04

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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 83/22

10:00 a.m., January 31, 1983

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

Executive Directors	Alternate Executive Directors
	A. B. Diao, Temporary
	C. Taylor
J. de Groote	
B. de Maulde	A. Le Lorier
	M. Teijeiro
R. D. Erb	
	S. R. Abiad, Temporary
A. H. Habib	Jaafar A.
T. Hirao	
	M. Casey
A. Kafka	
G. Laske	G. Grosche
G. Lovato	C. P. Caranicas
R. N. Malhotra	
Y. A. Nimatallah	J. E. Suraisry
J. J. Polak	T. de Vries
A. R. G. Prowse	K. G. Morrell
G. Salehkhou	
F. Sangare	
M. A. Senior	
	L. Vidvei
	Wang E.

L. Van Houtven, Secretary
J. A. Kay, Assistant

Also Present

African Department: O. B. Makalou, Deputy Director; I. Kapur. Asian Department: J. T. Boorman, S. M. Schadler. European Department: L. A. Whittome, Counsellor and Director; P. B. de Fontenay, H. O. Schmitt. Exchange and Trade Relations Department: S. Mookerjee, Deputy Director; S. J. Anjaria, E. H. Brau, M. Guitian, S. Kanesa-Thasan. External Relations Department: A. F. Mohammed, Director; H. P. G. Handy, H. O. Hartmann, H. P. Puentes. Fiscal Affairs Department: G. Blöndal, O. Pettersen. Middle Eastern Department: M. C. Niebling, G. Tomasson, S. von Post. Research Department: W. C. Hood, Economic Counsellor and Director; C. F. Schwartz, Associate Director and Director of Adjustment Studies; A. Crockett, Deputy Director; J. Artus, C. P. Blackwell, M. C. Deppler, S. J. A. Gorne, M. D. Knight, A. Lanyi, C.-Y. Lin, A. K. McGuirk. Secretary's Department: A. P. Bhagwat. Treasurer's Department: I. A. H. Diogo, J. R. Karlik. Western Hemisphere Department: S. T. Beza, Associate Director; J. Ferrân, E. V. Zayas. Bureau of Statistics: C. A. Patel. Personal Assistant to the Managing Director: N. Carter. Advisors to Executive Directors: J. R. N. Almeida, S. E. Conrado, J. Delgadillo, S. El-Khouri, P. Kohnert, H.-S. Lee, I. R. Panday, P. D. Péroz. Assistants to Executive Directors: H. Arias, L. Barbone, R. Bernardo, M. Camara, L. E. J. Coene, T. A. Connors, R. J. J. Costa, G. Ercel, I. Fridriksson, G. Gomel, A. Halevi, M. Hull, M. J. Kooymans, W. Moerke, V. K. S. Nair, J. K. Orleans-Lindsay, J. G. Pedersen, G. W. K. Pickering, E. Portas, M. Z. M. Qureshi, J. Reddy, P. S. Tjokronegoro, M. Toro, J. C. Williams, A. Yasseri, Zhang X.

1. WORLD ECONOMIC OUTLOOK - GENERAL SURVEY

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

The Chairman explained that topics for discussion had been suggested in Section IV of ID/83/1. He proposed that Executive Directors should address themselves to those topics and others that they might have selected in a single intervention. He looked forward to receiving a broad tour de table that would assist him in making his presentation to the members of the Interim Committee at their meeting the following month.

Mr. Taylor commented that the survey of the World Economic Outlook was particularly timely; the staff deserved commendation for producing a valuable report under pressure. He was also grateful for the staff paper on capital markets, which would no doubt be brought to the Executive Board for discussion during March 1983.

In general, Mr. Taylor stated, he agreed with the staff's cautious assessment of developments in 1982 and the prospects for 1983. While there were always major hazards in forecasting, at the moment there were particular uncertainties concerning the outlook for oil prices and the levels of exchange rates. Given the conventional assumptions with which the staff had been working, he could accept the broad range of projections for growth and inflation in 1983. The most important development in 1982 from his standpoint was the rapid decline in inflation in the industrial countries. It had indeed been faster than expected, particularly in the United States and the United Kingdom. Recent events were a clear demonstration that firm domestic economic policies had been working; and, as a consequential benefit, interest rates had followed inflation rates down to single digit figures in many cases. He would, however, agree with the staff that world activity was not yet showing convincing signs of recovery. Growth prospects had been revised downward quite sharply since the previous discussion on the World Economic Outlook (EBM/82/113 and EBM/82/114, 8/20/82) as both domestic and external demand had proved to be weaker than expected. The major immediate reasons for the postponement of recovery seemed to be depressed investment and destocking.

Naturally, Mr. Taylor went on, the greatest cause for concern at the moment in most industrial countries was the record level of unemployment. In 1982 employment in the major countries had declined in aggregate for the first time since 1975. But it was noticeable that North America and Japan had achieved, comparatively speaking, a rather better employment record than the rest of the world, even if in North America employment had been maintained on the strength of lower growth of productivity. Of course the resumption of faster growth in the industrial world rather than continued stagnation was a necessary condition for reducing unemployment. It would also be necessary if developing countries were to recover through the only route available to them, faster export growth. Unfortunately, taken in aggregate, the export markets of industrial countries seemed likely to remain rather sluggish. The conclusion was that growth would depend mainly on recovery in domestic demand within the industrial countries themselves. However, whatever recovery took place would have to be modest, and it would have to be undertaken by countries whose inflation performance and balance of payments position warranted it if the upswing was not quickly to regenerate inflation and hence prove unsustainable.

Commenting on the staff current account projections, Mr. Taylor said that he agreed with the picture of a growing U.S. deficit and a widening Japanese surplus. Those potential imbalances, combined with changing interest rate differentials, could herald an uncomfortable period of exchange rate volatility. So far as the United Kingdom was concerned, his authorities did not quite accept the staff view that there had been an easing of domestic monetary conditions in the last two months of 1982. They had reservations about the interpretation of policy stance at one or two points in the report, which he would take up direct with the staff.

Many developing countries had already carried out considerable adjustment, Mr. Taylor noted. In some cases adjustment had taken the form of a severe compression of imports, partly as a consequence of a loss of creditworthiness and partly because of the lessening of the flow of commercial bank lending. The Asian countries had on the whole managed to adjust earlier than others, with consequent better records of output and more satisfactory external positions. So far in the 1980s, Asian members had been relatively active users of Fund resources, while simultaneously managing to lengthen the average maturity of their external debt. Adjustment was admittedly far from easy in an environment of very slow growth, high debt service burdens, and poor prospective export growth rates, but there was a need to avoid complacency and sustain the thrust of the adjustment effort. Experience showed that if adjustment was forced on countries by, say, a liquidity crisis, it was a much more costly process than if it was accomplished through the timely steady application of corrective policies, supported by adequate finance.

He strongly endorsed the staff warning on page 24 of ID/83/1 that the threat of a further reduction in the commercial banks' aggregate exposure to developing countries could not be lightly dismissed, Mr. Taylor said. The threat of a massive financial collapse had receded, but banking confidence remained vulnerable. An obvious major cause for concern was the possible downstream effects of a further fall in world oil prices. In particular, the consequences for the debt servicing capacity of oil exporting countries, which had accumulated large burdens of debt, would have to be carefully watched. On the other hand, a further weakening of oil prices would benefit many countries by lowering their import bills and consequently the rate of price increases. It would be useful if the staff were able to assess the consequences of lower oil prices when making projections.

Commenting on policy stances in the main industrial countries, Mr. Taylor observed that, in view of the widespread existence of high unemployment, it was natural to consider whether countries that had succeeded in reducing inflation and interest rates should not now take the lead in relaxing their demand management policies. The conclusion reached by the staff was that a major shift toward expansion would rekindle inflationary expectations and jeopardize longer-term growth. The staff did, however, also say that individual countries should carefully assess their own room for maneuver, because their individual circumstances did differ, and countries had different policy mixes. Such a position was entirely consistent with the view, which he strongly endorsed, that the major industrial countries could very usefully increase their policy coordination. The benefits of greater convergence on inflation and growth rates could be large, provided that the convergence was in the right direction. The consequences of increased protectionism or massive exchange rate volatility, or indeed of changes in national attitudes toward overseas borrowing and lending, could be very damaging. He therefore strongly endorsed the staff conclusion that persistence with policies of firm monetary restraint, coupled with fiscal prudence and action to break down structural rigidities, would lay the basis for durable non-inflationary growth. Low inflation should allow more room for growth within the monetary target, while on the fiscal side it would reduce incremental drag, and allow for greater volumes of expenditure when budgets were fixed in cash terms.

Real interest rates did, however, remain high when compared with the experience of the early 1970s, Mr. Taylor observed, despite the easing of 1982. The indications were that longer-run inflationary expectations had not yet come down to the levels of the better price performance recently observed. Moreover, long-term interest rates had fallen less than short-term rates, probably indicating that market agents had not yet been finally convinced that higher rates of price increase had been banished for good. At the same time, spontaneous economic recovery had not yet been seen, and the natural process of revival was still weak. In the circumstances, low-inflation countries should be invited to explore what scope they had for short-term flexibility, while maintaining a prudent medium-term stance.

Regarding policy in the United States, the importance not only to the United States but also to the rest of the world of controlling the fiscal deficit could not be overstated, Mr. Taylor said. He was glad that the President, in his State of the Union speech, had proposed a series of measures for that purpose, but firm fiscal policy would have to be complemented by an equally firm but flexible monetary stance. He had not found the staff's passage on U.S. monetary policy altogether clear, and he would be grateful if the staff would say whether it agreed with those observers who detected a somewhat easier policy stance emerging in 1983.

So far as Japan was concerned, Mr. Taylor said that he would agree that the draft 1983 budget seemed to imply a tighter fiscal stance than that of 1982, despite the reflationary actions of October 1982. In the presence of a widening current account surplus, the staff was probably right to urge the Japanese authorities not to reduce budget deficits too quickly, or without regard to the weak domestic recovery. He looked forward to discussing the issue in connection with the forthcoming Article IV consultation with Japan. In passing, various indicators suggested that, despite the recent strengthening, the yen was still undervalued.

He shared the German authorities' concern about the difficulties of encouraging domestic recovery without provoking inflationary expectations in Germany, Mr. Taylor remarked. Maintenance of the 1982 monetary target throughout 1983 should allow more room for growth, and in the medium term he agreed with the Government that further fiscal tightening was needed. Germany, as well as the other industrial countries, was burdened by a structural problem requiring a medium-term policy. In the short run, however, the authorities could perhaps make more allowance for the effect of the recession in their assessment of their fiscal stance.

The modification of policies that had taken place in France, particularly since June 1982, had yet to convince the financial market, Mr. Taylor noted. As a result, reserves had been seriously depleted, and the authorities had been forced to intervene to support the franc on a large scale. There seemed little scope for policy relaxation in France. The same seemed to be true of Italy, where unions and employers had finally agreed to reduce wage indexation at the cost of quite substantial tax concessions. The authorities might be forced to concede still more, thus adding to the seemingly insuperable task of reducing the public sector borrowing requirement.

In the United Kingdom, Mr. Taylor continued, the Chancellor of the Exchequer would be submitting the budget in six weeks. One of the prime aims of the United Kingdom's medium-term financial strategy had been to reduce the structural public sector deficit, and that policy had so far been reasonably successful. A combination of monetary and fiscal restraint in the United Kingdom had produced an exceptional fall in the rate of inflation, from about 21 per cent in the spring of 1980 to an annual rate of 5.4 per cent in December 1982. Nevertheless, inflationary expectations did remain strongly ingrained. The United Kingdom had experienced double-digit inflation for almost a decade, with the rate twice exceeding 20 per cent. The authorities expected consumer price inflation to fall to about 5 per cent a year or even a little less in the next few months; but the decline might not be smooth because of recent falls in the value of sterling. The rate of wage increases was still above the current rate of inflation, and real interest rates were still comparatively high. Government revenue would moreover be affected by weaker oil prices. For all those reasons, he would be surprised if the U.K. authorities were able to contemplate a more relaxed policy stance in their budget during 1983.

Commenting on the relationship between the Fund and the commercial banks in the context of recent major financing programs, Mr. Taylor stated that his authorities wanted more time to consider the matter.

They hoped that circumstances calling for such initiatives by the Fund would remain exceptional. Accordingly, they were reluctant to begin thinking in terms of a standard response to each crisis as it arose. The best way forward for the time being would probably still be along ad hoc rather than predetermined lines. The Fund should not be distracted from its primary objective of preventing crises. He would welcome in due course an opportunity to review the initiatives that the Managing Director had taken with considerable success, as well as those cases in which it had been necessary for the Fund to take the lead in global aid coordination and debt restructuring.

Mr. Hirao commented that economic activity in the industrial countries during the past three years had been poor. In particular, 1982 had been a year of stagnant economic activity and rising unemployment. One notable feature of the period had been that actual economic performance had persistently undershot the official forecasts by governments or international organizations. The fact that the projected economic recovery had not materialized as expected seemed to pose a challenge to those who believed in the traditional demand-oriented macroeconomic framework. According to the conventional theory on the cycle, economic recession was caused by a shortage of effective demand, and recovery would take place either by spontaneous combustion or as the result of stimulative policies. Yet there had been little sign of a strong recovery in the industrial world. Even when an expansionary policy was adopted as a means of inducing additional aggregate demand, there seemed to be no assurance that the economy would return to a sustained growth path. The conventional approach had been based on the presumption that, given a sufficient level of aggregate demand, economic recovery would take place automatically, with resources being allocated in an efficient manner through relative price movements.

However, a number of factors had prevented the economic system from working in that way during the recent past, Mr. Hirao commented. First, the impact of the sharp rise in the real price of energy had not really been taken into account. Second, chronic and growing fiscal deficits had been damaging many of the industrial countries' economies. The protection of declining industries and the accumulation of external debt might also be considered factors that could not easily be dealt with by the use of traditional policy tools. Economic activity throughout the industrial world had been influenced strongly by factors other than changes in aggregate demand. In certain cases, expansionary demand policies themselves had resulted in higher inflation and deeper unemployment.

In many industrial countries, Mr. Hirao went on, real wages had remained unchanged despite a sharp rise in energy prices. As a result, profitability had been severely squeezed, and investment in plants and equipment had slowed down. The deceleration of capital formation in real terms had been one of the most conspicuous developments in the past several years. It could be argued that capital decumulation was attributable to the shortage of aggregate demand, but in a number of cases it seemed more appropriate to attribute it to the profit squeeze. If real wages were to remain at a given level, productivity would have to increase in response to a rise in the real cost of inputs. However, productivity would not increase unless there was an appropriate level of new investment and technological advance. Otherwise, real wages would have to fall initially and then recover only slowly as capital accumulation proceeded. But real wages might fail to adjust for a number of reasons, including, resistance by powerful unions. In those circumstances, supply disturbances might well take the form of unemployment rather than wage reductions. One of the most important factors leading to higher unemployment was thus the profit squeeze, which had prevented fixed investment from growing in line with the increase in the size of the unemployed labor pool.

In a number of countries, Mr. Hirao noted, structural rigidities had been identified as a major source of the present economic difficulties. Among the most conspicuous was government intervention, a topic extensively discussed in earlier reviews of the World Economic Outlook. The adverse effects of government intervention on free international trade were well known. Government intervention could take a number of forms, including subsidies to declining domestic industries. In the real world, consequently, relative prices did not move flexibly to bring about efficient resource allocation. The more structural rigidities that were built into an economy, the less effectively could demand management policies work. For instance, the multiplier effects of demand management policies depended on the link by which increases in production and income in one industry would transmit to another. Where the mobility of productive resources was impeded, the multiplier effects were likely to be limited. A decline in the magnitude of multipliers had been observed in many industrial countries, perhaps because of increased government interference and structural rigidities. It might be inferred that the effectiveness of demand management policies might not be as strong as it had been in the past.

The fiscal deficits of the industrial countries often reflected structural problems, Mr. Hirao remarked. Since around 1973, the fiscal balances of the central governments for the major industrial countries had almost always been in deficit, a circumstance that seemed to indicate that part or most of the present large fiscal deficits could be considered structural. It would probably be too optimistic to believe that deficits of the present magnitude could easily be eliminated when economic activity recovered. Some observers, assuming that most of the present deficit was cyclical in nature, had put forward the view that additional expenditure or tax reduction was needed to stimulate demand and thereby reduce budget deficits. Such a view also implicitly assumed that the present stagnation was caused only by a shortage of demand. It did not, however, take adequate account of the fact that there were various factors other than the shortage of demand behind the present stagnation, or that the fiscal stimulus did not have a multiplier effect as high as several years previously. In any case, fiscal deficits were bound in the end to be monetized. The prospect of eventual monetization might possibly be responsible for high interest rates and even for the delay in economic recovery. Finally, the very existence of "big government" might have adverse consequences for the revitalization of the private sector.

It seemed unlikely that there would be any brisk resumption of economic activity or much boost in employment during 1983, Mr. Hirao stated. That was partly because the aftereffects of high inflation and high interest rates would remain, and partly because substantial stuctural adjustments were still required in most countries, particularly to restore the fiscal balance, bring about some moderation in wage increases, and restructure industries. There were, however, some healthy signs that real wages were moving in the right direction. In the United States, the United Kingdom, and Germany, increases in nominal wages had already started to moderate. Improvements in productivity would also help to correct the level of real wages. In many countries, substantial progress had been made in bringing inflation under control. In the United States, a modest improvement in economic activity seemed already to be under way. However, if sustained growth were to be ensured for the 1980s, the reduction of structural rigidities and the reform of the public finances would continue to be essential elements of the adjustment process.

Commenting briefly on the Japanese economy, Mr. Hirao noted that fiscal policy had been used flexibly in the past two years, in response to weaker than expected economic growth. As a result, domestic demand was growing at an annual rate of about 3 per cent. While continuing its efforts to reduce the fiscal deficit over the medium term, his authorities intended to take a rather neutral stance in its proposed budget for fiscal year 1983. They believed that domestic demand would continue to grow at a similar pace during that year, probably aided by a further deceleration in inflation, the expected further appreciation of the yen, and reduced interest rates.

It was reassuring to learn, Mr. Hirao commented, that the staff felt that there seemed to be a good chance that the adjustment of external positions already undertaken could bring the current account deficit for the non-oil developing countries into a broadly viable range, and that further sharp curtailment of net flows of credit from private financial institutions to those countries would not occur. Nevertheless, he agreed with the staff that an acute need for adjustment would remain in many countries, and that the size of outstanding external indebtedness, as well as the high level of debt service payments, would continue to pose serious problems. The role of the Fund would continue to be important.

On the question of international cooperation, Mr. Hirao said, first, that it would remain of the utmost importance to conserve a liberal international environment for trade and payments. It bore repeating that protectionism impeded structural adjustment and endangered efficient production in industrial and developing countries alike. Second, the Fund was playing an increasingly active role in framing adjustment programs involving the arrangement of financing from private sources. Nevertheless, the borrowing country should continue to bear the primary responsibility for negotiating with private or official lenders and for carrying out appropriate adjustment programs. Private banks formed their own judgment regarding their priorities in granting credit on the basis of commercial considerations, while paying due attention to the maintenance of stability in the international financial system. It was important for the banks to avoid any abrupt reduction of their exposure, and to continue providing the necessary finance. The role of the Fund was to restore public confidence in the economy of the borrowing country by formulating appropriate adjustment programs in close consultation with the authorities of the country, thereby giving the country easier access to private credit. The national monetary authorities, for their part, were under an obligation to supervise commercial banks and to give appropriate guidance. The need for a timely and adequate increase in Fund quotas should of course be assessed in the context of the role that the Fund was expected to play in assisting members in their adjustment efforts. The main consideration was to provide the Fund with an adequate volume of its own usable resources. A substantial overall increase in quota shares and their appropriate distribution were urgently needed to enhance the Fund's liquidity.

Mr. Vidvei commented that the staff paper was interesting but rather discouraging. He himself could not share the staff view on some crucial economic policy issues, and thus on the policy recommendations that should be offered to member countries with the aim of alleviating their problems. On some other issues, however, he could fully support the staff. He was particularly grateful for the account of the international capital markets and the external debt situation. Many suggestions had been made in recent months to the effect that in its Article IV consultations the Fund should devote increasing effort to studying the external debt profile of its members and, not least, their short-term debt. Much would need to be done before the staff would be able to present consistent information on external debt developments. Nevertheless, the staff had made a very important step and he would encourage it to make further efforts in the same direction.

A related field--balance of payments statistics and analysis--deserved the Executive Board's attention, Mr. Vidvei considered. The gravity of the situation was illustrated by the statistical asymmetry, which had been found to amount to $93 billion in 1982, with a forecast of $77 billion for 1983. Only a few billion were easily identifiable; it was of paramount importance to try to place the rest of that vast amount, something that might require discovering which countries' balance of payments data were in fact fallacious. The Fund's policy recommendations and lending operations were largely based on countries' balance of payments figures, as were the arguments in favor of the policies pursued by individual countries. Being unable to place the ownership or movement of some $70 billion must have a significant bearing on economic policy. Presumably, the ability of some countries to monitor and hinder volatility in money supply and currency holdings would be impaired. Limited confidence should be placed in figures relating to balance of payments and analyses based on them after the sharp rise in the statistical asymmetry since 1981. The staff had in fact had an almost impossible task in trying to explain external adjustment and financing in Section III of ID/83/1. He wondered whether the staff's policy recommendations would have been the same if it had had access to the correct figures. He was aware that tracing missing amounts in international payments was a task that would require close cooperation with national authorities and private international financial institutions. But the improvement of balance of payments statistics was one of the responsibilities of the Fund, and he urged the staff to give the highest priority to reducing the extent of the statistical deficiency. So doing would greatly enhance the ability not only of the Fund but also of its members to avoid false premises in taking decisions and making policy recommendations.

Taking up the main issues covered by the staff, Mr. Vidvei noted that economic growth projected for the major industrial countries from 1982 to 1983 was only slightly above 1 per cent. Restrictive policies had been much stronger than assumed, and his authorities worried that the present projections might also be too optimistic, as each year's had been since 1980. Although inflation had been brought down significantly in a number of countries, accompanied by sizable reductions in interest rates, excess capacity and underutilized productive resources appeared to have had greater dampening effects on investment than had been assumed hitherto. The significant slowdown in inflation had been achieved at the cost of higher unemployment. Total employment had fallen in 1982 for the first time since 1975, as mentioned by Mr. Taylor. Moreover, the staff projections for growth in 1983 for all major country groups had been revised substantially downward since the Executive Board had discussed the World Economic Outlook in August 1982 (EBM/82/113 and EBM/82/114, 8/20/82).

It seemed only logical, Mr. Vidvei said, to be less optimistic again than the staff had been. Countries' policy goals were to improve their balance of payments, reduce their fiscal deficits, reduce or stop the growth of public goods and services, and introduce trade restrictions, none of which were consistent with world economic expansion. On the contrary, they all seemed likely to lead to further contractions. Admittedly, there were some promising developments: the fall in interest rates, the decline in the rate of price increases, the easing of energy constraints, and the abatement in nominal income claims were all helpful signs. However, those factors were unlikely to generate sufficient economic growth without coordinated, and it was to be hoped, consistent policy efforts.

In view of the present recession and the outlook for slow growth in 1983, Mr. Vidvei considered, there was an urgent need for a reorientation of economic policy toward more expansion in the leading industrial countries. The most favorable conditions for such a change were to be found in those countries that had brought inflation under control and enjoyed a fairly satisfactory external balance. Table 1 on page 43 (ID/83/1) showed that inflation rates in four of the main industrial countries were at the same level as they had been in the "golden" 1960s and early 1970s. Against that background, he had difficulty understanding the staff conclusion, on page 21, that a shift to actively expansionary policies in the four major industrial countries with relatively low inflation rates would be inadvisable. He hoped that the staff would explain more fully the economic analysis that it had been using in coming to that conclusion, the consequences and risks it had seen for other countries, and the fundamental changes that it felt had taken place in the economies of those countries that made it undesirable to try to bring economic activity up to the level of the 1960s.

In some countries, such as the United States, Germany, and the United Kingdom, Mr. Vidvei went on, there had been a slight modification of monetary policy toward expansion. While welcoming such a change, his authorities pointed out that real interest rates continued to be very high considering that most countries' economies were in a deep recession. A further moderation of credit policy through an increase in the monetary growth targets and a coordinated reduction of interest rates was most desirable. According to the Organization for Economic Cooperation and Development (OECD), fiscal policy in most of the major industrial countries had tightened in the years 1979 to 1982. Nevertheless, budget deficits had arisen because of the action of automatic stabilizers and high interest rates. The OECD expected a further slight tightening of fiscal policy in 1983. His authorities believed that countries with a favorable external position and low inflation should undertake a careful easing of their fiscal policies wherever possible.

As stated on earlier occasions, his authorities believed there was a need for a more analytical approach to government deficits, Mr. Vidvei stated. They should be judged in relation to the position in the economic cycle and to unused capacity, as well as in relation to the savings behavior of other sectors of the economy. He was of course not trying to detract in any way from the importance of structural restraint for the public sector. He hoped that the staff would comment on the proposal for a closer look at the implications of government deficits and their impact on policy evaluation that his chair had made during the discussion for the 1982 Article IV consultation with Canada (EBM/83/20, 1/26/83). Greater attention should also be given to adopting a broader approach to the much abused concept of "crowding out."

His chair also took the view that incomes policy could be vitally important in connection with a concerted policy approach, Mr. Vidvei continued. However, the staff seemed to feel that only strict fiscal and monetary policies were significant. In ID/83/1 the staff had said that incomes policies of concertation seemed to be especially appropriate at the present time in view of the need for public understanding of the inflationary mechanism. However, he wondered if there had been a change in the staff's attitude to the effectiveness and usefulness of efforts in a society to obtain a deliberate consensus on incomes, covering not only wages but also such issues as the pricing of goods and services.

There appeared to be a fundamentally different approach to economic policy by the staff compared with that of the countries that had elected him, Mr. Vidvei remarked. In those countries it was commonly believed that in highly developed societies with well organized interest groups it was essential to resort to moral suasion to try to obtain binding social consensus between the groups concerned, often with the government as negotiator, interested partner, and even contributor. Better results could be obtained in that way than by compelling people to comply with economic realities through the use of the rough forces of the reigning market mechanism. His countries believed that the policy of moral suasion helped the market to function in the proper manner. Moreover, it often offered leeway for implementing a more expansionary monetary and fiscal policy, leading thereby to more effective employment of available productive resources.

Without a reorientation of economic policy toward expansion in the countries where conditions were most favorable, economic growth in the years beyond 1983 would be very slow, and unemployment would continue to rise, Mr. Vidvei stated. His authorities also found the present low level of investment activity particularly worrisome. In their view it represented insufficient demand and insufficient demand expectations. Without stronger growth and increased capacity utilization, investment activity was unlikely to expand. The outlook for continued sluggishness of investment was perhaps the most serious feature of the picture, in both the short run and the long run. In the longer term, low and insufficient investment must be expected to reduce productivity and result in bottlenecks when activity began to recover.

His authorities were concerned that the balance of payments projections for the non-oil developing countries were on the optimistic side, Mr. Vidvei indicated. The presumption that economic growth in the industrial countries would not be lower than he had mentioned was questionable. The same applied to the assumption that there would not be a significant decline in capital availability from private financial institutions. Assuming that the latest oil price developments were not reversed, they could lead to an improvement in the external accounts of the non-oil developing countries; but there was also the danger that economic activity in those countries could sink to unacceptably low levels, thus reducing even further the already low demand in the industrial countries. Prices of non-oil primary products had fallen very sharply in 1982. The staff's original expectation had been that those prices would rise by 1 per cent during the year; a revised estimate followed showing a fall of 6.8 per cent; the staff concluded at present that the fall might actually be as much as 12 per cent.

For 1983 the staff was projecting a 3 per cent increase, but the forecast obviously involved a large margin of error, Mr. Vidvei noted. He would be particularly interested to know how the staff expected primary product prices to move during 1983. A recovery of 3 per cent would only be a small help after declines of 15 per cent and 12 per cent in 1981 and 1982, respectively. The terms of trade for non-oil developing countries had deteriorated by almost 18 per cent during the past five years. The outlook for 1983 did not indicate any reversal. It would be interesting to have a systematic presentation of the commodity-by-commodity assessment of terms of trade movements, matched with the country-by-country projections in terms of trade made by the area departments.

Every effort to preserve a liberal international environment for trade and payments would be supported by his authorities, Mr. Vidvei stated. Political pressures for protection were very strong and his authorities feared that if the world economy did not show clear signs of a strong recovery in the near future, such pressures would gain still further momentum. His authorities also wholeheartedly supported the recommendations on harmonization and concertation of the policies of the major industrial countries. A strengthening of multilateral cooperation within the Fund and the OECD, as a means of encouraging a move toward more growth-oriented developments and policy in the leading industrial countries, was long overdue. His constituency had welcomed the Versailles summit statement on international monetary undertakings. Its content had as much validity today as it had in 1982, if the world was to recover from the present protracted recession.

His authorities were satisfied with the more active role that the Fund had been playing lately in constructing and supporting comprehensive adjustment programs for member countries, Mr. Vidvei stated. It was all the more essential that the Fund should have adequate resources at its disposal, which underscored the need for a large and immediate increase in Fund quotas.

Speaking personally, Mr. Vidvei remarked that there could be no disagreement that the world was facing tremendous economic problems, which might be regarded as a threat to political stability in many countries and to the economic relationships between them. He wished to draw Executive Directors' attention to an article in Newsweek dated January 24, 1983 by Dr. Kissinger. While his thoughts were neither new nor revolutionary, the economic and related policy issues were presented in a thought-provoking manner.

As to the outcome of the present discussion on the World Economic Outlook, Mr. Vidvei said that he hoped that in its recommendations for the Interim Committee, the Executive Board would not identify itself too strongly with the restrictive policy stance that emerged from ID/83/1. It would be better to stress the need for, and the possibility of, concerted policy actions. He hoped that strong support by the Executive Board for such actions would have an influence on the endeavors to agree on policies that would be discussed by Ministers of the OECD countries when they met in Paris early in May 1983. The Executive Board should also set its hopes on the summit meeting to be held May 28-30, 1983 in Williamsburg, Virginia.

His authorities realized that to make people believe that they had to cooperate and to contribute to the better functioning of their economies was a tremendous task, Mr. Vidvei remarked. As one of his Governors had said in 1982: "The enormous problems in the world economy at present call for some of the pioneering spirit which characterized the OEEC in the first decade after the war." The challenge was still there.

Mr. Lovato commended the staff for offering figures on capital flows, outstanding external arrears, and short-term debt. ID/83/2, containing a survey of the external debt situation, was a remarkable piece of work. The Fund's renewed interest in such matters helped it to act more efficiently in its role as a provider of early warnings, mandated by its surveillance responsibilities. The fact that discussions on the World Economic Outlook were being held at shorter intervals was a sign of the troubled times. It was also a sign of the seriousness of the present recession that the papers prepared by the staff on each succeeding occasion during the past two years had had to register a further postponement of the expected turnaround in the economic cycle. And now the staff had mentioned that, under the working assumptions associated with present policies, a pickup could only be expected toward the end of 1983, and a modest one at that. Even if such a pickup did occur, it would be based in all likelihood on an increase in consumption and in inventory accumulation, with capital formation remaining depressed. The modest recovery would not be sufficiently strong to prevent a further surge in the already high level of unemployment. Such a forecast represented a rather dismal outcome of two years of adjustment policies; it should stimulate Executive Directors and staff alike to re-evaluate the appropriateness of the policy stances they had been pursuing and preaching.

Monetary stability should naturally remain one of the objects of current policies, Mr. Lovato considered. However, the problems of inflation, budget deficits, external debt burdens, and balance of payments disequilibrium would have to be tackled together. Any solution would depend both on developments in the business cycle of the industrial countries and on the determination of debtor countries to carry out stabilization policies. In the view of his authorities, substantial progress in the abatement of inflation had been achieved in some major countries. In the United States, the United Kingdom, Germany, and Japan, policies of restraint had generated sufficient slack to allow room for an unwinding of inflationary pressures and expectations, helped by a particularly favorable situation insofar as the prices of primary products and oil were concerned. In the judgment of his authorities, therefore, there was room for a reorientation of policies aimed at sustaining the world economy and increasing the chances for a healthy recovery.

His authorities were to some extent in disagreement with the staff, Mr. Lovato said. While it was true that there was no room for maneuver in countries like Italy and France, which had committed themselves to adjustment policies that still had to break the inflationary spiral, it was difficult to agree with the staff assessment of the situation in other major industrial countries. Continued insistence on a restrictive policy stance, for fear of a possible revival of never measured and therefore always threatening inflationary expectations, when the rate of price increase was the lowest in over a decade, had to be weighed against possible consequences. Excluding any consideration of the numbers of unemployed, which were becoming more worrying, the arguments against continued adoption of a restrictive policy stance were reinforced by the increasing risk of an even worse recession. During 1982 international trade had contracted severely, and nearly every day there were new examples of protectionist measures. If the trend continued, the situation would soon be reached where economic retrenchment was the only possible course for developed and developing countries alike.

There was no disputing the fact, Mr. Lovato considered, that the typical Fund program, while it might help an individual country to restore its balance of payments equilibrium, could not be the basis of a viable global strategy since it required an initial improvement in a country's external accounts that could not be achieved by all countries simultaneously. It was therefore important that, while countries still in need of adjustment would continue their efforts in that direction, the progress achieved by others should be fully utilized to give the necessary boost to the world economy.

To be more specific, Mr. Lovato continued, further progress in the same direction was still needed, and a greater change in policy mix than had hitherto been seen was required. In the other major economies where there had been some success in reducing the rate of inflation, the authorities should be bolder than they had been and take full advantage of the existing room for maneuver.

The staff had expressed skepticism about the prospects for coordinated action on the part of major industrial countries, Mr. Lovato noted. While past experience might support such a view, only a common effort by countries that could afford to do so was likely to succeed in overcoming the bleak prospect for recovery. Excessively restrictive policies might well lead the world into a position in which traditional policy tools would be less capable of dealing with the cycle than they already were.

A serious rethinking of the role of the recycling mechanism would probably be needed in the future, Mr. Lovato stated. While the danger of a major financial crisis seemed to have been averted for the moment, thanks in particular to the strenuous efforts of the Fund, in the medium run things might still be very different. It seemed unlikely that the banking system, which had financed current account deficits throughout the 1970s, would replicate such an effort in the years ahead, a state of affairs that might have some advantages in view of the apparent inability of the banks correctly to assess the appropriate level of country indebtedness. On the other hand, the likelihood of a withdrawal by the banks was already causing forced adjustment at levels of activity that were not compatible with either social or political requirements in many countries. The role of international institutions in general, and of the Fund in particular, would have to be enhanced, and it was quite appropriate that the current quota review should be helping the Fund to move in the right direction.

On the question of reserves, a point raised by the staff, Mr. Lovato remarked that the figures were certainly becoming worrying, and that many countries needed to build up their reserves. During the past few months a large majority of Fund members had made it clear that they did not wish the negotiations for the Eighth General Review of Quotas to be burdened by the introduction of the question of an SDR allocation. However, they had also said that the issue should be reconsidered on its own merits. The time might well have come for a careful assessment of the problem.

Mr. Casey said that he was particularly grateful to the staff for the additional data provided on debt and capital flows. He would pass some updated statistics and comments on individual countries in his constituency to the staff.

The most serious aspect of the present recession, Mr. Casey considered, was the weakness of business investment and the poor productivity in the major industrial countries, a matter on which he agreed with Mr. Hirao. He did not believe that poor investment had been caused mainly by weakening demand, as Mr. Vidvei had suggested. While several theories could be put forward to account for the present recession, it was not certain that its true nature was fully understood. Business cycle theory would suggest that autonomous investment should recover when plant and equipment began to wear out; but structural barriers appeared to be preventing any such recovery. If, as seemed possible, the world was facing a new kind of recession, policymakers might well have to cope with an unprecedented situation in which there were very few guideposts. As to the growing statistical asymmetry referred to by Mr. Vidvei, Article IV consultations with the major countries should be used in future to try to resolve the problem. Perhaps even special consultations would be required.

On general policy, Mr. Casey observed, he largely agreed with the staff. The situation was particularly delicate because the likely response of the business sector to government intervention was no longer clearly understood. Mr. de Vries, for instance, had on a previous occasion referred to the possibility that expansionary fiscal policies could have a perverse effect on private investment. Another difficulty was to define in a prudent and operational way what the staff meant by "room for maneuver." After all, part of the improvement in inflation had been due to transitory factors such as a sharp fall in commodity prices; he therefore shared Mr. Taylor's concern that inflationary expectations might still be ingrained in the system. Governments should not overreact and thereby sacrifice the gains so far achieved. On the other hand, it would be damaging if governments persisted in offsetting the impact of the built-in stabilizers. The question of policy stance should not be considered solely in terms of ratios of fiscal deficits to GNP and the like, but also in the light of how the deficits were structured and financed. Where automatic stabilizers were allowed to operate, policymakers should ensure that the deficits were not financed in a monetary way, and government spending and taxation should be restructured so as to maximize productive investment and minimize disincentives to work, save, and invest. If such a structural approach was not adopted, the use of the room for maneuver could lead the world back into stagflation along the lines of Scenario B.

He noted from page 19 of ID/83/1 that policies in 1982 were considered to have been not nearly as tight as those in 1980 and 1981. He also noted that the U.S. fiscal deficit could be as high as 5.5 per cent of GNP in

1983. Those circumstances, combined with a low savings rate in the United States, could conceivably lead the country back into the morass of high interest rates, rising inflation, and low growth. Indeed, he inclined toward the OECD view that the external current position of the United States would deteriorate much more sharply in 1983 than the staff suggested. He had therefore been somewhat surprised to see the staff place the United States in the camp of countries considered to have room for maneuver. Such a judgment could be justified, however, if the U.S. policy mix were reoriented so as to tighten fiscal policy and allow monetary policy to be somewhat accommodating. Naturally, other countries besides the United States had difficulties with their policy mix; and a change in the mix would go far toward leading the world into sustainable growth without any discretionary relaxation of overall demand management. Naturally, any easing of monetary policy would have to be both cautious and reversible. The monitoring of real interest rates might serve as a useful indicator of the room for maneuver, which was a concept difficult to put into practice. The room for maneuver could prove to be slightly wider than anticipated by the staff if the real price of oil fell further than the staff had assumed.

The two watchwords, Mr. Casey believed, should be caution and reversibility. Nevertheless, sustainable growth could be achieved if the monetary effects of fiscal deficits were reduced and if the deficits were restructured so as to promote investment and remove disincentives, if the policy mix problem were alleviated, if protectionist measures were rolled back, and if relative prices, including exchange rates and the price of labor, were allowed to clear markets. His basic conclusion was therefore that, even with fairly tight demand management, a great deal could be done to lead the world out of recession.

Commenting on external adjustment and financing, Mr. Casey stated that, while he was aware of the somewhat improved current external position of the non-oil less developed countries, he was still concerned by their serious debt overhang and the rundown of reserves. Adjustment in the non-oil less developed countries had clearly been quite costly. The recycling mechanism had come under strain, and it was important that deficit countries should ensure that their creditworthiness was not further eroded. Both the international financial institutions, including of course the Fund, and bilateral donors had an important role to play. Improved policy formation in the major economies would have an important bearing on the prospects for the non-oil less developed countries.

In connection with international cooperation, Mr. Casey noted the worrying tendency toward protectionist measures which, while intended to be of short duration, could become entrenched over the longer term. It was also clear that such measures led to global inefficiency and kept ailing industries on an expensive life support system. If a major concerted effort were made to roll back those restrictive measures, it would of itself help to lead the world out of recession, and probably even help to reduce fiscal deficits. More generally, like the staff, he felt that ex ante policy coordination was unlikely to be very successful. Nor was he very sanguine about concertation, even though it should be tried in a careful way. A very high degree of international cooperation could come to produce a sort of herd instinct on the part of national authorities. Consequently, there might be something to be said for policy diversification between countries.

The Fund had shown what it could do, especially through the personal actions of the Managing Director, and particularly in the Western Hemisphere, Mr. Casey observed. One of the Fund's main roles should be to help countries to promote conditions that would bring about renewed confidence by the commercial banks. Although an argument could be made for closer consultation between commercial banks and the Fund, his authorities had reservations about a formal relationship for reasons relating to confidentiality and the risk of embarrassment in case a Fund program should fail or a bank place in default a country with which the Fund had a program. An earlier paper on the relationships between the Fund and commercial banks should be updated.

Commenting on the situation in the capital markets and the problem of external debt, Mr. Casey said that it was clear that the sharp drop in the rate of growth in net bank lending and the worsening maturity profile were causing severe problems for non-oil less developed countries. The recent trend toward medium-term rather than short-term credit would be helpful, as would the adjustment policies of the non-oil less developed countries themselves. However, those countries would remain in difficulty until the larger economies put their own houses in order.

His authorities had a number of detailed comments on ID/83/1, Mr. Casey noted, relating in particular to data from the Bank for International Settlements, the worrying attitudes of some second-tier banks toward the non-oil less developed countries, and the need to make a clearer distinction between higher spreads, the general interest rate structure, and front-end fees. He would make those comments available to the staff. Finally, he supported the recent initiative of the Central Banking Department in providing technical assistance in the area of debt statistics.

Mr. Kafka considered that the staff's exceptionally good paper should be published. Concentrating on policy matters, he remarked that in the industrial countries, on whose recovery that of the rest of the world depended, the question whether the time had come to initiate stimulatory policies was being posed with increasing insistence. He agreed with the staff that certain countries had not yet made sufficient progress against inflation to enable them safely to initiate such policies. But he was not convinced that the staff prescription for the four major countries, which had made much progress, was not excessively subtle. What the staff suggested was that the United States, Japan, Germany, and the United Kingdom should utilize their room for maneuver, but that it was too soon for them to engage in properly stimulatory policies. He agreed with Mr. Casey regarding the effects of changes in policy mix, and the removal of structural rigidities and imbalances in increasing the room for maneuver. However, while it was evident that if inflationary expectations were not sufficiently subdued, more stimulatory policies would revive inflation and thereby prejudice growth, it was also true that if near stagnation continued for another full year and even if there were some recovery in GDP, but no relief in unemployment, there could be a revulsion against anti-inflationary policies, which would imply a revival of inflation, with similar or even greater prejudice to sustained growth.

As to the situation in individual countries, Mr. Kafka said that he agreed strongly that for the United States to achieve a sustained growth of output and employment, a further and decisive improvement in the fiscal position was necessary. He also agreed with the staff recommendation that Japan should bring about a medium-term reduction in the deficit but that, in the face of continued weakness of private demand, an excessively restrictive fiscal policy should be avoided. Germany faced a similar problem to that of the United States: in the medium term the fiscal deficit of the public sector would have to be reduced and profitability strengthened. He also agreed that it would be helpful if a better coordination of monetary policies could be instituted among the major trading countries, thus minimizing the extremely bothersome medium-term fluctuations in their exchange rates, which had made the simultaneous fight against both inflation and depression more difficult.

Many oil exporting countries faced difficult adjustment problems, some as difficult as those of the non-oil less developed countries, Mr. Kafka considered. There had been steady progress in the adjustment of the balance of payments of non-oil less developed countries during 1982. The adjustment was, however, being bought at a high price of declining growth, with widespread repercussions, partly because it had come so late. The trend would continue. Overall measures of net bank lending for the future, amounting to some 8 per cent a year, seemed reasonable; but they did mean that the recovery of imports would have to depend entirely on the recovery of exports. Despite the availability of nonbank financing and the likelihood that the same total financing would be available in 1983 as in 1982 ($75-80 billion), the need to stop reserve drawdowns and reconstitute reserves would make it necessary to further reduce deficits. The slowdown in the growth of debt had not prevented an increase in debt service burden in 1982 because of the downturn in export earnings in that year. Even if 1983 should bring some improvement, the weight of the external constraint would continue to bear heavily on the growth of less developed countries and on the world as a whole. Even if everything possible at the present time was being done to minimize the worldwide beggar-thy-neighbor policy, efforts to overcome the external constraint would have to occupy the financial community in the years to come.

In that connection, it was appropriate to stress the dramatic change that had come about in the operations of the Fund in helping to bring about major adjustments for less developed countries in very difficult financial circumstances, while avoiding a major international financial crisis, Mr. Kafka remarked. Thanks were due to the Managing Director and the staff of the Fund for the unprecedented role that they had had the decisiveness and courage to assume. He was also grateful to the Bank for

International Settlements and to the major central banks and treasuries, as well as to the major international banks that had taken an active part in alleviating the crisis of 1982. He agreed that their actions had averted for the moment the danger of rekindling catastrophically large new contractionary forces in an already weak world economy, although even that danger was by no means removed. The ad hoc actions unavoidably involved in much of recent international cooperation suggested the need not only for an increase in the resources of the Fund, but also possibly for the institutionalization of procedures for the provision of bridging credits. It also seemed clear that an early new look was required at the need for SDR allocations as global reserves were falling. All those experiences underlined the need for emphasis on the promotion of recovery in the industrial countries, the overwhelming need for at least a standstill on protectionism, and, if at all possible, a return to liberal trading policies for the benefit both of the developing countries and of the industrial countries themselves. Had the time perhaps come for another antiprotectionist pledge in the Organization for Economic Cooperation and Development, as in 1974?

The medium-term outlook described by the staff for the non-oil less developed countries was also disappointing, Mr. Kafka observed. It seemed fairly clear that the debt service burden as conventionally measured would not decline by very much even by 1986. Consequently, in the absence of a more rapid growth of the world economy than currently foreseen or the absence of more liberal trade policies by the industrial countries, the external constraints for the less developed countries would continue to be severe, and the countries themselves would remain extremely vulnerable. The emphasis placed by the staff on debt service ratios to exports was overdone; the ratio of interest to GDP would probably be more significant.

The recent activities of the Fund in promoting the solution of debt problems had led to a more intimate relationship between the Fund and the major international banks, Mr. Kafka said. The change had been a helpful one. Nevertheless, the Fund would have to continue to guard the confidentiality of information supplied to it unless released by the member countries concerned. Moreover, the Fund must at all times leave to the member countries the initiative as to whether they wished to approach commercial banks through the intermediation of the Fund.

Mr. Grosche stated that his authorities were in broad agreement with the staff analysis. They supported most of the suggestions for economic policies to be pursued by member countries at the present time. He had found the four topics for discussion listed by the staff very helpful.

Commenting briefly on recent developments and short-term prospects, Mr. Grosche remarked that economic performance in 1982 had been disappointing in nearly all member countries. Both national authorities and international organizations, particularly the Fund, had many reasons for concern. The seriousness of the world economic situation and the dangers that could result from it called for a strengthening of international cooperation. The cooperative manner in which the acute payments difficulties of a few large developing countries had been tackled in the recent past was promising.

On the whole, Mr. Grosche continued, the outlook for 1983 did not seem very encouraging. The new projections for economic growth were lower than those presented to the Interim Committee in September 1982. The weakness of economic activity coincided with sluggish demand for labor. Unemployment had increased to levels far too high to be sustainable. The unemployment problem had become the most pressing concern both socially and politically.

There were a number of reasons, Mr. Grosche considered, why the world economy had become even more depressed than an adjustment to rapidly changing circumstances would have implied. First, there had been a lack of understanding in government, industry, and unions alike that the burden of adjustment should be carried by society as a whole. Second, rigidities in bargaining and price setting as well as a lack of flexibility in social programs had hampered the adjustment of structural imbalances. Third, undue delay in implementing appropriate measures had led to a situation in which adjustment policies had coincided with relatively large losses in economic growth. He agreed with the staff that there had been some positive signs in a number of industrial countries that a slowdown in inflation and a reduction in interest rates were beginning to bear fruit. Inflation had come down as a result not only of a movement in the business cycle but also following some success in adjustment. Those achievements should lay the ground for the revival of the world economy.

As far as the projections for 1983 and the underlying assumptions for oil prices were concerned, he would be interested to know whether the staff could give some comment on the consequences of a further decline in nominal oil prices, Mr. Grosche stated.

Commenting generally on policies to be pursued in the major industrial countries, Mr. Grosche remarked that experience in the past two years in some countries had shown that the adoption of a more expansionary fiscal policy was no longer a reliable prelude to a revival of economic activity. Despite large and increasing budget deficits, the effect on economic growth and employment had not been as favorable as expected. The main reason for the disappointing response to fiscal stimulus might have been structural rigidities. From the previous Executive Board discussion of the World Economic Outlook (EBM/82/113 and EBM/82/114), he had drawn the conclusion that expansionary demand management policies should only be applied very cautiously. His authorities continued to believed that too hasty a shift in the direction of stimulating the economy, without any assurance that the necessary structural measures would be taken at the same time, would only turn out to be counterproductive. Financial markets were still very nervous about any hint that inflation and interest rates might turn upward in the future.

He did not wish to give the impression that policy stances should not differ among the larger industrial countries at the present time, Mr. Grosche stated. Countries that still had relatively high inflation rates should not allow any relaxation of the anti-inflationary stance, while others, which had been more successful in bringing down inflation, should support a cautious recovery of their economy. However, even those countries were still passing through what might be called a transitional period to a disinflationary economy, so that a shift to a more expansionary stance was hardly advisable. The staff had been correct to point out that such a move would be far too risky in view of the fragility of the progress so far made toward sustainable growth.

Commenting on the room for maneuver in Germany, Mr. Grosche observed that one could argue that the time had come to change the stance of both fiscal and monetary policy because of Germany's relatively successful fight against inflation, the improvement in the balance of payments, and rising unemployment. His authorities had given high priority to reducing the socially and politically unacceptable numbers of persons unemployed. But in view of the large proportion of structural unemployment in the total, even a strong recovery was unlikely to bring significant relief to the employment situation. The problem was a medium-term one that would have to be solved by strengthening the incentives for investment. His authorities strongly believed that pump priming by deliberately running higher public sector deficits was not a workable solution. Public concern about the high deficits at all levels of government, particularly the Federal Government, was widespread and deep-seated. Any cessation of his authorities' efforts to bring those deficits under control would most likely have an adverse psychological impact on the business community, thus delaying rather than accelerating investment decisions and postponing a further sustainable recovery. His authorities were therefore continuing their policy of gradually reducing the so-called structural budget deficit in the medium term without stifling a recovery of economic activity in the short run. The policy of reducing the structural component of the deficit was being complemented by a gradual restructuring of the expenditure side so as to increase those outlays that were likely to stimulate investment and employment.

On the subject of monetary policy, Mr. Grosche explained, the central bank had eased its stance during 1982 in view of the reduced inflationary pressures and the improvement in the balance of payments. Interest rates had been reduced significantly and the growth of central bank money expanded. For 1983, the Bundesbank would be aiming at keeping money growth at the upper end of the target range, which was the same as for 1982, so as to support the expected revival of the economy. Such a stance of policy provided for maximum monetary growth consistent with the maintenance of anti-inflation objectives.

In brief, Mr. Grosche went on, his authorities were of the view that that they could best contribute to the recovery of the world economy by continuing their medium-term policies, which would allow for a sustainable economic revival without endangering the success achieved in reducing inflationary pressures. The expected recovery in Germany on a year-on-year basis was very modest. In the course of 1983, however, recovery was expected to become relatively strong. By the end of the year real GNP could be 2.5 per cent higher than at the end of 1982.

As to external adjustments and financing, Mr. Grosche explained that his authorities believed that a quicker pace of economic activity in the industrial countries would help to ease the burden both of internal adjustment and of external indebtedness in the non-oil developing countries. To bring about a recovery of the world economy and move the current account deficits of the non-oil less developed countries into a broadly viable range would call for the pursuit of a medium-term policy. He agreed with the staff that the need for additional adjustment would remain acute in many developing countries. His authorities therefore attached great importance to the Fund in its role as an advisor on sound economic policy and as the provider of temporary balance of payments financing. They strongly hoped that the forthcoming meeting of the Interim Committee would bring about a substantial increase in Fund quotas. A successful outcome of that meeting would be helpful in establishing greater confidence in international financial markets.

The effectiveness of international cooperation would be demonstrated in the fight against protectionism, Mr. Grosche observed. Protectionism impeded structural adjustment by discriminating against efficient producers in industrial and developing countries alike. He had been convinced by Mr. Kafka's remarks on the subject on the occasion of the previous Executive Board discussion of the World Economic Outlook (EBM/82/113 and EBM/82/114).

The outcome of the most recent ministerial meeting of the General Agreement on Tariffs and Trade had not been encouraging, Mr. Grosche reflected. He supported the staff in its efforts to preserve a liberal international environment for trade and payments, and he welcomed the intention to include an analysis of trade policy in the appraisal written for Article IV consultations, especially with the larger trading countries. As to the coordination of policies among the major industrial countries, he strongly supported the staff view that each country should independently pursue sound policies, but that it should assess them in the light of international discussions of their probable impact and their mutual compatibility. Discussions in the Executive Board should contribute to a higher degree of compatibility of economic policies. In the past, Germany had on several occasions been affected quite markedly by the inconsistencies of national economic policies.

Commenting on the role taken by the Fund in arranging financing from private sources in connection with Fund programs, Mr. Grosche expressed his gratitude to the management and staff for their efforts in recent months. The idea that a Fund arrangement with member countries could only become effective if overall financing consistent with the Fund's program could be assured was welcome. Otherwise, the credibility of the Fund's contribution could be adversely affected. His observation would apply, regardless of the size of the increase in Fund quotas, and the date that it became effective. The commercial banks had to be prepared to continue lending to countries that demonstrated reasonable adjustment efforts. After years of huge increases in lending, a complete shutdown would be even more dangerous. The Fund should make it clear that it would not accept a policy by which the commercial banks would cut down on their lending to countries while hoping that official creditors would take up the slack with heavily indebted countries.

Mr. de Groote stated that in general terms he could go along with the proposed analysis of the present economic situation, but that he had reservations regarding both the staff's forecast for recovery in 1983 and the policy recommendations for the time when recovery began. The choice of policy instruments between fiscal and monetary policy would need to be changed decisively from one phase of recovery to the next, while restraint in real incomes should be stressed as the main policy instrument to be used continuously as a means of combining sustained recovery with acceptable changes in prices.

As to the staff's analysis, Mr. de Groote remarked that it would have been useful to devote some attention to the reasons why the Fund's projections had been systematically overoptimistic for a number of years. Determining why the Fund had constantly overprojected either investment or consumption, or both, could perhaps lead to the discovery of changed attitudes toward those aggregates, and might perhaps provide some useful hints for policy formulation.

The present projections were based on two propositions, Mr. de Groote noted; first, that investments would somehow recover toward the end of 1983; and second, that lower rates of inflation were conducive to higher growth. As to the possibilities of a recovery of investment toward the end of 1983, the staff had stated that it had found unanticipated declines in fixed investment and inventory holdings for 1982. That was the third consecutive year in which there had been a decline in investment in the industrial countries, and the staff had not provided any insight into the underlying causes of such a trend. Nevertheless, the staff projected a modest recovery in the second half of 1983, equally without explanation. The trend in investment was the more disquieting in that enterprises were operating at very low rates of capacity, while the pickup in demand that was envisaged did not seem sufficient to stimulate investment.

Moreover, he was by no means convinced that a further decline in interest rates, if it did materialize, would be sufficient to stimulate investment in the face of a continued depression of consumer demand, Mr. de Groote observed. A further factor that gave rise to the suspicion that investment would remain stagnant in 1983 was the changes in productivity for the industrial countries as a whole, compared to labor costs. Productivity had declined sharply after the first oil shock, and even more so after the second. In sharp contrast to the situation in the decade preceding the oil shock, the slowdown in real income growth had been less pronounced than the slowdown in productivity growth, except perhaps in the last few months. Real wage compensation had consistently risen faster than national income, making a recovery of investment unlikely in the immediate future. Slow productivity growth and stagnant investment in new capacity were likely to lower the medium-term growth of potential output.

The staff appeared to hold to the underlying assumption, which also pervaded many recommendations by the Fund to member countries, that lower levels of inflation would per se be conducive to higher economic growth, Mr. de Groote observed. The staff presentation created the impression that there was an automatic linkage between lower rates of inflation and economic recovery. There was, however, ample evidence that such a link could not be proven. While it was perhaps partly true that high inflation would not allow sustained growth to take place, low rates of inflation were a necessary, but not a sufficient, condition for the resumption of growth. Further, the declining growth of the past year might have cumulatively affected expectations, so that more stimulation than was envisaged might be required at present to achieve a given growth target.

The events of the past two years in Japan and Germany certainly made it clear that lower rates of inflation did not necessarily lead to higher growth, Mr. de Groote commented. In the absence of additional stimulative action, the growth rates attainable according to the staff's medium-term scenario would be clearly insufficient. The present high rates of unemployment could not be maintained for very many years without affecting the social fabric of society. Yet that was just what the staff proposed in the medium-term scenario for most European countries. Slow growth was particularly harmful for the stability of the international financial markets, as non-oil developing countries would have increasing difficulties in servicing their debt. In that connection, it would be interesting to have some indication of the export growth that would be required in 1983 and 1984 if non-oil developing countries were to be able to service their debt without accumulating further arrears or resorting to more rescheduling.

As to the staff's policy recommendations, Mr. de Groote said that he fully agreed with the need for a differentiated approach between countries. A number of countries had certainly not made sufficient progress in combating inflation; they still had such imbalances in both the fiscal and external fields that there was little room for them to follow expansionary policies. Nevertheless, even in those countries more emphasis should be laid on structural measures, rather than on a further cutting of demand. As to the countries that had achieved substantial gains in the fight against inflation, Executive Directors should perhaps not be too concerned about the limited upward price adjustments that were bound to take place once recovery began. The staff stated that continuous fears of an inflationary flare-up were only just below the surface in Germany, but it gave no justification for its evaluation. In the United Kingdom and the United States, according to the staff, low rates of inflation had not prevailed long enough to permit expectations to be affected. He wondered whether that statement was correct. It would surely be more useful to focus on the policies pursued by the authorities in trying to assess the significance of any price increases that anyway would occur in line with recovery.

A more substantive point regarding policy recommendations was that there should not only be a differentiation between countries according to the degree of success in the battle against inflation; there should be a differentation in policy instruments to be used in the various stages of recovery, with clear changes in the use of policy instruments once recovery began, Mr. de Groote stated. His approach contrasted with the staff's recommendations, which perhaps tended to present the available options too much in black and white, thus creating the undue impression that without continued overall restrictive policies, inflation was bound to reaccelerate immediately, without sufficient regard to the time for which the recommended policies were to apply. In the first phase of recovery, he would advocate a more expansionary stance of monetary policy to allow interest rates to fall, and thereby make room for the recovery of demand. During the same period--which could be short if policies were pursued more energetically--fiscal policy should be maintained at its present supportive level to allow for the stimulation of demand. The experience of 1982 in the United States, Germany, and Japan showed that more expansionary, or less contractionary, fiscal policies did not prevent a rapid slowdown in inflation. The expansion of activity during the first phase of recovery would permit some absorption of underutilized capacity.

In the second phase, Mr. de Groote went on, once recovery had begun and capacity utilization had improved, selective policies should be applied as a means of stimulating investment, and the Government should withdraw its fiscal stimulus. At that stage, a reduction in the budget deficit would be needed to free financial resources for investment without increasing interest rates. Unless there were fiscal restraints at the second stage, the recovery could be short lived because interest rates would rise as the result of increased competition for available funds. The situation was particularly likely to arise in the United States, where the government deficit was expected to absorb almost all net savings by the private sector. Accordingly, in 1983 and 1984 it might be possible to attain the higher growth rates envisaged in Scenario B without an undue acceleration of inflation.

The only element of policy that should remain constant throughout the various stages of recovery, Mr. de Groote considered, was the restraint of labor income. The major risks of a resurgence of inflation lay in the cost element. Labor costs rising faster than productivity increases would push enterprises into raising prices in order to maintain profitability. The restraint of wages was also essential to ensure the establishment of new capacity as a means of maintaining noninflationary growth by expanding supply in the medium term. If the policies were not differentiated according to the phases of the recovery, with gradually more restrictive fiscal policies being implemented and wage restraint being maintained, developments could become more negative than anticipated, as had been the case in 1982. On the other hand, gradual, moderately stimulative policies would only have their full effect if they were implemented simultaneously in those countries that had room for them. The high growth rate achieved through such policies would be helpful for countries that still needed to make adjustments, particularly developing countries and some small industrial countries.

The improvement in the current account of the non-oil developing countries in 1982 and 1983 was to some extent illusory, as it resulted mainly from cuts in imports, Mr. de Groote remarked. Such an "improvement" was not a viable option for the medium term and could not be considered an adjustment. It was important to avoid applying the term "adjustment" to any change that did not offer sustainable medium-term results. The situation in the non-oil developing countries in 1982 had indeed been much worse than was shown in Table 11. The drop in "other short-term borrowing, net" was indeed larger than indicated, but it had been offset by a substantial increase in arrears. Since reserves had been further depleted and commercial bank lending had been further reduced, any improvement in the current account was bound to come from import reductions. He would therefore be much less optimistic than the staff in assessing the prospects for adjustment and the provision of finance for developing countries. The Fund would have to continue to assume a greater role in the adjustment effort and in arranging financing from private sources for the non-oil developing countries.

Insofar as private financing was concerned, Mr. de Groote suggested that the Executive Board might consider at an appropriate time whether the Fund should not play a more active role in financial arrangements to ensure more uniformity of treatment of member countries. There might be some merit in the Fund establishing general guidelines for such negotiations. Eventually, the Fund could also be actively involved as an intermediary for channeling commercial bank funds to developing countries. The Executive Board would of course have to examine all the implications and risks inherent in such an approach. He hoped that Executive Directors would return to the matter in due course.

In conclusion, Mr. de Groote stated that he was inclined to join those who feared the danger of cumulative deflationary developments and saw the need to avoid a short-lived recovery. He did not believe that the required adjustment and new growth would be self-generating. The Fund needed to adopt a differentiated approach with varying instruments to stimulate a gradual expansion of activity according to the degree of adjustment achieved in the various countries, with changes in policy to fit the successive stages of recovery.

Mr. de Maulde commended the staff for the rapidity with which it had produced a report in time for discussion before the meeting of the Interim Committee. The staff had shown that it knew how to react quickly and effectively to timetable constraints.

Speaking first on recent developments and short-term prospects, Mr. de Maulde remarked that in each recent report on the World Economic Outlook the staff had postponed recovery and made it weaker. The latest forecast was for painfully slow recovery in the industrial countries, triggered by a somewhat faster recovery in the United States led by a resumption of consumer demand. The staff, it was true, mentioned that the outlook was subject to considerable uncertainties; however, it had insufficiently identified the various factors that could halt the recovery, in particular the self-perpetuating character of the expectations of slow growth. The longer that growth remained very weak in Europe, the greater the risk that the weakness would become self-perpetuating. Once the expectation of a sluggish sales outlook became entrenched, it could prove extremely difficult to revitalize the corporate sector and encourage it to invest on the scale needed to make significant inroads into unemployment. The point had been made with great clarity in the report by the Bank for International Settlements during the summer of 1982. The Fund's report had been rather overoptimistic regarding the outlook for growth; he would like the staff to dwell more on the risk that growth might be even lower than suggested in the present paper.

There was also the risk, Mr. de Maulde continued, that the working of the international transmission mechanism itself might have deteriorated over time. How would the staff, for instance, measure the impact of a recovery in output in the United States on the growth of world trade? It was not inconceivable that any impact that might have been envisaged would be canceled out by various other factors, such as the implementation of adjustment programs, so that in the end world trade would continue to contract and countries outside the United States would not benefit from its recovery.

It was evident, Mr. de Maulde commented, that changes in exchange rates had played a major role in deepening the present recession. He therefore wondered what exactly the staff had in mind by calling for a more sustainable pattern of exchange rates. How did the staff expect that the development of such a pattern would contribute to the improvement in growth? Also, he joined earlier speakers in asking the staff how it assessed the influence of possible developments in the oil market on its projections?

Taking up the policies of the major industrial countries, Mr. de Maulde emphasized that he was in agreement with Mr. de Groote's comments. He welcomed the apparently new idea set out on page 37 of ID/83/1 that the countries that had been most successful in reducing the rate of inflation should continue to take judgmental advantage of their room for maneuver within an anti-inflationary policy framework, to support the level of activity or encourage recovery. Nevertheless he wondered why the staff should be so cautious as to have to refer to the anti-inflationary framework in taking judgmental advantage. The Fund would surely be doing itself no harm if it stated outright that a coordinated approach by the more successful countries was urgently needed, especially as most of their finance ministers had freely acknowledged the need for such action.

He had nothing to add to what the staff had said in its country-by-country studies, Mr. de Maulde mentioned. He had noted that at present the Japanese authorities seemed to be considering a more restrictive stance than the one implied by the staff. In Germany he had understood that the highest priority was to fight unemployment and that the authorities were trying to adhere to a budget policy that remained medium-term oriented, meaning not very stimulative. Nevertheless, they were not considering any further tightening, and the Bundesbank had been making efforts to support domestic activity.

In the United States, a number of questions could still be raised, Mr. de Maulde considered, first and foremost those about fiscal policy. Like other speakers, he was glad that attempts were to be made to reduce the fiscal deficit in the future rather than immediately, which would certainly assist recovery in 1983. On the monetary side, in 1982 the income velocity of both M-1 and M-2 had slowed down considerably, at least by historical standards. It was not clear whether the cause had been a reduction in consumption, a decrease in the rate of price increases accompanied by relatively high short-term interest rates, institutional changes making short-term financial assets more attractive, or an increase in the velocity of changes in interest rates. What did appear evident was that the stance of monetary policy had been more restrictive than would appear from an examination of the growth of the various aggregates. For 1983, it was difficult to determine the consequences of selecting any given set of monetary targets. The staff seemed to assume that the adoption of the targets announced in July 1982 would allow some pickup in activity, because of the fall in inflation. While he did not disagree with that appraisal, it was worth stressing that, in view of the difficulty of identifying changes in the income velocity of money in the next few months, a flexible approach might well be warranted. A more fundamental question, to which at present there seemed to be no answer, was: how could a central bank be expected to control the evolution of monetary aggregates, when those aggregates were composed of instruments that were remunerated at market rates?

Referring to the medium-term prospect, Mr. de Maulde inquired what the criterion of success might be in the fight against inflation. Logically, the Fund would have to decide on an optimum rate of inflation. What did the staff intend to recommend? Was 5 per cent an ideal figure for all industrial countries, or should it be something lower? Should there be a different figure for different countries and, if so, on what grounds?

Since the crux of the Fund's recipe for renewed growth was the return to profitability of the business sector, Mr. de Maulde remarked, it could be asked why the Fund paid so little attention to the most direct and effective way of achieving profitability--the adoption of incomes policies. Insufficient attention had been paid to the point during the 1982 Article IV consultation with Canada (EBM/83/19 and EBM/83/20). He also wondered whether the Fund's current approach to monetary and fiscal policies was not too brutally arithmetic. The Fund seemed to believe that the combination of a constant and moderate increase in the money supply with budgetary discipline was the only precondition for growth. It might be better to be less doctrinaire and to adopt other approaches, including some management of interest rates, the adoption of fiscal policies designed to encourage growth-oriented expenditure, and the use of government expenditure in fields such as research and education. Similarly, he had missed the assessment of the medium-term prospects for the prices of primary products. It was evident that those prices would have to regain some of the ground they had lost over the years if there was to be an economic recovery in developing countries. He would therefore welcome staff comments on the outlook for commodity prices beyond the very short period.

On the subject of external adjustment and financing, Mr. de Maulde said that he was in complete agreement with Mr. Kafka regarding the larger role of the Fund, and the part that the Managing Director had played in recent arrangements involving cooperation with commercial banks. He also agreed that it was essential to avoid any further reduction in bank lending to developing countries. If the reduction in lending that had taken place in recent months continued, more imaginative approaches would be needed. He also agreed with Mr. Lovato regarding the advisory role of the Fund, and its surveillance function. So far as liquidity was concerned, the Fund should take a rapid decision on the Eighth General Review of Quotas and immediately proceed to address the question of SDRs.

Mr. Habib spoke first on recent economic developments and short-term prospects. He remarked that the performance of the world economy in 1982 had been disappointing. The economic situation could be characterized by low growth for the third consecutive year, with output actually declining fractionally in 1982; a decelerating rate of inflation; declining interest rates, although remaining still high; some reduction in external current account imbalances, with the level of deficits continuing to be excessively high for developing countries; and difficult financing situations for the less developed countries, with debt service burdens increasing in 1982 and improving only slightly in 1983, on the assumption that interest rates showed further improvement and there was some export recovery.

A weak recovery was in prospect for 1983, Mr. Habib considered. The staff forecast of 1.3 per cent was significantly lower than the projection of 2.5 per cent in August 1982. At that time, moderate growth of 3 per cent for the period 1984-86 had been projected in Scenario A, which implied that industrial countries, faced with stagflation, would persist with policies of monetary restraint while undertaking policies of fiscal discipline and measures to reduce structural rigidities. Output in 1982 had actually declined, due to the weakness of investment and capital formation, accentuated by drops in real imports by non-oil developing countries. If a similar margin of error occurred with the current projection of 1.3 per cent growth in 1983, it was only too possible that growth would be about zero for the year. Such an outcome would be a serious cause for concern, since it was clear that the underlying economic forces were not strong enough to generate the required momentum to pull the world out of the present slump. A poor outturn could lead the world into a downward spiral in which declining world trade would sharply intensify the burden of adjustment, especially on the developing countries. The debt burden might indeed become so acute that it would threaten the stability of the international monetary system.

He would welcome comment from the staff on whether it still considered its previous prescription consistent with a growth rate of 2.5 per cent and an inflation rate of 6.9 per cent, Mr. Habib stated. Such a conclusion would be at variance with the prescription set out on page 21 of ID/83/1. While similar to the previous one, the prescription was expected to produce a recovery in 1983 of 1.3 per cent, the argument being that any attempt at more expansionary growth--say 2.0-2.5 per cent--would rekindle expansionary expectations, although a similar stance with 6.9 per cent inflation (as opposed to the present 6.0 per cent) had been consistent with a growth rate of 2.5 per cent.

Executive Directors should be cautious about endorsing the staff conclusion that major industrial countries should continue with restrictive demand management policies in order to reduce the rate of inflation still further, Mr. Habib considered. First, it was crucial to bring about growth in investment and capital formation that would induce technological change and raise productivity. If investment continued to be low, there could only be further stagnation in economic activity and larger fiscal deficits. Second, the impact on the non-oil developing countries would bring about continued deterioration in export performance and in the terms of trade. As a consequence, cutbacks in imports of capital goods in the developing countries would drastically affect growth, economic development, and employment. A relatively more expansionary stance of policy in the industrial countries was therefore desirable.

On balance, Mr. Habib considered that six policy conclusions could reasonably be reached. First, the major industrial countries should maintain their stance in their fight against inflation, but not at the cost of poor growth prospects. Major industrial countries should adhere to budget discipline, while maintaining a firm but easier monetary stance and with policies to encourage structural adjustment and to minimize rigidities. Second, increasing social and political strains associated with high employment were creating pressures for protection. If the industrial countries were to turn toward still more restrictive and protectionist policies, it would become very difficult to sustain the economies of the developing countries. The developing countries could only reach a suitable rate of growth if the world market remained open for both agricultural and manufactured goods from the developing countries. The improvement in the position of the non-oil developing countries in the face of an adverse trend in the terms of trade was in part no more than the reflection of the weakness of those countries' payments positions. Developing countries had severely cut back imports and consequently economic development. The growth rate of 1.8 per cent in 1982 achieved by the non-oil developing countries was less than the growth rate of their populations. Even the growth rate of 2.4 per cent projected for 1983 would not keep pace with the projected rise in population. The point had been insufficiently stressed by the staff. Moreover, it was disappointing that issues relating to trade policies and development had been relegated to an appendix.

Third, in their drive for budgetary austerity, the industrial countries should avoid recourse to reducing development assistance, Mr. Habib went on. Development assistance had never represented more than a small fraction of the gross national product of industrial countries, and yet it had gone far to meet the needs of developing countries. He was disappointed to have seen no mention of that point in the staff paper. Fourth, the staff had scarcely touched on incomes policies. In the fight to contain price increases within reasonable bounds, wages must be kept in line with productivity growth and changes in the terms of trade. The staff had not paid sufficient attention to the problem, which was embedded in many of the industrial economies. He would like to see a section of the report for the World Economic Outlook devoted to examining wage developments in Europe, Japan, and the United States. There had been various discussions on the subject during Article IV consultations, and it had been said that in Europe real wages had been growing faster than productivity. He would appreciate a more critical appraisal of the topic, especially in relation to investment and capital formation.

Fifth, Mr. Habib remarked, he would urge the staff to investigate the asymmetry in the balance of payments statistics. As the staff had mentioned, in 1982 a surplus of $93 billion appeared to have been excluded from official statistics. He was not convinced by the staff argument that the asymmetry was due to errors in estimating service and transfer amounts for the industrial and oil exporting countries. The deficiency cast doubt on the Fund's work on the World Economic Outlook. Sixth, very little had been said about the exchange rate in the present study. He urged the staff to conduct a more thorough review of the relationship between exchange rates and interest rates, and changes therein.

Taking up issues relating to external adjustment and financing, Mr. Habib remarked that exports from developing countries should be revived. Unfortunately, it was beyond the power of the developing countries to bring about any such revival; the key lay with the major industrial countries. If economic activity in those countries was weak, the export earnings of the developing countries could do nothing but deteriorate. The burden of adjustment seemed therefore likely to remain acute, especially if the terms of trade worsened, as projected by the staff. In the major developing countries with a high volume of external debt, the extent of their debt servicing difficulties would depend mainly on their success in expanding exports. Although the current account deficit of the non-oil developing countries was expected to decline in 1983, the medium-term prospects for 1984-86 indicated a further widening of the current account deficit. He agreed with the staff suggestion that the Fund could play a crucial role in supporting adjustment measures in those countries. It was encouraging that the prospects for a lower level of international interest rates seemed fairly bright.

Recent developments had exerted considerable pressure on the international monetary system, Mr. Habib observed. Access to capital markets by developing countries had become more difficult, and the cost of borrowing relatively higher. In that context, it was perhaps worth noting that a great deal of LDC debt was concentrated on a few borrowers. The staff could therefore suggest that financial institutions should apply a differentiated approach in lending, based on the assumption that requests for assistance would be evaluated on a case-by-case basis. He would therefore support the recent move by financial institutions to obtain more timely and comprehensive data on debt.

Finally, Mr. Habib expressed appreciation of the role that the Fund, particularly the Managing Director, had recently played in leading the international financial community in handling the difficulties faced by a number of countries.

Mr. Polak said that he would concentrate his remarks on ID/83/1 on two specific aspects: policies in industrial countries, and adjustment and financing for developing countries. As to policies in industrial countries, like Mr. de Groote, he felt that differentiation was particularly important. The staff paper did not go far enough in making distinctions between countries, policies, and timing.

Regarding comments on Italy, Canada, and France on page 37 of ID/83/1, Mr. Polak remarked that he agreed with the staff that none of those countries had much room for maneuver, and that their first order of business must be to continue trying to bring inflation under control. As to the other four countries, he would be inclined to take a rather less black and white attitude than he found in the paper. The current situation differed from that of recent years. Throughout those years governments had said that they would like to see some expansion, but it was fair to say that until 1982 that desire had not been very strongly expressed. The situation had now changed. The staff had spoken of the pressing need for economic growth, although it had not pursued the subject further. It was probably true that at present there was no single country that did not strongly wish for expansion, particularly if it were to come about by exports. The world should be prepared at present to accept the impact that the expansion would have on the prices of primary products, which were far too low, and which should not be kept at their present level on the grounds that any rise in primary product prices would be inflationary. The anti-inflationary policies of the industrial countries had gone so far that some badly needed increases in raw material prices could be handled and should be accepted.

If the majority of countries wished for expansion, Mr. Polak went on, the question was how it could be achieved. The staff was too negative on that point, and had painted an unreasonable picture of governments losing their nerve and opting for aggressive inflation. A more useful approach was to see what room there was for individual countries that had been successful with anti-inflationary policies to use their room for maneuver to bring about the expansion that was so pressingly needed. In the United States in particular, there had after all been some change in the application of policy. The staff had nowhere indicated that it welcomed the change in the emphasis of monetary policy in the United States that had taken place in mid-1982. It was surely well established that the earlier focus on M-1 had produced some unintended overkill, a point that had been acknowledged by members of the Federal Reserve Board. The effects of the change in policy had not been to rekindle inflationary expectations. It had produced lower interest rates, a shift that had been extremely important for both the automobile and the housing industries in the United States. It had also been important for other industrial countries, where it had mitigated severe policy conflicts. And, most of all, it had been very important for making more manageable the situation of less developed countries by reducing their current account deficit by something like $15 billion through the application of lower interest rates.

Another aspect of the change in U.S. policy was its potential impact on exchange rates, of which some mention had been made in an interesting paper by the Institute for International Economics, Mr. Polak observed. He regretted that no mention of the point had been made by the staff, which had made too few references to exchange rates. Current U.S. monetary policy should be pursued with a target rate of growth for M-2 in the neighborhood of 10 per cent. Such a policy ought to have a further impact on interest rates; but he completely agreed with the staff that the future of interest rates in the United States would depend on the tightening of fiscal policy, especially in the medium run. It was becoming increasingly clear, as Mr. Erb had mentioned on previous occasions, that one of the most important factors in economic policy in the United States was not the current year's budget but the deficit for future years. He was not certain that the staff was correct in saying that the continuation of high interest rates in the United States reflected skepticism about anti-inflation policies. It seemed to him that it reflected fear of future large government deficits, which would require high interest rates because the government would be competing with private demand. Those high interest rates cast their shadow forward and produced higher interest rates than were compatible with the current relative monetary ease.

With regard to the positions of Japan, Germany, and the United Kingdom, Mr. Polak remarked that fortunately the yen was appreciating, thus reducing the external constraints on Japanese policy. He hoped that the rise in the value of the yen would permit the authorities to pursue a structural budget policy, which was very much needed, with a longer time horizon than had been possible hitherto. In Germany, the fiscal problems were mainly structural. In the circumstances, it would be unreasonable to expect the German authorities to adopt a stimulative fiscal policy. What could be hoped for in Germany was the encouragement of expansion by a relatively accommodating monetary policy. In the United Kingdom, the authorities had shown considerable flexibility in adapting their policies to circumstances, including their exchange rate policy, about which little was said in ID/83/1. He understood that there had been some modest moves toward fiscal relaxation in the United Kingdom, and it was important to see what further possibilities might exist in that field.

The description and analysis of the position of the developing countries in ID/83/1 was outstanding, Mr. Polak considered. He was interested to see that the staff was still projecting growth rates of something like 3.5-5 per cent for the various groups of developing countries in the period 1984-86. But he wondered how such figures were compatible with the not very optimistic growth rates that the staff had projected for the industrial world. He also noted that the staff expected the current account deficit for the non-oil less developed countries to return to about $100 billion by 1985-86. How could such deficits be financed, and in particular what were the implications for the resumption of bank credit to the less developed countries?

One point that was worth pursuing in that connection, Mr. Polak went on, was the question of interest payments by the less developed countries, for which figures were displayed by the staff in the table entitled "Current Account Balances of Non-Oil Developing Countries" on page 26 of ID/83/1. It was clear from that table that interest payments were a large part of the explanation for the increased current account deficit of the developing countries in recent years; the table also showed that it was not expected that there would be any improvement even by 1983. Naturally, the payment of interest by the developing countries affected income distribution in the industrial countries. The developing countries increasingly had to use the proceeds of their exports to pay interest to banks instead of placing orders with exporters in the industrial countries. The situation had been brought on in part by the return to positive real interest rates. But it might also be worth paying more attention to the large spreads over the London interbank offered rate (LIBOR) that currently applied for the substantial volume of rolled over and rescheduled loans. The commercial banks, which were not altogether blameless for the situation that had arisen in the international financial system, were receiving better incomes on their loans to less developed countries, leaving both those countries and the exporters in industrial countries to suffer. The Fund had done a great deal for the commercial banks, and it should seriously consider what could be done to ease the enlarged interest burdens. He hoped that the staff could pay attention to the matter in the near future, perhaps making some calculations as to what sums were involved.

Commenting on the form of the staff paper, Mr. Polak suggested that the staff should put aside Scenario B. It was perfectly proper for the staff to warn Executive Directors against the risks of any early relaxation of fiscal and monetary policy; and he agreed with the staff support of cautious policies and that imprudent policies could produce inflation and then recession. Nevertheless, it was not possible to organize such a concept in terms of a scenario with specific years, implying that some countries might initially follow bad policies and then change course. In brief, Scenario B should be retired.

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

DECISION TAKEN SINCE PREVIOUS BOARD MEETING

The following decision was adopted by the Executive Board without meeting in the period between EBM/83/21 (1/28/83) and EBM/83/22 (1/31/83).

2. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/83/34 (1/27/83) and EBAP/83/35 (1/27/83) is approved.

APPROVED: July 6, 1983

LEO VAN HOUTVEN
Secretary