of those and other less developed countries.

Many Directors had referred to the staff statement about current account deficits and the import/export situation of non-oil developing countries, Mr. Malhotra noted. He himself had found little optimism in the most recent IMF Memorandum, which contained trade figures for the first quarter of 1984, or in the September 3 issue of the IMF Survey, in which the staff expressed its belief that the developing countries had clearly passed from the import compression phase of adjustment to the export expansion phase. The imports of non-oil developing countries were estimated to reach a figure in 1984 that was well below the figure for 1981 and close to that for 1982; again, the exports of those countries in the first quarter of 1984 were almost exactly the same as they had been in the last quarter of 1983.

The staff had raised the right issues on international collaboration, Mr. Malhotra considered. The plight of many countries would be alleviated if the onward march of protectionism could at least be halted. Reiterating the need for such action had apparently been of no avail so far. The old wisdom had been that intensified protectionism meant that the world economy was in trouble. Once protectionist devices became a part of the system, they were difficult to expel.

There was continuing need for increased flows of official development assistance, Mr. Malhotra added. ODA had shown some increase in nominal terms, but had stabilized at around 50 percent of the 1970 target. Important sources of concessional finance, such as IDA, were in serious decline. To the extent that the volume of private direct investment could be increased, it would be welcome, but it would not be a substitute for other sources of international and commercial financing.

While the Fund had been doing its best to carry out its surveillance responsibilities, Mr. Malhotra remarked, the effectiveness of the surveillance system would remain in doubt as long as some of the major currencies were misaligned.

It was a matter of satisfaction that the Fund had played an important role during the past few years, both before and since the debt crisis, Mr. Malhotra concluded. But looking to the future, the various issues that he had raised would have to be seriously addressed. As he had already mentioned, he was hesitant to recommend publication of the General Survey under discussion, because of its overoptimistic tone and the rapidity with which circumstances changed. However, he could go along with the publication of updated tables, together with explanatory notes.

Mr. Olsen said that his authorities had noted with satisfaction that growth in the world economy in 1984 appeared to be stronger than had previously been assumed. Against the background of high unemployment in the industrial countries, and the difficult balance of payments situation, and weak economic conditions in general in the developing countries, the Nordic countries found that to be a very positive development. Nevertheless, it was disturbing that Europe had been lagging behind to such a great extent in the economic upturn. The difference in growth rates had led to major divergences in capacity utilization and unemployment between Europe and the United States and had simultaneously caused growing imbalances among the current account positions of major countries. The prospects for 1985 and further were therefore uncertain, and there was some risk that the global rate of growth might soon decline, underscoring the need for coordination of economic policy measures in the various countries. A positive feature of the world economic upswing was that inflation had continued to abate, in spite of stronger growth particularly in the United States. An immediate change in the U.S. fiscal and monetary policy mix was greatly to be desired, Mr. Olsen considered. A tightening of economic policies through the use of monetary policy measures alone might, however, lead to a further rise in the already very high U.S. interest rates, and thus reduce the possibility of a "soft landing." Such an outcome might create difficulties for the other industrial countries as well as for the developing countries. As growth in the U.S. economy gradually started to abate, it was of great importance for the world economy that other industrial countries should start to increase their growth rates, as a group, to a satisfactory pace. In that connection, the growth forecast for 1985 for the industrial countries was somewhat disturbing. It would seem that Japan, with its huge balance of payments surplus, should play a more active role in the endeavor to improve the performance of industrial countries in general. For the European industrial countries, the estimated growth rate implied little or no decline in the prevailing high unemployment.

Continuing, Mr. Olsen commented that growth in Europe had been weak in spite of low rates of inflation for a relatively long time and sharply reduced public sector deficits in several countries. A different balance of economic policies would therefore appear to be necessary. The staff had pointed to the need for greater incentives to enterprises to increase employment and investment, namely, by means of a slower growth of real wages and an increase in profits. His authorities fully agreed, but they doubted that such measures would be sufficient to reactivate European economies; in their opinion, the need for tight demand management policies was on the decline. In that connection, they supported the independent interest rate policy pursued, especially in Germany, even at a time when a high and rising exchange rate for the dollar had made such a monetary policy difficult. On the other hand, in contrast to 1983, fiscal policy in 1984 would have a restrictive effect in three of the four major industrial countries in Europe, and in 1985 the staff expected that it would be restrictive in Italy as well. His authorities doubted that it was proper for countries with relatively stable prices, minor or no balance of payments problems--and with one of those countries even having cyclically adjusted public sector surpluses--to pursue such a tight economic policy; they might therefore have to adopt a less restrictive policy stance. Cautious steps in that direction would seem to be called for in Germany in particular. Measures to stimulate demand would presumably have a less inflationary effect than in the 1970s; developments in the United States in the 1980s appeared to give some support to that view.

The changes in developing countries had been more positive than previously expected, even though many--especially in Africa--had not yet benefited from the economic upswing, Mr. Olsen stated. The staff also regarded the prospects for export and economic growth as positive for 1985, but he would like to point out that great uncertainty attached to the forecasts. Progress in 1984, which showed great differences between the various regions, should also be viewed against the background of the decline in the standards of living--by 15 percent on average--for the developing countries in the western hemisphere in the three preceding years.

His authorities also wished to draw attention to the increase in international interest rates, which were a negative feature of the developing countries' situation, Mr. Olsen remarked. The staff's conclusion that it was realistic to anticipate a satisfactory solution of the debt problem, provided appropriate policies were followed by both debtor and creditor countries, was based on a series of relatively favorable but uncertain assumptions. It would be crucial to maintain economic growth in the industrial countries over a long period and at a rate that would provide enough room for maneuver for the developing countries. In that connection, it was also essential that the industrial countries try to open up further their markets to imports from the developing countries.

His authorities had noted with dissatisfaction that the balance of payments disparities among the industrial countries had increased strongly in 1984 and were expected to increase further in 1985, with the United States having large deficits and the other industrial countries--primarily Japan--having surpluses, Mr. Olsen said. It was a development that harbored substantial risks for the growth of the world economy, for the free trading system, and for exchange rate stability. The present prospects for growth in the U.S. economy, and the resulting balance of payments situation and capital inflow, raised questions about the consequences of present U.S. policy for international capital markets, interest rates, and exchange rates. His chair would have appreciated a more thorough discussion of those questions in the General Survey of the World Economic Outlook.

Mr. Salehkhou welcomed the opportunity once again to discuss the World Economic Outlook, which presumably represented a general instrument of surveillance and a global adjustment tool for the Fund. Since his chair had already stated its position on most of the specific issues discussed in the World Economic Outlook on previous occasions, he would limit his comments to some elements that surfaced repeatedly in the staff's analysis of economic prospects. According to the staff assessment, recovery was strengthening more rapidly than projected, but in the six months since the previous discussion of the World Economic Outlook, he had noted no significant decline of inflation in most industrial countries, despite the decelerating trend, and no change was projected in the prospects for growth and inflation for 1985. Moreover, the staff regarded the projections as highly tentative, because of general uncertainties about the unpredictable behavior of certain other major economic, financial, and monetary variables.

Among the factors listed by the staff, Mr. Salehkhou noted, was the growing external debt of developing countries--from \$830.1 billion in 1984 to \$865.9 billion in 1985, according to Table 35--combined with increasing debt service payment of short-term and long-term external debt, as shown in Table 38. Unprecedentedly high real interest rates, the considerable difference in fiscal policy and growth performance among industrial countries, and growing imbalances in current account positions had also been cited. Another factor was very high unemployment in most industrial countries, especially among OECD members, which estimated the numbers of their unemployed at 31 million, to say nothing of the billions of unemployed and underemployed in developing countries that were dependent on growth in the developed countries. Weak growth in many developing countries had been coupled, in some of them, with exceptional drought. Protectionist policies continued to be followed by many countries. And the last, but certainly not the least of the factors noted by the staff, was that exchange rate developments around the world were having unbearable consequences.

With those developments in mind, Mr. Salehkhou continued, and while he could agree with the thrust of the staff's projections of economic prospects, he was less certain about its scenario analysis suggesting that "a gradual reduction in debt burdens is compatible with a resumption of per capita income growth." He tended to be skeptical about the preconditions that were assumed, in the proviso to that statement, to be essential for that analysis to be borne out: first, "...no sharp downturn in the industrial countries," and second, "that the developing countries themselves pursue adjustment policies that enable them to exploit adequately the growth of markets in the industrial world." Even based on the optimistic view that world recovery would be less vulnerable to an economic slowdown in the industrial countries, or on the assumption that a comprehensive scheme would be implemented that would nullify the pessimistic economic projection that perhaps the best part of the recovery was already past, he would still have strong reservations about both components of the second precondition of the staff's scenario.

With respect to the pursuance of economic adjustment by developing countries, Mr. Salehkhou recalled the consistently held view of his chair that, in general, such adjustment and self-sufficiency in the supply of goods in those countries should be primarily a matter of self-reliance. Yet he had stated previously, notwithstanding certain exceptions, countries that had already courageously swallowed the bitter medicine of economic adjustment and followed difficult prescriptions in an extremely inhospitable external environment had, nevertheless, found themselves bereft of any effective or lasting chance of averting external influences, forcing them deeper into economic crises of confidence and/or political disorder.

Moreover, the staff's own observation with respect to the policy implications of the base scenario that "...the persistence of high real interest rates (has) somewhat conflicting implications for adjustment policies" was clear testimony of the continuous and diligent adjustment policy undertakings by the developing countries that had nevertheless been hampered, and in some cases even stopped, by one or several external factors. As for the other aspect of that second precondition, he asked how, in face of all the uncertainties and problems he had mentioned, most of which were exogenous--high international interest rates, volatile exchange rates, one-sided primary commodity prices, self-serving monetary and even self-defeating fiscal policies, trade protectionism, the lack of transfer of real technical know-how--it was logically possible for developing countries to be able to "exploit adequately the growth of markets in the industrial world"?

To be more specific, Mr. Salehkhou considered that some of the assumptions underlying the medium-term scenario for developing countries were not supported by recent trends. He cited, for instance, assertion that the degree of restrictiveness of the trade measures adopted by industrial countries vis-à-vis developing countries' exports would remain constant, the estimate of a 4.5 percent annual increase in U.S. dollar prices of non-oil primary commodities, and constant changes in real exchange rates among the major currencies, all of which might prove highly optimistic. He did not wish to repeat the arguments put forward by his chair during the two previous discussions of the World Economic Outlook on the need to introduce greater realism into existing and/or new scenarios. He would simply reiterate that there was indeed no easy way out of the complex network of present global economic problems, nor was it easy to generate original ideas, new approaches, or dynamic methodologies: neither was there any justification for failing to make the effort. The World Economic Outlook was the most comprehensive forecasting exercise of the Fund, prepared by highly competent and professional staff and aimed at correcting deviations from the desired course and finding the best paths to economic stability and growth. Therefore, he repeated his previous suggestion that it might be worthwhile searching for new working assumptions by means of a deeper look into the root causes of many existing and emerging economic and social problems. Only then could it be concluded with confidence that the worst was already past.

Among the topics for discussion, he would concentrate his comments on the main features of the projections, Mr. Salehkhou went on. He sympathized particularly with the staff in its uncertainty about the lack of a recent precedent for the present cycle. That uncertainty became all the more worrisome with the thought as reflected in another international economic report, that "the world economic recovery is already behind us and that the international economy may now be near the peak of the current business/economic cycle." The underlying source of that uncertainty could be attributed to three general factors--namely, specific economic developments, cyclical trends, and policies pursued by governments and monetary authorities. Nonetheless, one unique feature of the present economic situation encompassed all three of those factors of uncertainty: only one large economy was dominating the current recovery. It might well be that that singularly dominating force was contributing most to the uncertainty of economic forecasting, with the result that not even relative and/or comparative projections on the course of the recovery, upward or downward, could be made with any confidence. Thus, the answer to the question posed by the staff on whether its "projections are a reasonable reflection of the balance of probabilities" was subject to its own apprehension about the evolution of global economic behavior characterized by one dominating force of recovery. In the uncertain situations he had described, he could not agree to the publication of a second survey of the World Economic Outlook following the Annual Meetings.

Nevertheless, several valid points could be made within the framework of the arguments in the paper under discussion, Mr. Salehkhou remarked. The notable issue with respect to the growth of output in the developing countries was the diversified pattern of that growth, with higher growth rates being concentrated in Asia where financial resources flowed more easily. The restoration of economic activity in Africa and the Western Hemisphere seemed to be at a slower pace. It was noteworthy that the staff had highlighted the fact that per capita output in the developing countries had either stagnated or fallen below 1980 levels. Again, in such regions as Africa and Latin America, where the debt burden and climatic conditions had taken a heavy toll, absolute declines--of as much as 15 percent in three years--had been recorded in living standards.

As for the revised staff projections of inflation in non-oil developing countries--other than the five countries that had triple digit rates of price increase--a slowdown from an average rate of 21 percent to 17 percent might be quite negligible, taking into account the margin for error, quite apart from the hazards of inflation forecasting, Mr. Salehkhou considered.

The projected fall in the current account deficit of non-oil developing countries reflected a contraction of imports, Mr. Salehkhou said. Recent statistics showed a fall of 10 percent in imports--mostly development goods--in the first quarter of 1984, and the staff's forecast of a rise in such imports for 1984 no doubt made allowance for the earlier shortfall in imports. Furthermore, the gross reserves of many developing countries would shrink further in the future, leading them to require an even greater inflow of external financial resources. According to Appendix Table 15, gross reserves as a percentage of imports of low-income countries would fall from 15 percent to 10 percent by 1985.

It was worth noting that the projection for the growth of non-oil sectors in the economies of oil exporters had been revised downward for 1984, Mr. Salehkhou added. The terms of trade of oil exporters had been declining in the past three years, and according to current estimates, they would continue to fall in future; thus, with the present slack demand in the oil market, he found it difficult to share the staff's projection of a 4-5 per cent growth in the oil sector of oil exporting countries in 1984 and 1985. Given the prospects at present, those countries with massive populations and that were high absorbers would no doubt continue to experience slower growth.

On the flow of financial resources and debt restructuring, Mr. Salekhou observed, the major developments in the past three years had been a slowdown in the flow of net resources to the developing countries as well as a fall in direct foreign investment. Future prospects were highly uncertain, and terms and conditions relating to debt restructuring were hardening.

Finally, Mr. Salehkhou remarked, the estimates of an improvement in commodity prices were optimistic. Recent experience suggested a distinct weakness and fall in the prices and marketing prospects for certain commodities. The protracted and uncertain nature of the projected recovery in the economies of European countries would unleash major forces to further slow down the incipient upsurge in commodity prices. Protectionism had accelerated in many countries, and on page 48, the staff had correctly mentioned the dire consequences of further protectionist measures. Trade liberalization would be of benefit both to developing countries and to the industrial nations.

Ms. Bush remarked that she had not been surprised by the criticism of the U.S. budget deficit and its presumed impact on the rest of the world. But as her chair had mentioned during the discussion of the 1984 Article IV consultation with the United States, and as she had reiterated that morning, the U.S. Government was certainly not indifferent to large budget deficits and was determined to tackle them with vigor in the remainder of the present year and into 1985. However, the size of the deficit was not really the issue: the key issue was the structural impact of the large involvement of government in any economy, not just economy, but even more that of other industrial countries where rigidities were adversely affecting both current and future growth, as had been pointed out by many Directors in the present discussion of the World Economic Outlook. The slow growth in some of those countries would jeopardize the continuation of the world economic recovery when the rate of growth in the United States abated; it would also affect the ability of developing countries to grow and to adjust to the problems facing them. She fully expected that the variety of both the problems and the economic responsibilities of all member countries would be recognized in the agreed view that emanated from the Interim Committee's deliberations on those issues.

Mr. Fujino, noting the references by some Directors to the current account surplus of Japan, observed, first, that his authorities expected the strengthening of domestic economic activity that was being witnessed, supported by a strong recovery in private consumption as well as in business fixed investment, to continue. Along with that favorable development in the domestic economy, the hope was that the external balance would also be brought to a more sustainable level. Second, as had been mentioned on page 39 of the General Survey, his authorities had done their utmost to further liberalize Japanese markets, in order to counter the movement toward protectionism around the world. Furthermore, the staff had rightly stressed that it would not be appropriate for Japan to shift toward a more expansionary fiscal or monetary policy; the result would be a weakening of the yen, which would exacerbate the problem. Finally, as the staff had commented on page 27, the improvement in the external position of Japan and of Germany was attributable mainly to the growth of demand in their export markets and, to a lesser extent, to the effects of improved competitiveness.

The Economic Counsellor noted that Mr. de Groote and Mr. de Vries had commented on the way in which U.S. monetary policy had been described in the General Survey. The staff had shied away from the word "accommodating" because it connotated a willingness to adapt to any situation that might develop and not just to the one that had in fact developed; there was no suggestion of such an attitude on the part of the U.S. monetary authorities, whose policy might best be described as appropriate.

Also in response to Mr. de Groote, who had expressed the hope that the staff's arguments against a much more expansionary fiscal position outside the United States should not be interpreted as ruling out fiscal expansion in certain circumstances as and when appropriate, the Economic Counsellor confirmed that the staff had not intended to imply such a restrictive approach.

Several reasons could be adduced for the strength of investment, the Economic Counsellor commented. First of all, the climate for investment had improved greatly, particularly in those countries that had managed to bring the rate of inflation down more than had been expected, thereby enhancing the willingness of investors to undertake longer-term risks. In the United States, strong final demand had contributed to the strength of capital investment, even in the face of high interest rates. Recent changes in taxation, including depreciation allowances, had also been relevant. As one Director in particular had emphasized, the influence of the tax system on investment in industrial countries in the present phase of the cycle did indeed merit further study. It was difficult to foresee when higher interest rates would begin to affect investment adversely. Presumably, reductions in the rate of growth of final demand suggested that the stimulus to investment from that factor would be falling.

It was Mr. Fujino who had asked why so little progress was being made in reducing unemployment rates, even though investment spending was relatively strong in a number of countries--notably, the United States, Germany, Japan, and the United Kingdom--the Economic Counsellor observed. In point of fact, there had been a substantial decline in unemployment in the United States that roughly paralleled the surge in investment. Rates of unemployment in the other three countries were high and roughly stable, despite increases in investment spending that while significant, were much more moderate: in 1984 investment would increase by, say, 3.5-5.5 percent, compared with 18.5 percent for the United States. Moreover, the growth of employment was a function of the growth of total output and not merely of one of its components; since actual output was rising roughly in step with potential output, especially in Germany and the United Kingdom, unemployment rates could not really be expected to decline but rather to stop rising, as in fact they had. Account had also to be taken of various structural factors--labor market rigidities, demographic factors, and high real wages--that tended both to slow the responsiveness of employment to changes in output and to put upward pressure on the rate of unemployment. It was because of those considerations that the staff had placed considerable emphasis on the importance of structural adjustment, in the European countries in particular.

The response by Mr. Fujino himself to references that had been made during the discussion of Japan's balance of payments surplus was very much in line with his own views and those expressed in the General Survey, the Economic Counsellor noted.

The scenario had been described variously as optimistic or pessimisitc, and doubts had been expressed about the basis for certain assumptions; for instance, that there would be no change in protectionism, the Economic Counsellor noted. The essence of the scenario analysis, as Mr. de Maulde himself had defined it during the previous discussion of the World Economic Outlook, was to attempt to make some calculations that would be of assistance in arriving at a judgment as to whether the policies required to manage, say, the debt situation, seemed both possible and sustainable. Those calculations could be made in various ways; if they were based on the assumption of no change in protectionism, it was because any other assumption would be difficult to make. Nevertheless, the assumption made colored the judgment about the feasibility and prospects for success of the required policy stance. The staff had not failed to stress the vital importance of resisting the trend toward greater protectionism and had emphasized the negative impact of higher interest rates on the prospect of successfully managing the debt situation. Thus, the calculations had been of assistance in focusing on the danger points. As for the prospects of dealing with the debt situation, his judgment was that they were moderately better at present than they had been in the spring, although he would resist any suggestion that he was being complacent; his apprehensions on that score were second to none.

Commodity prices had not been weak throughout 1984 so far, but they had been weak recently, the Economic Counsellor admitted. One argument that he had heard, but that he did not accept, was that certain commodities that used to predominate in manufacturing processes were no longer in demand as a result of changes in technology; consequently, supplies were excessive and prices weak. While the process of technological change might be under way, it was too slow to provide an explanation for the sudden drop in commodity prices over the past two or three months. The increase in interest rates, and thus in the cost of carrying inventories, might have led to smaller commodity inventories in the world marketing system than as recently as six to eight months earlier. The sellers of some commodities might be making special efforts to increase exports, possibly related to their debt situation and even to the interest rate situation. The appreciation of the U.S. dollar was probably also having a negative effect, which some econometric work by the staff suggested might go beyond the mechanical effect deriving from the currency in which certain commodity prices were denominated. The initial rise in commodity prices that had been induced by the economic recovery might also have gone too far. Finally, it was possible that the strike-induced weakness of industrial production in Europe during the summer months might have had some effect.

He would agree with Mr. Zhang that the U.S. fiscal deficit should not be brought down too steeply, the Economic Counsellor remarked, although as would be apparent from the section in the General Survey on interactions of economic policies and conditions, the staff would take a more cautious attitude to an increase in deficits in the rest of the world.

The comparisons drawn by Mr. Malhotra between the figures for imports and exports of non-oil developing countries, and their implications for the judgment in the General Survey that those countries had passed from the stage of import compression to the stage of export expansion, had probably not allowed for seasonal factors, the Economic Counsellor remarked. The trade figures published in the IMF Memorandum, as well as in the IMF Survey for September 3, 1984, were not seasonally adjusted. As reported in International Financial Statistics, almost 70 percent of the 8.7 percent drop in imports between the last quarter of 1983 and the first quarter of 1984, in nominal terms, was due to seasonal factors; on a seasonally-adjusted basis, the decline in imports was 2.7 percent. Beyond that, the erratic nature of trade data, which were measured on the basis of three-month moving averages in the World Economic Outlook, made it necessary to make an assessment of developments over the three preceding quarters. It was germane to note that imports had been quite buoyant in the third and fourth quarters of 1983 and that in the first quarter of 1984 they had been running some 4.5 percent above the level of the corresponding period of 1983 in dollar terms. In addition, because of the appreciation of the U.S. dollar, account had to be taken of the parallel development in unit values of imports, which had probably risen by one quarter of 1 percent in the first quarter of 1984. Thus, the decline in imports in real terms from the fourth quarter of 1983 had been about 3 percent. However, unit values had fallen by 2 percent on a year-to-year basis, so that the volume of imports in the first quarter of 1984 had risen by 6-7 percent compared with the same period of 1983. Chart 7 in EBS/84/177, showing the exports and imports of non-oil developing countries, seasonally adjusted and as reported by industrial countries, reflected the actual data available when the General Survey had been written; the chart was not based on estimates.

The Deputy Director of the Research Department said that the projections in EBS/84/177 showed a downward revision of output in the oil exporting countries--while there had been an upward revision for most other groups of countries--essentially owing to developments in the oil market. The lower estimate for oil exports stemmed not from lower consumption of oil but from higher production than had been expected earlier from sources such as the North Sea. At the same time, oil consumption was not expected to increase in parallel with the projected increases in the rates of economic growth in the world, perhaps partly owing to the appreciation of the U.S. dollar, which had increased energy prices in Europe.

Statistics on government expenditure did in fact seem to indicate that the oil exporting countries had adjusted to the fall in oil revenues, the Deputy Director noted. The rate of growth of government spending, which had been at or above 20 percent in each of the three years from 1979 through 1981, had fallen to 4.3 percent in 1982 and to about 1 percent in 1983. The fact that the growth in total government spending had then accelerated to an estimated 5 percent in 1984 suggested that the decline in the rate of growth had ended and that the adjustment was more or less complete.

The staff's estimate of Germany's current account surplus for 1984 could be said to be on the high side if account was taken of recent strikes, although a rebound in the trade balance was expected by the end of the year, the Deputy Director remarked. The improvement would be consistent with developments expected by trading partner countries and with a high income elasticity of demand for imports. For 1985, the staff had assumed a lower income elasticity of demand for imports, mainly because during the initial phase of recovery, stockbuilding had been relatively more important and the import content of stockbuilding was higher than that of other components of demand.

The assumption made by the staff in its scenario analysis about bank lending to developing countries was more in the nature of a ceiling than an estimate, the Deputy Director observed. The assumption was that such lending, insofar as it related to import financing, would not exceed the rate of growth of imports in dollar terms; bank lending that was not import related would not rise in real terms but would increase only at the global rate of inflation. However, partly because of the improvement in the balance of payments situation of a number of developing countries, the implied use of bank credit was somewhat lower in the staff's latest projections than in the scenario presented in March.

Aggregate figures on debt could sometimes be misleading, the Deputy Director said. It was possible that the benefits to a country of increases in its export earnings, due to stronger growth in the industrial countries, could be outweighed by the adverse consequences of higher interest payments, if its debt was sufficiently large. The staff's estimates for 1984 and 1985 had not attempted to abstract the impact on interest rates of growth in the U.S. economy from that of all other factors, including estimates of the interest elasticity of demand for money presented in the staff report for the 1984 Article IV consultation with the United States. Rather, the estimates took account essentially of the amalgamated impact of all changes in the world economic situation since the previous calculations that had been made in March 1984. For the great majority of countries, the higher exports in prospect, whether due to the improved outlook for growth in the industrial world or to other reasons, would generally outweigh the higher interest payments. Although they had not been cited in the survey, calculations had been made for the entire scenario period, for the individual countries mentioned as being major borrowers; but in greater or lesser degree, the qualitative characterization made for the group of countries as a whole would be found to apply to the individual members of the group.

For two reasons the staff had not been explicit in recommending the adoption of policies by industrial countries to improve the structural functioning of their economies, especially in the labor market, the Deputy Director said. First, policies would have to differ from country to country, depending upon social and political factors. Second, some mention of possible policies had been made on page 25 of the previous survey of the World Economic Outlook (EBS/84/33, 3/2/84). Those policies included the following: greater emphasis in public sector wage settlements on attaining rates of wage increase that were more in line with underlying economic conditions; the use of retraining schemes to improve labor mobility; the revision and updating, where necessary, of legislation covering wage bargaining; the deindexation of wages where indexation was a major cause of upward wage pressure; and the avoidance of protectionism, which tended to validate increases in wages that were perhaps not justified in terms of labor productivity.

The Chairman made the following summing up:

In summarizing this interesting discussion on the World Economic Outlook I shall group my remarks around the four main topics selected for discussion in the staff paper.

1. Main features of the projections

It is fair to say that Directors were in general agreement with the main lines of the projections in the staff report. They noted in particular that growth in the industrial countries had been higher than expected during 1984 and that expansion was expected to continue in 1985, although with a moderation in the pace of growth in the United States. A number of Directors also stressed the relative weakness of growth in the European countries, where very high unemployment still prevails. Satisfaction was expressed at the fact that inflation had been kept under reasonable control and that business fixed investment had revived quite strongly in a number of countries. The situation in developing countries was also regarded as more encouraging, although many

Directors drew attention to the diversity of developments across these countries and pointed out that the improvements that were evidenced in the aggregate statistics had not prevented a number of countries from experiencing continued highly adverse economic conditions.

As far as external developments were concerned, Directors noted the actual and prospective strengthening in the current account position of developing countries and noted that, compared to the import compression of last year, there was some shift toward export revival and import growth. Among industrial countries the principal feature of the external situation was the growth in the U.S. deficit on current account and the continued strength of the U.S. dollar. The increase in the current surplus of Japan was also noted.

Although, as I have mentioned, Directors were encouraged by the prospects described in the staff report, reservations were also expressed and unsustainable features were highlighted. Several Directors noted the staff's point that uncertainties were particularly large in the present conjuncture and considered that the projections in the report were optimistic in that they implied a favorable resolution of these uncertainties. Skepticism was expressed by some speakers about the possibility of a "soft landing" for the U.S. economy onto a sustainable path given the continued size of the fiscal deficit and the high level of interest rates. Structural problems, including labor market rigidities, were seen as hampering the reactivation of economic activity in Europe. Some Directors cited unsustainable exchange rates and payments positions as jeopardizing prospects for sustained economic growth, while the recent decline in commodity prices was thought by others to undermine the prospects for improving the external position among developing countries.

2. Policies in industrial countries

There was general agreement with the staff's view that pursuit of a stable economic and financial environment was an important prerequisite for sustaining expansion. In this connection, all Directors stressed the importance of a significant reduction in the U.S. fiscal deficit. Most speakers considered that such a reduction was essential if lower interest rates were to be achieved and a more sustainable pattern of exchange rates and current account balances established. The U.S. Executive Director, while agreeing that action to cut the fiscal deficit was very important, did not subscribe to what might be called the conventional view of the relationship among the fiscal position, the level of interest rates, and the pattern of exchange rates. The U.S. Director saw the importance of a reduced fiscal deficit as lying in a further reduction of public outlays and in the contribution that such a reduction could make to underpinning the continued growth of the private sector. She stressed the structural importance of such action not only in the United States but perhaps even more so in other industrial countries where the size of government claims on the economy is a factor in economic rigidity and slow growth.

As far as industrial countries other than the United States were concerned, Directors generally felt that the present stance of anti-inflationary monetary and fiscal policies was broadly appropriate. However, some Directors questioned whether more flexibility in the implementation of fiscal policy with a view to improving the employment situation would not be appropriate, especially in countries where inflation is under control and where the balance of payments is strong. Most others, however, including Directors representing those countries most directly concerned, felt that the dangers of a substantial change in the present course of fiscal policy would outweigh the benefits.

Directors felt that a major reason for the more satisfactory performance over the past two years of the U.S. economy compared with the European economies lay in the greater flexibility with which markets, particularly labor markets, functioned in the United States. They considered it to be very important that authorities in European countries should intensify, wherever possible, their efforts to reduce rigidities and improve the structural functioning of their economies. Progress in this area would have beneficial results in helping to create additional employment opportunities and would thereby serve to moderate protectionist pressures.

3. Debt and adjustment in developing countries

A number of Directors noted the encouraging thrust of the revised scenarios for external debt in developing countries that had been developed by the staff. These showed a more rapid improvement in the external position of developing countries over the short term, reflecting both the strength of output growth in the industrial world and the firmness with which adjustment policies had been adhered to. Nevertheless, it was pointed out that not all developing countries were benefiting to a meaningful extent from the improvements that were evident in the overall figures. Sub-Saharan African countries in particular had experienced several years of low growth, and their capacity to adjust was being undermined by a number of adverse developments, many of which were outside the control of the authorities themselves. Doubt was expressed whether the improvement in growth performance of some low-income developing countries projected by the staff would in fact materialize. A few Directors also voiced skepticism about the realism of some of the main assumptions underlying the medium-term scenarios.

Concerning policies to deal with the debt situation of developing countries in the coming period, Directors generally endorsed the points made in the staff paper. The importance of sustained recovery in the industrial world was underlined; so too was the need to achieve an improved fiscal position in industrial countries, notably in the United States, in order to bring down the very heavy burden of interest payments. Another factor that received attention was the need to ensure that financing flows were appropriate, in respect both of amounts and terms, to the needs of the situation. The possible advantages of measures to encourage nondebt creating flows--for example, direct investment--were noted, as was the importance of an ample supply of official development assistance. Several Directors mentioned the need to maintain adequate access to Fund resources in this connection and mention was also made of the potential role that could be played by an allocation of SDRs. Directors stressed the importance of a continued collaboration between creditors and debtors in the handling of debt problems. They welcomed the steps taken toward a multiyear treatment of external debt problems for countries having shown determination in their adjustment policies. All Directors recognized the importance of the pursuit of appropriate policies by the indebted countries themselves. It was considered vitally important that adjustment efforts should be continued with vigor and not relaxed as their initial benefits began to become apparent. However, several Directors noted that the adjustment efforts of developing countries would fail to achieve their potential if they were not matched by the policy improvements, including free trade measures, in industrial countries, as the staff also noted.

4. International collaboration

In commenting on the importance of continued and indeed enhanced collaboration, Directors again underscored the importance of resisting protectionist measures and regretted that in the present phase of the cycle there was not much evidence of a rollback in protectionism. The industrial countries, which have a heavy weight in world trade, bear a great responsibility for the overall health of the world economy and should be especially mindful of the special importance of providing a lead in this area.

Each group of countries bore a share of responsibility for achieving successful collaboration, and the Fund itself had a fundamental role to play, through its support of adjustment and its surveillance activities, to help ensure the global consistency of policies.

Referring to the proposal in Supplement 1 to EBS/84/177 to publish an updated survey, the Chairman said that he had sensed reservations on the part of Executive Directors, in particular in relation to the publication of other than the macroeconomic view contained in Chapter II. The presentation should thus preferably be descriptive. The alternative of presenting only updated tables with an accompanying explanatory text would have serious drawbacks, including the difficulty of interpretation; more questions might be raised than would be warranted.

The Economic Counsellor added that the various problems to which a more limited publication could give rise included the following: first, it might be asked why it had been decided to issue a publication containing only statistics when six months previously an extensive commentary on the World Economic Outlook had been published. It would be virtually impossible to publish in tabular form material pertaining to the scenarios, which thus would have to be omitted. Second, the omission of any reference to the single most important problem facing the world community at present--the debt problem--would inevitably lead to questions. Nor could any other major policy issues be handled adequately.

It might be worth noting in particular that the OECD issued a publication combining analysis and tables twice a year, in the winter and summer, the Economic Counsellor remarked. It would therefore not seem inappropriate for the Fund to consider publishing its General Survey of the World Economic Outlook in the intervening spring and fall months.

The Chairman suggested that the only alternative to publishing Chapter II by itself, given the reluctance on the part of some Executive Directors to publishing Chapters III and IV, would be to have no publication at all.

Mr. Templeman asked how an edited version of Chapter II would differ from the one discussed by the Executive Board in terms of the sensitivities of certain authorities on different issues.

The Economic Counsellor responded that in the weeks preceding the Board's discussion of the World Economic Outlook in the spring, Executive Directors had been asked to indicate which passages might be troublesome to their authorities so that the staff could take their views into account. A similar procedure could be followed with respect to Chapter II of EBS/84/177, although early comments would be needed if the publication was not to be unduly delayed.

The Chairman, in reply to a question by Mr. Angeloni, recalled that Executive Directors had agreed in their discussion of the work program in May (EBM/84/77, 5/14/84), to publish a second, much shorter publication on the World Economic Outlook following the Annual Meeting. Without wishing to prejudge whether or not there would always be a publication in the autumn, it seemed to him that the Executive Board had on various occasions seen considerable merit in moving in that direction.

The Executive Directors agreed to publish Chapter II of EBS/84/177, edited as appropriate and accompanied by the relevant tables.

Adopted September 7, 1984

APPROVED: June 25, 1985

LEO VAN HOUTVEN
Secretary