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J. de Larosière, Chairman

Executive Directors	Alternate Executive Directors
	J. K. Orleans-Lindsay, Temporary
	L. E. J. Coene, Temporary
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	J. Delgadillo, Temporary
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M. Finaish	
T. Hirao	T. Yamashita
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G. Lovato	
R. N. Malhotra	A. S. Jayawardena
Y. A. Nimatallah	
	T. de Vries
	K. G. Morrell
G. Salehkhou	O. Kabbaj
F. Sangare	M. Camara, Temporary
	E. Portas, Temporary
	A. Lindø
	C. Taylor
Zhang Z.	Wang E.

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

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Also Present
C. F. Schwartz, Special Consultant. African Department: O. B. Makalou, Deputy Director; F. d'A. Collings. Asian Department: J. T. Boorman, R. J. Hides, S. Kashiwagi, I. Otani, S. M. Schadler. Central Banking Department: L. M. Koenig, Deputy Director. European Department: L. A. Whittome, Counsellor and Director; P. Gotur. Exchange and Trade Relations Department: S. Kanesa-Thasan, N. Kirmani. External Relations Department: H. P. G. Handy, N. K. Humphreys. Fiscal Affairs Department: V. Tanzi, Director; D. C. McDonald. Legal Department: G. P. Nicoletopoulos, Director; J. G. Evans, Jr., Deputy General Counsel. Middle Eastern Department: S. von Post. Research Department: W. C. Hood, Economic Counsellor and Director; A. D. Crockett, Deputy Director; R. R. Rhomberg, Deputy Director; J. Artus, C. P. Blackwell, J. E. Blalock, M. E. Bond, J. M. Boughton, M. C. Deppler, S. J. A. Gorne, O. E. G. Johnson, N. M. Kaibni, M. D. Knight, A. Lanyi, C.-Y. Lin, P. J. Montiel. Secretary's Department: A. P. Bhagwat. Western Hemisphere Department: E. Wiesner, Director; S. T. Beza, Associate Director; J. Ferrán, E. Hernandez-Cata, Y. Horiguchi, L. R. Kenward. Personal Assistant to the Managing Director: N. Carter. Advisors to Executive Directors: A. A. Agah, J. R. N. Almeida, T. A. Connors, S. El-Khouri, S. M. Hassan, L. Ionescu, P. Kohnert, H.-S. Lee, Y. Okubo, P. D. Péroz, M. Z. M. Qureshi. Assistants to Executive Directors: H. Alaoui-Abdallaoui, R. J. J. Costa, I. Fridriksson, G. Gomel, V. Govindarajan, N. U. Haque, C. M. Hull, A. K. Juusela, H. Kobayashi, M. J. Kooymans, J. Reddy, J. Schuijer, D. I. S. Shaw.

1. WORLD ECONOMIC OUTLOOK - GENERAL SURVEY

The Executive Directors considered a staff report containing a general survey of the world economic outlook (ID/83/5, 8/19/83).

Mr. Hirao noted that since the previous Executive Board discussion of the world economic outlook (EBM/83/93 and EBM/83/94, 6/29/83), there had been increasing signs that the world economy was on a more solid track toward recovery. In particular, the apparent pickup in the speed with which the U.S. economy was advancing was welcome, as it could lead the way to global recovery. Four factors could be cited as contributing to the present upturn: first, inventory adjustment had almost run its course, and the economy was in the upward phase of the inventory cycle; second, pent-up demand from the recession of the previous three years was being released; third, anti-inflationary policies were beginning to bear fruit; and fourth, progress had been made in some of the areas faced with structural problems.

The second factor, the release of pent-up demand, reflected the regained confidence of consumers, Mr. Hirao continued, which in turn had been reinforced by the progress made on the inflation front. The inflation rate had been markedly declining during the previous 12 months in the United States, the United Kingdom, and some other industrial countries. As a result, there had been an increase in the real income of households, leading to the increased confidence of consumers, a most favorable element in the prospective recovery. No policy shift should be allowed to cause a rekindling of inflation if sustained recovery was to be secured. The fourth factor included various structural rigidities that had been rooted in the fabric of national economies throughout the 1970s. Such rigidities were so closely intertwined with each other and were so deeply embedded in various economies that it would take a considerable period of time to overcome them.

The lack of appropriate medium-term measures was responsible for a major part of the difficulties facing the world economy at present, Mr. Hirao considered. Even where suitable measures had been formulated to cope with the structural problems, the lack of strict enforcement had resulted in persistent economic difficulties. It was especially worrisome that the pursuit of medium-term policy objectives was often hampered by short-term considerations. The primary policy objective of the authorities should be to adhere to a program for correcting structural problems without accommodating demands for policy changes in the short run. In that regard, he strongly endorsed the staff's view expressed on page 39 of ID/83/5. If authorities failed to adhere to the medium-term policy objectives, the structural difficulties were bound to recur, constantly threatening stable growth.

Among the structural problems, there were some areas in which encouraging signs of improvement were visible, most conspicuously in the labor market, Mr. Hirao continued. In that area, progress had been made in Germany, the United States, the United Kingdom, and some other industrial countries. During the 1970s, the relative price structure of various production inputs had undergone drastic changes. Nevertheless, real wages had been held unchanged. As a result, profitability had been severely squeezed and capital formation had been hindered.

Although many observers attributed the decline in business fixed investment to an inadequacy of demand, Mr. Hirao commented, it might be more closely linked to the profit squeeze. If real wages were to remain unchanged, productivity would have to increase, and new investment was a prerequisite for achieving higher productivity. However, because of low profitability, business investment had stagnated, and productive capacity had failed to expand in line with the growth of the labor force, contributing greatly to the increase in unemployment. High unemployment still plagued many economies, but, under the pressure of high unemployment, flexibility was being regained to some extent in the wage formation process. If that favorable trend continued, business profits could be expected to recover gradually, particularly if there were productivity gains at the same time. It could then be expected that business confidence would gradually be restored. However, at present, business confidence was not yet strong enough to suggest long-term favorable prospects, and investment remained stagnant. For the economic recovery to be well sustained, it would be essential for business investment to increase to adequate levels.

Another structural difficulty common to all industrial countries was the problem of large fiscal deficits, Mr. Hirao observed. Business confidence was undoubtedly affected adversely by the persistence of such deficits. In the 1960s, a period of economic prosperity, any public investment could produce a favorable chain reaction through multiplier and other effects. Under the persistent fiscal deficits, when there was always a risk that fiscal stimulus might be withdrawn at any time, the increased income resulting from the fiscal stimulus might be viewed as temporary. Thus, the chain reaction tended to be weak. Business firms, in making their investment decisions, took into account not only their present revenues but also the aggregate of future revenue flows. Therefore, even if an expansionary fiscal policy was adopted, a surge in business investment would not necessarily follow, if such a policy shift was expected to be short-lived. Those considerations suggested that sustained growth could be achieved not by quick expansionary measures, but by a firm policy, steadfastly implemented, as well as through sustained business confidence over the long run.

Fiscal deficits eventually had to be monetized, Mr. Hirao went on. Large structural deficits would mean, therefore, a persistent expectation of large monetary injections, and the resultant inflationary expectations would tend to contribute to continued high interest rates. On the other hand, business confidence had been hampered by the recurrence of high real interest rates and investment had been discouraged. It would be almost impossible to bring the huge fiscal deficits into balance in under five-ten years. Most of the underlying causes were structural, having evolved from socioeconomic developments since the 1960s.

What ought to be achieved, and could be achieved, in a single fiscal year was the steady reduction of deficits under a medium-term strategy for restoring fiscal balance, Mr. Hirao suggested. Steady implementation of a medium-term strategy was probably the only means of reinforcing public confidence in the authorities' determination. If a good prospect of the restoration of fiscal balance could be presented, and if that prospect was substantiated by an actual annual decrease in fiscal deficits, the perception of economic agents would change accordingly, even if the complete elimination of fiscal deficits took a long time. In those circumstances, interest rates could also be expected to decline. In that regard, he agreed with the staff that the "most important policy element that remains to be set in place is a credible plan for reducing fiscal deficits in those several countries (particularly the United States) where structural budget deficits are high or increasing." A decline in interest rate levels in the United States would enable other countries to lower their interest rates, creating room for stimulating domestic economies. Moreover, a decline in U.S. interest rates would contribute to lowering the value of the dollar, which should bring about an improvement in the U.S. external balance, while bringing the value of other major currencies into better alignment.

Economic recovery in the non-oil developing countries was essential to global recovery, Mr. Hirao stated. It was encouraging to note that under the staff's central scenario the current account of that group was projected to become more manageable in the medium term. However, in order for that projection to be realized, strict adherence to adjustment policies in both the short term and the long term would be essential. Such adjustment efforts should help to restore confidence in those countries, thus creating a smoother inflow of capital that would, in turn, expedite the adjustment process.

Commenting on the present state of the Japanese economy, Mr. Hirao said that while domestic demand had not been expanding at a fully satisfactory rate, it was believed that the official projected growth rate of 3.2 percent for the fiscal year 1983/84 was attainable, with the major part of the thrust coming from domestic demand. The staff projected a substantial increase in the net foreign balance for 1983. However, that judgment applied only to the first quarter of 1983, because economic growth for 1983/84 as a whole was forecast to be based largely on the increase in domestic activity. As for the projected increase in Japan's current account surplus, it was largely a reflection of a decline in imports, mainly due to the decline in oil prices, oil conservation, and other factors.

Mr. Lovato remarked that world economic conditions had presumably changed only marginally since the Board's previous discussion of the world economic outlook. The contours of the recovery in a number of countries were somewhat neater: output performance in industrial countries in 1983 had been stronger than originally anticipated, and the reduction in inflation had worked its way through at a remarkable pace. However, much optimism would hardly be justified at present. The recovery was confined to some countries, and it did not appear to be spreading to other industrial or developing economies. To claim that a global recovery was under way would be overstating the case, and it would be more correct to state that encouraging signs and examples of recovery were beginning to emerge.

Uncertainties continued to loom large and the world economic system as a whole did not seem to have automatic self-correcting properties, Mr. Lovato continued. Many economies needed to restore a measure of external payments balance, and some of them were still beset by heavy external debt burdens. Policymakers in the countries concerned, the Fund, other multilateral institutions, and the international financial community were all groping for a solution to the complex issues, but no conclusive answer was in sight. The best combination of adjustment and financing remained to be found. There was also a widespread consensus that no solution to present international economic problems was possible without strong growth in world trade and in demand. The medium-term projections by the staff, although only illustrative, underscored that point forcefully.

At present, Mr. Lovato observed, all countries with Fund-supported programs were advised to reduce imports and to increase exports. The yardstick against which the success or failure of an adjustment program was judged in the first place was whether or not the current account deficit had been reduced and a more manageable debt situation had been achieved. While many countries had succeeded in complying with the first recommendation by curtailing domestic demand to the point where they entered a recession, not many of them had been able to boost their exports adequately, given the stagnation in world trade. On the other hand, industrial countries, potential outlets for developing countries' exports, were advised to consolidate their anti-inflationary achievements by gearing their policies toward reducing budget deficits and keeping monetary expansion at a rate deemed to be consistent with price stability. While he could agree with that kind of recommendation for a single country, or a few countries in a different world economic environment, he could not concur with the often stated view that such a policy could operate in the present phase of the economic cycle with beneficial effects for the world as a whole. The complexities of the present world economy constituted to a certain extent a vicious circle that needed to be broken as promptly as possible.

Developing countries had squeezed domestic absorption and imports considerably, Mr. Lovato commented. In addition, they could not increase their exports further in the short run, and they did not have much room for further adjustment. Industrial countries, having disinflated their economies, were currently experiencing higher rates of idle capacity and unemployment, and they were increasingly tempted by protectionist solutions to their economic problems. He was very much opposed to any form of protectionism in trade relationships, but it might not be reasonable to expect that such pressures would subside simply by saying that protectionism was counterproductive and terrible. It might be necessary to set in place the conditions for an upturn in work demand, such as a different policy mix that could lead to lower interest rates in those countries that had been successful to date in bringing down inflation. As he had stressed on previous occasions, the current state of the world economy, with ample unused capacity and decelerating price and cost pressures, represented the most favorable environment for a change in policies in the countries that had the leeway to do so. He remained convinced that imbalances in the policy mix, particularly in the United States, ought to be corrected with a view to reducing interest rates. Once authorities had firmly decided on a credible plan for reducing the fiscal deficit, they could and should pursue a less restrictive monetary policy.

He broadly agreed with the staff's remarks on the subject of exchange rates and policy interdependence, Mr. Lovato said. It was, indeed, critical that the constellation of exchange rates that would prevail in future months should be consistent with the needs of economic recovery in all countries. The wide gyrations in exchange values, coupled with the persistently strong and rising U.S. dollar, exerted a destructive influence on the prospects of an evenly distributed economic upturn. He had been pleased to read in the press that, according to Mr. Cross of the Federal Reserve Bank of New York, "the [recent] intervention was successful and beneficial in certain ways and it helped to cushion the dollar's rise." It should also be stressed that exchange rate movements, whatever equilibrating mechanism they might trigger in terms of trade flows, were being prevented from operating by the increase in protectionist tendencies. Such developments resulted in the positive impact of exchange rate changes being lost and they only added to the increase in uncertainty over future economic conditions, thereby hindering the widening of the recovery.

In that regard, he did not fully subscribe to the staff's analysis, Mr. Lovato added. In particular, in a discussion of the international repercussions of a strong dollar, it was important to focus not only on the standard linkages operating through the current account--the higher costs of imports and of debt service--but also on the capital account and on the pattern of international financial flows. Capital outflows toward strong economies with high interest rates might be only partially stemmed through more stringent monetary policies in the weaker countries since such policies would have adverse effects on those countries' prospects for recovery. Continued inflows of financial assets into the United States and away from other industrial and developing countries were primarily being channeled to the financing of fiscal deficits; they were not being recycled in ways that would sustain a revival of the world economy.

Mr. de Vries said that he could agree with the main thrust of the staff paper. The staff argued that the painful and prolonged actions to eliminate maladjustments in the world economy that had built up over a decade or more were beginning to produce results, particularly in those countries that had been most determined in implementing policies to correct the imbalances. However, many imbalances remained, and the policy actions needed to correct them were not in place in all countries; perhaps in no country were all measures in place. He could agree with those main conclusions of the staff, although there were points in the staff's analysis that were not wholly satisfactory.

The staff stated that, if there was a recovery, it was mainly attributable to easier monetary conditions, in particular, lower interest rates, Mr. de Vries continued. He doubted whether interest rates had been the main factor, although they had played a role. A simple monetarist explanation might be more appropriate. A number of countries had limited monetary expansion in nominal terms, resulting in a recession and in lower price increases. That same monetary expansion had produced a higher degree of real expansion and a lower degree of inflation, which was what monetarists had claimed it would do, perhaps even in the short run. Thus, if initially an increase in the money supply of 10 percent had led to 10 percent inflation and no growth, in a situation of lowered inflation the same 10 percent monetary expansion led to 5 percent inflation and 5 percent growth.

However, monetarist theory could not explain the important adjustment that was taking place primarily in the private sector, which was adapting itself to a noninflationary situation, Mr. de Vries argued. Previously, when inflation had been strong and there had been strong expectations that it would continue, many companies had made profits as a result of increased inventory prices and the like. At present, such windfall profits had disappeared. Stronger cost control measures had proved necessary and considerable adjustments in private industry had occurred. As a result, it was possible for an economy to begin growing again in a basically noninflationary situation.

In those countries where much of that adjustment had taken place, particularly the United States, recovery was beginning, Mr. de Vries remarked. In many European countries, where the process was only at an early stage, recovery was lagging; however, in the United Kingdom where, within its own historical setting, a great deal of adjustment had taken place, expansion appeared to be somewhat more firmly embedded. Thus, interest rates had not been the main factor behind the recovery, although the decline in interest rates had helped. The fundamental adjustment had been brought about by steady policies to eliminate inflation.

It was also believed, as a corollary, Mr. de Vries suggested, that high interest rates, arising from large government deficits, would abort the recovery. He disagreed strongly with that analysis, although he could agree, for different reasons, that deficits were too large and that many countries could appropriately take action to deal with them. A fiscal deficit was a strong stimulative factor in the economy; if as a result of that stimulus the private sector began to expand, interest rates would have to rise rapidly if inflation was to be avoided again. An increase in interest rates would be required to prevent the recovery becoming too strong and leading to a situation in which an economic decline became inevitable. Thus, he feared that interest rates perhaps were too low rather than too high. They might not be high enough to bring about the necessary squeezing of the private sector, given the structural deficits. There was no reason why it might not be possible to have a cyclical recovery initially based on consumption, although in the long run the lack of investment could not sustain rapid growth.

He also had difficulties in subscribing to the worries about the high level of the exchange rate of the U.S. dollar, Mr. de Vries went on. The staff argued that the effective exchange rate of the dollar at present was about 7.5 percent higher than in 1970, before the period of currency adjustments. However, current adjustments had already begun in 1969 at the latest. The significance of the effective exchange rate was also questionable. The nominal exchange rate of the dollar relative to the deutsche mark, and to a number of currencies strongly influenced by the deutsche mark, was lower than it had been in 1970, and certainly lower than in 1969. The same point was true with regard to the dollar and the yen. Thus, if the exchange rate for the dollar was lower against those important currencies, to which many other currencies were related, it was not clear what significance should be attached to a statement that the effective exchange rate of the dollar was higher. He invited the staff to comment further on the issue.

The U.S. economy was the economy expanding most rapidly, Mr. de Vries noted. The increase in the dollar exchange rate had led to a weakening of the U.S. current account, and, therefore, to the possibility of strengthening the current account of laggard economies, such as those on the European continent. His authorities found the strength of the dollar a welcome development in the short run, and it need not be considered an adverse development in cyclical terms. In the medium term, perhaps, the world economy was helped by stability in exchange rates, and it was reasonable to believe that present exchange rates could not be maintained over the medium term and that further adjustments would take place. But in 1983, and perhaps in 1984, the high level of the exchange rate of the dollar would help the world economy to recover rather than hinder it.

The influence of the policy of the United States on its partners in both the industrial and the developing world was another matter deserving consideration, Mr. de Vries observed. He could not recall a prolonged period when U.S. policy had been considered "correct" from a European point of view. In the 1960s, the United States had been accused of exporting inflation; at present, as the staff pointed out, the United States was importing scarce savings. While such developments might be uncomfortable, it was not clear that anything could be done about them. In the first place, it was not easy to say what was the correct U.S. policy stance from the European point of view. The appropriate policy stance would differ according to individual countries; thus, whatever the United States did, some countries would be dissatisfied. In addition, the United States was at least partly correct in paying predominant attention to the policies necessary for its own economy; it had always done so. As far as the industrial countries were concerned, if they did not like the impact of the U.S. policy stance on their economies, they had a large array of policy instruments available to mitigate it. For example, if U.S. interest rates were considered too high, European countries could take appropriate exchange rate action or they could change the domestic policy mix between fiscal and monetary policies. Alternatively, they could take measures to make their financial markets more independent.

Nevertheless, it would be desirable for the United States, and for other countries with large fiscal deficits, to take appropriate actions to deal with them, Mr. de Vries considered. Many U.S. citizens agreed that it was in the interests of the United States to deal with its budget deficit, if only because the composition of demand was unlikely to be satisfactory from the U.S. point of view. There was also an important international argument for such actions from the point of view of developing countries, which had less protection against the undesirable effects of the U.S. policy stance than industrial countries. If large fiscal deficits in the United States led to high interest rates, developing countries would have to pay higher rates on their debts. A further point to bear in mind was that, while it was true that the United States was borrowing international savings, so were several other industrial countries. The problem of large budget deficits was not confined to the United States alone. In that regard, he agreed with Mr. Hirao that governments should continue to take actions to reduce deficits.

Although he could not accept the staff's analysis, Mr. de Vries went on, he could agree with its conclusions. First, it was necessary for a number of countries to reduce budget deficits, although significant actions were unlikely to take effect before 1985 or 1986. Second, measures to reduce inflation in those countries in which it remained a serious problem were necessary. Third, there was a need to bring about a shift in income distribution from wages to profits, especially in a number of European countries where profitability was so low that expansion was unlikely to occur without some action in that area. The task would be as difficult to undertake as the reduction of budget deficits. Fourth, protectionism should be avoided.

The staff's fifth conclusion was that there should be an increase in official development aid and long-term finance for developing countries, Mr. de Vries remarked. He agreed with the staff's analysis of how funds had been accumulated by the oil producers and channeled through the banking system to developing countries. That mechanism no longer existed, and it was unlikely to return quickly. As a result, there had been a major shift in the availability of savings to developing countries. With budget deficits in industrial countries using up a large proportion of savings, the medium-term prospect for developing countries was that they would have to survive with much smaller inflows of capital and that, if development was to continue, they would have to replace those foreign savings with domestic savings. However, once savings had increased in industrial countries and a surplus was available for developing countries, it was questionable whether the world could safely rely on the banking system to recycle it. The recycling function of the banks had carried with it a number of risks that should be avoided in future. It was a matter of concern, therefore, that little thought was being given to alternative channels for the flow of savings from industrial to developing countries.

At an earlier discussion of the world economic outlook, Mr. de Vries recalled, Mr. Polak had questioned whether even the relatively moderate amount of credit needed to finance the current account deficit of developing countries would be forthcoming through the banking system. The staff assumed that such finance would be available over the medium term, apparently in the belief that the banks were being unduly pessimistic at present. However, it could also be argued that the banks were actually lending more than they wished to do. Thus, the flow of credit might diminish further. In the next world economic outlook exercise, the staff should look again at its assumptions with regard to bank lending to developing countries, and it should consider alternative channels through which the necessary flow of finance to developing countries could be stimulated.

Mr. Kafka commented that the staff had presented Directors with a relatively less pessimistic forecast in a few respects than at some earlier world economic outlook discussions, but it had been rightly cautious about the many dangers confronting both industrial and developing countries. It was understandable that growth in the industrial countries, both in the immediate future and in the medium term, should be seen to be slow. The danger of a resurgence of high inflation was widely believed to continue to exist. Whatever one thought of the danger of pressure for wage increases in excess of productivity and their obvious effects on profits as well as prices, it was also questionable to what extent present excess capacity was realistically measured, because of doubts with regard to the adaptation of the world's productive structure to the emerging structure of relative prices. The lagging recovery in business investment added to such fears.

Even before the effective capital constraints in industrial countries began to be felt, Mr. Kafka continued, dangers were posed by the existing and proposed structural deficits. They threatened to lead at an early stage to an increase in real interest rates, thus not only impeding sustained economic growth, but possibly cutting short the recovery. Moreover, high interest rates, particularly in the United States, were likely to keep the dollar at an inconvenient exchange rate relative to the currencies of other industrial countries. That factor was likely to encourage imports into the United States, thereby promoting protectionism in that country, and prevent compensatory liberalization in other industrial countries, except Japan. Important industrial countries had at least refrained from increasing their protectionism.

Most developing countries continued to face difficult adjustments and debt problems despite courageous actions already taken with the assistance of the international financial community, Mr. Kafka observed. The staff's forecast of a 4.5 percent growth rate in the less developed countries was assumed to be compatible with the 3 percent growth rate forecast for the industrial countries. In some countries it would take several years for such growth rates simply to restore the level of per capita income prevailing in 1981. Moreover, even such modest growth rates would require increased net savings because of the reduction in foreign savings available to the developing countries that had already taken place. Thus, for a time, it would be difficult even to maintain, let alone increase, per capita consumption in developing countries.

The expectation of a 7 percent expansion in net borrowing by the non-oil developing countries from commercial banks, which underlay some of the staff's forecasts, might be too optimistic, even though it was a modest increase, Mr. Kafka considered. To date, commercial bank loans had been spread over a large number of banks, and the smaller banks, and perhaps even some of the larger banks outside North America and the United Kingdom, might opt out of any further expansion of lending to the non-oil developing countries. If such an event were to occur, the rate of expansion of bank exposure, of total lending to the non-oil developing countries, and of growth of those countries could become much smaller.

The interest rate burden might rise sharply again if continued recovery in the industrial countries was hindered by the maintenance of large public sector deficits, Mr. Kafka went on. The danger of slow growth in the developing countries, perhaps even at rates below the staff's forecasts, should be seen not only in terms of per capita income. The absorption of unemployment in the cities of the less developed countries, in which population and labor force growth rates were much higher than overall population growth rates, required industrial growth rates much higher than could be expected at present. It was also clear that in those countries the mechanisms for protecting the unemployed and the underemployed against the extremes of misery were rudimentary. The growth rate of the developing countries could be accelerated if the industrial countries avoided increases in protectionism and followed a path of increased trade liberalization. At some point, similar steps in the direction of liberalization would be required of the developing countries themselves, but only after they had placed their current accounts on a more secure basis. Sustained high growth rates in the developing countries would affect the industrial countries directly, because the latter had important markets in the developing countries for their exports.

The acceleration of growth was a complicated and time-consuming process, often requiring considerable structural changes, Mr. Kafka remarked. It might also require the imaginative application of trade and exchange rate policies. In sum, the coming few years would be especially dangerous for the developing countries, even if recovery and the subsequent growth in industrial countries were to continue at the modest rates foreseen by the staff. Directors should, therefore, consider what might be done to accelerate growth and to alleviate the burden falling on the developing countries. Growth could be faster in the industrial countries if the danger of wage inflation could be banished through mechanisms of wage adjustment that did not require keeping a tight lid on the growth of demand beyond the limits imposed by the growth of supply capacity; such a policy might be possible in many important countries. Furthermore, it might not be possible to increase productivity as much as would be physically possible if there were less regulation of economic activity. Just as price stability contributed to sustainable growth, continued recovery in the industrial countries depended on coming to grips with the large expected fiscal deficits in some of those countries, however difficult it might be to envisage sufficient action in that direction in the next two or three years.

The negative resources gap foreseen for the developing countries placed a special duty on the multilateral financial institutions and on the potential donors of official development assistance, Mr. Kafka considered, if the necessary adjustment in developing countries was to be successfully carried through. The existence of the gap might also mean that the effective burden on private financial institutions of continued lending to developing countries was less than was sometimes suggested; it should encourage a forthcoming stance with regard to continued lending and with regard to the conditions of rescheduling for those countries. However, whatever improvement in financial flows might be possible, it did not relieve the developing countries of the primary responsibility for dealing with their adjustment problems.

In such difficult circumstances, it could be expected that capital flows to the developing countries, even on the reduced scale foreseen, might be occasionally interrupted, Mr. Kafka added. That possiblility increased the responsibilities of the Fund. The Eighth General Review of Quotas had ended with a disappointingly small increase that had not yet gone into effect, and might never go into effect in its entirety. It would be desirable, therefore, to accelerate the Ninth General Review. Moreover, the Fund urgently needed to meet the commitments that already existed and that would continue to exist. The narrow interpretation being placed on the expansion of the General Arrangements to Borrow by one or two important participants was particularly disturbing. Such attempts should be resisted. In addition, the Fund should begin to tap the private markets on a prudent scale. The stagnant level of reserves and their maldistribution strengthened the justification for a resumption of SDR allocations. The success of the Fund as a result of the efforts of the Managing Director did not obscure certain disquieting developments within the institution. The Executive Board, in formulating its policies, must not give the impression that it was tightening policies beyond need or in a fashion that would appear to result in their asymmetrical application. Finally, the world economic outlook exercise should remind Directors of the need to begin thinking about the further evolution of the international monetary system and about action to avoid large medium-run swings in exchange rates, which should be endowed with greater viscosity.

Mr. Finaish stated that the fact that the recent recession had been the deepest and the most protracted in the postwar period only served to underline the need for achieving an early and sustained global recovery. A major policy challenge at present was to consolidate and strengthen the recovery that appeared to be getting under way in industrial countries. It was true that an element of restraint in their financial policies would need to be maintained for some time to prevent a resurgence of inflationary pressures. However, in those large industrial countries that had been more successful in bringing down inflation, there appeared to be some scope for a moderate change in policy toward stimulating economic expansion. A careful exploitation of their room for maneuver would help to make the incipient recovery become more firmly established in those countries and it would also help to stimulate recovery in other countries in which economic activity continued to be sluggish. Other policy measures for the promotion of sustained recovery in industrial countries included correction of imbalances in the mix of financial policies, and a reduction of structural distortions and rigidities.

The staff had rightfully placed a good deal of emphasis on the need to reduce structural fiscal deficits in the industrial countries, Mr. Finaish continued, particularly where they were large, as they had been an important factor impeding the revival of business investment. They could thereby jeopardize world economic recovery, as could inappropriate government intervention in the industrial countries to prop up declining industries through protectionism and other devices.

The need for greater policy harmonization among major industrial countries in light of the important international implications of their domestic policies had also been emphasized, Mr. Finaish noted. From that multilateral perspective the main focus of attention recently had been, again, the reduction of the high structural deficit in the United States. In addition to its other adverse international implications, an increasing redirection of available capital flows away from other countries, notably developing countries, appeared likely because of the accompanying large and growing U.S. current account deficit. Many observers believed that such a development was not only undesirable from the standpoint of an efficient use of global savings but that it would also involve a substantial crowding out of the potential credit demands of developing countries in a market that had already become much tighter.

The relationship between the U.S. balance of payments deficit and the flow of global savings pointed to an interesting aspect of the present international monetary system, Mr. Finaish suggested. Additions to global liquidity in the form of foreign exchange holdings occurred when the reserve currency countries ran a balance of payments deficit. Larger and continuing additions to international liquidity in that form required larger and continuing deficits in the balance of payments of those countries, but since the same deficits tended to weaken the relevant reserve currency, such a form of liquidity creation had long been said to contain a liquidity paradox. When the effect of those reserve-creating payments deficits on the direction of the flow of world savings was considered, the same process of liquidity creation might also be seen to involve potential efficiency costs as a result of a misuse of world savings. Such a result was possible because the process involved a net absorption of world savings by the reserve currency countries, which were large industrial countries, thereby diverting the savings away from other countries, notably developing countries, where potential returns might be higher.

In talking about the international implications of U.S. fiscal deficits, Mr. Finaish remarked, he had argued essentially from a global standpoint. The implications of a strong U.S. dollar and high U.S. interest rates could, of course, be positive for some individual countries, at least over a period of time.

In Section V of ID/83/5, Mr. Finaish continued, the staff touched on the impact of the sharp drop in the surplus of oil exporting countries in the context of international savings flows. The discussion raised the interesting question of a possible relationship between the structure of the balance of payments among groups of countries and the availability of international credit. He invited the staff to comment on the issue of whether the recent large shift in the balance of payments of the oil exporting countries had been a factor in the current and prospective reduced availability of finance to the developing countries.

The discussion in Section V of the staff paper focused on policy interdependence among industrial countries, Mr. Finaish noted. While it did look into some of the effects of the policies of industrial countries on developing countries, the constraints imposed on the policy options in the latter countries by policies adopted in the industrial countries had not been brought out. That aspect ought also to be analyzed in conjunction with policy interdependence among industrial countries, not least because the room for policy maneuver in developing countries was generally much narrower, and they were more vulnerable to external shocks.

Many of the developing countries continued to face a difficult external situation, Mr. Finaish observed. While the large-scale adjustment programs that had been undertaken in many of them had contributed to a significant reduction in their combined external deficit, payments imbalances remained large and widespread. Furthermore, the reduction in deficits had been achieved at the cost of a sharp curtailment of imports that carried adverse implications for investment and growth. While adjustment policies would need to be continued, and where necessary strengthened, the restoration of a satisfactory growth and payments position in the developing countries would also require the adjustment endeavors of those countries to be accompanied by a firm recovery in the world economy, greater access to export markets, and adequate external financing.

Commenting on the external debt situation, Mr. Finaish noted that the rate of increase in net exposure of commercial banks to developing countries was projected by the staff to be about 5-7 percent a year in the medium term. That rate of growth represented a steep fall from the almost 25 percent rate of increase up to 1981. The question arose whether those reduced rates of net bank lending would be consistent with the medium-term financing requirements of developing countries, given expected financing from other sources, and, if so, at what further cost to their growth rate? In addition to the factors noted by the staff in its discussion of the origins of the debt crisis, did the staff also believe that the skewness of the distribution of international bank credit had been a significant factor? The staff noted that four borrowers alone accounted for about 40 percent of the outstanding debt of developing countries in 1982. Their proportion of total outstanding bank debt would be even higher.

The staff might also wish to comment on whether the distribution of the flow of bank credit might have become even more skewed since the emergence of the debt crisis, Mr. Finaish added, because the banks were having to continue to lend to the large borrowers facing debt servicing difficulties, and they might therefore have cut back further in the amounts lent to smaller borrowers. Furthermore, if it was true that the larger borrowers had overborrowed, could the same be said of the average or median borrower? In other words, was the behavior of the average or median borrower also a cause for concern? It might be noted that even the very rapid rates of debt accumulation by the larger borrowers during the 1970s had been considered rational by some analysts in view of the then prevailing high rates of world inflation and relatively low nominal interest rates and, hence, the expectation of a relatively low burden of debt servicing in real terms.

It appeared curious that, while the projected average growth rate for industrial countries for 1983 had been raised from the level projected in the world economic outlook paper in June, reflecting improved prospects for recovery, the projected expected growth rate for non-oil developing countries for the same year had been reduced significantly from the already low figure projected in the previous report, Mr. Finaish remarked. He invited the staff to comment on the factors that had led to the downward revision. With regard to the situation of the oil exporting countries, the advice to those countries to adopt more restrained financial policies was appropriate, in view of both the recent large decline in oil revenues and the suboptimal use of the resources arising from the highly expansionary policies of previous years.

The case for greater international cooperation derived both from growing economic interdependence among countries and from the present difficult situation of the world economy, Mr. Finaish stated. There were several areas in which greater cooperation was needed and would be feasible if expressions of cooperative intentions could be matched by a will to convert them into actual deeds. The areas included harmonization of policies among countries, especially the major industrial countries; checking protectionism; and the provision of adequate financing to the developing countries on appropriate terms. The Fund could play an important role in promoting cooperation in those areas. The implementation of the Fund's surveillance function could be made more effective by paying greater attention to the policies of major industrial countries, including their trade policies, and to the international implications of their policy choices. The Fund's role in balance of payments adjustments and financing had become more important in the current circumstances of large and widespread payments imbalances in a fragile international financial system. The proneness to instability and distribution flaws exhibited by private bank financing of balance of payments disequilibria called for a strengthening of the Fund's direct and catalytic role in financing. Such a development would clearly be possible only through continuing strong support for the institution by its membership.

Mr. Laske noted that the present discussion was the third that the Executive Board had held in 1983 on the world economic outlook. Since the previous discussion, the Board had also discussed the economic policies and prospects of the United States and of Germany. Directors had, therefore, been tracking developments closely, and it did not appear that the situation in the world economy had changed significantly since June.

The recovery in industrial countries had gained ground, Mr. Laske continued, particularly in the United States, where an impressive rate of real growth had been registered in the second quarter. In Germany, the recovery had also continued, but not with the same strength and speed as in the United States. There had also been continued improvement in price stability, both in the United States and in Germany, although, unfortunately, in some other industrial countries inflation rates continued to be uncomfortably high.

The path and shape of the recovery in the United States was one of the most important factors in the continued progress of the world economy and undoubtedly a prerequisite for improvement in those countries struggling with balance of payments and debt problems, Mr. Laske continued. He had expressed serious concern on the occasion of the Article IV consultation with the United States (EBM/83/106 and EBM/83/107, 7/20/83) about the U.S. fiscal policy stance and its ramifications for interest rates, exchange rates, and the prospects for continued recovery. In recent days, analysis by professional economists suggested that the speed of the U.S. economy's recovery might have slowed somewhat. Given the strong increases in the growth that had been recorded in the first and second quarters, such a development was neither surprising nor a reason for uneasiness. At the present stage of the recovery, and bearing in mind the normal variations of business activity, somewhat less rapid growth would serve to stabililize the recovery and to maintain it at a sustainable level. It should also ensure the maintenance of the price stability so far achieved. A too speedy recovery could carry the risk of reigniting inflationary pressures. In the interests of the long-term benefits, a lowering of growth expectations might well be warranted.

He fully agreed with the staff that the main causes of the recovery in the United States were the marked decline in the rate of inflation since 1982, Mr. Laske added, and the easing of interest rates that had occurred since the middle of that year. So far, the recovery had been based on the revival of consumer expenditures, particularly for goods sensitive to financing costs. A spillover of the strengthening of consumer demand into more vigorous business expenditures for investment purposes had not yet been observed on a significant scale. Given the prevailing low utilization of productive capacity and the firming of both short-term and long-term interest rates, that lack of movement was not wholly surprising. It would be premature, therefore, to conclude that the economic recovery was firmly secured.

The most important factor that could threaten the sustainability of the recovery was the fiscal position of the United States, Mr. Laske considered. It was indeed disturbing to learn that the prospects for the correction of fiscal policy in the foreseeable future were not great. According to a report in The New York Times on a speech given by a senior

U.S. Treasury official, significant action did not appear to be contemplated, or to be considered politically possible, on either the revenue or the expenditure side. A possible effect of the present recovery was an increase in tax revenues, but the increase would have little impact on the projected deficit. As a consequence, interest rates could remain high. That pressure on interest rates would be reinforced through an increase in credit demand from the private sector.

The reduction of marginal tax rates that had been implemented in 1980 had been expected to strengthen savings in the United States, thereby increasing the flow of loanable funds, Mr. Laske commented. However, there were indications that those expectations had failed to materialize so far. It had recently been reported that the personal savings ratio had slipped to only 4 percent in the spring of 1983, a 33-year low. According to a recently published study by the Wharton School, the average savings rate in the United States might rise to only 4.9 percent in 1984, only marginally higher than in 1983. Those prospects made it all the more important to urge again credible action in the fiscal field designed to reduce budget deficits to a level that would ease the pressure on interest rates. In the business community, especially in the financial world, the perception appeared to prevail that continued high deficits were unavoidable, thereby feeding expectations for a firming or even an increase in interest rates. Unless those expectations were proved wrong through convincing action, the present recovery would remain subject to uncertainties.

The effect of high U.S. interest rates on the pattern of exchange rates and on the level of interest rates in other countries was equally worrying, Mr. Laske suggested. The recovery in Germany, for example, was exposed to risks because domestic interest rates could not decline to a level that would be better suited to Germany's needs. On the previous day, the Bundesbank had raised its rate for loans against colateral (Lombard rate) by 0.5 percentage point, a move that had been triggered by an increase in market rates. The latter increase had, in turn, been affected by interest rate developments in the United States, which had led to a widening of the interest rate differential in favor of the U.S. dollar with a consequential impact on the exchange rate. Although his authorities believed that exchange rates should be determined by market forces, they could not look upon such exchange rate variations with equanimity because of the potentially detrimental effects on price developments in Germany. The Bundesbank's action on the previous day had been primarily motivated by the behavior of the monetary aggregates, which had continued to grow rapidly, threatening to overshoot the target set for 1983 unless action were taken.

Commenting on economic policy in Germany, Mr. Laske noted that the staff had comprehensively described the reasons for his authorities' intentions to reduce the fiscal deficit. He fully agreed with the staff's presentation. An additional consideration, however, was that the high interest rate on the public debt had become one of the most expensive items in the budget, considerably narrowing the room for maneuver in fiscal policy, and highlighting the urgent need to contain the budget deficit. His authorities were confident that the deficit in 1983 would be kept within the limits set in the budget. The staff had also referred to the recent increases in the value-added tax that had taken effect on July 1, 1983, and it appeared to suggest that the primary purpose had been to reduce the deficit. However, such emphasis was a little one-sided, because it had also been important to generate tax revenues to compensate for a reduction in certain business taxes. Those reductions were designed to strengthen business profitability and thereby the propensity to invest in order to support the recovery that had begun sometime earlier. As a result, it was expected that the budget deficit as a percentage of GNP would remain constant.

The staff's balance of payments projections for Germany in 1983 deserved to be viewed with caution, Mr. Laske commented. The performance of exports and imports in recent months made it highly unlikely that the projected current account surplus of $7 billion could be achieved. His authorities currently expected that the surplus might not even reach $4 billion; the exact figure depended on the exchange rate that was applied.

The recovery had proceeded approximately as forecast, Mr. Laske said. However, real growth in private consumption and fixed investment could be expected to be at least 1 percentage point higher than forecast by the staff in ID/83/5. The German Minister of Finance in his budget speech before Parliament on the previous day had indicated that the authorities' projections at present were a little more sanguine than those made at the beginning of the year. There was, therefore, justification in believing that the authorities' efforts to correct the situation with regard to public finances were not excessive and that they would not stifle the recovery.

Turning to the international aspects of the present situation, Mr. Laske remarked that he fully shared the views of the staff. The countries confronted with severe balance of payments and debt problems had to make every possible effort to adjust their position to a level that could be sustained over the long term by capital inflows. Achieving such sustainable positions required a period during which balance of payments financing would be needed, in some cases at substantial levels, as Directors were aware. Some developing countries had already demonstrated that determined efforts could relatively quickly restore their credibility with international lenders, especially the banking community. Improvements in the conditions for foreign direct investment could also serve to ease balance of payments strains in significant ways. The closing of the financial gaps arising from the banks' reluctance to continue the generous lending policies of earlier years could not be expected to be brought about automatically by official institutions, either national or international. The capacities of those institutions were also limited, as Directors knew well from the discussions that they had held in recent months. He supported without reservation the staff's observations on the potentially evil effects of protectionism, whether exercised by industrial or developing countries.

Mr. Taylor said that he agreed broadly with the staff's forecast of a recovery in the industrial countries' activities beginning in 1983 and continuing in 1984. He could go along with the staff's judgment that the world economy "appears to be launched on the path of recovery." However, a good deal of caution was warranted. Lower inflation and lower interest rates had certainly helped to stimulate activity, but an important element in the recovery had been inventory adjustment in a number of major countries, a development that appeared to be ending, particularly in the United States. Another reason for caution was that the recovery had been heavily concentrated in North America to date. Progress in Europe had been rather halting, and, although there had been modest growth in Japan, it did not appear to be accelerating. If the North American economy could continue to grow without a significant rise in interest rates and inflation, the recovery had a chance of spreading and of activating the main engine of longer-term growth--fixed investment, particularly business investment.

The points made by Mr. de Vries with regard to fiscal deficits had been most interesting, Mr. Taylor continued, but his authorities continued to believe very strongly that a major concern at present was the damaging effects on confidence, and thereby on interest rates, of the large fiscal deficits that appeared to be set to continue into the medium term in a number of countries, above all in the United States. It was reasonable to argue that there was a link between the level of the deficit and the level of interest rates, given the thrust of monetary policies in the United States and other relevant countries. On that basis, real interest rates could be expected to remain relatively high, and a further rise might stifle the recovery. His authorities believed, therefore, that it was essential that the United States should not allow its interest rates to be driven up by excessive public sector demands for finance.

Commenting on employment and the labor market, Mr. Taylor noted that the information in Section II of ID/83/5 indicated that there had been both a cyclical rise in unemployment in the industrial countries and a long-term trend increase. The rising trend reflected structural factors that probably could not be changed quickly. Therefore, the best strategy would be to attempt to ensure that labor markets responded as smoothly and flexibly as possible to the developing recovery. Authorities, particularly in Europe, needed to tackle labor market rigidities so that the fuller benefits of the recovery could result in a pickup in employment. He agreed with the staff that improvements in the real rate of return were needed to encourage investment, which would require, inter alia, continued wage restraint. Governments had to try to get across the message to their work forces that the recovery was fragile and that it would be placed in jeopardy if trade unions seized the opportunity to try to make up for lost time. Although there undoubtedly had been a squeeze on real wages during the recession, wage settlements that were not warranted by productivity improvements were likely to be a major threat to a sustainable recovery.

The staff correctly pointed out that attention had to be focused on the changes in external current account positions rather than on the levels of imbalances among the major groups, Mr. Taylor considered. One question was whether the decline in imports of the oil producing countries would be as large as the staff predicted and, thus, whether the current account of those countries would improve to the extent that the staff expected. The staff would also be aware that exchange rates had changed since the projections had been made. He invited the staff to comment on the implications of recent developments in exchange rates for the forecasts.

Structural adjustment in both industrial and developing countries required governments to adopt and pursue medium-term policies, Mr. Taylor observed. He very much agreed with Mr. Hirao's observations in that regard. The U.K. authorities had recently adopted a package of measures that they believed would allow the British economy to adhere to the medium-term financial strategy that they had been pursuing over a period of years. All governments, especially in countries where inflation had not declined to tolerable levels, needed to take adequate measures to convince the markets of their continued anti-inflation resolve. In that connection, he endorsed the general policy guidelines outlined by the staff on page 16 of ID/83/5.

Commenting on the question of exchange rates and policy interactions, Mr. Taylor suggested that the welcome convergence in inflation rates had contributed to greater exchange rate stability but that, in other respects, the prospects for greater viscosity of exchange rates did not appear to be promising. High U.S. interest rates were a major factor in the strength of the dollar at present. That strength had contributed to the growing current account imbalances among the major countries, and it was the unfortunate factor behind the projected sizable growth in the U.S. current account deficit as well as in the modest increase in the current account surplus of Japan. A continuation of such imbalances could lead to the danger of greater exchange rate volatility in due course, and to the unwelcome encouragement of protectionism.

Adjustment policies in the developing countries would need to be pursued with continued determination, Mr. Taylor remarked. The staff raised the interesting question of the pattern of financing for developing countries that might be expected in the medium to long term. A good deal of attention in recent months had been paid to the role of commercial banks and of the Fund. Although those concerns would remain important, there was a more fundamental question, which Mr. de Vries had touched upon, namely, whether developing countries should appropriately count on finance from the banks. It was obviously difficult to finance economic development, a long-term investment process, through reliance on bank financing that was normally short-term or medium-term in character. His chair had suggested on a number of occasions that direct investment might play an increasing role in the financing needs of developing countries. In some circumstances, it might be appropriate to develop long-term capital market instruments to deal with the financing requirements of those countries, such as long-term bonds or equity participation, assuming that a more stable economic environment could be created. Perhaps the staff could examine such possibilities in greater detail in a future world economic outlook paper.

The dangers of protectionism had been underlined by the staff, Mr. Taylor continued, but it was likely that not a great deal could be done to halt protectionism without sustained economic recovery. Nevertheless, all authorities should take every opportunity to make clear their distaste for import restrictions designed to shore up moribund industries. Official development assistance would play an increasing role in the pattern of financing for developing countries, and it would be important for donor countries to do all that they could to maintain and, where conditions permitted, to increase the flow of development assistance. In addition, the Fund should make every effort to promote realistic adjustment policies and to provide appropriate levels of financing.

The Fund's surveillance role was also extremely important, Mr. Taylor stated. He welcomed the staff's efforts in individual country analyses and in the world economic outlook exercise to bring to the fore the international impact of national economic policies. The staff's work on exchange rate volatility was an example that should be encouraged. An assessment of the external impact of members' policies was important in the Article IV consultations with industrial countries, but it was also relevant to smaller countries, especially where there were important interregional relationships. Despite the difficulties of such analyses, it would be useful if the staff could devote a section of the Article IV consultation papers to an assessment of the main international consequences of policy changes in the countries concerned. It would also be useful for authorities to respond to the questions raised by the staff in such assessments.

Mr. Joyce commented that the main issue in the outlook for industrial countries and, consequently, for the world economy, was the fragility of the recovery, which had become more evident in recent months. The only real source of economic strength appeared to be in North America and, even there, the response of the investment sector remained a matter of concern, with high real interest rates and the size of the U.S. fiscal deficit raising doubts about the durability of the recovery in the United States unless it was reinforced by recovery in other countries. The staff had been justified in revising upward the forecasts for growth, but it had also suggested that in 1984 high interest rates could choke the growth already seen in residential investment and durable consumption expenditures, and that they could also inhibit the prospect for a rise in private fixed investment. Although it was difficult to measure long-term real interest rates, the staff had estimated that in August 1983 nominal rates had been 7.5 percentage points above current rates of inflation, compared with a margin of 1-2 percentage points in similar stages of the previous three cycles. Such a situation was particularly worrisome. Given the recent firming of rates on long-term government bonds, had it been appropriate to raise the growth forecast for the United States by a greater amount for 1984 than 1983?

The staff had also projected a gradually rising level of business investment in 1984, Mr. Joyce noted, a prospect that could also be significantly influenced by developments in interest rates. Furthermore, the typical assumption that nominal exchange rates would remain stable was particularly problematic in current circumstances. If the large U.S. budget deficit kept real interest rates high in the short run, there was an increased chance of a precipitous decline in the dollar at a later stage as the effect of the unparalleled deterioration in the U.S. current account reasserted itself. The staff believed that the appropriate stance of policies in Germany and Japan required continued progress toward the medium-term objectives of reducing fiscal deficits and lowering the rates of monetary growth. It also suggested that such policies should be pursued with moderate speed in light of domestic demand conditions. That view, with which he agreed, was slightly more expansionary than the one put forward in previous world economic outlook papers; indeed, in the present situation, Japan might have more room to address weak domestic demand in the short term.

He also agreed with most of the points made by the staff in the section on policy interdependence and exchange rates, Mr. Joyce continued. The present high interest rates in the United States and the strong dollar affected trade as well as financial markets. Economic expansion in the United States provided a strongly growing market for the rest of the world while the strength of the dollar reduced the competitiveness of U.S. exports. If the U.S. authorities followed the advice of the staff to reduce their fiscal deficit substantially, lower interest rates would probably result, but there would also be a loss of stimulus from the public sector, which could weaken the recovery. Depending on the interest elasticity of investment and consumption demand in the United States and the lags in response to interest rate changes, the loss of stimulus from the public sector might not be offset quickly enough by the private sector. The immediate impact of lower interest rates on the balance of payments would probably be a slowing of capital inflows and a weaker dollar, bringing about a lower U.S. current account deficit and a weaker trade stimulus to the rest of the world. Authorities outside the United States had to consider whether lower international interest rates as a result of a reduction in the U.S. deficit would result in conditions conducive to stronger growth in their economies and in the economies of the industrial countries generally. Given the other factors that affected investment demand, especially the lower level of profitability, the strength and timing of the upturn in demand in other countries in response to lower interest rates in the United States could be questioned. The staff could usefully have discussed that complicated issue at greater length in the paper.

It was also questionable whether, as the staff suggested, continued large borrowing requirements by the U.S. Government and competition for funds in U.S. financial markets would maintain the exchange rate for the dollar, irrespective of what policies of monetary restraint or monetary accommodation were being pursued, Mr. Joyce added. If monetary policy in the United States became accommodating, a resurgence of inflationary pressures arising from purchasing power parity considerations could be expected to lead to a weaker dollar, especially in the longer run.

The staff could have provided more information on the economic policies and prospects of developing countries, particularly the larger ones, Mr. Joyce considered. Given the potential impact of those larger countries, both on other developing countries and on the industrial countries, a brief description of developments and policies in four or five of the larger developing countries, as was normally included for some of the industrial countries, would have been welcome.

The staff's forecasts for developing contries appeared reasonable, Mr. Joyce remarked, but risks remained, particularly with the forecast for capital inflows from the banks, the level of protectionism, and the strength of recovery in the industrial world. Nevertheless, there were grounds for optimism. Many countries had undertaken, or were undertaking, major adjustment programs, often in conjunction with Fund financing, and those policies appeared to be taking effect. Average rates of inflation and aggregate current account deficits in the developing countries were expected to decline in 1983. But there were no grounds for complacency. The reduction in the combined current account deficit of developing countries projected for 1983 was not yet sufficient to bring it to a level where it could be assured of financing by voluntary financial flows. A number of countries in the developing world continued to pursue overly expansionary policies, and there had to be continued concern about the degree to which the improvement in current accounts in many of those countries had resulted from an unsustainable compression of imports. Furthermore, debt service ratios remained high and in some countries they might increase as rescheduled debt came due.

Commenting on international cooperation, Mr. Joyce said that he shared the concerns of other Directors about the dangers of growing protectionist pressures in both developed and developing countries. It was also worrisome that those protectionist pressures had tended to concentrate recently on nontariff barriers, the most difficult area to deal with. The degree to which the momentum toward freer international trading conditions had been lost was alarming. Progress had to be made in that regard if recovery in the industrial countries was to be firmly based, and if the developing countries were to meet their financial obligations and to achieve a satisfactory level of development. It was also vital to restore levels of official development assistance, particularly if some of the poorer developing countries were to prosper. The reduction in aid flows could be attributed, in part, to the recession, but it was also worrisome that there might be a change in public perceptions occurring in the developed countries with regard to the effectiveness and desirability of foreign economic aid. Developing countries had to help the developed countries to counter such trends and they had to begin, in conjunction with the international financial institutions, to make a greater effort to explain the need for continued high levels of development assistance.

Mr. Camara considered that the main conclusion to be drawn from ID/83/5 was that the growth prospects of the world economy were better than they had been in June. While such information was welcome compared to the gloomy assessments of the prospects for the world economy common in recent years, it could not be said that a sustained recovery was assured or that its impact would be widespread. The recovery, upon which the rest of the world depended, had gained momentum only in a limited number of industrial countries, and it was not yet supported by the kind of investment expenditures that would generate increased economic activity in the longer run. Although inflation and interest rates had declined from the unusually high levels of two or three years earlier, real interest rates remained high, a factor that could be expected to have a negative impact on private investors' consideration of the profitability of investment. If such a crisis of confidence existed, it could result in a short-lived recovery. Furthermore, an inappropriate shift in exchange rates resulting from the lack of convergence of economic policies among the major industrial countries was also a cause for concern, as that development could increase the pressure for protection against international competition at a time when an increase in the volume of world trade was essential to a broad-based recovery.

The staff projection of the average growth rate for non-oil developing countries in 1983 had been adjusted downward by about 0.75 percentage point from the figure in the June world economic outlook paper, Mr. Camara noted. It was clear that those countries had not yet begun to feel the impact of recovery in the industrial countries, and that the difficulties experienced with regard to their external payments positions, mainly as a result of adverse developments in the international economic environment, remained. For many of the poorer countries, the problems had grown greater, a point that was not sufficiently brought out in the staff paper, perhaps because the data had been presented in a highly aggregated manner.

However, there were grounds for hope that, if the recovery in the industrial economies was sustained into 1984, there would be a positive impact on the non-oil developing countries through increased export earnings, Mr. Camara went on, an important factor in easing their external financial constraints, given their very limited access to financial markets. Although the combined current account deficits of those countries had narrowed in 1982, it would be a mistake to think that there had been an underlying improvement in the situation, because the brunt of adjustment had fallen on imports, whose substantial reduction carried negative consequences for investment and future growth.

Against such a background, Mr. Camara remarked, it was questionable whether the kind of adjustment that relied on restrictive demand policies would produce the desired goal of stable and sustained economic growth. He fully recognized the need for adjustment; as a practical matter, a country could not expect to live continuously beyond its means. But it was a practical matter that countries would begin to doubt whether policies of deflation practiced for an extended period would necessarily lead to improvements in welfare, especially when the causes of the initial disequilibrium in the economy lay not only in expansionary domestic policy but also in external developments, such as the prolonged recession. The hardship resulting from restrictive demand policies in terms of inordinately high levels of unemployment was a real concern in countries that did not have unemployment insurance schemes. A decline in the morale of those who had to implement public policies was also a real concern, as was the relative neglect of investment expenditures, a neglect that postponed the ability of an economy to generate wealth independently. The staff, in stressing the need for the steadfast pursuit of adjustment in developing countries, should have given appropriate weight to the impact of external factors on the economies of those countries and to the role of an expanding world economy.

It was important to have an appropriate strategy that would reinforce the recovery taking place, Mr. Camara added. Policies aimed at lowering inflation had played an important role in getting the recovery under way, and it would be necessary to continue with anti-inflation policies in some of the major industrial countries where inflation continued to be a problem. He agreed with those Directors who saw the need for several major countries to put into place a credible plan for reducing their fiscal deficits. However, further thought should have been given to the appropriate policy stance of countries with lower inflation rates and relatively high levels of excess capacity. A global strategy based solely on fighting inflation might not be sufficient to sustain the recovery.

Rescheduling arrangements had bought some time for developing countries to implement adjustment policies, Mr. Camara observed, but it continued to be important to maintain adequate flows of financial resources to them. Official development assistance on a meaningful scale would be required, particularly for low-income countries that did not have access to private financial markets. The relatively low levels of assistance in recent years had made the process of adjustment to external constraints more difficult than would otherwise have been the case. He fully agreed with the staff when it advocated "an active role for the Fund throughout the period of transition from deep recession to sustainable prosperity, both to cover gaps in external financing and to assure that reasonable steps are taken to close those gaps." Recent attempts in some quarters to limit the access of members to Fund resources could be considered inconsistent with the staff's most pertinent observation.

Mr. Salehkhou stated that, as had been expected, the hope of improving prospects for the world economy in general, and for the developing countries in particular, remained to be fulfilled, despite the relative economic recovery in some of the industrial countries. The staff accurately observed that the situation could be primarily attributed to difficulties with fiscal deficits and high interest rates in several industrial countries. While creating a very difficult situation in the developing world, such impediments continued to hinder any prospects for a broader world economic recovery. However, even in the industrial countries, the recovery had yet to gain a footing, as many of them had not felt its effects and others remained in the downward phase of the economic cycle.

He agreed with the staff's view that total oil export revenues in 1983 were likely to decline by 21 percent and to remain low in 1984, Mr. Salehkhou continued. It became clear that the oil exporting developing countries that had provided substantial financial resources to be shared by non-oil developing countries in the past decade might no longer be in such an accommodating position.

Commenting on the position of the non-oil developing countries, Mr. Salehkhou agreed with the staff that "the sharp cutback in private lending...has forced many countries to implement long-delayed programs of adjustment" and thus "...over time, [has improved] the capacity of the countries concerned to service their debt and reduce their reliance on external finance to sustainable levels, thus improving medium-term growth prospects." The irony of the matter was that such a development should be considered a blessing; the developing countries should be thankful to the private lenders who had curtailed their lending. Although the process of adjustment and recovery would thereby be further complicated and more hardship would be entailed in the short term, he believed that such a curtailment would, in the long run, prove rewarding to developing countries in terms of making their economies self-sustaining.

The discussion in Section III of ID/83/5 concerned the means to ensure effective policy formulation, Mr. Salehkhou remarked. The potential benefits of any economic policy would be in question unless authorities determined the root causes of the problems and dealt with them decisively. The key questions were: What were the original causes of the almost worldwide inflation? How did unprecedented deficits come about? What were the reasons for unbearably high interest rates? The staff had skillfully dealt with some aspects of those problems, but a more elaborate analysis would have helped the process of moving toward a better world economy.

He fully agreed with the staff that adjustment ought to be continued as the only effective way to overcome the chronic economic and financial problems, Mr. Salehkhou continued, especially with regard to those countries facing grave economic and financial difficulties. The most important lesson to be learned from the experience of the last decade was that, if developing countries were to avoid another debt crisis, they should implement a persistent self-sustaining adjustment policy rather than continue to resort to external borrowing and deficit financing. He agreed with the staff that the difficulties facing developing countries arose not only from adverse external developments but also partly from inadequate domestic policies and delayed responses to external developments. Any adjustment policy ought to be geared mainly to the long term because, as past experience demonstrated, most economic dislocations were long term in nature.

The question of policy interdependence and exchange rates was always a crucial topic, Mr. Salehkhou observed. As the staff pointed out, "economic interdependence among countries is such that the interactions of policies and conditions in different countries can produce results in all of them that depart significantly from the original objectives." In many instances, the exchange rate represented the most influential interaction of policies and conditions in the market place. In other words, the volatility of exchange rates was significantly subject to the level of interest rates and inflationary fiscal policies among some of the leading industrial countries. One of the factors contributing most to the gloomy and uncertain economic outlook was the fluctuation in exchange rates. He agreed with the staff that a major step toward a healthy economy in the developing world would be the adoption of realistic adjustment programs by the countries concerned. He also agreed that the lack of stable exchange rates was mainly attributable to budget deficits in several industrial countries, the consequences of which were the draining of net savings from other parts of the world and the strengthening of protectionist tendencies.

The main objective of adjustment policies should not be merely "re-establishing confidence in these countries' creditworthiness" so that the developing countries might provide lucrative business opportunities and a healthy environment for private capital profit-taking, Mr. Salehkhou considered. Once proper adjustment policies were steadfastly and successfully pursued, international confidence in the countries' creditworthiness would automatically be regained. The countries would then be in a strong negotiating position with regard to their capital inflows and imports. He was confident that the example of his own country was a case in point.

He could associate himself with the staff's observation that the elimination of protectionist policies was of paramount importance, Mr. Salehkhou added, and that, in a cooperative and interdependent world economy, any malfunctioning in any area of economic activity had a universal effect on all the members of the market place. While he realized the serious need and great difficulties facing the developing countries, he personally believed that the first and main action necessary to rid those countries of their problems was self-reliance and self-sustaining adjustment. As a Persian proverb said: "Austerity is the best road to riches." On those grounds, he agreed fully with the staff that price stability would play, as it had always done, a central role in any overall recovery. However, price stabilization would not be possible without a reduction in fiscal deficits; those deficits usually contributed to higher interest rates, fluctuating exchange rates, inflation, and protectionism.

Mr. Malhotra noted that the staff had struck a somewhat more optimistic note than it had a few months earlier with regard to recovery, and that, in at least some countries, particularly the United States, the outlook for growth appeared to have improved considerably. However, the recovery remained patchy, concentrated as it was in the United States, Canada, and, to a limited extent, the United Kingdom. The Japanese economy continued to perform along the lines witnessed in recent years.

The mix of fiscal and monetary policies required modifications in at least some important countries, Mr. Malhotra continued. In particular, fiscal deficits in the United States remained high. According to press reports, the U.S. authorities did not believe that fiscal deficits were responsible for high interest rates. However, he agreed with most outside economists and the staff that there was probably a strong relationship between the level of interest rates and the level of deficits in the United States, and that there was also a close relationship between those factors and the exchange rate for the U.S. dollar. The impact of all those factors on both industrial and developing countries was severe; particularly, high interest rates had seriously aggravated the debt service burden of many developing countries. The situation made the task of adjustment complicated and difficult.

The staff had suggested that the policies pursued so far by industrial countries should be continued, Mr. Malhotra went on. However, it should be emphasized that several countries now had more room for maneuver and should follow flexible policies in order to provide greater stimulus to their economies. Part of the momentum in the U.S. economy had come from more accommodating monetary policies and the large fiscal deficit. The contribution of those factors had to be taken into account with that of lower inflation, which had probably given a very important impetus. It was important, therefore, that the Fund should avoid being too constrained or even negative on the question of stimulus, lest important economies continued to be too restrictive and thereby aborted the recovery.

The staff had correctly described the varying circumstances of the major industrial economies, Mr. Malhotra said. It was right to emphasize that Germany and Japan should not be in a hurry to reduce their fiscal deficits as overall demand in those economies was not picking up. Too rapid a reduction in the fiscal deficits of those countries might not be good either for them or for the world economy.

Commenting on exchange rates and policy interactions, Mr. Malhotra stated that he agreed broadly with the staff's assessment. There was apparently a degree of misalignment in the exchange rates of some major currencies, at least partly due to the financial policies of the countries concerned.

The staff's analysis of adjustment and financing in the developing world was broadly reasonable, Mr. Malhotra considered, but a much deeper analysis of the problems faced by various groups of developing countries was needed. Not surprisingly, the staff appeared to focus its attention on a few countries with a high level of debt, in light of the current debt situation and the concerns of commercial banks. However, the problems of various groups of countries at different stages of development and their prospects for growth should also be a matter of serious concern. A degree of adjustment was unavoidable, and many countries were in fact adjusting in difficult circumstances. However, it was necessary to avoid taking undue satisfaction from the fact that the overall current account deficit of developing countries was declining. As many Directors had noted, the decline was mainly due to reduced imports, mostly of basic inputs such as food, energy, spare parts, and capital goods.

Because of the lack of finance, Mr. Malhotra observed, many countries were unable to utilize the industrial capacity that they had developed at tremendous cost and often with international cooperation. The reduction in current account deficits did not fully capture the severity of the adjustment that had been taking place. The staff could have usefully analyzed the impact of the adjustment on developing countries' industries and their agricultural sectors as well as on their growth prospects, and their ability to cope with adverse circumstances, such as reduced food availability because of poor weather conditions. In some countries, nutritional levels were declining. Although the Fund was not a development organization, it ought to pay due attention to the need for increasing those countries' productive capacities, a goal that was inherent in Article I of the Articles of Agreement.

As Mr. Salehkhou had noted, many developing countries had increased their self-reliance, Mr. Malhotra added. Several of them had raised their savings rates substantially, but major problems persisted. The Fund, the World Bank, other development organizations, and the private sector all had a role to play in helping developing countries. The role of the private sector would depend on the circumstances of each country. Many low-income countries had hardly any access to private markets and their problems should be examined with particular care. Other countries could not afford to increase their debt burden. In many cases, the lack of developed infrastructures discouraged private investment. In sum, the adjustment process had to take into account development needs, and further analysis was needed of ways in which the flow of finance to the developing countries could be maintained for that purpose.

The staff had correctly emphasized the need to avoid protectionism, Mr. Malhotra stated. Protectionism should not only be halted, it should be rolled back. The failure of the developed countries to respond positively to the advice of the Fund was an example of the asymmetrical nature of the international economic system. He was glad that important industrial countries were seeking greater convergence in their policies, although progress in that area would be slow. It was equally important that greater efforts should be made to enhance cooperation between the industrial and the developing world. Perhaps the staff could also look into that question at a later date.

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

APPROVED: March 8, 1984

LEO VAN HOUTVEN
Secretary