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Minutes of Executive Board Meeting 83/24

10:00 a.m., February 2, 1983

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

Executive Directors	Alternate Executive Directors
A. Alfidja	W. B. Tshishimbi
	C. Taylor
	E. M. Ainley, Temporary
J. de Groote	H. G. Schneider
B. de Maulde	A. Le Lorier
	J. Delgadillo, Temporary
R. D. Erb	
	T. Alhaimus
A. H. Habib	Jaafar A.
T. Hirao	T. Yamashita
	M. Casey
A. Kafka	
G. Laske	G. Grosche
G. Lovato	C. P. Caranicas
R. N. Malhotra	
Y. A. Nimatallah	J. E. Suraisry
J. J. Polak	T. de Vries
A. R. G. Prowse	
G. Salehkhou	
F. Sangare	
M. A. Senior	
	L. Vidvei
	Wang E.

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

Also Present

B. Legarda, Consultant. African Department: O. B. Makalou, Deputy Director; I. Kapur. Asian Department: H. Neiss, Deputy Director; J. T. Boorman, L. H. De Wulf, I. Otani, S. M. Schadler, B. J. Smith, X. Vongsathorn. European Department: P. de Fontenay. Exchange and Trade Relations Department: S. Mookerjee, Deputy Director; M. Guitian, G. G. Johnson, S. Kanesa-Thasan, N. Kirmani, C. Puckahtikom. External Relations Department: A. F. Mohammed, Director; H. P. G. Handy, N. K. Humphreys. Fiscal Affairs Department: G. Blöndal, O. Pettersen. Legal Department: S. A. Silard. Middle Eastern Department: M. C. Niebling, G. Tomasson, S. von Post. Research Department: W. C. Hood, Economic Counsellor and Director; C. F. Schwartz, Associate Director and Director of Adjustment Studies; A. D. Crockett, Deputy Director; J. Artus, C. P. Blackwell, J. E. Blalock, J. M. Boughton, M. C. Deppler, S. J. A. Gorne, M. D. Knight, A. Lanyi, C.-Y. Lin. Secretary's Department: A. P. Bhagwat. Treasurer's Department: W. O. Habermeier, Counsellor and Treasurer; I. A. H. Diogo, J. R. Karlik. Western Hemisphere Department: S. T. Beza, Associate Director; J. Ferrán. Bureau of Statistics: P. L. Joyce. Personal Assistant to the Managing *Director: N. Carter. Advisors to Executive Directors:* S. R. Abiad, E. A. Ajayi, J. R. N. Almeida, C. J. Batliwalla, S. E. Conrado, S. El-Khouri, P. Kohnert, H.-S. Lee, I. R. Panday, P. D. Péroz. Assistants to Executive Directors: H. Arias, L. Barbone, R. Bernardo, M. Camara, L. E. J. Coene, T. A. Connors, G. Ercel, I. Fridriksson, G. Gomel, A. Halevi, M. Hull, M. J. Kooymans, W. Moerke, V. K. S. Nair, Y. Okbuo, J. K. Orleans-Lindsay, G. W. K. Pickering, E. Portas, *M. Z. M. Qureshi, J. Reddy, D. I. S. Shaw, H. Suzuki,* P. S. Tjokronegoro, M. Toro, J. C. Williams, A. Yasseri.

1. WORLD ECONOMIC OUTLOOK - GENERAL SURVEY

The Executive Directors continued from the previous meeting (EBM/83/23, 1/31/83) their consideration of a staff paper giving a general survey of the World Economic Outlook (ID/83/1, 1/17/83). They also had before them a paper discussing trends and prospects in international capital markets and providing a survey of external debt developments (ID/83/2, 1/19/83).

The Director of Adjustment Studies made the following statement on oil prices:

> The international oil market has weakened significantly during the past several weeks--that is, during the period after the main statistical part of the current World Economic Outlook exercise had been largely completed. Several factors have contributed to the present weakness of the oil market. In addition to the continued low level of economic activity, the unusually mild weather conditions in all major consuming areas during the past few months have caused a significantly lower level of consumption of heating oil than normal. Moreover, the anticipation by oil companies and traders of a fall in oil prices appears to have led to a larger reduction in oil inventories than had been expected.
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> As widely reported in the press, the recent meeting of the Organization of Petroleum Exporting Countries (OPEC) ended without any agreement on production quotas and realignment of price differentials. The market reaction has been a further decline in spot market prices, which are now some $3-5 a barrel below the official selling prices; spot prices are currently highly volatile because of the confusion in the oil market. While there have been no significant changes in the official selling prices so far, it appears likely that short-term forces will exert downward pressure on the effective export prices of the oil exporting countries. However, there are a number of uncertainties in the picture. These concern the scope for further cutting of inventories, the nature or effectiveness of any further action that may be taken by OPEC, and the degree of strength that will be imparted to the world oil market in the period immediately ahead by the expected economic recovery in the industrial countries. In view of these and other uncertainties, any prediction of short-term market developments and changes in oil prices would be extremely tenuous at this time.
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> But let me refer more specifically to our projections. In light of the recent oil market developments that I have touched on, it now appears likely that the total volume of oil exports of the oil exporting countries in 1983 will be some 0.5-1.0 million barrels a day lower than had been projected in the current World Economic Outlook exercise. This would reduce the projected value of 1983 exports of the oil exporting group by something up to $12 billion. On the other hand, it appears likely that the value

of total imports of the oil exporting group will also be lower in 1983 than we have projected, thus providing some offset to the expected reduction in exports. Nevertheless, it now seems probable that the group's combined current account position will shift into deficit in 1983, even with no change in the nominal price of oil. (As Executive Directors will recall, the staff has projected a surplus of some $3 billion in the General Survey paper.)

It is important to note that the assumption in the current World Economic Outlook exercise is that the nominal price of oil will remain unchanged from the fourth quarter of 1982 through 1983. This represents a change from the 1982 World Economic Outlook papers, when we assumed that the price of oil would remain unchanged in real terms from 1982 to 1983. As I have already indicated, there have been no significant changes in the official selling prices during the past two months (up to the end of January), even though there have been some increases in the effective discounts that have been provided in various ways. Finally, I might note that each $1 a barrel decline in the average price of oil would result in a reduction in the total value of exports of the oil exporting countries of about $6 billion.

Recent oil market developments have engendered widespread speculation about the economic and financial impact of a possible significant decline in the price of oil. In the present World Economic Outlook discussion, several Executive Directors have expressed an interest in hearing the views of the staff on this question.

There can be no doubt that a reduction in the price of oil would have favorable effects on real economic activity and prices in the industrial and non-oil developing countries. In essence, such effects would be the obverse of those emanating from the 1979-80 oil price increases that were discussed in the 1980 World Economic Outlook publication (on pages 71-74). For convenience and in a purely hypothetical way, let us consider the effects of a 10 per cent decline in the price of oil measured in U.S. dollars. As a technical assumption, the average price of oil exports by the main group of oil exporting countries was projected in the current World Economic Outlook exercise at $32.40 a barrel during 1983. A 10 per cent decline would bring this price down to just over $29. Now, following the methodology described in the 1980 World Economic Outlook report, we estimate that such a decline would have the following effects on output and inflation in the oil importing countries as a group: it would raise real gross product by about 1/2 a per cent and would reduce prices (as measured, broadly, by domestic demand deflators) by about 3/4 a per cent. These are the estimated effects in the first full year and, if maintained, they could become considerably larger over time.

Such effects on inflation and growth would be significant, and they would be especially beneficial at the present juncture of the world economy. For one thing, lower inflation in industrial countries would tend to reduce nominal interest rates commensurately. And a reduction of nominal interest rates in the industrial countries would, among other things, help to reduce debt service ratios and current account deficits in the non-oil developing countries, thus reinforcing the direct effects of the assumed decline in oil prices on those countries. Also, under present circumstances, a decrease in oil prices would seem likely to produce effects that could help to offset the profitability losses of the 1970s in a number of industrial countries. Notably, because wage demands are already tending to decelerate in response to anti-inflation policies, they would probably decelerate further in response to a decrease in oil prices. Thus, the improvement in the terms of trade of the industrial countries stemming from the oil price decline would ultimately be reflected in an increase in profitability, rather than an increase in real wage rates. This process would constitute one of the major channels for improvement of noninflationary growth in response to a lower price of oil.

Industrial countries with significant domestic production of oil would face special adjustment problems that could either offset or enhance the benefits I have just mentioned. Perhaps the most notable example is the United Kingdom, which has been a net exporter of oil since the middle of 1980 but which remains a substantial importer as well. Another country in this special category would be Canada, as Mr. Joyce mentioned in the Article IV consultation discussion in the Board last Wednesday.

To the extent that exchange rates were to adjust to reflect the relative dependency of countries on oil, some of the effects I have mentioned could be modified. Simulations using the Fund's Multilateral Exchange Rate Model provide indications of the exchange rate changes that would be required in order to offset the effects of a decline in oil prices on the current account balances of industrial countries. I will not go into details on this matter, but might note that in those countries experiencing exchange rate depreciation, the estimated beneficial effects on inflation from a decrease in the dollar price of oil might be reduced, but not the benefits to real growth. Also, let me add, one of the significant points emerging from this exercise on exchange rates is the indication of an appreciation of the Japanese yen--which, of course, would be welcome for a number of reasons and would further improve the room for policy maneuver or adjustment in Japan.

So much, in very brief fashion, for the impact of a hypothetical 10 per cent decline in the price of oil on real economic activity and on prices. Another major effect of a possible decline in oil prices would be to change the current account balances of major groups of countries, as well as of individual countries. Let me mention a few figures to indicate the amounts of such change without allowance for consequential changes in the imports of oil exporting countries or for the effects of the oil price decline itself on oil consumption and trade. In terms of U.S. dollars, the combined current account balance of industrial countries might improve by some $21 billion in a full year as a result of a 10 per cent fall in the price of oil. The main oil exporting countries would have a deterioration in their current account balance also amounting to some $21 billion. The dozen or so net oil exporters included in our classification of the non-oil developing group would suffer a deterioration of several billion dollars. The net oil importers in the non-oil developing group would experience a significant decline in their combined current account deficit, perhaps of the order of $6 billion or so, and a few billion dollars (of deterioration) would spill onto countries that are not members of the Fund.

I have so far touched on recent developments in the international oil market and on the effects, in general terms, of a hypothetical 10 per cent decline in oil prices on output and inflation in the oil importing countries, as well as on current account balances. By and large, as I have said, the effects on output and prices, and to a large extent on current account balances, would be positive--they would be welcome and timely at this juncture of the world economy. But there would also be some negative effects, which I will mention very briefly. First, on the basis of the sort of decline in oil prices I have mentioned, or particularly if the decline were to turn out to be larger, a number of oil exporting countries--both in the main group of oil exporters and among those classified in the non-oil developing group--might encounter new or added problems in the management of their economies. Some of these countries, particularly those with large amounts of external debt, might experience acute financial difficulties, which could possibly be the cause of severe disturbances in the international financial markets and of new and very unwelcome strains on the system. Further, a substantial decline in real oil prices, if sustained, would tend to weaken or reverse conservation gains and jeopardize progress toward the development of non-oil sources of energy. In the private and public sectors of many countries, large investments have been made on the assumption that the increase in oil prices that occurred through 1980 would, in the main, prove irreversible, and a prolonged decline in the real price of oil that itself was later reversed could, from that standpoint, be quite disruptive. With respect to the effects in this area, much would depend on the timing and magnitude of developments and on the responses that were made to them.

That is all I wish to say about oil prices and related matters. It is a big subject, and I am sorry in a way to have treated it in such a general fashion, but I believe that I have spent enough time on it at this stage of our discussion on the World Economic Outlook.

Extending his remarks, the Director of Adjustment Studies recalled that questions had been raised about the staff's view of the U.S. Federal Reserve Board's policy. Monetary conditions in the United States had recently eased, but it was difficult to say whether or not monetary policy itself had changed. In his judgment, the policy objectives of the Federal Reserve had not changed, a point that Mr. Volcker and other Federal Reserve officials had stressed repeatedly and convincingly. At the same time, M-1 had been allowed to move above the target range on the grounds that, for well-known reasons, it had become distorted; whether or not that development should be viewed as a change in policy was a question of semantics. He welcomed the move that had been taken by the Federal Reserve; it was the correct thing to do in the circumstances. However, the remaining room for maneuver by the Federal Reserve might be quite limited at present. One Executive Director had specifically endorsed the change in Federal Reserve policy toward the end of 1982, referring to the growth of M-2 in that connection. Actually, M-2 had increased by 9 1/2 per cent during 1981 and by a little under 10 per cent during 1982. However, there was reason to believe that there had been a sudden reduction in velocity that might have resulted in some rise in M-2 in the closing weeks of 1982. Adjusting for that factor, and given that the rise in M-2 in 1982 was similar to that in 1981, it was not clear that Federal Reserve policy had been relaxed in the course of 1982.

A number of Executive Directors had expressed concern about the statistical asymmetry in the global summary of current account balances, the Director noted, and they had urged the staff to give high priority to efforts to reduce that discrepancy. The staff shared the concern of those Directors, and it was working to achieve a better understanding of the causes of the asymmetry. However, Directors should recall that the statistical discrepancy was embedded in the official balance of payments records submitted to the Fund by national statistical authorities; it was not to any significant extent a result of imbalances in staff projections for periods not yet covered by reported data. The scope for inconsistencies among the reported balance of payments statistics was all too evident in the "errors and omissions" or balancing items included in the reported data for individual countries. In the U.S. statistics, for example, the "errors and omissions" component exceeded $25 billion in each of the three years from 1979 through 1981. The staff planned to include in the forthcoming World Economic Outlook publication a special appendix analyzing the main factors, insofar as they could be identified, that lay behind the problem.

One Executive Director had questioned the validity of the staff's statement that the errors and inconsistencies reflected in the global asymmetry were probably centered in the service and transfer accounts of industrial countries and the oil exporting countries, the Director added. However, first, the staff's estimates of the current account balances of the non-oil developing countries were made in the full balance of payments context, encompassing financial flows as well as trade and service aggregates. The double-entry accounting approach yielded an estimate of the group's current account deficit from the financial side that was of the same order of magnitude as the estimate from the current account side. The staff did not have any similar type of confirmatory estimate from the financial side for the industrial countries as a group, or for the oil exporting countries. Second, if the under-reporting of receipts, or the over-reporting of payments, was not in the accounts of the industrial countries or of the major oil exporting countries, it would have to be in the accounts of the non-oil developing countries, meaning that the staff had grossly overestimated the collective current account deficit of those countries, thereby implying that their external financial problems were considerably less serious than the staff's figures seemed to suggest. Such an implication ran counter to all of the collateral or subsidiary information available on the issue.

Several Executive Directors had remarked that the staff had not said much on the subject of incomes policy, the Director observed. However, that did not mean that the staff had changed its mind about the possible usefulness of incomes policy, a subject that had been addressed on page 21 of the General Survey paper of August 1981; but there did not appear to have been any particular reason to discuss the subject in detail in the present paper. In fact, on page 18 of ID/83/1, the staff had commented positively on the incomes policies being pursued in Canada, France, and Italy, i.e., three out of the seven major industrial countries. In Japan and Germany, the authorities had for some time been pursuing informal types of incomes policies on which the staff had often commented in a favorable way. With regard to the United States and the United Kingdom, the views of the authorities on the subject of incomes policy were well known; they would not seem to be susceptible to change on the basis of further comments by the staff. One Director had specifically raised the question of the use of incomes policy as an instrument to increase the rate of return on investment. In theory, such an approach was possible, but the historical experience was not very promising. Too often, labor unions asked for a distribution of incomes no less favorable than the existing one, as a condition for accepting an incomes policy.

Commenting on commodity prices, the Director recalled that several Executive Directors had remarked on the relative lack of attention given to developments in commodity prices in ID/83/1 and that they had asked for additional information. A great deal of information on commodities was assembled in connection with the World Economic Outlook project. First, preliminary price projections for each of 37 commodities were prepared by the Commodities Division. Those estimates were based on preliminary notions and assumptions with respect to the likely development of growth rates, inflation rates, exchange rates, and world trade prices, as well as information on the specific supply factors affecting the outlook for each individual commodity. The preliminary projections were then used by the area departments as one of the elements taken into account in the detailed projections made for each country. The commodity price projections were especially important to the projections of export earnings for the developing countries and of import prices for the industrial countries. The area departments' detailed projections for each country were then aggregated or averaged by the Research Department.

At that point, the Director continued, the commodity price projections were reviewed to bring them into line, as necessary, with a revised picture of the world economy. That review had been carried out with particular care in the current World Economic Outlook exercise to ensure that the projections took account both of individual commodity market characteristics and of macroeconomic considerations. The review included a check on the historical relationship of commodity prices to the usual cyclical variants--industrial production, inflation, and foreign trade prices--as well as interest rates, a factor that appeared to have been quite important in the past several years. He emphasized that forecasting commodity prices was always a hazardous exercise. It was very difficult at any one point in time to weigh the relative importance of diverse forces--e.g., the fact that many commodities were selling at prices below production costs and that they were subject to marked supply shocks; that, with the decline in interest rates, commodities were becoming more attractive investment opportunities; and that the overall tone of demand remained quite depressed.

In light of such conflicting considerations, the Director said, the staff had felt unable to provide the kind of details on commodity price projections that had been requested by Mr. Vidvei, whose ongoing interest in the staff's commodity work was much appreciated. However, the staff was moving forward in that area, and, within the limits of staff resources, it would seek to improve the projections in every way possible. The traditional table on commodity prices, Table 6 in ID/83/1, had been expanded to show for the first time the terms of trade of the subgroupings of non-oil developing countries. The staff believed that that represented a substantial improvement. It was worth mentioning that the published World Economic Outlook report usually contained a special appendix on commodity prices, as well as a table providing details by major commodity and country groups; the staff planned to expand considerably the treatment of commodity prices in the World Economic Outlook report to be published in a few months.

One Director had asked a specific question about the medium-term prospects for non-oil commodity prices, the Director observed. The staff expected a gradual increase in non-oil commodity prices and a gradual improvement in their terms of trade in relation to manufactured products. After an improvement of about 3 per cent in terms of trade of non-oil primary commodities in 1983, the staff projected a further improvement of about 3-4 per cent between 1983 and 1986. Those figures emerged from the development of the scenarios.

Some Executive Directors had commented on the question of the optimal rate of inflation, the Director remarked. To a large extent, it was difficult to define an "optimal" rate of inflation. First, a major problem with any inflationary process was that it tended to feed on itself and to get out of control. Thus, an optimal rate of inflation was one that did not, by itself, lead gradually to rising inflationary expectations and to rising inflation rates. Second, it was difficult to judge how low the inflation rate had to be in order to become acceptable, in the sense of not risking the start of an unstable inflationary process. Some economists might argue that the rate had to be zero. More realistically, a low positive rate might be acceptable. Furthermore, an acceptable rate might differ somewhat among countries. While it could be difficult to say what was the optimal rate of inflation, it was easy to recognize that many countries were still quite far away from it.

Several Executive Directors had noted that there was no necessarily close relationship between the reduction of inflation and the resumption of economic growth, the Director added, and they had seemed to imply that the staff held a contrary view. In fact, the staff agreed; it had often made the same point in papers on the World Economic Outlook. The staff's view was that the reduction of inflation was a necessary condition for the resumption of sustainable economic growth, but that it might not be a sufficient condition. Other aspects of policy deserved emphasis, such as the reduction of rigidities arising from structural imbalances.

Recalling the observation by several Executive Directors that the main discussion of protection in ID/83/1 had been placed in an appendix, the Director gave assurance that that had been done purely for presentational purposes and that it did not indicate in any way that the staff attached less urgency or importance to the problem of protection. Further, developments in the exchange rates for major currencies had been only one of several important subjects that the staff had not treated in depth in order to hold the paper to manageable proportions. However, it was planned to give exchange rates a much more extensive treatment in the forthcoming publication of the World Economic Outlook.

One Executive Director had asked for an explanation of the staff's conclusion on page 21 of ID/83/1 that "a shift to actively expansionary policies in the four major industrial countries with relatively low inflation rates would be inadvisable," the Director went on. The essential explanation was provided in the subsequent sentence, which said that "Such a policy shift would be far too risky, if only because the progress made against inflation--and toward sustainable growth--still remains fragile." In the following paragraph, the staff had noted that one piece of evidence confirming the continuation of inflationary expectations was that real interest rates remained very high.

In a related area of discussion, the Director observed, one Executive Director had suggested that the staff had exaggerated when it said that governments might lose their nerve and that they might opt for aggressive reflation. There appeared to be some misunderstanding. The staff did not believe that in present circumstances the governments of the major industrial countries would opt for aggressive inflation. It had stated that "expectations of future inflation could...be rekindled if the impression was created that governments were losing their nerve and opting for aggressive reflation." The possibility of such an impression being created remained real, given the skepticism of markets regarding government policies.

The staff's projections of economic growth had been too high in the past, the Director commented, essentially because the current economic situation was complex. It had resulted from the building up of stagflation over a period of many years and from the attack on it over the past three years primarily through the use of monetary policy without the adequate support of fiscal and other policies. The situation was unprecedented, and there was great difficulty in judging how the economic process was working, how long the lags were in response to policies, how deep-seated structural imbalances were, and so forth. The staff had sometimes been too optimistic in projecting real economic growth, but its projections had been less wide of the mark than those of most other forecasters.

A request had been made for more information on why the industrial economies had failed to rebound during the second half of 1982 in line with earlier staff projections, the Director added. As the staff had noted in ID/83/1, the failure of the recovery was primarily the result of unexpectedly weak exports, largely because of a marked weakening in the imports of non-oil developing countries, and of a further weakening in fixed investments and inventories. The failure of output to recover as the staff had expected could be traced to widespread underestimation of the difficulties of structural adjustment, and of the lingering effects of inflation and the associated anti-inflation policies. It was conceivable that the staff projections would again be too optimistic for 1983. However, with regard to investment, the main source of error in 1982, only a mild recovery was projected for residential construction, from a very depressed level, with the easing of mortgage interest rates. On the other hand, nonresidential investment in the major industrial countries as a group was expected to decline through the first half of 1983 and merely to stabilize in the second half of the year. A decline of about 2 per cent was expected in the year-on-year rate of that component of investment spending.

The factors that could block recovery had been discussed in general terms on page 19 of ID/83/1, the Director pointed out. There, the staff had stated that, on the pessimistic side, output could continue to stagnate if the lags with which larger industrial countries responded to the disinflationary process were to prove longer than expected, or if the fears and uncertainties generated by the present severe recession were to feed on themselves. On the other hand, if a recovery got under way and if it seemed to be firmly established, the return of confidence could spur a more rapid upturn in spending than envisaged in ID/83/1.

One Executive Director had asked whether the beneficial effects of U.S. recovery on European growth rates might be inhibited by adjustment in the non-oil developing countries, the Director noted. The non-oil developing countries might use the increase in their export earnings arising from a recovery in the United States to reduce the amount of their external borrowing, instead of using it to increase their imports from Europe or elsewhere. In view of the widespread need for adjustment, the dynamic multipliers associated with a given expansionary impulse were likely to be smaller than they would otherwise be. However, those considerations had been taken into account in the staff's projections. Furthermore, they were of secondary importance. The main point was that the recovery in the United States would raise U.S. imports and that it would encourage European exports to the United States. That direct expansionary effect on European economies of recovery in the United States would significantly outweigh any conceivable reduction arising from the indirect effect of adjustment in the developing countries.

The question of the impact on economic growth of a more sustainable pattern of exchange rates among major industrial countries had been raised, the Director recalled. The main result would probably be a lower U.S. dollar, which would ease the problems arising from a growing U.S. trade deficit, in particular, the risk of protection. Furthermore, it would increase the room for maneuver in countries such as Japan, Germany, and the United Kingdom. With stronger currencies, those countries would be better able to move to a policy of lower interest rates. As for an analysis of wage developments in the United States, Japan, and Europe, and of the impact of those developments on profits and investment, the staff had done considerable work in that area in the past. Wage developments had been discussed on pages 4-7 of the 1982 Annual Report of the Executive Directors; on pages 25-26 of the 1981 World Economic Outlook; and on pages 12-13 and pages 34-36 of the 1982 World Economic Outlook.

It had been suggested that the staff had been relatively optimistic with regard to the medium-term growth rates of non-oil developing countries in Scenario A, the Director continued. In fact, the projected growth rates of between 3 1/2 and 5 per cent for the various analytical subgroups, averaging 4 1/2 per cent, were disturbingly low from a historical standpoint and by comparison with demographic trends. They were also low in light of the fact that most non-oil developing countries had a large subsistence sector not much affected by world trade developments, so that most of the assumed decline in overall growth rates was the result of a rather sizable decline in the growth rates of the modern sectors.

The staff did not believe that the current account deficits of the non-oil developing countries projected for 1986 were likely to lead to financing difficulties, the Director stated. First, the growth of the deficits had been expressed in nominal terms, rather than in real terms. The \$108 billion deficit projected for 1986 amounted to 16 per cent of exports of goods and services, whereas the \$90 billion deficit in 1982 had amounted to about 20 per cent of exports. Second, some of the financing flows, such as foreign aid and direct investment, were expected to grow moderately in nominal terms from 1982 to 1986. Thus, the flow of bank loans necessary to help finance the deficits would continue to decline. As mentioned in ID/83/1, net bank claims, both long-term and short-term, on non-oil developing countries would rise by 8 1/2 per cent a year in the 1984-86 period, compared with growth rates of 20-25 per cent in the 1979-81 period and of 9 per cent in 1982. One Executive Director had suggested that the staff's analysis of current account deficits should be extended to cover industrial countries, especially the medium-sized countries. The staff agreed that such an extension would be desirable and that further work on the international capital accounts of all the industrial countries could prove useful; it hoped to pursue the subject more intensively within the limits of its resources and of the available national balance of payments statistics.

One Executive Director had expressed a hope for the resumption of economic growth, the Director went on, observing that, without such a resumption, the Fund's adjustment programs with member countries could encounter serious difficulties. The staff shared that view, but the question remained of how best to encourage sustainable economic growth. In that regard, the staff would be seriously concerned that the adoption of actively expansionary policies would lead to the pattern of developments depicted in Scenario B, an analysis that had the illustrative value of depicting the lessons of the 1970s, as explained on page 21 of ID/83/1.

Another Executive Director had suggested that the staff should make explicit projections for exchange rates in the World Economic Outlook exercise, the Director of Adjustment Studies noted, rather than using a conventional working assumption, which in the present case involved holding constant the nominal exchange rates of the first ten days of December. While the staff would ideally wish to be able to make such projections, there were at least two strong reasons for refraining from the attempt. First, making reliable projections of exchange rates was extremely difficult, since they were subject to a number of imponderable factors not susceptible to objective measurements of the kind underlying most of the staff's projections. Second, there was a question of the sensitivity of such projections from the standpoint of the national authorities whose currencies were involved. The authorities would find it objectionable to have to deal with disturbances of exchange markets that could possibly be influenced by projections emanating from an official institution like the Fund.

Mr. Erb observed that the Director of Adjustment Studies had suggested that a weaker dollar could reduce protectionist pressures and that it could give some countries other than the United States room for maneuver in their domestic policies. While a weaker dollar might reduce protectionist pressures in the United States, it could exacerbate them in Europe and elsewhere. The decline of the dollar had improved the competitive position of European countries and, as a result, they had been able to export more than they otherwise would have been able to do. On the question of the room for maneuver, it appeared that one of the reasons why the dollar had not fallen even more sharply as a result of the shift in U.S. monetary conditions was that other countries had moved simultaneously in the same direction, and, because the markets had perceived those developments, there had not been the shift away from the dollar to other currencies.

Mr. Taylor commented that the exposition of the consequences of a change in oil prices by the Director of Adjustment Studies had been most valuable. He encouraged the staff to provide Executive Directors with more detailed explanations of the consequences of alternative assumptions in the projections underlying the World Economic Outlook. Forecasting was always difficult, particularly with regard to such areas as oil prices and exchange rates, and it would not be appropriate to attempt to predict what might actually happen. However, a more systematic exploration of the consequences of various alternative developments was an appropriate area for the Fund, within the limits of the staff's resources.

The Director of Adjustment studies said that he agreed with Mr. Taylor. The staff's efforts at simulations had so far consisted mainly of the development of various scenarios, with analysis of the implications of each. In addition, the staff had engaged in various types of sensitivity analysis from time to time, and several years earlier it had undertaken an analysis of the economic impact of oil price increases at a time when that issue had been very sensitive.

Mr. Kafka remarked that he agreed with Mr. Taylor in principle, but that a proliferation of scenarios would present practical difficulties for the staff and for the reader. A more modest approach might consist of presenting sensitivity analyses for a number of key parameters.

Mr. Casey stated that he agreed with Mr. Kafka's suggestion that the staff should undertake, where appropriate, sensitivity analyses. The Director of Adjustment Studies had undertaken such an approach in his discussion of oil price developments. Perhaps those comments could be included in the World Economic Outlook publication, amended as appropriate in the light of new information. On the question of the statistical asymmetry in balance of payments data, he welcomed the information that the issue would be looked at in more detail in the published World Economic Outlook. The Article IV consultations with the major countries could be used more actively to try to understand the reasons behind the discrepancies. Informal technical consultations with the major countries might also be useful. Mr. Polak had suggested that Scenario B could be eliminated from the World Economic Outlook exercise. However, that scenario provided a useful illustration of the negative consequences of misguided policies.

Mr. Erb commented that the World Economic Outlook report focused a good deal of attention on monetary policy, especially in the major countries, but relatively little on exchange rates, particularly the linkages between exchange rates and monetary policy. A more explicit analysis of exchange rates, focusing primarily on the relationships among the yen, the dollar, and the deutsche mark, would be most useful. The relative tightness of monetary policies in the major countries was one reason why earlier forecasts had not turned out as expected, and the cause of that relative tightness could be traced in part to the reaction of different countries to exchange rate developments. The staff's present forecast with respect to inflation, however, might be too low because of a failure to pay adequate attention to the impact of easier monetary conditions in several countries together. If monetary conditions continued in the same direction, the result could be both higher output and higher inflaton than projected in the staff report.

The Director of Adjustment Studies noted that the staff had focused on two major issues in ID/83/1, i.e., on fiscal and monetary policies in the major industrial countries and on problems of external adjustment and financing. The published World Economic Outlook would be much more comprehensive and it would give considerably more attention to exchange rates.

Mr. Vidvei observed that, if the staff was to produce further analysis of the kind suggested by Mr. Taylor, it would require a strengthening of resources along the lines his chair had suggested in the past, especially in the statistical field.

The Chairman made the following remarks:

All Executive Directors agreed that the severity of the recession has added to the difficulty of achieving the needed adjustment in the external positions of many countries.

The first observation I want to make concerns the degree of adjustment that is already under way in the non-oil developing countries. For example, the table on page 26 of the staff paper (ID/83/1) shows the impact of oil trade and interest payments on the external position of non-oil developing countries. In 1981, after accounting for oil imports and interest payments, there was still room for \$12 billion of net imports of other goods and services by these countries. In 1982, these "other current transactions" were in balance, while in 1983, they are projected to be in surplus by \$14 billion, representing a net shift of resources from these countries to the rest of the world. The imports of non-oil developing countries declined by 4 per cent in volume terms in 1982 and, while the staff anticipates a recovery of some 2 1/2 per cent in 1983, this would still leave aggregate imports of these countries below the 1981 level in real terms.

My second observation is that the pattern of external financing assumed by the staff is fragile. Allowing for the significant statistical imperfections, which are well known, the situation can be summarized as follows:

In 1981, the current account deficit of the non-oil developing countries was about \$103 billion; it declined to \$90 billion in 1982; and it is projected to be \$70 billion in 1983. In 1981, the current deficit was financed (in very round numbers) by: \$25 billion of nondebt-creating flows; \$25 billion of long-term official financing, much of which was concessional (i.e., a total of \$50 billion of "core" financing); \$40 billion of private medium-term and long-term lending; an increase in short-term bank credit of about \$10 billion; and net financing by the Fund of \$6 billion. Thus, the \$50 billion increase in the outstanding private credits to the non-oil developing countries in 1981 represented about half of the financing of their balance of payments; it also represented an increase of 22 per cent in the stock of such credit to these countries over the previous year. These amounts simply could not continue at such rates. They were bound to lead exactly to the situation faced in the middle of 1982, i.e., a financial crisis, that caused "forced" adjustment to take place in conjunction with the organized adjustment in which some countries were already deeply engaged.

In 1982, of a total financing need of approximately $90 billion, nondebt-creating flows and long-term official financing both remained close to the previous year's level of $25 billion each. Net new private lending, long-term and short-term, was $25 billion, compared with $50 billion in 1981, a 9 per cent increase in the commercial banks' exposure. There was also $6 billion of net financing by the Fund, and reserve use of about $10 billion. Thus, a shift in the right direction took place: the rate of increase in bank exposures, which in 1981 had averaged 22 per cent--and to some countries it was much higher--fell to the more normal growth of 9 per cent in 1982. However, it was absolutely essential that the world's monetary authorities and the Fund should work to ensure that there was not a precipitous decline to a zero increase; in such circumstances the health and the survival of the financial system would have been at stake. The risk was very great indeed. Through adjustment programs and financial packages, we have been able to manage a sharp deceleration to a more viable rate of increase in the exposure of the financial institutions toward the non-oil LDCs.

In 1983, expected developments are again in the right direction. An increase in nondebt-creating flows would be welcome but, unfortunately, a realistic analysis suggests that they will remain at the same level as in 1981 and 1982, i.e., $25 billion. Long-term official financing is projected again to be some $25 billion, which is consistent with the efforts that the Fund is making, with the cooperation of governments, to encourage the long-term lending of official institutions to a number of countries in difficulties. Private bank credit, both long-term and short-term, is projected to increase by about $20 billion, continuing the deceleration begun in 1982. That amount, which could well have been much lower without the efforts of the Fund, represents an increase of between 7 per cent and 8 per cent in the outstanding credits of the banking system to the non-oil developing countries. Finally, net financing by the Fund would be about $12 billion, thus allowing gross reserves to regain some badly needed margin.

But the above pattern of financing of non-oil developing countries' deficits depends on a number of factors that could perhaps be summarized as follows:

First, it depends on basic developments in the world economy. All the financing estimates assume some recovery in world trade; it is absolutely clear that, without a modest recovery in world trade and in the economies of the major industrial countries, the financial situation of the non-oil developing countries would become even more difficult, and that the economic foundations of the adjustment programs that the Fund has arranged with a number of countries would be severely weakened. Thus, it is very important for these countries, and for the stability and the health of the financial system, that at least a moderate pickup in activity occurs.

A second fundamental condition is that the governments engaged in these programs implement them. If there are slippages in implementation, the financial conditions for the success of the programs--particularly as regards private sector confidence--would be undermined. Thus, the responsibility of the member countries to implement the programs as they have been negotiated and devised is central to the stability of the financial system.

A third condition is that the Fund continues to work closely with all members of the financial community, including both central banks and commercial banks. There has to be an integrated effort.

Returning to the first condition, recovery in the world economy, we all agree that it is vital that this revival of growth happen and that it happen soon. The implications go beyond the stability of the international financial system. The central question, which Directors addressed in their different ways in the discussion, is how to ensure that the recovery takes place in a sustainable way, not just through a burst of activity in the short term that would quickly falter.

The "room for maneuver" is limited. Some of the large industrial countries have indicated that, because of the persistence of inflationary conditions, they are not in a position to take stimulatory measures. As far as the others are concerned, views differ on what can be done in countries such as Japan or Germany on the fiscal or monetary side, and the specifics of the various situations suggest that there is no universal prescription in these countries. Furthermore, the recommendations that are offered generally involve very moderate shifts in policy, rather than any strong impetus to economic activity.

In the United States, there is considerable slack in the economy, with a great deal of capacity underutilization, but there, too, the room for maneuver in the short run is less than it might appear. The monetary authorities in the United States have been seeking to accommodate economic recovery, and they have gone a considerable way in that direction. It is striking, however, that as they moved further toward monetary relaxation in recent weeks interest rates did not continue to react as expected. Long-term rates actually rose slightly, and short-term rates have not been responding to cuts in the discount rate. It would appear, therefore, that the Federal Reserve Board no longer has much room for maneuver. The rate of increase in M-2 is about 10 per cent, while the increase in nominal GNP is modest; those are not what might be termed very strict monetary conditions. I would judge that there is not much more that the authorities can do, and that to go too far could be counterproductive in terms of interest rates and market expectations.

With regard to fiscal policy, no Executive Director expressed the view that the fiscal position in the United States should be relaxed or made more expansionary. Furthermore, everyone agrees that in the medium run, i.e., beginning in fiscal year (FY) 1984, the deficit should be reduced, not for doctrinaire reasons, but because of the belief that a reduction in the deficit would lay the foundation for stronger and more sustainable growth--a view shared by the U.S. authorities, as Mr. Erb made clear.

The relationship between the federal deficit and net private savings in the United States is worth noting. In 1982, the federal deficit (not including the off-budget items financed through federal borrowing or guarantees) amounted to approximately 80 per cent of private savings, an unprecedentedly high figure. In 1976, by comparison, following the severe recession of 1975, the deficit was also quite high, at 3 per cent of GNP, but it then represented 45 per cent of net private savings. The present large deficit therefore represents a heavy burden on the financial markets. Even if it should appear that there is no "crowding out," because the demand for private credit is now low, the fact that the deficit has to be financed through the markets is an element preventing interest rates from falling further. Thus, a decline in the fiscal deficit and a perception that it will be reduced in FY 1984 and beyond are essential if there is to be a drop in U.S. interest rates.

It is widely acknowledged that the housing and automobile industries are key factors in economic growth in the United States and that both sectors are very sensitive to interest rates. However, interest rates remain high in real terms. In my judgment, there is little scope for further action through monetary policy to reduce interest rates further. The action has to be taken on the fiscal side, not because a budget deficit per se is harmful, but because the resumption of growth is absolutely fundamental to the survival of the international financial system and because, in the present circumstances, the best way to stimulate durable growth is for the United States to take significant fiscal measures--measures that would allow interest rates to decline further with the reduction in inflationary expectations.

The Chairman then made the following summing up:

Our discussion of the world economic situation has taken place at a time of exceptional difficulty and uncertainty. While the views expressed by Directors have covered a wide spectrum, there has been general agreement that the world economy faces a particularly complex set of circumstances and problems, to which there are no easy answers. In my summing up, I will deal in turn with the four specific topics for discussion noted in Section IV of the staff's General Survey paper.

Recent developments and short-term prospects

In their comments on the review of economic developments and prospects contained in the staff paper, Executive Directors noted the further downward revisions in the estimates for both growth and inflation in the industrial world. Concern was expressed at the delay in economic recovery, particularly the weakness of investment and trade. On the other hand, Directors welcomed the further progress in the fight against inflation, and the reduction in interest rates which it had facilitated.

The downward revisions for the 1982 output estimates led a number of Directors to question the attainability of the new projections. Specifically, some speakers implied that overestimation of the strength of investment and export demand might be repeated again in 1983. On the other hand, other Directors noted that the projections rested on quite conservative assumptions, and that actual growth rates might well turn out to be higher. On balance, perhaps we could say that the staff's projections could be accepted as fair central estimates.

Many Directors commented on the unsatisfactory situation facing non-oil developing countries. The growth rates of these countries, which had averaged about 6 per cent in the 1960s and early 1970s, have averaged only 2 1/2 per cent in the past two years (implying virtually zero growth in per capita terms), with not much improvement in prospect for 1983. Directors noted that the very modest increases in aggregate output during recent years were being achieved against a background of deteriorating terms of trade, very high interest rates on external debt, rapid population growth, and strains in the financing of current account deficits.

In their discussion of the global payments situation, several Directors commented on the large size of the statistical asymmetry in the estimation of current account balances. The problem here is obviously not amenable to simple solutions, but the staff will continue to make its best efforts--including the use of Article IV consultations--to improve understanding of this complex phenomenon.

Another aspect of the payments position to which attention was drawn was the economic and financial impact of a possible decline in oil prices. The Director of Adjustment Studies has given us a brief and preliminary, but illuminating, view of the matter, and we will continue to follow developments in this area closely.

Policies in the major industrial countries

The unsatisfactory state of the world economy prompted Directors to reconsider the issue of whether some modification in the policies of the major industrial countries was needed. Not surprisingly, a considerable diversity of views was expressed. However, I believe it would be fair to draw the following tentative conclusions.

First, there was no dissent from the proposition that achievement of sustainable growth is the central objective of policy in present circumstances. Differences of view rather revolved around the means by which this objective can and should be achieved.

Second, there was a wide measure of agreement--perhaps I might say unanimity--that durable economic recovery depends on the continuing credibility of anti-inflation policies. Most Directors agreed with the staff that further progress against inflation was necessary in at least several of the major industrial countries, and that policymakers should avoid measures to promote recovery that might generate harmful expectations with regard to inflation. Several Directors noted that a reduction in inflation might not in itself be sufficient to produce recovery--a view with which the staff fully agrees. However, I believe we could accept the view that successful handling of the inflation problem is a necessary--albeit not sufficient--condition for growth to be sustained over the medium term.

In this connection, a third point of widespread agreement concerned the importance of tackling structural fiscal deficits. It was pointed out by many Directors that a durable recovery would involve rising private demands for credit--and that these could be met only if governments were to reduce their own demands on the pool of available savings. Indeed, in certain countries, policies to bring down budget deficits should be set in place now, so that the prospective deficits do not "cast their shadow forward" in the form of high real interest rates that would hinder the process of recovery.

Fourth, many Directors noted that the problem of structural maladjustment went well beyond the size of the fiscal deficit. They pointed out, in particular, that low economic growth could not be explained simply in terms of deficient aggregate demand. Declining profitability had led to falling investment, which in turn had reduced the rate of growth of productive potential. These Directors believed that stable noninflationary growth would require firm action to deal with structural problems, which included, inter alia, labor market rigidities, excessive levels of real wages and inadequate profit incentives, and inappropriate government intervention in the form of support for declining industries. In that vein, a number of Directors underscored the importance of reaching a social consensus on the need to contain the growth of real wages.

Fifth, there was broad agreement that the policy approach to be followed should differentiate among countries according to their particular circumstances. Indeed, some Directors called for even more differentiation than was specifically mentioned in the staff paper. In this connection, I may perhaps review the main observations that were made about the policies of the major industrial countries.

With respect to France, Italy, and Canada, there was general agreement with the staff's view that present circumstances do not permit any relaxation in the stance of monetary and fiscal policies. Restraint in demand management continued to be necessary, along with effective implementation of the incomes policies now in place.

With respect to the other four countries (the United States, Japan, Germany, and the United Kingdom), there was a broader range of views. All agreed that noteworthy progress had been made in the fight against inflation, and that financial policies and conditions in these countries had generally become less restrictive in the past year or so. This change was welcomed, and Directors agreed with the staff that the authorities concerned should continue to take judgmental advantage of the "room for maneuver" that may be afforded by declining inflation rates. But the preponderant view of the Board was that the basic anti-inflation framework of policy should be maintained, and that any deliberate shift to a more expansionary stance would carry risks of rekindling inflationary expectations and of thwarting the achievement of sustained economic growth. Adding weight to this view is the fact that it was shared by the Executive Directors representing all four countries with relatively low rates of inflation.

On the other hand, a few Directors judged the balance of risks differently, and favored a shift toward active stimulus. They based this view on a number of factors: a belief that inflationary expectations had now receded; a judgment that the downside risks of prolonging the recession were serious; and a view that continued high unemployment might produce a revulsion against present policies, with adverse consequences for the anti-inflation effort in the medium term. In addition, there were a number of Directors who more or less went along with the staff's analysis but differed in some points of emphasis--feeling, in particular, that the staff tended to be too cautious in its approach, or perhaps not sufficiently nuancé. The interventions of these Directors reflected, understandably, a good deal of concern and even distress that economic recovery had proved so elusive. Nevertheless, I did not draw from the Board discussion any specific recommendations for the adoption of substantially different policies in any of the four major industrial countries with relatively low rates of inflation. In my view, this brings us to an important consideration--that, despite the changes that have occurred in the world economic situation, there is still no satisfactory alternative to the general strategy of bringing down inflation and tackling structural rigidities and imbalances.

The situation of the United States naturally attracted the most attention. All Directors who expressed views on this subject stressed the importance of a credible reduction in the prospective fiscal deficit. They noted that deficits of the magnitude currently projected not only posed a threat to stability in the medium term, but also could hamper the process of recovery in the interim by tending to keep interest rates high. Decisive action to reduce the structural component of the deficit would allow interest rates to come down further and underpin the process of recovery that seemed to be getting under way. As far as monetary policy was concerned, it was noted that the interpretation of monetary growth rates had become complicated in recent months, and there was general agreement with the manner in which the Federal Reserve Board had implemented policy. Directors differed in their views as to how much leeway the Federal Reserve still had to continue its recent efforts to encourage lower interest rates.

Concerning the other three countries with relatively low inflation rates, Directors noted that fiscal policy in Germany and Japan had been implemented flexibly during the course of the past year or so. There was general agreement with the medium-term fiscal objectives of these countries, although a number of Directors felt that the pace at which such objectives were approached could be further modified in the light of current conditions. For the United Kingdom, Directors noted that the recent decline in the exchange rate for sterling restricted the authorities' freedom of maneuver by contributing to upward pressures on prices--although, at the same time, it should help to improve the competitive position of British producers and thus strengthen net foreign demand.

External adjustment and financing

In considering the position of the non-oil developing countries, many Directors drew attention to the exceptionally difficult external environment faced by these countries. Their terms of trade have deteriorated by almost 20 per cent over a five-year period, their markets in the industrial world have been sluggish, prices for many primary commodities are below costs of production, and interest payments on external debt have grown substantially.

Executive Directors observed that the current account deficit of the non-oil developing countries had declined in 1982 and was projected to decline further in 1983. Sluggish growth in exports and financing difficulties had necessitated a sharp compression of imports, which in turn had been achieved at the cost of lower investment and growth. While Directors agreed with the staff that the aggregate current account deficit of non-oil developing countries was moving into a broadly more viable range, several of them noted that uncertainties continued to prevail--in particular, uncertainties concerning growth prospects in the industrial countries and continuation of private banking flows on an adequate scale.

Concerning the accumulation of external debt by non-oil developing countries, Directors welcomed the statistics and analysis contained in the staff paper, "Trends and Prospects in International Capital Markets and Survey of External Debt Situation." They agreed with the main thrust of this analysis, and looked forward to a detailed discussion of debt issues in the Board meeting tentatively scheduled for the end of March.

Most Directors commented on the extent of adjustment that had already been achieved by non-oil developing countries, or was expected in 1983. They further noted that, with due allowance for the differing positions of individual countries, further progress depended not only on the determination of authorities in pursuing appropriate policies, but also on the success of industrial countries in promoting economic recovery. Only in that way could a sustainable adjustment be achieved, with satisfactory domestic growth and adequately remunerative levels of primary commodity prices.

Many Directors noted the extent to which current account deficits of non-oil developing countries in 1982 had been financed out of official reserves. They considered that such a process could not be repeated, and were led by this observation to suggest the need for reconsideration of the case for further allocations of SDRs.

With respect to the adjustment process in other groups of members, Directors noted the difficulties faced by some of the smaller industrial countries and by certain of the oil exporting countries. Several speakers referred to the recent changes in exchange rates among major currencies, agreeing with the staff that these changes could be viewed as a move back toward a more sustainable pattern of rates. At least one Director, however, felt that the present uncertainties could foreshadow a period of unsettled conditions in exchange markets. The Board will doubtless return to this issue in the near future. Many Directors felt that more attention should be devoted to exchange rate matters in future World Economic Outlook papers.

International cooperation

There was a strong view that individual country policies should be framed in a "concerted" or "harmonized" manner. The role of the Fund was stressed: in helping to finance current account deficits, in contributing to effective adjustment, and in exercising firm surveillance over policies, especially those of the major industrial countries. Many Directors noted the special role the Fund has recently played in encouraging commercial banks to maintain the necessary financial flows in a number of key situations. I think it is fair to say that Executive Directors welcomed the initiatives that had been taken by the management, but that they preferred a flexible or ad hoc approach to such problems as they arise, rather than a formalized or predetermined approach. The enhanced role of the Fund was regarded by all Directors as further evidence of the need for a significant increase in Fund quotas at an early date.

Last, but not least, Executive Directors stressed the need for continued vigilance against the forces of protectionism. Regret was expressed at the upsurge of protectionist pressures in the past year, and it is worth noting that, without exception, Directors underlined the paramount importance of resisting these pressures and, if possible, rolling them back. They also agreed with the increased emphasis that management had given and intended to give to trade questions in the context of Article IV consultations.

2. VANUATU - 1982 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1982 Article IV consultation with Vanuatu (SM/83/3, 1/3/83). They also had before them a report on recent economic developments in Vanuatu (SM/83/13, 1/19/83).

Mr. Prowse made the following statement:

This is the first Article IV consultation with Vanuatu. Though it is a new member, Vanuatu appears as something of a model -

- it has accepted the obligations of Article VIII;
- it makes no prescriptions of currency requirements and no distinction between the account of residents and nonresidents;
- it maintains only minimal restrictions on imports and none on exports; and
- it allows payments for current invisibles to be made freely.

The Vanuatu authorities congratulate the staff on its report, which they regard as, on the whole, clear, concise, and well balanced. For my own part, I want to emphasize the staff's assessment that "Vanuatu's economic policies, particuarly its fiscal and exchange rate policies, over the past two years [i.e., since independence], have been successful in meeting the challenges posed by independence and the generally difficult conditions in the world economy." In particular, I note that inflation is now between 2 per cent and 3 per cent a year.

The staff report (SM/83/3) and the paper on recent economic developments (SM/83/13) give a concise description of Vanuatu, but perhaps do not sufficiently emphasize the problems and features of this small South Pacific island economy or, indeed, the possibly unique features of Vanuatu itself. On this basis there is, I believe, legitimate room for debate whether some of the proposals that the staff believes merit consideration by the authorities are necessarily fully appropriate to the structural and geograhical features of Vanuatu.

Vanuatu is a fragile economy heavily dependent on trade, transfers, and tourism. In 1982, two-way trade accounted for 67 per cent of GDP, transfers for 43 per cent of GDP, and foreign grants 53 per cent of total government revenues. Tourism accounted for 33 per cent of GDP. An analysis of these aggregates only underscores this vulnerability. Seventy-six per cent of its export trade comes from copra, a commodity whose prices have in recent years been both widely fluctuating and declining. Furthermore, transfers in support of the current budget, coming mainly from the United Kingdom and France, have dropped 20 per cent a year since 1980 and, in line with the understanding with the former colonial powers, will eventually be phased out. Growth of capital aid grants coming from these two countries plus Australia, New Zealand, Canada, and the European Development Fund are presently sufficient to offset these reductions.

Despite its success in countering inflation and achieving some recovery in the level of economic activity, Vanuatu's position is barely a comfortable one; Table 3 of SM/83/3 indicates more precisely the successes achieved, including revenue raising. The staff's view, with which I concur, is that the outlook for 1983 is "cautiously optimistic."

This assessment for 1983 is, of course, for the very short term. As to the longer term, there is again, as is clear from the staff report, little difference between the staff and the authorities on the desirable course of action, though it is possible that the staff gives less recognition than do the authorities to the potential of the agricultural sector, particularly in terms of exports. In this regard, it is to be noted that, in addition to the factors mentioned by the staff, copra exports in 1983 leveled off in considerable part as a result of the Government's quality control program--with the emphasis on quality rather than quantity. It is also to be noted that at present some 75 per cent of agricultural exports (excluding cattle) come from the small-holder sector, which is monetized to a greater extent than may appear from the report. Thus, large-scale plantations at present account for only 25 per cent of agricultural exports.

As to fiscal policies, it is evident that the authorities have already achieved much--they expect that the outcome for the 1982 budget will be a deficit lower than that projected by the staff. More importantly, however, they are keenly aware of the need for further revenue sources; they are considering the staff's suggestions. For my own part, I am inclined to agree with the staff (page 15 of SM/83/3) that in prevailing circumstances the most efficient means of raising revenue would be by an increase in the consumption tax on imports. A sales tax on domestic production could be something for later consideration.

On the management of the exchange rate, it is perhaps worth noting that the depreciation of the vatu against trading partner currencies in 1981 was caused by the weakness of the French franc (to which the vatu was pegged). There may now be a question for consideration whether the vatu preferably should be based on a trade-weighted basket rather than the SDR, but the present arrangement has had some beneficial effects to date and it has considerable advantages in clarity and administration.

On some aspects of monetary policy and management there are some continuing differences between the authorities and the staff. Thus, the 15.5 per cent ceiling was not introduced "with a view to promoting investment." It was imposed mainly to assist the private sector, which had heavily borrowed at an already high rate at a time of severe economic disruption and very low demand. Actual lending rates were in general 1-2 points below 15.5 per cent at the time the ceiling was imposed. The banks therefore had some scope for increasing their deposit rates to bring them a little more into line with world rates but they did not. In addition, the Central Bank did not have the powers at that time to impose minimum deposit rates. To infer that a capital outflow occurred and that a vatu shortage came about directly as a result of the imposition of the ceiling is not convincing. The outflow and the vatu shortage came about rather as a result of significantly higher interest rates abroad that could not be matched without lending rates rising to over 20 per cent. Rates at this level would have caused very serious dislocation in the private sector (a problem not unknown in other much larger, industrial economies).

Again, the ceiling was raised to 18 per cent in September 1981 not because Vanuatu was "faced with the commercial banks' lack of loanable funds in vatu and the continued stagnant investment activity...." The rate was raised to give the banks a "cushion," i.e., to enable them to raise deposit rates in the event that the decision to link to the SDR was adversely received.

The staff (on page 2 of its report) notes "two important social issues." As to land tenure, it notes that the Government is in the process of resolving the various issues--but it is not by any means an easy matter. The second issue is the policy of "localization." The Vanuatu authorities believe that the staff report places too much importance on this. Only a "handful" of senior posts in the government service have been localized and, so far as the private sector is concerned, the Government is moving slowly and carefully; the implications of a drastic localization program are very well understood.

Finally, and very importantly, the Government of Vanuatu believes that lasting success will only be achieved through the prosperity of the private sector; they see the responsiblities of Government as providing an efficient infrastructure (in the broad sense of the word) and ensuring overall financial and social stability for the country.

Extending his remarks, Mr. Prowse said that the discussions between the Fund staff and the Vanuatu authorities in the context of the Article IV consultation had been a model of how discussions between the staff and the member should be conducted. The authorities had taken the discussions most seriously and they had listened carefully to the staff's view. The staff, in turn, had played an admirable role in stimulating the interest of the authorities and in convincing them of the importance of their relationship with the Fund. The authorities awaited with interest the views of Executive Directors on the thorough staff report.

Mr. Hirao noted that Vanuatu's economic policies in the previous two years had successfully met the challenges posed by independence and by the generally difficult conditions in the world economy. The Vanuatu economy seemed to be on its way to a gradual recovery and the outlook for 1983 could be characterized as cautiously optimistic. He agreed broadly with the staff appraisal.

Commenting on fiscal policy, Mr. Hirao observed that the Government was facing the challenge of making further adjustments, necessitated by the expected decline and eventual cessation of foreign cash grant aid to support the current budget. Efforts to streamline expenditures and to raise revenues would continue to be needed over the years to come. It was encouraging that the authorities had exercised tight control over government spending in both 1981 and 1982. Despite the wage increases granted in 1981 and 1982, total current expenditure in real terms had probably declined substantially between 1980 and 1982. With regard to the means of raising revenues, an increase in the consumption tax on imports was worth further consideration, although account had to be taken of the undesirable effects of creating protection. He welcomed the recent adoption of other revenue-increasing measures, since they provided considerable diversification in the sources of revenue.

In a welcome development, Mr. Hirao continued, the authorities had successfully carried out a currency exchange operation in order to substitute new vatu for other currencies in a short period after the establishment of the Central Bank of Vanuatu in 1980. The recent decision by the authorities to remove the ceiling on interest rates on loans in vatu was also welcome, especially in view of the openness of Vanuatu's economy. He joined the staff in welcoming the authorities' emphasis on the promotion of traditional exports. Several steps had already been taken to revitalize the traditional export sector, including the promotion of better methods of drying copra so as to increase its quality. He agreed that an import substitution strategy would not be effective in view of the limited size of the domestic market.

The authorities' use of exchange rate policy to keep inflation relatively low was understandable, Mr. Hirao remarked, especially because they could thereby avoid possible pressure for wage increases, particularly in the public sector. He invited the staff to comment on the reasons why the authorities had decided to link the vatu to the SDR instead of to a basket of currencies that might better reflect the country's trade pattern. It would be important for the authorities to keep balance of payments developments under constant review if they were to be able to take exchange rate action when necessary. The Fund had played a useful role, particularly in providing advice on revenue-enhancing measures, in helping to establish the Central Bank, and in solidifying the base for the promotion of monetary stability. He hoped that membership in the Fund would continue to be fruitful and rewarding for Vanuatu for many years to come.

Mr. Ainley commented that the staff appraisal was well balanced and that he could generally endorse the staff's conclusions and recommendations. The Vanuatu authorities had successfully come through a difficult period of transition. Real growth was picking up, inflation was remarkably low, and the balance of payments was in overall surplus. Those were impressive achievements by any standards, and they owed much to timely adjustment in fiscal policy and prudent management of the exchange rate in recent months. If the economic climate improved in 1983, as expected, it was easy to see why the staff described the short-term prospects as "cautiously optimistic."

Vanuatu faced a number of structural problems similar to those of other small island economies, Mr. Ainley observed. In Vanuatu's case, the problems of land tenure and land registration would not be easy to resolve, and there appeared to be a shortage of qualified personnel in several key areas. It appeared, from the evidence in SM/83/13, that there was only one land valuer in the entire country. However, the authorities were well aware of those problems and they had accorded them high priority in the recently announced development plan. It was encouraging that the authorities had made judicious use of technical assistance from the Fund and from other international organizations. In that regard, he wondered whether Mr. Prowse or the staff could provide further information on the World Bank mission that had taken place in December, and on whether any further contacts were planned.

The authorities had demonstrated their ability to take the necessary steps to limit the overall budget deficit, Mr. Ainley went on, and they clearly recognized the need for further adjustments on the fiscal side. He encouraged them in their efforts to reduce recurrent expenditures in real terms, particularly in view of the large size of the government sector. It would also be important to continue the progress being made in streamlining the civil service and to maintain the policy of wage restraint. He agreed with the staff on the need to broaden the existing tax base; he was confident that the authorities would give serious consideration to the proposals outlined on page 10 of SM/83/3. It appeared that a sales tax might be difficult to administer; it might, therefore, be more sensible to begin by increasing the consumption tax on imports, for which the administrative machinery was already in place.

Commenting on monetary policy, Mr. Ainley congratulated the authorities on the efficient way in which they had handled the currency conversion operation. He agreed with the staff, especially in the light of Vanuatu's recent experience, that it was difficult to see how direct controls on interest rates could be effective in an open economy like Vanuatu's. Interest rates were strongly positive in real terms, and it would be interesting to learn from the staff or Mr. Prowse to what extent they had been a factor behind the large increase in Vanuatu's deposits between August 1981 and June 1982. For the moment, the scope of monetary policy was and would be restricted, but the Central Bank could begin to develop its role as a lender of last resort once the range of financial instruments denominated in vatu was expanded, and once the Bank itself acquired more expertise.

Vanuatu's recent decision to adopt Article VIII status was welcome, Mr. Ainley considered. Some of the Fund's very small members were setting a good example in that respect. While external prospects, at least in the short term, were reasonably favorable, traditional exports had performed poorly in recent years. It would be important to encourage the flow of financial and real resources to productive sectors by offering appropriate incentives to domestic and foreign investors, particularly in the traditional export sector. The authorities would also have to monitor developments in the exchange rate, particularly in the trade-weighted exchange rate, to ensure that the incentives they offered were not eroded by an overvalued currency. The policy of pegging to the SDR appeared to have served Vanuatu well so far, but the possibility of switching to a trade-weighted peg was one that the authorities could keep in mind, particularly if the trade-weighted value of the vatu was to diverge frequently or significantly from its SDR value. In sum, Vanuatu had coped remarkably well since independence. The authorities had a firm base on which to build, and if they continued with the same far-sighted policies of the recent past, the staff's cautious optimism would be fully justified.

Mr. de Maulde stated that he had found the documentation provided by the staff excellent. He was somewhat puzzled as to how the staff seemed always to be able to produce an impressive set of figures, whatever the size of the economy or its degree of monetization. In the case of a first Article IV consultation, and even more so in the case of a country faced with the difficult task of constructing a data base, the work done by the staff should be most helpful to the authorities themselves. Of course, the figures should be analyzed in relation to the general setting of the country, rather than taken at their face value.

Vanuatu was an archipelago of about 80 islands, Mr. de Maulde continued, where only 45 per cent of the total surface was considered potentially arable. The population was 126,000, and it was growing at an annual rate of more than 3 per cent. Moreover, Vanuatu was a dual economy with a substantial nonmonetized sector. Given that the size of that sector was difficult to measure, some statistics, such as the rate of growth of GDP, should be treated with caution. It was also an open economy with few restrictions on imports or exports and with no restrictions on the financial transactions of both residents and nonresidents. The Board should carefully assess the specificity of the problems and features of Vanuatu. In particular, he fully supported the last sentence of the second paragraph on page 16 of SM/83/3, reflecting commendable concerns not always referred to in staff appraisals--concern with protection from economic dislocation, the recognition of traditional values and culture, and concern with pollution and disequilibrium in the ecological balance.

He agreed that Vanuatu had been doing well in relation to inflation and growth, Mr. de Maulde said. The staff had resisted the usual Fund criticism of price controls and there was evidence in SM/83/13 that the controls were administered flexibly; nor had the staff criticized the establishment of the Commodities Marketing Board, correctly considering it a healthy development. He welcomed Mr. Prowse's reply to the staff's criticism of interest rate ceilings, and he invited the staff to comment further on the question. Was it realistic to expect an economy such as Vanuatu's to develop without the selective use of negative real interest rates for certain promising areas of investment?

The staff correctly stated that fiscal discipline must continue to be pursued, Mr. de Maulde observed. The authorities should be warmly commended for having narrowed the gap between current expenditure and current revenues, excluding foreign grants, since 1980, and for aiming at a further substantial reduction in 1983. A number of courageous measures had been taken on the expenditure side: some administrative services had been abolished, recruitment was strictly controlled, and real wages in the public sector were substantially below their 1974 level. It was true that further efforts would be needed in view of the reduced availability of foreign aid. However, in a dual economy, it might be disruptive to attempt to curtail too severely basic public services such as health, education, and transportation. Although the view might be held that such services were unproductive, they could be a prerequisite for greater coordination among the various social institutions and economic sectors, particularly in an archipelago of 80 islands.

Revenue-raising efforts offered more promise, Mr. de Maulde considered. With regard to the various measures suggested, there would be little harm in increasing the levies on imports that were primarily consumed by tourists and by expatriates; however, it might be somewhat premature to introduce a sales tax in a partly monetized economy. Similarly, there appeared to be room for increasing company registration fees and taxes on offshore banking activities. It was interesting to note that SM/83/13 provided evidence that the contribution of the offshore Finance Center to Vanuatu's economy had been considerably lower than total expenses on salaries, taxes, and purchases might suggest. It was not clear that offshore banking was a very promising development, either for the international community or for Vanautu itself, in the present circumstances.

The scope for monetary action by the Central Bank was somewhat limited, Mr. de Maulde commented. The activity of the offshore Finance Center and its eventual relations with domestic banks might prove to be an additional constraint, reinforcing the openness of the economy and the total freedom of capital movements. He emphasized that selective interest rates should not be ruled out a priori. The description of the activities of the Development Bank of Vanuatu and the Cooperative Savings Bank in SM/83/13 was interesting. It was not realistic in present circumstances to expect the Savings Bank to offer much higher interest rates. The Bank was performing a difficult task well--mobilizing rural savings in parts of the country in which hoarding of currency was traditional--and it did not compete directly with commercial banks, the latter having abstained from undertaking such an effort because of the costs involved. It would be most difficult to measure the expected or current level of inflation in the rural areas. Therefore, the more immediate objective should be to reinforce the degree of penetration of the Development Bank and the Cooperative Savings Bank in the rural sector and to widen the scope of its operations steadily, instead of placing financial constraints on its activities. He invited the staff or Mr. Prowse to comment further on the question.

Pegging the vatu to the SDR was not necessarily the best long-term solution for the exchange rate, Mr. de Maulde suggested. A direct link to the Australian dollar might be worth consideration for obvious geographical and economic reasons, rather than replacing the SDR link with a complex trade-weighted basket. On a recent occasion, Mr. Polak had argued in favor of fixing the exchange rate for the currency of a small country in terms of the currency of a close neighbor when there was a large imbalance in their relative economic sizes. Similar considerations applied to Vanuatu; the possibility was worth exploring further. Finally, it would be useful if on appropriate occasions the staff reports could contain a map of the country being discussed. Such a practice was common in World Bank reports.

The staff representative from the Asian Department noted that Mr. Hirao had asked why the authorities had chosen to link the vatu to the SDR rather than to a trade-weighted basket of currencies. The authorities had given serious consideration to the implications of their action.

After reviewing the various advantages and disadvantages of alternative devices, the authorities had thought that the SDR basket, which included the currencies of the major countries, would be comprehensive enough to cover many of the currencies that might be included in a trade-weighted basket. The SDR basket was therefore a reasonable proxy for the kinds of baskets that the authorities had been studying. A second consideration had been the convenience factor. The Fund provided, on a daily basis, a list of the exchange rates in terms of SDRs and the cross rates, and one of the commercial banks could receive the telexes, so that it could quote the rates on a daily basis. If the authorities chose to peg the vatu to a currency basket other than the SDR basket, the staff of the Central Bank would have to calculate the exchange value of the vatu each day; if the need arose, it would have to change the rate in the course of the day when exchange rate markets were subject to considerable fluctuation. At the moment, the commercial banks did that automatically.

There was little difference between the views of the authorities and those of the staff on the reasons for the introduction and adjustment of interest rate ceilings, the staff representative continued. When the authorities had imposed the interest rate ceilings on domestic loans, they had been concerned about the lack of investment and the low level of domestic economic activity. They had sought to protect the private sector from the rise in international interest rates and accelerating inflation, hoping that they would thereby encourage investment. Similar considerations had applied when the authorities had raised the ceiling from 15.5 per cent to 18 per cent. At that time they had wanted to make room for the commercial banks to increase their deposit rates as a way of attracting deposits and thereby increasing the supply of loanable funds. The Government and the Central Bank had issued a joint statement on September 9, 1981, stating:

> The maximum rate of interest of 15.5 per cent payable on bank loans and advances in Vanuatu, announced in March, will be raised to 18 per cent. The banks are requested to increase their deposit rates in line with the rise in the maximum lending rate, to continue to give priority in their lending to the productive sectors, and for developmental purposes, and to charge for such priority lending the rate lower than the new 18 per cent maximum.

As for the relationship between Vanuatu and the World Bank, the staff representative from the Asian Department continued, the Fund staff had been informed that a Bank mission had visited Vanuatu in November and December 1982. A report was currently being prepared, focusing primarily on conditions in the agricultural sector; the staff expected to receive it upon completion.

The staff representative from the Exchange and Trade Relations Department said that the staff would look into the possibility of providing maps with staff reports on appropriate occasions.

Mr. Prowse commented that he shared the view implicit in Mr. de Maulde's remarks that the gains to Vanuatu from the offshore Finance Center were not very clear. He had discussed the question with the staff and with the authorities and he hoped that the staff would be able to provide a precise estimate of the benefits arising from offshore finance in time for the next Article IV consultation with Vanuatu. A rough estimate appeared on page 36 of SM/83/13. Pending the outcome of a more thorough analysis, there was a prima facie case for increasing the taxation of the offshore financial institutions.

The abandonment of the previous exchange arrangements and the adoption of the SDR link had been a sensitive question for the authorities, Mr. Prowse observed. Prior to the SDR arrangement, the currency had been pegged to the French franc. When the authorities had decided to change the arrangements, the most appropriate combination of neutrality and efficiency had been the SDR. However, the possibility of using a trade-weighted basket was being considered, but Directors should be aware that many countries with more developed infrastructure and administrative capabilities than Vanuatu used the SDR link. The key question would be whether the perceived benefits of a trade-weighted basket would outweigh the difficulties of administration and the benefits of clarity and precision that the SDR link provided. The difficulties of managing and administering a complex exchange system with such a small administrative structure ought not to be underestimated.

The possibility of a link with the Australian dollar was also being studied, Mr. Prowse continued, but he did not share the view that it was necessarily appropriate for a small country to link its currency to that of a large neighbor. The evidence in Table 22 of SM/83/13 indicated that a link to the Australian dollar might have led to much greater fluctuations in the value of the vatu than had in fact occurred. The authorities had been concerned to achieve as much stability within a framework of appropriate adjustment as was possible; in that regard, a basket was preferable to pegging to a single currency. Furthermore, while trade with Australia was important, it was not dominant. Thus, while the matter of exchange arrangements ought to be kept under review, as the authorities intended, the SDR link had served well to date, and if it was to be replaced, a link to a trade-weighted basket would be preferable to a link to the Australian dollar.

The role of the World Bank could be important in the future development of Vanuatu's economy, Mr. Prowse stated, and it was worth noting that the World Bank had established close liaison with the Asian Development Bank (AsDB) in Vanuatu. The AsDB would take the lead role in a number of joint projects, and the World Bank had been able to adopt some of the analyses prepared by the AsDB in the course of its assessment. The Vanuatu authorities were looking forward to the report being prepared by the World Bank on the agricultural sector.

A number of Directors had commented on the appropriate development of the revenue structure, Mr. Prowse noted. Their views appeared to be consistent with his own, and with those of the staff, to the effect that the first step should be to consider a tax on the consumption of imports, and that the imposition of a sales tax did not appear to be a practicable proposition in the present circumstances, given the administrative difficulties and the existence of a large nonmonetized sector. He agreed with Mr. de Maulde on the potential value of expanding the monetary sector through the use of the Cooperative Savings Bank; he would bring the point to the attention of the Vanuatu authorities.

The Chairman made the following summing up:

> Executive Directors welcomed the first Article IV consultation with Vanuatu and the recent adoption by Vanuatu of Article VIII status in the Fund. They noted with satisfaction that since independence the Vanuatu authorities had managed remarkably well in weathering difficult domestic and international economic conditions with commendable measures in the area of fiscal and exchange rate management. They warmly commended the authorities on the high degree of price stability in Vanuatu, and on the maintenance of external equilibrium. At the same time, they remarked that the authorities still confronted the task of resolving issues relating to land use and of strengthening the basis for the economy of the newly independent country to attain a sustained path of growth with stability.
>
> The most important challenge the authorities faced was the adjustment of the economy to the expected further declines in foreign grants. That adjustment would fall largely on the fiscal area. Further significant efforts to streamline expenditure were important, and they needed to be accompanied by steps to raise domestic revenue, for which the staff and technical assistance experts had put forward several suggestions. Some Directors commented on the comparative merits of different means of increasing revenues; they felt that increasing taxes on imports might be the more practical solution in present circumstances and that the introduction of a sales tax needed further consideration.
>
> Directors welcomed the establishment of the Central Bank of Vanuatu and they commended its progress in gathering monetary statistics and in monitoring economic developments. The increased role of the Cooperative Savings Bank in the rural sector was underlined. Directors endorsed the authorities' cautious policy toward industrial savings and development of the tourist industry, as well as their emphasis on promoting agricultural exports. They emphasized the need to enhance the export of traditional goods. They also noted that the authorities needed to keep their exchange rate policy under continuing review, in light of the developments in the balance of payments situation, and they suggested that the question of pegging the vatu to a trade-weighted basket of currencies merited study.

3. PROBLEM COUNTRIES - MEETING PROCEDURES

The Chairman observed that his attention had been drawn to a number of inadequacies in the existing arrangements for informing Executive Directors about problem countries through periodic luncheon meetings. At the moment, for practical reasons, only half of the Executive Board could be accommodated in one luncheon meeting, and the Executive Director for the country concerned could not be present at both luncheon meetings. To overcome such problems, it had been suggested that Directors should perhaps meet at more frequent intervals in the Executive Board room before the start of the regular Executive Board meetings instead of at lunch. He entirely agreed with the suggestion, and he intended to try to keep the meetings to about one hour. The meetings would be held on a restricted and informal basis, without formal statements by any Director, and without decisions being taken. The purpose was to provide information, not to replace the normal meetings of the Executive Board. The staff would be present to answer questions. His luncheon meetings with Executive Directors would continue, as appropriate, to discuss matters of general interest in the international economy or concerning particular countries. The only staff members present on the latter occasions would be the Deputy Managing Director and the Secretary. The new procedures would come into effect the morning of February 4, 1983.

The Executive Directors took note of the Chairman's remarks.

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/83/23 (1/31/83) and EBM/83/24 (2/2/83).

4. RWANDA - 1982 ARTICLE IV CONSULTATION - POSTPONEMENT

Notwithstanding the period of three months specified in Procedure II of the document entitled "Surveillance over Exchange Rate Policies" attached to Decision No. 5392-(77/63), adopted April 29, 1977, the Executive Board agrees to postpone its consideration of the 1982 Article IV consultation with Rwanda until not later than March 30, 1983. (EBD/83/26, 1/28/83)

Decision No. 7318-(83/24), adopted
February 1, 1983

5. EXECUTIVE BOARD TRAVEL

Travel by an Executive Director as set forth in EBAP/83/37 (1/28/83) is approved.

APPROVED: July 8, 1983

JOSEPH W. LANG, JR.
Acting Secretary