NOT FOR PUBLIC USE

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 83/93

10:00 a.m., June 29, 1983

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

Executive Directors	Alternate Executive Directors
	L. K. Doe, Temporary
	H. G. Schneider
	A. Le Lorier
A. Donoso	M. Teijeiro
	T. A. Connors, Temporary
M. Finaish	T. Alhaimus
	Jaafar A.
T. Hirao	T. Yamashita
R. K. Joyce	
	H. Arias, Temporary
G. Laske	G. Grosche
G. Lovato	
	A. S. Jayawardena
	J. E. Suraisry
J. J. Polak	
	K. G. Morrell
G. Salehkhou	O. Kabbaj
F. Sangare	E. I. M. Mtei
M. A. Senior	
	A. Lindø
N. Wicks	C. Taylor
Zhang Z.	Wang E.

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

Also Present

C. F. Schwartz, Special Consultant. African Department: J. B. Zulu, Director; O. B. Makalou, Deputy Director; A. C. Woodward. Asian Department: J. T. Boorman, S. Kashiwagi. Central Banking Department: L. M. Koenig, Deputy Director. European Department: L. A. Whittome, Counsellor and Director; P. B. de Fontenay, P. Gotur. Exchange and Trade Relations Department: D. K. Palmer, Associate Director; W. A. Beveridge, Deputy Director; S. Mookerjee, Deputy Director; M. Guitian, G. G. Johnson, S. Kanesa-Thasan. External Relations Department: P. de Fontnouvelle, H. P. G. Handy, N. K. Humphreys. Fiscal Affairs Department: V. Tanzi, Director; P. S. Heller. Legal Department: G. P. Nicoletopoulos, Director. Middle Eastern Department: J. G. Borpujari, G. Tomasson. Research Department: W. C. Hood, Economic Counsellor and Director; A. D. Crockett, Deputy Director; R. R. Rhomberg, Deputy Director; J. Artus, M. P. Blackwell, J. E. Blalock, M. C. Deppler, D. J. Goldsbrough, M. D. Knight, C.-Y. Lin, I. Zaidi. Secretary's Department: J. C. Corr. Treasurer's Department: T. B. C. Leddy. Western Hemisphere Department: J. Ferrán. Office in Europe: J. K. Rosenblatt. Personal Assistant to the Managing Director: N. Carter. Advisors to Executive Directors: A. A. Agah, C. J. Batliwalla, J. Delgadillo, S. El-Khouri, S. M. Hassan, P. Kohnert, H.-S. Lee, I. R. Panday, P. D. Péroz. Assistants to Executive Directors: L. Barbone, M. Camara, L. E. J. Coene, I. Fridriksson, M. Hull, H. Kobayashi, M. J. Kooymans, Y. Okubo, J. G. Pedersen, G. W. K. Pickering, M. Z. M. Qureshi, J. Reddy, J. Schuijer, M. Toro, Wang X.

1. WORLD ECONOMIC OUTLOOK - MAIN ISSUES

The Executive Directors discussed a staff paper focusing on the main issues relating to the world economic situation and outlook (ID/83/4, 6/30/83). They also had before them as background material the published World Economic Outlook Report (Occasional Paper No. 21, May 1983).

Mr. Wicks considered that the discussion of the main issues relating to the world economic situation and outlook was timely. Several important matters affecting the development of Fund policy in the medium term would have to be dealt with in the coming months, and the decisions that were reached would need to be practical and relevant to the world economic situation as the Fund saw it.

He was in broad agreement with the staff's latest forecasts and policy conclusions, Mr. Wicks noted. There were encouraging signs in Japan and in the United States that hopes of recovery would not be disappointed again, although his authorities were less sanguine about the prospects for a truly satisfactory recovery in the major European economies. The staff's forecast for the United Kingdom was a little more optimistic than that made in the Chancellor's budget in March, but he could broadly agree with the staff that a modest recovery of output in 1983 would accelerate throughout the year into 1984. The U.K. authorities expected only a slight pickup in world trade during the rest of the year, but a stronger one in 1984. Progress in reducing inflation would probably be less dramatic in the coming year or two than it had been in the recent past, particularly if commodity prices rose.

Referring to the mechanism by which the recovery was transmitted, Mr. Wicks remarked that the staff's forecast seemed to depend greatly on a revival of confidence in businesses and households, as well as in the international banking community. For their part, his authorities saw lower inflation and a lower interest rate pushing up personal consumption, residential investment, and stockbuilding. He wondered whether or not the staff would agree that those were the most likely factors for transmitting recovery. It would also be helpful if the staff could comment on the tendency of the money supply to increase in several countries at the present time--the United States, the United Kingdom, and the Federal Republic of Germany--and on whether it might have implications for inflation in, say, 18 months.

Referring to fiscal policies, Mr. Wicks mentioned the disturbingly high levels of real long-term interest rates. Those rates seemed to be proof of inflationary expectations' persisting in financial markets for the medium term, and if they continued at their present levels, the strength of the recovery might be seriously impaired, as the staff had noted. He had referred to interest rates under the heading of fiscal policies because their high level in real terms was related at present to fiscal policy, and in particular to the fiscal balance in the United States. Although he was concerned about the U.S. fiscal balance for FY 1983/84, he was more concerned about the structural deficits forecast for the years beyond. Present fiscal policies in the United States suggested that even with a good recovery the budget deficit was likely to be large in relation to the level of U.S. private sector savings, absorbing perhaps as much as 80 percent of net private savings. At a time when the watchword of international discussion was economic convergence, the U.S. budget deficit was not just a matter for the United States: it contributed to an undesirable exchange rate volatility; its financing would affect interest rates or inflation, which was bound to have an adverse effect on the rest of the world; and indeed, the U.S. economy itself might be adversely affected, if the near-monopolization of private sector savings by the U.S. Government sector meant that the private sector was denied the opportunity to increase its productive potential. High real interest rates also made it harder for the developing countries to deal with their debt problems.

More generally on fiscal policy, Mr. Wicks went on, a marked shift to active expansionary policies might be counterproductive, as the staff had stated, with the short-term gains being more than offset by the long-term penalties. But in those countries where there was less danger of resurgent inflation--Japan and Germany were examples--he accepted the staff's assessment that too rapid a reduction in fiscal deficits could inhibit the pace of domestic and therefore of world recovery. The United Kingdom was less fortunate than Japan and Germany with respect to inflationary expectations. The U.K. inflation rate, at 3.7 percent, was low by the standards of the 1970s, but the reduction had been rapid and relatively recent; the authorities were determined to take the further decisions necessary to keep inflation at that low rate and to reduce it further, as they had already demonstrated they could do.

As for the smaller industrial countries, Mr. Wicks remarked, many of them had followed a much less convincing path of adjustment than the major countries. For instance, in a number of Article IV consultation discussions in the Board, his chair had pointed to certain deep-seated structural imbalances that called for action.

One of the Fund's primary responsibilities concerning industrial countries was exchange rate surveillance, Mr. Wicks remarked. He shared the staff's doubt about achieving exchange rate stability when inflation rates varied so much. Although rates of inflation in many of the major economies were closer than for many years, determined policies were necessary in all industrial countries to convince the markets that inflation would not rise above the present underlying levels.

The Fund should hold Article IV consultations with all industrial countries on the regular 12-month cycle, Mr. Wicks considered. His authorities had argued that the external impact of members' policies should be assessed in the context of Article IV consultation discussions; to some extent, their concerns had been met, although more could be done. In many staff reports for Article IV consultations, the staff should be able to include a paragraph or two specifically addressing the question of the effect of the particular country's policies on other countries with which it had trading and other relations. He also urged the Executive Board to continue holding regular World Economic Outlook discussions as part of the Fund's overall surveillance of the international financial system.

Intensified collaboration between the Fund and the GATT had a role to play in dealing with trade problems, Mr. Wicks said, but the staff should continue to analyze, perhaps with greater concentration than in the past, the trade consequences of domestic policies described in Article IV consultation reports. Responsibility for maintaining an open global trading system meant that countries should be willing to undertake major structural adjustments in the medium term, especially when those adjustments were taking place under multiyear Fund programs.

On developing countries' debt, Mr. Wicks asked whether sufficient account was taken by the staff of the consequences of the forecast reduction in net bank lending in 1983. He hoped the consequences would be considered in some detail in the paper on SDR allocations, which would need to look closely at the prospects for banking flows and at the reserve needs of developing countries, in order to help Executive Directors to determine whether or not there was a long-term global reserve need.

In conclusion, Mr. Wicks stated, the staff paper usefully highlighted the three fundamental issues that should govern the Executive Board's forthcoming discussions of various policy matters. First, there was the need to continue the economic recovery without adding to inflationary pressures; second, rapid structural adjustment in debtor countries and in other countries as well was necessary; third, adequate but noninflationary levels of liquidity had to be provided.

Mr. Hirao mentioned, as the first of five major issues in the present world economy, the need for an expansion of world trade. In the current closely interrelated world economy, a free and smooth flow of goods and services across national boundaries was essential for the effective functioning of the whole system. Only free trade could ensure that resources in an increasingly interdependent global economy would be allocated and used in the most efficient manner. An expansion of world trade had never been more important, but unfortunately, after stagnating in 1981, trade had actually declined in volume by 2.5 percent in 1982. The major factors behind the decline had been elaborated in the World Economic Outlook Report, but he would comment only on the recession that had persisted over the past few years, and the resulting high unemployment.

The severity of the recession had forced an increasing number of governments to resort to import restrictions and/or export subsidies to alleviate their own difficulties, Mr. Hirao remarked. But such protectionism had actually intensified their troubles because it had obstructed optimal resource allocation on a global basis, making the recovery all the more difficult. Present problems were so complex that they could not be solved by a simple policy of expansion. What was truly required at present was structural adjustment to ensure an optimal allocation of resources on the supply side in response to the changing needs of the economy over the medium and long term. Structural adjustment called for open and liberal international markets, so that market forces could operate fully. At the same time, it was important to improve the international financial system so as to support an expansion in trade.

The second issue was recovery from the prolonged recession, Mr. Hirao continued. Already discernible early in 1983, the recovery had become steadier in recent weeks. The indices of housing starts and capacity utilization in manufacturing indicated that the U.S. economy was advancing solidly toward recovery. There were brighter prospects in other industrial countries as well. The present recovery could be viewed as an upward phase of the business cycle, reflecting a swing in inventories. But two more important underlying factors could be cited: first, the success or near success of anti-inflationary policies, and second, the results that the initial process of adjustment had begun to show in grappling with structural problems.

The rate of inflation had been declining markedly in the United States, Germany, the United Kingdom, and some other countries, Mr. Hirao observed. The result had been an increase in real household income, leading to greater confidence on the part of consumers, which would be a favorable element in the prospective recovery. But a rekindling of inflation could not be permitted. As for structural adjustment, gradual progress had been made in the past two or three years. High unemployment, an unavoidable cost of containing inflation, still posed a great threat to the stability of many economies. But under the pressure of almost intolerable unemployment, the bargaining power of labor unions had weakened considerably, making wages less rigid. Rigidity in real wages had been the largest barrier to the implementation of effective adjustment policies to deal with supply shocks since 1973, and its gradual easing was welcome. In his view, the global recession of the past few years had been due not so much to the inadequacy of total demand as to inflation and structural problems.

The pace of the recovery was the third issue of importance, Mr. Hirao commented. Few people saw in the present recovery--encouraging though it was--the strength that had characterized the economic upswings in the 1960s. In those years, once consumption had picked up, investment had surged; as investment had expanded, consumption had risen. Thus, total output had grown rapidly. More important, a net increase in investment had made it possible for production to rise without price increases. Fiscal and monetary policies had also been able to play an important role in economic expansion. Such an ideal mechanism could no longer be expected to work well. There were a number of structural problems on the current economic scene, including labor market rigidities, inadequate profit margins, and inappropriate government intervention. As a result, businesses did not see bright prospects ahead, and investment activity remained sluggish, perhaps the main reason for the lack of basic strength in the current recovery.

Another discouraging factor was the erosion of business confidence due to large fiscal deficits, Mr. Hirao added. In periods of economic prosperity, public investment could have the desired multiplier effects. However, under the heavy pressure of fiscal deficits, there was always a risk that fiscal stimulus might be withdrawn at any time. An increase in national income might therefore be regarded as temporary, and the full multiplier effects of public investment would not be realized. Similarly, businesses made investment decisions not on the basis of current income, but on future flows of estimated income. Therefore, even with expansionary fiscal policies, a surge in business investment was unlikely if those policies seen to be temporary. The impact of stimulative fiscal policies had become significantly smaller than in the 1960s. Steady and sustained growth could be achieved, not by policies of rapid expansion, but by ensuring the recovery of business profits over the long run and by sound programs for actually achieving a viable fiscal balance.

Fourth, Mr. Hirao referred to the issue of an international financial system compatible with trade expansion. Few could say that the existing system had been sufficiently supportive of trade growth and of the smooth flow of investments across national boundaries. In general, the experience of the past decade indicated that foreign exchange rates reflected differential inflation rates in the long term, and a cumulative current account balance in the medium term. But daily or weekly fluctuations in exchange rates appeared to be random, suggesting that there was no stable correlation of the relevant variables. It was not even so easy to find a meaningful correlation for monthly exchange rate variations, although strong correlations with interest rate differentials had sometimes been observed. To further trade and investment, it was most important that exchange rates be more or less predictable, or lend themselves to estimation based on possible changes in fundamentals. However, in the past year or so, exchange rates among the major currencies had often moved widely in a random fashion, and had sometimes even gone outside what might be considered a reasonable range. One was thus led to suspect that speculative transactions, which were inherently not a subject for reasonable estimation, might have played a major role in exchange rate changes. From financial reports describing how market participants formed their exchange rate judgments, it was apparent that in the past year or two they had based their estimates increasingly on weekly movements of monetary aggregates in the key reserve currency countries. If monetary aggregates changed randomly owing to unexpected developments, the result would be random fluctuations in exchange rates.

The adoption of a monetary policy that paid predominant attention to money supply figures had no doubt contributed greatly to the containment of inflation, Mr. Hirao continued. With the advent of various types of financial assets, the precise definition of money had become unclear. Therefore, at the present stage, it would be advisable in the formulation of monetary policy to take into account not only the monetary aggregates but also the level of interest rates. In that respect, the more pragmatic approach of the Federal Reserve Board since the summer of

1982 was certainly welcome. Needless to say, it was urgent to lower the current high level of international interest rates in order to solidify the ongoing economic recovery.

It was also important to promote trade between industrial and developing countries, Mr. Hirao said. For that purpose, adequate international financing was necessary, and continued recognition by international commercial banks of the need to maintain their global exposure was crucial. The banks would, however, act as desired only if their confidence in debtor countries were reinforced by the steadfast implementation of adjustment programs in those countries. In that respect, he fully agreed with the views expressed by the staff on pages 15 and 16 of ID/83/4.

The fifth issue, Mr. Hirao commented, was that close international cooperation was a prerequisite for a smoothly operating international economy, as the sequence of events since the fall of 1982 had demonstrated. Cooperation among industrial countries, and also between industrial and developing countries, had proved invaluable in reacting to crises. The Fund had played a central role in those cooperative actions, without which the international financial system would have suffered immeasurable damage.

Governments were sometimes under strong pressure from a legislature, or from various interest groups that were claiming priority attention, Mr. Hirao remarked. In some cases, cooperation among governments could help an individual government to make the right choice. There were emerging indications of a gradual realization that economic policies designed exclusively to meet countries' own interests were not only ineffective but actually counterproductive. Nevertheless, it was necessary to face the reality that freedom in the choice of national economic policies was still heavily constrained by domestic considerations. Most economic policies were planned and implemented independently in each country, but those policies should be qualified by the important consideration that they would be assessed in light of their international impact and mutual compatibility. Therefore, he fully endorsed the staff view on the need for a harmonization or concertation of policies. In that respect, the initiative taken by the leaders of the major industrial countries in Versailles and Williamsburg was welcome.

Mr. Schneider remarked that the world economic outlook had improved somewhat since the Executive Board's previous discussion, mainly as a result of the gradual recovery in the United States. At the same time, some major countries, especially the United Kingdom and the United States, had succeeded in reducing their past high rates of inflation to manageable levels. The staff had therefore rightly centered its analysis on the scope of economic policy necessary to promote and sustain the recovery under way. In view of the dominant role of the United States in the world economy, it was not surprising that the discussion focused on developments in that country. While all indicators pointed at present to a rather strong recovery, at least in 1983, it remained to be seen whether the recovery could be sustained in the longer run, since a number of problems loomed on the horizon.

As the staff had pointed out, the Federal Government's borrowing requirement had absorbed about 77 percent of net private savings in the United States in 1982, Mr. Schneider mentioned. What was even more disturbing was that no change was in sight. Consequently, if the recovery was to be sustained, private investment would have to compete with the public financing requirement, and interest rate levels might thus be pushed up again. Although the staff had correctly stressed the danger of a too-rapid reduction in the public sector deficit, fiscal policies should be formulated so as to bring about a substantial reduction of fiscal deficits in the medium term. It would be unfortunate to assume that action in that respect could be postponed until early 1985. Therefore, measures should be taken on both the expenditure and the revenue sides, keeping in mind that there was no substitute for certain essential public services, which ought therefore to be maintained. In sum, the recovery would not be sustainable if the competition for available savings between the public and private sectors drove interest rates that were already high in real terms even higher.

For inflationary expectations to subside, Mr. Schneider remarked, it was essential for the stance of fiscal policy to be on the conservative side. It would then be possible to allow monetary policy to be somewhat more relaxed, leading to lower interest rates and improving the investment climate. For the time being, the high level of interest rates in real terms was drawing funds into the financial market, where the return was higher and more certain than it was on real investment.

Lower interest rates in the United States would also be conducive to a more realistic exchange rate pattern among the major industrial countries, permitting them to reduce their interest rates and thereby improve the investment climate, Mr. Schneider commented. A complementary response on the European side would be policies aimed at achieving real wage rates consistent with an adequate rate of return on investment designed to expand capacity. Indeed, without the restoration of the appropriate conditions to bring about an adequate supply response, policies of demand stimulation could have rather short-lived effects. In that connection, it would be interesting if the staff could explain at greater length the conditions necessary for achieving the growth projections in Scenario C, because only if such growth was achieved could a reduction in unemployment rates be envisaged.

He had been somewhat surprised to note how lightly the prevailing high level of unemployment had been treated in the staff paper, Mr. Schneider added. The only scenario that might have some positive effects on employment had been dealt with in five lines, an intolerable approach to a serious problem that could have far-reaching consequences for the fabric of society in the longer run. An analysis of the problem of structural unemployment would be useful because conventional policy instruments seemed unlikely to solve it. It was not only a question of incomes policy, which had also not been dealt with in the staff paper, but of analyzing the apparently deep-rooted causes of unemployment, which had something to do with rapidly changing technology.

As a general remark, Mr. Schneider noted his disappointment over the way in which the medium-term scenarios had been treated in the staff paper as well as in the published Report. As a tool for analysis and policy prescription, he had considered those scenarios to be useful and to deserve more attention. Growth rates, current account balances, and other economic aggregates should continue to be shown for the three scenarios in one table. Such a presentation would give a rough indication of future developments, based on different assumptions, and could also serve to check past projections.

External adjustment among industrial countries had apparently been made more difficult by the behavior of the U.S. dollar, Mr. Schneider said. The appreciation of the U.S. dollar would generate growing imbalances in the pattern of current account positions not only of the United States but also of other major industrial countries. The prospective current account deficit for the United States, although large in nominal terms, would represent no more than about 1.5 percent of GNP in 1984, which would not be too worrisome if no further deterioration occurred. But if the current account position were considered unsustainable, it might again give rise to large exchange rate movements that were not fully justifiable on economic grounds and would therefore be worrisome because they were one of the causes of rising protectionism. More harmonious exchange rate relationships, and thus more appropriate exchange rate policies, were needed to stem the protectionist tide.

It was difficult to interpret the adjustment efforts being undertaken by the developing countries as a group, Mr. Schneider considered. There seemed to have been an impressive reduction from 1981 to 1983 in the weighted average current account deficit of non-oil developing countries as a percentage of exports of goods and services. However, the development of the median current account deficit in relation to exports of goods and services for those countries was less impressive, and implied a strong concentration of adjustment efforts in a few major developing countries, particularly those that had seen their access to financial markets severely curtailed. In addition, as the staff had noted, the progress had been achieved largely through a compression of imports, which could not be maintained for long without jeopardizing developing countries' prospects for development. As it was, he was somewhat less optimistic than the staff about the possibilities of restoring the demand for imports, because of the further contraction of bank financing and because official development assistance was not expected to expand.

The success of the adjustment efforts of developing countries would depend heavily on the simultaneous realization of three conditions mentioned by the staff, Mr. Schneider observed. First, sustained recovery in the industrial countries; second, continuous adjustment by developing countries; and third, continued lending to those countries by the international banking community. The Fund had an important catalytic role to play in the latter respect. Present lending levels would have to be maintained, at least until 1984-85, when the debt situation might have improved to a point where banks could again expand spontaneous lending to developing countries. It seemed inconceivable that the membership of the Fund would urge the international banking community to continue to expand its lending at a moderate rate, and itself be unwilling to provide the necessary resources for the institution to maintain its present lending levels.

He agreed with the staff that the most desirable macroeconomic policy for developing countries was to shift from consumption to investment, particularly investment in the export sector, Mr. Schneider said. But they could not make that shift unless there were greater demand for their export products from industrial countries. A sufficient recovery in the major industrial countries would call for a far greater coordination of policies than had been achieved so far, and, above all, for a willingness to adopt domestic policies that were suited to the necessities of the international adjustment process. There still seemed to be a certain lack of understanding by policymakers of how far the world had already progressed in the direction of interdependence. As long as there was little evidence of readiness to cooperate politically, surveillance would have only limited effects. The future policy approach of the larger industrial countries, especially during the present difficult period, would have an important bearing on the effectiveness of international cooperation, as the staff had stated.

Mr. Finaish referred first to the issues relating to industrial countries, noting that over the past two quarters, as the rate of inflation had dropped further in some major industrial countries, the level of activity had started to pick up. While there was still considerable uncertainty over the timing and strength of the recovery, the prospects for a resumption of growth in those countries looked more encouraging than they had for some time. An important policy challenge at present was to promote and sustain the emerging recovery. While a strong recovery would be desirable for a faster pullout of the world economy from the depths of the recession, care needed to be exercised so as not to reignite inflation and thereby undermine the prospects for steady, noninflationary growth over the longer run. Gains in controlling inflation remained somewhat fragile, and inflationary expectations had still not been adequately subdued. The task in those circumstances was to promote recovery while consolidating--and, where needed, further advancing--the progress made against inflation.

In that connection, he could agree with the staff that an overall policy framework of financial restraint would be necessary for some time, Mr. Finaish went on. However, authorities could seek to impose different degrees of restraint. An important question was whether there was scope at present for some easing of financial restraint in those major industrial countries that had been most successful in controlling inflation. While the future should not be mortgaged for a quick but temporary burst of recovery, it was also necessary to guard against the other pitfall of focusing policy so narrowly on the longer-term objectives of noninflationary growth that the dictates of the current difficult situation were almost completely ignored. What was required was a careful balance between easing and maintaining financial restraint. The staff had cautioned that shifting to actively expansionary policies, or a marked shift in the stance of monetary and fiscal policies aimed at stimulating growth in the short term, could be counterproductive at the present stage. The staff's view appeared to be consistent with some easing of financial restraint in countries where inflation had already been brought down substantially, both the kind due to easing of financial conditions that resulted from a fall in inflation, without any change in the financial targets, and the kind achieved through a more flexible use of financial targets. It would be helpful if the staff could confirm that understanding. In addition, would the view taken in the latest Annual Report of the BIS--that certain major industrial countries could now afford to take some measures to stimulate domestic demand--be consistent with the staff's position?

Apart from the continuation of an appropriate degree of financial restraint, Mr. Finaish observed, greater efforts should be made to improve the mix of monetary and fiscal policies and to tackle structural distortions and rigidities. While those objectives had been emphasized alongside demand management in the anti-inflation strategies of the industrial countries in recent years, monetary policy had carried an excessively large burden in the control of inflation. The lack of progress in achieving those objectives had also tended to aggravate the negative effects of inflation control on output and employment, not least by keeping interest rates high. An improved policy mix would permit faster growth in the future consistent with the maintenance of financial stability.

Among the structural imbalances and rigidities in industrial countries, Mr. Finaish noted, the staff had rightly singled out--in addition to labor market rigidities--structural fiscal deficits and inappropriate government intervention in the form of support for declining industries. Both were important areas for reform and adjustment. With respect to fiscal deficits, attention had tended to be focused mainly on controlling the aggregate volume of spending; the broad composition of expenditure also needed attention, as it bore importantly on the efficiency of resource allocation and the development of the productive potential of an economy. The rate of capital formation in the industrial countries had been falling for many years past, and had been negative over the preceding four years. Clearly, those trends did not augur well for the restoration of satisfactory growth rates over the medium term. The weakness of capital formation in the industrial countries had been partly related to the stagnation or decline in public sector investment outlays, a factor especially important in countries with large public sectors.

He had two further questions relating to the industrial countries, Mr. Finaish said. First, on page 9 of ID/83/4, the staff had drawn an analogy with the recovery period of the 1970s, to make the point that a relaxation of financial restraint at the present stage could lead to a resurgence of inflation. While that analogy was valid as an argument against a marked shift in financial policies, he wondered whether the staff would not agree that its relevance as a guide to the degree of financial restraint needed at present should not be qualified by two factors: first, the greater underutilization of resources and capacity at present than during the 1970s; and second, the significantly lower levels of inflation in those major industrial countries where some scope for relaxing financial restraint might be said to exist. Of course, as Mr. Hirao had mentioned, forces acting in the opposite direction might be the strength of structural rigidities, the state of confidence in the business sector, and the size of fiscal deficits.

Second, Mr. Finaish went on, he would like the staff to indicate the significance it attached to the much faster than expected growth of output in the United States during the second quarter of 1983, and to say whether it felt that the development pointed to a faster recovery than had been forecast to date.

Taking up the subject of adjustment and growth in developing countries, Mr. Finaish mentioned that a pickup of recovery in the industrial world would serve to facilitate the difficult task of adjustment facing many of those countries. Comprehensive adjustment programs had been mounted in many developing countries in response to the severe difficulties that they faced as a result of the global recession. Developing countries had already made substantial progress in reducing their current account deficits from the peak reached in 1981, although a large part of that improvement had been achieved through a sharp curtailment of imports, as the staff also had recognized. Adjustment through import compression was painful and growth inhibiting, and there were limits to it, especially in lower-income countries. A more fundamental and sustainable--and clearly more desirable--means of balance of payments improvement was through export expansion. But it was difficult to increase exports in an environment of stagnating world trade, especially when a number of countries were trying to achieve the same goal. The situation would change only with the resumption of growth in the industrial countries. A lowering of protectionist barriers against the exports of developing countries would be of additional help. As noted in the latest Annual Report of the BIS, a debt-ridden world fraught with financial fragility required not only "lenders of last resort" but also "buyers of last resort."

Since the recovery in the world economy over the year or two to come, and hence in international trade, was forecast to be relatively moderate, any expansion of exports from developing countries would still leave them with large external deficits needing to be financed, Mr. Finaish noted. If financing was to be available on the required scale, it would be important for banks not to withdraw precipitately or indiscriminately from international lending, in response to the recent debt service difficulties of some major debtors. It was useful to remember that net banking inflows were estimated to have covered almost one half of the aggregate current account deficit of non-oil developing countries from 1973-74 to mid-1982. The staff was right to say that the negotiated arrangements of recent months between debtor countries, international financial institutions, and the banks, should be viewed only as having provided some breathing space, though a vital one. The rescheduling and refinancing operations involved in those arrangements would represent no more than a postponement of debt service problems to later years, unless the balance of payments positions of the group of countries concerned became more viable over the intervening period. The immediate task facing the international financial community was to preserve the gains from recent coordinated actions until hoped-for developments brought fundamental relief to the debtor countries.

Beyond the immediate issue of maintaining an adequate flow of international bank financing in the near future, Mr. Finaish observed, the lessons that could be learned from recent experience and how they could be translated into more permanent and systemic improvements in the flow of financing were longer-term issues that would need to be given greater attention in the future.

As for the situation of the oil exporting countries, the most significant development over the past two years had been the substantial drop in their oil revenues, Mr. Finaish stated. He would agree with the staff that that development had necessitated a serious reappraisal of policies and priorities, and a number of those countries had already responded with a variety of adjustment measures, most notably by curbing the growth of expenditures. The staff was also correct in noting that the oil exporting countries needed to hold larger reserves than most other countries, due to the instability of their export earnings and the lack of diversification in their economies.

While the drop in oil revenues had provided the most immediate reason for restraining the growth of expenditures, Mr. Finaish pointed out, the need for closer scrutiny of outlays in oil exporting countries had started to be felt long before. It had become essential to cut down waste and inefficiency by bringing the growth of expenditure more in line with the limits of domestic absorptive capacity and by a more selective allocation of expenditures among different uses. Such considerations seemed not to have been adequately stressed in the staff's work on oil exporting countries, and the staff's advice on their expenditure policies appeared to have been related primarily to the availability of revenues. Thus, a rapid increase in expenditure had been encouraged when oil revenue was increasing, supposedly also in the interest of speedier international adjustment, and the need for restraint had begun to be stressed only when oil revenues started to decline--and even then mainly for countries actually experiencing financial difficulties in maintaining their previous rates of expenditure growth. The drawback to that approach was that economies might be overextended during periods of increasing oil revenues, leading to considerable waste, and to sharper cutbacks when revenues began to fall. Over time, such an approach was clearly not in the interest of smoother international adjustment.

In referring to the 12-15 percent decline in oil prices in March and April of 1983, Mr. Finaish continued, the staff had noted that "the reduction in oil prices should have a generously beneficial impact on the world economy...." That view was apparently based on simulations--presented in an appendix to the Report--of the various possible effects of a 10 percent drop in oil prices. But it was a view that needed to be appropriately qualified. First, the simulation exercise was, needless to say, far from comprehensive, the assessment of the negative effects of a fall in oil prices being especially weak. Second, to make such a clear judgment, it would probably be necessary to have some notion of the "right" price for oil. Third, whether or not a fall in oil prices of a particular magnitude would be beneficial to the world economy would also depend on the time horizon. Even if it could be established through simulations that the immediate, or short-run, positive effects would outweigh the negative effects, the balance might tilt the other way in the longer run. For instance, a drop in oil prices at present could be at the expense of a larger price increase in the future. In seeking the staff's views on those points, he was not expressing any preferences for certain price levels, but simply drawing attention to the need for further analytical support of the staff's view. A basic question of course was what the right price would be for the future, in order, for instance, to ensure adequate investment to permit exploration for new sources of oil and for alternative energy sources, as well as to maintain incentives for conservation in the use of oil and other forms of energy. For the time being, of course, for some countries a lower import bill was better than a higher one.

It had also been noted in Appendix A of the WEO Report, Mr. Finaish said, that "about three fifths of the large decline in exports of the oil exporting group from 1979 to 1982...is explained by the fall in oil consumption of other areas; one fifth is attributable to rising production elsewhere; and the remaining one fifth can be ascribed roughly to changes in inventories...." He wondered whether the basis on which the staff had arrived at those estimates--about which little explanation had been provided--would also allow the fall in oil consumption to be broken down between gains from conservation in the use of oil and the effects of the global recession.

A further question, Mr. Finaish continued, related to the staff's statement on page 17 of ID/83/4 that "an increase of 1 percentage point in the average annual rate of economic growth of industrial countries over the period 1984-86 could lead to an increase of about 3.5 percentage points in the average annual rate of growth in export earnings of non-oil developing countries." There appeared to be some inconsistency between that statement and the one in the January Survey (page 32, ID/83/1) that "a reduction of 1 percent per annum in the average growth of the industrial countries over the period 1984-86 was calculated to reduce the level of export earnings of non-oil developing countries by proportions ranging, among the various subgroups, from 7.5 percent to 13.5 percent." The staff's comments would be helpful. In passing, similar estimates for the oil exporting countries would have been useful.

Finally, on the subject of international cooperation, Mr. Finaish observed that while the need for greater cooperation had been widely felt and stressed in recent years, it was the translation of those desires into deeds that had been the most difficult problem. The staff had mentioned several areas in which greater cooperation was needed and was considered feasible. They included the harmonization of policies, with countries taking due account of the international repercussions of domestic policies; a halt to protectionism; and the provision of better-quality financing in adequate amounts to developing countries. A firmer commitment to greater cooperation by the major industrial countries was crucial to effective progress in all those areas. The Fund also had an important role to play, through the effective implementation of its surveillance function, which should focus appropriately on the policies of those countries, including trade policies, and by promoting adjustment and providing financing in support of adjustment. The Fund's role as an agent of cooperation had become even more important in the present circumstances of widespread adjustment needs in the global economy and the fragility of the international financial system. Clearly, the Fund would have to be kept supplied with adequate resources to carry out that role.

Mr. Laske commented that two issues seemed to dominate the outlook for the world economy. The first was the high level of unemployment in the industrial countries that was intimately connected with the long-lasting recession. The second was the precarious debt situation of a number of developing countries. Policymakers were thus posed with a veritable challenge. Both the unemployment situation and the debt dilemma had to be seen against the background of developments since the early 1970s, which had been discussed more than once in the Executive Board. The critical question was how to deal with the present predicament and bring the world economy back onto a path of balanced and sustainable growth.

It had become commonly accepted, Mr. Laske considered, that by deliberately stimulating economic activity, the industrial countries would jeopardize the gains made in combating inflation over recent years. That was true of those industrial countries that had already managed to reduce their rates of inflation quite markedly, as well as of those that still had some distance to go. Therefore, he fully agreed with the staff's conclusion that maintaining an adequate degree of monetary restraint was essential to preserve and increase the gains made in the fight against inflation. On the equally important conduct of fiscal policy, opinion seemed to have converged on the obvious necessity of reducing budgetary deficits, and restructuring government expenditure to emphasize investment rather than consumption.

Progress so far had unfortunately not been very impressive, Mr. Laske continued. Monetary restraint, together with the failure to rein in budgetary deficits, was keeping interest rates at a higher level than seemed necessary to sustain the recovery under way. When the heads of government of the seven largest industrial countries had met in May 1983, they had agreed to pursue appropriate monetary and budgetary policies that would be conducive, inter alia, to low rates of inflation and reduced interest rates. Yet, for at least three weeks in a row, the yields on three-month and six-month U.S. Treasury bills had risen at the weekly auctions, by about half a percentage point. Similarly, yields had also increased at the longer end of the maturity range. It was widely, although perhaps not universally, agreed that a lower level of interest rates--especially of real rates of interest--was an important prerequisite for the continuation of the still relatively feeble recovery that had been anxiously observed since the beginning of 1983. And the staff's projections were apparently based on the expectation that interest rates would gradually decline.

Considering the developments in money and capital markets over the past six to eight weeks, Mr. Laske inquired what the staff's projection would be if the most recent upward trend of U.S. interest rates were to continue. It was true that interest rates were significantly lower than they had been at their peak some time in 1982. But the recent increases were worrying, the more so because they had occurred at a time when the rate of inflation had been significantly lowered, thus further pushing up the real rate of interest. It should also be recalled in that context that a significant part of the growth projected for 1983 was expected to be generated by a turnaround in the inventory cycle. Bearing in mind that interest rates were the major element in inventory decisions, he viewed the recent developments with some anxiety.

U.S. interest rates were important not only for the domestic economy, Mr. Laske remarked; they exerted a strong influence on the exchange rate for the U.S. dollar. The protracted strength of the U.S. currency had been the subject of repeated comment over the past 6 to 12 months, in political, banking, and academic circles. Some industrial countries had felt constrained in the conduct of their monetary policy by the strength of the U.S. dollar, because of the likely impact on their own balance of payments positions. Other countries had expressed concern about the possible repercussions on trade and trade policies. He felt sure that the U.S. authorities' policy mix and its international ramifications would be considered thoroughly when the Executive Board discussed the staff report for the Article IV consultation with the United States on July 20.

The current account projections for industrial countries had been extended into 1984 in Table 7 of ID/83/4, Mr. Laske observed. The pattern that had emerged was not at all reassuring. Most worrying was the strong increase in the U.S. current account deficit, apparently the main reason for the expectation that industrial countries as a group would experience a rather steep drop into a deficit on current account. It would be quite unusual for a developed country like the United States to run a current account deficit while simultaneously recording surpluses on the overall balance of payments for an extended period. That would in effect mean that other countries' savings were being pulled into the United States for the purpose of financing Federal budget deficits. The outcome would be a misallocation of international savings that was apt to hamper investment and growth in other parts of the world.

The projection of current account patterns entailed considerable uncertainties, Mr. Laske noted, and he hoped that the staff's projections would prove to be too pessimistic. The OECD had projected less severe changes in current account positions, including a significantly smaller deficit for the United States in 1983 and 1984, with higher surpluses for some other countries. Such differences in projections had been mentioned on previous occasions, but he would nevertheless repeat his request to the staff for further enlightenment on their nature and causes, as for the period ahead they seemed particularly large.

The critical debt position of a number of developing countries could could be managed only by a cooperative effort of all those concerned, Mr. Laske considered. He had already intervened extensively on that subject in the recent discussion of international capital markets (EBM/83/88, 6/20/83). However, he wished to reiterate that the coordinated efforts of governments, central banks, and the IMF to provide the necessary financing--by rescheduling debt and making additional credit available--would have to be matched by equivalent adjustment efforts on the part of the countries in difficulty. While some of those countries were making satisfactory progress, others with a particularly precarious debt position were doing less well. The matter was of grave concern, since it posed the danger that commercial banks might be less inclined than had so far been assumed to provide even a reduced amount of new financing for the non-oil developing countries as a group. It would be an illusion to expect any shortfall to be made up by financing from official sources. For that reason, he strongly endorsed the staff's arguments in favor of sustained, medium-term adjustment efforts. Those efforts would have to be centered around the shift from domestic consumption to investment, from budgetary deficits to better-balanced fiscal situations, and from overvalued to competitive exchange rates.

Developing countries sometimes overlooked those elements of adjustment, Mr. Laske remarked, in the belief that their critical situation could be dealt with by the provision of new unconditional liquidity, either through an SDR allocation or by substantial transfer payments. There were other measures that might relieve the inevitable burden of the structural adjustment that had to be made, such as less volatile commodity prices, which might ease the economic strain for the producers of primary products. His authorities had therefore recently stated their willingness to explore possibilities for improving the working of existing international commodity agreements, and for helping the Common Fund to become operational. The industrial countries were also sometimes asked to ease their restrictive monetary stance to allow the demand for the products of developing countries to increase. But even in a period of recovery, which everyone hoped would be a prolonged one, it would not be wise to relax monetary policy, because to do so would allow the eventual increase in commodity prices to spill over into overall price levels. The rise in commodity prices must be allowed to bring about a genuine transfer of real resources to the producing countries, together with a change in the terms of trade in their favor.

There would be ample opportunity for Executive Directors to look closely at the German economic situation and the policies of his authorities during the forthcoming discussion of the staff report for the Article IV consultation, Mr. Laske noted. But it should be noted that at the Williamsburg Summit Meeting, his Government had undertaken to follow a policy that would contribute to the international convergence of economic conditions in the medium term. To that end, monetary and fiscal policy would be conducted in such a way as to optimize the growth potential of the economy, to preserve the low level of inflation that had been achieved, and to improve the structure and composition of the budget with the aim of reducing the deficit. In the international field, his authorities were determined to cooperate with those of other countries, with a view toward improving the functioning of the international monetary system and mastering the difficult world economic situation. Their particular objective would be to maintain an open international trade and payments system, an essential prerequisite for balanced global growth and higher levels of employment.

Mr. Connors said that he was in broad agreement with the staff's views on the economic recovery but was perhaps more optimistic about the growth of economic activity in the industrial countries. His view might be largely due to the availability of additional information about the pace of economic recovery since the staff had prepared its paper. For instance, the U.S. "flash" report of 6.6 percent GNP growth in the second quarter had been encouraging, as had the growth of the Canadian economy during the first quarter of 1983. He was a little more pessimistic than the staff about the growth prospects in the developing world during 1983. In particular, a number of countries that were experiencing debt difficulties and that had a relatively large weight in non-oil developing country GNP might suffer sharper declines in output during 1983 than during 1982.

He would differ somewhat with the staff's analysis on page 7 of ID/83/4 of the effects of fiscal deficits on economic activity and the sustainability of recovery, Mr. Connors continued. Although the staff did caution against cutting those deficits too quickly during the recovery, and acknowledged that fiscal deficits in countries with lower rates of inflation were unlikely to have large crowding-out effects in the near term, it considered that the deficits were causing the current high interest rates and weakening interest-sensitive components of demand, especially fixed investment. It was important to keep in mind that while investment might be somewhat lower as a result of the fiscal deficits, total domestic demand--including investment--was even higher than it had been, and the increased interest rates were the consequence of the greater demand. For the longer run, problems might arise if there was a failure to achieve meaningful reductions in both actual and cyclically adjusted--or structural--deficits, because the composition of output would be different with higher government spending than if government demand had been lower and investment demand higher. The capital stock might be smaller, which would have adverse effects on growth over the longer term. Nevertheless, it was important to keep in mind that interest rates were only one determinant of investment; continued expectations of low growth might be discouraging the investment necessary for sustained growth.

The different scenarios discussed on pages 8 and 9 of ID/83/4 had some plausibility and were useful, Mr. Connors considered, but they were illustrative and contained a substantial element of conjecture. There was an element of circularity in the use of scenarios that had to be avoided; the scenarios must not be used first to illustrate a hypothesis and then to test it. At some later stage, it might be interesting to obtain more details of the economic models underlying the scenarios. For instance, one argument made by the staff for the plausibility of its scenarios was that the relaxation of financial policies in the late 1970s--when excess capacity had existed but when inflationary expectations had still been significant--had led to a resurgence of inflation. It was not clear from the analysis that the contribution to inflation of the second round of oil price increases had been taken into account.

He would agree with the staff's assessment that it was difficult to explain the appreciation of the U.S. dollar, even with hindsight, Mr. Connors said. He would expect the large prospective U.S. current account deficit to put pressure on the dollar, although the actual timing of such pressure would be difficult to guess. Other offsetting factors might continue to support the exchange rate. In any case, the likely magnitude of the U.S. current account deficit that was implied by present exchange rates should help to strengthen imports by the United States from other countries--both developing and developed--and should thereby strengthen the recovery in those countries.

He was in broad agreement with the staff's description of the adjustment process in developing countries, Mr. Connors went on, although it might be worth qualifying the observation that the external debt burden of non-oil developing countries would fall gradually with the decline in their current account deficits relative to GDP. In some cases, external borrowing had financed capital flight, and domestic policies would not only have to reduce the current account deficit relative to imports, but give residents and foreign investors confidence to invest in the country. Clearly, the debt problems of many developing countries were a major concern; so far, they had been dealt with in a way that provided a good example of the need for international cooperation. Governments, the Fund, and banks had worked well together. Besides cooperation among the parties involved, a lasting solution to debt problems would lie in the recovery of economic activity, sound economic and financial policies--in countries with debt problems as well as in others--and the growth of world trade. His authorities believed firmly that it was of great importance to resist further protectionist measures and to dismantle existing ones wherever possible, in industrial and developing countries alike.

Mr. Doe observed that in 1982, the world economy had performed below expectations, except on the inflation front. Instead of rising by about 1 percent, real GNP had fallen, marginally in industrial countries, but rather considerably--by nearly 5 percent--in oil producing countries. In non-oil developing countries, the rate of economic growth achieved, 1.4 percent, was less than half of the 3.8 percent projected. The recession, together with intensified protectionism, had also led to the contraction of world trade far beyond expectations. Among the most severely hit had been the non-oil developing countries, whose export volume had grown by less than 1 percent compared with a projected increase of nearly 7 percent.

Developing countries should continue to implement painful and hopefully salutary adjustment measures--in particular with respect to pricing and fiscal policies--as the Managing Director and staff had stated on several occasions, Mr. Doe continued. As for external debt, the outstanding external financial obligations of all developing countries, amounting to $704 billion at end-1982, had increased by 25 percent in just two years. As the Managing Director had pointed out in his speech in Florida in May, there were substantial differences among debtor countries relating, inter alia, to the size of their debt, its terms, and the economic endowment and structure of the borrowing countries. He shared the Managing Director's view that "there are no quick and easy remedies to debt problems." However, he was of the opinion that the medium-term and long-term economic progress of several small developing debtor countries and of small lending institutions in advanced countries hinged mainly on the formulation and implementation of concerted action to resolve debt problems. Therefore, the Fund should also be somewhat more actively involved in the search for a durable solution to the problem, especially for countries that had benefited from debt rescheduling.

The success of the stabilization programs under way in some developing countries, according to the staff, would depend crucially on the strength of the recovery in industrial countries, the pursuit of adjustment policies by developing countries, and the continued flow of international commercial bank credit to the less advanced economies, Mr. Doe noted. To that list, he would add the adoption of appropriate macroeconomic policies in industrial countries, and more especially the improvement in the terms of trade of non-oil developing countries. In that connection, it should be noted that with the exception of a short-lived improvement in 1976 and 1977, the terms of trade of non-oil developing countries had deteriorated since 1973, with the largest fall of 6.2 percent having been recorded in 1980. Their terms of trade had also deteriorated more rapidly than expected in 1982. Unless the projected reversal of that downward trend occurred--and it was not clear how it would in the absence of a concerted effort--the export earnings of countries producing predominantly primary products and raw materials were not likely to record significant gains in 1983.

As for the direction of policy in developed countries, Mr. Doe continued, the United Kingdom and the United States had been most successful in the fight against inflation in 1982, the increases in their GNP deflators having been respectively 2 percentage points and 1 percentage point lower than forecast. France had also performed above expectations, although a deterioration in varying degrees had occurred in other major countries. The preliminary indications of price developments for the first quarter of 1983 in the United Kingdom, the United States, and to some extent in Japan and Germany, were encouraging. On the other hand, in 1982, the rate of unemployment had risen more than expected in all seven major industrial countries, with the exception of France, where the actual rate of unemployment of 8.6 percent had been marginally lower than the 8.8 percent projected by the staff.

As to whether the countries where inflation had slowed down significantly should adopt expansionary policies, with the risk of reigniting inflation, Mr. Doe considered that the fight against inflation should continue with firmness, even in the United Kingdom and the United States. However, instead of using almost exclusively monetary tools to combat expectations of rising prices, national authorities should also use other tools, especially fiscal and external sector policies. In that connection, the combined fiscal deficit of the seven major industrial countries had risen by the equivalent of 1 percent of GNP to 4.5 percent of GNP in 1982. In the United States alone, the Federal deficit had risen from 2.5 percent of GNP in 1981 to 4.25 percent in 1982 and was forecast to reach 6.25 percent in 1983. The recession had contributed to revenue shortfalls and to higher transfer and interest payments. But there were also indications that nearly 1 percent of the increase in the 1982 deficit and 1.75 percent of the higher deficit projected for 1983 had been occasioned by discretionary policies involving tax cuts and higher outlays, especially on defense.

Understandably, Mr. Doe stated, the greater borrowing need of the U.S. government to finance its deficit had put pressure on interest rates in the United States and abroad. Hence, he shared the staff view that developed countries, especially the United States, should take corrective fiscal measures instead of taking a passive attitude to the call from the rest of the world for the restoration of financial balance. A similar appeal could be made to the United States for the implementation of corrective action, including market intervention, in order to ease the value of the dollar down to more realistic levels.

To end, Mr. Doe stated that a greater movement toward a convergence on macroeconomic policies and performance among countries was most desirable.

Mr. Lindø said that his authorities were encouraged by the growing number of signs indicating that economic recovery was under way in the industrial countries. In particular, positive signals had recently emerged in the United States. Lower oil prices and slightly easier monetary policies in several leading industrial countries would contribute to improving the prospects for an increase in production and demand in the period ahead. It should be underlined, however, that great uncertainty still surrounded both the strength and the durability of the recovery. Financing problems would continue to constrain import demand in the developing countries. In addition, lower revenue from oil exports might force the OPEC countries to reduce their imports more than projected at present. Moreover, high real interest rates--especially on long-term loans--low capacity utilization, and a depressed level of profitability in the business sector might prevent the necessary increase in private investment from being realized. In that connection, the negative effects of high interest rates over a longer period than ever before should not be underestimated.

The main task at present had to be to ensure that the moderate recovery under way in the world economy would be lasting, Mr. Lindå continued. Given the huge payments difficulties of many developing countries, the pressure on the international banking system, and a rate of unemployment of 9 percent in the industrial countries and a far higher one in several developing countries, the need for sustained growth was more urgent than ever before in the past 40 years. The rate of growth projected for 1983 and 1984 was substantially lower than desirable: at that rate, unemployment would not decline appreciably, and the threat of a serious crisis in the international financial system would still be present. A principal objective therefore had to be to ensure the achievement of at least the moderate growth rates projected.

A disquieting feature of the present economic recovery was that it was based predominantly on an upswing in the United States, Mr. Lindå remarked. It was particularly striking that countries such as the Federal Republic of Germany and Japan, which had low rates of inflation and large external current account surpluses, were contributing so little to the recovery. The projected increase in total domestic demand in Japan for 1983 was 2.6 percent, compared with an average of about 5.5 percent a year in 1977-79. In the Federal Republic of Germany, total domestic demand in 1983 would decline or be stagnant for the third year in succession.

Those different growth rates contributed strongly to the emergence of balance of payments disparities between the dominant countries in the world economy, Mr. Lindå commented. The expected current account deficit of the largest industrial countries as a group was a positive feature, as it would help the developing countries to reduce their deficits. A more even distribution of the combined deficit among the largest industrial countries would, however, facilitate smoother adjustment. In addition, the surpluses and deficits projected for Japan and the United States respectively might entail major problems with respect to the maintenance of a liberal trading system. Balance of payments disparities might also lead to exchange market disturbances, even though price and cost developments in the major countries showed a greater convergence at present than they had since the 1960s.

His authorities considered it unlikely that world economic growth in 1983 and 1984 stronger than projected by the staff would necessarily lead to higher inflation, Mr. Lindø stated. In that connection, he would mention inter alia the staff's conjecture that oil price developments in the few years to come were unlikely to rekindle inflationary expectations. In addition, productivity growth in the first phase of the economic recovery should allow for lower price increases in the years immediately ahead. Moreover, even if economic growth were to be stronger than forecast by the staff, unemployment would remain very high and have a dampening effect on wage increases. He would welcome some further remarks from the staff about the outlook for unemployment in 1984.

Against that background, his authorities found it worrisome that a tightening of fiscal policy, cyclically adjusted, was planned for 1983 in Japan, the Federal Republic of Germany, and the United Kingdom, all countries with low inflation and a strong external balance, Mr. Lindø observed. As to the United Kingdom, it might be asked whether fiscal policy had not been too restrictive in recent years. With respect to the United States, his authorities agreed with the staff that a change in the mix between fiscal and monetary policy was necessary. Without such a change there was the risk that toward the end of 1983, interest rates would again rise so high as to strangle the economic recovery in its infancy. A different policy mix in the United States would also facilitate the more effective use of economic policy instruments in other countries.

His authorities also considered that the financing and debt situation of the non-oil developing countries remained volatile and could easily deteriorate, Mr. Lindø remarked. They fully shared the staff's view that a markedly lower growth of the world economy than shown in the World Economic Outlook forecasts and in Scenario A might create substantial problems for those countries and jeopardize the efficient functioning of the financial system in the years to come. His chair also agreed with the staff on the continued need for adjustment and structural change in the developing countries, but there were limits to how far demand and the level of activity could be brought down in countries where large segments of the population lived at a subsistence level. In that context, he wished to emphasize the importance of undiminished development aid as well as of continued financing from the private banking system.

The close integration of the world economy over the past 40 years called for increased coordination of economic policies in the various countries, Mr. Lindø declared. In particular, there was a need for closer coordination of exchange rate policies, an area in which the Fund had an important role to play. His authorities joined the staff in welcoming the support given to the Fund's surveillance policy at the Williamsburg meeting. As the staff had noted, the Fund's surveillance function was especially important vis-à-vis the largest industrial countries. His chair agreed with the staff that it was of great importance for those countries to formulate their policies with due regard to their probable interaction and mutual compatibility with those followed by other countries. In certain circumstances, exchange market intervention might be an effective means of stabilizing exchange rates.

Miss Le Lorier considered that the issues selected by the staff for discussion were challenging, not only because of their scope but because of the high degree of uncertainty beyond the short run. Since the Executive Board's discussion of the World Economic Outlook in January, the one bright spot was that economic activity was giving stronger signs of picking up in the main industrial countries. Moreover, the progress made in reducing inflation in the major industrial countries had been further substantiated. However, the main question for the world as a whole remained unanswered, namely, how to promote and sustain the recovery under way. It might perhaps be fairer to say that the answer to the question had yet to be found, whereas the risks attached to a short-lived and insufficiently strong recovery had become more unacceptable than before.

The Fund should be more forthcoming on at least one question of current concern, Miss Le Lorier observed, namely, the unsustainable level of real interest rates. She could not resist quoting from the concluding chapter of the Annual Report of the BIS:

> The single most powerful obstacle in the way of a sustained business upswing is the high level of U.S. interest rates, which remain particularly high when set against the low current inflation rate...such rates could prevent any vigorous pickup in capital business outlays...internationally their influence in equally damaging....From every conceivable angle, the most important and most urgent task for policy is to exert downward pressure on U.S. interest rates.

The weakness in fixed investment since mid-1982 had perhaps been unexpected, Miss Le Lorier remarked, but there was little doubt that it could be traced back, partly if not wholly, to high real interest rates. A variety of reasons had been advanced to explain the present interest rate level in the United States: some had traced it to inflationary expectations and even to a lack of credibility of monetary policy, whereas others had emphasized the consequences of large fiscal deficits. She would certainly associate herself with the staff's fear that the prospect for continued high fiscal deficits in the United States would keep real interest rates at a level inconsistent with a prolonged recovery. The need for deliberate action was all the more pressing since, if she was correct, a higher rate of growth than forecast would not significantly change the fiscal outcome, whereas continuing progress toward price stability would aggravate the expected level of fiscal deficits over the two years to come. That did not mean that the pursuit of monetary objectives could not be modified with a view to minimizing the costs in terms of interest rates. After all, interest rates were not the sole yardstick against which to measure the degree of monetary restraint.

True enough, a vital world recovery depended on a recovery in the United States, Miss Le Lorier remarked; on the other hand, the U.S. recovery was linked with world recovery. Unlike Mr. Connors, she was not sure that stronger U.S. imports would be a reassuring factor, taken by themselves; apart from the possibility of increased protectionist pressures, the question was whether U.S. growth was sustainable without some improvement in the prospects for U.S. exports at some point in time. The staff had commented at length on what it called harmonization of domestic policies. Equally important at present was the need to avoid a disorderly correction of the present pattern of exchange rates, or an equally disorderly absence of such corrections. In that respect, she would be interested to learn from the staff how the use of a dollar value that was roughly in line with indicators of competitiveness would affect the projections both for 1984 and in the medium-term scenarios.

She would like the staff to indicate not only the level of the U.S. current account deficit that would be associated with a lower value of the U.S. dollar, Miss Le Lorier added, but also how the development of U.S. imports and exports would be affected. Several combinations of export and import growth could be associated with a given current account deficit. Movements in the U.S. current account seemed to affect the dollar exchange rate with lags that were fairly long and difficult to predict, and if the recent appreciation of the dollar could not be fully explained, the pace at which it would eventually be corrected could surely not be predicted either. In the circumstances, high priority should be assigned to the coordination of exchange rate policies, including concerted intervention on the exchange markets whenever appropriate. Although exchange market behavior and expectations were not easy to understand, that did not mean that nothing could be done to remove some of the uncertainties that had plagued the international and economic financial system.

With those two points of emphasis, she could concur with the general assessment by the staff of the policies to be pursued by industrial countries, Miss Le Lorier remarked. She could certainly subscribe to the idea that economic conditions differed markedly among countries, and that, accordingly, policy stances had to be different. Unless she had overlooked it, the view that countries that had succeeded in bringing down inflation should take advantage of their room for maneuver had not been explicitly reiterated in ID/83/4. Instead, the condemnation of actively expansionary policies as being counterproductive had been underscored several times. She hoped that the two approaches were not seen as being exclusive, and that the need to support recovery would be kept in view. It would also appear helpful to advocate whenever possible any means of helping to mitigate the cost of restrictive financial policies in terms of output and employment, such as successful incomes policies.

If inflationary expectations had received great attention so far, Miss Le Lorier observed, the same could not be said of growth expectations. There had perhaps been an underestimation of the endogenous factors underlying the current decrease in fixed investment and the still depressed prospects for its recovery, even in countries that had succeeded in their fight against inflation. Any risk of lower growth than projected should continue to be carefully analyzed with a view to finding the necessary remedies, even perhaps at the expense of encouraging inflationary expectations. After all, was it certain that those expectations should be brought down below what they were currently supposed to be, if that were to mean an absence of growth expectations? Needless to say, she hoped that her pessimism would turn out to be unfounded, and that the outcome in the coming months would establish that the recovery was well under way.

On the topics of adjustment, growth in developing countries, and international cooperation, Miss Le Lorier concluded, all parties concerned, including the debtor countries, should pursue their efforts to ensure an adequate and steady flow of financing. The Fund would continue to play a key role through the various functions listed by the staff: access to its own resources, surveillance, and relations with official and private lenders. She would add to that list a review of the adequacy of international liquidity in light of recent developments in the level and distribution of reserves, together with the recent behavior of the banking community. In that respect, she associated herself with Mr. Wicks's comments.

Mr. Polak noted that, as Mr. Wicks had indicated, the reason for the present discussion was to prepare for the major policy issues that would come before the Executive Board in the weeks ahead. For that purpose, two requirements would have to be met: first, the right bearings would have to be taken on the guiding principles for sustaining the recovery; and, second, the factual base would have to be correct. The published World Economic Outlook Report and ID/83/4 provided a wealth of material on both scores, and he could add little to the endorsement by previous speakers of the staff's policy pronouncements. He would therefore concentrate on certain aspects of the factual base that in his view called for attention.

His first question concerned the medium-term current account deficit of the developing countries, Mr. Polak said. The staff had said on page 17 of its paper that it expected the current account deficit of non-oil developing countries to settle in the neighborhood of 14 percent of exports of goods and services in 1984-86, lower than the ratios of 22 percent in 1980-81 and 19 percent in 1982, but close to the average for the years immediately preceding the second oil price increase. The implication of the staff's estimate was that, in absolute amounts, the current account deficit of the non-oil developing countries would rise beyond its 1982 level; in Scenario A, the staff saw it moving from $87 billion in 1982 to $93 billion in 1986. He had no independent way of judging the reasonableness of that estimate, but he had been struck by the fact that it differed significantly from the views of other experts. He mentioned in particular the testimony of William Cline before the U.S. Congress, and the June edition of the Morgan Guaranty monthly letter, reflecting the views of Rimmer de Vries. Both experts seemed to think that the solution of the developing countries' debt problem lay in a continued contraction in absolute amounts, of the current account deficit of those countries, and an even further contraction as a percentage of exports of goods and services.

Even though the Morgan Guaranty figures covered a smaller sample of countries--about 20 of the heavily indebted developing countries--the data for the subgroup of those countries in the Western Hemisphere was similar to that of the Fund, Mr. Polak observed. On the basis of its figures, Morgan Guaranty saw a need for the current account deficit of non-oil developing countries to be halved--not increased--from 1982 to 1986; as a percentage of exports of goods and services, where the figures were comparable with those of the staff, Morgan Guaranty aimed at a ratio of 8 percent in 1985 and 5 percent in 1990. On the basis of some evidence presented in the Morgan Guaranty letter, it was suggested that a ratio of debt to exports in excess of 160 percent was quite dangerous; the 1982 average was stated to be already 180 percent, while the authors expected it to fall to 165 percent in 1985 and 125 percent in 1990 for many countries, including the Western Hemisphere as a whole, the present average was well over 300 percent.

The staff had said that on its assumptions the debt burden would show some reduction, Mr. Polak continued, but he would be interested in a comparative analysis of the various studies that had been made, because of the crucial importance of using the right study. On a matter of such direct importance to the banks, the Fund should know whether its own view was compatible with the view of a well-informed bank. In that connection, the staff might also occasionally change its usual practice of classifying developing countries into four groups, and subdivide them into different groups, one of which would include the heavily indebted countries. It was necessarily difficult to categorize countries, but for the purpose of analyzing the debt problem, it would seem useful not to classify all developing countries in one group--including those countries for which the debt problem was not important--thereby diverting attention from the central subject.

The second factual issue of concern to him, Mr. Polak said, was the statistical asymmetry in the aggregation of projected current account balances. The balances for all the countries in the world should add up to zero--and had once done so--but in recent years, the excess of deficits had risen until in 1982 it had reached about $90 billion. Thus, there had to be an underreporting of positive items on current account of that magnitude, or of an even greater one, because, as the staff had indicated, there was probably some underreporting of negative items as well. It was not just a matter of statistical nicety but of policy. Insofar as countries were guided by their current account positions when they were assessing their economic and financial situations, they were collectively considering themselves to be $80 billion-90 billion worse off than they actually were. As Professor Grassmann had pointed out in a recent seminar, such underreporting of credit items in the balance of payments had to have a large deflationary impact.

In Section 11 of Appendix A to the Report, a great deal of interesting material was presented on the problem of the statistical asymmetry, Mr. Polak remarked. The staff had made a convincing case that it was not overestimating the combined current account deficit of non-oil developing countries, but was perhaps underestimating it; there probably was underreporting of hidden capital exports, or capital flight, to which Mr. Connors had referred. The staff's analysis had successfully attributed part of the current account discrepancy to particular items of the current account, which had been matched across all balance of payments statements between the credit and debit sides, revealing that over $50 billion of the total discrepancy could be attributed to two items: the underreporting of income from shipping and from what was called "other investment income." A plausible case had been made by the staff that such underreporting probably took place on a large scale in countries with positive receipts on those items in the balance of payments; the errors were no doubt primarily made on account of the industrial countries and to some extent of the oil exporting countries. The staff's explanation was excellent as far as it went, but the problem could not be disposed of in an appendix to the Report; it should be pursued further if the Fund was to establish a decent data base for considering the policy issues under discussion.

Reference had been made by Mr. Laske to the serious consequences that would follow from the large current account deficit of the United States, Mr. Polak recalled. But the United States itself had an errors and omissions item in its balance of payments, for which a figure of $42 billion was given for 1982, far above the current account deficit for that year, and twice as large as the current account deficit estimated for 1983. In fact, the item for errors and omissions in the U.S. balance of payments had been in the order of $25 billion or more for a number of years, though not regularly. Consequently, there was no way of knowing whether or not the United States would have a current account deficit or current account surplus in 1983.

It was therefore necessary for the staff to go beyond its analysis of the problem, Mr. Polak considered, and take two steps. First, when the staff knew that there were large errors in balance of payments figures, it should inform the countries concerned that they were not fulfilling the obligation to provide balance of payments information to the Fund if they submitted data with such large errors. Second, since immediate results would not be possible, the staff should accompany current account figures, when they were being used for policy purposes, with a warning signal and perhaps a rough estimate of what proportion of the $80 billion or $90 billion might be attributable to the major industrial countries in particular; in some countries, surpluses would be raised, and, in others, deficits lowered, but the Fund and members would at least be alerted to what was a very important problem.

Mr. Lovato remarked that although an exchange of views on current global affairs was always welcome, world economic conditions changed rather sluggishly, and with the number of reviews that the Executive Board had made recently, the marginal returns were diminishing quite rapidly.

The signs of a recovery in output that had emerged in recent months in industrial countries were certainly encouraging, Mr. Lovato said, even though they were not grounds for undue optimism. Inflation had been brought down, and the decline in oil prices had created some room for the expansion of domestic demand in oil importing countries, while at the same time reducing cost pressures. However, the pace of recovery was still moderate and unevenly distributed across countries. Compared to the recovery from the 1974-75 recession, global output would recover in very modest proportions, as shown in Table 1 of the staff paper.

He could broadly concur with the staff assessment of current developments in various countries, Mr. Lovato remarked. It was clear that a continued recovery in world output hinged on developments in the more important economies that had already been successful in fighting inflation, particularly the U.S. economy. Yet the uncertainties about budgetary developments and the stance of monetary policy were still such as to cast doubt on the possibility of the United States' recovering its full potential. At the same time, recovery in other industrial countries, with the exception of Japan, seemed to be even tardier and more uncertain. He could also fully share the staff's analysis of developments in less developed countries, which the Executive Board had had an opportunity to review at length on several occasions in the recent past.

The picture of the world economy that emerged at present was therefore still one of uncertainties, Mr. Lovato considered. He did not believe that the international economic and financial system was able to strengthen itself. Therefore, while keeping an eye on longer-term objectives, developing and developed countries should continue their short-run efforts, particularly to finance payments imbalances, and follow appropriate macroeconomic and exchange rate policies.

Reduced lending by commercial banks had strained the liquidity position of many countries, a worrisome development that would have to be counterbalanced by increasing the resources available through official institutions, Mr. Lovato stated. The Fund and the World Bank had increased their net lending significantly in the recent past. But the needs for financing were still there, and the Fund had to have a sufficiently strong financial position to meet the requests of member countries in balance of payments deficit, particularly in the period before the enlarged quotas and the expanded GAB became effective. In that respect, all major industrial countries should look favorably to a strengthening of international monetary and development institutions.

If payments imbalances disappeared, there would again be scope for private international lending to countries, Mr. Lovato considered, even though its character would clearly be different, as the Executive Board's recent discussion on capital markets had revealed. Better supervision of international banking and more widespread information on the exposure of sovereign borrowers should help to avoid the errors of the recent past. In that context, he underlined the extremely useful part played by the Fund in convincing commercial banks to provide the necessary support for adjustment programs. Nevertheless, the Fund should avoid applying in all cases the exceptional procedures it had followed to deal with several extremely grave debt problems.

As for the current policy stance in industrial countries, although he agreed with the staff assessment that there was room for policy changes, he would stress various aspects differently, as on previous occasions, Mr. Lovato continued. The staff seemed to be too worried, if understandably, about expansionary policies in the countries that had been successful in the fight against inflation. Some of the arguments advanced to justify that concern seemed highly conjectural. For instance, how could the staff surmise, as it did on page 7 of ID/83/4, that "sufficient time had not yet elapsed to permit the development of firm expectations that inflation in these two countries [the United Kingdom and the United States] will continue to be reduced and then held down"? The cautious policy attitude reflected in such a judgment should be substantiated with some sort of evidence, which was in fact not available. As had been repeated many times, the world economy in its present state, with ample unused capacity and diminishing pressures on costs, probably presented the most favorable environment for a change in policy in the countries having the room for it. The contention of the staff that "an attempt to force the pace of activity by shifting to actively expansionary policies would risk being counterproductive" did not take into full account the apparent potential for growth, and in particular did not give appropriate weight to the dangers of insufficient growth in the course of the year ahead.

He remained of the view that a stepping up of economic activity was both possible and desirable in the United States, Japan, the Federal Republic of Germany, and the United Kingdom, Mr. Lovato stated. Like the staff, he too was concerned about the need to correct the imbalances in policy mixes, in particular in the United States, where the budget deficit should be decreased and a more restrictive stance of monetary policy avoided. A tightening of monetary policy in the United States toward the end of 1983, which the staff seemed to fear was a real possibility, would lead again to an increase in interest rates. The chances of a continued recovery in other countries might thereby be jeopardized, while the solvency of a number of developing countries might be thrown further into question.

On the subject of policy coordination, Mr. Lovato went on, he agreed with the staff that the Fund's role was important--albeit still difficult--as had indeed been stressed at the Williamsburg Summit Meeting. The staff had been frank in confessing in ID/83/4 that it was almost impossible to explain the recent behavior of exchange rates by accepted theories. However, and there again the Williamsburg communiqué had sent a clear message, it was critical for exchange rate developments in future months to be consistent with an extension of the recovery to other countries. As had been stressed, active intervention in exchange markets to counter short-term destabilizing movements--without acting in conflict with underlying fundamentals--was both possible and desirable as part of the working of international cooperation.

Although the matter of international liquidity had not been directly dealt with in the staff paper, Mr. Lovato said, considerable attention should be devoted to developments in liquidity. Official reserves had declined for two years, and it was time to start asking whether the existing supply of international liquidity was sufficient to finance the hoped-for recovery in international trade. The issue was bound to assume more importance, especially if the U.S. balance of payments remained strong, if only because of the reduced contribution by the commercial banking system in the provision of reserves. In those circumstances, deeper consideration should be given to the role of SDRs. The staff papers on the SDR, currently awaiting discussion, were a first step in the right direction, although they did not focus on the problem of international liquidity.

Finally, Mr. Lovato commented, a World Economic Outlook discussion would not be complete without a condemnation of recent protectionist trends. Since, like all other Directors, he had repeatedly stated his unrelenting opposition to protectionist practices, he would not elaborate the point.

Mr. Senior considered that in the highly interdependent and worrisome world economic environment, depressed levels of activity could not continue for much longer without unfavorable consequences for all. The staff papers under discussion were clear evidence of need for a reappraisal of policies to promote economic recovery and showed at the same time that, without a concerted international effort, economic progress would necessarily be constrained.

As for recent economic developments and short-term prospects, Mr. Senior went on, he would limit his remarks to noting, first, that the most positive success had been attained on the inflation front. In most industrial countries, restrictive economic policies had played a key role in lowering inflation, but the achievement had been costly in terms of stagnant economic activity and rising rates of unemployment. Indeed, real GNP growth in 1982 had fallen in relation to the already depressed rates of the previous two years. At the same time, several other problems related to the low levels of economic activity--for instance, the stagnation of world trade, increased protectionist tendencies, and the volatility of interest and exchange rates--had become more acute. The situation of the developing countries was particularly serious. The staff's short-term projections did not afford any great cause for encouragement. For the non-oil developing countries especially, both actual growth rates for 1981 and 1982 and forecast rates for the next two years were markedly lower than the average of the recent past; for some important regions, the rates had even become negative.

To a great extent, the current and prospective situation of oil importing developing countries was a consequence of the unfavorable external environment that had accompanied the increasingly restrictive financial policies adopted by the major industrial countries, Mr. Senior observed. As the staff had pointed out in 1982, a continued depression in markets in industrial countries, deteriorating terms of trade, increased protectionist tendencies, and high debt service costs had intensified the problems faced by non-oil developing countries. The unfavorable external environment had made increasingly difficult the significant adjustment undergone by non-oil developing countries in the past few years; imports in real terms had declined substantially, and expansion of money and credit to the public sector had decelerated sharply. Little scope was left for national authorities to formulate policies of economic management. Even when corrective adjustment took place, the situation of non-oil developing countries could not improve markedly if growth in the major industrial countries was severely constrained. The staff had illustrated vividly the impact of higher rates of economic growth on the growth of export earnings of non-oil developing countries.

On the policies needed to promote economic recovery, Mr. Senior mentioned his agreement with the staff that prevailing conditions did not permit a significant relaxation of the anti-inflationary stance of monetary and fiscal policies in Canada, France, and Italy. Expansionary policies would clearly undercut the gains already made against inflation by those countries, particularly by Canada. But he could not share the staff's conclusion that there was little room for a different mix of policies in the four major industrial countries that had been successful in the fight against inflation. The serious effects of restrictive policies on output and unemployment made it clear that there was indeed room for a change in priorities. Clearly, low rates of inflation and a reduction in inflationary expectations were necessary to achieve sustained rates of economic growth in the medium term, but they were not a sufficient condition. As the staff had indicated, industrial countries needed to tackle rigidities, especially in the labor market, that had contributed to a low rate of productivity growth and inadequate profit margins.

It was also obvious that fiscal restraint was needed, Mr. Senior added. In reference more specifically to U.S. economic policies, there was no question that a tight monetary policy had contributed greatly to the current success of the United States in reducing inflation, and that, by continuing to apply such a policy, the authorities could further lower inflationary expectations. However, they seemed to have placed too much reliance on monetary policy at a time when fiscal policy had been expansionary. As his chair had already indicated in previous discussions, the high fiscal deficit had created uncertainties and had kept interest rates at levels higher than indicated by the tight monetary policy, working against an adjustment of inflationary expectations. Last, while a tighter fiscal policy would be essential for economic recovery in the United States, to combine it with the current monetary policy, as the staff seemed to suggest, would depress economic activity. A substantial shift in the U.S. policy stance would run the risk of making the situation much worse in the medium term, as the staff had suggested. By contrast, a more appropriate policy mix, comprising a somewhat tighter fiscal policy and a more accommodating monetary policy, could promote economic recovery, have a positive impact on inflationary expectations, and be consistent with policies aimed at eliminating structural and other rigidities.

Referring to adjustment and growth in developing countries, Mr. Senior remarked, it should be clear that many of those countries were currently undertaking comprehensive adjustment programs in extremely difficult external conditions. So far, the adjustment had taken the form of a severe reduction in imports, which had in several places affected the production system and resulted in a decline in output and employment, as the staff had recognized. Adjustment by that means was not an acceptable and long-lasting solution: a further decline in imports could only lead to more of the same difficulties and further affect the developing countries' prospects for servicing their external debt.

As the staff had said, adjustment would have to take a different form involving the reallocation of resources toward the trading sector, Mr. Senior observed. Some important adjustment measures to that end had already been adopted, and further efforts would need to be made; however, they would need to be accompanied by a favorable international environment. In that respect, he shared the staff's view that higher rates of economic growth in industrial countries, the expansion of trade, and a reduction of protectionist measures, were urgently needed to permit exports by developing countries to increase at a faster rate. Similarly, he agreed with the staff that debt problems of developing countries would not be solved if the banking community made abrupt cuts in its international lending. The role of the Fund in that respect was crucial, as had been demonstrated in several recent cases. It was a role that should of course not be limited to that of a lending institution, but that should aim at promoting international adjustment on a more coordinated and cooperative basis. Fund surveillance had to be symmetrical.

As on other occasions, Mr. Senior reiterated the need for the Fund to have enough resources to meet its responsibilities, and for a substantial SDR allocation, which would be extremely useful in present circumstances.

Mr. Sangare noted that the staff papers showed that 1982 was another year--the third in a row--of sluggish economic performance for the world. With a decline in real GDP in industrial countries and a dramatic slowdown in the growth rate of developing countries, the past year seemed to represent the trough of the three-year world recession. It was true that reductions in inflation and interest rates had been achieved in several major industrial countries, but those encouraging signs had been overshadowed by the continuous rise in unemployment and the decline in world trade. The impact of the recession was therefore global, but the developing countries, particularly those in Africa, had been severely hit. The sluggish demand for the exports of those countries, the deterioration in their terms of trade, their greatly enlarged debt servicing costs, and the sharp curtailment of the net inflow of external finance had deepened the effects of the recession and jeopardized adjustment efforts and development prospects. In 1982, aggregate growth rates of developing countries had declined to the low level of 1.5 per cent--with rates being negative in many countries--compared with rates of 6 percent in the 1960s and 5 per cent in the 1970's.

The staff was right in stating that the dramatic slowdown in growth did not in fact show the full extent of the strains being experienced by those countries, Mr. Sangare continued. Their limited ability to adjust and the further curtailment of domestic absorption had made the situation more difficult for them. Indeed, a further reduction of consumption in favor of domestic investment might be impracticable. Despite those limitations, and the extremely unfavorable external conditions, many developing countries had already started to implement comprehensive adjustment programs. But the success of their programs, as the staff had indicated, would require the right kind of domestic policies; yet it was hard for him to see any chance of success or of lasting adjustment without a favorable international environment and significant external financing. At a time of higher interest rates, low growth of demand in industrial countries, sharply reduced flows of net bank lending, mounting external debt service costs, and diminished reserves, it should be recognized that developing countries could do little without effective external financing, the cooperation of international financial institutions, and official development assistance.

A considerable decline in net bank lending to developing countries in the second half of 1982 was a matter of concern, Mr. Sangare remarked. It was certainly damaging to those countries' adjustment efforts, given their low levels of reserves and declining export earnings. The staff was right in saying that any shortsighted effort by international commercial banks to reduce their exposure to developing countries could only be self-defeating, leading to results contrary to the basic interests of the banking community itself over the long run. He endorsed the vital role played by the Fund in reducing the impact of adverse financial factors on developing countries. He also stressed that it was necessary to continue the coordinated efforts that had provided for the much-needed rescheduling of outstanding obligations and had made possible the provision of new credit from the Fund, other financial institutions, and private banks.

There was a pressing need to supplement international liquidity through the allocation of new SDRs, Mr. Sangare reiterated. There could no longer be any doubt that the quota increase agreed under the Eighth General Review was known to be grossly inadequate. It was therefore crucially important to focus attention on the means of securing further resources through borrowing from all possible sources, including the private capital markets. With the same objective of providing the Fund with needed financial resources, consideration should also be given to the possibility of advancing the Ninth General Review of Quotas by at least two years. The financing problems faced by many members were obvious. Action was called for immediately; delay could prove fatal.

The signs of recovery indicated by the staff's projections were gratifying, Mr. Sangare remarked. He recognized the importance of the anti-inflationary stance of policies continued in 1982, but it was important not to overlook the heavy social costs of rising unemployment and weakening of ouput growth to which that policy stance had contributed.

More balanced monetary and fiscal policies in the countries that had brought inflation under control might be necessary in order to reduce the sufferings of the unemployed millions whose welfare had been considerably reduced. Such policies would also have salutary effects on international interest rates and the exchange markets.

On the issue of cooperation, Mr. Sangare declared that the increasing interdependence of nations was showing more than ever before the pressing need for international cooperation. A basic principle was that countries should be concerned about the consequences of their policies for other countries. To be specific, such cooperation meant appropriate domestic monetary and fiscal policies, and required not only resistance to protectionist pressures, but also a rollback of existing measures of protection. For the developing countries to benefit from the expected recovery, a more liberal attitude by industrial countries to importing from developing countries was of the utmost importance. In that connection, the surveillance function of the Fund might be crucial, especially in the case of major countries that had considerable weight in the world economy. The granting of additional development assistance to low-income countries--most of which were in Africa, and whose access to private markets was virtually nil--and the reversal of protectionist policies in major industrial countries were among the essential ingredients for the success of adjustment programs in place in many of those countries. Finally, he reiterated his chair's stand that, under present circumstances, the Fund's role in both the provision of resources and in exercising surveillance should be a flexible one that took cognizance of the fact that adjustment programs would not only vary from one group of countries to another, but also from country to country within a group.

Mr. Joyce joined other Directors in finding the discussion of the World Economic Outlook to be timely and useful by providing a better basis for the Board's consideration of policy issues throughout the weeks to come. The issues raised would of course have to be taken up again before the Annual Meeting, because the world economic situation was changing fairly rapidly.

Three main questions arose in considering the current economic situation and prospects, Mr. Joyce commented. First, would the current recovery, particularly in North America, be as strong as expected in the staff paper, and could that recovery be sustained? Second, how quickly would the results of the recovery in North America transmit themselves to other industrial countries, and how would those countries assist the process? The third question, relating to the developing countries, was how quickly debtor countries, not only the non-oil developing countries but also the eastern European countries, would be able to benefit from those developments.

Referring first to the industrial countries, Mr. Joyce said that he did not disagree fundamentally with the projections and views expressed in the staff paper and in the Report. However, recently released data, particularly in respect to the first quarter of 1983, seemed to yield a picture for most of the major industrial countries that, while similar in overall perspective, was significantly different in detail. The authorities' projections showed a somewhat stronger growth of the U.S. economy in 1983 and 1984 than had seemed likely when the staff had made its projections, as well as a somewhat better outlook for the economies of Japan and Germany. The staff's estimates of real growth in the United Kingdom for 1983 were also somewhat lower than those of his authorities, although the forecasts for 1984 were similar. Furthermore, the measures taken by France subsequent to the currency realignment in the European Monetary System suggested that real growth in 1983 would be weaker than projected in the staff paper; the French economy would recover in 1984, albeit hesitantly. As for prices, developments in 1983 were likely to be along the lines foreseen by the staff, but his authorities looked for a somewhat faster deceleration of prices across the board in 1984.

With respect to current account balances, including official transfers, Mr. Joyce continued, his chair forecast results for the United States, Japan, Germany, and Italy similar to those of the staff for both 1983 and 1984. However, the recent weakening in the U.K. trade account would bring the staff's projection of the size of the current account surplus into question. Although the United Kingdom might have a small surplus in 1983, and a somewhat larger one in 1984, his authorities considered that it would be about half the size projected in Table 7 of ID/83/4. Similarly, trade developments in France to date suggested that the staff's forecast was on the optimistic side, especially with respect to 1983, when his authorities considered that the deficit was likely to be some $2 billion higher. The forecasts used by his authorities allowed for exchange rate changes, whereas he understood that the staff assumed constant nominal rates of exchange.

Overall, Mr. Joyce remarked, he saw a considerably more varied outlook for individual countries than the staff showed in its projections, but no large differences in the average performance for the group of major industrial countries as a whole. The major difference was that his authorities foresaw a somewhat larger aggregate current account deficit for the major seven industrial countries in 1983, principally because they took a different view of developments in the United Kingdom and France. He shared the concern of the staff and of other Directors that recovery might not be sustainable beyond the short term. Aside from the factors affecting the U.S. economy, as enumerated in the staff paper, developments in other major countries made the medium-term outlook somewhat uncertain, including the impact of the French austerity measures, the deterioration in the U.K. external account, suggesting that restrictive measures might have to be taken; and continued poor price performance in Italy. There were also considerable doubts as to how the U.S. authorities would react to the large current account deficit forecast for the two years to come, a subject that would be taken up when the Executive Board discussed the staff report for the Article IV consultation with the United States. Finally, the size of the current account surpluses forecast, notably for Japan but also for Germany, did raise to a lesser extent questions about the effect on potential attitudes in other countries. Indeed, those surpluses could have longer-term negative effects and consequently inhibit sustained growth in the world economy.

As for Canada, Mr. Joyce commented, his authorities were in broad agreement with the staff's forecast, although again, more recent information seemed to indicate a somewhat better performance on growth and on inflation. For instance, preliminary information for the first quarter of 1983 indicated that real growth had been somewhat stronger, underlining the fact that recovery in Canada was clearly under way. Inflation remained a matter of concern but was beginning to drop rapidly; the increase in the cost of living index had decelerated on a year-over-year basis from May 1982 to April 1983 by more than 1 percentage point. Thus, the current stance of fiscal policy in Canada allowed for some short-term stimulus on a selective basis while continuing to provide for restraint in the medium term.

All the major economies seemed to be well on the road to the pursuit of broadly common policies, Mr. Joyce observed, including generally tight fiscal policies and the intention to allow for some relaxation of monetary policy as circumstances permitted. However, major uncertainties did remain, and most national authorities seemed to be waiting for clearer evidence of the direction in which their own economies and those of their major partners would move before making any major policy changes.

The projections for the developing countries seemed reasonable, Mr. Joyce said, although they hardly provided grounds for great complacency, as the staff admitted. While a limited number of non-oil developing countries--those that had important access to international capital markets--were effectively cutting back their still significant current account deficits, many other developing countries continued to run large current account deficits. In addition, although the average ratio of current account deficits to exports for non-oil developing countries was expected to fall to 14 per cent by the end of 1983, the ratio prevailing in 1973-79--or possibly lower if the figures cited by Mr. Polak were accepted--and remain at that level through 1984-86, it should be remembered that in the earlier period, international financing had been much more readily available, and bank financing had been available at much lower rates of interest.

Furthermore, the position of many oil-exporting countries was beginning to be a matter for concern, Mr. Joyce noted. Obviously, the outlook for both the oil developing and the non-oil developing countries would depend critically on developments in the industrial countries, in particular on the rate of growth and the extent to which those countries did not move to protect their domestic markets. The success of the developing countries would also of course depend upon their achieving external positions that were sustainable, which in turn meant pursuing policies suited to that end. Certainly, the focus of policy should shift from a compression of imports--compression often achieved by administrative means--to policies emphasizing the reorientation of production toward the traded goods sectors. For that purpose, appropriate exchange rate policies, domestic pricing policies, and government investment strategies would have to be pursued, with a view in the end to reducing domestic absorption in relation to output.

In drawing policy conclusions, Mr. Joyce stated, he would first agree with the view that if the recovery was to be sustained, it would be essential for the authorities of the industrial countries in particular to remain firm in their pursuit of anti-inflationary policies. No country could afford to give signals that might lead to a rekindling of inflationary expectations. Second, he would also agree that it was vital that structural deficits be tackled and reduced, and that the developed and the developing countries alike make the necessary adjustments in their economies. As already noted, however, there would still be room for policy differentiation between countries, and he would argue that there was limited scope for temporary, selective, and careful stimulation to help cope with major unemployment problems. Third, he had sympathy with those who had emphasized the importance of seeking greater exchange rate stability, and the importance equally of achieving a lowering of real rates of interest, particularly longer-term rates. The first was necessary to provide the greater degree of certainty demanded by investors, and the latter for major new investments to prove essentially viable. The achievement of those objectives would require the pursuit of the right national policies, and the harmonization of policies between the main economic players. While some progress was being made with harmonization, not much was being achieved in reducing real rates of interest, especially at the longer end of the spectrum. He was at one with those who considered that long-term rates of interest, at least in the United States, were unlikely to decline as long as U.S. fiscal deficits continued to increase; he agreed with Mr. Wicks that the sheer weight of the U.S. economy in the world meant that developments in the United States could not remain a matter of concern solely to the U.S. authorities.

The fourth policy conclusion that he would draw, Mr. Joyce said, was that the developing countries, if they were to profit from the recovery, would have to pursue policies that restored confidence in the international financial community, among both lenders and investors. Debt problems remained serious in many countries, and the flow of funds from the banks to debtor countries might not be sufficient to accommodate the degree of recovery foreseen, or at any rate desired.

With respect to international cooperation and the role of the Fund, Mr. Joyce welcomed the Fund's increased activity, which was sorely needed at the present time. He also welcomed the greater emphasis on conducting surveillance, not only on a bilateral but also on a multilateral basis. The new arrangements worked out, at present confined to the five largest industrial countries, were helpful, but it would be important to share the results of the discussions to be held with the rest of the membership. Thought might also need to be given to expanding multilateral surveillance to cover other countries. As had been mentioned in the staff paper, the areas being given greater attention as part of the surveillance process included specifically trade, exchange rates, and debt. The emphasis that it was proposed to place on trade policy matters was particularly welcome, because he saw a growing threat of protectionism in the industrial world and suspected that the protectionist danger would not disappear as recovery proceeded. With the large current account deficits anticipated in the United States, it was hard to envisage how the U.S. Administration would manage to resist the likely pressures to provide additional protection for American workers. He was by no means suggesting that the United States was more protectionist than any other industrial country, but was simply pointing to the most likely place where the greatest danger would presumably lie in the months ahead as the economic recovery proceeded.

His other reason for welcoming the greater attention to be paid to trade by the Fund in exercising its surveillance responsibilities, Mr. Joyce added, was that it was only by lowering trade barriers in the North that developing countries would be able to repay part of their debts. If the creditor countries were not prepared to grant greater access to their markets, they would have no alternative but to be freer and fuller in extending financial assistance to those countries. The latter development was unlikely. Protectionism was disadvantageous for all countries. Protectionism could inhibit the development of trade between the developing countries of the South, which should be a major source of growth of trade in the developing world. Furthermore, as the staff had pointed out, continued protectionism in any country tended to distort development, and was therefore likely to have even more serious effects in a country where there was a need for rapid development than in countries where the productive system was better established.

On exchange rate matters, Mr. Joyce welcomed the intervention study and the renewed understandings reached at the Williamsburg Summit Meeting. However, he was concerned about the threat of competitive devaluations, and particularly about the idea that seemed to be current, especially in developing countries but not confined to them, that somehow or other the way to counter protectionism in other countries was to proceed much more rapidly and to a much greater degree with policies of currency depreciation. It so happened that the pursuit of devaluation was a policy that the Fund had frequently urged on countries and had thus acquired over the years a certain aura of approval that might not always be legitimate, particularly if it was being used for the reasons that he had mentioned.

Finally, Mr. Joyce welcomed the attempts to improve the Fund's data base on debt, and to improve the coverage of the analysis of debt--within the Fund, and outside--to encompass not only its magnitude but also its maturity. The countries in his constituency also welcomed the technical assistance that the Fund had been able to provide in improving the collection of debt data.

The Executive Directors agreed to resume their discussion of the World Economic Outlook in the afternoon.

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/83/92 (6/27/83) and EBM/83/93 (6/29/83).

2. AFGHANISTAN - 1983 ARTICLE IV CONSULTATION - POSTPONEMENT

The Executive Board notes the request contained in EBD/83/158, Supplement 1 (6/23/83). 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 further postpone its consideration of the 1983 Article IV consultation with Afghanistan until not later than August 5, 1983.

Decision No. 7455-(83/93), adopted
June 27, 1983

3. ASSISTANT TO EXECUTIVE DIRECTOR

The Executive Board approves the appointment set forth in EBAP/83/166 (6/23/83).

Adopted June 27, 1983

4. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/83/164 (6/24/83), EBAP/83/168 (6/27/83), and EBAP/83/169 (6/28/83) is approved.

APPROVED: November 25, 1983

ALAN WRIGHT
Acting Secretary